AIRA | Association of Insolvency & Restructuring Advisors

Journal

News from the Association of Insolvency & Restructuring Advisors

Volume 26, Number 5 - 2013

Fiduciary Duties of Directors and Officers of Distressed Companies

Ben H. Logan
O'Melveny & Myers LLP

Guiding a company through financial distress can tax the time and talents of the company's directors and officers. Distress also often leads to litigation, with directors and officers increasingly the targets. This paper explores the land mines that confront directors and officers of a company facing financial distress and explores how a director or officer of such a company can best ensure that he or she properly discharges these duties and minimizes his or her exposure.

Such risks can be minimized, but not eliminated. This is true for a variety of reasons including that the law in this area is evolving and often does not provide a clear answer as to what is required. Yet, directors and officers of distressed companies have to deal with a multitude of tough decisions, often in the context of extreme time pressure—leisurely analysis often forecloses options for the company. So deferring a decision is often akin to making one.

CAVEATS

At the outset, it is important to lay out a number of caveats beyond the usual boilerplate.

The Following is a General Summary

The law of fiduciary duties of directors and officers is complex and nuanced. A multitude of cases deal with this topic and it is not possible to explore all the relevant issues in a paper of this sort. For example, Stephen A. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors* (16th ed. 2009) is an excellent four-volume treatise on this topic. Directors and officers are well advised and rely on counsel to ensure that they do not run afoul of subtleties and issues presented by particular facts.

The Law Regarding Officers Is Less Well Developed Than for Directors

Cases regarding fiduciary duties most often arise in the context of directors rather than officers. A few years ago, the Delaware Supreme Court held that an officer's fiduciary duties of care and loyalty are the same as these duties imposed on directors. *Gantler v. Stephens*, 965 A.2d 695, 708-709 n.37 (Del. 2009). Most other state laws *probably* follow suit.

But even once that premise is accepted, the consequences are not clear. For example, many courts have *assumed* that the business judgment rule applies to officers as well as directors, but without directly so holding. Radin, *supra*, at 398-401. And there is some authority supporting the view that the business judgment rule is not available to officers, at least under the laws of some states. *Gaillard v. Natomas*, 256 Cal. Rptr. 702, 710-711 (Cal. Ct. App. 1989) (under California law, an officer is not entitled to the business judgment rule); Radin, *supra*, at 2. This confusion has caused some commentators to bemoan the fact that courts almost universally assume that the same principles apply to officers and directors, but without careful analysis. Johnson & Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm. and Mary L. Rev. 1597, 1600-01 (2005) (a "curious fact remains: state fiduciary duty law makes no distinction between the fiduciary duties of these two groups. Instead, courts and commentators routinely describe the duties of directors and officers together, and in identical terms. . . . Hardly a week goes by without yet another Delaware decision addressing the subject of director duties. Yet, surprisingly, no Delaware decision has ever clearly articulated the subject of officer duties and judicial standards for reviewing their discharge.").

As a result, the legal principles for officers—for example a chief restructuring officer ("CRO")—are less well-developed than for directors.

When a person is both an officer and a director, the analysis is muddied further since parsing whether the person is acting as an officer or a director is not always clear.

The State of Formation and the Legal Form of the Company May Affect the Analysis

This paper focuses on companies organized under Delaware law. Although Delaware is the most common state of formation and

***Fiduciary Duties** continues on p. 4*

ALSO IN THIS ISSUE

CONTENTS

AIRA Journal is published six times a year by the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501.

A Letter from the President

Anthony V. Sasso, CIRA
Corporate Restructuring Group
Deloitte Financial Advisory Services LLP

Hello fellow members. We're halfway through winter and hopefully everyone has been spared at least an excessive dose of what the harsh winter weather can offer.

We Would Like to Hear From You

Every winter, the AIRA Board holds its longest meeting of the year over a two day period, spending most of that time working hard on how we will continue to meet our objectives over the next year, along with our long term strategy of where we think the organization should go. This includes assessing our history and successes along with what we should continue to do and what we can do better or should do differently to best serve our members. In that regard, we held our Winter Board Meeting this year on January 24 and 25 (as to full disclosure, the meeting was held in Florida and yes, the perk of getting away from winter for a few days did add extra motivation to attend the meeting and we had a great turnout).

As those who have been a part of the AIRA for a while can attest, the AIRA's primary focus is on providing educational offerings that are relevant to professionals serving our industry. In this regard our offerings include:

- Formalized certification programs including the CIRA and CDBV program
- Annual Bankruptcy and Restructuring Conference
- Sponsorship of the NCBJ opening reception and panel presentation at a breakfast session
- New York Advanced Plan of Reorganization Conference and other regional conferences
- Other educational sessions such as a 2 hour program recently held in Dallas focusing on the energy industry
- Publication of the AIRA Journal
- Webinars covering important current topics relevant to our membership

The Board continues to consider these activities, express thoughts and take action on how best to stay current and improve on what we currently do, and also to consider additional activities in which the AIRA might engage to best serve all of you and the ever changing nature of the insolvency and restructuring business. Ideas run the gamut, including updating and improving the content of existing programs, expanding the volume of existing activities such as regional live education sessions and webinars, what locations are best suited for live events including our annual conference and regional sessions, etc.. In making these types of decisions, we consider many things such as our membership's geographic profile, the various types of financial, accounting, advisory and legal organizations that employ our membership, changes in the law and the evolving needs of our collective client community based on the many transactions, filings and other events we see in the marketplace. We have even considered the development of additional certification programs.

Given the ever changing business environment and the vast complexities we collectively deal with every day, we are always looking for new ideas as to what we can do better. In that regard, please send us your ideas on any of these subjects. We are happy to consider what you have to say; just email your suggestions to Executive Director Grant Newton, at gnewton@aira.org.

AIRA's 29th Annual Bankruptcy and Restructuring Conference

As a reminder, our 29th Annual Conference in Chicago, to be held on June 5-8, 2013 at the Westin Chicago River North, continues to move closer. In my last letter I gave highlights of some of the educational sessions and social activities that can be part of your AIRA experience in Chicago. Details are being finalized and will be available soon at www.aira.org.

We look forward to seeing you in the Windy City,

Tony Sasso

Anthony Sasso

Executive Director's Column

Grant Newton, CIRA
AIRA Executive Director

Recently there have been several court decisions impacting bankruptcy and restructuring practice. Two cases that are of special interest to financial advisors are *In re Indianapolis Downs* (postfiling agreements among creditors), and *Stern V. Marshall* (authority of the bankruptcy court).

Indianapolis Downs

On January 31, 2013, the Bankruptcy Court for the District of Delaware approved the confirmation of the proposed plan in *In re Indianapolis Downs, LLC*[1] allowing post-petition lock-up agreements. Lock-up agreements are made among two or more prepetition creditors providing that if the plan contains certain provisions the agreeing parties will support the plan. The issue with lock-up agreements, also referred to as plan support or restructuring agreements, is that Section 1125 of the Bankruptcy Code provides that a disclosure statement must be approved and distributed before a party in interest can solicit the acceptance or rejection of a plan. "Solicitation" is not defined in the Bankruptcy Code and as a result courts have differed in the interpretation of the meaning of solicitation.

In *Indianapolis Downs* the bankruptcy court found that lock-up agreements are not likely to cause designation of the votes of the parties for or against a plan of reorganization. In this ruling the court distinguished and found not precedential certain prior Delaware cases suggesting that post-petition lock-up agreements may constitute an invalid post-petition solicitation and as a result would support disallowance of the votes of the parties that entered into such agreements.

Thus, at least in the District of Delaware, it is now clear that the circulation of a draft plan for purposes of discussion among creditors does not constitute an improper solicitation of votes.

Stern v. Marshall

As a result of the decision by the U.S. Supreme Court in *Stern v. Marshall*,[2] uncertainty exists as to whether bankruptcy courts have Constitutional authority to enter final orders on matters that do not involve the bankruptcy claims allowance process. Both the Ninth and Sixth Circuits have ruled on the issue and reached different decisions.

In *Waldman v. Stone*,[3] the plaintiff asked the bankruptcy court to first, disallow the defendant's claims against the debtor's bankruptcy estate and second, to allow affirmative damages based on the defendant's fraudulent conduct. The defendant expressly stated in his pleadings that both of the debtor's causes of action were "core" proceedings, thereby affirmatively consenting to entry by the bankruptcy judge of final orders on both the disallowance claims and the affirmative damage claims. The bankruptcy court found in favor of the plaintiff, disallowing the defendant's bankruptcy claims, awarding the plaintiff both compensatory and punitive damages, and entering a final order to that effect. The defendant appealed to the district court, which affirmed the bankruptcy court in all respects. The defendant then appealed to the Sixth Circuit. The Sixth held that the bankruptcy court had the authority to issue a final order with respect to the disallowance claims. However, relative to the damage claims, the Sixth Circuit held that the bankruptcy court could not enter a final order with respect to the claims in which the debtor sought affirmative monetary damages. The Sixth Circuit likened the Affirmative Claims to the counterclaim in *Stern*, as claims arising exclusively under state law and existing without regard to any bankruptcy proceeding.

The Ninth Circuit reached a different decision in *In re Bellingham Insurance*,[4] holding that a party may consent to a bankruptcy judge entering a final order on a matter that, absent such consent, would require final adjudication by an Article III judge. The Ninth Circuit concluded that waiver of the allocation of adjudicative authority between bankruptcy courts and Article III courts is well established. The court also reviewed the Supreme Court's decision in *Stern* and pointed out that the Stern majority's concern with respect to Article III was to "protect primarily personal, rather than structural, interests."

At its annual midyear meeting in Dallas, the American Bar Association adopted a resolution that provides support to the position that Bankruptcy Judges should be allowed to rule on matters in core proceedings even if the matters underlying the proceeding are beyond the court's constitutional authority. ■

1 Case No. 11-11046.
2 131 S. Ct. 2594 (2011).
3 698 F.3d 910 (6th Cir. 2012).
4 No. 11-35162, 2012 U.S. App. LEXIS 24873 (9th Cir. Dec. 4, 2012).

MEMBERS IN THE NEWS

Karl Knechtel, CIRA, *Selected by CBIZ for Emerging Managing Directors Academy*

The New York office of CBIZ MHM, LLC recently announced that as a result of the significant contributions he has already achieved in his career, Karl Knechtel, CIRA, CPA, CFF, was selected to participate in the CBIZ Emerging Managing Directors Academy (EMDA). He has met a variety of stringent criteria and attributes such as business development, practice management, organizational leadership, and commitment. Knechtel began his career at CBIZ MHM, LLC in 1998 as a staff accountant and was promoted to director in July of 2012. As a member of the Corporate Recovery Services group, he has specialized in bankruptcy, insolvency and forensic accounting. He now will embark upon CBIZ's intensive two-year career training program for future leadership development, working in conjunction with his office's leadership and the faculty of EMDA.

most other states follow Delaware corporate law, there are differences among states.[1]

In addition, the duties of managers of an LLC are probably very different than the duties of directors and officers of a corporation; "*probably*" because the law applicable to LLCs is not very well developed.

Partnerships are much like LLCs with regard to these sorts of duties, although a partnership structure often poses its own set of issues.

Public Companies

Public companies present special issues involving compliance with the Securities Act of 1933, the Securities and Exchange Act of 1934, the Sarbanes-Oxley Act and other statutes applicable to public companies. These public company issues are beyond the scope of this paper.

Revlon Duties and Other Special Situations

When a board decides to attempt to sell the company, certain special duties arise—so-called *Revlon* duties. M&A attorneys focus on these issues, and directors and senior officers should be sure that they receive advice from experienced counsel who practice in the M&A field when a company considers attempting to sell itself.

1 For example, the Enron Examiner concluded that Oregon law (Enron was organized in Oregon) applied a negligence standard to the duty of care, as opposed to the gross negligence standard applied in Delaware. Third Interim Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp. et al.*, Case No. 01-16034 (Bankr. S.D.N.Y June 30, 2003), at 17.
In addition, one California court concluded that the business judgment rule is *not* available to officers of corporations organized under California law. *Gaillard v. Natomas*, 256 Cal. Rptr. 702, 710-711 (Cal. Ct. App. 1989).
California law also generally follows a trust fund theory in assessing the nature of a directors' duties to a distressed company. *Berg v. Berg*, 178 Cal. App. 4th 1020, 1041 (2009). Some courts have concluded that this means that directors and officers of an insolvent California entity owe duties directly to creditors since they are the primary beneficiaries of this trust. *In re Mervyn's Holdings, LLC*, 426 B.R. 488, 501 (Bank. D. Del. 2010). If that is California law, it differs from Delaware law and the recent trend. Yet, after endorsing the trust fund theory, the court in *Berg* reached the opposite conclusion—*i.e.*, California law provides that a director owes no direct duty to a creditor, irrespective of whether the company is solvent or insolvent, which would bring California law into synch with Delaware and the recent trend in other states. However, the *Berg* court also held that because the assets of an insolvent company are held in trust for the benefit of creditors, the directors owe a duty to avoid "actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors [*sic*] claims. This would include acts that involve self-dealing or the preferential treatment of creditors." Some have suggested that this holding could impose duties on directors not to pay preferences to creditors and promptly to liquidate a company if it is deteriorating; a duty similar to the much maligned tort of deepening insolvency. If so, *Berg* would represent a significant departure from most case law and would be inconsistent with provisions of the California (and Delaware) statutes that provide that a corporation is free to prefer some creditors, even when insolvent, subject to possible recovery of the payment if the company files bankruptcy within the applicable preference period of Bankruptcy Code § 547. While followed by a number of California courts, the trust fund theory has been "largely discredited and abandoned" by most other courts, including courts in Delaware. *CMC V LLC v. Bax*, 6 A.3d 238, 253-254 (Del. Sup. Ct. 2010).

DYNEGY: A CAULDRON OF CUTTING EDGE ISSUES INVOLVING THE DUTIES OF DIRECTORS AND OFFICERS OF A DISTRESSED COMPANY

Dynegy Inc. ("DI") and its subsidiaries recently completed a complex and contentious restructuring that has plumbed many of the cutting-edge issues involving fiduciary duties of distressed companies, including the duties of directors and officers of wholly-owned subsidiaries and the implications of distinctions between a corporation and an LLC. It is a fascinating case study that would be hard to replicate in even the most creative hypothetical. Since Dynegy illustrates many of the key and most difficult issues affecting duties of directors and officers of a troubled company, it is discussed throughout this paper. A brief diversion to describe its facts is warranted here.[2] Simplified corporate organization charts showing the structure of the Dynegy family before and after the restructuring are set forth as Exhibits 1 and 2 on page 5.

The Dynegy family of companies produced and sold electric energy, capacity and ancillary services through seventeen operating power plants located in six states.

The parent entity, DI, was publically owned. The two largest blocks of DI were owned by Carl Icahn and Seneca Capital, although significant DI stock was held by others.[3]

DI was a parent holding company. Its only asset was 100% of the stock in Dynegy Holdings, Inc. ("DHI").

DHI was a second-tier holding company. It owned stock in Dynegy Power Corp., a third-tier holding company that in turn owned the stock in the operating companies.

DI had limited debt. It was a guarantor on a senior secured bank facility on which $1.3 billion was outstanding as of June 30, 2011. Otherwise, DI had no debt.

DHI was the borrower on the $1.3 billion senior secured bank facility. DI was also obligated on $3.5 billion of covenant-lite unsecured bonds.[4] DHI also had guaranteed $500 million of lease obligations owed by its subsidiaries that operated its Roseton and Danskammer plants. These lease obligations arose out of a May 2011 sale-leaseback transaction with Public Service Enterprise Group ("PSEG") in which PSEG acquired the Roseton and Danskammer plants for $940 million and then leased them back to Dynegy.[5] While DHI was the Dynegy entity obligated on the bonds and the PSEG guarantees, it did not own any hard

Fiduciary Duties *continues on p. 6*

2 The following description of the Dynegy transactions includes a number of simplifications not relevant to the key points.

3 As of April 19, 2011, (i) Icahn beneficially owned 14.8% of DI's common stock, (ii) Seneca 9.2%, (iii) Habrok 5.6%, and (iv) BlackRock 5.6%.

4 These unsecured bonds consisted of $3.37 billion of senior unsecured notes and $200 million of subordinated unsecured notes.

5 In May 2011, Dynegy sold four of the six generating units at its Roseton and Danskammer plants in an asset-backed sale-leaseback. The Dynegy subsidiaries that owned these facilities sold them to PSEG for approximately $940 million and then leased them back; DHI guaranteed the lease payments. PSEG financed its purchase price with $800 million of pass-through trust certificates secured by mortgages on the facilities and approximately $140 million of equity.

EXHIBIT 1: DYNEGY PRE-RESTRUCTURING (SIMPLIFIED)

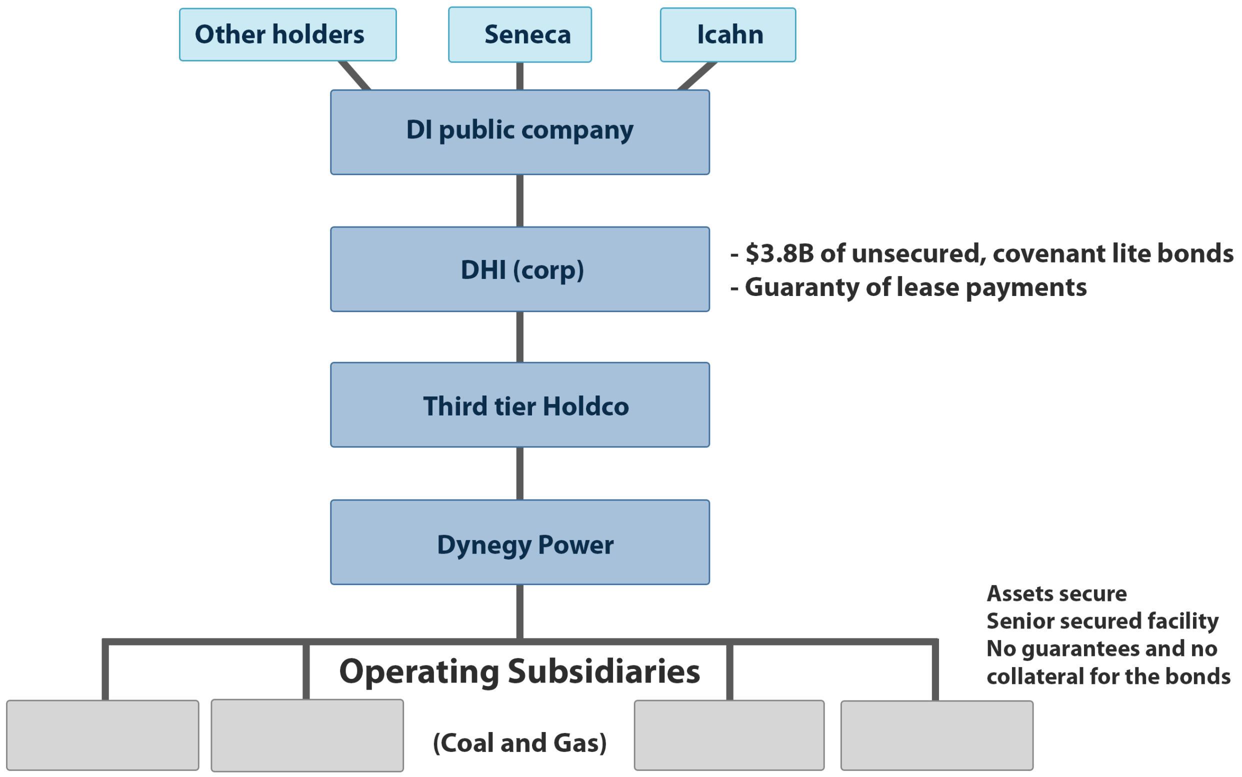
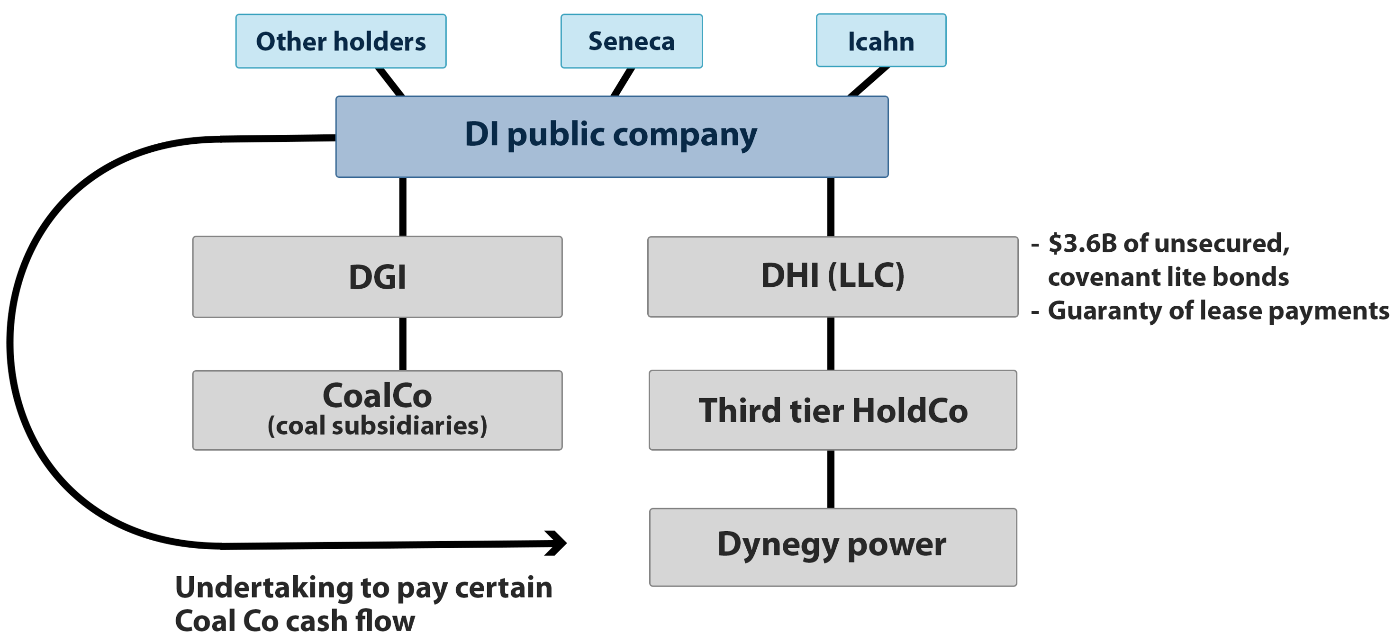


EXHIBIT 2: DYNEGY POST-RESTRUCTURING (SIMPLIFIED)



assets. The Dynegy bonds and PSEG's guarantees placed few restrictions on DHI.

DHI's subsidiaries guaranteed the $1.3 billion senior bank facility. Otherwise, DHI's subsidiaries had minimal debt. For example, these subsidiaries were not obligated on the $3.5 billion of bonds issued by DHI. Of course, the two subsidiaries that operated the Roseton and Danskammer plants were the lessees on the sale-leasebacks with PSEG. Otherwise, the operating companies had trade debt and some relatively minor project debt.

Thus, DHI, a second-tier holding company, was the only company in the Dynegy family obligated on $3.5 billion of unsecured covenant-lite bonds. DHI was also the only company in the Dynegy family obligated on the PSEG leases other than the subsidiaries that owned these plants.

From August 2010 through February 2011, first Blackstone and then Icahn tried to acquire Dynegy. In August 2020, Dynegy negotiated a cash-out merger with Blackstone. Blackstone sweetened the offer once, but even so this merger was rejected by Dynegy's shareholders. Icahn then topped Blackstone's offer. In December 2010, Dynegy entered into an agreement with Icahn and Icahn launched a tender offer. However, the tender offer failed and expired on February 18, 2011.

At this point, most of the members of DI's board resigned, as did senior management. The vacancies on the board were filled by representatives of Icahn and Seneca plus new management and one independent director. The new DI board decided to focus on an internal restructuring of the company's indebtedness. Dynegy needed to move quickly since it was likely to breach financial covenants under its senior bank facility during the next quarter. Thus, the DI board formed a special committee, consisting of representatives of Icahn and Seneca and the new CEO.

In July 2011, Dynegy announced the first step in its proposed restructuring. The company's operating subsidiaries were reorganized into two "ring-fenced" silos—a silo for Dynegy's six coal-fired plants ("CoalCo") and a separate silo for Dynegy's eight gas-powered plants ("GasCo"). These ring-fenced silos were designed to be bankruptcy remote, which helped them arrange new senior debt. Dynegy explained that this restructuring, particularly the ring-fencing, allowed Dynegy to take-out the existing $1.3 billion senior credit facility with lower cost financing and provide $400 million of additional liquidity to boot—CoalCo entered into a $600 million new senior credit facility and GasCo arranged a $1.1 billion new senior credit facility. Dynegy also separated the entities that operated the Roseton and Danskammer plants so that they were in their own silo ("Roseton & Danskammer"). Dynegy expected to shut down and sell the Roseton and Danskammer plants, so they were not part of its core going-forward business.

At the end of this first phase:

DI, the parent holding company, owned 100% of the stock in DHI.

DHI, the second-tier holding company, owned 100% of the stock in Dynegy Power Marketing ("DPM").[6]

DPM was a third-tier holding company. It owned 100% of the stock in GasCo, CoalCo, and Roseton & Danskammer.

If Dynegy had stopped there, it probably would not have provided grist for an analysis of fiduciary duties. It also may not have been able to have completed a restructuring of its $3.5 billion of unsecured notes.

In September 2011, Dynegy launched an exchange offer for these notes. Dynegy proposed to exchange these notes for (i) $400 million of cash, (ii) $1 billion of new senior secured notes issued by DI, and (iii) $2 billion of new convertible notes issued by DI. DHI's notes were extremely covenant-lite. They also were not particularly close to the hard assets. But at least they were structurally closer to the hard assets than was DI, which provided them structural seniority to DI's equity holders. That is until Dynegy implanted phase 2 of its restructuring.

To implement phase 2, DI created a new wholly owned-owned subsidiary, DGI. DI owned DGI and DHI, so DGI and DHI were sister companies. At the same time, DHI converted from a corporation to an LLC. Then on September 1, 2011, DPM transferred the stock in CoalCo and Roseton & Danskammer to DGI in exchange for DGI's "undertaking" to pay DPM certain cash generated by CoalCo. This undertaking was subject to CoalCo's $600 million credit facility allowing these payments and was subject to formulae that provided for adjustments, including a reduction in the amount that DPM was to pay DHI based on acceptances of the exchange offer. DI asserted that this "undertaking" was worth approximately $1.25 billion and equaled the fair market value of the equity in CoalCo. Others disagreed and argued that the undertaking was soft and subject to a complex set of formulae that could both reduce the amount owed and defer the timing of payments.

These transactions were orchestrated by a committee of the DI board, including representatives of Icahn, Seneca and the new CEO. However, technically it was the boards of DHI and DPM that approved them. Those boards were comprised of mid-level company officers. DHI's and DPM's boards never met in person, at least not formally, to discuss these matters. Rather, the DHI and DPM boards approved these transactions by unanimous written consent. Of course, neither DHI nor DPM had its own counsel or financial advisors.

All this was allowed by the terms of the covenant-lite bonds and PSEG's leases. But the transactions had the effect of weakening the credit-worthiness of the bonds and PSEG's guarantee from DHI. DHI was transformed from a holding company that owned the stock of the entities that owned and operated Dynegy's coal-fired plants, to being an entity that had the benefit of a soft, unsecured undertaking from a new company formed by DI.

DI's acknowledged purpose was its leverage as it negotiated the exchange offer with the bondholders. Although the exchange offer did not garner sufficient acceptances to be implemented out of court, an ad hoc committee of bondholders entered into an agreement with Dynegy to support the implementation of the exchange offer through a chapter 11 plan of reorganization, which would bind all bondholders. Thus, on November 7, 2011, DHI and certain of its subsidiaries filed chapter 11 petitions in the Southern District of New York. DI, DGI, CoalCo and

6 DPM was the successor to Dynegy Power Corp.

Roseton & Danskammer did not file bankruptcy; there was no reason for them to file bankruptcy for they were not obligated on DHI's bonds.

The plan proposed when DHI first filed bankruptcy provided for the satisfaction of DHI's $3.4 billion of senior unsecured bonds by: (1) $400 million in cash, (ii) $1 billion of senior secured notes issued by DI, and (3) $2 billion of convertible notes issued by DI. The chapter 11 plan provided that DHI's $200 million of subordinated notes would receive nothing. DI would continue to own DGI, which would own CoalCo. This preserved provided value for DI, and presumably DI's equity holders Icahn and Seneca. The plan also contemplated that Dynegy would shut down the Roseton and Danskammer plants.

These transactions attracted widespread attention in the restructuring community. Even though Dynegy's mid-2011 spin off of CoalCo did not violate the terms of the bonds, some argued that it was a fraudulent transfer. Yet, DI had a host of possible defenses: (1) Dynegy was arguably solvent at the time since DI's common stock had a market cap of around $600MM, (2) DHI was not the transferor of anything (the transfers were made by DPM, which was not obligated on the bonds), and (3) DPM arguably got fair value for these transfers via the undertaking.

Some also questioned whether the directors of DI, or more likely DHI, had breaded their fiduciary duties. These claims also faced serious obstacles: (1) the DI charter exculpated its directors from breaches of the duty of care and, moreover, DI was not obligated on the bonds or PSEG's leases, (2) DHI had converted to an LLC and the Delaware Supreme Court had recently held that creditors of an LLC do not have standing to bring a derivative action, and (3) DHI had not transferred anything—DPM, rather than DHI, transferred CoalCo and Roseton & Danskammer, and DPM was not obligated on the bonds or the leases with PSEG. Moreover, the plan was supported by a majority of the bondholders.

Not all bondholders supported the plan, however. Nor did PSEG, which was dependent on its guarantee from DHI to make up the likely shortfall that would be realized from selling the Roseton and Danskammer plants.

Faced with what appeared to be a train heading for the station, PSEG filed a motion for the appointment of an examiner who would be charged with investigating claims for fraudulent transfers and breaches of fiduciary duties. The court granted that motion and gave the examiner 60 days to analyze this situation and issue a report. That order also directed the examiner to act as a mediator in an effort to reach a consensual resolution.

On March 9, 2012, the examiner issued his report. Report of Sushell Kirpalani, Court-Appointed Examiner, *In re Dynegy Holdings, LLC*, et. al., Case No. 11-38111 (CGM) (Bankr. S.D.N.Y Mar. 9, 2012) (hereinafter, the "Dynegy Examiner's Report"). He concluded that there was a strong likelihood that the transactions could be set aside as fraudulent transfers and that valid breach of fiduciary duty claims could be asserted against the directors of both DHI and DI. In so doing, the examiner set forth an extensive analysis of the duties of directors of companies, particularly directors and managers of an insolvent subsidiary. The examiner, however, was clear that these conclusions were preliminary for, among other things, he had not had time to investigate some key issues, including solvency. Rather he described certain indicia of solvency and other indicia of insolvency and *assumed*, for purposes of the report, that the debtors were insolvent on September 1, 2011 when CoalCo was spun off from DHI.

DI filed an extensive response in which it set forth its legal and factual objections to the examiner's conclusions. Among other things, DI asserted that it was improper for the examiner to *assume* that DHI (or any of its subsidiaries) was insolvent since solvency was a "material and gating issue" to the examiner's conclusions that the transactions could be avoided as fraudulent transfers and that the directors had breached their fiduciary duties. DI recounted assorted indicia of solvency and argued that the directors had "real life and real time duties" that they could not ignore based on an *assumption* that Dynegy was insolvent.

Although the parties staked out the conflicting legal and factual disputes, they were not litigated. Instead, the major parties engaged in mediation overseen by the examiner. In order to deal with the allegations that the DHI board had not acted independently of DI and was unlikely to be able to consider DHI's interests on a stand-alone basis, DHI retained an outside independent manager and gave him full authority with respect to restructuring issues.

The mediation succeeded. The major players agreed to a settlement pursuant to which DI reconveyed CoalCo. to DHI, DI agreed to merge into DHI, and DHI's unsecured creditors received $200 million of cash and 99% of the equity in reorganized Dynegy. PSEG and DHI's subordinated notes shared in that distribution to DHI creditors; the plan set an allowed amount for PSEG's guarantee claims and provided for a distribution to the subordinated notes without requiring them to turn it over to senior noteholders. DI received 1% of the equity in reorganized Dynegy, plus 5-year warrants to acquire an additional 13.5% at a strike price set so that creditors would receive a 100% recovery if the warrants were in the money.

The bankruptcy court approved this settlement on June 1, 2012. It was structured as a settlement rather than a chapter 11 plan for a variety of reasons, but it was to be followed by a chapter 11 plan. That plan was later confirmed by the bankruptcy court.

The Dynegy examiner's report and DI's response are must reading for anyone who wants to explore the most difficult issues involving fiduciary duties of a troubled company. But do not expect definitive answers, for the end result was a settlement.

Fiduciary Duties *continues on p. 8*

Fiduciary Duties continued from p. 7

THE BASIC DUTIES OF A DIRECTOR AND OFFICER

The basic fiduciary duties of a director and officer are the duty of care and the duty of loyalty.

Duty of Care

1. The Standard

The duty of care requires directors and officers to exercise that degree of care and prudence that ordinarily careful and prudent men and women would use in similar circumstances. This is often expressed as requiring action in an *informed* and *deliberate* manner. Radin, *supra*, at 2. By referring to a "prudent man standard," the duty of care sounds much like a standard negligence test. However, Delaware law applies a *gross negligence* standard in determining whether directors and officers have met this duty of care. *Id*. at 465-534. Gross negligence is defined in Delaware law as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 192 (Del. Ch. 2005), *aff'd*, 906 A.2d 114 (Del. 2006).

Court assessments of the duty of care focus on the *process* used by directors and officers, rather than the substance of the decisions. As the Delaware Supreme Court put it: "Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only." *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (emphasis in original). This principle is also often articulated as the business judgment rule discussed below.

However, if a decision is widely off the mark, some courts will conclude that it was made in bad faith (and, therefore, violates the duty of loyalty) even if the *process* was appropriate. *Id*.

When a company is distressed, it generally will be prudent for directors to spend much more time and effort than in normal times. When the company faces a sort of crisis that is inherent in a major restructuring, events unfold quickly and opportunities can pass if not acted upon promptly. Special board committees are a common, and generally wise, approach since they allow a smaller group of directors to commit to spending the necessary time to delve into details in a manner that might be difficult for the entire board.

2. The Role of Restructuring Professionals and Independent Board Members

Directors and officers are entitled to rely on the advice of experts. Indeed, the Delaware Corporation Code provides that a member of a board will "be fully protected in relying in good faith upon . . . any . . . person as to matters the member reasonably believes are within such person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation." Del. Gen. Corp. Law § 141(e). Thus, the fact that a company received such advice can provide a substantial defense to a claim of breach of the duty of care. When a company faces the need to restructure, it is generally prudent for directors and officers to assess whether they have the skills and experience to deal with issues and an environment that is likely to be foreign to them. Thus, in addition to providing sound advice, turnaround professionals can provide a significant level of defense to existing management by virtue of the very fact that they were retained.

In sum, financial advisors, turnaround managers, independent board members with expertise in troubled company situations and attorneys who specialize in restructurings all can provide important guidance and protections to existing board members and management.

While professional help of this sort can be extremely beneficial, it is not a panacea. As noted above, the Delaware Corporation Code requires that a director rely on such advice in "good faith." Directors and officers are not entitled to rely blindly on such advice, particularly if they realize that the professionals do not have a full appreciation of the facts. *Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985).

Nor are directors or officers allowed to abdicate in favor of a restructuring professional. In *Bridgeport Holdings,* directors were held to have breached their duty of loyalty by abdicating crucial decision-making authority in the sale of the company to a well-respected turnaround professional, who had been engaged as an officer of the company, failing to monitor the officer's execution of an abbreviated and uninformed sale process, and ultimately, approving the sale of the business for consideration that the court concluded was grossly inadequate. *In re Bridgeport Holdings, Inc.*, 388 B.R. 548, 563-65 (Bankr. D. Del. 2008). The court held that the board's actions were tantamount to an intentional disregard of their duty of care, and thus constituted a breach of their duty of loyalty, notwithstanding the fact that the plaintiff did not allege self-dealing by the board or a lack of independence. *Id*.

3. Are Officers Subject to a Different Standard Than Directors?

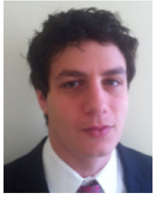
For years, there was uncertainty as to whether officers also are subject to the duties of care and loyalty. The Delaware Supreme Court resolved that fundamental question in 2009 when it held that the same fiduciary duties apply to officers and directors. "That issue—whether or not officers and fiduciary duties identical to those of directors—has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold." *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009). But holding that officers are subject to the same duties as directors is just a threshold issue. There can be significant differences between officers and directors as those principles are applied, particularly with respect to the duty of care.

For example, in *Gantler*, the Delaware Supreme Court observed that directors, but not officers, can be exculpated from the duty of care by a charter provision. *Id.* at 709 n.37. According to the court, this results from the fact that § 102(b)(7) of the Delaware Corporation Code provides that a corporation's charter can exculpate a director from the duty of care, so long as the director did not act in bad faith, but there is no mention of officers in the statute. *Id*.

Fiduciary Duties continues on p. 22


AIRA's 29th Annual
Bankruptcy & Restructuring Conference
in CHICAGO
The Westin Chicago River North—June 5-8, 2013
For sponsorship opportunities contact:
Cheryl Campbell - ccampbell@aira.org for details
More information and registration coming soon at www.AIRA.org

Technology and Telecom Turnarounds in a Private Equity Context

Matt Thompson, CIRA and Alan Steier
Skyview Capital

As the technology and telecommunications industries mature, private equity firms are increasingly attempting turnarounds of troubled businesses in this sector. These leveraged buyouts aim to restore profitability by growing revenue and streamlining operations before an exit to a strategic or financial buyer.

Private equity firms need to obtain results quickly. In order to achieve strong returns, most portfolio companies are held for only 3-5 years. Since at least a year of improved results is necessary to support a higher exit valuation, private equity turnarounds must happen quickly – sometimes in as little as 6 months. The following steps outline some key steps to turnaround a technology business. Many of the steps are similar to those involved in turnarounds across industries, but the technology and telecommunications businesses have nuances related to the rapid pace of product evolution and highly skilled work force.

1. **Perform a Realistic Business Analysis**
   - As with any distressed business, success begins with understanding the company's challenges. PJ Louis, a turnaround CEO who works with private equity firms, comments "A business analysis of the targeted company is necessary to understand how the company makes money and how the company ought to be making money in the next 6 to 8 quarters." In the technology space, innovative products can make baseline analysis difficult. For example, many software companies have mature products generating steady cash flows. New software can be budgeted to bring in significant revenue with uncertain prospects.
   - A detailed cash flow model based on realistic assumptions is crucial for mapping the turnaround. Calculating a proper benchmark for expected risk and return for technology companies can be difficult because the market and competitive landscape change rapidly. Be conservative.
   - The core economics of the business can be lost in the technical acronyms and jargon. By working with the engineering staff in cross-functional reviews, the private equity buyer can prepare a more realistic forecast.
   - Successful turnarounds focus on the most profitable customers. Marginal and unprofitable customers consume resources that can be directed towards more profitable customers. In the technology and telecom space, the most common examples of less desirable customers are customers who have long payment terms and those that have previously missed payment deadlines. In addition, some customers require excessive amounts of customer support and/or R&D. By understanding each customer's profitability, these commercial arrangements can be improved, or, if necessary, ended.
2. **Top-grade and Incentivize Management Team**
   - In a turnaround, a motivated management team is critical. In some cases, additions to the management team should be made to add new capacity or replace existing members. A cohesive management team that has a bias towards action can accomplish great things in a short timeframe. Weak performers hurt morale and impede the turnaround.
   - While incentives based on product milestones or individual performance are effective for many employees, senior management should be aligned with ownership interests. Accordingly, a compensation scheme based on top- and bottom-line business metrics is often useful. Revenue, EBITDA, and cash flow can all play a role in these plans.
3. **Develop Monitoring Systems and Processes**
   - Relevant real-time data is important in a turnaround. However, the implementation of an accurate and effective enterprise planning and reporting system can be very costly and take a long time to put into place.
   - A centralized dashboard with key figures and progress measures keeps the management team and private equity owner informed of the business status and progress. Examples of key dashboard metrics to include are working capital turns, headcount by region and function, margins by product, customer support statistics, and sales pipeline.
4. **Evaluate and Prioritize R&D and Capital Expenditures**
   - For many technology firms, R&D makes up a significant portion of the budget and plays a key role in driving future products. At the same time, technology R&D is often a binary proposition: either an organization expends significant resources towards bringing a new product to market, or not. "You need to determine what can be brought out of the 'lab' and into the marketplace quickly. As a rule of thumb, any R&D money expended must be spent on those products that can be commercialized and generating revenue in 4 to 6 quarters. The more time it takes to move from development into commercialization, the less critical the R&D effort is to the targeted company's turnaround," said PJ Louis. In the case of technology turnarounds, realistically assessing existing R&D expenditures and curtailing uncertain or non-performing projects can dramatically improve cash flow.
   - Oftentimes technology firms are driven by engineers, who are more focused on developing the latest technology rather than generating solid cash flows. By outlining all

of the possible R&D projects and focusing resources on those with the best cash flow dynamics, the business can be improved.

- Like R&D, each CAPEX project needs to be assessed on its own merits to determine which are essential, nice to have, or unnecessary.

5. **Divest Non-Core Assets to Generate Liquidity.**

   It is crucial that turnaround targets concentrate on stabilizing core business units. All business lines should be evaluated objectively and any asset that does not appear to be on a path to generating shareholder value should be shut down or sold. Oftentimes selling off a division is a faster and better alternative than shutting it down. It is important to realize that a profitable business unit can still be considered non-core to the scope of the turnaround and should be divested prior to becoming a distraction.

6. **Streamline Headcount and Back Office.**

   - Once a strategic turnaround plan is established, the management team must evaluate which staff are crucial to execute the plan. Extra headcount and back-office expenditures must be removed. Similarly, administrative functions must be scaled with likely future revenues and profitability of the business.
   - Technology turnarounds can be challenging because the engineering talent is hard to find and retain. In addition, it is oftentimes difficult to understand exactly the role that each technical professional provides. Having knowledgeable engineering managers who can accurately scope R&D staffing requirements and who can explain technical roles clearly can help determine the optimal resources to maintain and grow the business. Key comparative metrics like revenue and gross margin per headcount can help determine the required staffing levels for the business.
   - Many technology firms outsource some R&D and customer support functions. It is important to understand the fully loaded personnel requirements of FTEs, contractors, and third-party R&D or call center vendors. Labor rates in some of the third-party outsourcing countries have appreciated significantly, so it is important to evaluate the costs and benefits of performing the work in other countries.

For a private equity buyer, these steps serve as a baseline to restoring a technology business to profitability with an eye towards a future exit. ■

__Matt Thompson, CIRA,__ is VP of Portfolio Operations at Skyview Capital. __Alan Steier__ is an Associate at Skyview Capital. Skyview Capital is a Los Angeles-based technology and telecom-focused buyout firm that has completed several turnarounds of distressed companies. You can reach Matt Thompson, CIRA, at mthompson@skyviewcapital.com or Alan Steier at asteier@skyviewcapital.com

Is the Decline in Corporate Restructurings Since 2008 Due for a Reversal?[1]

Boris J. Steffen, CDBV
Gavin/Solmonese LLC

US federal bankruptcy filings decreased significantly for the third straight year in 2012. For the fiscal period ending September 30, total filings fell 14 percent to roughly 1.2 million; Chapter 11 filings decreased 12 percent to 10,597; and Chapter 7 filings fell 16 percent to 874,337. Across these cases, business bankruptcy filings fell 16 percent to 42,008.

Underlying this decline, prolonged in part by the use of amend-and-extend transactions, expected as well as realized bond yields continued to fall through the end of December. Analysts predicted the 10-year Treasury would trade below 2 percent through March 2013, consistent with the realized yield, which fell to 1.62 percent on November 9, coincident with the start of the Federal Reserve's $400bn Operation Twist program, in which short-term maturities are replaced by long-term debt. This easy-money policy is expected to continue for the foreseeable future, with the Fed forecasted to add Treasuries to its $40bn per month of mortgage bond purchases after the $667bn Operation Twist program is completed.

1 This article is an update and adaptation of an article initially published in *Financier Worldwide*.

Notwithstanding, there is compelling evidence to suggest that the decline in corporate restructuring will reverse in 2013. Though the economy has created new jobs, housing prices are recovering and consumer confidence is the highest it's been in five years, the bill passed by US policy makers to avert the 'fiscal cliff" has in substance done little to alleviate the uncertainty of businesses and consumers, and left the economy vulnerable to significant risks. With federal borrowing nearing the $16.394tn debt ceiling and public debt increasing about $100bn per month, the Treasury has had to resort to "extraordinary measures" to stay under the statutory limit, including not reinvesting federal workers' retirement contributions in short-term bonds. Further, the deal agreed to by US policy makers serves only to defer for two months the start of the $1.2tn in spending cuts mandated by sequestration over the next ten years, and is expected to result in a decrease in US gross domestic product of from 1.0 to 1.73 percent versus 2.3 percent growth otherwise. This equates to an unemployment rate of above 9 percent, with significant job losses likely across the aerospace, construction, defense, federal, healthcare and technology sectors, in addition to retail and other sectors dependent on consumer confidence and discretionary spending.

Also noteworthy, an unintended consequence of the Fed's easy-money, low interest rate policy has been an increase in the

***Decline in Corporate Restructurings** continues on p. 12*

Decline in Corporate Restructurings *continued from p. 12*

present value of pension fund liabilities, and in turn, the pension funding deficit and requirements for many companies under GAAP and ERISA accounting. Specifically, the aggregate funding deficit for companies in the S&P 500 was $355bn at the end of 2011, versus a funding surplus of $63bn at the start of 2008. In market cap terms, this represents a ratio of pension deficit to market cap of 9 percent. Similarly, the aggregate deficit in pension plans sponsored by S&P 1500 companies increased by $73bn to a record year-end high of $557bn at December 31, 2012 despite annual asset growth of roughly 16% in the US equity market.

Lastly, though the amend-and-extends implemented between 2008 and 2012 succeeded in pushing out the near-term bank debt maturities of borrowers, approximately $350bn of bank debt is scheduled to come due between 2013 and 2014. And while it may be that large corporates will be able to refinance or otherwise modify their debt maturities, smaller, more levered middle market firms, those having values of between $200m and $1bn, may not be similarly greeted by the market. Regardless, there is a limit to maturity extensions for even the largest of firms, and debtors unable to achieve their business plan due to competitive, operational or financial issues and retire debt will have no choice but to be restructured or sold. ■

***Boris J. Steffen, MM, CPA, ASA, ABV, CDBV**, is a Managing Director in the Corporate Restructuring group of Gavin / Solmonese in Washington, DC, where as an expert in accounting, corporate finance, valuation and solvency, he focuses on advising corporations, government agencies and law firms in managing mergers, corporate restructurings, related claims and litigation.*

Bankruptcy Taxes

The following articles were written by guest contributor:

D. Joshua Elliott, CIRA, CPA
Dixon Hughes Goodman LLP

IRS'S SUB POSITION TORPEDOED BY THE COURT?—EXAMINING THE QUALITY STORES DECISION

In the April-May 2010 issue (Vol. 24, No. 1) of *AIRA Journal*, Forrest Lewis reviewed a Michigan District Court decision that sided with employers in exempting certain severance payments from employee and employer FICA taxes by characterizing those payments as supplemental unemployment benefits ("SUBs") not subject to FICA. The good news continued on September 7, 2012, when the United States Court of Appeals (Sixth Circuit) confirmed the lower court decision.

In *United States v. Quality Stores, Inc., et. al.* (110 AFTR 2d 2012-5827), the Sixth Circuit found that pre- and post-petition severance payments paid to former employees as part of a reduction in force and store closings do not constitute wages for FICA purposes and are not subject to FICA taxes.

Background

Quality Stores was a large agricultural retail company with nearly 400 locations. An involuntary Chapter 11 bankruptcy petition was filed against Quality Stores in 2001. The company consented and a plan of reorganization was confirmed in May 2002.

Prior to its petition in 2001, Quality Stores closed 63 stores and 9 distribution centers and terminated 75 employees. Under its Pre-Petition Severance Plan, employees received severance payments based on job grade, management level and years of service. These payments were not tied to the receipt of state unemployment compensation and were not attributable to the provision of any particular service by the employees. The severance payments were paid over the severance period as part of the normal payroll cycle. FICA payments under the Pre-Petition Severance Plan were approximately $385,000 (both employee and employer taxes combined).

Subsequent to its petition, Quality Stores closed its remaining 311 stores and 3 distributions centers and terminated all remaining employees. Under the Post-Petition Severance Plan, employees received lump-sum severance payments using a formula based on years of service. For 900 employees hired immediately by successor companies, no severance was paid. FICA payments under the Post-Petition Severance Plan were approximately $620,000.

Under both plans, Quality Stores did not require employees to prove they were unemployed to receive their severance payments. Because the payments represented gross income for the employees, Quality Stores reported the wages on Form W-2, Box 1. The company withheld and remitted income taxes and employee FICA taxes and paid employer FICA taxes, in aggregate totaling over $1,000,000. However, Quality Stores, not believing that the severance payments represent FICA wages, filed protective refund claims for the FICA taxes paid and remitted.

The IRS rejected the refund claims and the two sides clashed in bankruptcy court. Quality Stores won in bankruptcy court and has now prevailed in both District Court and the Court of Appeals. Both parties stipulated to many of the above facts. The issue in the case is whether severance payments constitute FICA wages.

The basis for the Courts' rulings in favor of Quality Stores is its determination that the Pre- and Post-Petition Severance Plan payments do not constitute wages but instead constitute SUBs. Further, the Sixth Circuit concluded that Congress specifically intended SUBs to be exempt from FICA taxes.

When Wages Are Not Wages

Under Internal Revenue Code §3121(a), "wages" (with certain exceptions) for FICA purposes are defined as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. Section 3121(b) defines "employment" as any service, of whatever nature, performed by an employee for the person employing him. For income tax withholding purposes, "wages" are all remuneration (with certain exceptions) for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. The definition of wages for income tax withholding and FICA purposes are very similar. However, note that IRC §3402(o) separately extends income tax withholding to "certain payments other than wages," including "any supplemental unemployment compensation paid to an individual". By specifically "extending" the withholding requirement to these SUB payments, the IRC is explicitly distinguishing "wages" from "SUBs".

IRC §3402(o)(2) defines SUBs as:

(1) Amounts paid to an employee;
(2) Pursuant to a plan to which an employer is party;
(3) Because of an employee's involuntary separation from employment (whether or not temporary);
(4) Resulting directly from a reduction in force, the discontinuance of a plant or operation or similar conditions; and
(5) Included in the employee's gross income.

Both parties in *Quality Stores* stipulated to the first four items above and the fifth was assumed. The Sixth Circuit ruling gives the construction for its decision including the comment, "our objective in interpreting statutes is to give effect to the intent of Congress, and if that intent is clear, then both the courts and the government agency charged with implementing the statute, here the IRS, must give effect to that clear Congressional intent." They concluded that the necessary implication of the statutory segregation of SUBs as a payment other than wages "is that Congress did not consider SUBs to be 'wages', but allowed their treatment as wages to facilitate federal income tax withholding for taxpayers."

Is the IRS's SUB Sunk?

While Judge Jane B. Stranch, writing the Sixth Circuit's opinion, concludes that Congressional intent was very clear that SUBs are not wages subject to FICA, other courts have provided mixed interpretations. In *Rowan Cos. v. United States* (452 U.S. 247, 255 (1981)), the Supreme Court concluded that Congress coordinated the definitions of wages for both FICA and tax withholding purposes to promote simplicity. In its ruling, the Supreme Court invalidated certain treasury regulations that included meals and lodging as wages for FICA but not for withholding purposes.

The IRS countered in *Quality Stores* that Congress superseded *Rowan* with the Social Security Amendments of 1983. In the legislative history of the SSA of 1983, Congress stated that the intent of the Social Security system were significantly different than the income tax withholding system and the determination of whether or not amounts are includible in Social Security wages are to be made without regard to whether such amounts are treated as wages for income tax withholding purposes. The Sixth Circuit rejected the IRS's argument under the SSA of 1983.

Just prior to the *Quality Stores* case being heard in bankruptcy court, the Federal Court of Claims ruled for the taxpayer in *CSX Corp., Inc. v. United States* (518 F.3d 1328), a case that also centered on the definition of wages for FICA and income tax withholding purposes. Just after the bankruptcy court ruled for the taxpayer in *Quality Stores*, based in part on the *CSX* case, the United States Court of Appeals for the Federal Circuit overturned the lower court decision in *CSX*. However, in *Quality Stores*, the Sixth Circuit concluded that the Federal Circuit's decision in *CSX* was confined to interpreting that SUBs are wages for income tax withholding purposes and was silent on whether SUBs are wages for FICA.

Bankruptcy Taxes *continues on p. 14*

Bankruptcy Taxes *continued from p. 13*

The *Quality Stores* opinion references numerous other cases and revenue rulings from which we will mercifully spare the *Journal's* readers. Suffice it to say that the legislative and judicial history on this issue is complex and the case is ripe for the Supreme Court attention.

How Does This Affect Employers Paying SUBs?

Employers that have paid or are paying former employees amounts that qualify as SUBs under the five-part test may want to consider filing protective refund claims. Keep in mind that employer SUB payments may be paid troubled debtors continuing as a going concern or by residual entities such as liquidating trusts set up to pay out former debtor claims. Generally, a taxpayer's statute of limitations expires after three years. By filing amended returns and requesting a protective refund claim, a taxpayer may either receive the refund (if the IRS gives up on its quest to overturn *Quality Stores*) or may extend its statute of limitations until after the FICA issue is finally settled in the courts.

SURVIVAL OF THE FITTEST: WHICH ACCOUNTING METHODS PREVAIL AFTER A TAX-FREE ASSET ACQUISITION?

Rev. Proc. 2012-39, issued on October 9, 2012 provides guidance on several accounting method change issues, primarily related to tax-free reorganizations and liquidations. This provides a good opportunity to review the rules related to what accounting methods survive in certain tax-free reorganizations and liquidations.

Internal Revenue Code §381 sets forth the tax attributes, including accounting and inventory methods, that carry over to a surviving corporation in the acquisition of assets by a corporation in a tax-free subsidiary liquidation (IRC §332) or in certain tax-free reorganizations (generally, a Type A, C or F or a liquidating Type D or G). Subparagraphs (c)(4) and (c)(5) provide the basic rule – if the various parties to the tax-free asset acquisition used the same accounting and inventory methods before the transaction, then that those methods carry over after the transaction. However, if there are accounting or inventory method differences between the various parties – either between the acquirer and transferor or between multiple separate transferors, then the Treasury Regulations provide guidance.

Final treasury regulations (TR §1.381(c)(4)-1 for accounting methods and TR §1.381(c)(5)-1 for inventory methods) related to the carryover of accounting methods under IRC §381 were released in July 2011, effective for transactions occurring after August 31, 2011. The final regs determine the required carryover method, in part, by whether the acquired businesses will be operated as separate and distinct trades or businesses or whether they will be integrated into the acquirer's trade or business. Generally, business are not considered separate and distinct trades or business unless a complete and separate set of books and records are maintained for each business. Separate legal entities may not be required.

When the acquirer will operate the acquired trades or businesses as separate and distinct trades or businesses after the transaction, then all parties will carry over their historical accounting and inventory methods unless either the methods were impermissible (requiring a change) or the acquirer desires to change the method. No method change filing (Form 3115) is required if the acquirer continues the carried over method.

However, if the acquired assets are operated as integrated trades or business after the transaction, then the parties must use the "principal" method of accounting after the transaction (unless such method is impermissible or the parties wish to change). The principal method of accounting is presumed to be that of the acquirer unless the acquired entity had higher adjusted asset basis and gross receipts (for general accounting methods) or higher inventory FMV (for inventory methods). For the former trade or business that has to change to the larger trade or business's principal accounting method, no method change filing is required. Additionally, no back-year IRS audit protection is granted (as would be with a formal accounting method change filed on Form 3115).

If the carryover method otherwise required under the regs is an impermissible method, then the acquiring corporation must file a method change requesting a change to a permissible method. Additionally, even with permissible methods, the acquirer may file a method change for the year of the transaction.

Example: Corporation P is in the service business. Its corporate subsidiaries, S1 and S2, are in the service and manufacturing businesses, respectively. S1 is roughly twice the size of P (revenue and net asset basis). S1 and S2 are liquidated tax-free under IRC §332. After the liquidation, S1 and P's service businesses will be integrated. S2 will be maintained as a separate business. In the service business (former P and S1), S1's accounting methods will be the principal methods (unless it was an impermissible method). P will have to change its method of accounting to match S1's former method of accounting. No Form 3115 will be required and no back-year audit protection will be provided to P. S2 can continue its own method of accounting. P, as the acquirer, could file for a different method of accounting during the year of liquidation if it so desires.

Now, back to Rev. Proc. 2012-39... This revenue procedure provides minor updates to prior Rev. Proc. 97-27 (governing automatic method changes) and Rev. Proc. 2011-14 (governing non-automatic method changes) :

Previously, Rev. Proc. 2011-14 provided a two-year safe-harbor period (the first two years ending after December 31, 2010) for electric transmission and distribution companies changing to the method of accounting provided in Rev. Proc. 2011-43 (related to the deduction as a repair expense or capitalization as an improvement, of costs incurred to place in service electrical transmission and distribution property). Rev. Proc. 2012-39 extends the safe-harbor period to three years.

Under Internal Revenue Code §179D, a tax deduction is allowed for certain energy efficient building placed in service during the year. When the building owner is a government entity, the deduction (which is unusable by the government entity) can be allocated to the designer of the energy efficiency property. Rev. Proc. 2012-39 clarifies how designers may claim the allocated deduction and reinforces that doing so does not constitute an accounting method change.

With regards to tax-free asset acquisitions as discussed above, Rev. Proc. 2012-39 updates both of the accounting method Revenue Procedures to allow method changes during the transaction year, consistent with the guidance of the final IRC §381 regulations. Previously, the two Revenue Procedures had disallowed the filing of any method changes during the transaction year for transactions subject to IRC §381. ■

D. Joshua Elliott, CIRA, CPA, *is a tax partner in the Greenville, SC office of Dixon Hughes Goodman LLP.*

Bankruptcy Taxes (Cont.)

Forrest Lewis, CPA
Section Editor

WORTHLESS SUBSIDIARY STOCK LOSSES IN CONSOLIDATED GROUPS: TREAD WARILY

A recent IRS pronouncement illustrates the difficulties for a corporate group filing a consolidated return to obtain a tax benefit from deducting a loss for the stock of a worthless subsidiary. Generally under the Internal Revenue Code a loss on corporate stock is a capital loss and capital losses are mainly only useful in reducing capital gains. However, IRC Section 165(g)(3) allows an ordinary loss deduction which may be used against any type of income for the write-off of basis in the stock of a worthless subsidiary which meets certain requirements as to ownership and active business history. A loss on a subsidiary in which the parent owns less than 80% of the stock will generally be stuck with a capital loss. A worthless stock loss deduction for an unconsolidated controlled subsidiary which meets the 80% ownership test [among others] can qualify for ordinary loss treatment. But in groups filing a consolidated return, many hurdles must be cleared to gain a true tax advantage for a loss deduction on a worthless subsidiary. [Chief Counsel Advice Memorandum 2012-003]

The general requirements for a deduction of the tax basis in the stock of a worthless unconsolidated subsidiary under IRC 165(g) are:

- **Worthlessness**—the taxpayer must be able to establish that the stock has no continuing value, usually a balance sheet insolvency test will suffice, i.e. the liabilities exceed the fair market value of assets.
- **Ownership**—the parent must own at least 80% of the sub's voting stock
- **Active business**—more than 90% of the sub's gross receipts must from come from operating a business, i.e. not rents, dividends, interest, etc.

But the consolidated return regulations provide many additional requirements which apply to subsidiaries in consolidated return groups and some adverse tax consequences triggered by the deduction:

1. **Worthlessness test**—As pointed out in the IRS pronouncement mentioned above, Chief Counsel Advice Memorandum AM20012-003, the consolidated return regulation requires that all assets must be abandoned or disposed of, not simply that the balance sheet is under water [1.1502-19(c)(1)(iii)(A)]. In the ruling the subsidiary was entitled to income tax refunds from the carryback of its losses and held certain legal claims against its directors and officers. Even though the liabilities of the subsidiary apparently exceeded the value of those claims, the IRS ruled the subsidiary had not disposed of all assets as required by the regulation. (In 2008 this rule was tightened from disposition of "substantially all assets" to "disposition of all assets" as part of the adoption of the Unified Loss Rules discussed below.) Another possible IRS attack is to treat purported intercompany debt as equity because of failure to observe all the formalities of debt—written notes, market interest, repayment when due, etc. If the purported debt is reclassified as equity, it will be harder to meet the absolute worthlessness test above.
2. **Timing**—The aforementioned regulation postpones any deduction for worthless subsidiary stock until the disposition of all assets or certain discharge of third party indebtedness events takes place. [Reg. 1.1502-80(c)] The IRS said that the underlying reason behind the stringent disposition requirement was to allow all related intragroup adjustments to take place in keeping with the "single company treatment" principle of the consolidated return regulations. The ruling referred specifically to investment adjustments to the subsidiary stock in the hands of the parent resulting from income or loss and intercompany transfers such as the subsidiary's share of the consolidated income tax refund. Presumably that would also include any remaining deferred gains and losses from intercompany transactions which should be triggered by a worthless stock deduction under the "acceleration principle", i.e. the subsidiary will no longer be able to match any corresponding items.
3. **No advantage for losses on intercompany debt**—In many cases the Parent or other group members will have lent money to the troubled subsidiary. In a consolidated group, the recognition of the worthlessness of the intercompany loan will lead to no net tax advantage. The seller or lender does get a bad debt deduction but the borrower must recognize cancellation of debt income. Under the consolidated return regulations, the usual Section 108 relief provisions of bankruptcy, insolvency, etc. are turned off. If one member gets a bad debt deduction for an intercompany loan, another member must have COD income.
4. **Acceleration of excess loss accounts**—Many times troubled subsidiaries have built up a sort of negative basis in their stock in the hands of the parent known as an Excess Loss Account. Having an ELA causes no harm until the subsidiary leaves the group or is the subject of a worthless stock deduction by its parent. The ELA is then triggered and must be taken into income. [Reg. 1.1502-13(g)(4)(i)(C)]
5. **Unified Loss Rules**—A relatively recent addition to the IRS consolidated return arsenal is the ULR of Reg. 1.1502-36. While these rules are mainly aimed at subsidiaries leaving the group which have uneconomic losses or losses that can potentially be duplicated, e.g. seller realizes a stock loss stemming from a decline in inside asset value which the subsidiary then carries with it, they also can apply to worthless stock deductions.

What To Do When Confronted With a Worthless Consolidated Subsidiary?

The first task is to work through the maze of traps discussed above [plus any others] and project the net effect on the group to see if there will be any net tax advantage to the deduction. If there is, obviously you take it. On the other hand, if there is an offsetting Excess Loss Account, some practitioners have tried causing the parent of the sub to contribute enough capital to restore the tax basis to zero or a positive amount and then liquidate the sub taxfree under Section 332. While that does not give the group a deduction, it would eliminate the potential taxable event of the ELA. This strategy is risky in that the IRS has said they will ignore any "merely transitory" capital contributions preceding a 332 liquidation and tax the ELA [Rev. Rul. 68-602]. Thus, if

***Bankruptcy Taxes** continues on p. 16*

Bankruptcy Taxes *continued from p. 15*

the capital contribution is old and cold it may not be connected to any subsequent 332 liquidation. Alternatively, if there is a good business purpose for the contribution, e.g. to pay off third party creditors to maintain good supplier relations or uphold the reputation of the group, that may justify the capital injection and near term liquidation of the sub. If there is any doubt as to the worthlessness of the subsidiary, perhaps it is best from a tax point of view to merely let it languish. [Clearly, business circumstances such as a threatened involuntary bankruptcy petition or other creditor action may demand movement.] Even sitting still can be risky as IRS has said where there is an ELA and a clearly worthless subsidiary, it is supposed to be recognized as worthless, i.e. a worthless stock deduction and taxation of the ELA. There is no magic bullet when dealing with these consolidated loss sub situations.

Thanks to Grant Newton, Dennis Bean and Joshua Elliott for their assistance with this article.

IRS PROPOSES TO APPLY 3.8% MEDICARE TAX TO BANKRUPTCY ESTATES OF INDIVIDUALS

A new 3.8% medicare tax on investment income was added under the Obamacare legislation (Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152, 124 Stat. 1029) adding section 1411 to the Internal Revenue Code. The law which is effective for taxable years beginning after December 31, 2012 imposes a 3.8 percent tax on certain individuals, estates, and trusts. Recently released Internal Revenue Service Proposed Regulation 1.1411-3(d)(1) provides that "a bankruptcy estate of a debtor who is an individual is treated as an individual for purposes of computing the tax under section 1411. IRC Section 1398 provides rules for the taxation of bankruptcy estates in chapter 7 and chapter 11 cases under the Bankruptcy Code in which the debtor is an individual. In these cases, the bankruptcy estate computes its tax in the same manner as an individual. The income tax rate for the bankruptcy estate is the same as that imposed on a married taxpayer filing separately, and section 1398(c)(3) provides that the bankruptcy estate is entitled to a standard deduction of a married taxpayer filing separately. Therefore, consistent with section 1398, regardless of the actual marital status of the debtor, a bankruptcy estate of a debtor who is an individual is treated as a married taxpayer filing separately for purposes of the thresholds in section 1411(b), and therefore the threshold amount applicable to such a bankruptcy estate is $125,000."

In the case of an estate, the law imposes an additional tax for each taxable year equal to 3.8 percent of the lesser of (A) the estate's undistributed net investment income, or (B) the excess (if any) of (i) the estate's adjusted gross income for such taxable year, over (ii) the $125,000 figure mentioned above.

Net investment income means the excess of (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, (ii) other gross income derived from a trade or business to which the tax applies (generally passive income), and (iii) net taxable gain from nonbusiness property; over (B) related deductions.

In computing the undistributed income of an estate, a deduction is allowed for "distributions" to individual beneficiaries of the estate. How this applies in the bankruptcy estate context is not spelled out, especially in view of the BAPCPA provision treating all wages earned by the debtor as property of the estate and payment of a living "allowance" to the individual from his wages by the estate. Those payments are already taxable to the individual as wages, thus it does not seem likely they would also carry out distributions of net income of the estate.

Commentary

While many individual bankruptcy estates do not have substantial interest and dividend income, it is possible some may have substantial rental income, particularly after discharge or compromise of debt, or substantial taxable gains on sales of property. The IRS should be commended for some creative regulating in allowing a $125,000 threshold amount to bankruptcy estates. The comparable amount for a decedent's estate is $7,500. It remains to be seen if applying the 3.8% tax to bankruptcy estates will raise much tax revenue, especially in view of the inconvenience it will cause to those having to compute whether it applies or not in every bankruptcy estate. The IRS will be receiving comments on the proposed regulations and perhaps AIRA may want to study and comment on this specific provision.

FISCAL CLIFF TAX LEGISLATION EXTENDS RESIDENCE COD FORGIVENESS

The recently enacted tax law extending most of the Bush era tax cuts, the American Taxpayer Relief Act of 2012, extended the exclusion for discharge of indebtedness on "qualified personal residences" through 2013. As part of Congress's response to the early stages of the subprime mortgage crisis, the Mortgage Forgiveness Debt Relief Act of 2007, created a new exception to the recognition of cancellation of debt income, Internal Revenue Code Sec. 108(a)(1)(E), which excluded from gross income any income from the discharge (in whole or in part) of "qualified principal residence indebtedness". Qualified principal residence indebtedness is acquisition indebtedness, as defined in the home mortgage interest deduction provisions of IRC Sec. 163(h), but with a $2 million dollar limit ($1 million for a married taxpayer filing a separate return). An individual's acquisition indebtedness is indebtedness with respect to that individual's principal residence if it is incurred in the acquisition, construction, or substantial improvement of such residence and is secured by the residence. Qualified principal residence interest also includes refinancing of such indebtedness to the extent that the amount of the refinancing does not exceed the amount of the refinanced indebtedness. "Principal residence" has the same meaning for purposes of the exclusion as it does for purposes of IRC Sec. 121 on sale of a home. In a deviation from the normal attribute reduction rules, the amount of COD income excluded on the residence debt is applied to reduce the basis of the home (IRC Sec. 108(h)(1)). The exclusion had expired as of December 31, 2012 but now has been extended through December 31, 2013. ■

Forrest Lewis, CPA, *Section Editor, is a tax practitioner based in East Lansing, Michigan.*

Bankruptcy Cases

Professor Baxter Dunaway

EXAMPLE OF UNSUCCESSFUL ATTEMPT TO CRAMDOWN SECURED CREDITOR—RIVER EAST PLAZA

The requirements for the confirmation of a typical chapter 11 real estate reorganization plan are very well illustrated by *In re River East Plaza, LLC*, 669 F.3d 826 (7th Cir.(Ill.) Jan 19, 2012). The opinion is set forth below. This opinion is selected because 1) it was written by well-respected Seventh Circuit Court of Appeals Circuit Judge Posner, 2) the facts are typical for the numerous single asset real estate cases in which there is an attempt to cramdown a secured party, 3) Judge Posner cites the relevant statutes, precedents and motivations for the steps taken by the parties in this type of case, 4) the facts of the case are not difficult to understand, and 4) the case has been widely discussed.

For the benefit of the reader, and for elaboration and convenience, titles and some comments have been added to the written opinion, with the added text and comments shown in brackets. The opinion is followed by a "Selected References" section which cites meaningful articles commenting on the *River East* case.

In this case, a Panel of the Court of Appeals for the Seventh Circuit affirmed dismissal of the *In River East Plaza* ("River East") single asset real estate case in which the debtor was unable to file a confirmable plan.[1] The Panel agreed with the bankruptcy judge's decision to dismiss the case after the debtor filed two plans that were legally deficient. Although the debtor filed a third plan that might have been confirmable, the bankruptcy judge dismissed the case anyway. Affirming the dismissal, the Panel Opinion (669 F.3d 826, 833-4) held that:

> [t]he third proposal left the Chapter 11 proceeding still far from completion, because there was bound to be wrangle over the current value of the building and the proper interest rate. With [the debtor] having compromised its credibility by submitting two plans that sought to circumvent the statute, the 90–day deadline [for filing a confirmable plan] having expired long ago (the Chapter 11 plan was filed on February 10, 2011, and the third proposed plan on August 23—194 days later), the [secured creditor] having waited years to enforce its lien, the bankruptcy judge was not required to stretch out the Chapter 11 proceeding any longer.[2]

> *Holdings*: The Court of Appeals, Posner, Circuit Judge, held that: (1) substitute collateral of $13.5 million in 30–year Treasury bonds was not indubitable equivalent of creditor's mortgage lien on real estate valued by debtor at $13.5 million and (2) bankruptcy judge did not abuse his discretion by refusing to consider third proposed reorganization plan. *Affirmed.*

> Before POSNER, FLAUM, and SYKES, Circuit Judges. POSNER, Circuit Judge.

1 *In re River East Plaza, LLC.*, No. 11– 3263, 2012 U.S.App. LEXIS 1048, 2012 WL 169760 (7th Cir. 2012).

2 *In re Olde Prairie Block Owner, LLC*, 467 B.R. 165, Bkrtcy.N.D.Ill.,2012.

[Direct appeal to Court of Appeals under Section 158(d)(2)(A) of the Judicial Code]

United States Court of Appeals, Seventh Circuit

In re River East Plaza, LLC, Debtor, In re River East Plaza, LLC, 669 F.3d 826, 55 Bankr.Ct.Dec. 265, Bankr. L. Rep. P 82,153 (7th Cir.(Ill.) Jan 19, 2012) (NO. 11-3263)

Appeal of River East Plaza, LLC and Geneva Leasing Associates, Inc., et al.

LNV Corporation, Appellee.

No. 11–3263.Argued Dec. 6, 2011, Decided Jan. 19, 2012.

This is an appeal directly to us, skipping the district court, from the dismissal of what is called a "single asset real estate" bankruptcy proceeding. The debtor, River East Plaza, LLC, is the principal appellant.*828 The appellee, LNV Corporation, is River East's principal creditor and had successfully urged the dismissal of the proceeding.Section 158(d)(2)(A) of the Judicial Code authorizes a court of appeals to permit the district court to be bypassed if, so far as relates to this case, the order appealed from involves a question of law that has not been definitively resolved, or involves a matter of public importance, or if an immediate appeal "may materially advance the progress of the case." The first and last of these considerations point to our allowing this appeal—the last because, as we'll see, the Bankruptcy Code directs speedy resolution of single asset real estate bankruptcies for reasons well illustrated by this case. 11 U.S.C. § 362(d)(3); see River Road Hotel Partners, LLC v. Amalgamated Bank, 651 F.3d 642, 645 (7th Cir.2011), cert. granted under the name RadLAX Gateway Hotel, LLC v. Amalgamated Bank, ––– U.S. ––––, 132 S.Ct. 845, 181 L.Ed.2d 547 (2011).

[Single Asset real estate under 11 U.S.C. § 101(51B).]

[1] A single real estate asset, within the meaning of the Bankruptcy Code, is a nonresidential property, or a residential property containing five or more apartments or other residential units, "on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto." 11 U.S.C. § 101(51B). The single asset in this case is a building in downtown Chicago called River East Plaza that houses offices and a restaurant. LNV Corporation, a banking firm, has a first mortgage on the building.

[Facts of case]

The building's owner and mortgagor, River East Plaza, LLC, defaulted on the mortgage in February 2009, and LNV promptly started foreclosure proceedings in state court, prevailed, and a foreclosure sale of the property was scheduled. That was almost three years ago, and the sale has yet to take place. For in February 2011, just hours before it was to occur, River East filed

Bankruptcy Cases *continues on p. 18*

Bankruptcy Cases *continued from p. 17*

for bankruptcy under Chapter 11 (reorganization, as distinct from liquidation), and the filing automatically stayed the sale. 11 U.S.C. § 362(a)(4).

[Creditor subjected itself to authority of bankruptcy judge to approve Chapter 11 plan of reorganization that might affect its mortgage lien]

[2] As a secured creditor, LNV could have bypassed the bankruptcy proceeding and continued its efforts to enforce its secured claim in state court. *In re Penrod*, 50 F.3d 459, 461–63 (7th Cir.1995). But stymied by the automatic stay, it decided to become a party to the bankruptcy proceeding so that it could ask the bankruptcy judge, as it did, to lift the automatic stay. But by becoming a party it subjected itself to the authority of the bankruptcy judge to approve a plan of reorganization that might affect its lien. Id. at 462; *In re Airadigm Communications, Inc.*, 519 F.3d 640, 647–48 (7th Cir.2008). Normally a mortgage lien remains a lien on the mortgaged property until the mortgage is paid off, even if the property is sold, because a lien runs with the property. But if the bankruptcy judge confirms a plan of reorganization that removes the lien of a participating creditor, the lien is gone. Id. at 648.

[The creditor can try to protect himself from losing his lien by objecting to the plan unless it can be crammed down under one of the three subsections of 11 U.S.C. § 1129(b)(2)(A).]

[Creditor's right to credit bid]

[Indubitable equivalence]

The creditor can try to protect himself against such a fate by objecting to the plan, and his objection will block it, see 11 U.S.C. § 1129(a)(8)(A), unless it can be crammed down his throat under one of the three subsections of 11 U.S.C. § 1129(b)(2)(A). Under (i), the reorganized debtor keeps the property and may be allowed to stretch out the repayment of the debt beyond the period allowed by the loan agreement, but the lien remains on the property until the debt is repaid. Under (ii), the debtor auctions the property free and clear of the mortgage but the creditor is allowed to "credit bid," meaning to offer at the auction, not cash, but instead a part or the whole of his claim, *829 *FDIC v. Meyer,* 781 F.2d 1260, 1264–65 (7th Cir.1986), so that, for example, LNV could bid $20 million for River East's building just by reducing its claim from $38.3 million to $18.3 million. Under (iii), the lien is exchanged for an "indubitable equivalent." *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 304–05 (3d Cir.2010); *In re Sun Country Development, Inc*., 764 F.2d 406, 409 (5th Cir.1985); *In re Murel Holding Corp*., 75 F.2d 941, 942 (2d Cir.1935) (L. Hand, J.). The last subsection is the one River East invoked in its proposed plan of reorganization—unsuccessfully. The bankruptcy judge rejected the plan, lifted the automatic stay, and dismissed the bankruptcy proceeding.A question before the Supreme Court in the *River Road* case (the case, cited earlier, now called *RadLAX Gateway Hotel*), but unnecessary to try to answer in this case, is whether the third form of cramdown, the "indubitable equivalent" cramdown, can be used to eliminate a creditor protection imposed under the second subsection, which allows encumbered property to be auctioned free and clear of an existing lien only if the lien creditor is allowed to credit bid at the auction. In River Road we rejected rulings by the Third and Fifth Circuits that a plan allowing sale of property free and clear of a secured creditor's lien without letting the creditor credit bid can still be crammed down, under the third rather than the second subsection, so long as the plan provides some means of assuring that the creditor receive the indubitable equivalent of its claim. See *In re Philadelphia Newspapers, LLC*, supra, 599 F.3d at 311–13; *In re Pacific Lumber Co.,* 584 F.3d 229, 246–47 (5th Cir.2009). We said that to allow the debtor in such a case to elude credit bids by convincing the bankruptcy court that it has given the creditor an indubitable equivalent in the form of substitute collateral would circumvent the procedure established by subsection (ii), and by so doing deprive the creditor of the opportunity conferred by that subsection to benefit from an increase in the value of the property if, the credit bid having been the high bid, the creditor becomes the owner of the encumbered property. While the debtor in *River Road* sought to avoid the creditor's right to credit bid under subsection (ii) by invoking indubitable equivalence, River East seeks to avoid the requirement in a subsection (i) cramdown of maintaining the mortgage lien on the debtor's property by transferring LNV's lien to different collateral, also in the name of indubitable equivalence. The logic of River Road forbids such an end run, but even if the Supreme Court reverses *River Road*, [But see, Supreme Court holds that a Chapter 11 plan proposing to sell a creditor's collateral free and clear of liens must also provide the creditor a right to credit bid. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 80 USLW 4399, 12 Cal. Daily Op. Serv. 5784, 2012 Daily Journal D.A.R. 6974, 23 Fla. L. Weekly Fed. S 328 (U.S. May 29, 2012) (NO. 11-166).] River East's plan could not be confirmed because the substitute collateral that it proposed was not the indubitable equivalent of LNV's mortgage. (Later we'll explain when substitute collateral can be indubitably equivalent to the original collateral.)

[11 U.S.C. § 1111(b)(2) election]

LNV is owed $38.3 million but River East's building is currently valued at only $13.5 million (this is River East's valuation, and may as we'll see be too low). So LNV's secured claim is undersecured, and an undersecured creditor who decides, as LNV has decided, to participate in his debtor's bankruptcy proceeding has a secured claim for the value of the collateral at the time of bankruptcy and an unsecured claim for the balance. 11 U.S.C. § 1111(b)(1)(A). But generally he can exchange his two claims for a single secured claim equal to the face amount of the unpaid balance of the mortgage. § 1111(b)(1)(B), (2). LNV made this choice, so instead of having a secured claim for $13.5 million and an unsecured claim for $24.8 million it has a secured claim for $38.3 million and no unsecured claim.*830 The swap is attractive to a mortgagee who believes both that the property that secures his mortgage is undervalued and that the reorganized firm is likely to default again—which often happens: between a quarter and a third of all debtors who emerge from Chapter 11 with an approved plan of reorganization later re-enter Chapter 11 or have to restructure their debt (that is, default—"restructure" is just a euphemism for default) by some other method. See, e.g., Lynn M. LoPucki, Courting Failure 97–122 (2005); Harvey R. Miller & Shai Y. Waisman, "Does Chapter

11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty–First Century?" 78 Am. Bankr.L.J. 153, 188–89 (2004); Stuart C. Gilson, "Transaction Costs and Capital Structure Choice: Evidence from Financially Distressed Firms," 52 J. Finance 161, 162 (1997); Edith Shwalb Hotchkiss, "Postbankruptcy Performance and Management Turnover," 50 J. Finance 3 (1995); Lynn M. LoPucki & William C. Whitford, "Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies," 78 Cornell L.Rev. 597, 608 (1993); but cf. Robert K. Rasmussen, "Empirically Bankrupt," 2007 Colum. Business L.Rev. 179, 223–27 (2007). The swap enables the creditor, in the event of a further default after the value of the property has risen, to apply a higher value of the collateral to the satisfaction of the debt than if he had accepted a secured claim equal to the lower value of the collateral at the time of bankruptcy. Had LNV chosen not to give up its unsecured claim in exchange for a larger secured claim, it would receive some fraction of its unsecured claim in the Chapter 11 proceeding, and would continue after the bankruptcy to have a $13.5 million claim secured by the building. The building would continue to be owned by the debtor if the latter had emerged from bankruptcy, having been permitted to reorganize. If the debtor later defaulted and the building was sold, LNV would realize a maximum of $13.5 million (the amount of its secured claim) from the sale, even if the building was sold for more. In contrast, given the swap, if the value of the building rose say to $20 million by the time the former debtor again defaulted, LNV, if allowed to foreclose, would realize all $20 million because his secured claim would exceed that amount. In June 2011, when LNV made its choice, the U.S. real estate market, commercial as well as residential, was severely depressed (as it still is), but LNV expected real estate prices to rise, which may be why it made that choice.

> [See also, Terri L. Gardner, Creative Battles in Single Asset Real Estate Cases: Use of Rents, Cramdown Strategies, and Lenders Buying Equity to Avoid Cramdown! 072512 ABI-CLE 111, July 25-28, 2012.("(5) The court concluded that, by proposing to substitute collateral with a different risk profile and stretching out loan payments, debtor was essentially proposing a defective subsection § 1129(b)(2)(A)(i) cramdown by way of subsection (iii).")(page not cited).]

River East, joined by several creditors listed as appellants on River East's briefs but about which the briefs say very little and we shall say nothing, was unhappy with LNV's choice. Probably like LNV it expected the value of the building to appreciate and didn't want to share that appreciation with its creditor. Or maybe, as it argues, prospective financiers of the reorganized firm wanted to have a senior lien on the building. Whatever the precise motive, River East wanted LNV out of there and decided to seek confirmation of a plan of reorganization that would replace the lien on the building with a lien on $13.5 million in substitute collateral, namely 30–year Treasury bonds that would be bought by an investor in the reorganized firm. At current interest rates, River East argued, the bonds would grow in value in 30 years through the magic of compound interest to $38.3 million, thus guaranteeing that LNV would be repaid in full. The substitute collateral would be equivalent to LNV's lien.

> [See also, Bankruptcy Desk Guide § 28:23, Best interest of creditors test-Election of treatment under 11 U.S.C.A. § 1111(b) (2012)
>
> Bankruptcy Law Fundamentals s 12:23, Section 1111(b) election (2012)
>
> 2012 Bankruptcy Service Current Awareness Alert 6, Circuit holds that, where a creditor has made a S 1111(b) election, debtor does not provide indubitable equivalence under S 1129(b)(2)(A)(iii) by substituting a lien on 30-year Treasury bonds for the creditor's (2012)]

The bankruptcy judge rejected the plan (River East's second plan—River East is not complaining about the rejection of the first, a rejection based on the plan's failure to comply with the cramdown statute once LNV chose to waive its unsecured claim in *831 exchange for retaining a larger secured claim). Section 362(d)(3)(A) of the Code requires the bankruptcy judge in a single asset real estate bankruptcy, upon the request of a party to "grant relief from the [automatic] stay ..., such as by terminating, annulling, modifying, or conditioning such stay," unless within 90 days of the filing of the Chapter 11 petition "the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time." See *In re Williams*, 144 F.3d 544, 546 (7th Cir.1998). When River East's second plan was rejected, the 90–day deadline had expired, and the bankruptcy judge at LNV's request vacated the automatic stay, thus allowing the long-delayed foreclosure sale to proceed. We stayed the sale pending the decision of this appeal. Once the stay is lifted and the sale takes place, there will be nothing left to reorganize, this being a single-asset bankruptcy. That's why, having decided to lift the automatic stay, the bankruptcy judge dismissed the bankruptcy proceeding.River East argues that the reason LNV chose to convert the entire $38.3 million debt that it was owed to a secured claim is that it wanted to thwart the bankruptcy proceeding. No doubt. LNV wanted to foreclose its mortgage and doubtless expected to be the high bidder at the foreclosure sale and thus become the building's owner and so the sole beneficiary of any appreciation if and when the real estate market recovered. But there is nothing wrong with a secured creditor's wanting the automatic stay lifted so that it can maximize the recovery of the money owed it.[3] The bankruptcy judge stated flatly that a secured creditor cannot be forced to accept substitute collateral if the creditor has chosen to convert a combination of a secured and unsecured claim into a secured claim equal to the total debt that it is owed. Banning substitution of collateral indeed makes good sense when as in the present case the creditor is undersecured, unlike a case in which he's oversecured, in which case the involuntary shift of his lien to substitute collateral is proper as long as it doesn't increase the risk of his becoming undersecured in the future. See, e.g., In re Sun Country Development, Inc., supra, 764 F.2d at 409; *In re San Felipe @ Voss, Ltd.*, 115 B.R. 526, 530–31 (S.D.Tex.1990). It is proper because the existing lien may make it difficult for the debtor to obtain new financing, cf. Olive Can Co. v. Martin, 906 F.2d 1147, 1149 (7th Cir.1990); Spartan Mills v. Bank of America Illinois, 112 F.3d 1251, 1255–56 (4th Cir.1997); Restatement (Third) of Property: Mortgages § 7.3, comment. e (1997), which he may need in order to be able to reorganize

***Bankruptcy Cases** continues on p. 20*

successfully; and provided the substitute collateral gives the creditor an ample cushion against becoming undersecured, he can have no reasonable objection to the substitution. The secured creditor is thus not allowed to "paralyze the debtor and gratuitously thwart the other creditors by demanding superfluous security." *In re James Wilson Associates*, 965 F.2d 160, 171 (7th Cir.1992); see also *In re Pacific Lumber Co.*, supra, 584 F.3d at 247.Substituted collateral that is more valuable and no more volatile than a creditor's current collateral would be the indubitable equivalent of that current collateral even in the case of an undersecured debt. But no rational debtor would propose such a substitution, because it would be making a gift to the secured creditor. And a case in which the creditor, by making the choice authorized by section 1111(b), gives up his unsecured claim—the amount by which the debt exceeds the present value of the security—is a case of an undersecured claim. The debtor's only motive for substitution of collateral in such a case is that the *832 substitute collateral is likely to be worth less than the existing collateral. And so it comes as no surprise that the lien on the Treasury bonds proposed by River East would not be equivalent to LNV's retaining its lien on the building. Suppose the building turns out to be worth $40 million five years from now, yet River East, having borrowed heavily in the interim to finance improvements that bring the building's value up to that level, defaults. With its lien intact and the bankruptcy court unlikely in this second round of bankruptcy to stay foreclosure, LNV would be able to foreclose, and so would be paid in full. In contrast, if its lien were transferred to the substituted collateral, it would have to wait another 25 years to recover the $38.3 million owed it. Over that long period there almost certainly would be some inflation, so that in real terms the substituted collateral would turn out to be worth less. Suppose, moreover, that during that period interest rates on 30–year Treasury bonds rose because of the nation's deteriorating fiscal position, or because of actual or expected inflation. The price of a fixed-income security is inverse to prevailing interest rates. With the interest rate on Treasury bonds 3 percent when River East proposed their substitution for the building as LNV's collateral, a $1000 bond would yield $30 in interest every year until the bond matured. Suppose interest rates doubled and as a result newly issued $1000 Treasury bonds carried a 6 percent interest rate and so yielded $60 in annual interest. Then no one holding a 3 percent bond would be able to sell it for $1000. The price would not fall all the way to $500 (the level at which a $30 annual interest payment in perpetuity, as on a British consol, would constitute a 6 percent return on the buyer's investment), because the principal would be repaid when the bond matured, and so the price would creep upward as that date approached and knowing this current buyers would pay more than $500. But the bondholder may have a less valuable asset than the building owner if maturity is far in the future and interest rates rise in the meantime; and in that case a lien on the bond would be less valuable than a lien on the building, especially since the market value of the building might be growing while that of the bond was shrinking. Assessments of risk differ, moreover, and there are multiple sources of risk. Treasury bonds carry little default risk (though more since the financial crisis of 2008 and the ensuing surge in the nation's sovereign debt), but long-term Treasury bonds carry a substantial inflation risk, which might or might not be fully impounded in the current interest rate on the bonds.[4] The substituted collateral might, it is true, turn out to be more valuable than the building and thus provide LNV with more security. But because of the different risk profiles of the two forms of collateral, they are not equivalents, and there is no reason why the choice between them should be made for the creditor by the debtor. Since LNV is undersecured, we have trouble imagining what purpose could be served by substituting collateral other than to reduce the likelihood that LNV will ever collect its mortgage debt in full. A striking omission from River East's brief is a description of the subsection (iii) plan itself, beyond a statement that River East hopes to attract $40 to $50 million in loans or equity investment to refurbish the building. Were that feasible River East should have been able to strike a deal with LNV. River East's aim may have been to cash out LNV's lien in a period of economic depression and reap the future appreciation in the building's value when the economy rebounds. Such a cashout is not the *833 indubitable equivalent of a lien on the real estate, and to require it would be inconsistent with section 1111(b) of the Code, which allows the secured creditor to defeat such a tactic by writing up his secured claim to the full amount of the debt, at the price of giving up his unsecured claim to the difference between the current value of the debt and of the security. It's true that a secured claim is altered by a subsection (i) cramdown because the debtor is allowed to stretch out the payments due the creditor. But at least the creditor retains his collateral. That is the quid for the quo of giving up the right to immediate payment. By proposing to substitute collateral with a different risk profile, in addition to stretching out loan payments, River East was in effect proposing a defective subsection (i) cramdown by way of subsection (iii).Even a valid subsection (i) cramdown may be hard on the secured creditor—his retention of the lien may be a poor substitute for immediate payment, or payment on the schedule set forth in the original loan agreement, since he could, in principle anyway, have bypassed bankruptcy, thus retaining his lien without having to make any concessions to his debtor. Had River East proposed a subsection (i) plan (it did eventually—but that was too late, as we're about to see), it would have owed LNV $38.3 million, but that sum of money, paid over 30 years, has a present value of only $13.5 million at a 3 percent interest rate. It is easy to see why the creditor might prefer the original, tougher payment schedule, which might precipitate a default, enabling the creditor to foreclose at a time when the lien was worth a lot more, and thus his recovery would be greater, and earlier, than if he had to wait 30 years. True, if he foreclosed immediately, he might get just the depressed value of the building—but not if he were the high bidder at the foreclosure sale, for then he would get the building itself. It is also true that if the debtor doesn't default again, the creditor will have to wait for repayment in accordance with the repayment schedule in the original loan agreement. So subsection (i) is friendly to debtors; River East wanted to make it friendlier still by squeezing a modified form of a subsection (i) cramdown into subsection (iii). As an aside, we point out that bankruptcy provisions "friendly to debtors" are so only in the short run; in the long run, the fewer rights that creditors have in the event of default, the higher interest rates will be to compensate creditors for the increased risk of loss. [5] After its subsection (iii) plan was rejected, River East submitted a third proposed plan, which was—at last—for a genuine subsection (i) cramdown. LNV would retain its lien on the building, and the $13.5 million in 30–year Treasury bonds would guarantee payment in full of LNV's mortgage over 30 years. But the bankruptcy judge had lost patience. He refused to consider the third proposed plan, lifted the automatic stay, and dismissed the Chapter 11 proceeding. In doing these things he did not abuse his discretion—the applicable standard of appellate review. *Colon v. Option One Mortgage Corp.*, 319 F.3d 912, 916 (7th Cir.2003); *In re Williams, supra*, 144 F.3d at 546. The third proposal left the Chapter 11 proceeding still far from completion, because there was bound to be a wrangle over the current value of the building and the proper interest rate. With River East having compromised its credibility by submitting two plans that sought to circumvent the statute, and the 90–day deadline having expired long ago (the Chapter 11 petition was filed on February 10, 2011, and the third proposed plan on August 23—194 days later), and LNV having waited years *834 to enforce its lien, the bankruptcy judge was not required to stretch out the Chapter 11 proceeding any longer. We therefore affirm his decision and vacate the stay that we granted pending appeal.

AFFIRMED.C.A.7 (Ill.), 2012. In re River East Plaza, LLC669 F.3d 826, 55 Bankr.Ct.Dec. 265, Bankr. L. Rep. P 82,153

SELECTED REFERENCES

In *re Olde Prairie Block Owner, LLC*, 467 B.R. 165, 172+ (Bankr.N.D.Ill. Mar 14, 2012) (NO. 10 B 22668)

Bankruptcy Desk Guide § 28:23, Best interest of creditors test-Election of treatment under 11 U.S.C.A. § 1111(b) (2012)

Bankruptcy Law Fundamentals § 12:20, Cram down confirmation following rejection by one or more classes-Fair and equitable as to secured creditors (2012)

Bankruptcy Law Fundamentals § 12:23, Section 1111(b) election (2012) Bankruptcy Law Manual s 11:65, Fair and equitable as to class of secured creditors (2012)

Bankruptcy Practice for the General Practitioner § 12:15, Claims and interests (2012)

Bankruptcy Practice for the General Practitioner § 12:26, Confirmation Requirements-Cramdown rules (2012)

W. Homer Drake, Jr. and Christopher S. Strickland, *Chapter 11: Reorganizations, Second Edition* § 14:20, Fair and equitable requirement-Secured claims-Realization of indubitable equivalent (2012)

Commercial Asset-Based Financing § 11:45, Modes of cram down for secured debt-Indubitable equivalent (2012) Creditors' Rights in Bankruptcy § 17:16, Cramdown of a dissenting class of secured claims (2012)

Ginsberg & Martin on Bankruptcy § 13.14, Forcing a Plan on Dissenters (2012)

2012 Norton Annual Survey of Bankruptcy Law 35, Recent Developments in Chapter 11 (2012)

2012 Norton Bankruptcy Law Adviser 4, Recent Decisions from the Appellate Courts (2012)

Norton Bankruptcy Law and Practice 3d § 43:48, Single-asset real estate cases (Code §362(d)(3)) (2012)

Norton Bankruptcy Law and Practice 3d 11 USC § 362, § 362. Automatic stay (2012)

Norton Bankruptcy Law and Practice 3d 11 USC § 1129, § 1129. Confirmation of plan (2012)

Ordin on Contesting Confirmation § 15.02, Defining "Indubitable Equivalence" (2012)

Pratt's Journal of Bankruptcy Law 2012.10-3, Has Radlax Made "Indubitably Equivalent" Arguments Any less Indubitably Confusing? (2012)

Pratt's Journal of Bankruptcy Law 2012.12-3, Recent Developments Affecting Workouts of Secured Loans (2012)

Rutter Group Practice Guide: Bankruptcy, National Edition CH 11-J, J. Nonconsensual "Cramdown" Confirmation Requirements (2008)

When Can Substitute Collateral Constitute the Indubitable Equivalent?, 31-APR Am. Bankr. Inst. J. 42, 42+ (2012)

Chicago Real Estate Cases Foreshadow Radlax's Impact on Lien-stripping Cramdowns, 31-MAR Am. Bankr. Inst. J. 32, 32+ (2012)

2012 Bankruptcy Service Current Awareness Alert 6, Circuit holds that, where a creditor has made a § 1111(b) election, debtor does not provide indubitable equivalence under § 1129(b)(2)(A)(iii) by substituting a lien on 30-year Treasury bonds for the creditor's (2012)

Rebuilding the Fallen House of Cards: The Bankruptcy Courts Should Require a Discounted Cash Flow Analysis as a Floor in Valuation Hearings to Value Mortgage Portfolios in Dysfunctional Markets, 21 J. Bankr. L. & Prac. 3 ART. 3, 3 ART. 3+ (2012)

Indubitable Equivalence: A Standard Designed to Protect the Secured Creditor's Bargain, 21 J. Bankr. L. & Prac. 2 ART. 2, 2 ART. 2+ (2012)

072512 American Bankruptcy Institute 111, Concurrent Session: Creative Battles in Single Asset Real Estate Cases: Use of Rents, Cramdown Strategies, and Lenders Buying Equity to Avoid Cramdown! Adequate Protection, Assignment of Rents, and Cash Collateral Issues (2012)

071212 American Bankruptcy Institute 271, Concurrent Session: The Reaches of the Indubitable Equivalence Test Musings on Cramdown and the Indubitable Equivalent Standard (2012)

071212 American Bankruptcy Institute 441, The Intersection of Criminal Law and Bankruptcy Law Offices of Lee Darst (2012) (examples of 1111(b) cases)

Credit Bidding and Cram down Plans: The Supreme Court Rejects the Indubitable Equivalent Alternative for Sales Free and Clear, TSUR01 American Law Institute-American Bar Association 3 (2012)

Cramdown Plan with Substituted Collateral Fails, 55 Bankruptcy Court Decisions Weekly News & Comments 12 (2012)

Substitute Collateral Not Indubitable Equivalent, 55 Bankruptcy Court Decisions Weekly News & Comments 1+ (2012)

Cramdown Plan with Substituted Collateral Fails, 24 Commercial Lending Litigation News 22 (2012)

Treasury Bonds Not "Indubitable Equivalent" of Lien, 02-8-12 West's Bankruptcy Newsletter 6 (2012)

8 Westlaw Journal Bankruptcy 2, Rejected Cramdown Plan Warranted Case Dismissal, 7th Circuit Rules (2012) ■

Prof. Baxter Dunaway, *Section Editor, is Professor Emeritus at Pepperdine University School of Law.*

Fiduciary Duties *continued from p. 8*

The California Corporations Code has a similar provision that exculpates directors but is silent with respect to officers. Thus, in *Neubauer v. Goldfarb*, 108 Cal. App. 4th 47, 57 (2003), the court concluded that an officer of a California corporation cannot be exculpated from the duty of care.

A few cases have explored whether there might be other differences in the duties owed by officers versus directors. For example, there is limited authority for the proposition that in applying these standards an officer will be tasked with care at a more detailed level. As one court put it, "[t]o a great extent, the rules governing liability are the same whether the officer sued is a director or some other officer such as the president, vice president, secretary, . . . [citation omitted]. But an officer's duties may be more expansive than those of a director since directors may rely on management decisions and recommendations of officers. [citation omitted]. We believe that judicial inquiry into the level of fiduciary duty owed is necessarily affected by the circumstances under which the dispute arises, including whether the allegedly defective conduct was that of an officer or a director." *Potter v. Pohlad*, 560 N.W.2d 389, 392 n.1 (Ct. App. Minn. 1997) (applying Delaware law). But that court still concluded that the standard under Delaware law was gross negligence and that officers get the benefit of the business judgment rule. *Id*. at 392.

The Enron Examiner expressed a similar thought. "Notwithstanding the general similarity of officer fiduciary duties and director fiduciary duties, an officer's accessibility to corporate information and responsibility for the corporation's day-to-day operations may subject the officer's conduct to a higher degree of scrutiny than that given to director conduct." Third Interim Report of Neal Batson, Court-Appointed Examiner, *In re Enron Corp. et al*., Case No. 01-16034 (Bankr. S.D.N.Y June 30, 2003), App. B at 7 (hereinafter, the "Enron Examiner's Report").

The Delaware Supreme Court has also stated that fiduciary duties "depend upon the specific context." *McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000). *McMullin* involved an issue other than whether officers are required to delve deeper than directors, but makes the point that whether a director or officer acted in a grossly negligent manner needs to be considered in the context of the specific decision or action.

To be clear, few cases to date have suggested that officers are required to delve into greater detail than directors—the great body of cases simply treat officers and directors with the same broad brush. Even so, it is prudent to assume that courts will take into account that management personnel are closer to details than are directors and, accordingly, the *context* in which their conduct will be examined will be more granular than for directors. But the standard for the conduct of an officer, at least presently in Delaware, is gross negligence.

One law review article has challenged this conclusion and has argued that simple negligence should govern whether an officer has breached his or her duty of care. Johnson & Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm. and Mary L. Rev. 1597, 1632-35 (2005). The authors admit, however, that this position is inconsistent with the ALI's Principles of Corporate Governance and current case law, other than apparently in Oregon—the Enron Examiner concluded that Oregon law provides that both officers and directors are subject to a negligence standard, rather than the more normal requirement of gross negligence.

Duty of Loyalty

Under Delaware law, the duty of loyalty requires action in *good faith* and in the best interests of the corporation regardless of any personal interest. Radin, *supra*, at 2.

If a director or officer has an interest in a transaction, that can give rise to a claim for a breach of the duty of loyalty. The transaction can nonetheless withstand attack if the material facts are disclosed and approved by disinterested directors or approved by stockholders. Del. Gen. Corp. Law § 144.[7]

Further, the interest must be significant to be the basis of a duty of loyalty claim. Delaware courts have held that "[t]he receipt of any benefit is not sufficient to cause a director to be interested in a transaction. Rather, the benefit received by the director and not shared with stockholders must be 'of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest . . . .'" *In re Trados Inc. S'holder Litig.*, 2009 Del. Ch. LEXIS 128, at *22 (Del. Ch. July 24, 2009).

If action is taken in *bad faith*, that will also violate the duty of loyalty. Some courts previously articulated the requirement to act in good faith to be a separate fiduciary duty. But the Delaware Supreme Court clarified that the duty of good faith is actually an element of the duty of loyalty. *Stone v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006). "[A] director cannot act loyally towards the corporation unless she tries— *i.e.*, makes a genuine, good faith effort—to do her job as a director." *ATR-KM Eng. Fin. Corp. v. Araneta*, 2006 Del. Ch. LEXIS 215, at *71 (Del. Ch. 2006). The standards for a finding of bad faith are described in Section D below (p. 23).

The Business Judgment Rule

1. The Rule

If applicable, the business judgment rule will provide a director or officer with substantial additional protection from liability for his or her corporate actions in most circumstances. This rule provides a *presumption* that a company's directors and officers have been "faithful to their fiduciary duties." This rule is viewed as a "foundation" of corporate law and the presumption is frequently referred to as "powerful," "strong," and "substantive." Radin, *supra*, at 40-41. If the business judgment rule applies, a court will not second-guess business decisions and will presume that directors and officers made decisions based on an informed basis, in good faith and with an honest belief that the action was in

7 If the Board did not follow the sort of procedures allowed by Del. Gen. Corp. Law § 144 and a director or officer has an interest in a transaction, the court will apply an "entire fairness test," and the burden will shift to the defendant to affirmatively demonstrate entire fairness. The court will generally consider whether there was "fair dealing" and "fair price"—the test is not bifurcated, as both are important elements in determining "entire fairness."
Entire fairness is a high standard. Because of this and because it is fact-specific, such lawsuits typically survive motions to dismiss and therefore have substantial settlement value, even where they ultimately lack merit.

the best interests of the corporation. The business judgment rule focuses on the *process* used.

Several elements of the business judgment rule warrant emphasis:

- ***Being Informed***. In order to invoke the business judgment rule, directors need to have *informed themselves* of "all material information reasonably available to them." *Cede & Co. v. Technicolor*, 634 A.2d 345, 367 (Del. 1993). *Gross negligence* is the standard for determining whether a business judgment was an informed one, and the burden is on the plaintiff to show gross negligence. *Smith v. Van Gorkum*, 488 A.2d 858, 873 (Del. 1985). This largely focuses on process.
- **Business Decision**. The business judgment rule covers only business *decisions*. Inaction is not protected unless it is based on a conscious decision not to act. Radin, *supra*, at 87. If the directors or officers abdicate their responsibilities they will not be protected. *Id.* at 88.
- ***No Interest in the Transaction***. The director or officer must not have an interest in the transaction. *Id.* at 92.
- ***Good Faith***. The courts are split whether to phrase the requirement of good faith as an element of the business judgment rule or an element of the duty of loyalty. Radin, *supra*, at 320-71. But no matter how categorized, if a director or officer engages in bad faith conduct, it is likely that a court will find a way to impose liability. Similarly, most Bankruptcy Courts are willing to approve indemnification agreements for financial advisors and turnaround management firms, but generally insist on liability for actions taken in bad faith (as well as willful misconduct and gross negligence).
- ***Absence of Fraud or Willful Misconduct***. If a director or officer engages in fraud, willful misconduct or illegal acts, he or she will not be a beneficiary of the business judgment rule. *Id.* at 378.

The business judgment rule is rebutted if the director or officer violates the duties of care or loyalty—*e.g.*, acts in a grossly negligent manner in informing him or herself of the facts, engages in self-dealing or acted in bad faith. *McMullin v. Beran*, 765 A.2d 910, 917 (Del. 2000). If the business judgment rule is rebutted in this manner, the defendant has the burden to show the "entire fairness" of the transaction. *Id*.

To a certain extent, this analysis is circular—cases often consider whether a director or officer has the benefit of the business judgment rule by considering whether he or she violated the duties of care and loyalty (including good faith). So much of the analysis centers on the elements of those two duties whether the court purports to be applying the business judgment rule or simply the duty of care. If a director or officer fails this test, no matter how articulated, he or she has the burden of establishing the entire fairness of the transaction and that is a heavy burden.

2. Application to Officers

It is not clear that the business judgment rule is available to officers. The Delaware Supreme Court's holding in *Gantler v. Stephens* that the fiduciary standards for officers are the same as directors implies that officers should get the benefit of the business judgment rule. And that is the assumption of many courts applying Delaware law, as well as the law of many other states (*e.g.*, Connecticut, New York, Florida, and Tennessee). *See* Radin, *supra*, at 398-401. Yet, a Federal District Court in Pennsylvania, applying Delaware law, concluded that the business judgment role is not available to officers. *Platt v. Richardson*, 1989 U.S. Dist. LEXIS 7933, at *6 (M.D. Pa. June 6, 1989). This decision, however, predates *Gantler v. Stephens*.

The business judgment rule also may not be available to officers of a company organized under California law. California fiduciary duty law is largely a creature of statute. At least one court has held that since the business judgment rule applicable to California corporations is set forth in California Corporations Code § 309, which only refers to directors, officers of a California corporation may not enjoy the protections afforded by the business judgment rule. *Gaillard v. Natomas Corp.*, 208 Cal. App. 3d 1250, 1265 (1989).

Even if the business judgment rule does not apply to officers, the normal duties of care and loyalty apply, and those standards are similar to the business judgment rule—*e.g.*, officers must inform themselves of relevant facts, subject to a *gross negligence standard*, and officers may not engage in self-dealing unless this self-interest is fully disclosed and approved by disinterested directors or shareholders.

What Constitutes Bad Faith?

Much of the litigation involving fiduciary duty claims explores the limits of "good faith" for requiring directors and officers to act in good faith is an element of the duty of loyalty and many courts have said that acting in good faith is also necessary to invoke the business judgment rule.

This issue is frequently litigated in the context of the exculpatory protections afforded directors by statute. Del. Gen. Corp. Law § 102(b)(7) provides that the certificate of incorporation of a Delaware corporation may include a provision liberating directors from needing to satisfy the duty of care. This exculpation provision, however, may not absolve a director from the duty of loyalty, and has a carve-out for transactions in which the director did not act in good faith, derived an improper personal benefit, or engaged in intentional misconduct.

Exculpatory provisions adopted in compliance with this statute have allowed many directors to dismiss claims for the violation of the duty of care at the pleading stage. For example, in *Lyondell Chemical v. Ryan*, 970 A.2d 235, 241 (Del. 2009), the trial court characterized the directors' involvement in a sale as "slothful indifference." But upon review, the Delaware Supreme Court noted that the directors were sophisticated, generally aware of the company's value and prospects, and considered an offer that they accepted with the aid of financial and legal advisors in the time constraints imposed by the buyers. *Id.* at 241-44. The Delaware Supreme Court held that while the directors had fallen far short of running an ideal M&A process, they were exculpated from a duty of care claim by language in the charter tracking Del. Gen. Corp Law § 102(b)(7). *Id*. at 239.

The *Lyondell* court then turned to claims for the violation of the duty of loyalty. Since there was no allegation of self-dealing, the Delaware Supreme Court held that no such claim could be asserted unless it could be shown that there had been a failure

Fiduciary Duties *continues on p. 24*

to act in good faith. *Id.* at 239-40. The court concluded that bad faith encompasses an "intentional dereliction of duty"; while "mere" gross negligence ("including failing to inform one's self of available material facts") without more cannot constitute bad faith. *Id.* at 240. In contrast, a "sustained or systematic failure of the board to exercise oversight" could constitute lack of good faith, and "bad faith will be found [when] a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.' . . . [But] there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties." *Id.* at 240-243. Given that the directors were generally aware of the value of the company and solicited and followed the advice of financial advisors and counsel, and engaged in give and take with two potential buyers, the court concluded that a claim for breach of the duty of loyalty could not be sustained. *Id*. at 244.

Similarly, in *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006), the Delaware Supreme Court held that "a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence)." The court explained that the normal examples of bad faith are (i) intentional acts with a purpose other than advancing the interests of the corporation, (ii) acts intentionally designed to violate applicable positive law, and (iii) intentional failure to act in the face of a known duty to act, demonstrating a conscious disregard of duties. *Id*. at 369.

The Delaware Chancery Court illustrated that "bad faith" should only be found when the director or officer engages in severe misconduct. In *McPadden v. Sidhu*, 964 A.2d 1262, 1266-67 (Del. Ch. 2008), the directors entrusted marketing of a division to the manager of that division. That manager concluded that an MBO that he led was the best offer. *Id.* at 1271-72. He did not contact some potential bidders, including a competitor who had offered a substantially higher price a few years earlier. *Id*. at 1271. The board received a fairness opinion from an investment banker, but that opinion was based on projections that were prepared by the management team behind the MBO. *Id*. at 1267-68. About two years later the management team flipped the division to the competitor that they had frozen out of the sales process at a price equal to over eight times what the management team paid in the MBO. *Id*. at 1271-72. The Chancery Court concluded that the Board was grossly negligent in entrusting this process to the manager who led the MBO, subject to minimal oversight. *Id*. at 1274-75. Even so, the Chancery Court held that charter's exculpatory language based on § 102(b) (7) was sufficient to protect the directors because the Board's gross negligence did not constitute bad faith conduct. *Id*. at 1273-74. The directors were guilty of reckless indifference, but because they had not been motivated by "subjective bad faith" or engaged in the "intentional dereliction of duty or the conscious disregard for one's responsibilities," their actions were not capable of being characterized as bad faith. *Id.*

Similarly, in *In re Tribune Co., et al.*, the court-appointed examiner observed that in determining bad faith, courts look to whether "directors took any intentional acts that are contrary to their known duties," that an "extreme set of facts" premised on an allegation that disinterested parties "intentionally disregarded their duties" is required to find bad faith, and that it is "a relatively low threshold to satisfy the requirements of good faith under Delaware law." Volume II of the Report of Kenneth N. Klee, Examiner, *In re Tribune Co., et al.*, Case No. 08-13141 (Bankr. D. Del. July 26, 2010), at 372-85 (hereinafter, the "*Tribune* Examiner's Report"). Although the *Tribune* examiner concluded that the conduct of the directors was far from satisfactory, he could not conclude that their conduct was "so egregious as to support a conclusion that they consciously abdicated their responsibilities under Delaware law." *Tribune* Examiner's Report at 385-86.

The exculpatory language permitted by Delaware is not failsafe because some courts have stretched to find bad faith. For example, some commentators have questioned whether the conduct of the directors in *Bridgeport Holdings* truly satisfied the standard required for a finding of bad faith, and therefore violated the duty of loyalty. The court was very critical of the directors for what the court characterized as "abdicating" to a turnaround manager, but this manager was a well-regarded professional and retaining someone with this background would normally be considered a positive fact for the board. And there was no allegation that the directors engaged in self-dealing. The court was likely influenced by (i) the fact that it believed that the sale yielded a grossly inadequate price, so low that a creditors' trust brought a fraudulent transfer suit against the buyer and obtained a very sizable settlement, and (ii) the court's conclusion that the sale process was badly flawed and was conducted immediately prior to the company filing bankruptcy, whereas if the sale process had been conducted under the auspices of the Bankruptcy Court, it undoubtedly would have been far different. 388 B.R. at 564-66.

TO WHOM DO DIRECTORS AND OFFICERS OWE DUTIES?

Several years ago, most of the case law implied that directors and officers of insolvent companies and companies in the zone of insolvency owed fiduciary duties directly to creditors. But recently the case law has shifted substantially. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007), the Delaware Supreme Court held that directors' and officers' fiduciary duties run to the corporation, rather than to creditors. *Gheewalla* followed a trend that goes back at least to *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 774, 790-91 (Del. Ch. 2004), in which the Delaware Chancery Court explained that when a corporation is insolvent or in the zone of insolvency, directors and officers are allowed to consider the interests of creditors, but they owe their duties to the company, rather than to creditors.

Given *Gheewalla*, directors and officers of a troubled company should focus on the interests of the *enterprise*. Sometimes this is phrased as owing duties to the "corporate enterprise" or the "community of interests." This does not mean indifference to the interests of creditors or to the interests of equity holders. But in discharging duties to the enterprise, which stakeholder benefits will take care of itself and the directors should focus on the enterprise rather than whether than creditors or equity holders benefit. In other words, do what is right for the corporation and let the chips fall where they may between creditors and shareholders.

Even after *Gheewalla*, some courts still espouse the time-honored statement that directors and officers of a solvent company owe duties to the company *and* its shareholders. When a company is solvent, those interests are synonymous and this phraseology does not mean that a shareholder can bring an individual action against a director or officer for breach of a duty—such actions are brought by the corporation, or derivatively on behalf of the corporation, because it is the corporation that is owed these duties. The Delaware Chancery Court made this point in *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 195 n.75 (Del. Ch. 2006), *aff'd*, 931 A.2d 438, 438 (Del. 2007). Courts sometimes refer to duties as being owed to a corporation and its shareholders when the company is solvent and being owed to the corporation and its creditors when the company is insolvent. Yet, under Delaware law, whether solvent of insolvent, these duties are owed to the corporation, not directly to shareholders or creditors. Adding shareholder to the list when the corporation is solvent and adding creditors when the corporation is insolvent merely identifies who is the primary residual beneficiary if the corporation recovers on a breach of fiduciary duty claims. But the duty is owed to the company and it is the company's claim if that duty is breached. *Id*.

There is still confusion on this issue and some commentators and courts persist in asserting that when a company becomes insolvent, or perhaps enters the zone of insolvency, duties shift.

That confusion largely results from a related issue—who has standing to bring a derivative action on behalf of a company. When a company is insolvent (or probably in the zone of insolvency), a derivative action can be brought on behalf of the company by creditors. In Chapter 11 cases, such estate causes of action are often assigned to an official creditors' committee or to a liquidating trust established in a plan. Similarly, if the case converts to chapter 7 or a chapter 11 trustee is appointed, that trustee can bring an action on behalf of the estate. So saying that a director or officer does not owe duties to third parties is not the same as saying that a director or officer can ignore the risk that creditors can allege that the directors or officers breached their duties to the company and seek standing to bring this action on the company's behalf.

Indeed, because who has standing to bring a derivative action changes when a company becomes insolvent, some courts have suggested that the "actual point of insolvency becomes integral to assessing the director's duty to creditors." *USDigital, Inc. v. Huston*, 443 B.R. 22, 42 (Bank. D. Del. 2011); *In re Autobacs Strauss, Inc.,* 473 B.R. 525, 560 (Bankr. D. Del. 2012). These cases accept the principle that fiduciary duties run to the corporation, rather than to creditors. So analytically they overstate the shift when a company becomes insolvent — the duties remain the same; what changes are whether those with standing are likely to sue.

The foregoing discussion focuses on Delaware law. Many corporations are organized under Delaware law and many other states follow Delaware's lead. Yet, when a company is organized under the laws of a state other than Delaware, the law may be different. For example, in *In re Mervyn's Holdings, LLC*, 426 B.R. 488, 501 (Bankr. D. Del. 2010), the court held that the law for corporations organized under California law diverges from Delaware and that fiduciary duties for an insolvent California corporation run directly to creditors. *Id*. The court based this conclusion on a number of California cases that adopt the trust fund theory—*i.e.*, when a company is insolvent its assets are held in trust for creditors. The logic goes that since creditors are the primary beneficiaries of this trust, the trustees—the officers and directors—owe duties directly to creditors.

California law on this point is far from clear. For example, in *Berg v. Berg*, 178 Cal. App. 4th 1020, 1041 (2009), a California Court of Appeal reached the opposite conclusion and held that there is no duty to creditors under California law even when a company is insolvent or in the zone of insolvency. Even so, the *Berg* court affirmed that the trust fund theory applies to insolvent California corporations. After holding that, nonetheless, directors and officers of an insolvent California corporation do not owe duties to creditors, the *Berg* court stated that directors of an insolvent California corporation owe a duty to the corporation to avoid "actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims. This would include acts that involve self-dealing or the preferential treatment of creditors." From the facts, it is clear that the court viewed these as limited exceptions often dealing with self-dealing by the directors. The allegation in *Berg* was that the directors dissipated an asset—NOLs—by instituting an assignment for benefit of creditors rather than filing a chapter 11 bankruptcy petition. The court undoubtedly thought it was creating a tougher standard than would arise if fiduciary duties arose in favor of creditors and noted that determining insolvency (much less the zone of insolvency) is extremely difficult and should not be required of directors. But plaintiffs might seize on the language used by the court regarding dissipating assets or preferring creditors to sue directors of California companies.

If so, this would be at odds with long-standing law that a corporation is generally free to pay some creditors but not others, subject to the potential that the payment may be recovered as a voidable preference under Bankruptcy Code § 547. Cal. Civ. Code section 3432 ("A debtor may pay one creditor in preference to another, or may give to one creditor security for the payment of his demand in preference to another."). This is also the law of Delaware. *Asmussen v. Quaker City Corp.*, 18 Del. Ch. 28, 31-32 (Del. Ch. 1931). *See also Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004) (citing *Asmussen* as having "establish[ed] the general rule that discrimination in priority between creditors of equal priority by insolvent companies is usually permitted."); *QRS 10-12(TX), Inc. v. CalComp Tech., Inc.*, 1999 Del. Ch. LEXIS 79, at *9-10 (Del. Ch. May 12, 1999) ("[W]hile our law recognizes that a corporation's insolvency gives rise to fiduciary duties owed by the directors of the corporation to its creditors, it is equally true (at least outside the context of a dissolution or receivership) that directors of insolvent corporations may prefer one creditor over another."). It is unlikely that the *Berg* court thought that it was potentially expanding the universe of claims that could be asserted against directors of a troubled company for the heart of the opinion indicates that the court intended to follow the modern trend that there is no tort of deepening insolvency.

Fiduciary Duties *continues on p. 26*

Fiduciary Duties continued from p. 25

IS THERE A TORT OF DEEPENING INSOLVENCY?

A few years ago, some courts held that there is a tort for deepening insolvency. This reasoning was based largely on a footnote in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp.*, No. 12150, 1991 WL 277613, at *34 n.55 (Del. Ch. 1991), which implied that when insolvent or in the zone of insolvency directors and officers owe duties to creditors. This line of reasoning led the Third Circuit to rule that under *Pennsylvania law* there was a tort of deepening insolvency. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 354 (3d Cir. 2001).

This theory received substantial criticism for it in essence followed the European model of imposing liability on directors for allowing a corporation to operate ("trade" in Eurospeak) while insolvent. The European approach tends to force a company to liquidate when it starts to experience financial distress. However, that is contrary to the US model, which places an emphasis on attempting to reorganize. Indeed, this preference for reorganization is at the heart of chapter 11 and its presumption that the debtor should remain in possession rather than the automatic appointment of a trustee.

In recent years, most US courts have rejected the contrary theory of deepening insolvency that had started to gain currency. Thus, cases currently hold that there is no tort for deepening insolvency under Delaware law, California law or the laws of most other states.

The Delaware Chancery Court started this trend away from the concept of a tort of deepening insolvency in *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 801 (Del. Ch. 2004). Then in 2007, the Delaware Chancery Court squarely held that there is no such tort under Delaware law and the Delaware Supreme Court affirmed in a short affirmance. *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 174-75 (Del. Ch. 2006), *aff'd*, 931 A.2d 438, 438 (Del. 2007).

Similarly, in *Berg & Berg*, the court observed that under California law "there is not a duty to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good faith judgment there is an alternative." *Berg*, 178 Cal. App. 4th at 1038.

In *In re Citx Corp.*, 448 F.3d 672, 680-81 (3d Cir. 2006), a panel of the Third Circuit intimated that *Lafferty* was probably wrongly decided and that there was not tort of deepening insolvency under Pennsylvania law. Under principles of *stare decisis* the *CitX* panel was unable to reverse *Lafferty*, but suggested that only fraudulent conduct will support a deepening insolvency claim under Pennsylvania law. *Id*. at 681.

A Delaware Bankruptcy Court decision emphasizes, however, that if directors and officers breach their fiduciary duties, the company's deepening insolvency may be a proper measure of damages. *In re the Brown Schools*, 386 B.R. 37, 47-48 (Bankr. D. Del. 2008). The predicate for assessing damages for deepening insolvency, as the court suggested in *Brown*, however, should be that the directors and officers breached their fiduciary duties of care and loyalty. *Id.* at 46. In dealing with this threshold question, a director or officer probably should have the benefit of the business judgment rule and the fact that the duty of care requires gross negligence in order for liability to attach.

DIRECTORS AND OFFICERS OF SUBSIDIARIES

Duties of the Directors of a Subsidiary

Many "companies" are actually a family of separate entities. The active board is generally the board of the parent. Subsidiaries have boards, but many subsidiary boards seldom meet and are often comprised only of officers of the company. To the extent that a subsidiary's board takes action, it is often by unanimous written consent prepared by the general counsel.

When a subsidiary is wholly-owned and solvent, this is normally not a problem. In that situation, the duties of the subsidiary's directors and offices will be to the subsidiary, but the company's and the parent entity's interests will be aligned. As the Delaware Supreme Court recognized years ago, "in a parent and wholly-owned subsidiary context, the directors of a subsidiary are obligated *only* to manage the affairs of the subsidiary in the best interests of the parent and its shareholders." *Andarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988) (emphasis added). *Andarko* has generally been followed and the principle it articulates is relatively unremarkable when a subsidiary is wholly-owned and solvent, for in that situation the interests of the subsidiary and its parent are synonymous. Radin, *supra*, at 1238-49.

Recent cases, however, have questioned this premise when a subsidiary is insolvent. The fundamental holding of *Gheewalla* is that officers and directors owe duties to the enterprise. When a company is solvent, those duties are for the benefit of shareholders, which in the case of a wholly-owned subsidiary means for the parent. But when a subsidiary is insolvent, the interests of the parent and the subsidiary often diverge. A number of recent cases have made this point and held that when a subsidiary is insolvent, its directors and officers must look out for the interests of the subsidiary, not the parent. *United States Bank Nat'l Ass'n v. Verizon Communs. Inc.*, 2012 U.S. Dist. LEXIS 131469, at *32-33 (N.D. Tex. Sept. 14, 2012); *Burtch v. Seaport Capital, LLC (In re Direct Response Media, Inc.),* 466 B.R. 626, 649-50 (Bankr. D. Del. 2012); *In re Scott Acquisition Corp*., 344 B.R. 283, 290 (Bankr. D. Del. 2006); *In re Verestar, Inc*., 343 B.R. 444, 473-74 (Bankr. S.D.N.Y. 2006); *Trenwick Amer. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 203 n.96 (Del. Ch. 2006); *In re RSL Com Primecall, Inc.*, 2003 Bankr. LEXIS 1635, at *42-44 (Bankr. S.D.N.Y. Dec. 11, 2003); *In re Magnesium Corp. of America*, 399 B.R. 722, 773 (Bankr. S.D.N.Y. 2009); Radin, *supra*, at 2172-82. In addition, when a subsidiary is insolvent, its creditors will have standing to bring a derivative action on behalf of the subsidiary against the directors and officers.

The view that insolvency radically changes the duties of a director of a subsidiary has gained force in recent years. It would seem to be a logical extension of *Gheewalla* and, as indicated above, has been endorsed by a number of bankruptcy courts applying Delaware law. However, neither the Delaware Court of Chancery nor the Delaware Supreme Court has yet to squarely deal with this question. In *Trenwick*, the Chancery Court observed this trend but seemed reluctant to follow it. As Vice Chancellor Strine put it, if there "is conceptual room for equity in this context, that room is quite narrow. At most one might conceive that the directors of a wholly-owned subsidiary owe a duty to the subsidiary not to take action benefitting a parent corporation that they know will render the subsidiary unable to meet its legal obligations. Any lesser standard would undercut the utility of the business judgment rule by permitting creditors to second-guess good faith action simply because the subsidiary ultimately becomes insolvent. Even the recognition of a cause of action along stringent lines requires careful consideration." *Trenwick*, 906 A.2d at 203. Vice Chancellor Strine also observed that the more traditional way of dealing with such issues would be through fraudulent transfer laws. *Id*. In a footnote, Vice Chancellor Strine commented on Bankruptcy Judge Walsh's holding in *Scott* that when a subsidiary is insolvent, its directors cannot follow the lead of the parent. Vice Chancellor Strine observed that this conclusion could be "rationalized in traditional terms." *Id*. at 203 n.96. But that comment was *dicta*, for Vice Chancellor Strine emphasized that the plaintiffs in *Trenwick* had presented no evidence that the subsidiary was insolvent and he indicated that careful consideration would be required before any such rule should be adopted. Such a rule is also hard to reconcile with Vice Chancellor Strine's statements that the mere incantation of the word insolvency should not radically change a director's duties, much less turn him or her into a collection agent for creditors. *Id*. at 195, 202.

Until the Delaware Chancery Court or Supreme Court speaks definitively on this issue, there will remain some uncertainty whether directors of a subsidiary are required to determine whether the subsidiary is insolvent and, if it is, ensure that the subsidiary acts independently of the parent. Yet, room to argue about this situation before a court will provide little solace to directors of subsidiaries who have to act in the real world without knowing whether a court might be persuaded to disagree with the growing number of bankruptcy courts and examiners who assert that once a subsidiary becomes insolvent, the subsidiary's directors are required to act independently of the parent.

One commentator has argued that this situation is particularly difficult for directors and officers of a subsidiary since they are likely to be interested parties—they may also be officers of the parent and be paid by the parent. If so, they may be subject to claims that they breached the duty of loyalty, will not be entitled to rely on exculpation from the duty of care in a charter and may not get the benefit of the business judgment rule. J. Haskell Murray, *"Latchkey Corporations": Fiduciary Duties in Wholly Owned, Financially Troubled Subsidiaries*, 36 Del. J. of Corporate Law 577, 602-04, 609-12 (2011). In other words, directors of an insolvent subsidiary who are beholden to the parent may be put in the awkward position of not getting most of the protections normally available to directors coupled with the reality that discharging their duties to the subsidiary may require them to disobey their bosses.

This concern is far from academic. A number of the recent cases involving failed LBOs have turned a spotlight on the directors of subsidiaries. *See* Tribune Examiner's Report at 365-367, 387-389; *In re TOUSA, Inc*., 437 B.R. 447, 457-60 (Bankr. S.D. Fla. 2010).

This was one of the central issues in *Dynegy*. The Dynegy examiner was particularly critical of the board of DHI—a wholly-owned subsidiary of DI. The examiner asserted that the DHI board performed in a perfunctory fashion, rarely if ever meeting and taking action by unanimous written consent. The DHI board did not consist of any independent directors; rather it was populated with Dynegy employees who in practice reported to the DI board. When asked to approve the spinout of CoalCo, the DHI board rubber stamped what DI (and, therefore Icahn and Seneca) wanted, rather than analyzing whether these transactions were in the interests of DHI. The examiner emphasized that the DHI board did not engage its own counsel or financial advisors, and did not try to determine whether DHI was solvent. *See* Dynegy Examiner's Report at 8, 135-138.

The situation the Dynegy examiner found so troubling is the real world of most wholly-owned subsidiaries. Rarely is the board of a subsidiary active.

Perhaps the most disturbing aspect of this analysis is that what is required of a subsidiary's directors will turn on whether the subsidiary is solvent. If it is solvent, the directors can safely take direction from the parent. Indeed, the law requires them to do so. But if a subsidiary is insolvent, its board is required to spring into a searching inquiry of what is in the interests of the *subsidiary* and at most consider the parent's preferred course of action as one of many factors to consider, and perhaps a relatively unimportant factor.

Determining whether any operating business is solvent or insolvent is hardly a science. Valuations are inherently subjective and depend on projections of what will happen in the future and appropriate discount and capitalization rates. As Professor Coogan famously observed, "valuation is an estimate compounded by a guess." Coogan, Confirmation of a Plan Under the Bankruptcy Code, 32 *Case W. Res. L. Rev*. 301, 313 n.62 (1982). Bankruptcy cases often involve battles of well qualified experts who come to widely different valuation opinions. Even if such analyses could lead to a definitive conclusion, this sort of analysis takes precious time and is expensive. Directors of a company in distress seldom have either time or money to spend on such analyses. In the face of a crisis, this principle would put directors of a wholly-owned subsidiary in the extraordinarily difficult position of assessing the solvency of the subsidiary and if the conclusion is that it is insolvent, refusing to do what their bosses instruct them to do.

Avoiding the need to determine whether a company is solvent or insolvent and tailoring their conduct on a conclusion that necessarily could not be definitive was what the Delaware courts thought they achieved in the line of cases that culminated in *Gheewalla*. As Vice Chancellor Strine put it, the "incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries." *Trenwick,* 906 A.2d at 174.

DI made this point in its response to the Dynegy examiner's report. The examiner criticized the board of DHI for not determining whether DHI was solvent. Yet, as DI pointed out, the examiner also did not reach a conclusion regarding whether DHI was insolvent. The examiner *assumed* that DHI was insolvent because the 60 days and over $4 million allotted to his analysis were not sufficient to analyze this question. DI asked, why then is it appropriate to second guess the board of DHI, which had even less time and was trying to manage a business in distress, when the DHI did not commission a solvency study and radically change its conduct if that study concluded that DHI was insolvent.

Fiduciary Duties *continues on p. 28*

Fiduciary Duties continued from p. 27

Determining whether a company is solvent or insolvent is inherently subjective, and can be particularly difficult when the inquiry is directed to a subsidiary since that analysis will often turn on intercompany accounts. Sorting out intercompany accounts and determining if they instead should be considered to be capital contributions is far from a simple task.

Moreover, directors of a subsidiary are generally ill equipped to tackle such difficult and academic topics. Subsidiaries seldom have counsel or financial advisors separate from their parent's. And seldom do subsidiary boards have independent directors. The Dynegy examiner was highly critical of the DHI board for relying on its parent's law firm and financial advisors and was even more critical of the law firm for allowing this to happen. In order to deal with this criticism in the mediation that followed, DHI engaged an independent manager and entrusted him with the reorganization process. He then hired separate counsel for DHI and for himself personally.

Does this mean that each subsidiary in a corporate family requires a fully functioning independent board that is equipped and sufficiently sophisticated to look out for a subsidiary's standalone interests? And does that board require independent counsel and financial advisors? If so, this development in the law will be a full employment act for independent directors and restructuring professionals. The burden on companies will be enormous.

In short, if the recent trend in these cases becomes accepted law, serving on the board of a subsidiary will be more difficult and riskier than serving on the board of a parent. That legal principle would be hard to reconcile with the reality of corporate governance of most companies, even the most conscientious.

Duties of the Parent of an Insolvent Subsidiary

Even if one concludes that directors of the subsidiaries that comprise a troubled enterprise are at the greatest risk, it would be wrong to conclude that parents and their directors are safe. Again *Dynegy* illustrates the point. The Dynegy examiner concluded that while some directors of the parent "did not even understand" that movement of assets would shield shareholders at creditors' expense, others "knew exactly what was happening." Dynegy Examiner's Report at 4. Following the transfer of assets, the parent then put the subsidiary in bankruptcy, effectively hurting the subsidiary's bondholders without affecting the parent's shareholders. *Id*. at 5. After determining that the parent board used its powers to control the subsidiary to disadvantage the subsidiary for the benefit of the parent, the Dynegy examiner concluded that the breach of fiduciary duties by the subsidiary board should be equally attributed to the parent board. Dynegy Examiner's Report at 4.

But what theory would create liability for a parent or its board as a result of a breach of fiduciary duties by the subsidiary's board? In *Trenwick*, the Chancery Court rejected any such claims and held the parent of a wholly-owned subsidiary owes the subsidiary no duty. If the parent owes no such duty to the subsidiary, certainly the members of the parent's board do not owe the subsidiary a duty of any sort. *Trenwick*, 906 A.2d at 194.

It is also conceivable that an action might be brought against the parent and its board for aiding and abetting breaches of the duties owed by the directors and officers of the subsidiary. Murray, *supra*, at 600; Tribune Examiner's Report at 390-91. At least one court has found an aiding and abetting action to be a colorable claim. *Asarco v. Amer. Mining*, 382 B.R. 49, 70 (S.D. Tex. 2002). Aiding and abetting generally requires that the defendant knowingly and actively assisted the primary breach. So in order to establish aiding and abetting liability, the plaintiff should have the burden of establishing that the parent and its board were knowing and active participants in the breaches by the subsidiaries board. *See MC Asset Recovery v. The S. Co.*, 2006 WL 5112612, at *7-8 (N.D. Ga. 2006) (applying Delaware law).

Some courts have suggested that a parent can be held liable pursuant to a line of cases dealing with a subsidiary that has minority shareholders. Delaware law generally holds that a controlling shareholder owes certain duties to minority shareholders. That duty requires that the majority not use its majority position to obtain an advantage not available to shareholders generally. Radin, *supra*, at 1122-25. Several recent cases have implied that this principle can expose a parent of an insolvent subsidiary with minority shareholders to claims for a breach of this controlling shareholder duty. *In re Teleglobe Communs. Corp*., 493 F.3d 345, 367 (3d Cir. 2007); *In re Tronox*, 450 B.R. 432, 437-39 (Bankr. S.D.N.Y. 2011). However, these cases appear to have conflated a duty that a majority shareholder owes to minority shareholders with a duty owed to the subsidiary and also have misconstrued the nature of the duty that majority shareholders owe to minority shareholders. For example, in *Hechinger*, a Federal District Court assumed that a controlling shareholder owes the same duties to a subsidiary corporation as do the subsidiary's directors and officers. *In re Hechinger Inv. Co. of Del., Inc.*, 274 B.R. 71, 89 (D. Del. 2002). The defendants asked the District Court to certify this question to the Delaware Supreme Court, but the District Court declined to do so. *In re Hechinger Inv. Co.*, 280 B.R. 90, at *12-13 (D. Del. 2002). The *Hechinger* court's assumption was probably wrong and was based on a misconstruction of the duties of a controlling shareholder. Standard Delaware law creates no duty owed *to the company* by its majority shareholders. Majority shareholders do owe minority shareholders a duty, but it is a relatively limited duty — the controlling shareholder cannot use its control position to obtain an advantage for itself that is not available to other shareholders. Although these cases are probably wrong, they are on the books and imply that a subsidiary (or someone acting on behalf of the subsidiary, such as a bankruptcy trustee or a derivative action brought on behalf of the subsidiary by the creditors of an insolvent subsidiary) can bring an action against the parent and the parent's board.

In addition, if directors of a parent board also serve on the board of a subsidiary, they may have different duties when wearing their subsidiary hat. *See Grace Bros. v. UniHolding Corp.*, 2000 WL 982401, at *13 (Del. Ch. July 12, 2000).

LIMITED LIABILITY COMPANIES ("LLCS")

Businesses are increasingly organized as LLCs, particularly when they are closely held. The law regarding duties of managers and directors[8] of LLCs is still developing, so this structure involves less certainty than a more traditional corporation. But the present state of the law generally indicates that directors and managers of an LLC are probably afforded greater protection than are directors and officers of a corporation.

LLCs are essentially entities formed by a contract among the members—often termed an operating agreement or LLC agreement. The law of most states allows the members substantial latitude to determine in that contract the form of management structure used—a "board" member-managed, etc.—and to define (or disclaim) duties among the members.

For example, Del. Gen. Corp. Law § 18-1101(c) provides that "[t]o the extent that, at law or in equity, a member, manager, or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's, manager's or other person's duties may be expanded or restricted or eliminated in the limited liability agreement; provided, that the limited liability company agreement may not eliminate the implied covenant of good faith and fair dealing." Thus, it is common for LLC agreements to disclaim any duties, other than the duty of good faith and fair dealing, or to define them specifically. Courts have generally enforced these agreements. *See Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1063 (Del. Ch. 2006) ("In the alternative entity context, where it is more likely that sophisticated parties have carefully negotiated the governing agreement, the [Delaware] General Assembly has authorized even broader exculpation [than permitted in the corporate context], to the extent of eliminating fiduciary duties altogether."); *Metro Comm'n Corp. BVI v. Advanced Mobilecomm Tech. Inc*., 854 A.2d 121, 157 (Del. Ch. 2004).

But what if the LLC Agreement is silent — *i.e.*, the LLC Agreement neither specifies that managers have any duties nor disclaims duties? Until recently, most cases have concluded that directors and managers of LLCs owe the same fiduciary duties as do directors and officers of corporations if the LLC Agreement is silent. *See, e.g., In re Mervyn's Holdings, LLC*, 426 B.R. 488, 500-01 (Bankr. D. Del. 2010) (applying California law, but noting that there are no California cases on point); *Bay Ctr. Apartments v. Emery Bay PKI, LLC*, 2009 WL 1124451, at *8-11 (Del. Ch. Apr. 20, 2009); *In re Atlas Energy Res*., 2010 Del. Ch. LEXIS 216, at *19 (Del. Ch. Oct. 28, 2010); *Kelly v. Blum*, 2010 WL 629850, at *11-12 (Del. Ch. Feb. 24, 2010); *Auriga Capital Corp. v. Gatz Props., LLC*, 40 A.3d 839, 852 (Del. Ch. Jan. 2012); *In re Global Service Group*, 316 BR 451, 459 (S.D.N.Y. 2004) (applying New York law and without analysis).

On November 7, 2012, the Delaware Supreme Court cast substantial doubt on this conclusion. *Gatz Properties, LLC v. Auriga Capital Corp*., 2012 Del. LEXIS 577, *28-37 (Del. Nov.7, 2012). The facts of the case were extreme. The manager of the LLC in question had a controlling interest in the LLC and could outvote the minority investors on essentially any matter. However, the LLC Agreement required any affiliated party transaction to be approved by a majority of these minority investors. The manager received an offer from a third party to purchase the LLC's assets. The manager of the LLC engaged in a bit of give and take with the possible buyer, but not much, because it turned out that he wanted to buy the LLC's assets for himself. The Chancery Court concluded that the manager consciously discouraged the third party bid, lied to the minority about this, and then orchestrated an auction that consciously excluded the third party prospective purchaser. The manager was the sole bidder at that auction and bought substantially all the LLC's assets. After the facts came out, the minority investors sued. The Chancery Court held that the manager breached the fiduciary duties of care and loyalty, which the Chancery Court concluded applied to the manager since they were not expressly disclaimed in the LLC Agreement. *Auriga Capital Corp. v. Gatz Properties, LLC*, 40 A.3d 839, 843-75 (Del. Ch. 2012). The Delaware Supreme Court affirmed the decision that the manager was liable, but chose a different path to come to that conclusion. The Delaware Supreme Court held that the manager had violated duties expressly incorporated into the LLC Agreement, but concluded that it could not let stand the lower court's statements that when an LLC Agreement is silent, the standard fiduciary duties of care and loyalty apply. The Delaware Supreme Court characterized the Chancery Court's statements about this default situation to have been "improvident and unnecessary" and "without any precedential value." *Gatz Props., LLC v. Auriga Capital Corp*., 2012 Del. LEXIS 577, at *29 (Del. Nov. 7, 2012). After holding that the Chancery Court should not have reached this issue, the Delaware Supreme Court observed that it was a topic about "which reasonable minds could differ." *Id*. at *31. The Court observed that the statute "begins with the phrase, '*[t]o the extent that*, at law or in equity, a member or manager or other person has duties (including fiduciary duties)" and characterized this phrasing as perhaps reflecting a choice by the legislature to be "consciously ambiguous." *Id*. at *32 (emphasis in original). The Delaware Supreme Court did not commit the sin for which it criticized the lower court — reaching a tough question that it did not need to address in order to resolve the case. But the Court left the unmistakable impression that it did not agree that there are general equitable fiduciary duties imposed on managers of LLCs when an LLC Agreement is silent. Rather, LLCs are creatures of contract. If as a matter of policy this provides insufficient protections for investors in Delaware LLCs, the legislature should address this issue. *Id*. at *33.

Before managers of LLCs conclude that *Gatz* gives them free rein to run roughshod over the interests of other stakeholders in a Delaware LLC, it is important to focus on the fact that the Delaware Supreme Court held the manager liable. Even though the Court's decision is founded on the language in the LLC Agreement, the Court adopted a quite expansive reading of that language. The LLC Agreement required that transactions with affiliates be approved by a majority of the minority investors. The Court concluded that this contractual provision was the "contractual equivalent of the entire fairness equitable standard of conduct and judicial review" despite the fact that the LLC

Fiduciary Duties continues on p. 30

8 LLC law affords substantial flexibility regarding the structure used for corporate governance. An LLC may be governed by one or more managing members, an executive committee, or a board, among other structures that can be specified in an LLC agreement. This paper uses the phraseology "members and directors" to describe generically these governance structures.

Fiduciary Duties *continued from p. 29*

Agreement never used those words. *Id*. at *15. Thus, the Court held the manager to an "entire fairness standard" which it had no difficulty in concluding that he violated. The manager clearly engaged in sharp practices, including dissuading the third party bidder from going forward, lying about that to the other investors and maneuvering the auction so that the potential bidder was not even aware of it. But unless the Court had taken a broad interpretation of the duties set forth in the LLC Agreement, it would have been hard to have held him liable, since at least some of these acts arguably involved a failure to pursue a third party transaction rather than pursuit of an affiliate transaction without the votes required by the LLC Agreement.

The LLC Agreement also exculpated the manager, with a carve-out for gross negligence, willful misconduct, or willful misrepresentations. The Delaware Supreme Court also had no problem concluding that this exculpation would not save the manager since he was guilty of egregious bad faith and had made outlandish misrepresentations. *Id*. at *25.

This last aspect of *Gatz* brings to mind that fact that Delaware LLC law does not allow for a disclaimer of the implied covenant of good faith and fair dealing. This implied covenant has traditionally been used by courts to assist in interpreting duties set forth in a contract. It is a means of interpreting that contract, and is used to supplement the provisions of the contract, rather than in writing new terms that the court might think should have been addressed, but were not, much less to create an implied duty that is at odds with the express terms of the contract. Since an LLC Agreement is a contract among the members, it probably makes sense to acknowledge that this general contract principle applies in interpreting the express terms of the agreement, and to prevent it from being disclaimed in the LLC Agreement. But the implied covenant of good faith and fair dealing arguably cannot be used to create duties that are not at least addressed in the LLC Agreement, particularly since *Gatz* suggests that courts should not infer duties not created in the LLC Agreement.

An LLC agreement is an agreement *among the members*. It is at least arguable that such an agreement cannot bind the *LLC* as an entity. So if the *LLC*—perhaps acting through a bankruptcy trustee or a creditors' trust—asserts an action against a manager of an LLC for breach of duties *to the LLC* (as opposed to duties among the members) it is unclear whether an agreement among the members in the LLC has any relevance. Some LLC agreements attempt to bind the LLC by disclaiming any duties to the LLC. Such agreements are similar to an exculpation from the duty of care, which is specifically authorized by the Delaware Corporations Code, but subject to certain limitations (*e.g*., no exculpation for bad faith or violations of the duty of loyalty). In *Mervyn's*, a claim for breach of fiduciary duty was asserted against the sole member in an LLC. The LLC Agreement disclaimed any fiduciary duties of the member to the LLC. The member filed a FRCP 12(b)(6) motion to dismiss based on this exculpatory language. The Delaware bankruptcy court denied that motion on a procedural ground, holding that such a defense was not appropriately decided in the context of a 12(b)(6) motion since it was an affirmative defense; *i.e.*, the court required the defendant to continue the litigation at least to the point where summary judgment would be appropriate. *In re Mervyn's Holdings, LLC,* 426 B.R. at 502.

While the court in *Mervyn's* ducked this issue, a strong argument can be made that disclaiming fiduciary duties to the *LLC* in the LLC Agreement should work. As noted above, Del. Gen. Corp. Law § 18-1101(c) expressly allows for disclaimers of duties to the LLC, as well as among members.

Managers of LLCs have another line of defense not available to directors and officers of a corporation. In *CML V, LLC v. Bax*, 28 A.3d 1037, 1046 (Del. 2011), the Delaware Supreme Court held that creditors of an LLC do not have standing to bring a derivative action on behalf of the LLC. The court based its conclusion on the precise wording of the Delaware statute authorizing derivative actions, which is not applicable to an LLC. As a result, creditors of an insolvent corporation have standing to bring a derivative action on behalf of the corporation, but creditors of an insolvent LLC do not. But whether this distinction makes much practical difference remains to be seen for an action against managers of an LLC brought by a bankruptcy trustee or creditors' trust on behalf of the LLC probably would not be a derivative action.[9] For instance, in *Dynegy*, the examiner concluded that the bankruptcy estate of an LLC could pursue claims owed to the LLC; these were direct claims held by the LLC, rather than derivative claims that would be barred by *CML V, LLC v. Bax*.

The foregoing cases also highlight an important point—the specifics of LLC agreements also vary and a person considering serving on the governing body or acting as a manager of an LLC should review the specific agreement with care.

Because an LLC agreement may afford greater protection for officers and directors than would a corporation, companies in distress may consider converting from a corporation to an LLC. Whether adopting such a change in corporate structure for the purpose of insulting directors and officers is itself a violation of duties owed by the companies' officers and directors was one of the questions probed in *Dynegy*.

Such a change in corporate structure can also have a major impact on a valuable asset that most distressed companies have in abundance — tax net operating losses ("NOLs"). NOLs can shelter future taxable income and sometimes are among a distressed *corporation's* most valuable assets (and often are a renewable asset). An LLC, in contrast, is a tax pass-through, so conversion from a corporation to an LLC can result in eliminating a company's ability to utilize these tax attributes. After conversion, NOLs will only benefit the people or entity that owns the LLC. In essence conversion from a corporation to an LLC might be a subtle way for a parent company or shareholders to extract value from an insolvent company (now an LLC) without declaring a dividend or overtly transferring an asset.

Dynegy involved all these issues. In phase one of its mid-2011 restructuring, DHI (the second-tier holding company that was the obligor on approximately $3.5 billion of unsecured bonds)

9 The bankruptcy trustee would be empowered to act on behalf of the LLC to bring actions held by the LLC, and a creditors' trust would be an assignee of the claims. In contrast, a derivative action is brought in the name of the entity by plaintiffs who do not normally have the ability to direct the entity but are afforded the right to sue in the entity's name if the standards for bringing a derivative action are satisfied.

converted from a corporation to an LLC. Two things flowed from this.

First, the DHI LLC operating agreement arguably had stronger exculpatory protections for its directors and officers than they enjoyed when DHI was a corporation. And given *CML V, LLC v. Bax*, conversion to an LLC meant that DHI's creditors would no longer have standing to bring a derivative action. So DHI's directors presumably felt more comfortable that they would not incur personal liability when they implemented the next steps of these transactions, including spinning off the coal business.

Second, conversion of DHI to an LLC meant that approximately $1.4B of NOLs could no longer be used by DHI, but rather would only benefit DI. This weakened DHI and benefitted DI and its shareholders.

As a result, the Dynegy examiner was charged with investigating whether the conversion of DHI to an LLC breached fiduciary duties or involved a fraudulent transfer of the NOLs.

The Dynegy examiner easily dispensed with the argument that conversion to an LLC insulated the managers of DHI. If insulation was the intent, it was not well implemented, for the exculpatory language in DHI's LLC provided that the managers would be liable for bad faith, gross negligence and willful misconduct. Gross negligence is the applicable corporate standard for the duty of care and bad faith is an element of duty of loyalty, so the duties specified in the LLC agreement were not materially different than the duties of the directors when DHI was a corporation. In addition, whether creditors of DHI could bring a derivative action was of little moment. Even if DHI creditors could not sue derivatively, DHI could sue its directors if they breached their duties. Such a claim could be brought on behalf of DHI by a bankruptcy trustee or a creditors' committee and would not be a derivative action barred by *CML V, LLC v. Bax*.

One might have thought that the examiner also would conclude that conversion to an LLC amounted to transfer of the NOLs and, therefore, was a fraudulent transfer if DHI was insolvent at the time (which the examiner assumed). Other courts have had no problem in concluding that tax elections that adversely affected a debtor's ability to use NOLs involve a transfer of the debtor's property. *See, e.g., In re Prudential Lines, Inc*., 928 F.2d 565, 575 (2d Cir. 1991). But the Dynegy examiner decided not to go there. He concluded that the decision to convert to an LLC probably did not violate any fiduciary duties because there was a tax rationale for it. This conclusion was ironic since the tax-based reason for the conversion was hardly benign.

During the mediation, it became clear that DHI's creditors wanted DI and DHI to merge. There were several reasons for bargaining for this merger, including allowing reorganized Dynegy to use these NOLs and taking advantage of some provisions in some contracts regarding a change in control. This leverage assisted DI in these negotiations and DI emerged with 1% of the equity in reorganized Dynegy and 5-year warrants for an additional 13.5% at a strike price designed to ensure that creditors would receive a 100% recovery.[10]

10 Interestingly, after this settlement was reached, trading in the shares of DI caused an ownership change for tax purposes which limited the ability to use these NOLs.

D & O INSURANCE

Most companies have D & O insurance. Policies vary, however, and some policies are not well drafted with respect to issues that arise in distressed situations.

Issues involving D& O insurance include:

- ***The amount of coverage***
- ***Whether the policy is a "claims made" or "incurrence" policy***. Most current policies are "claims made." Former directors and officers are generally covered for subsequent policy years so long as the company continues in existence and stays with the current carrier. But it will be wise for a person who leaves the company to consider providing notice to the carrier of possible claims (which generally count as "claims made") or to consider purchasing a tail.
- ***Side A vs. Side B Coverage***. Many policies provide insurance both for: (i) directors and officers ("Side A"), and (ii) the company to the extent it indemnifies the director ("Side B"). When the company is in bankruptcy, there is often an issue about whether the directors and officers may be paid by the carrier, for that would deplete the company's Side B coverage, which is property of the bankruptcy estate. Some carriers have attempted to deal with this by adjusting their policy language. For example, some policies provide that Side B coverage is subordinated to Side A. At least one court has held that this sort of subordination means that directors and officers are able to access the Side A proceeds without affecting property of the company's bankruptcy estate. *In re Downey Financial Corp*., 428 B.R. 595, 606-08 (Bankr. D. Del. 2010). The exact language of such subordination provisions is probably relevant and without reviewing that language with care one should not assume that the policy can be freely accessed by directors and officers without affecting property of the estate. Other policies are Side A only, which should provide directors and officers a stronger case still.
- ***Retention***. Most policies are structured under the assumption that the company will indemnify the directors and officers and be reimbursed by the carrier <u>after</u> satisfying a retention amount. Typically the policy also provides that if the company "cannot" indemnify the directors and officers, the directors and officers will be covered directly with no retention. Policies vary as to how this is phrased and some phrasing fits better with the likely situation in bankruptcy—technically, a company in bankruptcy will be able to pay a claim for indemnification much like other prepetition claims; probably not at 100 cents on the dollar, but does that really mean that the company "cannot" pay indemnification?
- ***Insured vs. Insured***. Policies typically provide an exception for claims made by one insured against another. In a derivative action, the company (which is an insured) technically sues a director or officer (another insured). The insured vs. insured exception is not intended to deny coverage in a derivative action brought in the company's name but initiated by outsiders, so policies are generally

Fiduciary Duties *continues on p. 32*

Fiduciary Duties *continued from p. 31*

clear that the exception does not apply in this context. In the bankruptcy context, actions can be brought in the company's name by creditors' committees, liquidating trusts, bankruptcy trustees and CROs. Cases are in conflict as to whether the exclusion applies to claims brought by such plaintiffs. Some courts have ruled that the exception does not invalidate coverage in this setting. *See, e.g.*, *Cirka v. National Union Fire Ins. Co. of Pittsburgh*, 2004 WL 1813283, at *9 (Del. Ch. 2004) (holding that the exclusion does not apply to a suit brought by a creditors' committee acting derivatively on behalf of a debtor's estate); *In re County Seat Stores Inc.*, 280 B.R. 319, 328-29 (Bankr. S.D.N.Y. 2002) (finding the exclusion inapplicable to claims brought by a chapter 11 trustee). In contrast, other courts have found that the exclusion precludes coverage for a claim by a trustee or other third party in a bankruptcy. *See, e.g.*, *Biltmore Associates LLC v. Twin City Fire Insurance Company*, 572 F.3d 663, 673-74 (9th Cir. 2009) (barring coverage for claims by a debtor in possession); *Reliance Insurance Co. v. Weis*, 148 B.R. 575, 583 (E.D. Mo. 1992), aff'd, 5 F.3d 532 (8th Cir. 1993), cert. denied, 510 U.S. 1117 (1994) (denying coverage brought by a creditors' committee). The languages of policies varies widely with regard to how well or explicitly they deal with this situation and it is wise to review the specific policy carefully.

- ***Ability to Assign the Policy or the Right to Proceeds Against the Carrier***

Historically, parties frequently attempted to realize a benefit for the estate by essentially settling with the director and/or officer by agreeing not to collect from the director or officer but instead to pursue the policy. A number of recent cases have questioned this practice, the result of which may be to make it more difficult for directors and officers to settle claims against them.

For example, in the *Interstate Bakeries* chapter 11, the bankruptcy estate settled with the directors and officers by agreeing to pursue the carrier only and those rights were assigned to a creditor trust established in the plan. *In re Interstate Bakeries Corp., et. al*, No. 04-45814-JWV (Bankr. W.D. Mo. 2004). However, the Eighth Circuit recently agreed with the carrier that there was no coverage—the policy only covered a "loss" suffered by the insured directors and officers and since they could not suffer a loss, given the terms of the agreement not to pursue them, there was no coverage. *U.S. Bank, N.A. v. Federal Ins. Co*. (*In re Interstate Bakeries*), No. 10-3472 (Dec. 13, 2011 8th Cir.).

In addition, most state insurance laws only allow a plaintiff to proceed directly against a carrier in limited circumstances. For example, the general rule under California law is that a plaintiff in an underlying case has no direct action against an insurance carrier. *See*, *e.g.*, *Royal Indemnity Co. v. United Enterprises, Inc.*, 162 Cal. App. 4th 194, 205 (Cal. App. 4th Dist. 2008). There are certain limited exceptions. For example, the California Insurance Code provides for a direct action by a "*judgment creditor*" injured in an action "*based upon bodily injury, death, or property damage*." Cal. Ins. Code § 11580 (emphasis added). Claims brought under a directors and officers insurance policy do not qualify for they are not based on bodily injury, death or property damage. *See*, *e.g.*, *GDF Int'l, S.A. v. Associated Elec. & Gas Ins. Servs. Ltd.*, 2003 WL 926790, at *3-4 (N.D. Cal. March 4, 2003) (denying coverage as a matter of law because "judgment in the underlying action was not based upon bodily injury, death, or property damage."). In addition, a plaintiff would need to have obtained a final judgment—*i.e.*, be a judgment creditor—in order to avoid the prohibition on direct actions. *See*, *e.g.*, *Fireman's Fund Ins. Co. v. City of Lodi*, 302 F.3d 928, 956 (9th Cir. 2002) (holding that Cal. Ins. C. § 11580 prevents third party claimants from suing another policy holder's insurer without a judgment in the underlying action); *Laguna Publishing Co. v. Employers Reinsurance Corp.*, 617 F. Supp. 271, 272-73 (C.D. Cal. 1985) ("under the law of California … a direct action against the insurer is not allowable until after the claimant shall have secured a final judgment against the insured").[11]

The practice of assigning rights under an insurance policy (as opposed to proceeds of a policy) is also suspect. The Ninth Circuit recently reversed confirmation of a plan in a mass-asbestos chapter 11. That plan assigned the debtors' insurance policies to a trust. The Bankruptcy Court held that the plan was neutral to the carriers and that they did not even have standing to argue that assigning the insurance policy invalidated coverage. The Ninth Circuit reversed, holding that the carriers had standing and that their appeal was not barred by equitable mootness. *In re Thorpe Insulation Co.*, 671 F.3d 1011 (9th Cir. 2012).

In addition, the Supreme Court's decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), has increased the prospects that a bankruptcy court will not be able to determine insurance issues, such as the extent of coverage.

INDEMNIFICATION FROM THE COMPANY

It is fairly common for a bankruptcy court to approve a retention agreement for a financial advisory or turnaround firm that provides for indemnification of that firm and its personnel, including a CRO. Most courts, however, insist on carving out gross negligence and willful misconduct. *In re UA Theatre Co*., 315 F.3d 217, 226-27 (3d Cir. 2003). It is less common for courts to be asked to approve indemnification for directors, but presumably even without court approval the indemnification provisions of the debtor's articles and bylaws provide this protection for directors at least to the extent that the predicate acts for which indemnification is sought occurred postpetition.

Indemnification provided by a company prepetition for prepetition acts will be substantially less valuable than an indemnification agreement for postpetition acts. But even indemnification for prepetition acts will have some value.

In analyzing this situation, it is important to distinguish between two different types of indemnification.

Indemnification for Actions Brought in the Name of the Company

First, a company can agree to indemnify the directors and officers for actions brought in the name of the company. This is also sometimes phrased as a hold harmless or exculpation agreement. Such indemnification will almost certainly carve out gross negligence and willful misconduct, but will generally provide that the company advances defense costs. Del. Gen. Corp. Law § 145(b) provides that a corporation can indemnify a "director,

11 The other exceptions under California law to the prohibition on direct actions are for medical payments to the injured party and to assignees of the insured's claims. *See*, *e.g.*, *Royal Indemnity, Inc.*, 162 Cal. App. 4th at 205-06.

officer, employee or agent" for claims brought by the corporation directly or brought derivatively on behalf of the corporation *for expenses*, subject to the requirements that the indemnitee acted in good faith and reasonably believed that the conduct in question was in (or not opposed to) the best interests of the corporation. This form of indemnification does *not* cover any amounts actually owed if the indemnitee is found liable. In addition, if the court finds the indemnitee liable on the claims, the corporation is allowed to indemnify the person for *expenses* only if the court concludes that this is fair and reasonable given "all the circumstances."

In most respects, this type of indemnification is not particularly different than exculpation from the duty of care, which is quite valuable. Indemnification is different in that it also entitles the director or officer to get attorneys' fees if a claim is brought. Assuming that the claim is based on prepetition acts, this claim for attorneys' fees and costs will likely be a prepetition claim; arguably this claim will entitle the director and officer to a right of set off at least to the extent that the director or officer acted in good faith, based on a reasonable belief that his or her action was in the best interests of the company, and the court concludes that providing this indemnification is fair and reasonable notwithstanding that the director or officer was ultimately found liable.

Indemnification for Claims Brought by Third Parties

Second, indemnification agreements are designed to protect the indemnitee against non-derivative claims asserted by third parties. Delaware law allows a company to indemnify an officer, director, employee or agent for such third-party claims (not just expenses) so long as the indemnitee acted in good faith and reasonably believed that the acts were in (or not opposed to) the best interests of the corporation. Del. Gen. Corp. Law § 145(a).

Such an indemnification agreement that is not approved by the Bankruptcy Court is likely to be of limited benefit to an officer or director of a bankrupt company for two reasons. First, the plaintiff is likely also to bring the claim against the debtor. Bankruptcy Code § 502(e)(1)(B) disallows such indemnification claims where the debtor is also liable to the third party and the indemnitee has not paid the third party; otherwise, the estate would face duplicate claims. Second, the party seeking indemnification can be put to the untenable task of proving that it will be held liable to the plaintiff. *In re Baldwin–United Corp.,* 43 B.R. 443, 445–62 (S.D. Ohio 1984) illustrates both problems.

OTHER POTENTIAL SOURCES OF LIABILITY FOR DIRECTORS AND OFFICERS

Officers and directors of a trouble company might incur personal liability based on certain specific statutes. They include:

- ***Employee withholding taxes***. Management personnel responsible for payroll and payroll deductions can have personal liability if these funds are not properly withheld. The IRS and most state taxing authorities also take the position that these are "trust fund taxes" and they are usually able to ensure that they receive the relevant funds.
- ***Minimum wages and overtime under the Fair Labor Standards Act ("FLSA")***. There is case authority holding that officers and directors can be personally liable for the failure to pay minimum wages or overtime if the officer or director has economic control or exercises control over the nature and structure of the employment relationship. This liability is asserted somewhat rarely and has generally been applied when the officer and director is also a significant equity holder, but that is not technically required. *Boucher v. Shaw*, 572 F.3d 1087, 1088-89 (9th Cir. 2009). There are usually a multitude of reasons why paying employee wages is a high priority in distressed situations, including this potential liability.
- ***Other Trust Fund Assets***. Obviously, officers of a company should ensure that appropriate procedures are in place to segregate ERISA accounts and other assets that are not the company's. Otherwise, it is possible that the responsible person could be liable for conversion.
- ***Special Statutes***. Particularly when a client is in a regulated industry, care should be taken to understand and comply with any special statutes or regulations applicable to officers. The client presumably will understand these rules, but it would be wise for a director of officer to understand them before taking on such an engagement.

CONCLUSION

Over the last several years, restructurings have spawned more litigation than in prior cycles. The law presently is in flux, particularly with respect to directors and officers of subsidiaries and members and directors of LLCS. Of course, directors and officers of troubled companies are well advised to consult with knowledgeable counsel about these issues and to seek the assistance of financial advisors experienced in restructurings. There is little radical in those conclusions; however, recent cases and reports issued by court-appointed examiners highlight that one area may be undergoing radical change—what is expected of directors of subsidiaries. Traditionally, boards of wholly-owned subsidiaries have received little attention, either in litigation or in how they function. If the current trend holds, that sort of passive approach will not pass muster. The result could be a sea change in how boards of subsidiaries operate. Unfortunately, even if a subsidiary upgrades its board in terms of composition, time spent on the board and quality and quantity of professional advice, subsidiary directors may be told that what they should do depends almost entirely on whether the subsidiary is solvent or insolvent. If this is where the law settles, it will be unfortunate for directors and officers of subsidiaries will be required to act based on a determination that is at best an art; and an art that depends on a host of unknowns and the ability to predict the future. ■

Mr. Logan *is a partner in O'Melveny & Myers LLP. This paper is intended to describe generally certain legal issues. It is not legal advice. Nor should the positions in this paper be attributed to O'Melveny & Myers LLP or any of its clients.*

Lindsay Lau, *an associate at O'Melveny & Myers LLP, was a major contributor to this paper. The author is grateful for her untiring assistance and patience.*

NEW AIRA MEMBERS

Helen Bai
Pension Benefit Guaranty Corporation
Washington, DC

Richard Behrens
Alvarez & Marsal
Los Angeles, CA

Andrew Boone
Grant Thornton LLP
New York, NY

Kailey Crum
Crowe Horwath LLP
Sherman Oaks, CA

Jon Curton
Pension Benefit Guaranty Corporation
Washington, DC

Stacy Dasaro
New York Law School
Oakdale, NY

Karen Denu
Pension Benefit Guaranty Corporation
Washington, DC

Mary Dewhurst
ARPC
Washington, DC

Tracy Dobbins
Pension Benefit Guaranty Corporation
Washington, DC

Nicole Ferenzy
Deloitte
Arlington, VA

Beata Gruszecka
Pension Benefit Guaranty Corporation
Washington, DC

Dan Hamman
QHR Intensive Resources
Nashville, TN

Chris Hebard
Deloitte
Dallas, TX

Scott Herz
Austin, TX

Steven Hilfer
Navigant Capital Advisors LLC
New York, NY

Taylor Jones
Pension Benefit Guaranty Corporation
Washington, DC

Vikram Kapoor
Navigant Capital Advisors LLC
New York, NY

Teresa Kohl
SSG Capital Advisors, LLC
New York, NY

Brian Lantier
AlixPartners LLP
Darien, CT

Peter Lechowick
Alvarez & Marsal
San Francisco, CA

Alicia Leonhard
Office of the U.S. Trustee
Brooklyn, NY

Andre Long
Pension Benefit Guaranty Corporation
Washington, DC

Andrew Masini
CohnReznick LLP
Edison, NJ

Emil Mathew
Thomas & Peterson LLC
Dix Hills, NY

Gregory McDonough
Blackburn Management LLC
Washington, DC

Joseph McKay
Grant Thornton LLP
New York, NY

Nicole Mignone
US Bankruptcy Court EDNY
Brooklyn, NY

Toneisia Montgomery-Chase
Pension Benefit Guaranty Corporation
Washington, DC

Barry Mukamal
Marcum LLP
Miami, FL

Ryan O'Neill
Grant Thornton LLP
Chicago, IL

Thomas Plumb
Cordes & Company
Minneapolis, MN

Ross Prossner, Jr.
Conway MacKenzie
New York, NY

Timothy Raab
ARPC
Washington, DC

Rachel Reis
Deloitte FAS
Arlington, VA

Timothy Rhodes
Pension Benefit Guaranty Corporation
Washington, DC

Bruce Richman
CohnReznick
Buffalo Grove, IL

Steven Roopenian
Crowe Horwath LLP
Sherman Oaks, CA

Armando Saavedra
Pension Benefit Guaranty Corporation
Washington, DC

Aseer Samuel
Pension Benefit Guaranty Corporation
Washington, DC

Amy Shockley
Deloitte Financial Advisory Services LLP
Arlington, VA

Steven Shore
Pension Benefit Guaranty Corporation
Washington, DC

Jon Silverberg
LiquiTec
Schaumburg, IL

Olorundo Simmons
Llancelot Investment Group
Barbados, W.I.

Jeffrey Smith
Webb & Smith, PLLC
Aberdeen, NCW

Robert Spigner
AlixPartners LLP
Chicago, IL

Elaine Tseng
ASm Capital
Woodbury, NY

Neal Tuli
MBIA
Armonk, NY

Craig Unterseher
Deloitte Financial Advisory Services LLP
Arlington, VA

Thomas Weber
McKinsey & Company
New Canaan, CT

Thomas White
Pension Benefit Guaranty Corporation
Washington, DC

James Whittenburg
Austin, TX

Randy Williams
Thompson & Knight LLP
Houston, TX

Todd Yuba
Pension Benefit Guaranty Corporation
Washington, DC

CLUB 10

Firms with 10 or more professionals who have received CIRA certification or have passed all three examinations:

FTI Consulting, Inc.	**89**
Alvarez & Marsal North America, LLC	**69**
AlixPartners, LLP	**67**
Deloitte./Deloitte CRG	**44**
KPMG LLP	**31**
Huron Consulting Group LLC	**29**
Mesirow Financial Consulting LLC	**25**
Capstone Advisory Group LLC	**24**
Navigant Capital Advisors LLC	**23**
Ernst & Young LLP	**22**
Grant Thornton LLP	**18**
Conway MacKenzie, Inc.	**17**
Protiviti Inc	**17**
Zolfo Cooper	**16**
Loughlin Management Partners + Company	**14**
BDO Consulting LLP	**14**
PricewaterhouseCoopers LLP (PwC)	**13**
CBIZ	**12**
CohnReznick LLP	**11**
Office of the U.S. Trustee	**10**

NEW CIRAS

Adi Berger
Pension Benefit Guaranty Corp
Washington, DC

Chris Brown
Navigant Capital Advisors LLC
Evanston, IL

Garrit Dahl
Berkeley Research Group, LLC
Salt Lake City, UT

Patrick Diercks
Clear Thinking Group
Parrish, FL

Quincy Evans
Forest Hills, NY

Sean Farrell
Development Specialists Inc
Chicago, IL

Matthew Flynn
Verdolino & Lowey PC
Foxborough, MA

Debra Foister
Schaffner, Knight, Minnaugh Co PC
Erie, PA

Kurt Herwald
Chandelle Advisors
Greer, SC

Marshall Huffman
AlixPartners, LLP
Dallas, TX

Eric Jenkins
Cordes & Company
Wilmette, IL

Stuart Kaufman
Alvarez & Marsal North America, LLC
Highland Park, IL

Young Kim
AlixPartners, LLP
San Francisco, CA

Don Levy
Duff & Phelps
New York, NY

Thomas McInerney
Lantern Asset Management
Dallas, TX

Patrick Nguyen
BDO USA, LLP
New York, NY

Jeremy Peterson
RPA Advisors, LLC
Paramus, NJ

Michael Scannella
Huron Consulting Group
New York, NY

Scott Schneider
Deloitte CRG
New York, NY

Matthew Smith
Protiviti Inc
Richmond, VA

Carin Sorvik
GlassRatner Advisory & Capital Group LLC
Miami, FL

Richard Surett
Ports America
Bridgewater, NJ

Mark Werling
Burr Pilger + Mayer, LLP
San Francisco, CA

Martin Young
Loughlin Management Partners + Company
New York, NY

NEW CDBVS

John Baumgartner
Charles River Associates
Houston, TX

Robert Cronin
Ostrow Reisin Berk & Abrams, Ltd.
Chicago, IL

Andrew Frisvold
Protiviti Inc
Baltimore, MD

Raoul Nowitz
Navigant Capital Advisors LLC
Atlanta, GA

AIRA Association of Insolvency & Restructuring Advisors

221 Stewart Avenue, Suite 207
Medford, OR 97501
Phone: 541-858-1665
Fax: 541-858-9187
aira@aira.org
www.aira.org

CIRA
CDBV

AIRA Officers and Board of Directors