



AMERICAN
BANKRUPTCY
INSTITUTE

2019 Mid-Atlantic Bankruptcy Workshop

Bankruptcy Litigation

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2019 ABI Mid-Atlantic Meeting

Bankruptcy Litigation – Topics, Trends, Practice Pointers

Judge Frank J. Santoro, U.S. Bankruptcy Court, Eastern District of Virginia

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Fiduciary Duty Law and Insolvency

- Basic duties and business judgment rule.
- What precisely happens upon insolvency—is there a “shift” in fiduciary duties?
- Does the business judgment rule continue to apply upon insolvency?
- If the corporation’s certificate of incorporation has an exculpation clause (a.k.a., a “Section 102(b)(7) clause”), does it continue to apply upon insolvency, and why?



Derivative Standing for Creditors' Committees of LLCs

- *CML v. Bax*: creditors of an insolvent LLC do not have standing to pursue derivative claims.
- Can creditors' committees of debtor LLCs obtain derivative standing?
 - Caselaw
 - Alternatives

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Wholly Owned Subsidiaries

- The fiduciary duties of directors of a solvent wholly-owned subsidiary flow exclusively to its parent.
- Insolvency changes the analysis.
- Determining the precise moment of solvency (and hence whether to consider other constituencies) can be a litigable issue.
 - *Quadrant III*
 - *Official Committee of Unsecured Creditors v. Meltzer* (D. Me. 2018)

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Discussion of *Quadrant* Decisions

- Case study from the Delaware Court of Chancery: *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d at 167 (2014) and slip opinions from May 4, 2015 and October 20, 2015.
 - Claims of taking on more risk dismissed, even though arguably the decision to take on more risk benefited those in control and put creditors at peril.
 - Claims concerning transactions with insiders not dismissed.
 - There was evidence that the defendants in *Quadrant* (out-of-the-money subordinated noteholders) purchased equity “probably [worth] zero” for the express purpose of buying voting control.
 - But that claim was not substantially addressed due to a standing issue.

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Sexual Harassment and Fiduciary Duties

- Should shareholders or creditors -- not just the victims -- have claims against D&O's by utilizing corporate law theories like breach of fiduciary duty?
- *Caremark*—What is the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?
- Do *Caremark* implications change depending on whether the conduct of the applicable executive was with an employee?
- Some authors have contended that a director or officer who is engaged in sexual abuse is breaching his duty of loyalty because he preferred personal interests over those of the corporation.
 - What are the implications of allowing claims of this nature?
 - Does the “preferring personal interests” standard have to relate to a transaction?

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Gathering Evidence in Liquidation Cases

- Less access to employees and, in some cases, corporate records than in typical litigation.
- Challenges with Rule 30(b)(6) depositions.
- Use of Rule 2004.
- Demands on buyer (access to records, employees).

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Attorney-Client Privilege Issues

- Who owns privilege after sale of operating business?
- Waiver issues – privileged emails on a sold server.
- Fiduciary exceptions to privilege
- Common interest privilege
- Joint client issues

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Solvency

- Employ expert early
- Identify key dates
- Tests vary – know your test.
 - Fair market value of debt, or face value?
 - “No reasonable prospects” test.

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D & O Insurance

- Who is covered by the policy?
 - Side A: Ds&Os directly covered
 - Side B: Entity covered for indemnifications of Ds&Os
 - Side C: Entity covered for its own litigation costs
 - Side A difference-in-condition coverage with a different carrier (1) may provide coverage if the primary carrier can’t or won’t pay; and (2) likely won’t be considered part of the bankruptcy estate
- What are the policy exclusions and how broad is the language?
 - *Goggins* (Del. Super. Ct. 2018) – equity sponsors who were also directors allegedly acting to their benefit as creditors weren’t covered by D&O policy that had an exclusion that the court found covered acting in multiple capacities
 - *Schorsch* (N.Y. Sup. Ct. 2019) – insurer required to pay despite insured-vs.-insured exclusion as exception for bankruptcy trustees and “comparable authorities” was ambiguous and must be construed as including creditors’ trust

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D & O Insurance

- Policy exclusions, cont.
 - *Zucker* (6th Cir. 2017) – insured-vs.-insured exclusion was found to include creditors’ litigation trust as an assignee of the insolvent company
- Are there ways to overcome deficits in coverage?
 - *Goldsmith* (Bankr. D. Mass 2019) – creditors’ and bankruptcy trustee’s breach-of-contract actions against insurance broker who acquired insufficient tail coverage survived motions to dismiss. Creditors’ action was as a third-party beneficiary of broker’s contract with insolvent company

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D & O Insurance

- Takeaways
 - Does the policy cover Ds&Os directly or indirectly, or the entity itself?
 - Is the policy the property of the estate or stayed from payouts?
 - Does an exclusion (capacity, insured-vs.-insured, etc.) apply to the insurance claim?
 - Are there another reason the policy can’t cover litigation (*in pari delicto* defense, carrier insolvency, etc.)?
 - Can a deficit in coverage be overcome in another way?

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Small Business Reform Legislation

- 92% of chapter 11s are small businesses or individuals; existing chapter 11 apprentice too expensive
- Subchapter 11 = like chapter 13
- \$2.5 million debt limit
- Plan filed immediately and payments begin
- Confirmation without a vote
- No UCC unless requested and ordered for cause
- Relaxed absolute priority rule; objections could require five years net disposable income commitment

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Retail Vendor Litigation

- Sophisticated monitoring and early credit tightening
- Administrative claim status and Critical Vendor status is not what it used to be; rise of insurance
- Accelerated litigation at final DIP hearing:
 - Carve outs for vendors
 - Pushback on 506(c) waivers
 - Marshalling collateral

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Use of Experts in Bankruptcy

- Sophistication of judges (no juries); Rule 702 admissibility; topics: valuation, feasibility, solvency/fraudulent transfers
- Privileges and discoverability
 - Rule 26(b)(4)(B) & (C) – draft reports
 - Adversary proceedings (Part VII Rule) vs. contested matters (Rule 9014)
- Experts as advisors – insulation and separation of roles?
 - Retention as professionals under 327?

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Judge's Perspective

- Likes & Dislikes – Pet Peaves and Practice Pointers
- Mediation – Judicial, non-judicial, success rate? Factual vs. legal issues
- Sidebars/Chambers meetings – when advisable? Non-public sensitivity of information to marketplace
- Evidentiary presentations; effectiveness; demonstratives and use of technology in courtroom

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