Insolvency, Incivility, and Incorrigibility: A Look Into the World of High-Stakes, Bare-Knuckles Bankruptcy Litigation

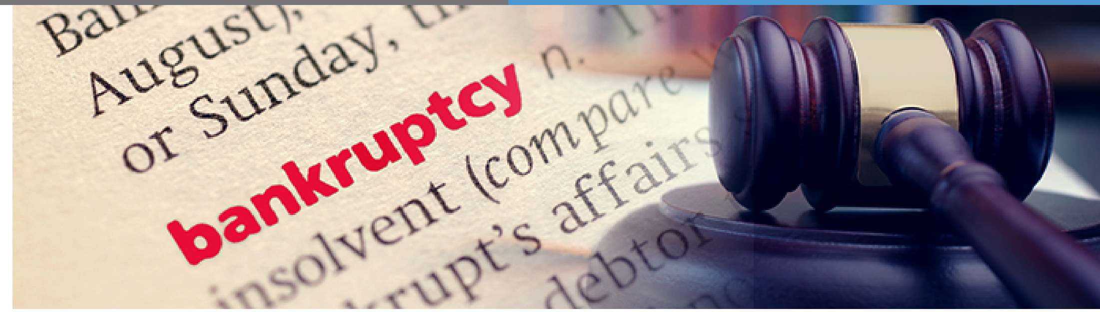
Prepared by Robert Klyman, Oscar Garza. Mitch Karlan, & Kahn Scolnick

February 24, 2016

GIBSON DUNN

Beijing • Brussels • Century City • Dallas • Denver • Dubai • Hong Kong • London • Los Angeles • Munich
New York • Orange County • Palo Alto • Paris • San Francisco • São Paulo • Singapore • Washington, D.C.

Table of Contents



Substantive Litigation

Overview of Fiduciary Duties of Directors

- Directors of a financially stressed company may be asked to approve certain transactions, financings, payments or restructuring strategies that could be attacked (with the benefit of 20/20 hindsight) if the company were subsequently to falter or if stakeholders perceive that they were harmed by the transaction or restructuring or perceive a strategic advantage to asserting such claims.

- When a company is financially stressed, the fiduciary duties of its directors expand to include stakeholders other than the company and its equity stockholders, such as senior lenders, bondholders and other creditors.

- The environment in which directors of a financially stressed company operate has become much more difficult. Courts, regulatory agencies, lenders, bondholders and other stakeholders have become more aggressive and willing to second-guess directors' decisions.

Overview of Fiduciary Duties of Directors (Cont'd)

- Lawsuits for breach of fiduciary duty are rampant in bankruptcy cases.
- Bankruptcy creates a forum that avoids "collective action" problem outside of bankruptcy.
- Creditors' committee, trustee or post-confirmation litigation trust can bring the action on behalf of all creditors.
- Litigation is funded through carveout or other estate property, so no one creditor bears the cost.
- D&O insurance may be a primary source of recovery for unsecured creditors.
- As a result, most breach of fiduciary claims get litigated in bankruptcy courts.

Fiduciary Duties

- The business affairs of a company are to be managed by its officers under the direction of the board of directors.

- The law of the state of organization of the company determines the scope and extent of management's and the board's fiduciary duties.

- The vast majority of debtors are each Delaware corporations, and the actions and decisions of their respective boards are governed by Delaware Law.

Application of Fiduciary Duties in a Solvent Company Context

Stockholders	Creditors
• General Rule: Directors of a solvent company owe their fiduciary duties to the company and derivatively its stockholders. • Stockholders have no contractual protections. Accordingly, they are entitled to a high degree of protection from mismanagement as a matter of law.	• Creditor Rights Are Contractual: Creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, general commercial law and other sources of creditor rights.

Application of Fiduciary Duties in an Insolvency Context

- At all times, directors owe a fiduciary duty to the entire "corporate enterprise" or the "community of interests that [sustain] the corporation."
  - When a company is insolvent, however, the community grows to *include creditors*. At that point, creditors become the primary beneficiaries of the fiduciary duties and stockholders become the secondary beneficiaries of the fiduciary duties.
  - Case law has clarified that directors do not owe direct fiduciary duties to creditors when the corporation is insolvent or in the zone of insolvency. Rather, as with its shareholders, all duties to creditors in these contexts are derivative: They flow through the directors' duties to the company.
- <u>When It Is Unclear if the Company Is Solvent</u>:
  - Often it is prudent for directors to assume when making decisions that in hindsight a court might find the corporation was insolvent.
  - Directors should act in a manner that preserves and maximizes the value of the company.

The Duty of Care

- Duty of Care
  - The actions and conduct of directors must be informed and considered, and decisions must be made with "requisite care."
  - Directors are entitled to rely *in good faith* on reports prepared by officers of the company or outside experts.
- To establish that a board has acted with requisite care, it is important to create and follow a decision making process and maintain good records to demonstrate that the board's decision was informed after consideration of all relevant factors associated with the ultimate decision made.

The Duty of Loyalty

- Duty of Loyalty
  - Directors must act in good faith and in the best interests of the company.
    - As discussed, in an insolvency context, the company can be construed broadly to include the entire corporate enterprise, including creditors.
  - To receive the benefit of the presumption of the "business judgment rule" (discussed below), directors must be disinterested with respect to the transactions being considered — where there may be questions regarding disinterestedness with respect to a specific decision, disinterested directors may choose to consider the issue without interested directors present, and then make a recommendation to the full board for a vote.
- Traditionally, a duty of loyalty analysis addresses the director's personal interest, if any, in the corporate decision.
- Because, in an insolvency context, the family of interests protected by fiduciary duties now includes creditors, employees and individuals affiliated with the controlling shareholders may be seen as acting at the direction of the controlling shareholders, which could lead to questions of conflict or interestedness (i.e., putting the interests of the sponsor ahead of the stakeholders).
  - Case law suggests that when a director designee breaches the duty of loyalty at the direction of the controlling shareholder(s), the controlling shareholder(s) may be financially liable.

Standards of Review of a Board's Decision Making
(1) The Business Judgment Rule

- The business judgment rule creates a legal presumption whereby courts are deferential to a decision of the board, even if the decision was ultimately unprofitable or a mistake in hindsight.
- Directors are presumed to have acted in good faith and in the best interests of the company.
- Directors must fulfill the duty of care and avoid conflicts of interest to receive the protection of this presumption.
- The following acts, for example, could result in the loss of such presumption:
  - conflicts of interests;
  - preferential treatment of certain creditors and other stakeholders (including insiders);
  - failure of a director to disclose material aspects of a transaction; and
  - acting without requisite information or deliberation (i.e., breach of the duty of care).

What Is an Interested Director?

- An interested director (a) appears on both sides of the transaction, (b) receives a benefit from the transaction that is not received by stockholders generally, or (c) is beholden to a party involved in the proposed transaction such that the director is unable to exercise independent business judgment.
  - Even where some directors are "interested," the protections of the business judgment rule can be preserved if a special committee of non-interested members of the board separately approves the transaction.
  - However, to the extent the transaction is not so approved, a stricter "entire fairness" standard (discussed below) may be applied to evaluate the transaction.

Standards of Review of a Board's Decision Making
(2) Entire Fairness

- The "Entire Fairness" standard applies where a board may be conflicted. It often arises in interested director transactions.
  - For a distressed company, it typically is prudent for the directors to put in place a process to defend all actions under the entire fairness standard.
  - The standard consists of two inquiries: (a) fair price and (b) fair dealing.
    - Fair price means a price that a reasonable seller, under all of the circumstances, would regard as within a range of fair value.
    - Fair dealing considers both the process that the board followed and the quality of the result achieved.
  - Unlike the business judgment test, the burden of proving entire fairness falls upon the board.

Fiduciary Duties: The Corporate Opportunity Doctrine

- Arises from duty of loyalty.

- Corporate Opportunity Doctrine: Directors and officers, as insiders, cannot use their strategic position for their own or their affiliate's advantage to the exclusion or detriment of the corporation they represent.

- Delaware courts have held that the rule is also applicable in determining whether a controlling shareholder has preempted an opportunity that rightfully belongs to the corporation.
  - A "corporate opportunity" exists when a proposed activity, in which the corporation has the ability to engage, is related to the corporation's present or prospective business.

Fiduciary Duties: The Corporate Opportunity Doctrine (Cont'd)

- The determination of whether a controlling shareholder or corporate fiduciary has usurped a corporate opportunity that rightfully belongs to the corporation is a fact-intensive inquiry that turns on a number of elements:
  - (1) Whether the corporation is financially able to undertake the opportunity
  - (2) Whether the opportunity is in the corporation's line of business
  - (3) Whether the corporation has an interest or reasonable expectancy in the opportunity
  - (4) Whether, in taking advantage of the opportunity, the self-interest of the corporate fiduciary will come into conflict with the interests of the corporation

Duty of Loyalty Recent Case Law

- Recent case law has expanded the duty of loyalty beyond self-dealing and corporate usurpation to include a failure to act in good faith.
- In one case, the following components were ruled sufficient to support a claim for breach of fiduciary duties:
  - the defendants failed to place corporate assets up for sale prior to a liquidity crisis;
  - the defendants failed to hire a restructuring advisor in a timely manner, despite urgings from senior lenders;
  - the defendants abdicated all responsibility to the restructuring advisor when one was finally hired; and
  - the defendants acquiesced to the restructuring advisor's hasty decision to sell corporate assets.

Strategies to Minimize Risk of Director Liability

- Key Steps to Avoiding Director Liability in Decision Making:
  - avoid interested director transaction issues and the application of the Entire Fairness standard (e.g. through the formation of a subcommittee of independent directors to review and approve transactions or restructuring alternatives where there is a potential conflict of interest between equity holders and creditors);
  - analyze the company’s financial condition before and after the proposed transaction or restructuring;
  - retain restructuring advisors and counsel to analyze proposed transactions and associated risks;
  - document any decisions made, including any supporting advice; and
  - take actions designed to maximize value of enterprise, rather than the interests of a particular stakeholder.

Strategies to Minimize Risk of Director Liability (Cont'd)

- Avoid Corporate Opportunity Liability
  - Waiver
    - In Delaware, a corporation can renounce its interest in certain types of corporate opportunities by providing so in its certificate of incorporation or through action of its board of directors (*see* section 122(17) of the Delaware General Corporation Law)
    - Joint-venture members can also waive their expectations to corporate opportunities in the joint venture agreement
  - Disclose opportunity to corporation where necessary
  - Establish record in support of corporation's decision to decline opportunity
  - Conflicted director should abstain

Strategies to Minimize Risk of Director Liability
(Cont'd)

- Directors should evaluate and consider a distressed company's alternatives with the following question in mind:
  - "Assuming the company is now insolvent, what is the best course of action that will maximize value, particularly for recoveries to creditors?"
  - "Given our relationship with our equity investors, would our decision making process be subject to challenge?"
  - Caution: A "home run" strategy that would benefit stockholders if successful, but which imposes significant risk of loss to other stakeholders if not successful, is an action that requires careful scrutiny.

Fiduciary Duties: LLC Agreements Can Provide Enhanced Protections Through Exculpatory Provisions

- Delaware law allows LLCs and LPs to include a waiver of fiduciary duties in the operating or partnership agreement (but it cannot waive implied contractual covenant of good faith and fair dealing) (6 Del. Code § 17-1101(d)-(f), § 18-1101(c)-(e))
  - A bankruptcy court has upheld this waiver in an LLC Agreement to deny a creditor's request to sue derivatively for breach of fiduciary duties and aiding and abetting breach of fiduciary duties (*In re Optim Energy, LLC*, 2014 WL 1924908, at *6 (Bankr. D. Del. May 13, 2014).
  - The specific drafting is important. In *In re BH S&B Holdings LLC*, 420 B.R. 112 (Bankr. S.D.N.Y. 2009), for example, an LLC's managers asserted that the LLC agreement's exculpatory provisions blocked claims for breach of fiduciary duty brought by an unsecured creditors committee against them. However, the LLC agreement expressly carved out of the exculpatory waiver provision claims for gross negligence. Because the standard under Delaware for breach of the duty of care is "gross negligence," the court found that the exculpatory provisions did not apply to eliminate the duty of care.

Fiduciary Duties: LLC Agreements Can Provide Enhanced Protections Through Exculpatory Provisions (Cont'd)

- Delaware law also prevents creditors from derivatively asserting fiduciary duty claims as to LLCs and LPs (6 Del. Code § 17-1002, § 18-1002).
  - In *CML V LLC v. Bax*, 28 A.3d 1037 (Del. 2011), the Delaware Supreme Court held that creditors of an insolvent Delaware limited liability company do not have standing under Delaware law to sue derivatively for breach of fiduciary duty. According to the court, § 18-1002 of Delaware's LLC Act limits standing to pursue such claims to members or assignees of the LLC's interests in the LLC. Creditors do not qualify as either a member or an assignee.
- At least one court has held that a Delaware LLC Agreement can block breach of fiduciary claims asserted in a bankruptcy case by a chapter 11 trustee (*see In re Heritage Organization, LLC*, 2008 WL 5215688 (Bankr. N.D. Tex. 2008)).
- Courts have yet to rule on whether *Bax* applies to derivative claims asserted in bankruptcy cases by official unsecured creditors' committees.

RICO: Overview

Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1962

- RICO makes it unlawful for any person employed by or associated with an "*enterprise*" that engages in interstate commerce to conduct or participate in conducting the enterprise's affairs through a "*pattern of racketeering activity*" (or to conspire to do so). 18 U.S.C. § 1962(c)-(d).
- Plaintiffs do not need to prove the defendant is connected to organized crime. *H. J. Inc. v. Nw. Bell Tel. Co*., 492 U.S. 229 (1989).
- Under the statute, "[a]ny person injured in his business or property by reason of a violation" of RICO may sue in federal district court and recover treble damages, costs, attorneys' fees, and other relief.

RICO

"We don't want one set of rules for people whose collars are blue or whose names end in vowels, and another set for those whose collars are white and have Ivy League diplomas."

-RICO's principal drafter

RICO: Elements

1	conduct	→	Operation and Management of an Enterprise
2	of an enterprise		
3	through a pattern	→	Predicate Acts
4	of racketeering activity		
5	affecting interstate commerce	→	Causation
6	Resulting in injury to plaintiff		

RICO: Elements

- "Enterprise"
  - Requires only three structural elements: a purpose, relationships among those associated with the enterprise, and longevity.
    Boyle v. United States, 556 U.S. 938 (2009).
- "Pattern"
  - Requires at least two acts of continuous and related "racketeering activity."
- "Racketeering Activity"
  - Activities that could be charged under a wide range of federal and state criminal statutes (mail/wire fraud, extortion, obstruction of justice, etc.).
- To establish a RICO violation, all elements of the underlying predicate acts (in addition to the RICO elements) must be alleged and, ultimately, proven.

RICO: Predicate Acts

- "Racketeering activity" includes "any offense involving fraud connected with a case under title 11 (except a case under section 157 of this title)." 18 USC § 1961.
- "[F]raud connected with a case under title 11" includes, for instance:
  - Concealing property from trustee. 18 U.S.C. § 152(1).
  - False oath/declaration in relation to a bankruptcy proceeding. 18 U.S.C. § 152(2), (3).
  - Fraudulent claim for proof against the debtor's estate. 18 U.S.C. § 152(4).
  - Fraudulently receiving material amount of property from debtor with the intent to defeat provisions of Title 11. 18 U.S.C. § 152(5).
  - Fraudulent transfer in personal capacity or as officer of corporation with intent to defeat provisions of Title 11. 18 U.S.C. § 152(7).
  - After filing a case under Title 11 or in contemplation thereof, fraudulently destroying, concealing, falsifying, mutilating, etc. any entry in recorded information (books, records, etc.) relating to the property or financial affairs of a debtor. 18 U.S.C. § 152(8).

Common Law Fraud

- ***Elements:***
  - Misrepresentation (false representation, concealment, or nondisclosure)
    - Concealment or nondisclosure require a legal duty to disclose facts, *e.g.*, fiduciary relationship
  - Knowledge of falsity (scienter)
  - Intent to defraud, *i.e.*, to induce reliance
  - Justifiable reliance
  - Resulting damage

Intersection of Bankruptcy, RICO, and Fraud

- Bankruptcy fraud is a federal crime
  - *United States v. Sabbeth*, 262 F.3d 207, 214 (2d Cir. 2001) ("Congress enacted [18 U.S.C. § 152] to prevent and punish efforts to defeat the provisions of Title 11.").
- Fraud claims can proceed against bankrupt defendants
  - *In re Harbinger Capital Partners Funds Investor Litig.*, No. 12-cv-1244, 2015 U.S. Dist. LEXIS 40516 (Mar. 30, 2015) (securities fraud claim against bankrupt defendant investment fund covered under the Securities Litigation Uniform Standards Act).
- Bankruptcy fraud is a predicate act for purposes of a RICO claim
  - *Bankers Trust Co. v. Rhoades*, 859 F.2d 1096 (2d Cir. 1988) (recognizing "overlap of RICO and bankruptcy law," which "does not present a question of … standing to bring a civil RICO claim, but rather presents the question of which and how much damages Bankers can recover under that RICO claim.").

Intersection of Bankruptcy, RICO, and Fraud

- *Harbinger Capital Partners LLC v. Ergen,* 103 F. Supp. 3d 1251 (D. Col. 2015)
  - Plaintiffs invested heavily in LightSquared, a nationwide wireless broadband network that eventually filed for bankruptcy.
  - Plaintiffs filed RICO and related claims, arguing that defendants engaged in fraud to prevent plaintiffs' control of LightSquared during bankruptcy proceedings.
  - District court dismissed on claim-splitting grounds, concluding that the bankruptcy court had jurisdiction over the RICO claims, and plaintiffs should have presented them to the bankruptcy court.

- *Vibe Micro Inc. v. Shabanets*, No. 9:15-cv-80999 (S.D. Fla.)
  - Plaintiffs allege that law firm attorneys helped a group of shareholders carry out a bankruptcy to prevent another shareholder's vision for the company.
  - Plaintiffs filed a RICO claim, alleging that the attorneys and shareholders conspired to put the company into bad faith bankruptcy.

Veil Piercing

- The shareholders of a corporation and the members of an LLC generally are **not liable for the debts** of the entity.
- But in appropriate circumstances, the distinction between the entity and its owners may be disregarded to require an owner to **answer for the entity's debts**.
- Delaware law permits a court to **pierce the corporate veil** where there is fraud or where the corporate entity is in fact a **mere instrumentality or alter ego of its owner**.
- Veil piercing applies to **LLCs**.

Veil Piercing – Two Part Test

- First, the parent and subsidiary must be shown to have operated as a **single economic entity** (as **alter-egos** of each other).
- To determine whether the parent and subsidiary acted as a **single economic entity**, courts look to the following:
  - undercapitalization,
  - failure to observe corporate formalities,
  - nonpayment of dividends,
  - insolvency of the debtor corporation at the time,
  - siphoning off of the corporation's funds by the dominant parent,
  - absence of corporate records, and
  - the fact that the corporation is merely a facade for the operations of the dominant parent.

Veil Piercing – Two Part Test

- Second, there must be an **overall element of injustice, unfairness, or fraud**.
- The fraud or injustice must be found in the firm's **use of the corporate form**.
- Veil piercing is appropriate if a parent corporation **misleads a subsidiary's creditors** into believing that the parent will answer for the creditors' claims against the subsidiary.

Equitable Subordination: Overview

- Under section 510(c)(1) of the Bankruptcy Code, a court may subordinate all or part of an allowed claim or interest to all or part of another allowed claim or interest based on equitable considerations.
- Courts generally apply a three-part test:
  1. The claimant must have engaged in inequitable conduct;
  2. The misconduct must have:
     (a) Resulted in injury to creditors, or
     (b) Conferred some unfair advantage on the claimant; and
  3. Equitable subordination must not be inconsistent with other provisions of the Bankruptcy Code

  See United States v. Noland, 517 U.S. 535, 538-39 (1996)
- There is no statute of limitations, but a court will examine the causation of harm alleged by the inequitable conduct, consistent with the three-part test above (*In re Bernard L. Madoff Inv. Sec. LLC*, 515 B.R. 117, 160 (Bankr. S.D.N.Y. 2014))

Equitable Subordination: Standing

- A trustee or debtor-in-possession has standing to bring equitable subordination claims.
- Most courts, in what appears to be the trend, hold that individual creditors must obtain court approval before bringing equitable subordination claims *unless the creditor alleges a particularized injury.*
  - *See, e.g.*, *In re Blockbuster Inc.*, 2011 Bankr. LEXIS 1025, at *6 (Bankr. S.D.N.Y. Mar. 17, 2011) (creditor must allege particularized injury or obtain court approval); *In re Elrod Holdings Corp*., 392 B.R. 110, 115 (Bankr. D. Del. 2008) (secured creditor has standing to the extent that it seeks relief for a particularized injury)
- At least one Seventh Circuit decision has held that individual creditors have standing to bring equitable subordination claims even without a showing of a particularized injury.
  - *See In re Vitreous Steel Prods Co.*, 911 F.2d 1223, 1231 (7th Cir. 1990)

Equitable Subordination: Standing (cont'd)

Particularized vs. Non-Particularized Equitable Subordination Claims

- Particularized injury where plaintiff alleged that it was fraudulently induced to sell its interest in the debtor based on misrepresentations by debtor's indirect corporate parent (*In re Autobacs Strauss, Inc*., 473 B.R. 525, 556 (Bankr. D. Del. 2012));
- No particularized injury where claimant received unlawful prepetition transfers, depleting funds that would otherwise be available to all general unsecured creditors, resulting in injury to estate as a whole (*In re Bernard L. Madoff Inv. Sec. LLC*, 515 B.R. 117, 160 (Bankr. S.D.N.Y. 2014)

Equitable Subordination: Insider vs. Non-Insider Status

- "A claim arising from the dealings between a debtor and an insider is to be rigorously scrutinized by the courts." *In re Winstar Commc'ns, Inc.*, 554 F.3d 382, 412 (3d Cir. 2009).
  - Most cases involve challenges to insider claims
- <u>Insider Claimant</u>
  - The party seeking to subordinate must present material evidence of unfair conduct that the insider *claimant then must rebut by proving the fairness of his transactions with the debtor*
  - Examples include:
    - Insider with secured loan delayed foreclosure on loan, induced other creditors to extend credit to the debtor, then subsequently foreclosed (*Stoumbos v. Kilimnik*, 988 F.2d 949, 960 (9th Cir. 1993))
    - Motion to dismiss denied where claimant was alleged, among other things, to have operated debtor as its alter ego, kept the debtor undercapitalized, secretly recharacterized capital contribution as a loan, and repaid portion of loan (*In re Autobacs Strauss, Inc.*, 473 B.R. 525, 583-86 (Bankr. D. Del. 2012))

Equitable Subordination: Insider vs. Non-Insider Status (Cont'd)

- <u>Non-Insider Claimant</u>
  - The party seeking to subordinate must present evidence of more egregious conduct such as fraud, spoliation, or overreaching.
  - Examples include:
    - Remedy for fraudulent transfer when no other remedy was available (*In re Pajaro Dunes Rental Agency, Inc*., 174 B.R. 557, 597-98 (Bankr. N.D. Cal. 1994))
    - Bank advanced and withdrew loan proceeds arbitrarily, and at the same time caused interest to run on misappropriated proceeds, resulting in depletion of funds available for construction project, which harmed other creditors (*In re 604 Columbus Ave. Realty Trust*, 968 F.2d 1332, 1362 (1st Cir. 1992))
    - But see *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (lender's exercise of contractual rights to refuse to make additional advances is not "inequitable conduct" even though lender would have been fully secured and lender's refusal was detrimental to debtor's business)

Equitable Subordination: General Takeaways

- Remember that 510(c) is used to reorder priorities (claims/claims and interest/interest) not to recharacterize secured debt.
- There is no statute of limitations associated with equitable subordination.
- Initial focus will be on whether claimant is an insider.
  - Claimants who are not "statutory insiders" should avoid actions that may cause them to fall within "non-statutory insider" status
- Insider status alone is not sufficient.
- Claimant's exercise of contractual rights, standing alone, will not constitute "inequitable conduct."

Substantive Consolidation

- A bankruptcy court may order that the assets of two or more related entities **be pooled together** and the liabilities of these entities may then be satisfied **from this common pool of assets**.

- A court can substantively consolidate the assets of firms that have **filed for bankruptcy**.

- More and more courts are allowing substantive consolidation of debtors and **non-debtors**.

Substantive Consolidation – Two Part Test

- First, a court will consider whether the entities whose assets will be consolidated were treated as **a single entity by creditors**.
- Courts examine:
  - The degree of difficulty in **segregating and ascertaining individual assets and liability**;
  - The presence or absence of **consolidated financial statements**;
  - The **commingling of assets and business functions**;
  - The **unity of interests and ownership** between the various corporate entities;
  - The existence of **parent and inter-corporate guarantees on loans**;
  - The transfer of assets **without formal observance of corporate formalities**;
  - Whether entities operated out of **the same location** at one time; and
  - Whether employees performed work for one entity but **were paid by another**.

Substantive Consolidation – Two Part Test

- Second, a court will consider whether consolidation will be **fair to the creditors** involved.

- Generally, where the operations of entities are too entangled to separate, consolidation will be considered beneficial and fair to creditors.

- If certain creditors will possibly receive less as a result of consolidation, that will weigh against consolidation.

Fraudulent Transfers

- Prepetition transfer may be avoidable if:
  - Transfer is made with actual intent to hinder, delay or defraud creditors

  OR
  - Transfer is made for less than reasonably equivalent value, while debtor is insolvent, or which renders debtor insolvent or leaves it with unreasonably small capital

- Bankruptcy Code Provisions:
  - Section 550 allows the debtor to recover property that has been “fraudulently’ transferred.
  - Section 548 allows avoidance of transfers/obligations incurred within 2 years of petition date (Bankruptcy Law).
  - Section 544 allows the debtor to avoid transfers under applicable state law (non-bankruptcy law) (State Law).

Fraudulent Transfers

- Common Scenarios
  - Acquiring assets from financially troubled company.
  - Leveraged buyout.
  - Internal reorganizations.
  - Accepting payment from someone other than the obligor
    - Affiliates
    - Guarantors
- Potential Protections:
  - Section 546(e) provides safe harbor within which transfers cannot be avoided as constructively fraudulent (intended to reduce systemic risk to the markets – avoid the disruption of settled transactions).
  - Solvency Opinions.
  - Fairness Opinions.
  - Helpful protections, but must be used with care and with knowledge of potential failure.

Preferences

- Preference law is intended to assure equal treatment among similarly situated creditors whose claims existed around the time of the bankruptcy filing.
  - Creditors receiving payment (or any transfer of property such as a lien) on account of their claim <u>within 90 days of the bankruptcy filing</u> may be sued to recover the payment/transfer.
- Defenses
  - Solvency
    - The debtor is presumed to be insolvent in the 90 days before bankruptcy
  - "Contemporaneous exchange" of value
    - Transfer was intended as contemporaneous, and the exchange must actually be "substantially" contemporaneous
  - Ordinary course of business
    - Made in the ordinary course of business or financial affairs of the debtor and creditor OR
    - Made according to ordinary business terms
  - Subsequent new value
    - Creditor advanced new unsecured credit (*e.g.*, shipped additional inventory) that is not repaid after receiving preferential payment, which creditor can set off against preference liability
  - Enabling loans
    - Creditor advanced new value/property and perfected security interest within 30 days

Make-Whole Premiums: Overview

- New York law generally prohibits voluntary prepayment of fixed maturity term debt without lender consent.
- Debt instruments – if they allow prepayment – often provide that they can not be prepaid without prepayment of a premium, such as a "make-whole" premium (a present value calculation that discounts the payments that would have been received if the bond had not been redeemed, calculated based on comparable treasury yields).
- Different types of debt instruments have different treatment for prepayment premiums in the event of acceleration of the debt.
  - Many debt instruments provide that the debt can be accelerated upon certain events of default and that the debt is automatically accelerated upon the issuer's filing for bankruptcy.

Make-Whole Premiums: Outside of Bankruptcy

- Generally speaking, outside of bankruptcy, prepayment premiums will be enforceable.
- In New York, a prepayment premium is generally analyzed under law applicable to liquidated damages provision.
  - Actual damages are difficult to determine in advance
  - The liquidated damages amount should not be plainly disproportionate to the possible loss
- Courts increasingly defer to negotiations of sophisticated parties unless the liquidated damages would be "an unreasonable penalty" – often considered an "I know it when I see it" standard.

Make-Whole Premiums: General Principles of Bankruptcy

- Indenture/notes should specifically provide for payment of premium after acceleration for any reason, including the commencement of a bankruptcy case
  - *U.S. Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 730 F.3d 88 (2d Cir. 2013) (disallowing make-whole premium where indenture clearly provided that make-whole payment was not due upon a bankruptcy acceleration)
  - *Wilmington Savings Fund Soc'y, FSB v. U.S. Bank Nat'l Ass'n (In re MPM Silicones, LLC)*, 531 B.R. 321, 336 (S.D.N.Y. 2015) (disallowing make-whole premium where "neither the make-whole provision itself nor any other provision of notes or indenture clearly and unambiguously required payment of make-whole premium if notes were accelerated")
- Accelerate pre-bankruptcy; any forbearance agreement should provide clear and unambiguous language that (a) the debt has been accelerated and (b) the make whole premium is reasonable, due and payable as part of the principal amount of the debt
  - *In re School Specialty, Inc.*, 2013 WL 1838513 (Bankr. D. Del. April 22, 2013) (upholding ~35% make-whole premium where parties entered into prepetition forbearance agreement recognizing that loan was accelerated and make-whole payment was due and payable)

Make-Whole Premiums: General Principles of Bankruptcy

- Better result if your debtor is solvent
  - *CSC Trust Co. v. Energy Future Intermediate Holdings Co., LLC (In re Energy Future Holdings Corp.)*, 513 B.R. 651 (Bankr. D. Del. 2014) (reasoning, in context of discovery dispute, that the court would enforce the make-whole terms of the contract under state law if the debtor is solvent, but the court would "most likely have to make a decision based on equitable principles" if the debtor is insolvent)
- Better result if approval of premium is part of a settlement supported by the debtor
  - *In re Chemtura*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010) (approving make-whole and damage claim under Rule 9019 settlement standards in light of split in case law – settlement fell within the "lowest point in the range of reasonableness")
- Avoid Louisiana
  - *In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. 823 (Bankr. E.D. La. 2001) (holding that fee is unreasonable if it does not effectively estimate actual damages and disallowing make-whole premium because lender did not introduce evidence of any damages it has or would suffer as a result of prepayment)
- Principles are not bulletproof, but better than relying on creative bankruptcy lawyering after the commencement of a chapter 11 case

Procedural Tactics

Litigation Practice in Bankruptcy Courts – Not for the Novice

Large bankruptcy cases tend to feature complex, high stakes litigation requiring trial skills.

Litigation in bankruptcy cases is complex and features traps for the unwary that may ensnare litigants.

Multiple sources of law must be consulted when litigating bankruptcy cases:

- United States Constitution
- Bankruptcy Code (11 U.S.C.)
- Federal Rules of Bankruptcy Procedure
- Federal Rules of Civil Procedure
- Federal Rules of Appellate Procedure
- Judiciary Code (28 U.S.C.)
- Local Rules of each District Court
- Local Rules of each Bankruptcy Court
- Individual Rules of each Bankruptcy Judge

The Bankruptcy Process Plays Out In Two Different Court Systems

Article III

- "The judicial power of the United States shall be vested in one Supreme Court and in such inferior courts as the Congress may from time to time ordain and establish."
- Article III judges have lifetime tenure.
- "The judicial power shall extend to all cases, in law and equity, arising under the Constitution [or] the laws of the United States."

Article I, Section 8, Clause 4

- Empowers Congress to establish "uniform laws on the subject of Bankruptcies throughout the United States."
- Congress did so pursuant to the "Bankruptcy Act" in 1898, and later the "Bankruptcy Code" in 1978.
- Bankruptcies were administered by "Referees" under the Act and are administered by Bankruptcy Judges under the Code.

This Has Created Two Different Separation of Power Issues

Problems –

- Bankruptcy Courts are not Article III courts.
- Bankruptcy Judges are not appointed by the President or confirmed by the Senate; they are appointed by federal appeals judges.
- Bankruptcy Judges do not have lifetime tenure; they serve 14-year terms.
- Thus, Bankruptcy Judges may not preside over jury trials without the consent of the parties and may not finally decide many issues, for example, questions of state law.

Solution –

- The "automatic reference" and the split of "core and non-core" matters.
- All bankruptcy cases are filed in the District Court, then "referred" by the District Court to the Bankruptcy Court, often automatically pursuant to a standing order. See 28 U.S.C Section 157(a).
- Then different kinds of matters (core vs. non-core) are handled differently.

What Can District Courts Do In Bankruptcy Cases?

District Court has –

- Original and exclusive jurisdiction in a bankruptcy "case." 28 U.S.C. Section 1334(a).
- Original and non-exclusive jurisdiction over all "civil proceedings" arising under the Code or arising in or related to a bankruptcy case. 28 U.S.C. Section 1334(b).

In other words, if District Courts wanted to do so they could adjudicate any and every issue that might arise in a given Bankruptcy case – but they do not want to do that and uniformly refuse to do so.

What Can Bankruptcy Courts Do (Part 1)?

CORE – 28 U.S.C. Section 157(b)

- Bankruptcy Courts can "hear and determine" disputes arising under 11 U.S.C. [the Code] or arising in a case under the Code.
- Determination is final subject only to appeal.

Common examples of core proceedings:

Approving the disclosure statement and plan of reorganization, resolving contested proofs of claim, adjudicating preference actions, approving fee applications, deciding motions to appoint a Chapter 11 trustee or to terminate exclusivity.

What Can Bankruptcy Courts Do (Part 2)?

NON-CORE – 28 U.S.C. Section 157 (c)

- Bankruptcy Court can "hear" but not finally determine non-core matters absent the consent of the parties.
- Court issues a report and recommendations to the District Court, which either party may object to.
- If no objection, then report becomes in effect a final adjudication.
- If either party objects, the District Court reviews the recommendation de novo.

Common examples of non-core proceedings:

Suits for breach of fiduciary duty against the debtor's former officers and directors, suits for common law torts (e.g., fraud or negligence) against non-debtors.

NB: Some non-core claims "become" core. If, for example, a creditor files a contested claim and the debtor files a counter-claim that arises out of the same set of facts, that counter-claim is core, although it would not otherwise be.

The "Stern" Gap

In 2011, the Supreme Court ruled in **Stern v. Marshall** that certain kinds of claims, which the Code statutorily defines as "core" claims, may not be finally determined by non-Article III courts. Such claims may only be finally determined by the District Court, just like statutorily non-core claims.

This created confusion and concern for some years, which was resolved only in 2014 when the Supreme Court unanimously ruled that such claims could be adjudicated on a non-final basis, notwithstanding the language of the Code, and treated as non-core claims – heard by the Bankruptcy Court, which renders proposed findings and conclusions, subject to de novo review by the District Court.

In 2015, the Supreme Court further clarified that litigants can consent to have the Bankruptcy Court enter a final judgment on a so-called Stern claims. If there has been no such consent, the losing party should always file a timely objection with the District Court to an adverse disposition and treat the Stern claim as if it were one the Bankruptcy Court lacked power to finally adjudicate.

Two Kinds of Litigation in Bankruptcy Courts

Adversary Proceedings – Part VII of the Federal Rules of Bankruptcy Procedure

- Essentially the same as a civil action in a federal district court -- complaint, answer, discovery, dispositive motions, and trial.
- Some disputes must be handled this way. See Bankruptcy Rule 7001.
- Preference actions, fraudulent conveyance actions, and actions by the debtor to recover money from third parties are all handled this way.
- Nationwide service of process by regular mail.

Contested Matters – Part IX of the Federal Rules of Bankruptcy Procedure

- Essentially the same as motion practice in a federal district court.
- Most disputes – even essential ones -- are handled this way (e.g. approving the disclosure statement, confirming the plan, awarding fees).
- Court may hear live testimony but often does not.

What If The Bankruptcy Court Cannot Enter Final Adjudication?

Typically, the dispute proceeds in the Bankruptcy Court, and is then subject of a de novo review by the District Court, but there are times when the dispute will not proceed in the Bankruptcy Court at all.

Withdrawing the reference -- the case may be returned back to the District Court and adjudicated there. 28 U.S.C. 157(d)(e).

Mandatory – on timely motion of a party, the reference must be withdrawn if (a) resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce, or (b) one party is entitled to a jury trial and has demanded it and has not waived its right to have such trial before an Article III judge.

Discretionary – on timely motion of a party the reference may be withdrawn if doing so will promote efficiency and consistent administration of justice.

Sua Sponte – A motion by a party seeking to withdraw the reference must be made "timely," but the District Court may on its own withdraw the reference at any time.

Ways District Courts avoid handling bankruptcy matters: Deferring the withdrawal until the eve of trial (deny the motion without prejudice), or appointing the Bankruptcy Judge to act as a de facto Magistrate Judge.

Jury Trials – Seventh Amendment Rights

The Seventh Amendment guaranties litigants a trial by jury in some kinds of cases.

Unless the parties consent, Bankruptcy Courts lack the power to conduct jury trials because they are not Article III courts.

The parties may consent to a jury trial before the Bankruptcy Court.

Absent consent, if either party has a right to a jury trial and demands one, the dispute in question must be tried in the District Court. Withdrawal of the reference is mandatory.

But often litigants do not have or will have forfeited their rights to a jury trial in an Article III court:

- If a creditor files a proof of claim, it consents to the jurisdiction of the Bankruptcy Court for all purposes and waives its right to a jury trial in the District Court. In such cases, if the creditor is entitled to a jury trial at all, the Bankruptcy Court may conduct it.
- Most proceedings in Bankruptcy Court are equitable in nature and do not entitle a party to a jury trial (e.g., if valuation is an issue in a competing plan contest, the court will decide value on the evidence without a jury).

Contractual Arbitration Clauses

Creditors and non-parties often prefer to litigate in some forum other than the Bankruptcy Court. Contractual arbitration clauses often offer such an opportunity.

While the Supreme Court has yet to address the question, lower courts typically hold that a Debtor is bound by a pre-petition arbitration clause in a contract unless enforcement would conflict with general policies promoted by the Bankruptcy Code.

On that basis, some courts have refused to permit arbitration of fraudulent conveyance claims, or where the outcome might have an impact on the equitable distribution of estate assets among creditors.

Because this law is not finally settled, a request for relief from the automatic stay is almost always a sound tactic.

Appeals Are Longer and Slower In Bankruptcy Cases

Unlike other cases in the federal system, rulings of the Bankruptcy Court – even final orders – are subject to two, not one, round of appeals as of right, unless the matter is certified for direct review by the Circuit Court. See 28 U.S.C. Section 158 and Part VII of the Bankruptcy Rules.

Absent certification, first final orders may be appealed to the District Court where conclusions of law are reviewed de novo and findings of fact are reviewed for clear error. Then the losing party in that court has a right to appeal again the Court of Appeals, where the standard of review is the same.

When appealing the confirmation of a plan of reorganization, the appellant should promptly seek a stay pending appeal because the appeal may be deemed moot if the plan becomes substantially consummated pending appeal.

Unlike in a civil action in District Court, there may be multiple "final" orders of a Bankruptcy Court that are appealable as of right long before the Court approves a plan of reorganization.

As with civil actions in District Courts, there are also procedures, rarely invoked successfully, permitting appeals of non-final orders.

Appendix I: Standards for Determining Solvency

Appendix I: Standards for Determining Solvency

- A solvency analysis is necessary to determine to whom directors' duties are owed.

- There are two tests commonly employed:
  - the balance sheet test; and
  - the equity or cash flow test.

- Balance Sheet Test
  - A corporation is considered insolvent under the balance sheet test if the sum of its debts exceeds the aggregate value of its assets (in each case measured at fair value).

- Equity or Cash Flow Test
  - A corporation is considered insolvent under the equity or cash flow test if it is unable to pay its obligations as and when they come due. While there is no bright line time frame established for this solvency test, courts typically look at foreseeable, near term obligations.

Appendix I: Standards for Determining Solvency (Cont'd)

- Summary of Solvency Determination
  - As a practical matter, both solvency tests boil down to many of the same components.
  - To address the potential for judicial hindsight, a board should take a conservative approach to the valuation of its assets and liabilities, including contingent or off-balance sheet liabilities, and in its assessment of other liquidity or solvency issues.
  - In the event that a large contingent liability exists, such as a contested lawsuit, the company should value the contingent liability as the amount of the potential exposure multiplied by the probability of its future occurrence.

Appendix I: Deepening Insolvency Theory

- The theory of "deepening insolvency liability" for directors has been asserted in several lawsuits.
- Consistent with the directors' fiduciary duties to act in the best interests of the company, this theory of liability provides that if a director causes a distressed company to *take action or refrain from action* that is not in the best interests of the company and which does not maximize the value of the company (and, in fact "deepens" the insolvency), the director may be liable for damages caused by such action or inaction.
- Whether "deepening insolvency" is a cognizable cause of action varies from state to state.
  - Delaware has determined that there is *no* independent cause of action for deepening insolvency. However the concept of "deepening insolvency" may potentially be utilized to calculate damages arising from a breach of fiduciary duty.

Speakers

Robert Klyman

333 South Grand Avenue
Los Angeles, CA 90071-3197, USA
T: 213.229.7562
RKlyman@gibsondunn.com

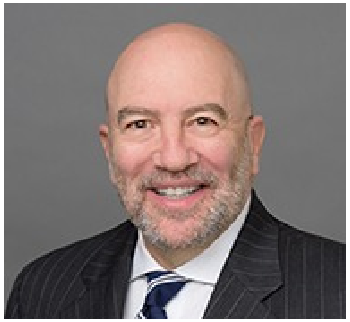
Robert A. Klyman is a partner in the Los Angeles office of Gibson, Dunn & Crutcher and a member of the Business Restructuring and Reorganization and the Energy and Infrastructure Practice Groups as well as the Corporate Department. Mr. Klyman represents debtors, acquirers, lenders and boards of directors. His experience includes advising debtors in connection with traditional, prepackaged and "pre-negotiated" bankruptcies; representing lenders and other creditors in complex workouts; counseling strategic and financial players who acquire debt or provide financing as a path to take control of companies in bankruptcy; structuring and implementing numerous asset sales through Section 363 of the Bankruptcy Code; and litigating complex bankruptcy and commercial matters arising in chapter 11 cases, both at trial and on appeal.

Mr. Klyman has been widely and regularly recognized for his debtor and lender work as a leading bankruptcy and restructuring attorney by *Chambers USA*; named as one of the world's leading Insolvency and Restructuring Lawyers by *Euromoney*; listed in the *K&A Restructuring Register*, a leading peer review listing, as one of the top 100 restructuring professionals in the United States; named as a "Top Bankruptcy M&A Lawyer" by *The Deal's Bankruptcy Insider*; named as one of the 12 outstanding bankruptcy lawyers in the nation under the age of 40 (in 1999, 2000, 2002 and 2004) by *Turnarounds & Workouts*; and one of "20 lawyers under 40" to watch in California by *The Daily Journal*.

Mr. Klyman developed, and for the past 15 years co-taught, a case study for the Harvard Business School on prepackaged bankruptcies and bankruptcy valuation issues. He has also taught classes on dealmaking in the bankruptcy courts at the University of Michigan Business School and UCLA Law School. Mr. Klyman is also a member of the ABA Subcommittee responsible for drafting a Model Bankruptcy Asset Purchase Agreement.

Mr. Klyman received both his J.D. from the University of Michigan Law School in 1989 and his B.A. degree from the University of Michigan in 1986.

Mr. Klyman is admitted to the California Bar. Prior to joining Gibson Dunn, Mr. Klyman was a partner at the firm of Latham & Watkins for more than 17 years.



Mitchell Karlan

200 Park Avenue
New York, NY 10166-0193, USA
T: 212.351.3827
MKarlan@gibsondunn.com

Mitchell A. Karlan is a litigation partner in Gibson, Dunn & Crutcher's New York office. He has more than 30 years of experience in major, complex commercial litigation, with significant concentration in the areas of mergers and acquisitions, corporate control disputes, directors' fiduciary duties, federal securities law, shareholder derivative actions, bankruptcy litigation, and domestic and international arbitration.

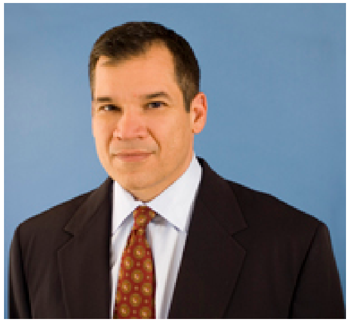
Mr. Karlan has extensive experience representing debtors, creditors and prospective acquirers in bankruptcy cases. He has tried fraudulent conveyance cases, contested plan confirmations, and break-up fee disputes. He has argued several of the leading bankruptcy decisions in the nation’s Courts of Appeals.

Mr. Karlan has tried numerous jury and nonjury cases in federal and state courts. He has represented broker dealers and issuers in securities class actions. He has defended and prosecuted numerous shareholder derivative cases in Delaware and elsewhere involving alleged breaches of fiduciary duties.

From October 2002 through December 2002, on behalf of Gibson Dunn, Mr. Karlan was acting Assistant General Counsel in charge of litigation worldwide for Tyco International, where he was responsible for overseeing and supervising all pending litigation.

Mr. Karlan is named as a leading commercial litigation attorney by *The Best Lawyers in America*©. In 2004 he was awarded the Thurgood Marshall Award by the Albany Branch of the NAACP for his work on the high-profile "Albany redistricting case," for which Mr. Karlan was pivotal in obtaining a federal injunction stopping the redistricting plan and having revised lines drawn and special elections ordered.

Mr. Karlan has argued in the highest courts of three states, and has appeared in state and federal courts in 27 states. He is admitted to the New York and Washington, D.C. Bars, and is a member of the bars of the United States Supreme Court and of the Courts of Appeals for the Second, Third, Fourth, Fifth, Sixth, Tenth, Eleventh and D.C. Circuits. He graduated from Columbia University School of Law in 1979 where he was a Harlan Fiske Stone Scholar.



Oscar Garza

3161 Michelson Drive
Irvine, CA 92612-4412, USA
T: 949.451.3849
OGarza@gibsondunn.com

Oscar Garza, a partner in Gibson, Dunn & Crutcher's Orange County and Los Angeles offices, joined the firm in 1990. He is a member of the Business Restructuring and Reorganization Practice Group (and was a former co-chair of the restructuring group), Transnational Litigation and Latin America Practice Groups.

Mr. Garza's restructuring practice involves representing debtors, creditors' committees, and secured creditors in chapter 11 cases, advising buyers and sellers of the assets of financially distressed companies, and representing Bankruptcy Trustees in complex cases.

Mr. Garza's transnational litigation practice is currently focused on leading and coordinating the defense against recognition and enforcement of foreign judgments with significant emphasis in defending actions in Latin America. He is also advising on litigation strategy for multinational corporations involved in litigation within Latin America.

Mr. Garza co-authored articles on break-up fees for asset purchasers in chapter 11 cases in *The Daily Deal* and the *California Bankruptcy Journal* as well as an article in the *Los Angeles Daily Journal* on how the Bankruptcy Reform Act of 2005 may change the sale of lease "designation rights." He has been (i) named as one of California's leading lawyers in business and restructuring by *Chambers USA – America's Leading Business Lawyers* (2007 – 2015); (ii) recognized by his peers as one of The Best Lawyers in America® in the area of Bankruptcy and Creditor-Debtor Rights Law from 2006-2016 (including being named Orange County Bankruptcy and Creditor Debtor Rights / Insolvency and Reorganization Law Lawyer of the Year in 2015 and Orange County Litigation – Bankruptcy Lawyer of the Year in 2014 and 2016); (iii) named as a Southern California Super Lawyer in the area of Bankruptcy & Creditor/Debtor Rights (2007 – 2015); and (iv) in 2000 he was named by *Global Insolvency & Restructuring Review* as one of the "Top 40 Under 40" international restructuring professionals.

Mr. Garza obtained his law degree from the University of Arizona College of Law, where he was a member of the *Arizona Law Review*, and he currently serves on the board of visitors for the law school. He is and has been a frequent lecturer on bankruptcy law and practice.

Kahn Scolnick

333 South Grand Avenue
Los Angeles, CA 90071-3197, USA
T: 213.229.7656
KScolnick@gibsondunn.com

Kahn A. Scolnick is an appellate and general litigation partner in the Los Angeles office of Gibson, Dunn & Crutcher. He is a member of the firm's Appellate and Constitutional Law, Class Actions, Securities Litigation, and Transnational Litigation practice groups.

Mr. Scolnick has handled a wide range of litigation matters in state and federal courts, from the pre-filing stage through the appeal. He has represented clients in a variety of breach-of-contract, real estate, consumer and securities class actions, and other business disputes, as well as constitutional litigation involving challenges based on due process, equal protection, the Commerce Clause, and the First Amendment.

Mr. Scolnick graduated *magna cum laude* in 2003 from the University of San Diego, School of Law. He was a Lead Articles Editor for the *San Diego Law Review* and the recipient of the Hickman Award for the Outstanding Student in Constitutional Law. Mr. Scolnick received his Bachelor of Arts degree in Public Policy Studies, with honors, from Michigan State University in 2000.

Before joining the firm in 2006, Mr. Scolnick served as a law clerk to Judge Ferdinand F. Fernandez of the United States Court of Appeals for the Ninth Circuit (2005–06), and as a law clerk to Judge Dana M. Sabraw of the United States District Court for the Southern District of California (2003–05). While in law school, Mr. Scolnick served as a judicial extern to Judge M. Margaret McKeown of the United States Court of Appeals for the Ninth Circuit, and also to Magistrate Judge Louisa S. Porter of the United States District Court for the Southern District of California.

Mr. Scolnick has published and spoken on a variety of topics, including class actions, trial practice, civil procedure, punitive damages, and constitutional issues. He has been named eight times as one of Southern California's "Rising Stars" by *Los Angeles Magazine* and *Southern California Super Lawyers – Rising Stars Edition* (2009-2016). Mr. Scolnick serves on the boards of the Legal Aid Foundation of Los Angeles (LAFLA) and the Los Angeles Chapter of the Association of Business Trial Lawyers (ABTL).

Mr. Scolnick is a member of the California Bar. He is admitted to practice before the United States Court of Appeals for the Ninth Circuit and the United States District Courts for the Northern, Southern, and Central Districts of California.

GIBSON DUNN