# CORPORATE GOVERNANCE ISSUES FOR THE FINANCIALLY TROUBLED COMPANY

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## I. INTRODUCTION

Bankruptcy in the United States is a matter of federal law. Corporate governance matters, however, generally are controlled by state law. Although federal laws preempt conflicting state laws, in most cases federal and state laws are interpreted and applied to eliminate conflicts so that no preemption occurs.

Bankruptcy is an excellent example of federal and state coordination. The federal bankruptcy statute governs the bankruptcy process with respect to debtors and creditors in the federal bankruptcy courts. The applicable state corporation statute governs the bankrupt corporation's internal corporate affairs. The discussion that follows reviews certain basic principles of corporate governance, including the duties owed by directors and officers to the creditors of financially troubled and bankrupt corporations, with particular attention on transactions involving a change of corporate control. This outline generally does not differentiate between the duties and liabilities of officers and directors, but rather considers them as a group for purposes of corporate governance issues. Because of the popularity of Delaware as a state of incorporation, with the result that a large percentage of both public and private corporations are incorporated in Delaware, and because Delaware has the most well-developed case law concerning corporations, Delaware corporation law is used as the primary state law reference.

The following discussion also concerns issues that may arise in connection with the insolvency of limited liability companies and limited liability partnerships. In addition, it addresses certain ethical issues that may confront attorneys advising insolvent and bankrupt entities. Finally, it focuses on the Sarbanes-Oxley Act of 2002, which has given rise to interpretive questions and issues relevant to corporate and bankruptcy practitioners.

## II. SCOPE OF FIDUCIARY DUTIES

### A. The Solvent Corporation

The Delaware General Corporation Law (the "DGCL") provides that unless otherwise provided in the DGCL or the certificate of incorporation, the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." DGCL § 141(a). The specific parameters of the relationship between a corporation and its officers and directors, however, traditionally has been established by common law rather than by statute. This relationship primarily is defined in terms of fiduciary duties. Common law liability may result for officers and directors if they breach their fiduciary duties, which are owed directly to the corporation in their capacities as officers and directors, and indirectly to the stockholders through the corporation. These indirect duties often are enforced through stockholder derivative suits initiated by stockholders on behalf of the corporation.

#### 1. Definition of a Fiduciary

A "fiduciary" is a person who stands in a special relation of trust. Fiduciary duty was described by Justice Cardozo as follows:

> Many forms of conduct permissible in a workaday world for those acting at arms' length, are forbidden to those bound by fiduciary ties. A trustee is held to

> something stricter than the morals of the market place. Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions . . . only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

*Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928); see also *Lawrence v. Cohn*, 197 F. Supp. 2d 16, 33 (S.D.N.Y. 2002).

2. Types of Fiduciary Duties

The boards of directors of Delaware corporations, in carrying out their managerial duties, are charged with an unyielding fiduciary duty to the corporation and its stockholders. *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 925 (Del. 2003)*; Smith v. Van Gorkom*, 488 A.2d 858, 872-73 (Del. 1985); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939);. These duties include (i) a duty to exercise an informed business judgment, *i.e.* the duty of care; and (ii) a duty of loyalty to the corporation and its stockholders. *See Van Gorkom*, 488 A.2d at 872-73.

To discharge the duty of care, directors traditionally have been required to use the degree of care that business people of ordinary prudence use in managing their own affairs, sometimes called informed business judgment. *See Van Gorkom*, 488 A.2d at 872-73; *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180 (Del. 1986). *See also In re Toy King Distributors, Inc.*, 256 B.R. 1 (Bankr. M.D. Fla. 2000), a lengthy and thorough opinion that addresses many fiduciary issues that confront insolvent entities. In *Toy King*, insider officers and directors authorized borrowings from the corporate parent at excessive interest rates and charges, which the court held to constitute a violation of the duty of care. *Id.* at 169.

The duty of loyalty prohibits corporate officers and directors from using their position of trust and confidence to further their private interests. *Guth*, 5 A.2d at 510. The duty of loyalty is a very broad and encompassing duty. It includes both an affirmative obligation to protect the interest of the corporation and an obligation to refrain from conduct that would injure the corporation and its stockholders or would deprive them of profit or advantage. Consequently, directors of a solvent corporation may breach the duty of loyalty by taking into account the interest of parties other than the stockholders and the company. For example, in *Revlon*, the directors of the company were held to have breached their fiduciary duty of loyalty to stockholders by agreeing to various "lock-up" and "no-shop" provisions in return for a transaction which was intended to protect the value of outstanding public notes. The court noted that the bondholders had threatened to sue the directors as a result of the diminished value of the bonds. However, the court stated that the board's fiduciary duty was owed to the corporation and not the bondholders. As will be discussed *infra*, under certain circumstances it is both proper and necessary to consider the interests of non-stockholder constituencies. However, in the absence of such special circumstances, the board of directors is constrained by the duty of loyalty from considering interests adverse to the corporation and the stockholders. *Revlon*, 506 A.2d at 182-83. *See also Toy King*, 256 B.R. at

170, in which two directors were held to have violated the duty of loyalty by acquiring a significant creditor's claims without advance disclosure to the court or the committee of unsecured creditors.

In the bankruptcy context, most reported cases in which a court has found that a breach of fiduciary duty to creditors has taken place involve diversion or disposition of assets from an insolvent entity for the benefit of insiders or shareholders. This is the type of behavior that fraudulent transfer, preference, and illegal dividend statutes are intended to prohibit. The fiduciary concept may extend the reach of personal liability for such behavior and may impose personal liability on directors for fraudulent transfers by a corporate entity. *See, e.g., Official Committee of Asbestos Claimants of G-1 Holding, Inc. v. Heyman*, 277 B.R. 20, 37 (S.D.N.Y 2002) (distribution to shareholders constituted not only fraudulent transfer but also breach of fiduciary duty to creditors by debtor's chairman, CEO, and controlling shareholder); *Hechinger Investment Co. of Delaware v. Fleet Finance Group*, 274 B.R. 71, 89-91 (D. Del. 2002) (even where payments to debtor's shareholders in connection with a leveraged buyout are insulated from avoidance as settlement payments under section 546(e) of the Bankruptcy Code, directors may still be personally liable for transfer amounts based on breach of fiduciary duty to creditors). Directors, officers, and, in most jurisdictions, all those who aid, abet, or conspire may be personally liable for breach of fiduciary duty to creditors. *See, e.g., In re Healthco International, Inc.*, 208 B.R. 228, 309 (Bankr. D. Mass 1997) (recognizing an action under Delaware law for aiding and abetting a breach of fiduciary duty).

3. Business Judgment Rule

The business judgment rule is a judicial expression of the reluctance by courts to interfere in the internal affairs of a corporation and substitute their judgment for that of the officers and directors. Despite mistakes of business judgment that damage corporate interests, as long as the officers and directors act in good faith and without any corrupt motive, they should avoid liability. In Delaware, courts examine a board's decisions only to the extent necessary to verify the presence of the business judgment rule's elements and only indirectly as a standard of conduct for corporate management. *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

If the business judgment rule applies, there is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. *See generally Brehm v. Eisner* 746 A.2d 244 (Del. 2000).

> A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment.

*Sinclair Oil Corporation v. Levien*, 280 A.2d 717, 720 (Del. 1971).

Under the business judgment rule, directors are presumed to have acted properly and in good faith, and are called to account for their actions only when they are shown to have engaged in self-dealing or fraud, or have acted in bad faith. *See Revlon*, 506 A.2d at 180. The burden of proof is placed upon the party challenging a board action or decision and, in order to overcome the presumption of the rule, the challenger must produce affirmative evidence that the board's decision was unreasonable, in bad faith, or not in the best interest of the corporation. The business judgment rule presupposes that a challenged corporate decision is made by disinterested corporate directors. Although the party challenging a corporate decision has the burden of proving that one or more directors were personally interested in the transaction, if such a showing can be made, the burden shifts to the directors to prove that the transaction was fair and reasonable to the corporation. *Geddes v. Anaconda Copper Mining Co.,* 254 U.S. 590, 599 (1921). *See also Green v. Fund Asset Management,* 245 F.3d 214, 227 (3d. Cir. 2001).

Delaware courts have generally discussed the following elements as being necessary for invoking the protections of the business judgment rule: (i) a business decision, (ii) disinterestedness, (iii) due care, (iv) good faith and (v) no abuse of discretion. *Van Gorkom*, 488 A.2d at 872; *see also* D. Block, N. Barton, S. Radin, *The Business Judgment Rule*, 12-22 (1988).

B. The Insolvent Corporation, Pre-Bankruptcy

1. Duty to Creditors

Normally, the duties of directors to creditors are contractual rather than fiduciary in nature. *See Revlon*, 506 A.2d at 182. The customary relationship between the company, its directors and its debtholders was stated in the case of *Katz v. Oak Industries, Inc.*, 508 A.2d 873 (Del. Ch. 1986) as follows:

> This case does not involve the measurement of corporate or directorial conduct against that high standard of fidelity required of fiduciaries when they act with respect to the interests of the beneficiaries of their trust. Under our law -- and the law generally -- the relationship between a corporation and the holders of its debt securities, even convertible debt securities, is contractual in nature . . . (citations omitted) [a]rrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented. The rights and obligations of the various parties are or should be spelled out in that documentation. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders.

*Id*. at 879.

However, at the moment a corporation becomes insolvent, the insolvency, rather than the actual institution of statutory proceedings (i.e., bankruptcy), creates fiduciary duties for directors for the benefit of creditors. *Geyer v. Ingersoll Publications Company*, 621 A.2d 784, 787 (Del. Ch. 1992). *See also Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp.,* 805 A.2d 221 (Del. Ch. 2002); *In re Safety International, Inc.,* 775 F.2d 660 (5th Cir. 1985) (creditors may challenge the breach [of fiduciary duties] if the transaction is made to defraud creditors or while the corporation is insolvent).

While most jurisdictions have acknowledged the finding of insolvency of the corporation as altering the general fiduciary duties owed to creditors, certain jurisdictions define pre-bankruptcy insolvency differently. For example, under Delaware law, insolvency means insolvency in fact rather than insolvency due to a statutory filing. *Geyer*, 621 A.2d at 787. The court in *Geyer* defined insolvency of a corporation occurring at the time in which the value of its assets has sunk below the amount of its debts. *Id.* at 788. The *Geyer* court also cited Webster's Ninth New Collegiate Dictionary 626 (1988), which provides that an entity is insolvent "when it is unable to pay its debts as they fall due in the usual course of business," but interpreted this definition to be the equivalent of an entity's becoming insolvent "when it has liabilities in excess of a reasonable market value of assets held." *Id*. at 789.

In insolvency, the directors' duties are to multiple constituencies. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Civ. 12150, 1991 Del. Ch. LEXIS 215 (Dec. 30, 1991). In *Credit Lyonnais*, Chancellor Allen noted that in insolvency the duty runs not directly to the creditors but to the "community of interest." Therefore, it appears that the duty does not necessarily place creditor interests ahead of the interests of stockholders, but requires the board to maximize the corporation's long-term wealth creating capacity. *Id*. In footnote 55, Chancellor Allen addressed the problem of directors' duties in insolvency by posing a complex numerical hypothetical. *Id*.

In some states (e.g., Texas), a finding of fiduciary duties being owed to creditors is not triggered until pre-bankruptcy insolvency is coupled with the cessation of business by the insolvent corporation. *See Tigrett v. Pointer*, 580 S.W.2d 375 (Tex. Civ. App. -- Dallas 1978, writ ref'd n.r.e.) (the [insolvency] test is whether the corporation's assets are insufficient for the payment of its debts and that it has ceased to do business or has taken, or is in the act of taking, a step which will practically incapacitate it for conducting the corporate enterprise with a reasonable prospect for success). *See also Askanase v. Fatjo*, 130 F.3d 657, 671 (5th Cir. 1997) (to pursue a successful trust fund claim, one must prove that a corporation is both insolvent and has ceased to do business at the time of the challenged transaction).

2. Denuding and Trust Fund Doctrines

An officer, director or dominant stockholder who uses his position to withdraw substantially all of the assets from the corporation without leaving sufficient resources for payment of the corporation's debts, can be held personally liable to the corporation's creditors for the payment of their claims under the corporate denuding theory. This doctrine was stated by the United States Supreme Court as follows:

> The law which sends a corporation into the world with the capacity to act imposes upon its assets liability for its acts. The corporation cannot disable itself from responding by distributing its property among its stockholders and leaving remediless those having valid claims. In such a case the claims after being reduced to judgments may be satisfied out of the assets in the hands of the stockholders.

*Pierce v. United States*, 255 U.S. 398, 402 (1921).

Under Delaware law, no specific denuding cause of action exists. However, Delaware courts have recognized that, when a corporation distributes its assets to its stockholders leaving unsatisfied creditors, the distributees take the assets impressed with a lien in favor of the unpaid creditors. *See John Julian Const. Co. v.*

*Monarch Builders, Inc.*, 306 A.2d 29, 35 (Del. Sup. 1973), *aff'd*, 324 A.2d 208 (Del. 1974); *Williams v. Don Yerkes Fine Cars, Inc.*, (slip opinion, C.A. No. 4777) (Del. Ch. 1977) ("[W]hen a transferee acquires the assets of a corporation without making provision for the payment of its debts, it constitutes a fraud upon creditors as well and renders the transferee liable to the extent of the value of the assets received as to which the creditor was formerly entitled to for satisfaction.")

The corporate trust fund doctrine, like denuding, was developed to protect creditors of an insolvent and dissolving corporation from being defrauded by unscrupulous officers, directors and stockholders and to provide an incentive for compliance with the statutory precepts involving the dissolution of corporations. The corporate trust fund doctrine was announced in 1824 in *Wood v. Drummer*, 30 F. Cas. 435. The trust fund doctrine was described in greater detail by the United States Supreme Court in *Hollins v. Brierfield Co. & Iron Co.*, 150 U.S. 371 (1893):

> When a court of equity does take into its possession the assets of an insolvent corporation, it will administer them, on the theory that they, in equity, belong to the creditors and stockholders, rather than to the corporation itself. In other words, -- and that is the idea which underlines all these expressions in reference to "trust" in connection with the property of a corporation, -- the corporation is an entity, distinct from its stockholders as from its creditors. Solvent, it holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien; free, also, from the touch of a stockholder who, though equitably interested in, has no legal right to, the property. Becoming insolvent, the equitable interest of the stockholders in the property, together with their conditional liability to the creditors, place the property in a condition of trust, first for the creditors, and then for the stockholders. Whatever of trust there is arises from the peculiar and diverse equitable rights of the stockholders as against the corporation in its property, and their conditional liability to its creditors. It is rather a trust in the administration of the assets after possession by a court of equity, than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder.

*Id*. at 383.

The Fifth Circuit considered both the corporate trust fund doctrine and denuding in the case of *In re Mortgage America Corp.*, 714 F.2d 1266 (5th Cir. 1983). In this case, the Fifth Circuit held that the trust fund and denuding doctrines state essentially the same theory. Each involves the imposition of personal liability upon the "trustees," that is, upon those who use their power of control for their personal benefit rather than for that of the corporation. *Id*. at 1272. *See also In the Matter of Schimmelpenninck*, 183 F.3d 347 (5th Cir. 1999).

C. <u>During Bankruptcy</u>

1. <u>Shift in Duties</u>

Bankruptcy unquestionably alters in the nature of a corporation's duties towards its creditors.

> While normally . . . fiduciary obligations [are] enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation -- creditors as well as stockholders.

*Pepper v. Litton*, 308 U.S. 295, 307 (1939).

Upon the filing of a bankruptcy petition by or against a corporation, fiduciary duties are owed to creditors since the assets of that corporation must be managed for the primary benefit of its creditors, not its stockholders. *Pepper*, 308 U.S. at 295. *See also Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355 (1985) (bankruptcy causes fundamental changes in the nature of corporate relationships; interests of stockholders become subordinated to the interests of creditors.); *Heyman v. M. L. Marketing Co.*, 116 F.3d 91, 96 (4th Cir. 1997).

In *Pepper*, the Supreme Court defined the fiduciary obligations of officers, directors, and dominant stockholders to stockholders and creditors as follows:

> Their powers are powers in trust. . . . Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. . . . The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arms' length bargain. If it does not, equity will set it aside.

*Pepper*, 308 U.S. at 306-7.

In *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001), the court recognized a cause of action for "deepening insolvency," a tort similar to breach of fiduciary duty. The court observed that expansion of corporate debt out of all proportion to ability to pay, and the consequent prolongation of corporate life, constitutes a tortious injury to the corporate entity and not merely an injury to creditors for which a bankruptcy trustee could not sue. The harm includes forcing an entity into bankruptcy and interfering with customers and operations.

2. Duties of the Debtor In Possession

In Chapter 11 cases, the debtor ordinarily remains in possession of the estate and operates the business. *See* 11 U.S.C. § 1108. Trustees are seldom appointed although the bankruptcy court has such authority. *See* "Appointment of a Trustee or Examiner," *infra*.

Except where a trustee has been appointed, the term "debtor in possession" refers to the debtor. *See* 11 U.S.C. § 1101(1). This means that in the case of a corporate debtor, the debtor in possession (the "DIP") is the corporation, not the officers or directors. However, for limited purposes under the Bankruptcy Rules, the bankruptcy court has the authority to order that the term "debtor" will include one or more of the officers or directors of the corporation. Rule 9001(5). Such designation permits the bankruptcy court to require officers and directors to perform certain acts under the Bankruptcy Rules, but does not make the officers and directors the DIP.

A DIP has sometimes been considered as a separate entity from the pre-petition debtor. *See In re Chapel Gate Apartments, Ltd.*, 64 B.R. 569, 576 (Bankr. N.D. Tex. 1986). At other times the debtor and DIP have been regarded as the same entity. *See NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 528 (1984) (viewing the DIP "as the same entity which existed before the filing of the bankruptcy petition" but vested with certain powers and obligations by Bankruptcy Code).

The DIP is required to "perform all the functions and duties...of a trustee," 11 U.S.C. § 1107(a), and functions essentially in the role of a trustee.

Bankruptcy courts have previously viewed a trustee's standard as analogous to the standard imposed by the business judgment rule. *See In re Curlew Valley Associates*, 14 B.R. 506 (Bankr. D. Utah 1981) (court will not entertain objections to trustee's conduct of estate where conduct involves business judgment made in good faith, upon a reasonable basis, and within scope of his authority under Code). In a footnote, the *Curlew Valley* court stated:

> An analogy may be drawn to suits by shareholders against directors who, like trustees, in the exercise of business judgment, make decisions of policy for corporations: "Corporate management is vested in the board of directors. If in the course of management, directors arrive at a decision, within the corporation's powers (intra vires) and their authority, for which there is a reasonable basis, and they act in good faith, as the result of their independent discretion and judgment, and uninfluenced by any consideration other than what they honestly believe to be the best interests of the corporation, a court will not interfere with internal management and substitute its judgment for that of the directors to enjoin or set aside the
> transaction or to surcharge the directors for any resulting loss." H. Henn, *Law of Corporations* 482 (2d ed. 1970).

*Curlew Valley*, 14 B.R. at 514, n.12.

A DIP owes a fiduciary duty to its creditors similar to the duty a corporate fiduciary owes the corporation. In *Fulton State Bank v. Schipper (In re Schipper)*, 933 F.2d 513 (7th Cir. 1991), the duty was analyzed in the context of a DIP selling assets pursuant to § 363 of the Bankruptcy Code. A prospective purchaser made a pre-petition offer to purchase the debtor's land for $45,830. However, the deal fell through and shortly thereafter, the debtor filed a Chapter 11 petition. As the DIP, the debtor sold the land to his parents for the price of $7,791. An appraisal ordered by the bank had valued the property at this amount. After this transaction, the party reappeared and offered to purchase the property from the debtor's parents for the same price of $45,830. *Id*. at

514. A creditor who learned of the sale brought an adversary proceeding alleging that the debtor had breached his fiduciary duty by not informing the creditors of the earlier offer when the land was sold. *Id*. at 515.

The bankruptcy court ruled that the debtor had not breached his fiduciary duty to the creditors by not informing them of the unconsummated, pre-bankruptcy negotiations. The district court affirmed. On appeal, the Seventh Circuit stated that the issue on appeal was the nature of the fiduciary duty the DIP owed to his creditors. The bankruptcy court recognized and discussed the DIP's general fiduciary duty and the specific requirements of § 363, and applied them to the debtor's sale of property to his parents. The bankruptcy court held that the DIP did not breach his fiduciary duty under either standard. *Id*. at 515. In analyzing the general fiduciary duty to creditors, the bankruptcy court reviewed this by analogy to the duties of a corporate fiduciary under state law and found that the DIP had some business reasons for making the sale (the price was based on an independent appraisal) and that the transaction met the general standard of inherent fairness because the sale was made in good faith and met all the earmarks of an arms' length transaction.

In appealing the decision, plaintiff suggested that the debtor should be held to the higher standard of duty of a trustee under common law. The Seventh Circuit held that the corporate fiduciary standard was appropriate, stating that the protections afforded creditors under that standard "are sufficient without engrafting as well the duties of care and loyalty reserved by the common law for trustees." *Id*. at 516. A finding that the common law trustee standards of duty applied rather than the more traditional corporate law fiduciary duties would result in a more rigorous standard for evaluating the discharge of a DIP's actions.

The United States Supreme Court has also indicated that the DIP also owes a fiduciary duty to stockholders. *Weintraub*, 471 U.S. at 355. The implications of this fiduciary duty are unclear since the DIP at the same time owes a fiduciary duty to creditors, and the interest of creditors and stockholders generally conflict. Consequently, it is difficult to define exactly how the DIP can properly act as a fiduciary for both the stockholders and the creditors.

## III. <u>LIABILITY IN CONNECTION WITH HIGHLY LEVERAGED TRANSACTIONS</u>

Many financially troubled and bankrupt companies were involved in highly leveraged transactions, commonly referred to during the boom period of the 1980s as leveraged buyouts ("LBOs"). Because of the large numbers of failed LBOs and their significant influence on corporate governance matters, certain key aspects of these transactions are discussed below.

LBOs refer to a purchase of a company using debts secured by the company's assets. Although LBOs take many forms, some of which are extremely complicated, the end result is generally the same: the target ends up pledging all of its assets as collateral for loans whose proceeds go to the selling stockholders and not to the target. Often, the only change in the target is that it suddenly has to service large amounts of new secured debt. The relative position of the company's unsecured creditors is worsened as a result of the LBO because there are few, if any, unencumbered assets to which they can look for payment if the business fails.

When a company's business fails after an LBO, causes of action may need to be asserted on behalf of the debtor. This may create the potential for a conflict of interest on the part of the DIP since this might require initiating a suit against the debtor's stockholders and its officers and directors.

A. Fraudulent Conveyances

An LBO may be challenged as a fraudulent transfer under state fraudulent conveyance laws or under § 548 of the Bankruptcy Code. § 544(b) of the Bankruptcy Code gives the bankruptcy trustee and the DIP the state law avoidance rights of the debtor's actual creditors. Most state laws are modeled after either the Uniform Fraudulent Conveyance Act ("UFCA") or the Uniform Fraudulent Transfer Act ("UFTA"). Each of these statutes provides for the avoidance of both intentionally fraudulent conveyances and constructively fraudulent conveyances.

Generally, the Bankruptcy Code, the UFCA and the UFTA provide that a transfer is avoidable if it is either (i) actually fraudulent - that is undertaken with actual intent to hinder, delay or defraud either present or future creditors, or (ii) "constructively" fraudulent. A conveyance is "constructively" fraudulent where (i) the conveyance was made for less than "reasonably equivalent value" or "fair consideration" and (ii) the transferor: (a) was insolvent or rendered insolvent thereby, (b) intended to incur or believed it would incur debts beyond the transferor's ability to pay as they matured, or (c) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the transferor was unreasonably small capital. The terms "transfer and conveyance" include the granting of liens as well as the payment of money.

Although public policy arguments have been made to the contrary, *see, e.g.*, Baird and Jackson, *Fraudulent Conveyance Law in Its Proper Domain*, 38 Vand. L. Rev. 829 (1985), the majority of courts which have considered the issue have found fraudulent conveyance laws, including the provisions regarding constructively fraudulent conveyances, applicable to leveraged buyouts. *See, e.g. Mellon Bank, N.A. v. Metro Communications, Inc.* (*In re Metro Communications, Inc.*) 945 F.2d 635 (3d Cir. 1991); *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D. Ill. 1988) (hereinafter "*Wieboldt*").

For example, while the *Wieboldt* court recognized that the application of fraudulent conveyance laws to LBOs could have the effect of insuring creditors against a corporation's subsequent insolvency and failure, it found no reason to exempt the transaction as a whole from fraudulent conveyance statutes. The court noted, as have other courts, that it is the domain of the legislature, not the courts, to narrow the statute. *Wieboldt*, 94 B.R. at 500 (citing *In re Anderson Industries, Inc.*, 55 B.R. 922 (Bankr. W.D. Mich. 1985)).

However, some courts have been reluctant to find liability when only constructive fraud was involved. For example, in *Kupetz v. Wolf*, 845 F.2d 842 (9th Cir. 1988), the Ninth Circuit refused to apply fraudulent transfer laws to force the selling stockholders to give back the money they received as a result of an LBO where (i) there was no evidence that the selling stockholders intended to defraud the company's creditors; (ii) the stockholders did not know that the purchaser was using an LBO to finance the purchase; (iii) no pre-LBO creditors existed; and (iv) the transactions had the indicia of a straight sale, not an LBO. *Kupetz v. Wolf*, 845 F.2d at 847-48. The court stated:

> [W]e hesitate to utilize constructive intent to frustrate the purposes intended to be served by what appears to us to be a legitimate LBO. Nor do we think it appropriate to utilize constructive intent to brand most, if not all, LBOs as illegitimate. We cannot believe that virtually all LBOs are designed to "hinder, delay, or defraud creditors."

*Id.* at 848. Despite the clear application of the constructive fraud provisions of the UFCA to creditors whose claims arise after the transaction in question, the Ninth Circuit stated that it would not allow subsequent creditors to attack an LBO as a fraudulent transfer.

The trend in the cases seems to be that fraudulent conveyance law will be applied to LBOs even if only constructive fraud is involved. *See In re Hechinger Investment Co. of Delaware,* 274 B.R. 71, 82 (D. Del. 2002)*; Crowthers McCall Pattern*, 129 B.R. 992 (S.D.N.Y. 1991); *Bay Plastics, Inc. v. BT Commercial Corp.* (*In re Bay Plastics, Inc.*), 187 B.R. 315 (Bankr. C.D. Cal. 1995); *Kendall v. Soriani* (*In re Richmond Produce Co.*), 151 B.R. 1012 (Bankr. N.D. Cal. 1993), *aff'd*, 195 B.R. 455 (N.D. Cal. 1996); *Murphy v. Meritor Savings Bank (In re O'Day Corp.),* 126 B.R. 370 (Bankr. D. Mass. 1991).

## B. Illegal Dividends

Depending on the structure of an LBO, liability may result for the payment of illegal dividends. This is most likely to arise in a recapitalization plan where shares of capital stock are repurchased or when dividends are paid to the holders of the capital stock. *See* Report of Examiner Sandra E. Mayerson In the Matter of Interco Incorporated, *et al.* (hereinafter "*Interco Examiner's Report*").

The DGCL contains certain restrictions with respect to the declaring and paying of dividends. Section l70(a) of the DGCL provides that the directors of a Delaware corporation may declare dividends out of the corporation's surplus or, if there is no surplus, out of the corporation's net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.

Section 173 of the DGCL prohibits the declaration and payments of dividends except in accordance with the DGCL. The liability of directors for an unlawful payment of dividends or an unlawful stock purchase or redemption is provided for under § 174. Under DGCL § 174, in the case of willful or negligent violation of § 173, the directors are jointly and severally liable at any time within six years after paying such unlawful dividend or after such unlawful stock purchase, to the corporation, and to its creditors, for the full amount of the dividend with interest thereon.

A safe harbor is provided under § 172 which provides that a member of the board of directors shall be fully protected in relying in good faith upon the records of the corporation and upon information, opinions, reports or statements presented to the corporation by any of its officers or employees, or committees of the board of directors, or by any other person as to matters the director reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

In a leveraged transaction, the issue may arise as to what constitutes a dividend, share repurchase or distribution. *See In re C-T of Virginia, Inc.*, 958 F.2d 606 (4th Cir. 1992). In *C-T of Virginia*, the court determined that a leveraged acquisition of C-T, structured in the form of a cash-out merger and consummated at arm's length, did not involve a "distribution" to stockholders under the Virginia Stock Corporation Act, Va. Code Ann. § 13.1-601, *et seq*. The merger in question in *C-T of Virginia* was a reverse triangular merger whereby stockholders of pre-merger C-T were to receive cash for their shares upon consummation of the merger with HH Acquisition, Inc., an independent corporation. The funds to acquire such shares were obtained by the parent company of HH Acquisition primarily from bank loans secured by C-T's assets. *Id*. at 608. The pre-merger directors of C-T were not involved in obtaining the financing. The payments to stockholders for their stock occurred after the change in control and were paid by post-merger C-T. Post-merger C-T struggled along for 18 months before filing for bankruptcy. *Id*. The official committee of unsecured creditors filed suit against the pre-merger directors and officers alleging breach of fiduciary duties and that the directors had approved an illegal distribution. *Id*. The court concluded that the pre-merger C-T stockholders were no longer post-merger C-T stockholders since their ownership interest had been lawfully canceled as of the effective time of the merger and, therefore, the payments did not constitute a "distribution." *Id* at 610.

Dividends paid while a company is insolvent can result in a finding of constructive fraud under the fraudulent conveyance statutes. In the case of *In re Dondi Financial Corp.*, 119 B.R. 106 (Bankr. N.D. Tex. 1990), the bankruptcy court held that, without any proof of actual intent to defraud, dividends paid while a corporation was insolvent amounted to constructive fraud pursuant to the state fraudulent conveyance statute in Texas. *See* Tex. Bus. & Com. Code Ann. Sec. 24.005 (2002) and Bankruptcy Code § 544(b).

Illegal dividends have rarely been challenged as fraudulent conveyances, probably because state corporate law permits the payment of dividends by corporations only from specified funds. *See* DGCL § 170 (dividends may be paid only from surplus or, if there is no surplus, from net profits from that fiscal year and/or the preceding fiscal year). As a result, a corporation generally will not declare dividends unless it meets the capital or profit guidelines, particularly those corporations whose financial statements are independently audited, unless actual fraud is involved. Furthermore, since directors are personally liable for illegal dividends, boards generally exercise caution to ensure that all dividend payments are proper. For example, DGCL § 174 provides that directors are jointly and severally liable to the corporation and its creditors any time within six years after paying unlawful dividends. Directors who understand their potential liability are understandably reluctant to vote in favor of any dividends which may be questionable.

### C. Breach of Fiduciary Duties

As previously discussed, officers and directors owe fiduciary duties of care and loyalty in the performance of their duties to the corporation and its stockholders. While the business judgment rule often insulates the board of directors from liabilities stemming from the discharge of their fiduciary duties, board of directors actions which are of a self-dealing nature or motivated to entrench incumbent management will not be entitled to the protection of the business judgment rule. In the event an LBO transaction is deemed to have self-dealing motives on the part of the board of directors, certain members of the board of directors may be susceptible to liability for a breach of the duty of loyalty. *See*, *Interco Examiner's Report* at 390-432. The more stringent test of intrinsic or entire fairness to the corporation and its stockholders must be met if the board is found to be interested in the transaction. *See Weinberger*, 457 A.2d at 710; *MacMillan*, 559 A.2d at 1280 (directors must demonstrate utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all stockholders generally).

Failure to satisfy the intrinsic fairness standard results in a breach of the duty of loyalty. *AC Acquisitions Corp.*, 519 A.2d at 114-15. A breach in the duty of loyalty does not permit a corporation to exculpate directors from liability pursuant to § 102(b)(7) of the DGCL.

Section 141(e) of the DGCL provides the following safe harbor:

> A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Delaware case law clearly states, however, that reliance on § 141(e) is not an absolute defense. This is true with respect to inside directors who might have access to more inside information than outside board of directors members. *See Interco Examiner's Report* at 396. Inside directors may not rely in good faith on professionals' advice when they are aware of contrary facts unknown to the advisors and, as a result, they cannot claim the safe harbor of § 141(e) of the DGCL. *Id.* at 405.

The *Wieboldt* case held that a breach of duty claim under Illinois law could be brought by the target's creditors against the target's directors who approved an LBO which allegedly harmed creditors. *See also, Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (recognizing a duty of directors under some circumstances to consider interest of all "constituencies," including creditors, in analyzing merit of offer to purchase corporation).

## IV. RESPONSIBILITIES REGARDING CHANGE OF CONTROL

### A. The Solvent Corporation

#### 1. Business Judgment Rule in the Change of Control Context

The business judgment rule (see discussion *supra*) has been applied to protect boards for decisions made in the change of control context. In this context, however, the business judgment rule's protection has been partially eroded by judicial decisions. There are several reasons for this trend. First, the change of control of a company is an overwhelmingly important event for a business, and may, therefore, inherently deserve closer judicial scrutiny than less significant business transactions. Second, although courts have decided that status as a director, by itself, should not constitute a sufficient self-interest to disqualify a director from claiming the protection of the business judgment rule, the courts nevertheless analyze change of control with a heightened skepticism, scrutinizing the decision's basis for signs of entrenchment or for signs of undue favoritism for management's recommended course of action. Consequently, boards must be cognizant of their "enhanced duties" in this area.

As previously noted, in 1985 the Delaware Supreme Court held in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) that the directors of Trans Union Corporation were not entitled to the business judgment rule protection because that board's decision to approve a cash out merger was not the product of an informed business judgment. The *Van Gorkom* case is not significant for its precedential value since the opinion did not establish new legal standards (the business judgment rule consistently has been interpreted to require an affirmative showing that directors have discharged their duty of due care). Instead, *Van Gorkom* is significant because it emphasized that a board will be held to a higher standard of care in making decisions regarding a change of control of a company.

A general analysis of a board's obligations in the change of control context begins with the principles discussed above. However, a different standard controls where a board adopts defensive measures to contest a change of control.

The Delaware Supreme Court set forth the business judgment rule standard to be applied in scrutinizing the legality of defensive measures undertaken in response to a hostile bid for corporate control in its decision in 1985 in *Unocal Corp. v. Mesa Petroleum Corp.*, 493 A.2d 946 (Del. 1985). The court stated in *Unocal* that a hostile battle for corporate control involves an inherent conflict between the board's interest in preserving its own position and its obligation to act in the best interests of the stockholders. As a result of this perceived conflict, the court concluded that there exists an "enhanced duty" that calls for judicial examination at the threshold before the protection of the business judgment rule is conferred on decisions to take defensive actions. *Id*. at 954-55. Directors can satisfy this burden by showing that (i) they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and (ii) the specific defensive measures adopted were reasonable in relation to the threat posed.

The "enhanced duty" of *Unocal* effectively mandates that a board thoroughly analyze a change of control situation and its effect on the corporate enterprise. Specific examples of appropriate inquiries that have been cited by the courts include:

(i) adequacy of the price offered;

(ii) the nature and timing of the offer;

(iii) questions of illegality;

(iv) the impact on constituencies other than stockholders (*i.e.*, creditors, customers and employees);

(v) the risk of non-consummation; and

(vi) the quality of securities being offered in an exchange.

A board acting within the ambit of the business judgment rule arguably faces no liability for rejecting an undesirable offer, or even an offer containing a substantial premium over the then-prevailing market price. In addition, the target arguably has no duty to negotiate directly with an offeror. The board may generally pursue a long-term profit maximizing mode rather than attempting to maximize the immediate value of a corporation. *See Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990). *But see QVC Network, Inc. v. Paramount Communications Inc.*, 637 A.2d 34 (Del. 1994).

A board generally seeks investment banking advice in a change of control situation with respect to the fairness and adequacy of the transaction. The investment banker's fairness report customarily will consist of a range of values of the target company that might be received, based upon various assumptions and methodologies of valuation (such as an analysis of transactions involving the acquisition of comparable companies, a discounted cash flow analysis, a recapitalization analysis, and a break-up or liquidation analysis, among others). The concept of adequacy relates to whether the board could obtain a higher price in an arms-length transaction engaged in without the pressure of time, such as by an auction or in a recapitalization, if it chooses so to do.

After receiving an opinion from the investment banker on fairness and adequacy, the board's use of such opinions in determining whether to accept or reject a transaction is also subject to the due care analysis. Directors' reliance on the advice of investment bankers retained by them is strong evidence that the directors satisfied part of the due care component of the business judgment rule. However, reliance does not represent an absolute defense to a claim of breach of the duty of due care because directors have some oversight obligations to become reasonably familiar with an opinion, report or other source of advice before relying on it. *See, e.g., Mills Acquisition v. MacMillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989). The board should question their financial advisors' conclusory opinion that the price offered is within the range of fair value.

As a general rule, a board has no affirmative duty to sell the company or to negotiate when the company is not otherwise deemed to be for sale. However, once a board of directors resolves to sell the company or determines that the sale of the company has become "inevitable," the board's duty is to maximize the company's "value" for the stockholders. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In *Revlon*, the Delaware Supreme Court began referring to directors' duties once a decision to sell the company had been made in terms of "auctions." The court held that the directors' duties changed significantly once a sale of the company became the goal. These duties changed from the preservation of the company as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.

The primary consideration with respect to this "duty to auction" is the determination of when the duty applies. The *Revlon* duties apparently could be assumed involuntarily, without the express subjective intention of so doing. Later decisions, including *Paramount Communications v. Time Inc.*, 571 A.2d 1140, however, have narrowly construed the triggering of the *Revlon* duties. *Revlon* duties have been held to arise only in the context of a change of control where the dissolution or break-up of the corporation is inevitable. The definition of "inevitable," however, is unclear. The following actions have been found not to constitute an inevitable sale:

(i) engaging in preliminary negotiations with one party concerning the potential sale of the company. *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio 1987), *aff'd*, 815 F.2d 76 (6th Cir. 1987), (applying Delaware law);

(ii) declaring a dividend to facilitate open market purchases by a 26% stockholder to increase its ownership to 49.7%, together with a ten year standstill agreement that limited such stockholder to 49.9% of the stock and a maximum of 40% of the board. *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987);

(iii) cashing out minority stockholders in a merger with the parent. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840 (Del. 1987).

(iv) a merger agreement that substantially reduced the likelihood of a future change of control transaction. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140.

The Delaware courts addressed *Revlon* duties in *QVC Network, Inc. v. Paramount Communications Inc.*, 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994). The courts concluded that because the Paramount board of directors committed to a transaction that would shift majority voting control from Paramount's public stockholders to a takeover bidder, the transaction was a change of control and conferred *Revlon* duties on the board. Paramount had argued that the transaction was a strategic alliance permitted under *Paramount Communications v. Time Inc.,* 571 A.2d 1140 (Del. 1990).

B. During Bankruptcy

1. Similar Approach

When a corporation is in bankruptcy, it is inevitable that major changes will occur in the company. Generally, the same standards imposed by state corporate law to judge the actions of the board of directors of a solvent corporation will govern the debtor during bankruptcy.

Courts have applied the corporate law principles discussed above to those managing a corporation in bankruptcy, including the protection afforded by the state corporate law concept of the business judgment rule. For example, in *In re 995 Fifth Ave. Assoc., L.P.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989), the court specifically observed that principles applicable to auctions in the "takeover" context have vitality by analogy in the Chapter 11 context. *Id*. at 28 n.4. In that case, the bankruptcy court applied the business judgment rule to authorize payment of a break-up fee to the unsuccessful bidder employed by the debtor to promote the sale of its assets. *See also In re O'Brien Environmental Energy, Inc.,* 181 F.3d 527 (3d Cir. 1999); *In re Tama Beef Packing, Inc.*, 290 B.R. 90 (8th Cir. B.A.P. 2003); *In re Bidermann Industries U.S.A., Inc.*, 203 B.R. 547 (Bankr. S.D.N.Y. 1997); *In re Integrated Resources, Inc.*, 147 B.R. 650, 658 (S.D.N.Y. 1992). *But see In re S.N.A. Nut Co.*, 186 B.R. 98, 104-05 (Bankr. N.D. Ill. 1995); *In re America West Airlines, Inc.*, 166 B.R. 908 (Bankr. D. Ariz. 1994) (standard for determining whether approve break-up fee is not business judgment rule, but whether transaction will further diverse interests of debtor, creditors and equity holders alike).

Courts have also applied the *Revlon* standard to transactions proposed by corporations in bankruptcy. The application of Revlon duties in the bankruptcy context is still dependent on the finding that the corporation is "for sale."

In *City Capital Associates L.P. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988), the Delaware Chancery Court rejected the claim that a recapitalization plan -- which involved the sale of assets representing one-half the company's sales, massive borrowings, and an extraordinary one-time dividend -- in effect constituted a break-up and sale of the company, thus requiring adherence to *Revlon* duties. The court stated that *Revlon* did not require the board to implement an auction as an alternative, if it had arrived at a good faith, informed determination that a recapitalization or other form of transaction was more beneficial to stockholders. *Id*. at 803.

In *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987), the Delaware Supreme Court held that *Revlon* was inapplicable to a corporate restructuring that involved a one-time cash dividend combined with a third party's "street sweep" to increase its holdings to 49% of Newmont's shares. Noting that "Newmont was never for sale," the court found that no change of control had occurred by virtue of the corporate actions, in large part due to a standstill agreement with the third party that ensured continued public control.

In *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988), the Delaware Federal District Court found that *Revlon* duties were triggered by a restructuring plan. The court held that *Revlon* encompassed a decision to sell "control" of the company and that the American Standard plan achieved that result by increasing the shares owned by management and various employee plans from 4.8% and 2.6%, respectively, to 23.9% and 30.6%, respectively.

A restructuring/recapitalization may constitute a *Revlon* event if it is the "functional equivalent" of a change of control. Based upon the above decisions, this appears to be a very fact-specific issue. However, if *Revlon* duties are triggered during a reorganization, the debtor might breach its fiduciary duties by not conducting an "auction" of the corporation to maximize the return to stockholders/creditors.

The structure of the Chapter 11 process has, in part, however, shielded management of the debtor corporation from *Revlon* duties that would ordinarily apply. The debtor corporation has been protected from the application of *Revlon* during what is known as the "exclusivity period." Section 1121(b) of the Bankruptcy Code states that "except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter." Extensions of the exclusivity period are common, while reductions of this 120 period are granted seldom and only "for cause". The exclusivity period allows the debtor the opportunity to negotiate and propose a plan of reorganization without interference from creditors and third parties. The conflict of the exclusivity period and the debtor's *Revlon* duties arises when, during this period, the debtor proposes a sale or change of control of the corporation. Third parties who may seek to enter a competing bid for the debtor corporation are prevented from doing so during the exclusivity period. Therefore, no "auction" of the corporation occurs to maximize return for stockholders and creditors.

Some commentators argue that if circumstances arise during the exclusivity period that would otherwise give rise to Revlon duties, the exclusivity period should be terminated at that point to allow the debtor corporation to be auctioned for the benefit of the creditors and shareholders. In their article, *The Revlon Duty as Cause to Terminate Exclusivity: A New Strategy for Effecting Corporate Change in Chapter 11*, 4 J. of Bankr. L. & Prac. 621 (Sept./Oct. 1995), Robert A. Klyman and Michael S. Lurey support this position and cite *In re Petroleum Recycling Corp*., Case no. LA 93-19446 SB, a case in which the court held that *Revlon* duties compelled termination of the exclusivity period. The outcome of the termination of exclusivity and the resulting auction process was an increased return to the general unsecured creditors amounting to four times what was proposed by the debtor-in-possession prior to termination of the exclusivity period. This result supports the basic concept that general corporate law, including *Revlon* duties, should apply equally to the debtor-in-possession.

### 2. Trading Claims

The trading of claims of debtors has increased significantly given the large numbers of corporate bankruptcies and the proliferation of failed LBOs. While trading claims generally occurs outside the scope of corporate governance matters, claims purchasers attempting to gain control over a debtor and its plan of reorganization may find themselves embroiled in fiduciary duty issues as a result of their actions. The following discussion will review issues that have been raised concerning the purchase of claims in order to gain control of the debtor and how courts have imposed certain restrictions on this change of control method.

In the case of *In re Allegheny Int'l., Inc.*, 118 B.R. 282 (Bankr. W.D. Pa. 1990), the court held that a creditor with superior knowledge of the debtor may be a fiduciary or an insider and therefore subject to the court's control. The court made this finding strictly on the view that possession of inside information makes an entity an insider and fiduciary in a Chapter 11 case. This was found even though the party involved, Japonica Partners, was not an officer, director, general partner or affiliate of any of the debtors, and did not have actual control or legal decision making power. The court noted that "Japonica sought and received inside information as a proponent of a plan. This court finds as a matter of fact that Japonica is an insider and a fiduciary for [the] purpose of this reorganization." *Id*. at 299.

This concept of a fiduciary relationship arising from the possession of confidential information seems to be inconsistent with the notion of fiduciary duties imposed upon corporate officers and directors to manage the assets and affairs of the corporation for the benefit of the corporation's stockholders. A proponent attempting to purchase the debtor's assets is motivated to pay the lowest price possible, whereas the creditors want to receive the highest price. Similarly, a creditor's plan may attempt to eliminate stockholders' interests, while a stockholders' plan limits the recovery of creditors. Nothing in this process should give rise to a fiduciary obligation that does not already exist. However, given the bankruptcy court's view that plan proponents involved in trading claims in a Chapter 11 case might find themselves imposed with a fiduciary duty, the particular facts of the *Allegheny* case are discussed below.

The opinion in *Allegheny* addresses (i) the debtor's motion to confirm its plan, and the objections of various parties to confirmation, (ii) the debtor's motion under § 1126(e) to disqualify votes of claims and interests of Japonica Partners and others acting in concert with Japonica, (iii) Japonica's similar motion under § 1126(e) to disqualify votes of claims and interest not solicited in good faith, (iv) the motion of the Official Equity Security Committee of Allegheny to disqualify all votes on the debtor's stock plan under § 1126(e), and (v) the complaint of the banks for equitable relief and to restrain Japonica and its affiliates.

On December 29, 1989, the debtor filed its plan of reorganization. The court conducted several days of hearings on the disclosure statement in January 1990. The court approved the debtor's disclosure statement on February 5, 1990.

However, on January 24, 1990, near the conclusion of the hearings on the debtor's disclosure statement, Japonica filed its plan of reorganization (the "Japonica plan") and disclosure statement which mirrored and utilized in large part the debtor's material and organization. The court was urged by Japonica not to approve the debtor's disclosure statement until Japonica's disclosure statement could be approved and a joint ballot distributed. Japonica requested an extraordinary reduction in the time the rules provided for confirmation. The court set separate schedules for confirmation of the plans and promised Japonica an opportunity for creditors to vote on the Japonica plan before any order of confirmation would be issued.

The Japonica plan offered cash equivalents to $6.42 per share with holdbacks, as compared to the debtor's proposed stock plan which offered $7.00 per share. Under the Japonica plan, Japonica would acquire control of the debtor. Although Japonica had indicated its interest in acquiring control of the debtor as early as July 1989, Japonica held no interest as a creditor or equity holder of the debtor until immediately prior to the filing of its proposed plan and disclosure statement. To qualify as a party in interest authorized to file a plan, Japonica purchased public subordinated debentures of the debtor with a face value of $10,000 for $2,712. At that time, the court was unaware that the purchase of claims would be the tactic used by Japonica to gain control.

On February 23, 1990, Japonica began purchasing claims of the secured bank lenders, Class 2.AI.2. This occurred after the debtor's disclosure statement was approved and the debtor's plan balloting had commenced. This was also after Japonica had proposed a plan and disclosure statement and had become a proponent of a plan. These claims were purchased between February 23 and March 26, 1990, at prices varying between 80% and 95% of the face amount of the claims. Most were purchased for between 80% and 85% of their face amounts, except that the claim which gave Japonica a "blocking position" in the class was bought for 95% of its face amount.

On or about March 26, 1990, Japonica purchased the claim of Continental Bank, N.A. with a face amount of $12,614,800, for $11,984,060, or 95% of the face amount. Following the purchase of the claim of Continental, Japonica held 33.87% of the claims in Class 2.AI.2, enabling Japonica to block an affirmative vote by that class on the debtor's plan of reorganization. After achieving its blocking position, Japonica purchased the claim of Bank of Hawaii, with a face amount of $2,242,630, for $1,838,956.60, or 82% of the face amount. Under the terms of the assignments by the aforementioned banks, Japonica caused the votes of the claims it purchased to be voted against the debtor's plan.

In addition to purchasing the claims for cash, Japonica agreed to indemnify the assigning banks for all expenses and liability arising from certain lawsuits against the members of Class 2.AI.2. At least some of the assigning banks would not sell their claims unless Japonica agreed to assume such liability. The most notable of the lawsuits was an adversary action in which the Official Committee of Unsecured Creditors of Allegheny International, Inc. (the "Creditors' Committee") sued the secured bank lenders under theories of preference, fraudulent conveyance, equitable subordination, and lender liability.

Japonica also purchased claims from senior unsecured creditors in Class 4.AI.2. Japonica purchased the claims of Swiss Volksbank and certain other holders of Swiss Franc notes, with a face amount of $21,793,590 for $14,383,769.40 or 66% of the face amount. Japonica caused the votes of these claims to be voted against the debtor's plan. Although Japonica purchased less than 1/3 of the claims in Class 4.AI.2, its negative votes were sufficient to defeat the debtor's plan in that class because of the large number of claims in Class 4.AI.2 that did not vote. Swiss Volksbank was a member of the Creditors' Committee and the Creditors' Committee had recommended a favorable vote on the debtor's plan. The Creditors' Committee, on behalf of all the unsecured creditors, was a plaintiff in the bank litigation. Unsecured creditors, such as the holders of the Swiss Franc notes, had interests adverse to the interests of the secured bank lenders and would have benefited from a favorable result in the litigation. Therefore, Japonica purchased claims that constituted a blocking position in two classes whose interests were diametrically opposed in the bank litigation.

The court granted the debtor's motion to disqualify Japonica's votes against the debtor's plan under § 1126(e), which requires good faith in connection with a plan. The court stated that in the instant case, Japonica's interest was to take over and control the debtor. The court felt that § 1126(e) and its predecessor were intended to enable the court to disqualify the votes of parties who engage in such conduct.

The court further stated that Japonica's actions with respect to the purchase of the claims were in bad faith. *Id*. at 289. Notwithstanding Japonica's allegedly longstanding interest in the debtor, Japonica filed its plan of reorganization at the eleventh hour. Japonica did not purchase significant claims until the voting period on the debtor's plan. Japonica was also at this time a proponent of a plan. Japonica purchased a clear blocking position in Class 2.AI.2., the secured bank lenders. Because that class was the most senior class, a negative vote in that class made confirmation extremely difficult, if not impossible. Japonica paid approximately 80% of the face amount of the first five claims in Class 2.AI.2. As Japonica approached ownership of 33% in amount of this class, it paid 85% of the face amount for the next claim, that of First National Bank of Boston. It then purchased the claim of Continental Bank <u>for 95% of the face amount</u>. Thereafter, Japonica purchased one more bank claim, but paid only 82% of the face amount. If Japonica purchased bank claims solely for economic purposes, it would not have paid 95% of the face amount and then return to an 82% purchase. Instead, it purchased almost exactly the amount required to block the plan of reorganization. *Id*. at 290. The court discerned from these facts that Japonica's purpose was control and was in bad faith.

Similarly, Japonica purchased only enough claims in Class 4.AI.2. to block an affirmative vote by that class. That class followed Class 2.AI.2. in priority. Thus, Japonica purchased a blocking position in the two highest classes that were impaired, ensuring that the debtor could not confirm its plan of reorganization. Again, the court noted that the two classes in which Japonica purchased claims had directly opposite interests with respect to the bank litigation. Therefore, the court was hard pressed to characterize Japonica's actions as merely furthering its own economic interests. Japonica and the debtor were proponents of competing plans of reorganization. Japonica's stated purpose was to take over the debtor. To do so, it was necessary for Japonica to block confirmation of the debtor's plan of reorganization. Thus, the court concluded that Japonica's actions were for an ulterior motive.

The court reasoned that under Chapter 11, creditors and interest holders vote for or against a plan of reorganization, after adequate disclosure, if such vote is in their best economic interests. If, as in the instant case, an outsider to the process can purchase a blocking position, those creditors and interest holders are disenfranchised. If competing plans of reorganization are pending, the court must consider the preferences of the creditors and interest holders. If a plan proponent, such as Japonica, can purchase a blocking position, the votes of the other creditors and interest holders are rendered meaningless. Moreover, Japonica, who chose to become a creditor, should not have veto control over the reorganization process. The court stated that such a result was not intended by Congress. *Id*.

A purchaser of claims in a Chapter 11 bankruptcy may be seeking to acquire control of the vote on the debtor's proposed plan of reorganization. It has not been firmly settled, however, that such a purchaser may control the vote of a class without acquiring all the claims in that class. Under the Bankruptcy Code, the affirmative vote of creditor's holding at least two-thirds in amount and more than one-half in number of the allowed claims in the class are required for the class to accept the plan. A purchaser who acquires claims aggregating more than the required two-thirds amount, but representing fewer than all the allowed claims may fail to control the class in the event that the purchaser cannot vote each acquired claim separately.

In the Chapter 11 bankruptcy of *Carter Hawley Hale, Inc.,* a party sought to obtain control of the debtor by purchasing claim in the bankruptcy. The acquiror addressed the "number and amount" test by conditioning its tender offer for claims on the bankruptcy court's entering an order declaring that each claim purchased by the acquiror was a separate claim with respect to the number of votes to be cast by the holder thereof. The bankruptcy court in fact entered such an order. At least one court has refused a similar request. *See* Fortgang & Mayer, *Trading Claims in Chapter 11*, 6 Collier Bankruptcy Practice Guide 94-1, 94-110.

Another interesting development in the context of restricting claims trading to effect a change of control occurred in the *Pan American Corporation* bankruptcy. In this proceeding, the bankruptcy court approved an order enjoining the transfer of all unsecured claims and certain publicly traded bonds and debentures in order to protect the debtor's net operating loss carryforward.

Prior to the 1991 amendment of Rule 3001(e) of the Federal Rules of Bankruptcy Procedure, courts established special procedures for determining whether a creditor's agreement to sell its claim would be honored. Typically, one of the primary concerns for courts related to the assignment of claims in a bankruptcy case was to ensure that the purchaser fully advised and did not take unfair advantage of the selling creditor. *See In re Odd Lot Trading, Inc.*, 115 B.R. 97 (Bankr. N.D. Ohio 1990); *In re Allegheny Int'l, Inc.*, 100 B.R. 241, 242 (Bankr. W.D. Pa. 1988); *In re Revere Copper and Brass, Inc.*, 58 B.R. 1, 2-3 (Bankr. S.D.N.Y. 1985). Further, courts focused on whether the purchaser paid adequate consideration for the claim. To avoid a purchaser's fraud and unfair dealing with a trade debt creditor, courts required the purchaser to fully advise the trade debt creditor the status of the bankruptcy case, including such information as whether or not a plan of reorganization has been filed and the potential estimated recovery for such trade debt claims in the case.

Although, as noted above, claims trading has occasionally been employed abusively, the current version of Rule 3001(e) largely rejects the parental role previously taken by the courts. Rather, the Advisory Committee note to Rule 3001(e) makes clear that the rule is intended to limit the court's responsibility to adjudicating disputes raised by the parties themselves. The rule also omits any requirement that the parties disclose the terms of the transfer, and permits only the seller to raise any objections. By restricting the courts involvement in the trading of claims, potential buyers have a greater incentive to pursue the purchase of claims in bankruptcy cases.

Under the amended Rule 3001(e), creditors may split their claims among more than one buyer. The ability to split claims may be beneficial to claims traders. For example, a buyer may be interested in purchasing the undisputed portion of a partially disputed claim. In addition, a creditor with very large claim may have difficulty finding a single buyer for its claim, but the creditor may be able to find several buyers to purchase part if its claim.

Although claim splitting may be beneficial to the traders in claims, there are several concerns applicable to claim splitting. For example, claim splitting clearly may affect the number of claim holders voting on a plan, which could impact whether a class of claims accepts or rejects the plan. *See* 11 U.S.C. § 1126(c). Further, claim splitting could become an administrative nightmare in a case.

Finally, even though a claim in the hands of a buyer is supposed to be no different that a claim in the hands of a seller, debtors (and courts) continue to find ways to question that basic principle. *See* Chaim J. Fortgang and Thomas M. Mayer, *Developments in Trading Claims: Participations and Disputed Claims,* 15 Cardozo L. Rev. 733, 759 (1993) and cases discussed therein. See also *In re Figter Limited*, 118 F.3d 635 (9th Cir. 1997) (creditor was entitled to vote separately each of unsecured claims purchased).

## V. INDEMNIFICATION IN BANKRUPTCY

Most states have statutes that generally provide for the indemnification of officers for actions taken in the lawful discharge of their duties.

When a corporation becomes a debtor under the Bankruptcy Code, the obligation of the corporation to indemnify its officers and directors becomes subject to many considerations. These considerations include whether the directors and officers are creditors of the corporation by reason of their right to indemnification and, if so, the priority of their claim. The answer to these questions often turns on whether the conduct that gave rise to the right to indemnification occurred before or after the bankruptcy petition was filed.

### A. Right to Indemnification

A director or officer's right to indemnification has been held to constitute a "claim" within the meaning of § 101 of the Bankruptcy Code, even if that right has not yet matured because the director or officer's liability has not yet been adjudicated. *See, e.g., In re Amfesco Indus. Inc.*, 81 B.R. 777 (Bankr. E.D.N.Y. 1988). In the *Amfesco* case, directors sought to have the debtor reimburse them for costs to be incurred in threatened litigation. The court held that the unmatured contingent right to indemnification was an assertable claim. The court reasoned that a claim existed since the acts for which litigation was threatened had already taken place. The claim, however, was not entitled to administrative expense priority because it was not an actual, necessary cost and expense of preserving the estate under § 503(b)(1)(A) since it was not shown that such acts were beneficial to the estate. Moreover, the court reasoned that post-petition legal fees necessary to defend the allegations asserted against the officers and directors did not amount to legal fees incurred in defense of the debtor.

In the case of *In re M. Frenville Co., Inc.*, 744 F.2d 332 (3d Cir. 1984), *cert. denied*, 469 U.S. 1160 (1985), which involved a claim by accountants for indemnification against the debtor corporation, the Third Circuit held that a right to indemnification that was based on pre-petition acts of the debtor but that (under applicable state law) did not mature until after the bankruptcy was filed was not a "claim" that arose pre-petition, and therefore was not subject to the automatic stay. It is important to note, however, that this claim for indemnification was not made pursuant to any indemnity agreement. *See Id.* at 336-37. Also, the *Frenville* decision has been distinguished by the Third Circuit and rejected by other courts. *See, e.g., In re Remington Rand Corp.*, 836 F.2d 825 (3d Cir. 1988); *In re Piper Aircraft Corp.*, 162 B.R. 619 (Bankr. S.D. Fla. 1994), *aff'd*, 168 B.R. 434 (S.D. Fla. 1994), *aff'd*, 58 F.3d 1573 (11th Cir. 1995).

Further, if the indemnification claim remains contingent as of the time the bankruptcy court examines the allowability of such claim, *i.e.*, the underlying liability of the individual has not yet been determined, the indemnification claim is subject to disallowance under section 502(e)(1)(B). *See, e.g., Sorenson v. Drexel*

*Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 146 B.R. 92, 94-97 (S.D.N.Y. 1992) (disallowing contingent indemnification claim of former officer).

B. Consequences of Pre-Petition or Post-Petition Status of Claim

The determination whether a claim for indemnification is a pre-petition or post-petition claim can affect the indemnified party's chance for recovery. If a claim for indemnification is a pre-petition claim, the indemnified party will usually be treated as a general unsecured creditor. The possibility of recovery therefore will depend on whether there are sufficient unencumbered assets to pay the unsecured creditors in full.

Post-petition claims are generally entitled to priority as an administrative expense under § 503(b)(1)(A) if it can be shown that such claims are actual, necessary costs and expenses of preserving the estate. *See, e.g., In re Consolidated Oil & Gas, Inc.*, 110 B.R. 535 (Bankr. D. Colo. 1990) (administrative priority denied for expenses of former officers related to post-petition litigation where no showing officers performed services for debtor post-petition).

Claims for indemnification by former officers and directors of a debtor corporation most likely will be treated as pre-petition claims since they relate to pre-petition activities of such officers and directors. *See, e.g., In re Baldwin-United Corp.*, 43 B.R. 443 (S.D. Ohio 1984). Former officers and directors will not be able to obtain advances for expenses since those advances will not benefit the debtor's estate. *See, e.g., In re Christian Life Center*, 821 F.2d 1370 (9th Cir. 1987) (where claim for indemnification was treated as pre-petition, claim for expenses was also pre-petition claim even though expenses were incurred post-petition).

C. Claims by Current Officers and Directors

While the services of current officers and directors of the debtor corporation are usually viewed as necessary for the preservation of the estate, courts generally view pre-petition indemnification claims of current officers and directors as general unsecured claims. *See, e.g., In re Amfesco Indus., Inc.*, 81 B.R. 777 (Bankr. E.D.N.Y. 1988). If it were demonstrated that retention of the services of officers and directors is essential for the preservation of the estate, one court has suggested that the bankruptcy court may have sufficient discretionary authority under § 503(b)(1)(A) to give administrative priority to officers' litigation expense claims arising from pre-petition conduct. *In re Baldwin-United Corp.*, 43 B.R. at 462. Indemnification claims relating to the officer's or director's post-petition conduct should be characterized as post-petition claims entitled to administrative priority, as should claims for expenses in connection with such an action. *See, e.g., In re Heck's Properties, Inc.*, 151 B.R. 739, 767 (S.D. W. Va. 1992).

## VI. <u>STOCKHOLDER MATTERS</u>

### A. <u>Right To Call Stockholders' Meeting</u>

The issue of the stockholders' right to compel a stockholders' meeting was before the bankruptcy court in *In re Lionel Corp.*, 30 B.R. 327 (Bankr. S.D.N.Y. 1983). The court held that the debtor was not entitled to enjoin the stockholders from prosecuting a state court proceeding seeking an order to compel an annual meeting since the debtor could not show irreparable harm and no reason was demonstrated for denying to the stockholders the right to such meeting. The bankruptcy court stated that this was a state corporate governance issue for which the state court was a proper forum and that such determination would not conflict with the reorganization process.

In *In re Bush Terminal Co.*, 78 F.2d 662 (2d Cir. 1935), the court held that the stockholders had a right to a stockholders meeting to elect a new board of directors even if the result of such a meeting was that the new board would submit a new plan of reorganization in conflict with one previously filed. The court stated:

> [T]he debtor is given the right to be heard on all questions. Obviously, the stockholders should have the right to be adequately represented in the conduct of the debtor's affairs, especially in such an important matter as the reorganization of the debtor. Such representation can be obtained only by having as directors persons of their choice . . . . [T]he debtor is given the power to propose a plan of reorganization. No reason is advanced why stockholders, if they feel that the present board of directors is not acting in their interest, or has caused an unsatisfactory plan to be filed on behalf of the debtor, should not cause a new board to be elected which will act in conformance with the stockholders' wishes. . . . If the right of stockholders to elect a board of directors should not be carefully guarded and protected, the statute giving the debtors right to be heard or to propose a plan of reorganization could not truly be exercised, for the board of directors is the representative of the stockholders.

*Id*. at 664; *see also In re Johns-Manville Corp.*, 801 F.2d 60, 64 (2d Cir. 1986).

Bankruptcy courts have resorted to their powers as a court of equity to block a stockholders' meeting upon a showing that the stockholders are guilty of "clear abuse." *See In re Potter Instrument Co., Inc.*, 593 F.2d 470 (2d Cir. 1979). While stating that a bankruptcy court should not lightly employ its equitable powers to block an election of a new board of directors, the *Potter* court stated:

> [T]he right of the majority of stockholders to be represented by directors of their own choice and thus to control corporate policy is paramount and will not be disturbed unless a clear case of abuse is made out. This has been the rule all along in equity receivership, in ordinary bankruptcy and in proceedings for reorganization under former section 77B of the Bankruptcy Act [the antecedent of Chapter 11] . . . [With respect to their choice of the type of reorganization plan,] the stockholders are entitled to elect directors who will abide by their

> wishes, provided of course the directors chosen are not persons who will injure the honest and efficient management of the corporate property.

*Id*. at 475, (*quoting, In re J.P. Linahan, Inc.*, 111 F.2d 590, 592 (2d Cir. 1940)).

In *In re Johns-Manville Corp.,* 801 F.2d 60 (2d Cir. 1986), *remand* 66 B.R. 517 (Bankr. S.D.N.Y. 1986), the Second Circuit reversed a summary judgment decision and remanded the case for a determination of whether holding a stockholders' meeting would amount to clear abuse. The Equity Committee objected to a plan formulated by Manville and representatives of future tort claimants. Under this plan, the equity holders' interest could have been diluted by 90% or more. *Id*. at 62-63. The Equity Committee viewed this action as evidence of the debtor's board's abdication of its responsibilities to the stockholders and, consequently, brought an action seeking to compel a stockholders' meeting pursuant to § 211(c) of the DGCL. The purpose of the meeting was to replace the debtor's directors in order that a new group of directors might reconsider submitting the proposed plan. *Id*. at 63.

The bankruptcy court issued an injunction prohibiting the Equity Committee from pursuing the Delaware action on the ground that the stockholders' meeting would obstruct the debtor's reorganization.

In reversing and remanding, the Second Circuit stated that stockholders have a right to govern their corporation and this right is ordinarily not affected by a reorganization. *Id*. at 64. The right to call a stockholders' meeting is impaired only if the Equity Committee is guilty of "clear abuse" in attempting to call the meeting. *Id*. It was not clear that the stockholders' motive of having a meeting to gain some advantage over creditors constituted a "clear abuse" of their right or of the bankruptcy process of a nature to enjoin such a meeting. The court held that this was a viable issue of fact and, on remand, the court should undertake a more elaborate inquiry into determining the issues of clear abuse and irreparable harm. *Id*. at 69. *See also In re Heck's Properties, Inc.*, 151 B.R. 739, 757-60 (Bankr. S.D. W. Va. 1992) (declining to enjoin state court action brought by Equity Committee to compel shareholders' meeting in absence of evidence of Committee's intent to put debtor's rehabilitation at risk altogether).

### B. Stockholders' Standing to Influence a Plan of Reorganization

Equity security holders are considered a party in interest in a bankruptcy case. *See* § 1109(b). They "may raise and may appear and be heard on any issue in a case under" Chapter 11. As such, stockholders may directly object to a debtor's plan or reorganization. *See In re Gaslight Club, Inc.*, 167 B.R. 507 (Bankr. N.D. Ill. 1994); *In re Texaco Inc.*, 84 B.R. 889 (Bankr. S.D.N.Y. 1988). However, the stockholder must have first sought to intervene on behalf of himself in the bankruptcy court action in order to have standing for such intervention in a case on appeal. *See Sandra Cotton, Inc. v. Bank of New York*, 87 B.R. 272 (W.D.N.Y. 1988).

## VII. CREDITOR COMMITTEES

Chapter 11 requires that a United States Trustee appoint a committee of unsecured creditors in every case and permits the appointment of other committees when necessary. *See* § 1102(a)(1). The court may also order appointment of additional committees on request of a party in interest. § 1102(a)(2). Generally, the creditors' committee consists of those creditors willing to serve who hold the seven largest secured claims against the debtor. § 1102(b)(1).

A. Duties of Committee

Section 1103(c) describes the duties of a committee appointed under § 1102 as including:

(i) consulting with the trustee or DIP concerning the administration of a case;

(ii) investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of continuing the business, and any other matter relevant to the case or the formulation of a plan;

(iii) participating in the formulation of a plan and advising those it represents with respect to such plan;

(iv) requesting the appointment of a trustee or examiner as deemed necessary;

(v) performing such other services as are in the interests of those it represents.

Although through exercise of these duties creditors' committees do not directly control a debtor in possession, they are able to indirectly exert significant leverage over a debtor corporation.

A significant area of leverage exists for creditors' committees in the form of actions to remove a DIP. However, actions taken by a creditors committee to remove a DIP are subject to restrictions that tend to insulate the DIP from such external control. Usually, the rationale proposed by a creditors committee for the removal of a DIP stems from a claim that the incumbent managers are acting in a wrongful manner or that their actions are not being taken in the best interest of the creditors.

The remedy for a creditors committee is to propose that a trustee be appointed to replace the management of a DIP. Section 1104 of the Bankruptcy Code requires the appointment of a trustee under either of two conditions: (1) "for cause" found, and (2) if such appointment is "in interest of creditors, equity holders and other interests of the estate."

Committees often become a significant factor in the reorganization and, consequently, the unsecured creditors serving on such committees have significant influence on corporate governance matters.

B. Fiduciary Duties

Committee members are deemed to have a fiduciary relationship with those whom the committee members represent. *In re Mid-Island Hospital, Inc.*, 276 F.3d 123 (2d. Cir. 2002); *Pan Am Corp. v. Delta Airlines, Inc.*, 175 B.R. 438 (S.D.N.Y. 1994) (committee held fiduciary duty to creditors, but not to debtor or other parties); *Locks v. United States Trustee*, 157 B.R. 89 (W.D. Pa. 1993); *Pension Benefit Guar. Corp. v. Pincus, Verlin, Hahn, Reich & Goldstein Professional Corp.*, 42 B.R. 960 (E.D. Pa 1984); *In re Caldor, Inc.*, 193 B.R. 165 (Bankr. S.D.N.Y. 1996). As a result of its fiduciary relationship, committee members may not use their role solely for their own personal advantage. *In re National Equipment & Mold Corp.*, 33 B.R. 574 (Bankr. N.D. Ohio 1983) (a committee member may not act through the committee where the only benefit would be to place the committee member in a more favorable light to creditors). Fiduciary duties are also owed by counsel to the committee and the individual creditors that the committee represents. *In re Mesta Machine Co.*, 67 B.R. 151 (Bankr. W.D. Pa. 1986). See also *In re J.F.D. Enterprises, Inc.*, 223 B.R. 610 (Bankr. D. Mass. 1998) (held that counsel to creditors' committee was not fiduciary of debtor or estate generally).

Committee members must act in good faith and exercise reasonable care in their decisions and recommendations. For example, in the case of *In re Tucker Freight Lines, Inc.*, 62 B.R. 213 (Bankr. W.D. Mich. 1986), the creditors committee was found to have violated its fiduciary duties by issuing a letter recommending against a proposed reorganization plan and asserting reasons the committee knew to be false. The court held that the committee may be entitled to limited immunity, pursuant to Bankruptcy Code § 1103(c) but this limited immunity did not shield the committee from dishonest or reckless acts.

> However, implied in this grant of authority must also be a concurrent fiduciary duty to all unsecured creditors. At a minimum, this fiduciary duty requires that the committee's determination must be honestly arrived at, and, to the greatest degree possible, also accurate and correct. For a Creditors' Committee to urge rejection of a plan for reasons they knew, or would have known but for the recklessness, to be false would violate this duty and deprive them of any limited immunity they might otherwise hold under § 1103(c)(3).

*Id*. at 216 (citations omitted).

C. Standing to Commence Actions

Bankruptcy Code § 1109(b) grants to a committee appointed under § 1102 the right to raise, appear and be heard on any issue in the case. This provision has been broadly construed to permit a committee to intervene in an adversary proceeding in which the debtor is not adequately representing the estate. Some courts have held that committees had standing to initiate actions to recover preferences and fraudulent transfers when it was demonstrated that the trustee or DIP failed to initiate such action. *See In re Evergreen Valley Resorts, Inc.*, 27 B.R. 75 (Bankr. D. Me. 1983) (debtor in possession unjustifiably failed to bring suit against an insider). Courts have required that the failure by the debtor to bring suit must have been "unjustifiable" before allowing a committee to initiate action. *See In re Wesco Products Co.*, 22 B.R. 107 (Bankr. N.D. Ill. 1982) (no implied right to sue in absence of evidence that debtor unjustifiably failed to bring suit). *See also In re Commodore International Ltd.*, 262 F.3d 96, 100 (2d Cir. 2001) (a creditors' committee may acquire standing to pursue the debtor's claims if (1) the committee has the consent of the debtor-in-possession or trustee, and (2) a court finds that suit by the committee is (a) in the best interest of the bankruptcy estate, and (b) is "necessary and beneficial" to the fair and efficient resolution of the bankruptcy proceedings).

The decision regarding whether to commence litigation rests with the business judgment of the debtor. *In re Revco D.S., Inc.*, 118 B.R. 468, 476 (Bankr. N.D. Ohio 1990). The DIP has considerable discretion in determining whether to sue on behalf of the estate. *Id*.

As previously stated, as a party in interest, a creditor or committee has the right to be heard on any issue in a case. § 1109(b); *In re Continental Airlines Corp.*, 59 B.R. 782 (Bankr. S.D. Tex. 1986). However, this right alone does not give a creditor standing to assert a fraudulent transfer claim or give the creditor the absolute right to intervene in a pending action. *Nebraska State Bank v. Jones*, 846 F.2d 477 (8th Cir. 1988); *Fuel Oil Supply and Terminaling v. Gulf Oil Corp.*, 762 F.2d 1283 (5th Cir. 1985). *But see Phar-Mor, Inc. v. Coopers & Lybrand*, 22 F.3d 1228 (3d Cir. 1994) (relying on § 109(b) in permitting creditors' committee to intervene in suit brought by debtor to pierce its own corporate veil for benefit of creditors). In both situations, the party seeking to bring an action on behalf of the estate must demonstrate that:

(i) it has asked the debtor to prosecute the action;

(ii) the debtor has refused to prosecute the action;

(iii) a colorable claim exists that would benefit the estate; and

(iv) the DIP's inactivity is not justified or is an abuse of discretion.

*In re Caldor Corp.*, 303 F.3d 161 (2d Cir. 2002); *Louisiana World Exposition v. Federal Ins. Co.*, 858 F.2d 233 (5th Cir. 1988); *In re E.F. Hutton Southwest Properties II, Ltd.*, 103 B.R. 808 (Bankr. N.D. Tex. 1989); *Continental Airlines*, 59 B.R. at 786; *In re Toledo Equipment Co., Inc.*, 35 B.R. 315 (Bankr. N.D. Ohio. 1983); *see also In re Revco D.S., Inc.*, 118 B.R. 468, 476 (Bankr. N.D. Ohio 1990) (holding that creditor seeking right to bring derivative action had failed to show debtor's failure to prosecute claim was not justified).

D. Challenge to Debtor's Exclusivity

The Bankruptcy Code gives the DIP the exclusive right to file a plan of reorganization for the first 120 days of the case. 11 U.S.C. § 1121(b). The exclusivity period for "small business" debtors is 100 days. 11 U.S.C. § 1121(e)(1). This right of exclusivity is the central element of control given to the DIP in order to enable it to shape the nature of the restructuring and the allocation of loss in the case. A key issue in many Chapter 11 cases is when should another financially interested party be given the right to propose its own method of reorganizing the debtor. The concept of exclusivity deals not only with the notion of displacing the DIP, but with giving parallel rights to those who are affected by the case. Because Chapter 11 allows parties to vote only on plans that have been officially proposed, the right of proposal carries with it an ability to influence the form of the plan that will bind all parties in the bankruptcy case.

The 120 day exclusive period may be extended "for cause." The express purpose of the exclusivity period is to give the DIP the opportunity and the leverage to negotiate a settlement. The DIP's control over which plans are proposed has a significant impact on bargaining and how long the DIP retains exclusivity substantially effects the rights of all parties. The intention of Bankruptcy Code § 1121(b) was to give the DIP the unqualified opportunity to negotiate a settlement and to propose a plan of reorganization without interference from creditors and other interested parties. *See In re Texaco Inc.*, 81 B.R. 806, 809 (Bankr. S.D.N.Y. 1988). Section 1121(d) provides that the court may for cause extend the exclusivity period. The use of the term "may" allows the bankruptcy court latitude in deciding whether to extend exclusivity. The court may only exercise its discretion after a party in interest establishes sufficient cause. *In re Sharon Steel Corp.*, 78 B.R. 762, 763

(Bankr. W.D. Pa. 1987). The absence of an adequate definition of the phrase "for cause" in this matter is significant. Congress has left the meaning of the phrase to be determined by the facts and circumstances of each individual case.

## VIII. BANKRUPTCY COURT ACTIONS

### A. Restrictions on Actions Against Management

Since officers and directors are frequently named as defendants in litigation by creditors, some courts have enjoined such creditor actions against the debtor's management on the basis that it interferes with the debtor's operation or affects the prospects of reorganization. *See Lomas Financial Corp. v. Northern Trust Co.* (*In re Lomas Financial Corp.*), 117 B.R. 64, 66-68 (S.D.N.Y. 1990); *In re Johns-Manville Corp.*, 40 B.R. 219 (S.D.N.Y. 1984); *American Film Technologies, Inc. v. Tartiero* (*In re American Film Technologies, Inc.*), 175 B.R. 847, 849-50 (Bankr. D. Del. 1994). However, the debtor generally must demonstrate a likelihood of irreparable harm to the estate before such an injunction is granted. *See In re Otero Mills, Inc.*, 25 B.R. 1018 (D.N.M. 1982); *see generally*, *In re Archambault*, 174 B.R. 923, 928-30 (Bankr. W.D. Mich. 1994).

### B. The Court's Ability to Change the Board of Directors

As previously noted, generally a corporation in Chapter 11 continues to be managed by its board of directors as long as the debtor is a DIP. However, courts have considerable authority to control management of the debtor in order to protect the interests of creditors. *See In re Gaslight Club, Inc.*, 782 F.2d 767 (7th Cir. 1986).

In the *Gaslight Club* case, at the request of the creditors' committee and with the consent of the debtor's president and majority stockholder, the court designated a new individual to exercise the DIP's powers with "full and exclusive" authority. After being discharged by this individual, the debtor's former president (who was also the majority stockholder) filed a motion to appoint a trustee and/or to vacate the prior consent order on the basis that the bankruptcy court lacked authority to issue the consent order.

The Seventh Circuit disagreed, citing Bankruptcy Code §§ 105(a) and 1107(a), stating that:

> The Bankruptcy Code authorizes the bankruptcy court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of the title." 11 U.S.C. § 105(a). Furthermore, it states that the rights and powers of a debtor in possession are subject "to such limitations or conditions as the court prescribes." 11 U.S.C. § 1107 (a). The case law demonstrates that the court has considerable authority to interfere with the management of a debtor corporation in order to protect the creditors' interests.

*Id* at 770.

In response to the argument that the bankruptcy court's designation of another individual as "person in control" improperly avoided the statutory requirements for the appointment of a trustee, the Seventh Circuit stated:

> We would certainly question recourse to the present procedure as a means generally to avoid appointment of a trustee. But we think the peculiar circumstances of the case before us as well as the consent on all sides to the procedure followed make this case different. The appointment of [the individual by consent] was appropriate to the circumstances and authorized by law.

*Id*. at 772.

In the case of *In re FSC Corp.*, 38 B.R. 346 (Bankr. W.D. Pa. 1983), the debtor was a Delaware corporation whose board of directors resigned immediately prior to the filing of the bankruptcy case. Shortly thereafter, the new group of directors also resigned, leaving the debtor with no members on its board of directors. The bankruptcy court appointed a "responsible officer" to perform the duties of the debtor and by a later order authorized him to vote the shares of and elect directors for the debtor's subsidiaries. The latter order was challenged by the Committee of Equity Security Holders. Among the arguments presented was that the stockholders' right to elect directors of their choice should not be denied even when a bankruptcy intervenes, citing *In re Lionel Corp.*, 30 B.R. 327 (Bankr. S.D.N.Y. 1983).

The debtor distinguished the case at hand from *Lionel* on the basis that *Lionel* involved the rights of stockholders under New York law, whereas *FSC* was a Delaware corporation. The court agreed, finding that under Delaware law there was sufficient authority for the court to appoint the responsible officer to conduct the affairs of the business and to elect directors. *Id*. at 350.

In *In re United Press International, Inc.*, 60 B.R. 265 (Bankr. D.D.C. 1986), a Chapter 11 debtor sought an extension of the exclusivity period for filing a plan and for obtaining acceptance of the plan. A creditor opposed the motion hoping to put forth its own plan. As part of its opposition, the creditor argued that the court's earlier order abolishing the board of directors and authorizing debtor's management to propose a plan was unlawful and void under Delaware law, and that in the absence of a board of directors, it had the right to file a plan. Citing *Gaslight Club, Inc., supra*, the court held that its earlier consent order abolishing the board and authorizing management to file a reorganization plan in the debtor's name was valid under Bankruptcy Code §§ 104, 1107(a) and 1121. Furthermore, such action was valid under Delaware corporate law.

In *In re Freedlander, Inc., The Mortgage People*, 86 B.R. 66 (E.D. Va. 1988), a Chapter 11 debtor sought to substitute management in an effort to render moot an action to appoint a trustee. The court held that the substitution of management would not render the trustee issue moot and that the motion for substitution of management would not be expedited. The court reasoned that although the court could substitute management as an alternative to the appointment of a trustee, it would not do so without the consensus of all those involved. The facts before the court indicated not only a lack of consensus as to substituting the management, but also raised the possibility of a conflict of interest with the proposed new management. Proposed new management intended to purchase the debtor.

### C. Appointment of a Trustee or Examiner

The appointment of a trustee under §1104(a) of the Bankruptcy Code is another way to change management of the DIP. A Chapter 11 trustee replaces the DIP as the party in possession of the debtor's estate and operator of the debtor's business. In addition, pursuant to § 1106, a Chapter 11 trustee may file a schedule of assets and liabilities of a debtor, investigate any of the debtor's actions, and file a plan of reorganization.

However, a substantial burden must be met before most bankruptcy courts will act to remove existing management. Under § 1104(a)(1), a trustee may be appointed "for cause," which generally requires proof of gross mismanagement or fraud. *But see In re Tahkenitch Tree Farm Partnership*, 156 B.R. 525, 527 (Bankr. E.D. La. 1993) (deadlock among general partners constitutes cause to appoint trustee, even in absence of fraud or gross mismanagement). Under § 1104(a)(2), a trustee may be appointed if it is in the "best interest" of creditors, equity security holders and "other interests of the estate," a more flexible standard than § 1104(a)(1). *In re Microwave Products of America, Inc.*, 102 B.R. 666, 675 (Bankr. W.D. Tenn. 1989); *In re Sharon Steel Corp.*, 86 B.R. 455 (Bankr. W.D. Pa. 1988). Under § 1104(a)(2) courts may utilize their broad equity powers to engage in a cost-benefit analysis in order to determine what is the "best interest." *Id*. at 457. Courts also have held that § 1104(a)(1) may leave the judge discretion in determining whether to appoint a trustee. *Committee of Dalkon Shield Claimants v. A.H. Robins Co., Inc.*, 828 F.2d 239, 241 (4th Cir. 1987); *In re Stein and Day, Inc.*, 87 B.R. 290, (Bankr. S.D.N.Y. 1988). Most courts require a showing of clear and convincing evidence before a trustee will be appointed. *See, e.g., In re PRS Insurance Group, Inc.*, 274 B.R. 381 (Bankr. D. Del. 2001); *In re General Oil Distributors, Inc.*, 42 B.R. 402 (Bankr. E.D.N.Y. 1984).

Assuming that the bankruptcy court orders the appointment of a Chapter 11 trustee, the United States Trustee then initially selects the person to be appointed as Chapter 11 trustee. However § 1104(b) provides that upon a timely request of a party in interest, the United States Trustee is required to convene a meeting of creditors for the purpose of "electing one disinterested person to serve as trustee." A formal election will be held upon the request of the holders of at least 20 percent of the claims eligible to vote on who shall be the trustee. The election is to be conducted in the same manner as is employed for the election of a Chapter 7 trustee. Under section 702(a), only unsecured creditors who hold allowable, undisputed, fixed, liquidated claims, and whose interest is not materially adverse to those of other eligible voters, are eligible to vote. A candidate receiving the votes of creditors holding a majority in amount of claims actually voted shall be elected as Chapter 11 trustee.

An examiner appointed by the bankruptcy court pursuant to § 1104(c) does not take possession of the debtor's assets or operate the debtor's business. An examiner's duties are normally limited by §1106(b) to investigating the acts and business affairs of a DIP, but may be expanded by order of the court.

## IX. NOTE ON THE IN PERSONAM JURISDICTION OF BANKRUPTCY COURTS OVER FOREIGN PARTIES

According to one bankruptcy court decision, a party may subject itself to the in personam jurisdiction of U.S. bankruptcy courts merely by entering into a debtor-creditor relationship with a U.S. corporation.

In *Schwinn Plan Comm. v. AFS Cycle Co. Ltd. (In re Schwinn Bicycle Co.)*, 192 B.R. 461 (Bankr. N.D. Ill. 1996), Schwinn Bicycle Co. ("Schwinn"), an Illinois company, sent certain purchase orders for custom made bicycles to China Bicycles Company (Holdings) Limited ("China Bike"), at its Hong Kong offices. China

Bike, a long time supplier of bicycles to Schwinn, informed Schwinn that it could not accept these particular orders, but suggested that its affiliate Regal International Development Co., Ltd. ("Regal") could fill the orders. Apparently, Schwinn never negotiated directly with Regal, but Regal accepted the purchase orders forwarded to them by China Bike. Regal delivered the bicycles to Schwinn in Hong Kong for shipment to the United States in accordance with the "FOB Hong Kong" term of the purchase orders. Regal was paid $3.7 million through two documentary letters of credit which were procured by Schwinn for Regal from an Illinois bank.

Less than 90 days after Regal was paid, Schwinn filed a petition for bankruptcy relief in the United States. The Plan Committee created during the bankruptcy proceedings commenced an adversary proceeding against Regal seeking the recovery of the two payments as preferential payments.

Regal moved to dismiss the preference action on the grounds that the bankruptcy court lacked personal jurisdiction over Regal. Regal, a Hong Kong corporation, had no offices, employees, agents, assets, records or telephone numbers in the United States, nor did it send any representatives to the United States in connection with the Schwinn purchase order. Regal did not file a proof of claim or otherwise participate in the bankruptcy proceeding so as to submit itself to the jurisdiction of the bankruptcy court.

The court, applying the traditional "minimum contacts" test, held that it did possess in personam jurisdiction over Regal. A court can constitutionally exercise in personam jurisdiction over a defendant not present within the territory of the forum where the defendant holds certain minimum contacts with the forum such that maintenance of the suit in that forum "'does not offend traditional notions of fair play and substantial justice.'"

The court concluded that Regal had sufficient contacts with the United States to support jurisdiction. Regal sold bicycles to an American corporation knowing that the bicycles would be resold on the American consumer market. Thus, it was reasonably foreseeable that Regal might be forced to defend an action in American courts arising out of that debtor-creditor relationship. The court noted that had Schwinn not paid for the goods, Regal would have been entitled to file a claim against Schwinn in the United States bankruptcy proceeding: "A foreign company cannot enter in to a major debtor-creditor commercial relationship with a United States corporation and be entitled to use advantages that our system provides for all creditors without submitting itself to jurisdiction when the result may be detrimental to it."

The court did not view the "FOB Hong Kong" term in the purchase order as evidencing Regal's lack of contacts with the United States. Even though the risk for the loss of the bicycles shifted before the goods entered the United States, the contract could not be considered as having been totally performed outside the United States. For instance, Schwinn retained the right to reject the non-conforming bicycles upon their delivery to its place of business in the United States.

Next, the court determined that it was "fair and reasonable" to exercise personal jurisdiction over Regal. Because Regal was a large company, transacting millions of dollars per year in international commerce, it would not be unduly burdened by the prospect of overseas litigation. The United States bankruptcy court appeared to be the forum where the dispute could most efficiently and effectively resolved. Several preference actions commenced by the Plan Committee were already pending in the bankruptcy court. All of these actions shared the common issue of Schwinn's insolvency during the period prior to the bankruptcy. Finally, because the cause of action arose under United States bankruptcy law, and is inextricably tied to the underlying bankruptcy, only a United States court would have subject matter jurisdiction over the preference action.

## X. SELECTED TOPICS AND CASES

### A. Equitable Subordination

Generally, unsecured creditors find themselves last in the line of creditors when payments are made from a bankruptcy estate. However, the bankruptcy court can use its equitable powers to adjust the priority of some claims using a doctrine called "equitable subordination". To paraphrase General George S. Patton, Jr., "No trade creditor got its debt paid by staying at the end of the line. It can get its debt paid by moving some other poor, dumb creditor to the end of the line."

Equitable subordination or recharacterizing certain "debts" as equity infusions is not a new creation. The Supreme Court recognized and applied the doctrine in *Pepper v. Litton* in 1939. *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L.Ed. 281, (1939). In that case, the principal of the debtor claimed that he had not received the full salary he thought he was entitled to. While the debtor was litigating with one of its creditors, the debtor (at the principal's request) confessed to a judgment in the principal's favor for the unpaid "salary". The bankruptcy court had no trouble in subordinating the principal's claim and treating it as equity instead of debt. "He cannot use the corporate device to avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and strategic position for his own preferment." 308 U.S. at 311.

When the Bankruptcy Code was enacted in 1978, Congress recognized the established body of case law by enacting 11 U.S.C. § 510(c).[1] In order to equitably subordinate a claim, courts have generally applied a three part test. Actions by a creditor can result in the subordination of its claim if (a) the claimant engaged in inequitable conduct (b) which either injured the debtor or other creditors or gave the claimant an unfair advantage over them and (c) subordination of the claim is not inconsistent with existing bankruptcy law. *In re Mr. R's Prepared Foods, Inc.*, 251 B.R. 24 (Bankr. D. Conn. 2000); *In re Mobile Steel*, 563 F.2d 692 (5th Cir. 1977); *Stoumbus v. Kilimnik*, 988 F.2d 949, 958 (9th Cir. 1993). If the claimant engaging in inequitable conduct is an insider or a fiduciary, the claim can be subordinated for less egregious actions.

Generally, inequitable conduct can be categorized into three types of activity: (a) fraud, illegality or breach of fiduciary duties; (b) undercapitalization; and (c) claimants' use of the debtor as a mere instrumentality or alter ego. *In re Clark Pipe and Supply Co., Inc.*, 893 F.2d 693, 699 ($5^{th}$ Cir. 1990); *In re M. Paolella & Sons, Inc.*, 161 B.R. 107 (E.D. Pa. 1993); aff'd 37 F.3d 1487 (3d Cir. 1994). There are

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[1] § 510. Subordination.

. . .

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may --

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any liens securing such a subordinated claim be transferred to the estate.

three types of cases where subordination has been employed. These cases can generally be described as cases where (a) a fiduciary of the debtor abuses his position to the detriment of other creditors; (b) a third party controls the debtor to the disadvantage of other creditors; and (c) a third party defrauds other creditors. *In re U.S. Abatement Corp.*, 39 F.3d 556, 561 (5th Cir. 1994).

When "loans" are made by insiders, the capitalization of the debtor should be carefully examined. An expert can determine and testify about whether the capitalization was sufficient to support a business of the size and type of the debtor when it was capitalized. The debtor's inability to obtain loans from informed non-insider third parties can be an indication of undercapitalization. *In re Herby's Foods*, 2 F.3d 128 (5th Cir. 1993).

Since equitable subordination is, by definition, an equitable undertaking, the remedy of subordination is limited to rectifying the injury inflicted by the wrongful conduct. Some courts have even subordinated a claim below some, but not all, unsecured claims. *In re N&D Properties, Inc.*, 799 F.2d 726, 732-3 (11th Cir. 1986).

Consequently, in preparing an equitable subordination case for trial, you will need to know and be able to prove the extent of the harm caused by the inequitable conduct. After all, the goal of equitable subordination is merely to put the creditors in the places in the payment line that they would have occupied but for the inequitable conduct.

While a court might be tempted to strictly construe this requirement by trying to evaluate the claim of every creditor to see how the creditor was harmed, a more general approach has been approved. For example, in *Herby's Foods*, the court found that unsecured creditors increased their trade credit exposure substantially (a 500% increase) between the time the insiders received their unrecorded liens and the filing of the bankruptcy petition. This increase in trade credit resulted in predictably smaller dividends for unsecured creditors which was held to be a sufficient injury to warrant subordination of the insiders claims below all unsecured claims.

Equitable subordination is not limited to unsecured claims. Section 510(c)(2) provides that liens can be transferred to the estate -- recognizing that secured claims can be subordinated as well. Therefore, the mere fact that an insider enhanced his position with liens does not prevent subordination.[2]

Where a debtor has engaged in questionable transactions or insiders are asserting substantial secured or unsecured claims, unsecured creditors or the unsecured creditors committee should carefully examine the facts to see if the claims can be equitably subordinated. Doing so can increase the dividends to general unsecured creditors by making the claims of the inequitable creditors the last in line for payment.

B. Withdrawal Liability - What Is A "Claim"?

[2] The Supreme Court has limited a bankruptcy court's ability to equitably subordinate tax claims in *U.S. v. Noland*, 116 S.Ct. 1524 (1996) and *U.S. v. Reorganized CF&I Fabricators of Utah, Inc.*, 116 S.Ct. 2106 (1996). These cases, which recognize the continuing validity of the equitable subordination doctrine for non-tax claims, are discussed in "Subordination of Punitive Tax Claims: Dead or Alive in the Wake of Supreme Court Decisions?" *ABI Journal*, July/August 1996.

In *CPT Holdings, Inc. v. Industrial & Allied Employees Union Pension Plan, Local 73*, 162 F.3d 405 (6th Cir. 1998), the Sixth Circuit held that withdrawal liability is not a "claim" prior to confirmation when an employer actually withdraws from a pension plan post-confirmation. Hupp, pursuant to a collective bargaining agreement, made contributions to a pension plan. Hupp filed for bankruptcy protection under Chapter 11, and eventually the court confirmed Hupp's plan of reorganization. Under the plan of reorganization, Hupp assumed the collective bargaining agreement and exchanged newly issued stock to CPT for $2 million. Subsequently, CPT foreclosed on its collateral and liquidated Hupp. As a result, Hupp ceased contributions to the pension plan and completely withdrew from the plan. The pension plan argued that it was owed withdrawal liability amounts from CPT representing not only post-confirmation membership in the pension plan, but also pre-confirmation membership. CPT argued that the pre-confirmation membership liability constituted a "claim" against Hupp, and therefore, was discharged by the confirmation of Hupp's plan. The Sixth Circuit held that the "claim" for withdrawal liability does not arise until the employer actually withdraws from the pension, and hence, if the employer does not withdraw until post-confirmation, the employer's plan cannot discharge the liability associated with pre-confirmation membership. The court reasoned that the legal right to payment does not arise until the employer actually withdraws from the pension plan, citing 29 U.S.C. §§ 1381-1391 and *In re of United Merchants and Manuf., Inc.*, 166 B.R. 234 (D. Del. 1994).

C. Eligibility/Authorization to File Chapter 11 Case

In *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997), Judge Tina Brozman held that despite lender imposed corporate governance provisions containing clauses designed to make bankruptcy unavailable to defaulting borrowers without the affirmative consent of the mortgagee's designee on the board of directors of the borrowers, involuntary bankruptcy petitions orchestrated by the borrowers' principal and petitioning creditors were still valid. The corporate governance documents of each of the debtors required unanimous consent of each director to commence a voluntary bankruptcy petition. The lender had designated an "independent director" for each board. The debtors defaulted and the lender commenced foreclosure actions. The principal, knowing that calling a board meeting would be futile because of the lender's designee, requested unsecured creditors of each of the entities to commence involuntary petitions on behalf of the petitioning creditors. The principal even paid the retainer of counsel to commence the involuntary petitions on behalf of the petitioning creditors. After commencement of the involuntary petitions, the lender moved to dismiss the involuntary petitions as bad faith filings under section 1112(b). The lender argued that the bankruptcy filings were collusive because they were orchestrated by the principal of the debtor, and therefore, cause existed to dismiss the petitions. The court disagreed and denied the lender's motion. One of the factors considered by the court was that the "independent director" selected by the lender was not "independent" at all. In fact, the independent director had breached his fiduciary duties to the entities and their creditors. The independent director stated that he was unaware that in his capacity as director that he had fiduciary duties to creditors. The court stated that because the director was an attorney "[i]t is inconceivable that he would not understand that the corporate general partners of which he was a director bore fiduciary obligations to the limited partners." Because the court found that the filings were not improper, the court never reached the question of whether the provision in the bylaws requiring an unanimous vote was void against public policy. However, the court's conclusion effectively rendered the provision void.

D. The Debtor-in-Possession - Governance and Duties

In *Official Bondholders Committee v. Chase Manhattan Bank (In re Marvel Entertainment Group, Inc.)*, 209 B.R. 832 (D. Del. 1997), the United States District Court held that the shareholders of Marvel Entertainment were not stayed under 11 U.S.C. § 362(a)(3) from voting their shares to replace Marvel's board of directors and that to enjoin voting of the shares the debtor must demonstrate a "clear abuse," which the court defines as "a willingness to risk rehabilitation altogether in order to win a larger share for equity." *Id*. at 838. The court found that the shareholders' action, while motivated by a desire to obtain more bargaining power in the negotiation of a reorganization plan, did not, without more, constitute clear abuse.

*In re Bidermann Industries U.S.A., Inc*., 203 B.R. 547 (Bankr. S.D.N.Y. 1997) involved an attempted management buy out of a Chapter 11 debtor by a turnaround professional who had become the chief executive officer. The court refused to approve the proposed sale on the ground that there was a conflict of interest and there had not been a sufficient exposure of the assets to the marketplace to assure that value to the estate had been maximized. Furthermore, the court was concerned with the amount of the topping fee and expense reimbursement. Observing that Judge Henry Friendly sitting on the Second Circuit Court of Appeals declared some thirty years ago "that the conduct of bankruptcy proceedings not only should be right but must seem right," *id*. at 549, the court directed the parties to show cause why an examiner should not be appointed with expanded powers to assess the desirability of the management buy out and other proposals.

In *Golman-Hayden Co., Inc. v. Fresh Source Produce Inc*., 217 F.3d 348 (5th Cir. 2000), the Fifth Circuit held that individual shareholders, officers or directors of a corporation who are in a position to control trust assets, and who breach their fiduciary duty to do so may be held personally liable under the Perishable Agricultural Commodities Act ("PACA"), 7 U.S.C. §§ 499a, *et seq*. In this case, the sole shareholder of the Chapter 7 debtor-produce merchant was held liable to produce suppliers when the debtor lacked funds to satisfy the suppliers' PACA trust claims. *See also Red's Market v. Cape Canaveral Cruise Line, Inc.*, 181 F.Supp.2d 1339 (M.D. Fla. 2002).

## E. Substantive Consolidation

### 1. Substantive Consolidation Generally

Substantive consolidation is an equitable doctrine whereby the assets of, and claims against, two or more separate but related entities are merged, creating a common fund of assets and a single body of creditors. *Eastgroup Props. v. S. Motel Ass'n, Ltd.*, 935 F.2d 245, 248 (11th Cir. 1991); *Union Sav. Bank v. Augie/Restivo Baking Co., Ltd. (In re Augie/Restivo Co., Ltd.)*, 860 F.2d 515, 518 (2d Cir. 1988); *In re Mortgage Inv. Co.*, 111 B.R. 604, 610 (Bankr. W.D. Tex. 1990).[3] In addition, claims between the entities are

[3] Some courts have held that the invocation of the doctrine of substantive consolidation is not limited to the situation where the related entities are all debtors in pending bankruptcy cases. If an affiliation is "nothing but a sham and a cloak," *Sampsell v. Imperial Paper & Color Corp*., 313 U.S. 215, 217 (1941), then courts will "pierce the corporate veil" so as to combine the assets of a debtor and a non-debtor, although subsequent cases have combined the assets and liabilities of a debtor with a non-debtor under substantive consolidation, instead of alter ego, principles. *See, e.g., Kroh Bros. Dev. Co. v. Kroh Bros. Management Co.* (*In re Kroh Bros. Dev. Co.*), 117 B.R. 499, 501-02 (W.D. Mo. 1989) ("KBDC"); *Munford, Inc. v. TOC Retail, Inc.* (*In re Munford, Inc.*), 115 B.R. 390, 397-98 (Bankr. N.D. Ga. 1990). *See also In re Tureaud*, 45 B.R. 658 (Bankr. N.D. Okla. 1985). *But see, e.g., In re DRW Property Co*., 54 B.R. 489, 497 (Bankr. N.D. Tex. 1985); *In re Alpha & Omega Realty, Inc.*, 36 B.R. 416, 417-418 (Bankr. D. Idaho 1984) (motion seeking substantive consolidation of non-debtor with debtor denied); *Feldman v. Trustees of Beck Indus., Inc.* (*In re Beck Indus., Inc.*), 479

eliminated upon consolidation. *Fed. Deposit Ins. Corp. v. Colonial Realty Co.*, 966 F.2d 57, 58-59 (2d Cir. 1992). Thus, substantive consolidation results in consolidated assets which "create a single fund from which all claims against the consolidated debtors are satisfied; duplicate and inter-company claims are extinguished; and, the creditors of the consolidated entities are combined for purposes of voting on reorganization plans. *In re Bonham*, 229 F.3d 750, 764 (9th Cir. 2000).[4] "The sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors." *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 618 (D. Del. 2001). The Ninth Circuit has stated that, "[w]ithout the check of substantive consolidation, debtors could insulate money through transfers among inter-company shell corporations with impunity." *In re Bonham*, 229 F.3d at 764.

Apart from the reference in Section 302(b) of the Bankruptcy Code (requiring the court to determine whether the estates of a husband and wife should be substantively consolidated), substantive consolidation is not expressly provided for either under the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure. However, it has long been established that the bankruptcy court, in the exercise of its equitable jurisdiction, has the power to order substantive consolidation of separate estates in proper circumstances. *See, e.g., In re Vecco Construction Indus., Inc.*, 4 B.R. 407, 409 (Bankr. E.D. Va. 1980).[5] Although substantive consolidation was

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F.2d 410, 419 (2d Cir.), *cert. denied*, 414 U.S. 858 (1973). *See also In re Julien Co.*, 120 B.R. 930, 936-38 (Bankr. W.D. Tenn. 1990) (refusing to substantively consolidate non-debtor individual with corporate debtor, particularly where consolidation was sought by motion instead of adversary proceeding).

It should be noted that where a non-debtor is substantively consolidated with a debtor or where a debtor is substantively consolidated with another debtor whose bankruptcy case was not commenced on the same date as its own, *nunc pro tunc* or "retroactive" substantive consolidation, if ordered as part of such substantive consolidation, will affect, for example, the calculation of avoidance periods under Sections 547 (preference) and 548 (fraudulent conveyance) of the Bankruptcy Code, as well as the determination of the "petition date" for the purposes of the exercise of a bankruptcy trustee's "strong-arm powers" under Section 544 of the Bankruptcy Code. *See, e.g., Drabkin v. Midland-Ross Corp.* (*In re Auto-Train Corp. Inc.* ("*Auto-Train*"), 810 F.2d 270, 275-78 (D.C. Cir. 1987); KBDC, 117 B.R. at 501-02. A bankruptcy court may order substantive consolidation to be *nunc pro tunc* or retroactive only in extraordinary situations. *See, e.g., Auto-Train*, 8 10 F.2d at 275-278; *but see First Nat'l Bank v. Rafoth* (*In re Baker & Getty Fin. Servs., Inc.*), 974 F.2d 712, 720-21 (6th Cir. 1992) (the court rejected the *Auto-Train* balancing analysis in favor of a strict rule that whenever substantive consolidation is ordered, the "petition date" for the consolidated debtors shall be the date the first bankruptcy petition was filed).

[4] The doctrine of substantive consolidation differs fundamentally from the doctrine of procedural consolidation, which pertains only to joint case administration matters involving cases of related debtors pending in the same court. *See* Federal Rule of Bankruptcy Procedure 1015. Procedural consolidation does not subject the assets of each of the debtors to the liabilities owing by all of the other debtors. *See, e.g., Unsecured Creditors Comm. v. Leavitt Structural Tubing Co.*, 55 B.R. 710, 711-12 (N.D. Ill. 1985) ("procedural consolidation is merely a matter of convenience and cost saving; it does not create substantive rights . . . . [T]he Committee could have sought substantive consolidation which would have given it standing to appeal in this case"), *aff'd*, 796 F.2d 477 (7th Cir. 1986). We express no opinion as to whether a bankruptcy court presiding over cases commenced under the Bankruptcy Code against Originator and the Company (or against Servicer and the Company) would order a joint administration of the estates of those entities pursuant to Federal Rule of Bankruptcy Procedure 1015(b) or any local variation thereof.

[5] The equitable powers of a bankruptcy court under the Bankruptcy Code were expressly recognized in the original jurisdictional grant contained in 28 U.S.C. § 1471, repealed by Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333, 334. Such statute was repealed in the wake of *N. Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982). A remaining statutory source of such equitable powers appears to be 11 U.S.C. § 105(a) (West Supp. 1992), which provides, in relevant part, that "[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." *See Walter E. Heller*

not codified in the statutory overhaul of bankruptcy law in 1978, the courts have found that the equitable power survived the enactment of the Bankruptcy Code. *Bonham*, 229 F.3d 765. Courts have found authority for the doctrine in the bankruptcy court's general equitable powers as set forth in §105.

It has, however, historically been held that substantive consolidation should be granted in "rare case[s]," since it can work harsh inequities on the creditors of the respective estates. *Kheel,* 369 F.2d at 847. *See also In re Cont'l Vending Mach. Corp.,* 517 F.2d 997, 1001 (2d Cir. 1975), *cert. denied*, 424 U.S. 913 (1976); *In re Commercial Envelope Mfg. Co., Inc.*, 14 C.B.C. 191, 195 (S.D.N.Y. 1977); and *In re Lewellyn,* 26 BR. 246, 251 (Bankr. S.D. Iowa 1982).[6] It should be used sparingly because it alters the substantive rights of parties to the bankruptcy. *Augie/Restivo*, 860 F.2d at 518 (citing *Chem. Bank New York Trust v. Kheel*, 369 F.2d 845, 847 (2d Cir. 1966)). Because the entities to be consolidated likely have different debt-to-asset ratios, substantive consolidation invariably results in the redistribution of wealth among the creditors of the various entities. *In re Bonham,* 229 F.3d at 764; *Fed. Deposit Ins. Corp.,* 966 F.2d at 61; *Eastgroup*, 935 F.2d at 248. Creditors of the less solvent entities stand to gain by substantive consolidation because now their claims will be satisfied out of the pooled assets of the relatively more solvent consolidated debtor, whereas creditors of the more solvent entities stand to lose by substantive consolidation because the consolidated debtor is relatively less solvent than the individual entity against which they originally held their claims. However, because of the proliferation of interlocking parent-subsidiary corporate structures, some courts have noted a liberal trend toward allowing substantive consolidation. *Eastgroup*, 935 F.2d at 248-49 (citing *In re Murray Indus.*, 119 B.R. 820, 828-29 (Bankr. M.D. Fla. 1990)).

Consistent with this concern, bankruptcy and appellate courts have held that substantive consolidation is appropriate in the limited circumstance where, based on the facts and circumstances of the particular case, the invocation of the doctrine is the only equitable method available for the court to administer the debtors' estates. For example, in *Kheel*, 369 F.2d at 847 the court stated:

> Yet in the rare case such as this, where the interrelationships of the group are hopelessly obscured and the time and expense necessary even to attempt to unscramble them so substantial as to threaten the realization of any net assets for all the creditors, equity is not helpless to reach a rough approximation of justice to some rather than deny any to all.

*See also In re Cont'l Vending Mach. Corp.*, 517 F.2d at 1001 (substantive consolidation based on infeasibility and expense of separate proceedings); *Soviero v. Franklin Nat'l Bank*, 328 F.2d 446 (2d Cir. 1964) (substantive consolidation based on extensive commingling of mortgage loans and business operations); *In re Commercial Envelope Mfg. Co., Inc.,* 14 C.B.C. 191 (S.D.N.Y. 1977) (substantive consolidation based on impossibility of segregating assets and liabilities of debtor corporations without prohibitive

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*& Co. v. Langenkamp (In re Tureaud)*, 59 B.R. 973, 975 (N.D. Okla. 1986); *In re Richton Int'l Corp.*, 12 B.R. 555, 557 (Bankr. S.D.N.Y. 1981).

6 Indeed, the Congress that enacted the provision dealing with substantive consolidation of estates of married persons stated that the aforementioned provision was not to be viewed as a license to consolidate estates to the detriment of creditors. H.R. Representative. No. 595, 95th Cong., 1st Sess. at 231 (1977), reprinted in 1978 U.S. Code Cong. & Admin. News 6191.

cost).[7]

In certain circumstances, a court may substantively consolidate debtor and non-debtor entities. *See In re Alico Mining, Inc.*, 278 B.R. 586, 589 (Bankr. M.D. Fla. 2002) (holding that the bankruptcy court has jurisdiction to consider the request to consolidate a debtor and a nondebtor entity). Substantive consolidation enables a bankruptcy court to disregard the separate corporate entities and to pierce their corporate veils in order to reach assets for the satisfaction of debts of a related corporation. *Id.* at 588. In those instances, substantive consolidation preserves the debtor's assets by avoiding the expense and difficulty of sorting out the separate assets and liabilities of the debtor and its affiliate entities, who may or may not also be bankruptcy debtors. *Drabkin v. Midland Ross Corp. (In re Auto-Train Corp., Inc.),* 810 F.2d 270, 276 (D.C. Cir. 1987).

2. The *Vecco* Elements of Consolidation Test

In determining whether substantive consolidation is appropriate, the substantive consolidation cases under the Bankruptcy Act of 1898 (the "Bankruptcy Act") remain applicable under the Bankruptcy Code since in each case it is a court's equitable power that is applied. *See In re Snider Bros., Inc.*, 18 B.R. 230 (Bankr. D. Mass. 1982).[8] In *In re Vecco Constr. Indus., Inc.*, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980), the bankruptcy court delineated the following "elements" of substantive consolidation:

(1) the degree of difficulty in segregating and ascertaining individual assts and liability;
(2) the presence or absence of consolidated financial statements;
(3) the profitability of consolidation at a single physical location;
(4) the commingling of assets and business functions;
(5) the unity of interests and ownership between the various corporate entities;
(6) the existence of parent and inter-corporate guarantees on loans; and
(7) the transfer of assets without formal observance of corporate formalities.
the assumption by the parent of contractual obligations of its subsidiaries;

Other courts have looked to three additional factors when considering consolidation:

(1) the entities have common offices and directors;
(2) a subsidiary transacts business solely with its parent;

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7 *See also In re Frontier Airlines, Inc.*, 93 B.R. 1014, 1016 (Bankr. D. Colo. 1988) ("The evidence established that virtually all transactions had been undertaken through Frontier and that the books and records of the companies did not clearly define the separate assets and liabilities such that a complete financial separation of the entities would be difficult to accomplish."); *Goldman v. Haverstraw Assocs.* (*In re R.H.N. Realty Corp.*), 84 B.R. 356, 358 (Bankr. S.D.N.Y. 1988) (no evidence was presented from which court could conclude that "the interrelationship of the Haverstraw partnership and the debtor corporation was so hopelessly obscured that the financial affairs of the partnership could not be unscrambled from those of the debtor corporation"); *In re Ford*, 54 B.R. 145, 147-49 (Bankr. W.D. Mo. 1984) (evidence was not sufficient to prove that entities were "indistinct").

8 Yet, it should be noted that Supreme Court cases in other contexts have indicated that a bankruptcy court's equitable power under the Bankruptcy Code is not unfettered. *See, e.g., Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) ("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code") ("*Ahlers*").

(3) both entities disregard the legal requirements of the subsidiary as a separate corporation.

*In re Gainesville P-H Props., Inc.*, 106 B.R. 304, 306 (Bankr. M.D. Fla. 1989) (citing *Pension Benefit Guar. Corp. v. Ouimet Corp.*, 711 F.2d 1085, 1093 (1st Cir.), *cert. denied*, 464 U.S. 961 (1983)).
Recent Bankruptcy Code cases, however, have questioned the *Vecco* delineation of "elements of consolidation" in favor of a test balancing "economic prejudice of continued debtor separateness versus the economic prejudice of consolidation."

3. The Balancing Test

Generally, courts employ a balancing test to determine whether to substantively consolidate by weighing the potential prejudice of consolidation against the prejudice of continued separation. *First Nat'l Bank of El Dorado v. Giller (In re Giller),* 962 F.2d 796, 799 (8th Cir. 1992); *Woburn Assocs. v. Kahn (In re Hemingway Transp., Inc.),* 954 F.2d 1, 11 n.15 (1st Cir. 1992) ("...the bankruptcy court must balance the potential benefits of consolidation against any potential harm to interested parties."); *In re DRW Prop. Co.,* 54 B.R. 489, 495 (Bankr. N.D. Tex. 1985).[9] Factors to consider when deciding whether substantive consolidation is appropriate include 1) the necessity of consolidation due to the interrelationship among the debtors; 2) whether the benefits of consolidation outweigh the harm to creditors; and 3) prejudice resulting from not consolidating the debtors. *Id.* Because substantive consolidation affects the substantive rights of those involved, courts have stated that the prejudice to the creditors must be heavily outweighed by the benefits of consolidation. *In re Cont'l Vending Mach. Corp.,* 517 F.2d 997, 1000 (2d Cir. 1975).

4. The Eleventh and DC Circuit Test

The Eleventh and D.C. Circuits have adopted a three-part burden shifting test. First, the proponent for substantive consolidation must make out a *prima facie* case by demonstrating that "(1) there is substantial identity between the entities to be consolidated; and (2) consolidation is necessary to avoid some harm or realize some benefit." *Eastgroup*, 935 F.2d at 249; *Auto-Train*, 810 F.2d at 276. An objecting creditor can rebut the *prima facie* case by showing that "(1) it has relied on the separate credit of one of the entities to be consolidated; and (2) it will be prejudiced by substantive consolidation." *Eastgroup*, 935 F.2d at 249. If the objecting creditor successfully rebuts the prima facie case, consolidation will be ordered only if it is determined that the "demonstrated benefits of consolidation heavily outweigh the harm." *Id.*

5. Second Circuit *Augie/Restivo* Test

A significant exposition of the substantive consolidation doctrine occurred in *Union Savings Bank v. Augie/Restivo Baking Co.* (*In re Augie/Restivo Baking Co.*), 860 F.2d 515, 518-19 (2d Cir. 1988) ("*Augie/Restivo*").[10] In that case, the Second Circuit Court of Appeals, in refusing to order substantive consolidation, summarized the doctrine as follows:

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[9] The Fifth Circuit has not adopted a standard for when substantive consolidation is warranted.

[10] *See also In re Bonham*, 2000 WL 1468752 (9th Cir. Oct. 4, 2000)(adopting the *Augie/Restivo* test).

> The sole purpose of substantive consolidation is to ensure the equitable treatment of all creditors. Numerous considerations have been mentioned as relevant to determining whether equitable treatment will result from substantive consolidation ... An examination of those cases, however, reveals that these considerations are merely variants on two critical factors: (i) whether creditors dealt with the entities as a single economic unit and did not
> rely on their separate identity in extending credit,' . . . ; or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. . . .
>
> The second factor, entanglement of the debtors' affairs, involves cases in which there has been a commingling of two firms' assets and business functions. Resort to consolidation in such circumstances, however, should not be Pavlovian. Rather, substantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets.

*Id*. In that case, the court found that several significant creditors had relied on the separate existence of one of the corporations involved and that there had not been an irreversible entangling of the business operations of such corporations.[11] Thus, the Second Circuit determined that substantive consolidation is merited where one of two critical factors has been demonstrated: (i) whether creditors dealt with the entities as a single economic unit and "did not rely on their separate identity in extending credit" . . . or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors. *Augie/Restivo*, 860 F.2d at 518.

Courts have looked at the following factors when considering the entanglement of the debtors:

(1) the presence or absence of consolidated financial statements;
(2) the unity of interests and ownership between various corporate entities;
(3) the existence of parent and intercorporate guarantees on loans;
(4) the degree of difficulty in segregating and ascertaining individual assets and liabilities;
(5) the existence of transfers of assets without formal observance of corporate formalities;
(6) the commingling of assets and business functions
(7) the profitability of consolidation at a single physical location.

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[11] *Id*. at 519-20. With respect to the second factor, entanglement of the debtors' affairs, the court stated:

> "The evidence of commingling of assets and business functions in the instant case in no way approaches the level of 'hopeless[] obscur[ity]' of 'interrelationships of the group' found necessary to warrant consolidation in *Kheel*, 369 F.2d at 847. Business functions may have been commingled, but that hardly weighs in favor of consolidation in the instant case because the principal beneficiary of consolidation, MHTC, was not deceived and fully realized it was dealing with separate corporate entities. So far as the commingling of assets is concerned, *Augie's* real property and equipment appear to be traceable. The record also indicates that each company's inventory, liabilities and receivables as of January 1, 1985 are identifiable. It also appears that records exist of all transactions subsequent to that date."

*Id*. at 519.

*See In re GC Cos., Inc.*, 274 B.R. 663, 672 (Bankr. D. Del. 2002) (citing *Augie/Restivo*, 860 F.2d at 518). In addition to the factors listed above, other courts applying the Second Circuit test have considered the following factors in ascertaining whether the interrelationship between the entities warrants consolidation:

(1) the sharing of overhead, management, accounting, and other related expenses among the different corporate entities;
(2) the parent paying salaries of employees of subsidiaries;
(3) the subsidiary having grossly inadequate capital;
(4) the parent owning all or a majority of the capital stock of a subsidiary;
(5) the parent or its affiliates financing the subsidiary;
(6) the parent shifting people on and off the subsidiary's board of directors;
(7) the parent referring to the subsidiary as a department or division;
(8) the directors of the subsidiary not acting independently in the interest of the subsidiary, but taking direction from the parent; and,
(9) the parent, its affiliates and the subsidiary acting from the same business location.

*Drexel Burnham Lambert Group*, 138 B.R. 723, 765 (Bankr. S.D.N.Y. 1992) (citing *Soviero*, 328 F.2d at 447-448; *Stone*, 127 F.2d at 286-88; and *Vecco*, 4 B.R. at 410). All of the factors listed above must be evaluated within the larger context of balancing the prejudice resulting from the proposed consolidation against the effect of preserving separate debtor entities. *Id.* at 764-65.

In reconciling cases such as *Vecco* with *Augie/Restivo*, a court might choose to analyze the case under both the "elements of consolidation" found in *Vecco* and similar cases and under the two tests delineated in *Augie/Restivo*.[12]

6. Challenge to Bankruptcy Court's Power

In *In re Bonham*, 299 F.3d 750 (9th Cir. 2000), the Chapter 7 trustee attempted to consolidate the debtor's estate with two non-debtor entities.[13] The Ninth Circuit found that the bankruptcy court had the authority to issue the consolidation order based in part on the historical roots of the bankruptcy court. The court noted that the power to issue consolidation orders had been an established power of the bankruptcy courts since the passage of the Bankruptcy Act of 1898. Although the power to consolidate is not specifically codified, the Ninth Circuit commented that no court has held that the power does not still exist. Further, the court concluded that "at present, consistent with its historical roots, the power of substantive consolidation derives from the bankruptcy court's general equity powers as expressed in § 105 of the Bankruptcy Code." *Id.* at 764.

Recently, the power of a bankruptcy court to issue a substantive consolidation has again come under attack. Through a motion for summary judgment, the equity committee in *In re Stone & Webster, Inc.* challenged

[12] *See, e.g., In re Mortgage Inv. Co. of El Paso, Tex.*, 111 B.R. 608-09 (Bankr. W.D. Tex. 1990 (Applying an analysis combining the "elements of consolidation" found in *Vecco* with the *Augie/Restivo* test).

[13] The bankruptcy court entered the order, which was subsequently affirmed by the district court. *In re Bonham*, 299 F.3d at 758.

the bankruptcy court's equitable authority to issue a substantive consolidation order following the Supreme Court's decision in *Grupo Mexicano*.[14] The bankruptcy court found that it was "highly doubtful" that the holding of *Grupo Mexicano* controlled the issue before the court and stated that the holding of *Grupo Mexicano* "has nothing to do with substantive consolidation or the authority of a bankruptcy court to grant the remedy of substantive consolidation." *in re Stone & Webster,* 286 B.R. 532, 537 (Bankr. D. Del. 2002).

The issue in the *Grupo Mexicano* case centered on the district court's power to enter injunctions based solely on the court's power in equity. *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 527 U.S. 308 (1999). In connection with a breach of contract claim, the district court issued a preliminary injunction preventing Grupo Mexicano from transferring rights it had in certain notes. The district court entered the injunction pursuant to Rule 65 of the Federal Rules of Civil Procedure.[15] The Second Circuit affirmed the order.

With Justice Scalia writing for the majority, the Supreme Court reversed the Second Circuit and held that "the District Court had no authority to issue a preliminary injunction preventing petitioners from disposing of their assets pending adjudication of respondents' contract claim for money damages." *Id*. at 333. The Court found that the district court's power to issue injunctions stemmed from the Judiciary Act of 1789 not Rule 65. Absent specific statutory authority, when issuing injunctions, courts must look to "'traditional principles of equity jurisdiction.'" *Id.* at 319 (quoting 11A CHARLES ALAN WRIGHT, ARTHUR R. MILLER, & MARY KAY KANE, FEDERAL PRACTICE AND PROCEDURE § 2941, p. 31 (2d ed. 1995). The court must determine if the injunction being issued is the type of injunction that could have been issued by the English Court of Chancery of the revolutionary days.

In *Grupo Mexicano*, the Supreme Court found that the type of preliminary injunction issued by the district court had no foundation in the traditional principles of equity, and with no statutory authority to issue the injunction, the Court found that the district court had exceeded its authority by issuing the injunction.[16] In light of *Grupo Mexicano*, the questions a bankruptcy court must address when issuing a substantive consolidation order are: 1) whether the Bankruptcy code provides statutory authority for this form of equitable relief or 2) whether the traditional principles of equity include substantive consolidation.

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[14] The Equity Committee's Amended Reply in Support of Its Motion for Summary Judgment on Motion for Substantive Consolidation, *In re* Stone & Webster, Inc., No. 00-2142 (Bankr. D. De. Sept. 10. 2002).

[15] Rule 65 pertains to injunctions.

[16] The Court distinguished *Grupo Mexicano* from *United States v. First Nat'l City Bank*, 379 U.S 378 (1965). In *First National City Bank*, the court issued an injunction preventing a third party bank from transferring the assets of a delinquent taxpayer. The court noted that the injunction in *First National* was issued pursuant to a statute that permitted courts to issue tax injunctions.

## XI. <u>WHAT BANKRUPTCY PRACTITIONERS NEED TO KNOW ABOUT THE SARBANES-OXLEY ACT OF 2002</u>

The Sarbanes-Oxley Act of 2002 (the "Act"), signed into law on July 30, is an attempt to help eliminate accounting fraud and restore confidence in the nation's financial markets. The Act makes significant changes in laws affecting directors, officers, and corporate reporting obligations. The Act directly impacts bankruptcy law, and bankruptcy practitioners should be aware of the significant amendments to federal securities laws, including expanded CEO/CFO certification requirements for annual and quarterly reports filed with the SEC, increased current reporting requirements, enhanced enforcement, stiffer civil and criminal penalties, and closer review of periodic filings by the SEC. The Act also establishes a new Accounting Oversight Board responsible for regulating accounting firms that audit companies filing financial reports with the SEC.

### A. <u>New Officer and Director Regulations</u>

#### 1. <u>Officer Certification of Annual and Quarterly Reports</u>.

a. <u>Certification Under Section 906 of the Act</u>. Effective July 30, 2002, Section 906 of the Act requires that each periodic report filed by a public company must include a certification by the company's chief executive officer ("CEO") and chief financial officer ("CFO") (or their equivalent) that the report fully complies with the periodic reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and that the information fairly presents, in all material respects, the company's financial condition and result of operations. The Section 906 certification is a criminal provision with severe penalties for non-compliance (fines of up to $1 million and up to 10 years imprisonment, with willful violations carrying penalties of fines up to $5 million and imprisonment up to 20 years).

b. <u>Certification Under Section 302 of the Act</u>. The SEC has adopted final rules effective August 29, 2002, under Section 302 of the Act, requiring principal executive officers and principal financial officers of all public companies to certify the accuracy of their annual reports on Form 10-K and quarterly reports on Form 10-Q. These representations are new and are not part of the certification required under Section 906 of the Act. The Section 302 certification applies to quarterly and annual reports and requires extensive representations by the principal financial officers and principal executive officers of public companies, or others performing similar functions. These representations include statements as to their responsibility for the company's internal reporting controls, both financial and non-financial. The certifications include representations regarding both the design of disclosure controls and procedures, and the evaluation of effectiveness of the company's disclosure controls and procedures within 90 days prior to the report. Disclosure of any conclusion about the effectiveness of controls and procedures and changes in internal controls are now required to be disclosed in the public reports.

The rules apply to all public companies, including small businesses and foreign private issuers. There is a special tailored form of certification for asset-backed issuers.

New Exchange Act Rules 13a-14 and 15d-14 require that the principal executive officer and the principal financial officer of each company filing periodic reports must certify in each annual or quarterly report filed with the SEC that, among other things:

?? the signing officer has reviewed the report;

?? based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, not misleading;

?? based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;

?? the signing officers-

✍✍are responsible for establishing and maintaining "disclosure controls and procedures";

✍✍have designed such disclosure controls and procedures to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to them;

✍✍have evaluated the effectiveness of the issuer's disclosure controls and procedures as of a date within 90 days prior to the report; and

✍✍have presented in the report their conclusions about the effectiveness of their disclosure controls and procedures based on their evaluation as of that date;

?? the signing officers have disclosed to the issuer's auditors and the audit committee-

✍✍all significant deficiencies in the design or operation of internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

✍✍any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

?? the signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

c. Under Section 302 Certification, Disclosure Controls and Procedures Must Include Both Financial and Non-Financial Internal Controls. The SEC Release adopting the new Section 302 certification rules (Release Nos. 33-8124, 34-46427, IC-25722), as well as the SEC's statement in Release No. 34-46079 (June 17, 2002) (the "June 17 Release"), make it clear that both internal controls for financial statement information and internal controls for disclosure of non-financial information are required. The new SEC rules contain the previously existing requirement that each reporting company establish and maintain systems of "internal procedures and controls" with respect to its financial reporting and control of its assets. However, the new rules also introduce the concept of "disclosure controls and procedures" which are intended to be broader than internal financial controls, and include compliance with securities law disclosure requirements generally. The SEC believes that the new requirement is complementary to this prior requirement and will help ensure that commensurate procedures for gathering, analyzing and disclosing all information required to be included in a reporting company's periodic and current reports are in place.

Accordingly, public companies must design disclosure controls and procedures to ensure that information required to be disclosed in the reports filed or submitted by it under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is effectively accumulated and communicated to the company's management in order to allow timely decisions regarding required disclosure. Additionally, although current reports are not covered by the new certification requirement, disclosure controls and procedures are required to be designed, maintained and evaluated to ensure full and timely disclosure in current reports, as well as definitive proxy materials and definitive information statements.

The rules do not require any particular procedures for conducting the required review and evaluation. The SEC suggests that each company will develop its own process, based on its specific business, management, and supervisory practices. The SEC does, however, recommend that each issuer create a committee with the responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. This committee would report to the principal executive and financial officers, and perhaps other senior management.

d. <u>Section 302 Requires Certification as to Fair Presentation Versus Compliance with GAAP</u>. The certification requires a statement that the financial statements and other financial information included in the report are fairly presented in all material respects. This not only requires that financial information be presented in accordance with generally accepted accounting principles ("GAAP"), but that the financial information disclosed in the report, when viewed in its entirety, meet a standard of overall material accuracy and completeness that is broader than the financial reporting requirements under GAAP. Additionally, the SEC states that a "fair presentation" includes the selection and application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events, and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of the company's financial condition, results of operations, and cash flows. The reference to cash flows was added by the SEC, even though Section 302 of the Act does not include explicit reference to cash flows.

2. <u>Certain Personal Loans to Executives Prohibited</u>. Under Section 402 of the Act a public company may not, directly or indirectly, make personal loans or otherwise extend credit to or for any director or executive officer. There are very limited exceptions for companies in the consumer lending business to make consumer loans of the type and on the terms made available by the company to the public. Existing loans can continue if there is not a material modification in the terms or renewal of the loan.

The Act does not clearly define to whom loans are prohibited. The term director will likely be defined by reference to Section 3(a)(7) of the Exchange Act and would include any director of a corporation or any person performing similar functions with respect to the corporation. A person who is a director of a subsidiary of a corporation (and not of the corporation itself) would not be covered by Section 402 of the Act with respect to the parent corporation, unless the director is otherwise an "executive officer" of the parent corporation. The term "executive officer" presumably will be defined similar to the term "executive officer" under Rule 3b-7 of the Exchange Act. This would include the issuer's president, vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy making function or any other person who performs similar policy making functions for the issuer. It could also include executive officers of a subsidiary if they perform policy making functions for the parent.

The scope of the Act's prohibition on personal loans to executive officers and directors is not clear at this time, as there is little legislative history about Section 402, and the SEC has not yet issued any interpretive guidance concerning Section 402. Its broad language could prohibit not only direct loans, but also a number of common compensation practices such as "cashless exercise" of options and split-dollar life insurance policies. We expect the SEC to issue rules to clarify the Act's prohibition on these practices, but prudence may dictate a cautious approach concerning the use of these practices pending further guidance from the SEC.

Public companies should review all arrangements with their directors and executive officers to determine if any could fall within the scope of a "personal" loan. Presumably, business travel, corporate credit cards, and other cash advances used for business purposes of the corporation will not be considered personal loans if such advances do not exceed acceptable per diem rates (in the case of business travel) or the reasonable cost of the anticipated business expense and are re-paid timely and promptly. The company should establish a clear policy that prohibits directors and executive officers from using advances, corporate credit cards, and other business loans for personal purposes.

Many other arrangements raise concerns under Section 402 or may require interpretive guidance. These arrangements include re-location assistance, the right to purchase stock with a note, leveraged co-investment plans, and any other personal credit arrangement such as guarantees and installment sales. Moreover, loans or other credit arrangements to the executive officer's family members or other persons or entities in which the director or executive officer has an interest should be reviewed carefully to determine whether they are personal loans "for" the director or executive officer. Other arrangements that may require interpretative guidance include indemnification arrangements, discounted stock options, and loans from the corporation's retirement plans.

3. <u>Code of Ethics for Senior Financial Officers</u>. On January 23, 2003, the SEC adopted rules requiring public companies to disclose whether or not (and if not, why not) the company has adopted a code of ethics for its senior financial officers. The new rules require immediate public disclosure by a company of any change in or waiver of the code of ethics. Issuers must comply with these requirements in their annual reports for fiscal years ending on or after June 15, 2003.

4. <u>SEC-Barred Persons Prohibited from Serving as Officers or Directors</u>. The SEC may bar persons from serving as officers or directors if they violate the general anti-fraud provisions of the federal securities laws and their conduct demonstrates "unfitness" to serve as an officer or director.

5. <u>Responsibilities of Legal Counsel Practicing Before the SEC</u>. On January 29, 2003, the SEC issued a release adopting rules of professional conduct for both inside and outside counsel who represent public companies before the SEC. The rules require that: (i) an attorney must report evidence of a material violation of the securities laws or a breach of fiduciary duty by the company or its agents to the chief legal counsel or the chief executive officer of the company; and (ii) if the chief legal counsel or chief executive officer does not respond appropriately, the attorney must report the evidence to the audit committee or other committee comprised solely of independent directors, or to the full board of directors. These rules are effective August 5, 2003.

B. New Insider Trading Regulations

1. Reporting of Insider Stock Transactions. The Act amends Section 16(a) of the Exchange Act to require reports of changes in beneficial ownership (i.e., Form 4) to be filed with the SEC by the end of the second business day following any transaction by insiders, effective August 29, 2002.

2. No Insider Trading During Pension Fund Blackout Periods. Senior management is prohibited from any insider trading during pension fund blackout periods imposed on 50% or more of the participants in a defined contribution plan, such as a 401(k) plan, if a director or executive officer acquired such securities in connection with his service or employment as a director or executive officer. These rules are effective for blackout periods commencing after January 26, 2003.

C. New Corporate Disclosure Regulations

1. Increased Review of Periodic Filings by the SEC. Public companies can expect enhanced scrutiny of their routine filings where reviews to date have been minimal and generally coincided with registered offerings by the company. Now the SEC must systematically review, on a regular basis (at least every 3 years), disclosures made by public companies in periodic reports. For purposes of scheduling reviews, the SEC must consider the following factors: (i) companies that have issued material restatements of financial results; (ii) companies that have experienced significant volatility in their stock price; (iii) companies with the largest market capitalization; (iv) emerging companies with disparities in price to earnings ratios; (v) companies whose operations significantly affect any material sector of the economy; and (vi) any other factors the SEC considers relevant.

2. Real Time Disclosures. Effective July 30, 2002, public companies must disclose on a "rapid and current basis" such additional information concerning material changes in the company's financial condition or operations, in plain English, as the SEC determines is necessary or useful to protect investors.

3. Financial Statements Must Reflect Material Correcting Adjustments. Each financial report that contains financial statements and that is required to be prepared in accordance with or reconciled to GAAP must reflect "all material correcting adjustments" identified by the company's registered public accounting firm in accordance with GAAP and SEC rules.

4. Disclosure of Off-Balance Sheet Transactions. Effective April 7, 2003, the SEC adopted rules requiring the disclosure within a separately-captioned subsection within the Management's Discussion and Analysis of Financial Condition and Results of Operation of all material off-balance sheet transactions and other relationships of the company with unconsolidated entities or other persons that may have a material current or future effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses. Issuers must comply with these requirements in registration statements, annual reports and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003.

5. Pro Forma Financial Information. On January 22, 2003, the SEC adopted rules requiring that pro forma financial information included in any report filed with the SEC must be presented in a manner that (i) contains no untrue statement of a material fact and does not omit to state a material fact necessary to make the

pro forma financial information, in the light of all circumstances, not misleading; and (ii) is consistent with the GAAP financial statements. These rules are effective as of March 28, 2003.

6. Management Assessment of Internal Controls. Each Form 10-K will contain an internal control report stating management's responsibility for maintaining an adequate internal control structure, procedures for financial reporting and an assessment of the effectiveness of the internal control structure. The company's accounting firm must attest to and report on this assessment.

## D. New Audit Committee Regulations

1. Public Company Audit Committee Requirements to Maintain Exchange Listing. Effective April 25, 2003, the SEC adopted a rule directing the national securities exchanges and national securities associations to prohibit the listing of any securities of a public company whose audit committee does not comply with the following requirements: (i) the audit committee must be directly responsible for the appointment, compensation and oversight of work by the accounting firm engaged by the company and the accounting firm must report directly to the audit committee; (ii) each member of the audit committee must be a member of the company's board of directors and must be "independent" (i.e., may not accept any consulting, advisory or other compensatory fee from the company except in her capacity as a member of the committee or board and may not be an affiliate of the company); (iii) the audit committee must establish procedures for handling complaints on company accounting matters and the confidential anonymous submission by employees of concerns on accounting matters; (iv) the audit committee must have the authority to hire independent counsel and other advisors; and (v) the company must provide funds to pay the accounting firm and any advisors employed by the audit committee.

2. Disclosure of Audit Committee Financial Expert. On January 23, 2003, the SEC adopted final rules to require each public company to disclose whether or not, and if not the reasons therefore, the audit committee has at least one member who is a "financial expert." The Act sets forth standards for the SEC to consider in determining whether an individual qualifies as a "financial expert," including whether a person has, through education or experience, an understanding of GAAP and financial statements, experience in the preparation or auditing of financial statements of comparable companies, experience with internal accounting controls, and an understanding of audit committee functions. The required disclosures must be made for public companies, other than small business issuers, in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers are required to make the disclosures in their annual reports for fiscal years ending on or after December 15, 2003.

3. Audit Committee Relationship with Auditors. An issuer's audit committee (or, if none, the entire board) will have the authority to approve all audit and non-audit services to be provided by the issuer's auditor, and approval of permitted non-audit services must be disclosed in the issuer's periodic reports. Neither the lead audit partner nor the review partner who prepares an audit for a public company can perform an audit for the same company for more than five consecutive years. In addition, the Act commissions a study with respect to mandatory rotation of audit firms. Auditors will be required to make more frequent and thorough reports to audit committees, especially with respect to an issuer's internal controls.

## E. New Accounting Oversight Board and Auditor Independence

1. Supervision and Regulation of Accounting Firms. The Act calls for the creation of a five-member independent Accounting Oversight Board (the "Board") appointed by the SEC and subject to SEC oversight. Accounting firms that conduct audits of public companies will be required to register with the Board. The Board will establish auditing and attestation standards, as well as quality controls and ethics standards. The Board will review annually each accounting firm that conducts more than 100 audits a year; accounting firms conducting fewer audits are to be reviewed every three years. The Board can investigate potential violations of rules and impose sanctions. The Board's power extends to domestic accounting firms as well as foreign public accounting firms that audit financial statements of companies under U.S. securities laws.

2. Auditor Independence. Under the Act, accounting firms are barred from providing several non-audit services to their audit clients. These include bookkeeping or other services related to accounting records or financial statements; financial information systems design, appraisal or valuation services; actuarial services; management functions or human resources; broker or dealer or investment adviser services; and legal services. The Act also prohibits public accounting firms from providing any audit services to a client if a CEO, controller, CFO or chief accounting officer of the client was employed by the accounting firm and participated in the client's audit during the one-year period prior to the initiation of the current audit.

F. New Securities Analysts Regulations

The SEC, or at its discretion, the NYSE or NASD, will adopt rules to limit conflicts of interest of securities analysts by enhancing the separation between investment bankers and research analysts. The Act suggests a number of rules, most of which are similar to those recently adopted by the NYSE and NASD. Among these rules is one imposing post-offering "blackout" periods during which brokerage firms that acted as underwriters in public offerings may not publish reports on the issuer.

G. New Enforcement Penalties and Liability (Effective July 30, 2002)

1. Bankruptcy Loopholes. The Act changes section 523 of the Bankruptcy Code[17] to make judgments and settlements based upon securities law violations non-dischargeable, preventing corporate wrongdoers from sheltering their assets under the umbrella of bankruptcy.

2. Criminal Liability for Failure to Certify Periodic Reports. As discussed above, Section 906 of the Act provides that each periodic report containing financial statements filed by a public company must include a certification by the company's CEO and CFO that the report fully complies with the requirements of the Exchange Act and that the information fairly presents, in all material respects, the company's financial condition and results of operations. A person who provides the required certification *knowing* that the report does not meet the requirements of the rule may be fined up to $1 million or imprisoned for up to 10 years, or both, and a person who *willfully* provides a certification *knowing* that the report is inadequate may be fined up to $5 million or imprisoned for up to 20 years, or both.

3. Forfeiture of Bonuses and Profits. If a company is required to restate its financial statements because of material noncompliance with SEC financial reporting requirements as a result of misconduct, the CEO and CFO are required to reimburse the company for (i) any bonus or other incentive-based or equity-based compensation received during the 12-month period following the public issuance or filing of the financial documents, and (ii) any profits realized from the sale of company securities during the 12-month period. The Act does not specify whose misconduct nor the level of misconduct that could give rise to CEO and CFO reimbursement.

4. Freezing of Assets. The SEC may, during an investigation, seek an order in federal court imposing a 45-day freeze on extraordinary payments to corporate executives by placing the payments in escrow to

[17] Section 523 Exception to Discharge

(a) A discharge under section 727, 1141, 1128(a), 1128(b), or 1328(b) of this title does not discharge an individual debtor from any debt –

…

(19) that –

(A) is for –

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of security; and

(B) results from –

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceedings;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

ensure that corporate assets are not improperly taken.

5. Statute of Limitations for Securities Fraud. The Act amends the statute of limitations for securities fraud claims which, under the Act, must be brought within two years of discovery of the facts constituting the violation or within five years after the violation.

6. Criminal Penalties for Defrauding Shareholders. The Act authorizes the imposition of criminal penalties, consisting of a fine or up to 25 years imprisonment, on persons who knowingly engage in securities fraud with respect to a public company.

7. White Collar Crime Penalty Enhancement Act of 2002. The Act amends the mail fraud provisions of the United States Code to make “attempt” and “conspiracy to commit” crimes punishable as mail fraud with jail sentences up to 20 years.

8. Document Destruction. The Act strengthens laws that criminalize obstruction of justice, such as document shredding or falsifying records, allowing for fines and up to 20 years imprisonment.

9. Whistleblower Protections. The Act creates criminal sanctions against those who retaliate against whistleblowers and includes both fines and up to 10 years imprisonment.