AMERICAN BANKRUPTCY INSTITUTE

2017 Winter Leadership Conference

Key Governance Issues for Debtors, Equity Owners and Professionals

Roger G. Schwartz, Moderator
Latham & Watkins LLP; New York

Hon. Kevin J. Carey
U.S. Bankruptcy Court (D. Del.); Wilmington

Julia Frost-Davies
Morgan, Lewis & Bockius LLP; Boston

Jennifer C. Hagle
Sidley Austin LLP; Los Angeles

CONCURRENT SESSION

2017

Key Issues in Corporate Governance

ABI Winter Leadership Conference 2017

***Hon. Kevin J. Carey**, United States Bankruptcy Judge, District of Delaware*
***Julia Frost-Davies**, Morgan Lewis & Bockius LLP*
***Jennifer C. Hagle**, Sidley Austin LLP*
***Roger G. Schwartz**, Latham & Watkins LLP (Moderator)*

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Key Issues in Corporate Governance
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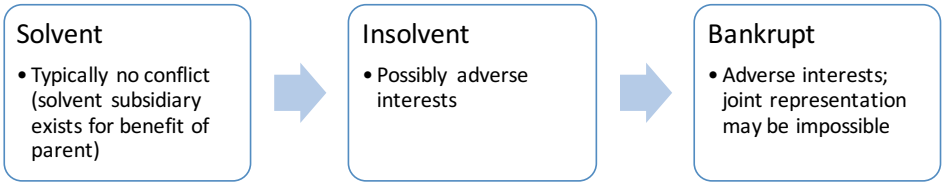
1. Lawyer Conflicts

Representing portfolio companies of sponsor clients

Lawyer Conflicts: Portfolio company representation

- Legal Framework
  - Ethics rules prohibit direct adversity of clients in a litigated matter but generally permit adverse interests (to current or former clients) if the lawyer can act without bias and if the affected clients give informed consent. *See, e.g.*, NY RPC 1.7 (conflicts of interest), 1.9 (duties to former clients).
  - The Bankruptcy Code requires that professionals be "disinterested" and not hold or represent an "adverse interest." *See* 11 U.S.C. § 327.
  - Joint representation of sponsor and portfolio company generally presents no conflict if the portfolio co. is solvent. When the portfolio co. is insolvent, however, it may have adverse interests to the sponsor. And joint representation may be impossible in bankruptcy.



- Counsel to the sponsor will often seek to represent the portfolio co. in bankruptcy.

Lawyer Conflicts: Portfolio company representation

Brown Media

K&L Gates represents management of Brown Publishing, who are interested in purchasing company's assets out of bankruptcy; **shortly before filing, K&L Gates switches to represent company but allegedly does not obtain consent or waiver from management. Ultimately, a competing bidder wins the auction**. **Management sues K&L Gates** on a variety of theories including breach of fiduciary duty and misuse of confidential information. *See Brown Media Corp. v. K&L Gates, LLP*, 854 F.3d 150 (2d Cir. 2017) (remanding for reinstatement of claims). (Case remains pending in E.D.N.Y.)

Transtar

Pre-bankruptcy, **Willkie represents parent FFL but takes on Transtar bankruptcy representation and arranges for separate counsel to represent FFL**. In addition, Willkie concurrently represents Silver Point, a late-arriving active creditor, on unrelated matters, but inadvertently fails to make prompt disclosure. Willkie ultimately resigns the Transtar representation and forfeits fees. However, the **Examiner largely vindicates Willkie's actions**, with the exception of the failure to properly disclose the Silver Point conflict. *See* Report of Richard Levin, Examiner, *In re DACCO Transmission Parts (NY) Inc.*, Case No. 16-13245 (MKV) (Bankr. S.D.N.Y. filed Mar. 3, 2017) (ECF No. 361).

Lawyer Conflicts: Portfolio company representation

Caesars

Pre-bankruptcy, **Paul Weiss represents both CEC (parent) and CEOC (OpCo) in several transactions in which CEC is effectively the buyer and CEOC is the seller. CEOC is insolvent at all times.** The Examiner concludes that a conflict existed, but the Examiner also concludes that any resulting damages claims are weak. *See* Final Report of Examiner, Richard J. Davis, *In re Caesars Entm't Operating Co.*, Case No. 15-01145 (ABG) (Bankr. N.D. Ill. filed Mar. 15, 2016) (ECF No. 3401).

Verso

Verso and NewPage debtors have **adverse interests at least in regards to their prepetition shared services agreement**. Both are represented by the **same general bankruptcy counsel**. **Conflicts issues are resolved through use of separate independent directors** (subject discussed later in this presentation), **conflicts counsel, and DIP facilities** for the Verso and NewPage debtors. Debtors' joint plan of reorganization is confirmed six months after petition date. *See* generally Disclosure Statement, *In re Verso Corp.*, Case No. 16-10163 (KG) (Bankr. D. Del. May 10, 2016) (ECF 868).

Lawyer Conflicts: Portfolio company representation

- Discussion Points
  - Is there anything inherently wrong with, or troubling about, the joint representation model?
    - Does a problem arise when counsel sets the strategy for the sponsor and the portfolio company during restructuring planning and then also selects counsel for the portfolio company upon separation?
    - How early in the process should counsel transition to the portfolio representation?
    - What (other) facts would make the practice troubling in a given case?
  - What role can or should other professionals and constituencies play in raising issues with sponsor/portfolio representations?
    - Is there any effective way for professionals and constituencies to police themselves when no court is involved?
  - *Creditor perspective:* As *Verso* demonstrates, independent directors and use of separate special/independent committees and financing structures can mitigate potential conflicts issues arising from joint representation.

Lawyer Conflicts: Portfolio-sponsor privilege issues

- Legal Framework
  - In an insolvency scenario, the portfolio company may assert an entitlement to documents of the sponsor (or vice versa) on the theory that they were joint clients of counsel (whether in-house or external) on the relevant matters. These risks can be managed by, among other things, carefully delineating the scope of any joint representations and by "seasonably [] separat[ing] counsel on matters in which subsidiaries are adverse to the parent." *In re Teleglobe Commc'ns Corp.*, 493 F.3d 345, 374 (3d Cir. 2007), *as amended* (Oct. 12, 2007).
  - On the other hand, no privilege protection may exist for communications within or by an allegedly conflicted firm regarding the conflicts/retention issue.

Lawyer Conflicts: Portfolio-sponsor privilege issues

Teleglobe

Teleglobe provides an extended discussion of joint-representation privilege issues. In *Teleglobe*, **the parent and subsidiary shared counsel. When the subsidiary entered bankruptcy, it asserted a broad entitlement to communications of the parent with counsel**, on the basis of an alleged joint representation. The court effectively rejected the assertion, stating that joint representations are limited to the scope of the shared purpose, and do not justify invasion of the privilege of the individual clients as to all communications with shared counsel. The case offers instruction on delineating the scope of joint parent-subsidiary representations. *In re Teleglobe Commc'ns Corp.*, 493 F.3d 345 (3d Cir. 2007); *on remand In re Teleglobe Commc'ns Corp.*, 392 B.R. 561, 594 (Bankr. D. Del. 2008).

Transtar

Willkie ultimately moved to resign the debtor representation in the face of a request by the Examiner for discovery of documents relating to the entry of FFL, Transtar, and Silver Point into an RSA. **Willkie stated that it could not advise the debtors on production of potentially privileged documents in light of the existing conflicts concerns** (Willkie's foregoing representation of FFL, and its concurrent representation of Silver Point on unrelated matters). *See* Debtors' Interim Objection to Examiner's Proposed Protective Order, *In re DACCO Transmission Parts (NY) Inc.*, Case No. 16-13245 (MKV) (Bankr. S.D.N.Y. filed Jan. 20, 2017) (ECF No. 221).

Lawyer Conflicts: Portfolio-sponsor privilege issues

- Discussion Points
  - What correspondence and other documents of the sponsor or portfolio company are at risk of discovery by the other based on a prepetition joint representation? What steps can be taken in the pre-bankruptcy planning phase to minimize the risk of discoverability?
  - Is there any basis to withhold internal firm documents when the firm becomes subject to a conflict allegation? Could it, or would it want to, choose to assert privilege over communications with internal conflicts counsel or general counsel? What about communications among the deal lawyers?

Lawyer Conflicts: Sidebar on retention issues

- Legal Framework
  - A law firm subject to a preference action for payments received prepetition likely is not disinterested as required by sections 327 and 101(14); payments made for services rendered within 90 days of the filing may be preferences, *see* 11 U.S.C. § 547 (payment on account of antecedent debt).
  - This risk is minimized through fully-earned pre-bankruptcy retainers that can be drawn down to cover invoiced amounts and then replenished. The payments are then not made on account of antecedent debt and cannot be preferences.
  - Other defenses may exist, such as that the payment was in the ordinary course of business. *See* 11 U.S.C. § 547(c).

Lawyer Conflicts: Sidebar on retention issues

Caesars Kirkland	Kirkland engagement letter calls for **"classic retainer"** (paid for future availability, not services) but then credits amounts against invoices, akin to an **"advance payment retainer."** Court concludes that the distinction is meaningless because in both cases the retainers immediately became property of Kirkland, not the estate. Only a **"security retainer"** (protecting against non-payment) would remain property of the estate until drawn. See *In re Caesars Entm't Operating Co., Inc.*, 561 B.R. 420 (Bankr. N.D. Ill. 2015).
Revel Fox Rothschild	Trustee objects to retention of Fox Rothschild on theory that prepetition payments by debtor were preferences; Fox Rothschild **allegedly had not structured the prepetition retainer and invoicing carefully enough to avoid preference claims**; parties eventually settle by requiring partial disgorgement but permitting retention.

Lawyer Conflicts: Sidebar on retention issues

- Discussion points:
  - Do the cases, and their interpretation of the requirements for prepetition payment, elevate form over substance?
  - Is any meaningful purpose served by pursuing a debtor's desired counsel for preference payments?
  - If there is a problem, how does the retainer construct solve the problem: Should any legal consequence attach to paying for services the day before they are rendered instead of the day after?
  - If so, why should the trustee not just assert the retainer is a fraudulent transfer (especially in the case of a "classic" retainer)?

2. Client Conflicts

Conflicts of control persons (D's & O's & controlling shareholders)

Client Conflicts: Control persons

- Legal Framework
  - Directors and officers owe fiduciary duties—principally duties of loyalty and care—to the companies they serve.
  - Controlling shareholders have at least some of the same duties. *See, e.g.*, *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
  - In an insolvent company, these duties run in favor of the creditors, who may obtain standing to pursue claims. *See generally N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

Client Conflicts: Control persons

DSI Renal Holdings	**Directors stand on both sides of transaction that allegedly sells debtor's key operating asset to purchaser for less than fair value** (in combination with other actions allegedly intended to leave creditors without recourse to assets and to artificially lower the valuation of the operating asset). Board of debtor appears to have **no independent directors**. Trustee brings claims for fraudulent transfer, breach of fiduciary duty, and more. Court (Carey, J.) denies or defers motion to dismiss on most claims. *See In re DSI Renal Holdings, LLC*, No. 11-11722 (KJC), 2017 WL 3105842 (Bankr. D. Del. July 20, 2017).
Caesars	In years leading up to bankruptcy, **Caesars OpCo engages in billions of dollars of asset transfers at the direction of its Board and its controlling shareholder parent**. The Boards of OpCo and parent overlap substantially and are majority controlled by the same equityholders. At relevant times, OpCo has **no independent directors**. The transactions allegedly remove OpCo assets for less than fair value and place them under other of the parent's subsidiaries. The Examiner concludes that potential claims for breach of fiduciary duty and aiding and abetting exist. *See* Final Report of Examiner, Richard J. Davis, *In re Caesars Entm't Operating Co.*, Case No. 15-01145 (ABG) (Bankr. N.D. Ill. filed Mar. 15, 2016) (ECF No. 3401).

Client Conflicts: Control persons

EFH	Prepetition, EFH operates "T-side" unregulated energy generation business (the TCEH debtors) and regulated "E-side" delivery business (the EFIH debtors). Boards of EFH, EFIH, and TCEH overlap, though each has one nominally independent director. The RSA in place at filing contemplates a tax-free spin of TCEH to its first-lien creditors and a recapitalization of EFIH. After EFH receives bids with superior valuations, it abandons the RSA and seeks to establish bidding procedures for the E-side business. T-side junior creditors **assert that the bid procedures are designed to replicate the RSA's spin transaction to the detriment of the T-side junior creditors**. A focus of the objection is that the boards of the relevant entities are conflicted and that **no independent director of any voted to approve the bidding procedures**. The court (Sontchi, J.) ultimately allows the sale process to go forward but requires improved corporate governance, including ensuring that specific votes are taken on every step in the process and that the steps must be actually approved by the independent directors.

Client Conflicts: Control persons

- Discussion Points:
  - Would the presence—and actual input—of independent directors in the above cases have avoided the harms or weakened the claims? What else could have been done ex ante?
  - Are post-hoc correctives to a lack of independence—*i.e.*, appointment of an examiner or trustee to pursue claims—useful remedies, or are they just risks that parties are prepared to run, knowing that forgiveness will cost less than permission?
  - *Creditor perspective:* Creditors that fail to require adequate conflicts prevention measures may be subject to claims for aiding and abetting the conflicted directors' and officers' alleged breaches of fiduciary duty and/or fraud.
    - Steps to avoid these outcomes may include requiring independent fiduciaries (CROs, independent directors, special committees, etc.); requiring that special committees deal with issues implicating the potential conflicts; and/or sending formal letters to fiduciaries who are conducting themselves in a manner that raises concerns and threatening further action if such concerns are not promptly and adequately addressed.
    - Creditors should also bear in mind that fiduciary duty waivers and provisions denying derivative standing to creditors of an LLC may operate to bar claims against other (non-creditor) parties that could otherwise provide a source of recovery for creditors.

Client Conflicts: Sidebar on Delaware LLC duties

- Legal Framework:
  - Creditors' rights and remedies vis-à-vis companies and their control persons can be limited by law—and are significantly limited by Delaware LLC law.
  - Delaware LLC law permits elimination of fiduciary duties (but not implied covenant of good faith and fair dealing). *See* Del. Code Ann. tit. 6, § 18-1101(c), 1104.
  - Delaware LLC creditors lack standing to pursue derivative claims. *See CML V, LLC v. Bax*, 28 A.3d 1037, 1041 (Del. 2011).

Client Conflicts: Sidebar on Delaware LLC duties

Prior to Bankruptcy	**Duties waivable**. Delaware law permits, and courts enforce, waivers of fiduciary duties.	*In re CLK Energy Partners, LLC*, No. 09-50616, 2011 WL 1312275, at *6 (Bankr. W.D. La. Mar. 31, 2011) ("Delaware courts have repeatedly ruled that the elimination of these duties in an LLC agreement is permissible under the Delaware LLC Act and that the elimination of these duties precludes fiduciary duty claims…."). *See, e.g.*, *In re Optim Energy, LLC*, Case No.14-10262 (BLS), 2014 WL 1924908, at *6 (Bankr. D. Del. May 13, 2014) (dismissing breach claim against member, and aiding and abetting breach claim against parent, based on waiver of fiduciary duties).
Bankruptcy	**Fiduciary duties of a trustee**.	"[T]he fiduciary duties to a bankruptcy estate may not be absolved by any state-law concepts to the contrary." *In re Houston Reg'l Sports Network, L.P.*, 505 B.R. 468, 481 (Bankr. S.D. Tex. 2014) (addressing impact of fiduciary duty waiver in partnership agreement of Delaware LP debtor on postpetition fiduciary duties).
Always	**Unwaivable duty of good faith and fair dealing.**	However, claims for breach of the duty of good faith and fair dealing are very difficult to sustain. *See In re CLK Energy Partners, LLC*, 2011 WL 1312275 at *6.

Client Conflicts: Sidebar on Delaware LLC duties

- Discussion Points
  - Will or should bankruptcy courts defer to elimination of fiduciary duties under state law? Or is the absence of fiduciary duties contrary to federal bankruptcy policy?
  - Is there any check on, or purpose to, a manager without duties to the managed entity? Does the implied covenant of good faith and fair dealing create a saving duty?

3. Policy Conflicts

Bankruptcy blocking rights: Their logic and limits

Policy Conflicts: Bankruptcy blocking rights

- State law determines who has the authority to file a voluntary petition for a corporation. *Price v. Gurney*, 324 U.S. 100, 107 (1945) ("[A]uthority to speak for the corporation [on matter of bankruptcy filing] [i]s a matter of local law").

- State law may permit absolute restrictions on bankruptcy filing, *e.g.*, an LLC operating agreement may simply prohibit filing.

- Similarly, parties may create contractual restrictions, *e.g.*, grant of a "golden share" or appointment rights for a "special member" whose control rights may be used to unilaterally block consent to filing.

Policy Conflicts: Bankruptcy blocking rights

Case	Control Mechanism	Outcome	Source of law
In re Intervention Energy Holdings, LLC, 553 B.R. 258 (Bankr. D. Del. 2016) (Carey, J.)	"Golden share," coupled with unanimous voting consent to file	Unenforceable	Federal public policy. Lodging sole consent right in hands of creditor (with no duty but to itself) is tantamount to absolute waiver of right to file.
In re Lake Michigan Beach Pottawattamie Resort LLC, 547 B.R. 899 (Bankr. N.D. Ill. 2016)	"Special member" of LLC with duties only to creditor appointing said member	Unenforceable	Federal public policy and Michigan LLC law. Special member must "be subject to normal director fiduciary duties" and free to vote to file.
In re Bay Club Partners-472, LLC, No. 14-30394, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014)	Conditional prohibition on filing—may not file while secured debt is outstanding	Unenforceable	Federal public policy. Cannot waive the prepetition protections of the Bankruptcy Code.
In re DB Capital Holdings, LLC, 463 B.R. 142 (B.A.P. 10th Cir. 2010) (unpublished)	Absolute prohibition on filing in LLC operating agreement	Enforced; case dismissed	No federal policy prohibits waiver found in organic documents rather than third-party contract. Provisions not contrary to state law.

Policy Conflicts: Bankruptcy blocking rights

- Discussion Points:
  - The cases establish that lodging a blocking right in a member with no duties to the corporation is a fatal flaw. Can creditors "fix" this flaw by maintaining "ordinary fiduciary duties" while privately instructing their chosen member never to consent to a filing? What is the risk to the chosen member? A suit for breach of duty? Who will institute such a suit, and what will be the damages?
  - Does Delaware present a particular problem given the ability of Delaware LLC operating agreements to waive fiduciary duties generally? In that case, there need be no particular instruction that the "special member" be self-serving, just a general disclaimer of duties. Does the unwaivable covenant of good faith come to the rescue?
  - Should "federal public policy" intervene to override structures approved by state law and/or agreed to by private contract?
  - *Creditor Perspective:* Creditors should be cautious here. As the cases illustrate, contractual or structural protections for creditors are only helpful to the extent they are ultimately enforceable, and bankruptcy waivers pose a significant risk of unenforceability, as well as damage to the creditors' credibility with the court, if such waivers are found to be overreaching.

4. Creditor Perspective

Questions on governance issues from the creditor perspective

Creditor Perspective: Discussion points

- What are creditor expectations in terms of conflicts and conduct to avoid conflicts?
  - When the borrower is solvent, any conflict concerns?
  - When the borrower is or may be insolvent, what do creditors hope to see from--
    - The borrower and its parents/affiliates
    - Counsel to the borrower and its parents/affiliates
  - Do any new concerns arise upon a bankruptcy filing?

- Which are the major conflicts concerns from the creditor counsel perspective?
  - In other words—what are the major risks to creditors from conflicts of interest--
    - At the company level (*i.e.*, between the borrower and its parent/affiliates)
    - At the counsel level (*i.e.*, shared counsel at borrower and parent/affiliates)

- In the face of a concerning conflict, how far will or should creditors push for change, and what is the best strategy to do so?
  - What can creditors do to avoid conflict risks (*e.g.*, collateral leakage) through contractual controls and amendments? Is this the primary lever? Is it sufficient?
  - What can creditors do to eliminate or check conflicts that do arise?
  - What is the best way to identify, raise, and deal with conflicts in the bankruptcy context?

Creditor Perspective: Discussion points

- How do the foregoing conflicts, or conflict risks, impact the possibility of consensual workouts or drive non-consensual workouts?
  - Do conflict risks drive creditors to negotiate and make concessions (*e.g.*, does the reality that a controlling parent may engineer asset transfers—*see, e.g.*, J. Crew—drive creditors to the table)?
    - To the extent that the risk arises due to ambiguity or holes in credit documents, is there any market movement toward greater and/or more explicit covenant restrictions?
  - How do, or can, creditors approach negotiations with counsel representing, or formerly representing, both the borrower and the parent?

- What are the risks for creditors in addressing conflicts? Is there a "Catch-22" insofar as being proactive could also be seen as overreaching that opens the creditors up to claims?
  - What potential claims do creditors worry over?
  - How can creditors structure their control mechanisms to best ensure that creditors do not, and do not appear to be, exercising undue control over the borrower?