Preparing Corporate and Individual Clients for Bankruptcy: Who's Your Client? Possible Claims Against the Person Who Hires You; Partnership and LLC Issues

Jimmy D. Parrish, Moderator
BakerHostetler; Orlando, Fla.

Richard Johnston, Jr.
Richard Johnston Law; Fort Myers, Fla.

Charles A. Postler
Stichter, Riedel, Blain & Postler, PA; Tampa, Fla.

Patricia A. Redmond
Stearns Weaver Miller Weissler Alhadeff & Sitterson, P.A.; Miami

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Panelists:

Charles A. Postler
Stichter, Riedel, Blain & Postler, P.A.

Patricia Ann Redmond
Stearns Weaver Miller Weissler Alhadeff & Sitterson, P.A.

Richard Johnston
Richard Johnston Law

Moderator:

Jimmy D. Parrish
BakerHostetler

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I. Introduction

The presentation and these written materials build on the basic fact pattern set forth below. Throughout the course of the presentation and these materials, the basic fact pattern will be altered to highlight different problems and issues that may arise within the topic areas.

The basic fact pattern comes from a letter from a prospective client:

> Thank you for agreeing to meet with me this Friday to discuss my current situation. I am the sole owner of a private company named Bradberry Electronics, Inc. ("**BEI**"). BEI was formed by my dad in the early 1970s in Melbourne, Florida and specializes in communications and mobile phone technology for military and disaster recovery operations. Since its inception, BEI grew from my dad and a few employees to a multi-million dollar company with over 150 employees. I grew up around BEI and have been actively involved in the business for the last 15 years. Historically, our primary business line is the manufacturing of cell phone and cellular base station technology. Unfortunately, new technology hit the market in the Spring of 2015 using a completely different system that is smaller and significantly cheaper than our products. Our sales started decreasing in 2014 after my father's death and we were recently notified that the United States Department of Defense will not be renewing our 5 year contract after it expires in May of this year. Our other sales had already been declining dramatically and with the loss of the Department of Defense contract we may as well close the doors at the end of May. The company has a separate division that I created just prior to my father's death that develops various cell and tablet applications for military and civilian use. This division is operated through a wholly owned subsidiary, Subliminal Applications, LLC ("**SUB**"). SUB has been in research and development for the past 5 years and has never made a profit.
>
> Currently, Sunny Bank has filed a foreclosure lawsuit in Volusia County against BEI and me individually for approximately $15 million. Sunny Bank has a mortgage on our manufacturing facility in Melbourne, our inventory and our accounts receivable. We have a separate lawsuit against us in Orlando by the family of a civilian contractor that was killed when one of our base stations exploded during use. I just received a demand letter from a company called Application Acquisition ("**AA**"), who I believe purchased a loan to BEI from Second Florida Trust Bank ("**SFTB**"). The SFTB loan is for approximately $5 million and is secured by my personal residence.
>
> Since the business started to decline in 2014 I loaned almost my entire inheritance of $2 million to the business and I don't see how that is ever getting paid back. I really have nothing left except my home, my car and about $250,000 in an IRA. One of my dad's friends from Vietnam has offered to help me in any way possible. I have tried to live up to my father's legacy, but I just can't do it anymore.

John

II. Preparing for Bankruptcy

A. Is Bankruptcy the Right Move?

1. Considering Proceeding Alternatives for Corporate and Individual Clients:

Debtor clients generally seek out the advice of bankruptcy professionals because they are having trouble paying their debts as they become due, but very few have any understanding of the alternatives available to them. As a practitioner, you have to process the information given by the client quickly and assist the client in determining the best way to resolve the problems. But who is the client? Is it the corporate entity or the entity's principals? How does the practitioner balance the needs of the entity with the goals of the principals in determining the appropriate insolvency vehicle?

Clearly, the practitioner has to make an early determination regarding who is the client. Many times representing both the corporate entity and principals or other interest holders will be prohibited. The potential clients must understand the conflict issues and the limitations and restrictions of a single firm representing both the corporate entity and the principals of that entity. In most circumstances, it will be advisable for the corporate entity and principals to have separate representation because of issues such as: (i) insider creditor claims against the debtor; (ii) attorney/client issues; and (iii) fraudulent transfer, breach of fiduciary duty, or other claims against the insiders. Notwithstanding these conflicts, many times the principals are the ultimate decision makers in determining the appropriate insolvency path a corporate debtor will take. In most instances, this dynamic is perfectly fine because the interests will be aligned, but corporate debtor's counsel has to be cautious and keep in mind who is the client at all times.

2. Initial Consideration: *Is there something to save or are you simply liquidating?*

The initial question in choosing an a restructuring path has to be: Is there an ongoing business to save or is an orderly liquidation necessary? The answer to this question will assist in narrowing down the options available to the debtor.

Consider Bradberry's current problems:

Bradberry's email indicates that BEI's cell phone and cellular base station technology is obsolete and

that the Department of Defense will not be renewing its contract when it expires in May. Moreover, Bradberry indicated that "*with the loss of the Department of Defense contract, we may as well close the doors at the end of May*." With respect to the separate division, Bradberry advises "*this division has been in research and development for the past 5 years and has never made a profit*."

What Options are Available? Liquidation Alternatives and Considerations:

The comments above would direct most practitioners to a liquidation analysis. A party may liquidate assets through any of the four insolvency proceedings (Chapter 7, Chapter 11, Assignment for the Benefit of Creditors, and Dissolution). In all four of these proceedings, a company's assets are liquidated and distributed among creditors according to priorities, but each have advantages and disadvantages to certain parties including the principals.

Corporate Chapter 11: Debtor controls the liquidation, but has a significant cost disadvantage. In addition, a corporate debtor is not entitled to a discharge in a liquidation under Chapter 11 or 7, so less of an advantage over a state law proceeding.

Corporate Chapter 7: Debtor relinquishes control to a trustee who liquidates assets. In a Chapter 7 there is a significantly higher risk of suit against principals and again no discharge. Also, there is an attorney/client issue here regarding statements made to the practitioner by the insiders/principals.

Assignment for the Benefit of Creditors ("ABC"): Debtor relinquishes control to an assignee of its choice, but still costly and requires marketable assets or cash.

Dissolution: Debtor controls liquidation and has relatively low costs.

B. Authority to File

A business may act only through an authorized representative, and this rule applies to the act of filing for bankruptcy. Thus, courts generally will dismiss unauthorized petitions. However, the Bankruptcy Code does not expressly set forth rules relating to authority to file a voluntary bankruptcy petition for relief. *See In re American Globus Corp.,* 195 B.R. 263, 265 (Bankr. S.D.N.Y. 1996). To determine authority to file, bankruptcy courts look to the state law governing the business entity. *Price v. Gurney*, 324 U.S. 100, 106 (1945). With respect to

general partnerships, the federal bankruptcy rules provide that a bankruptcy petition may be filed by any general partner, provided that all general partners consent, *See* Fed. R. Bankr. P. 1004(a), but in corporate and other contexts, the power to file a petition will depend on the actual authority of those wishing to do so.

1. Corporation

Bankruptcy petitions may be dismissed as unauthorized filings where the corporation's organizational documents do not provide the petitioner with authority to act on behalf of the company. Courts have applied the requirement of proper corporate authority strictly. The Supreme Court has held that the entity vested with "the power of management" has the requisite authority to file a bankruptcy petition. *Price*, 324 U.S. at 104. In evaluating whether a corporation's bankruptcy petition was properly authorized, bankruptcy courts will examine the corporation's articles of incorporation, bylaws, and the law of the state in which the corporation is incorporated. *See, e.g., In re Giggles Restaurant Inc.,* 103 B.R. 549, 553 (Bankr. D. N.J. 1989); *In re Nyack Autopartstores Holding Co*., 98 B.R. 659, 663 (Bankr. S.D.N.Y. 1989); In re Markus Enters. Inc., 91 B.R. 459, 460 (M.D. Tenn. 1988); *In re Minor Emergency Ctr. of Tamarac Inc*., 45 B.R. 310, 311 (Bankr. S.D. Fla. 1985); *In re Hawaii Times, Ltd*., 53 B.R. 560, 561 (Bankr. D. Haw. 1985); *In re Crescent Beach Inn, Inc*., 22 B.R. 155, 157 (Bankr. D. Me. 1982); *In re Autumn Press, Inc*., 20 B.R. 60, 61 (Bankr. D. Mass. 1982).

Corporate bylaws define the relationship and methods of operation of the corporation among the directors, officers, and owners. The bylaws are a contract to be followed by the shareholders of a corporation that regulates the internal governance of the business. *Centaur Partners IV v. Nat'l Intergroup Inc*., 582 A.2d 923, 928 (Del. 1990). The power to file a bankruptcy petition on the corporation's behalf, unless delegated expressly in the bylaws, is almost universally vested in the board of directors.

2. Limited Liability Company

In the context of limited liability companies, the authority of managers is not as clear. State LLC statutes generally do not prescribe whether members or managers have the power to file federal bankruptcy petitions, and this determination will require an analysis of the terms of the LLC's governing documents.

If the articles of organization and the operating agreement do not describe the authority of members or managers to file for bankruptcy, the answer to

this question will depend on whether the LLC is member-managed or manager-managed, and the extent to which the articles and operating agreement otherwise delegate actions to managers and reserve actions to members. For example, if an LLC's managers are given relatively broad authority to take significant business actions on behalf of the LLC, it might be appropriate for a bankruptcy court to conclude that the managers also have authority to file a bankruptcy petition. By contrast, if an LLC operating agreement reserves almost all significant business decisions to the members collectively (by whatever voting rule), the members will probably be deemed to have the authority to make the bankruptcy filing decision. The risk that a bankruptcy court will be vested with the power to determine which managers or members have the power to file a bankruptcy petition should provide sufficient justification for careful drafting of an operating agreement provision.

***In re Quad-C Funding LLC*, 496 B.R. 135 (Bankr. S.D.N.Y. 2013).**
The court's decision in *In re Quad-C Funding, LLC,* illustrates factors commonly considered regarding the issue of authority to file. 496 B.R. 135 (Bankr. S.D.N.Y. 2013). When Quad-C Funding filed in chapter 11, one member ("Crossroads") moved to dismiss the filing as unauthorized. Crossroad's primary objection was based on its argument that the debtor's operating agreement required a super majority vote to approve a bankruptcy filing, and therefore Crossroad's consent to the filing. Although Crossroads initially had sufficient rights to block the vote, the debtor diluted Crossroad's interests by raising equity capital through the sale of units.

The operating agreement also authorized Crossroads to dissolve the debtor under certain circumstances. When the debtor proposed an amendment to eliminate this right, Crossroads responded with an election to dissolve the debtor. However, the amendment was approved without Crossroads' consent, and became effective prior to dissolution. Crossroads then commenced litigation in state court to obtain dissolution and judgment declaring the amendment invalid. The state court denied a request for a preliminary injunction, but did find that the debtor was required to advance Crossroads' legal fees under the terms of a servicing agreement. The debtor appealed, and the fee order was upheld on appeal.

When negotiations with Crossroads failed, a meeting of members was called to consider authorizing a chapter 11 filing. Crossroads challenged the admission of new members, and claimed that it continued to have the ability to block the super majority vote required to authorize a bankruptcy filing. Nonetheless, the bankruptcy filing was approved. Crossroads then

moved to dismiss the bankruptcy petition on the basis that it was not authorized.

In ruling on the motion, the court considered the effects of countervailing federal interests on state rights and the goal of the Bankruptcy Code to avoid costly and lengthy litigation regarding the threshold issue of whether a debtor was allowed to seek bankruptcy. The court questioned the relevance of the status of the new investors, and ultimately declined to accept Crossroads' invitation to investigate the matter on the basis that it would be "wrong as a matter of federal policy." Considering various factors, the court concluded that the record was "adequate to sustain the petition and on that record finds that Crossroads has not sustained its burden to justify the relief it seeks." Given this holding, the court noted that it did not need to go on to consider whether the requirement for a super majority vote, which gave a minority a veto over a chapter 11 filing, was valid. The court appears to have been influenced by the fact that Crossroads itself was seeking dissolution, and that it was pursuing this position at significant expense to the debtor. The court also appeared hesitant to give a minority member the power to veto a bankruptcy petition that was otherwise considered to be in the best interest of the debtor. These considerations reinforce the weight that bankruptcy courts give to underlying contexts and policy considerations.

***In re East End Development, LLC*, 491 B.R. 633 (Bankr. E.D.N.Y. 2013).**

The court's decision in *East End Development, LLC*, highlights the importance of careful drafting in organizational documents. The case arose out of a long-stalled luxury condominium development and efforts of the developer and secured lender to restructure in chapter 11 over the objection of an investor. After numerous financial obstacles, East End defaulted under its loan obligations and the secured lender commenced a foreclosure action.

When East End filed for chapter 11, the managing member had agreed on a restructuring with the lender to be effected by a sale of the property. However, the other member ("21 West") moved to dismiss the petition, arguing that the managing member lacked the authority to file the petition without 21 West's authority. In the alternative, 21 West urged dismissal of the petition as a bad-faith filing. In denying the motion to dismiss, the court construed the operating agreement and concluded that the managing member had full authority to file the petition because the bankruptcy filing was not an enumerated event requiring 21 West's consent. The court also found insufficient evidence of bad faith.

The court observed that the operating agreement set forth broad powers of the managing member, in contrast to circumstances requiring 21 West's consent, which were "narrow and specific." Among those specific actions requiring consent of the non-managing member were actions to "dissolve, wind-up, or liquidate" the debtor. In declining to fill in what 21 West argued were gaps in the operating agreement, and construe it to require consent of the non-managing member for a chapter 11 filing, the court noted that "liquidation" and "dissolution" have precise meanings under applicable state law and held that they do not include chapter 11 bankruptcy.

Linking the lack of authority and bad faith arguments, 21 West asserted that the debtor's reorganization was futile because the petition was not properly authorized and the case was filed to benefit the secured lender and the managing member. Noting that the debtor had filed a liquidating plan, the court observed that, pursuant to § 1123(b)(4) of the Bankruptcy Code, liquidating plans, like plans of reorganization, were an appropriate use of the chapter 11 process. Ultimately, the court found no "objective futility" to the filing and no "subjective bad faith," and denied the motion to dismiss.

***In re Solomons One, LLC*, 2014 WL 846084 (Bankr. D. Md. 2014).**

In *In re Solomons One, LLC*, the court interpreted an LLC's operating agreement to resolve a dispute of whether majority vote or unanimous consent was required to authorize a bankruptcy filing. The Maryland LLC was formed to acquire, purchase, lease, sell and develop certain waterfront commercial real property. The LLC acquired a piece of real property (the "Harmon House"), and became obligated under two bank loans secured by the property. When the LLC defaulted on the loans, the first lienholder initiated proceedings to liquidate the obligation. Two days before a hearing on the state court proceeding, the LLC members met to discuss whether a bankruptcy petition should be filed to stay the hearing. A majority of the membership interests voted in favor of the filing, and the LLC filed for chapter 11.

The dissenting members filed a motion to dismiss, alleging that the operating agreement was silent as to the consent required to authorize a bankruptcy filing, and as a result, unanimous consent was required pursuant to Maryland law. Although the operating agreement did not contain such an express provision, the court ultimately inferred the requisite approval from the operating agreement.

The court looked to prevailing contract law in concluding that "a reasonable person could only understand [the operating agreement] as requiring the consent of the majority of the member interests to authorize the filing of a bankruptcy petition." In reaching its conclusion, the court reviewed every section of the operating agreement and noted which corporate actions required a majority vote and which required unanimous consent. The terms of the operating agreement provided that "both ordinary course and extraordinary transactions" could be accomplished by majority vote, and required unanimous consent only upon the dissolution of the LLC, acquisition of additional property, and modification of the agreement itself. Invoking the maxim expressio unius est exclusio alterius ("the express mention of one thing implies the exclusion of the other"), the court found that the enumeration of these corporate actions as requiring greater than a majority vote implied the exclusion of other corporate actions at the heightened voting standard.

The dissenting members also argued that the Maryland Limited Liability Company Act requires unanimous consent of the members to file a bankruptcy petition. This argument was quickly dismissed because "[a]lthough the Act requires unanimous consent of the members to authorize a bankruptcy filing, that provision is expressly qualified by 'unless otherwise agreed.'" The Maryland Act, like its counterpart in many other states, provides a default set of rules for the management, control, and operation of LLCs. And as is the case in many other states, most of these rules can be modified by the parties as they may "otherwise agree." The court acknowledged that "[t]he Act provides great flexibility to members of LLCs in the creation of their governance documents." It is only when the members choose not to agree on certain governance principles that the Act controls. Because the court was able to infer a majority vote requirement from the operating agreement itself, "maximum effect" was given to that agreement.

III. Who is Your Client?

John Bradbury schedules an appointment with the firm to discuss bankruptcy options. John's brother, Mike Bradbury, a vice president of BEI, attends the meeting. Mike has been operating the SUB for the past five years. Although the SUB has not been profitable for the past five years, the SUB's performance has gradually been improving. Mike believes that in the next calendar year it will turn a profit and that profits thereafter will escalate. While you are discussing options for BEI, Mike states he wants to purchase the SUB from BEI and

wants BEI to hold paper to finance his acquisition. He believes without the financial burdens of the parent the SUB can flourish and he can save his father's good name. As the supervising officer for the SUB, Mike is privy to all of the SUB's technological developments including some new innovations that are not known by the public. He wants your law firm to write up a purchase contract that will allow him to purchase the SUB "out of bankruptcy". Mike has personally guaranteed one of BEI's bank obligations that related to the SUB.

A. Restrictions on Attorney's Representation of an Insider

1. Necessity for Separate Counsel.

It is clear that Mike's interests in bidding or buying the SUB are potentially adverse to the estate and the Debtor depending upon the terms of the offer. Mike's negotiating the best deal for his purchase of the Debtor's assets necessarily places him in an adversarial position to the estate and the creditor body. Both the negotiations and asset sale process require separate counsel. *See In re: Moon Thai & Japanese, Inc.,* 2010 Bankr. Lexis 2729 (Bankr. S.D. Fla. 2010) (J. Olsen) [Representation of a shareholder or certain investors of the Debtor is an example of a material adverse interest so that counsel cannot be disinterested]. The conflict analysis in the bankruptcy context derives from both state ethical requirements and the Bankruptcy Code.

2. Ethical Considerations.

The firm has a duty under state ethical rules to preserve confidentiality of information relating to the representation and to maintain loyalty to the client. See Rule 4-1.6(a), 4-1.7, 4-1.8 and 4-10, Rules Regulating the Florida Bar. Dual representation in this case may violate both of those duties. Many times avoiding violation of these fundamental ethical tenets could be resolved using a written informed consent. Written disclosure of the possible ethical conflict to both parties and their written waiver of the conflict should suffice to avoid an ethical breach under state ethical rules.

3. Additional Requirements under the Bankruptcy Code.

The Bankruptcy Code imposes more restrictions on professional employment. Section 327 of the Bankruptcy Code creates three overlapping inquiries before retention of a professional is permitted. That provision requires that the professional: be 'disinterested'; not hold an interest 'adverse to the estate'; and have no 'actual conflict of interest.' *In*

re Kobra Properties, 406 B.R. 396 (Bankr. E. D. Ca. 2009). The requirements are distinct and cumulative but are interrelated.

4. Disinterestedness.

As defined in §101(14) of the Bankruptcy Code, a disinterested person is one who does not have an interest materially adverse to the interest of the estate or of any class of creditors for any reason. *See In re: Project Orange Associates, LLC,* 431 B.R. 363, 370 (Bankr. S.D.N.Y. 2010).

5. Adverse to the Estate.

To *hold* an interest adverse to the estate is either (a) to possess or assert an economic interest that would tend to decrease the value of the estate or create an actual or potential dispute with the estate or (b) to possess a predisposition that would amount to a bias against the estate. *Kobra, supra, citing Tevis v. Wilke, Fleury, Hoffelt, Gould & Birney, 347 B.R. at 688* (collecting cases). These two tests from §327(a) are two prongs that form a single test to judge conflicts of interest. *Project Orange,* 431 B.R. at 370. The test precludes both economic and personal interests of an attorney. *Id.* The test is administered on a case-by-case basis based upon the specific facts of the case. *Id. citing Bank Brussels Lambert v. Coan (In re; AroChem Corp.),* 176 F.3d 610, 623 (2nd Cir. 1999).

6. Actual Conflict of Interest.

Section 327(c) of the Bankruptcy Code disallows retention of counsel when there is an "actual conflict of interest." Some courts draw a distinction between actual and potential conflicts of interest. *In re: American Printers Lithographers, Inc.,* 148 B.R. 862 (Bankr. N.D. Ill. 1992) *citing In re: Diamond Mortgage,* 135 B.R. 78, 91 (Bankr. N.D. Ill. 1991). Other courts have rejected the distinction on the grounds that even the possibility of professional compromise based upon ongoing representation of adverse parties in other matters compromises representation of debtors. *Id. citing In re: Amdura Corp.,* 121 B.R. 862, 868 (Bankr. D. Col. 1990). The focus of cases involving actual conflict is ongoing representation outside of the bankruptcy case that is so pervasive that it will diminish the efforts of counsel on behalf of the debtor. Waiver of the conflict via informed consent is not sufficient in overcoming actual conflict. *American Printers,* 148 B.R. at 867; *Kobra Poperties,* 406 B.R. at 405; and *Project Orange,* 431 B.R. at 374.

7. Full Disclosure, Continuing Disclosure and Denial of Compensation.

Under Rule 2014, Federal Rules of Bankruptcy Procedure, a professional must make a full, candid and complete disclosure of all connections with the debtor, creditors, any party in interest, their respective professionals, the United States Trustee's office and their professionals. *Id. See also, Moon Thai,* 2010 Bankr. Lexis 2729; and *Neben & Starrett, Inc. v. Chartwell Fin. Corp. (In re Park-Helena Corp.),* 63 F.3d 877, 880-82 (9th Cir. 1995).The professional's duty to disclose conflicts and adversity to the estate is continual. Violation of this standard can result in denial of all professional compensation (*see* § 328(c) of the Bankruptcy Code).

B. Insider Injunctions

1. Extension of Stay to Insider.

In most small business Chapter 11 cases, insiders have likely executed guarantees of bank debt. As the financial condition of the debtor entity deteriorates, creditors will likely institute collection actions against all liable parties including the insider guarantors. Those insiders will invariably seek a co-debtor "stay" or an injunction under §105 of the Bankruptcy Code to protect them from these collection activities during the pendency of the Chapter 11 case.

2. Section 105 Injunctions.

The automatic stay provisions of § 362 are generally limited to the debtor and are not available to non-debtor third-parties including sureties, guarantors or others with similar legal or factual nexus to the debtor. *McCartney v. Integra National Bank North,* 106 F.3d 506, 509-510 (3rd Cir. 1997). Courts have utilized the extension of the stay to non-debtor entities via a § 105 injunction. The injunction is entered based upon "unusual circumstances" which fall into three categories. First where there is substantial financial identity between the debtor and the third-party such that the claim against the third party is tantamount to a claim against the debtor. *A.H Robbins Co. v. Piccinin,* 788 F.2d 994, 999 (4th Cir. 1986)[where actions against co-debtors would deplete available insurance and potential negative impact on the estate]; *In re American Film Technologies, Inc.,* 175 B.R. 847, 855 (Bankr. D. Del. 1994) [staying wrongful discharge claims against former and present directors because of the debtor's mandatory indemnification obligation]. Second, where the non-debtor's assets, credit or properties were going to fund a plan of reorganization. *In re; St. Petersburg Hotel Associates, Ltd., 37 B.R. 380* (Bankr. M.D. Fla. 1984) and *In re: Stephen P. Nelson, D.C.P.A.,* 140 B.R. 814 (Bankr. M.D. Fla. 1992). Third, where the actions against the debtor's key executives prevent the third party from focusing on the reorganization

process. *Id.; In re Johns Manville Corp.,*33 B.R. 254 (Bankr. S.D.N.Y. 1983); and *In re Ionosphere Clubs, Inc.* 111 B.R. 423, 435 (Bankr. S.D.N.Y. 1990). If the instant fact pattern results in a liquidating Chapter 11, it is unlikely that Mike or any of the officers may rely upon a §105 injunction to prevent the guaranty claims against them. *See generally Forcine Concrete & Construction, Co. v. Manning Equipment Sales & Service,* 426 B.R. 520, 523 (E.D. Pa. 2010).

C. Insider Releases.

1. Bar Orders.

More and more frequently third party insiders of Chapter 11 debtors are seeking releases of their personal liability as guarantors of the debtor's obligations pursuant to a confirmed Chapter 11 plan. The Circuits are split on whether or under what circumstances to permit such releases. The 5th, 9th and 10th Circuits conclude that the language of § 524(e) precludes entry of third party bar orders. The 2nd, 3rd, 4th, 6th and 7th Circuits allow such releases in unusual circumstances. Mike would certainly ask that BEI's plan include a release for his guaranty obligation, but will that request sail?

2. Standard for Third Party Release.

The decision in *In re: Transit Group, Inc.,* 286 B.R. 811, 817-818 (Bankr. M.D. Fla. 2002) summarized the positions of the Circuits on the issue of third party releases. It also articulated and summarized the tests utilized by the various Circuits in allowing such releases on a limited basis. In order to support a release there must be a demonstration of unusual circumstances and a showing that the release is fair and necessary. To determine if the release is "fair and necessary", Judge Jennemann articulated the seven-factor test which had been utilized by several of the "pro-release" courts:

> (1) Whether the debtor and the third party share an identity of interest, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate;
>
> (2) Whether the non-debtor has contributed substantial assets to the reorganization;

(3) Whether the injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor;

(4) Whether the impacted class, or classes, has overwhelmingly voted to accept the plan;

(5) Whether the plan provides a mechanism to pay for all, or substantially all, of the class, or classes, affected by the injunction;

(6) Whether the plan provides an opportunity for those claimants who choose not to settle to recover in full; and

(7) Whether the bankruptcy court made a record of specific factual findings that support its conclusions.

These provisions are justified only in unusual circumstances such as facilitation of complex litigation settlement or as an inducement to provide a significantly larger settlement pool conditioned upon the entry of a bar order.

D. Sale to an Insider

1. Insider as Bidder on the SUB.

Mike intends to create an entity in which he would be the principal to bid on the SUB and its assets out of a later filed Chapter 11 (or possibly in an ABC). Mike is concerned about issues which he may encounter as the manager of the SUB who also wants to be a bidder for the SUB. He wants the benefits of a bankruptcy sale so that the acquiring entity can avoid issues of continuation theory and defacto merger discussed *infra*. Although he has not finalized his offer, the new entity would likely offer a cash payment and an assumption of some of the debt [if that assumption can be negotiated with the creditor]. Mike and one other investor believe that they have sufficient cash on hand to complete the purchase. In any event the cash payment would be sufficient to cover administrative expenses so that BEI would not be administratively insolvent. Mark wants to understand the issues he might face in opposition to his bid. Mike would like a release from any personal liability on the bank debt he has guaranteed but may drop this requirement if the purchasing entity can assume the debt to which his guaranty relates.

2. Maximizing Return and Sound Business Reasons.

The central aim in any asset sale in bankruptcy is the maximization of the value of the asset sold. *In re: Family Christian, LLC,* 533 B.R. 600, 627 (Bankr. W.D. Mich. 2015) *citing In re: Integrated Resources, Inc.,* 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992) *aff'd* 147 B.R. 650 (S.D.N.Y. 1992). Nothing in the Bankruptcy Code prohibits insiders from purchasing estate assets. *Id.* However, sales to insiders are subject to a higher degree of scrutiny due to the greater opportunities for inequitable conduct. *Id* at 622 *citing Bayer Corp. v MascoTech, Inc.* 269 F.3d 700. 745 (6th Cir. 2001). In order to approve an asset sale, the bankruptcy court must find that there is a sound business justification for the sale based upon proof offered by the interested parties. *Id.* at 626 *citing Comm. Of Equity Sec. Holders v. Lionel Corp. (In re: Lionel),* 722 F.2d 1063, 1070 (2nd Cir. 1983) and *In re: Knott,* 2015 Bankr. Lexis 202 (Bankr. M.D. Fla. 2015)(J. Jennemann).

3. Following the Rules.

The Debtor has the fiduciary duty to the estate and creditors to ensure that the sale results in the highest and best bid. *See Family Christian* at 627. Mike should take certain actions and refrain from taking other actions to ensure that the bid for the SUB will have the greatest chance for success (many of which emanate from the good faith requirements of §363(m) of the Bankruptcy Code), including:

a. Early and accurate disclosure of his affiliation with the bidding entity and his former relationship with the Debtor.

b. Disclosure of any other connections with the Debtor. Disclosure of any intended post-sale employment of the Debtor's key personnel who are involved in the sale process.

c. Development of a sale process that includes safeguards including vetting of bids by a variety of stakeholders.

d. Clear expression of terms of an offer including non-cash elements.

e. Limiting communication with the Debtor's management to formal channels so that there is no appearance of impropriety.

f. Directing communications regarding the bid to key constituents to develop support for the bid.

g. Ensuring that the key assets – especially intangibles like avoidance actions and third party releases - have been evaluated and analyzed by the Debtor prior to the bidding so that all of the bids can be vetted for sufficiency.

h. Limiting releases to non-debtor guarantors or ensuring that sale terms meet the *Dow Corning* factors articulated in *Transit Group.*

i. Ensuring that the sale has adequate exposure to a relevant market so that the potential bidders pool is maximized.

j. Question the debtor and its professionals to ensure that a post-sale plan will be filed shortly after the conclusion of the sale to support a finding of sound business justification.

k. Independent appraisal of assets subject to sale so that bids can be properly evaluated.

l. Satisfying the other *Lionel* factors which support a finding of sound business justification.

IV. Possible Claims Against the Person Who Hires You

A. Fraudulent Transfers

BEI will keep paying the mortgage on my house, right? For years, BEI has just paid my monthly mortgage payment of $4,000. That's what my dad always did; he thought it was a waste of effort to have BEI pay him just to turn around and pay it to the mortgage company. Why not take out the extra step?

Principals of corporate debtor companies must be wary prior to filing bankruptcy, as they must know that many of the debtor's pre-petition transactions will be scrutinized. This is especially so in relation to transfers to or for the benefit of a debtor's principals. A fraudulent transfer can be avoided as a "constructive" fraudulent transfer when the debtor-transferor did not receive "reasonably equivalent value" if it made such a transfer while insolvent. *See* 11 U.S.C. § 548(a)(1)(B).

The problem here is that the debtor, BEI, is not obligated on the mortgage debt but is paying the mortgage debt on Bradberry's behalf. A trustee may elect to seek avoidance of the transfer as fraudulent by arguing that BEI did not receive any benefit from the transfer.

A similar situation was present in *In re Seaway Intern. Transport, Inc.*, 341 B.R. 333 (Bankr. S.D. Fla. 2006). In *Seaway*, a chapter 7 trustee sought to avoid and recover mortgage payments made by the debtor to its principal's mortgage lender, arguing the debtor received no benefit from the transaction. The defendant successfully argued that the mortgage payments were part of a "pattern of

compensation," and therefore the mortgage payments provided value to the debtor because the debtor made the payments in lieu of salary or distributions.

> ***Revocation of Subchapter S election in bankruptcy.*** Both BEI and SUB are taxed as subchapter S corporations. SUB's profits from last year will result in a huge tax liability for me. Why don't we just revoke the subchapter-S designation prior to bankruptcy so BEI absorbs the tax liability?

Is a subchapter S election "property" of the estate? If a corporation revokes its subchapter S designation, then the tax will be borne by the debtor instead of the owners. This reduces the distribution to the unsecured creditors by creating a priority tax claim. Courts have held that the revocation is a fraudulent transfer.

See Trans-Lines West, Inc., 203 B.R. 653 (Bankr. E.D. Tenn. 1996). *But see In re Majestic Star Casino, LLC*, 716 F.3d 736 (3d Cir. 2013) (non-debtor parent's revocation of debtor-subsidiary's QSub status was *not* fraudulent transfer).

B. Recharacterization Issues

> The $2 million of my inheritance I loaned to BEI should at least allow me to recoup some value as a creditor of BEI, right? I never formalized the loan with a promissory note or anything.

Bradberry's $2 million "loan" to BEI could pave the way for a party in interest, such as a creditor or an unsecured creditor's committee, to argue that the monies tendered by Bradberry should be treated as an capital infusion into BEI, not a loan, and thus subject to lower priority treatment.

Many bankruptcy courts have held that § 105(a) empowers them to look beyond a party's "debt" or "equity" label on a particular transaction. *See, e.g.*, *Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors (The Plan Monitoring Comm.) (In re Dornier Aviation, Inc.)*, 453 F.3d 225, 231 (4th Cir. 2006); *Cohen v. KB Mezzanine Fund II, LP* (*In re SubMicron Sys. Corp.*), 432 F.3d 448, 454 (3d Cir. 2006); *In re Cold Harbor Associates, L.P.,* 204 B.R. 904, 915 (Bankr. E.D. Va. 1997); *Celotex Corporation v. Hillsborough Holdings Corporation (In re Hillsborough Holdings Corporation,* 176 B.R. 223, 248 (M.D. Fla. 1994). Instead, courts can look to the "actual nature of the transaction to determine how best to characterize it." *Cold Harbor*, 204 B.R. at 915.

Court have identified as many as thirteen factors to consider whether a claim should be treated as debt or equity. *See, e.g.*, *Fairchild*, 453 F.3d at 233–34; *Cold Harbor*, 204 B.R. at 915. The most important and typically applicable factors appear to be: (1) the formalities associated with the alleged loan; (2) whether the

entity was adequately capitalized at the time; and (3) the relationship between the party who extended the funds and the debtor. *See Cold Harbor*, 204 B.R. at 916.

Bradberry's status as the sole owner of BEI, an insider, would create a reasonable suspicion that his "loan" should be recharacterized as an equity infusion. Indeed, that Bradberry only loaned the monies after BEI was already in decline also would lend in favor of treating the money as equity. And, perhaps most importantly, the fact that the loans were not documented by promissory notes or any other instrument likely would solidify a court in determining that the monies paid were not loans, but rather equity contributions.

C. Successor Liability

> After questioning Bradberry on why someone would want to acquire SUB, he advises you "*we have been discussing some new contracts with the Department of Defense and several private security firms that could be worth as much as $100 million over the course of the next five years.*" Bradberry further advises *"We were just about to sign the first contract, but our corporate attorney suggested we hold off until we finished the formation of our new entity."*

The bad news for Mr. Bradberry is that creating a new company to take whatever intangible assets the application divisions may have and or continuing its work and reaping the benefits of the costs borne by the division throughout research and development is only going to lead to Mr. Bradberry and the new entity being sued for successor liability, fraudulent transfer, and breach of fiduciary duty.

1. General Rule.

Florida law imposes the liabilities of a predecessor company on a successor under four (4) circumstances: (1) the successor expressly or impliedly assumed the obligations of the predecessor; (2) the transaction is a *de facto* merger; (3) the successor is the mere continuation of the predecessor; or (4) the transaction is a fraudulent effort to avoid the liabilities of the predecessor. *Bernard v. Kee Mfg. Co., Inc.*, 409 So.2d 1047, 1049 (Fla. 1982).

2. Express or Implied Assumption of Debt.

See Bernard v. Kee Mfg. Co., Inc., 394 So.2d 552, 555 (Fla. 1981) (finding this basis for successor liability not met where defendant did not assume any debts or obligations).

3. De Facto Merger.

A de facto merger occurs where one corporation is absorbed by another, but without compliance with the statutory requirements for a merger. To find a de facto merger there must be continuity of the selling corporation as evidenced by the same management, personnel, assets and physical location; a continuity of the stockholders, accomplished by paying for the acquired corporation with shares of stock; a dissolution of the selling corporation; and assumption of the liabilities. To determine if a *de facto* merger has occurred, the finder of fact may look at any factors reasonably indicative of commonality or of distinctiveness. *Amjad Munim, M.D., P.A. v. Azar*, 648 So.2d 145, 154 (Fla. 4th DCA 1994); *Coral Windows Bahamas Ltd.*, 2013 WL 321584, *5 (S.D. Fla. 2013); *Florio v. Manitex Skycrane, LLC,* 2010 WL 5137626, *5 (M.D. Fla. 2010); *Redman v. Cobb International*, 23 F.Supp.2d 1372, 1376 (M.D. Fla. 1988).

4. Mere Continuation (closely related to de facto merger).

Mere continuation occurs when the successor corporation is merely a continuation or reincarnation of the predecessor under a different name. The purchasing corporation is merely a "new hat" for the seller, with the same or similar ownership. They key element of a continuation is a common identity of officers, directors and stockholders in the selling and purchasing corporation, a change in form, but not in substance. While having common attributes does not automatically impose liability on a successor corporation, merely repainting the sign on the door and using a new letterhead certainly gives the appearance that the new corporation is simply a continuation of the predecessor corporation. The bottom-line question is whether each entity has run its own race, or whether there has been a relay-style passing of the baton from one to the other. *See Lab Corp. v. Prof'l Recovery Network*, 813 So.2d 266, 270 (Fla. 5th DCA 2002).

5. Fraudulent Effort to Avoid Liabilities.

See Orlando Light Bulb Service, Inc. v. Laser Lighting and Elec. Supply, Inc., 523 So.2d 740, 743-44 (Fla. 5th DCA 1988) (reversing summary judgment against alleged successor where successor had no knowledge of issuance of writ of attachment to plaintiff around the time successor purchased predecessor's inventory, furniture and a copier, and successor purchased goods from predecessor at fair market value and in good faith.); *Graef v. Hegudus*, 698 So.2d 655, 656 (Fla. 2d DCA 1997) (finding that [o]rdinarily, the issue of fraud is not a proper subject of a summary judgment.").

6. Standing.

Only assignee in ABC or trustee has standing to pursue successor liability (or other derivative claims) on behalf of the estate. *Moffat v. Nichol, Inc.*

v. B.E.A. International Corp., Inc., 48 So.3d 896, 899 (Fla. 3d DCA 2010); *In re Xenerga, Inc.*, 449 B.R. 594, 597-98 (Bankr. M.D. Fla. 2011) (finding that trustee had exclusive standing to bring alter ego claim where injury alleged was common to all creditors of the debtor).

7. Damages.

In re Metro Sewer Services, Inc., 374 B.R. 316, 323-24 (Bankr. M.D. Fla. 2007) (finding successor "financially responsible for paying all allowed unsecured and priority claims filed in [debtor's] bankruptcy case.

D. Other Issues with Related Entities and Parent/Subsidiaries

I thought all those interest-free loans from SUB really gave us a chance to dig ourselves out of the hole. Too bad it didn't work out. What do you suggest we do with SUB?

1. Conflict of Interest in Representation of Related Debtors?

Bankruptcy practitioners often represent related entities in bankruptcy. Section 327(a) of the Bankruptcy Code governs employment of professionals and requires that an attorney "does not hold or represent an interest adverse to the estate" and that the attorney is "disinterested." *See* 11 U.S.C. § 327(a). Representation of related debtors can become problematic, especially when one debtor may have claims against the other.

Most courts have held that the court should examine the totality of circumstances surrounding the proposed representation when considering whether multi-debtor representation is appropriate. *See, e.g.*, *Interwest Business Equip., Inc. v. United States Trustee (In re Interwest Business Equip., Inc.*), 24 F.3d 311, 318–19 (10th Cir. 1994); *In re BH&P, Inc.*, 949 F.2d 1300, 1315–17 (3d Cir. 1991). The focus should be on whether there is an actual conflict of interest. *See BH&P*, 949 F.2d at 1314.

The existence of intercompany loans typically does not *per se* result in a conflict of interest. *See In re Int'l Oil Co.*, 427 F.2d 186 (2d Cir. 1970); Further, the mere existence of inter-company claims between several entities may be insufficient alone to warrant disqualification. *In re Mulberry Phosphates, Inc.*, 142 B.R. 997, 998 (Bankr. M.D. Fla. 1992). But other, potentially tortious conduct may warrant disqualification. In *In re Jennings*, the court recognized an actual conflict where one debtor depleted its assets despite a related debtor's secured claim over those assets. *In re Jennings*, 199 F. App'x 845, 849 (11th Cir. 2006).

V. Partnership and LLC Issues

A. Authority to File After Member Files Chapter 7

> Did I tell you BEI was a corporation? I think it might actually be a limited liability company. SFTB just served a writ of garnishment on me, so I want to file a chapter 7 immediately. I'll still be able to decide whether to put BEI into a chapter 11 after I file, right?

If the member of a single member LLC files bankruptcy, the chapter 7 trustee becomes the only person entitled to put the LLC into bankruptcy. *See, e.g., In re A-Z Electronics LLC*, 350 B.R. 886 (Bankr. D. Idaho 2006); *In re B & M Land & Livestock, LLC*, 498 B.R. 262, 266 (Bankr. D. Nev. 2013) ("In obtaining the debtor's rights, the trustee is not a mere assignee, but steps into a debtor's shoes as to all rights, including the rights to control a single-member LLC.").

B. LLC Operating Agreement as Property of the Estate

> What happens to BEI if I file Chapter 7?

1. Is an Operating Agreement Executory?

Short answer, it depends. What is the nature of the relationship of the debtor to the other members of the LLC? What is applicable statutory and/or contractual language governing the consequences of a LLC member filing bankruptcy?

A member's interest in a LLC can be separated into two parts: (1) economic interests— the right to share profits and losses of the business and the right to receive distributions; and (2) non-economic rights—such as the right to vote, participate in management, and receive information relating to the operations of BEI.

Typically what happens is a dispute arises when the chapter 7 trustee notices the debtor's interest in the LLC for sale. Critical to the analysis are Sections 541 (property of the estate) and 365 (executory contracts and unexpired leases) of the Bankruptcy Code. Both of these code sections expressly limit or take priority over state law and contractual terms. In short, a debtor's economic interest is property of the bankruptcy estate pursuant to Section 541 notwithstanding *ipso facto* provisions and operating agreements or LLC statutes to the contrary. However if the LLC's operating agreement is executory, then §365 trumps §541 as to the non-economic interest of the LLC.

2. Authority

Section 541(c)(1) of the code provides that:
… An interest of the debtor in property becomes property of the state… notwithstanding any provisions in an agreement, transfer instrument, or applicable nonbankruptcy law—

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial conditions of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodial for such commencement, and the effects or gives an option to the effect of forfeiture, modification, or termination of the debtor's interest in property.

Notwithstanding *ipso facto* provisions in the LLC's operating agreements or LLC statutes, the debtor's economic interest in an LLC are property of the bankruptcy estate. While §541(c)(1) suggests that the debtor's non-economic interest are also property of the bankruptcy estate, §365 of the Bankruptcy Code also comes into play. §365(c)(1) provides that a trustee may not assume an executory contract if applicable law excuses a contracting party from accepting performance from someone other than the debtor, and that party does consent. §365(e)(1) provides in relevant part:

> Notwithstanding the provision in an executory contract…or in applicable law, an executory contract…of the debtor may not be terminated or modified, and any right or obligation under such contract…may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract…that is conditioned on—
>
> (A) the insolvency or financial condition of the debtor at any time before the closing of the case;
> (B) the commencement of a case under this title; or
> (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

Thus, if a LLC operating agreement is deemed an executory contract, the chapter 7 trustee cannot assume and sell the debtor's non-economic interests. *See e.g. In re Soderstrom*, 484 B.R. 874 (MD Fla. 2013); *In re Ehmann*, 319 B.R. 200 (Bankr. D. Ariz. 2005).

There is no bright line rule on whether an LLC operating agreement is an executory contract but requires a case by case factual analysis. For example, the *Soderstom* court held that the operating agreement was an executory contract under the functional approach "if it's assumption [] [or] rejection which ultimately benefit the estate and its creditors." *Citing Thompkins v. Lil' Joe Records, Inc.*, 476 F.3d 1294 (11th Cir. 2007). In that case the assumption of the management interest under the contract would ultimately benefit the estate than just the economic interest.

The *Ehmann* court found the operating agreement was not an executory contract by distinguishing other cases in which the courts found obligations to contribute capital and continuing fiduciary duties among partners key factors in making operating agreements executory contracts.

VI. Attorney-Client Privilege

> I am here talking to you and you will protect me and my company, right? I hope that you'll never tell anyone about our conversations? Isn't there an attorney-client privilege?

A. Generally

Bankruptcy often presents a uniquely complicated backdrop for assessing legal privilege because of its mix of transactional work, litigation, shifting corporate entities, alliances between parties with overlapping and rapidly changing interests, and fiduciary duties owed to multiple parties with divergent interests. In general, common law legal privileges apply with the same force to disputes involving entities in bankruptcy. Fed. R. of Bankr. P. 9017 (providing that the Federal Rules of Evidence apply in cases brought under the Bankruptcy Code); *see also,* Federal Rule of Evidence 501.

When a corporation is in financial difficulty, the common interest of the corporation and its principals can diverge. This is most likely to happen when principals are divested of their control in a chapter 7. A trustee in a chapter 7 case is required to make an examination into the affairs of the debtor firm, and this necessarily includes an examination into whether transactions between the corporation and its directors, officers and employees were conducted at arm's length. The trustee must also determine whether the corporation made any fraudulent transfers or preferences. The potential friction between a trustee in bankruptcy and the principals of the corporation has significant consequences for the attorney who has represented the corporation prior to filing.

Counsel may have previously simultaneously represented both the corporation and individual principals. Where a trustee is appointed for the corporation, it is effectively under new management, and the trustee has wide latitude to obtain information pertaining to the corporation's conduct or property. Thus, to the extent that an attorney formerly retained by a corporation is in possession of information that would be useful to the trustee, the attorney is required to produce the information upon a proper demand. The corporation's attorneys still owe a duty of loyalty to the corporate entity, which is now under the control of the trustee. This can present issues relating to the attorney-client privilege.

In light of the foregoing, best practices require that legal counsel consider both the scope and preservation of the attorney-client privilege in the bankruptcy forum, as well as the effect of the appointment of a trustee or examiner on the issue of control of the privilege. Moreover, because there is relatively little case law that directly addresses the transfer of the attorney-client privilege pursuant to a plan of reorganization or liquidation, when drafting a bankruptcy plan and/or liquidation trust agreement, the wise practitioner will expressly identify who will control the attorney-client privilege post-confirmation, the scope of such privilege, and the authority to assert or waive such privilege.

B. Attorney-Client Privilege:

The attorney-client privilege is defined as the client's right to refuse to disclose and to prevent any other person from disclosing confidential communications between the client and the attorney. *See* BLACK'S LAW DICTIONARY 1235 (8th ed. 2004) ("privilege—attorney-client privilege"). In 1985, the Supreme Court held in *Commodity Futures Trading Commission v. Weintraub*, that in corporate bankruptcy cases, the trustee acquires the attorney-client privilege of the debtor corporation and may waive or assert the privilege as required for the administration of the estate. *Commodity Futures Trading Com'n v. Weintraub*, 471 U.S. 343 (1985). In making this determination, the Court balanced two interests: (i) the importance of granting the bankruptcy trustee an avenue through which he or she can fulfill statutory duties, and (ii) the effect that the transfer of privilege would have on future clients' decisions to fully disclose information to their attorneys. Ultimately, the Court found that the interest of the bankruptcy trustee should prevail.

C. Co-Client Exception:

The co-client exception provides that where a lawyer represents two clients in the same case, communications between the lawyer and one client are not confidential as to the other. *See In re Ginn–LA St. Lucie, Ltd.*, 439 B.R. 801 (Bankr. S.D. Fla. 2010): *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del.),* 285 B.R. 601, 612 (D. Del. 2002); *see also, Bass Pub. Ltd. Co. v. Promus Cos. Inc.*, 868 F. Supp. 615, 620

(S.D.N.Y. 1994) (explaining that "[w]here there is a joint attorney/client privilege, there is no expectation that confidential information will be withheld from joint clients as there is no privilege between them").

This exception frequently arises in a corporate bankruptcy setting, and its purpose is to: (i) prevent unjustifiable inequality in access to information necessary to fairly resolve disputes that arise between parties who were in the past joint clients; and (ii) discourage abuses of fiduciary obligations and encourage parties to honor any legal duties they had to share information related to common interests. *Sky Valley Ltd. P'ship v. ATX Sky Valley, Ltd*., 150 F.R.D. 648, 653 (N.D. Cal. 1993).

1. In re Ginn-LA St. Lucie, Ltd.:

The Southern District of Florida recently addressed the enforceability of a joint defense agreement ("JDA") between a debtor and its former parent companies in *In re Ginn-LA St. Lucie Ltd*. *LLP*, 439 B.R. 801, 804-05 (Bankr. S.D. Fla. 2010). There, the parties attempted to use a JDA to circumvent the general rule prohibiting co-clients from invoking the attorney-client privilege where subsequent litigation arises between the parties. Significantly, the JDA expressly stated that it was entered into in contemplation of bankruptcy. The court held that the JDA was unenforceable on public policy grounds, as it would thwart the trustee's statutory duties to investigate potential claims held by the debtor. In support of its position, the Ginn-LA St. Lucie court cited *In re Mirant*, 326 B.R. 646 (Bankr. N.D. Tex. 2005), which addressed a situation in which the same law firm represented a debtor and its former parent company, and the parties had previously signed a "protocol for legal representation" that prohibited them from sharing confidential information if they later became adversaries in an action. *Id.*

The court in *Mirant* recognized the importance of the attorney-client privilege in fostering open communications between attorneys and their clients. However, it also held that the privilege must yield when necessary to promote an important public policy. The court noted that "[i]n a bankruptcy case, the need for investigation is far more acute than is any concern for attorney/client privileges." As such, the *Mirant* court allowed the trustee of the debtor subsidiary company to discover documents of the law firm that previously represented the subsidiary and its former parent company in order to promote the goals of bankruptcy law. Applying the reasoning from the *Mirant* decision, the court in *GinnLA St. Lucie* held that enforcing the JDA and shielding communications would offend public policy. Allowing unfettered enforcement of the terms of the JDA would have needlessly hampered the trustee from performing his duties and only benefited the alleged wrongdoers. The court noted that enforcement of the JDA—especially one that was signed in the anticipation of bankruptcy—

created a situation that was ripe for abuse. Enforcement of such a JDA in bankruptcy proceedings, the court held, is against public policy.

2. In re Fundamental Long Term Care, Inc.:

The Middle District of Florida also recently considered the application of the co-client exception in *In re Fundamental Long Term Care, Inc*., 489 B.R. 451, 477 (reconsideration denied), 493 B.R. 620 (Bankr. M.D. Fla. 2013). There, the court was presented with a situation in which it was left to determine whether a bankruptcy trustee could discover communications between a debtor's subsidiary and the subsidiary's former parent company made to the attorneys during the joint representation of the two. The court ultimately decided to give the trustee the ability to discover the confidential communications based on, among other things, the public policy of protecting or promoting the interests of justice.

Fundamental Long Term Care, Inc. ("FLTC"), a health care and rehabilitation facilities operator, filed an involuntary chapter 7 petition on Dec. 5, 2011. The trustee requested files and records relating to the debtor and its wholly owned subsidiary, Trans Health Management Inc. ("THMI"). Prior to 2006, Trans Healthcare, Inc. ("THI") owned several different subsidiaries that operated nursing homes. THMI, at the time a THI subsidiary, provided support services for nursing homes operated by other THI subsidiaries. In 2004, several negligence and wrongful-death lawsuits were filed against the companies, which THI defended. THI sold all of its stock in THMI to FLTC in March 2006. In 2009, THI was placed in a receivership, and the receiver continued to defend THMI in the negligence and wrongful-death actions, even though THMI was now owned by FLTC.

The issue arose when the trustee for the debtor sought to discover a number of books and records, including litigation files, that belonged to THMI from the lawyers and law firms who had provided the joint representation of THI and THMI in the negligence and wrongful-death lawsuits. THI's receiver objected on the grounds that the documents were protected by the attorney-client privilege. Thus, a question arose as to who controlled the subsidiary and therefore its attorney-client privilege. This question was significant in that it would potentially allow the trustee to possess privileged communications of a company where the debtor was only a 100 percent shareholder.

Because the subsidiary was defunct, the court disregarded the corporate form and allowed the trustee to control the subsidiary. *Wofford v. Wofford*, 129 Fla. 445 (1937) (the court "looked beyond the legal fiction of a corporate entity . . . in an effort to do justice between litigants," and found the shareholders to be the real parties in interest whose duties most closely

resemble those of management). Arising from the determination that the trustee had the power to control THMI and its attorney-client privilege was the question of whether the trustee could obtain the litigation files from the lawyers representing both THI and THMI. THI's receiver argued that THI subjectively believed that its communications to the law firms defending THI and THMI would be privileged, since THMI was defunct, administratively dissolved and not present for any of the communications. On the other hand, the trustee submitted that in order for her to direct THMI's ongoing litigation and investigate any potential causes of action, she would need access to the law firms' litigation files.

The court determined that the trustee was entitled to invoke the co-client status of THMI to obtain the communications relating to the defenses of THI and THMI in the negligence and wrongful-death actions. The court concluded that THI and the receiver did not have a reasonable expectation of privacy with respect to the communications related to the defense of the negligence and wrongful-death actions. This determination was based on the fact that THI and THMI had the same interest in not being held liable for the wrongful-death actions and that THI retained counsel to defend THMI in those cases. The trustee, standing in THMI's shoes, was entitled to obtain the information as a co-client of the Receiver.

When left to consider the effect of a JDA between the former parent and subsidiary, the court cited to the similar policy considerations in the *Ginn-LA St. Lucie* and *Mirant* cases. In this case, as in the others, the court found that the need for the trustee to investigate the truth in bankruptcy outweighed any concern for the confidentiality of attorney-client communications. Specifically, the court recognized the importance of the trustee's duty to thoroughly investigate claims that the subsidiary might have against third parties and the trustee's ability to direct the defenses of the subsidiary. The attorney-client privilege was once again forced to give way in order to promote an important public policy.