American Bankruptcy Institute

2019 Midwest Regional Bankruptcy Seminar

Pushing the Envelope in Chapter 11 — How Far Can You Go?

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Pushing the Envelope in Chapter 11 – How Far Can You Go?

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KEIPs and KERPs

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I. Introduction to KEIPs and KERPs in Bankruptcy Cases

A Key Employee Incentive Plan (KEIP) is an often utilized tool in Chapter 11 cases, helping debtors achieve certain performance and other business related targets by incentivizing the applicable important employees to meet the specified goals. Typically, to be awarded the KEIP bonus, the subject employee (who may be a rank-and-file employee or an executive or other "insider") must attain the specified business or operational metric. A Key Employee Retention Plan (KERP) is a program to award bonuses and/or other benefits to key employees (typically non-executives and non-insiders as discussed below) to incentivize them to stay in the debtor's employ during the Chapter 11 case. In order to qualify to receive the KERP bonus, the affected employee has to remain employed by the debtor through a date or event certain (for example, the consummation of a Code section 363 sale of the debtor's assets).

A. Statutory Requirements In General

Section 503(c) of the Bankruptcy Code prohibits three types of administrative expense payments in bankruptcy proceedings: (i) payments made to insiders to induce them to remain with the business (*i.e.*, payments under a KERP or de facto KERP) unless certain difficult requirements are met (11 U.S.C. § 503(c)(1)); (ii) severance payments to insiders unless certain express requirements are satisfied (11 U.S.C. § 503(c)(2)); and (iii) payments to anyone else outside the ordinary course of business (including, for example, KEIP payments to insiders and non-insiders and KERP payments to non-insiders) that are "not justified by the facts and circumstances of the case" (11 U.S.C. § 503(c)(3)). A copy of the full text of section 503(c) is attached hereto.

Congress had imposed substantial limitations on KEIP and KERP type payments with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), through the addition of Bankruptcy Code section 503(c). Generally, the purpose of section 503(c) was to limit a debtor's ability to favor insiders over the interests of the bankruptcy estate; Congress enacted section 503(c) to end abusive compensation practices by placing limits on the payment of retention and incentive bonuses and severance to insiders and others.[1]

B. Prevalence of KEIPs and KERPs

According to one analysis by Debtwire, KEIPs were implemented in approximately 18%-20% of larger corporate bankruptcy cases over the last several years. *See* J. Friedman & J. Sharma, Debtwire, 2016-2018 Restructuring Insights: Key Employee Incentive Plans. According to the same analysis, most of the KEIPs had relatively modest, potential employee payouts at least in the aggregate; only about 50% of the studied KEIPs awarded more than $1 million, and only about 27% of the studied KEIPs awarded more than $3 million to key employees.

[1] *See, e.g., In re Hawker Beechcraft, Inc.*, 479 B.R. 308, 312-13 (Bankr. S.D.N.Y. 2012); *In re Global Home Prods., LLC*, 369 B.R. 778, 784-85 (Bankr. D. Del. 2007).

Certainly, however, there are examples of significantly costlier and extensive KEIPs as the debtor's and case circumstances may require. For instance, recently, telecommunications companies Windstream and its affiliated debtors had proposed a KEIP for five company insiders who could receive in the aggregate over $20 million in maximum payouts. The debtors had commenced their Chapter 11 cases on an expedited basis, without a comprehensive restructuring strategy, and thus, the debtors needed a KEIP to ensure smooth operations and an efficient emergence from bankruptcy. The debtors also worked with their independent compensation consultant in designing the plan and determining the bonus amounts. Subsequently, based on negotiations with the creditors' committee, the maximum payouts were slightly reduced (a cost savings of $1.1 million at the maximum performance level) and portions were to be deferred to later payment dates. *See In re Windstream Holdings, Inc.*, Case No. 19-22312 (RDD) (Bankr. S.D. N.Y. May 15, 2019) (order approving modified KEIP (docket no. 531)).

The Debtwire analysis also found that KEIPs were most common in "free fall" bankruptcy filing cases and cases with a sale process (often started prepetition), which is not surprising in that critical employees may not be inclined to continue to provide services during, as applicable, an extremely difficult free fall situation (at least until business operations and case administration have stabilized), or the challenging and uncertain situation where the debtor's business or substantially all of the debtor's assets will be sold and likely the subject employees will ultimately lose their jobs.

Some commentators have observed that since the enactment of section 503(c) in 2005, traditional KERPs have been less commonly proposed and approved in Chapter 11 cases because of the strict limitations and restrictions in section 503(c)(1). In contrast, it appears courts have more readily approved KEIPs as ordinary course payments outside the ambit of section 503(c)(3), or payments justified by the facts and circumstances under section 503(c)(3), provided that the plans include features like true performance metrics. Because of the less exacting standards under which a non-retention, non-severance plan can be approved under section 503(c)(3), Chapter 11 debtors are more likely to attempt to incentivize their executive-level employees and officers by using a KEIP structure rather than a traditional KERP, which would likely fail the stringent tests under sections 503(c)(1) and (2).

C. <u>Section 503(c)(3) – Business Judgment Standard and Structuring Issues</u>

Under section 503(c)(3), as fleshed out by the courts, debtors may pay a bonus under a KEIP to employees after they attain specific measurable, difficult-to-reach milestones. Payments under a KEIP are described as being outside the ordinary course of business and are statutorily prohibited unless justified by "the facts and circumstances of the case."

The majority view is that "the facts and circumstances of the case" standard under section 503(c)(3) is the same as the deferential business judgment standard applied under Code section

363(b).[2] The minority view is that the standard for approval of plans under section 503(c)(3) is higher than the bar set by the business judgment test.[3]

The *Dana II* factors[4] have been widely adopted by courts analyzing KEIPs under section 503(c)(3):

(i) Is there a reasonable relationship between the proposed plan and the expected results?

(ii) Is the plan reasonably calculated to elicit the desired performance from the covered key employees?

(iii) At a bare minimum, must the insider do more than simply show up?

(iv) Is the plan's cost reasonable when compared with the debtor's assets, liabilities, and earning potential?

(v) Is the plan's scope fair and reasonable? Does it apply to all employees or does it discriminate among employees unfairly?

(vi) Is the plan consistent with industry standards?

(vii) What due diligence did the debtor perform to investigate the need for a plan, to identify which employees need to be incentivized, and is generally applicable in the debtor's industry?

(viii) Did the debtor receive independent legal and financial counsel in formulating the plan?

The appropriate provisions of a KEIP will depend on the particular circumstances and needs of the debtor and industry and market factors. For instance, some performance metrics for a debtor retailer's KEIP may be tied or related to:

(a) store closures or rent concessions by landlords;

(b) other expense reductions;

(c) financial metrics such as EBITDA or EBITDAR, cash flow, and operating income;

(d) budget compliance;

(e) confirmation of plan of reorganization by a specified date; and/or

(f) the amount of proceeds realized from a sale of the company or designated assets.

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[2] *See In re Dana Corp. (Dana II)*, 358 B.R. 567, 576-77 (Bankr. S.D. N.Y. 2006); *In re Velo Holdings, Inc.*, 472 B.R. 201, 212 (Bankr. S.D. N.Y. 2012); *In re Nobex Corp.*, 2006 Bankr. LEXIS 417 (Bankr. D. Del. Jan. 19, 2006).

[3] *See In re Pilgrim's Pride Corp.*, 401 B.R. 229, 236-37 (Bankr. N.D. Tex. 2009); *GT Advanced Techs., Inc. v. Harrington*, 2015 U.S. Dist. LEXIS 94743 (D.N.H. July 21, 2015).

[4] *Dana II*, 358 B.R. at 576-77.

Generally, the chosen performance metrics must be sufficiently challenging and facilitate the company's business plan and/or case objectives. Bankruptcy courts have refused to approve KEIPs where the performance metrics are relatively easy to attain, expressly or implicitly finding such arrangements to be impermissible KERPs.[5]

Further, KEIP details that must be determined by the debtor include the timing of payments and the length of performance periods. For example, many debtors use quarterly performance periods.

In determining the amount of potential payouts, the debtor should choose amounts that are sufficiently motivating. The debtor should also consider the payouts under similar KEIPs in other Chapter 11 cases, as well as market compensation levels. Some potential structures for KEIP payouts include:

(1) time basis: a percentage of salary or a pool of cash with allocations among the subject employees upon the successful completion of a sale, restructuring, or confirmation of a plan;

(2) performance metrics: a percentage of salary or a pool of cash for meeting operating performance goals;

(3) sale basis: determined by (i) a percentage of sale proceeds, (ii) a percentage of base salary, or (iii) specified dollar payments allocated among the participating employees; and

(4) creditor recovery: a cash pool allocated among participating employees for meeting or exceeding targets of creditor recoveries in the Chapter 11 case.

D. <u>Non-Insider KERP Issues</u>

At times, in addition to a KEIP for current executives and officers, the debtor may need to consider adopting a retention plan for important non-executives and other non-insiders in order to continue receiving said employees' services until, for instance, a sale transaction or plan confirmation. Unlike officers and other executives, rank-and-file, non-insider employees may receive bonuses simply for remaining in the debtor's employ through a specific date.

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[5] *See, e.g., In re Patriot Coal Corp*., 492 B.R. 518, 531 (Bankr. E.D. Mo. 2013) ("A court 'must examine a proposed [incentive plan] . . . and determine whether the proposed targets are designed to motivate insiders to rise to a challenge or merely report to work.' A plan that does not require affirmative action beyond that contemplated prepetition is not incentive, but is retentive and cannot be approved under the more lenient standards for incentive plans. A court must determine whether the debtor has proposed a retentive plan disguised as an incentive plan in order to circumvent the requirements of Section 503(c)(1). 'Although a purported [incentive plan] may contain some retentive effect, that does not mean that the plan, overall, is retentive rather than incentivizing in nature.' The burden of proof that the incentive plan is not a retentive plan lies with the proponent of the plans." (citations and quotations omitted)).

Whether a KERP-covered employee is a non-insider may be subject to dispute. The debtor has the burden to prove non-insider status, particularly where the employee's title (*e.g.,* Vice-President) may potentially suggest insider status.[6] Some factors that the bankruptcy court may analyze to determine insider or non-insider status include the following:

(i) whether the debtor's corporate charter and by-laws and/or other governance documents shed light on the matter;
(ii) whether the employee participates in corporate governance activities;
(iii) whether the board of directors appointed or otherwise hired the employee, and whether he or she reports directly to the board;
(iv) whether the employee is eligible to receive equity in the debtor; and
(v) whether the employee has discretionary control over the debtor's operations as a whole (including, for example, with respect to budgetary amounts and issues).

Generally, the Bankruptcy Code's distinction between insiders and non-insiders is intended to draw a line between those individuals who exercise control over corporate activities and corporate policy, and those that do not exercise such control.

II. Other Considerations

A. Expeditious Development and Approval

As discussed above, not surprisingly, KEIPs are most commonly implemented in "free fall" bankruptcy cases and cases with a sale process (which frequently are on a fast track at the insistence of the debtor's secured lenders). The challenging circumstances of such cases will often necessitate the debtor to quickly formulate and implement the KEIP or KERP, before important employees start quitting.

Among other factors, the Chapter 11 debtor must consider any existing bonus plans and the obligations thereunder. With respect to prepetition plans, it will be very difficult for the debtor to be allowed to make postpetition payments under a prepetition plan above the statutory cap for prepetition wages under section 507(a)(4) of $12,850 per employee. Possible options for the debtor include (i) attempting to pay the subject employees up to the statutory priority cap, plus additional amounts under a court-approved KEIP or KERP, or (ii) trying to roll the entire amounts due under the prepetition bonus plan into a new KEIP or KERP. In some cases, for the specific employee to be eligible for a bonus under a postpetition KEIP or KERP, the debtor may require the employee to waive any payouts or claims under any existing plan.

Relatedly, a debtor may decide to implement a prepetition retention plan and make payments to the subject employees prior to the bankruptcy filing, with a clawback provision in the event the employee does not provide the specified services to the debtor for the required time period. However, depending on the circumstances, a potential concern and risk are that the

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[6] Code section 101(31) provides a non-exclusive list of insiders of a debtor corporation including the corporation's directors and officers, and persons "in control of the debtor," and insiders of the debtor's affiliates.

payments made under the prepetition retention plan are attacked as fraudulent transfers or preferences subject to avoidance under the Bankruptcy Code. Anecdotally, some companies have used such plans to have more flexibility especially with respect to the potential attrition of the debtor's officers, executives and other insiders, and to eliminate the need for postpetition approval of the bankruptcy court and consent of key creditors.

With respect to designing the incentive or retention plan and obtaining court approval thereof, the debtor should preferably consult with compensation and other advisors, to more ably withstand any challenges by the U.S. Trustee, creditors' committee, or other party in interest (for example, challenges that the plan is overly generous or is a disguised retention plan for insiders, or that the asserted non-insiders should be viewed as insiders). The debtor should be prepared to explain the process that it used to investigate and determine the need for a KEIP or KERP, the selection of the employees that would be covered by the plan, and how the plan was designed to achieve the restructuring or performance results that the debtor seeks to obtain. Further, the debtor should be prepared to compare any prepetition plans to the terms of the proposed KEIP or KERP; if the proposed postpetition plan will result in substantially greater compensation, the debtor should be prepared to demonstrate that substantially greater efforts or contributions by the subject employees are required to earn the additional compensation. The case law reveals, not surprisingly, that key constituency support (like the creditors' committee and, if applicable, unions at the debtor's facilities) is often a key factor in obtaining court approval of plans challenged under section 503(c).

B. Confidentiality

In seeking approval of a KEIP or KERP, the debtor must take care to avoid publicly disclosing (i) sensitive, personal information about its employees, including salary and wage information and other personal information that could expose the employees to potential harm, and (ii) other confidential or sensitive business information of the debtor. If warranted, the debtor should file beforehand a motion to seal confidential or otherwise sensitive information relating to the KEIP or KERP under Code section 107.

III. Sixth Circuit Case Law

While the Sixth Circuit Court of Appeals has not opined on the matter of KEIPs and KERPs in bankruptcy cases and the relevant case law in the Sixth Circuit is relatively sparse, lower courts in the Sixth Circuit appear to generally adhere to the basic standards and legal concepts noted above.[7] However, arguably, a recent case may give incentive to parties opposing a debtor's plan to try to push for more rigorous judicial scrutiny.

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[7] *See, e.g., In re EaglePicher Holdings, Inc*., 2005 Bankr. LEXIS 2894 (Bankr. S.D. Ohio Aug. 26, 2005) (although revised section 503(c) under BAPCPA would not be binding until a few months later, the court took into account the amended statute in evaluating debtor's KERP; the court approved the KERP over the union's objections, finding there was a sound business purpose for implementing the KERP under section 363(b)).

In *In re FirstEnergy Sols. Corp*., 591 B.R. 688 (Bankr. N.D. Ohio 2018) (Judge A. Koschik), involving nuclear reactor operator debtors, the court ostensibly applied the business judgment test and the *Dana II* factors to the proposed KERP (under which close to $100 million could possibly be paid out over several years to a large percentage of the debtor's 3,000-employee workforce) since the litigating parties had agreed to this standard. The court though explained in depth prior case law and arguments espousing a more onerous, amorphous standard than the business judgment test. Ultimately, the court believed that the pending motion was "a poor vehicle to consider in depth the proper interpretation of Section 503(c)(3) and how it may, or may not, modify Section 363(b)'s business judgment standard as it applies to a non-insider employee retention plan."

The *FirstEnergy* court proceeded to reject the plan as proposed by looking in depth at various aspects of the proposed KERP, including the debtor's employee flight risk analysis and industry related standards. In particular, the court was troubled by the unions' objections that the KERP proposed substantial bonuses to management level (non-insider) employees and other non-union employees only, and not, for example, certain union employees that were critically necessary to operate and assist with the shutdown of the debtor's nuclear plants. The court found:

> [T]he Debtors' analysis by job function is somewhat scattershot and not comprehensive, at least as it was presented to the Court. It was anecdotal and given by example rather than as a comprehensive review. The Debtors did not provide evidence of every job function, the targets established by management, the basis for evaluating them, and the current number of employees qualified for each function. The Court has no dispute with the theory of the Debtors' approach. However, the evidence supporting its implementation is lacking. The fact that there is such a glaring failure to explain the Debtors' decision with respect to the [union] reactor operators gives the Court pause as to Debtors' analysis of all of the job functions ….
>
> ….
>
> It is undisputed that the proposed KERP discriminates between union and non-union personnel, with more than 70 percent of non-union employees qualified to receive bonus payments equal to at least 60 percent of their annual salary, while no union employees would receive any bonus. The burden is on the Debtors to prove a sound business reason for this discrimination, *i.e.*, that this discrimination was not unfair. They did not do so.

591 B.R. at 702-03, 711. Overall, the court concluded:

> The Debtors bear the burden of proving that the … KERP is a sound exercise of their business judgment and is justified by the facts and circumstances of the case. Among several criteria that courts review in evaluating whether debtors have made such an evidentiary showing are whether the plan bears a reasonable relationship to its purpose, whether it is fair and reasonable or instead discriminates unfairly, and whether it is consistent with industry standards. The evidence does not show that the Debtors satisfy

> these criteria in this case, and the Court finds that the Debtors' own caginess in presenting their evidence is a significant reason for that.

Id. at 711.

Although the business judgment standard was ostensibly applied, the recent *FirstEnergy* case arguably suggests (1) the debtor needs to consider and well-document clear, specific, rational grounds for the elements of the KERP or KEIP including any arguably disparate treatment of employees, and (2) the debtor should not underestimate the need for or benefits of the support of key players like the unions in the *FirstEnergy* case.

TEXT OF 11 U.S.C. § 503(c):

(c) Notwithstanding subsection (b), there shall neither be allowed [as an administrative expense], nor paid—

(1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—

(A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;

(B) the services provided by the person are essential to the survival of the business; and

(C) either —

(i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or

(ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred;

(2) a severance payment to an insider of the debtor, unless—

(A) the payment is part of a program that is generally applicable to all full-time employees; and

(B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or

(3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

Third Party Releases

Materials by Tiffany Strelow Cobb
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THIRD PARTY RELEASES

Accurately assessing the strategic value of pursuing – or the utility in challenging – proposed third party releases and exculpation clauses requires a careful consideration of the receptivity of the forum, a keen awareness of the approach favored (or disfavored) by the circuit at large, and a critical evaluation of the unique facts and circumstances surrounding the proposed releases. Below please find a discussion of the majority and minority approaches, as well as recent developments of note.

The Majority View:

The majority view permits third-party releases and exculpations under certain circumstances. While different jurisdictions favor different approaches or tests, the majority view tends to restrict third-party releases to narrowly tailored releases of third-parties where the circumstances indicate that such releases are necessary to the restructuring process and/or provide measurable benefit to creditors.

SECOND CIRCUIT:

- *Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 843 F.2d 636, 640, 649 (2d Cir. 1988) (permitting third-party releases in favor of Debtor's insurers where release (i) was not equivalent to the "umbrella protection of a discharge in bankruptcy;" (ii) was narrowly tailored to preclude claims against settling insurers arising from or related to debtor's insurance policies; and (iii) the claims were not per se released, but "simply channeled away from the insurers and redirected at the proceeds of the settlement.").
- *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 143 (2d Cir. 2005) ("nondebtor release in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release terms important to the success of the plan.").

THIRD CIRCUIT:

- *In re Cont'l Airlines*, 203 F.3d 203, 214 (3d Cir. 2007) (Releases must be fair, necessary to reorganization, and specific factual findings supporting these conclusions must be present.).
- *In re Washington Mut., Inc.*, 442 B.R. 314, 349 (Bankr. D. Del. 2011) (applying Master Mortgage factors in determining that director and officer indemnification claims were insufficient grounds to justify a release, particularly in light of the lack of contribution from such officers and directors).
- *In re Lower Bucks Hosp.*, 488 B.R. 303, 323-24 (E.D. Pa. 2013) ("Necessity" under Continental means (a) there exists a sufficient relationship between the success of the reorganization and the proposed release, and (b) the released party provided a critical financial contribution necessary to make the plan feasible; "fairness" means the non-consenting party was given reasonable consideration in exchange for the release.).

FOURTH CIRCUIT:

- *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 701-02 (4th Cir. 1989) (approving third-party release under 11 U.S.C. § 105(a) where release (i) was essential to the plan in light of the debtor's exposure to future indemnification claims; (ii) tort claimants would be fully compensated through a claims resolution trust pursuant to the plan, and (iii) 94.38% of claimants voted to accept the plan.).

- *Natl. Heritage Found., Inc. v. Highbourne Found.*, 760 F.3d 344, 348 (4th Cir. 2014) (applying Dow Corning factors).

SIXTH CIRCUIT:

- *In re Dow Corning Corp.*, 280 F.3d 648, 657 (6th Cir. 2002) (third-party releases may be appropriate where: (i) there is an identify of interests between the debtor and the third party, 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; (ii) the non-debtor has contributed substantial assets to the reorganization; (iii) 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; (iv) the impacted class, or classes, has overwhelmingly voted to accept the plan; (v) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (vi) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and (vii) the bankruptcy court made a record of specific factual findings that support its conclusions.

SEVENTH CIRCUIT:

- *Matter of Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) (section 524(e) "does not purport to limit or restrain the power of the bankruptcy court to otherwise grant a release to a third party.").

- *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640, 657 (7th Cir. 2008) (Holding that an exculpation provision (1) must be narrowly tailored, (2) must not constitute a "blanket immunity," and (3) must be essential to the debtor's reorganization.).

- *In re Ingersoll, Inc.*, 562 F.3d 856, 864 (7th Cir. 2009).

EIGHTH CIRCUIT, LOWER COURTS:

- *In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994) (providing a nonexclusive list of factors to consider in evaluating the propriety of third-party releases, including whether (1) there is an identity of interest between the debtor and the third party (e.g., an indemnity relationship), such that a suit against a nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) the nondebtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization; (4) a substantial majority of the creditors agree to such injunction / whether the impacted class or classes have overwhelmingly voted to accept the proposed plan treatment; and (5) the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.).

- *In re U.S. Fidelis, Inc.*, 481 B.R. 503, 519 (Bankr. E.D. Mo. 2012).

ELEVENTH CIRCUIT:

- *SE Prop. Holdings, LLC v. Seaside Eng'g & Surveying, Inc. (In re Seaside Eng'g & Surveying, Inc.)*, 780 F.3d 1070, 1077 (11th Cir. 2015).

The Minority View:

The minority view is that Section 524(e) specifically prohibits third-party releases: "Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e). Historically, the minority view has been interpreted as a per se prohibition against third-party release and exculpations within the minority jurisdictions, although lower courts are increasingly rejecting interpretation of circuit court authority as a per se prohibition, and considering the approval of extremely narrowly tailored releases under defined circumstances.

FIFTH CIRCUIT:

- *In re Coho Resources, Inc.*, 345 F.3d 338, 342 (5th Cir. 2003).
- *Hall v. National Gypsum Co.*, 105 F.3d 225, 229 (5th Cir. 1997).
- *In re Pacific Lumber Co.*, 584 F.3d 229, 252-253 (5th Cir. 2009) (noting that Fifth Circuit precedent "seem to broadly foreclose non-consensual non-debtor releases and permanent injunctions" in declining to approve exculpation provisions absolving non-debtor parties from negligent conduct occurring during the course of the bankruptcy under § 524(e)).

But see: In re Vanguard Natural Resources, LLC, et al., 17-30560 (Bankr. S.D. Tex.) (approving third-party release, exculpation, and injunction provisions under certain circumstances).

NINTH CIRCUIT:

- *American Hardwood, Inc. v. Deutsche Credit Corp. (In re American Hardwoods Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989) ("Section 524(d), therefore, limits the court's equitable power under section 105to order the discharge of the liabilities of nondebtors…").
- *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) ("[T]he bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan").
- *Resorts Intl. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1392, 1401 (9th Cir. 1995) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors.")

TENTH CIRCUIT:

- *Landsing Diversified Properties-II v. First Natl' Bank & Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592 (10th Cir. 1990), modified on other grounds, 932 F.2d 898 (10th Cir. 1991) ("Obviously, it is the debtor, who has invoked and submitted to the bankruptcy process, that is entitled to its protections; Congress did not intend to extend such benefits to third-party bystanders").

But see In re Midway Gold U.S., Inc., 575 B.R. 475 (Bankr. D. Colo. 2017) ("…this Court concludes the bar on third-party releases imposed by Western Real Estate is not as broad as it has previously been argued and applied in other cases. Accordingly, the Court is prepared to follow the majority view that while § 524(e) does not expressly provide for the release of a third party's claims against a non-debtor, § 524(e) does not expressly preclude such release. This is not *carte blanche*, however. The Court agrees §105(a) permits bankruptcy courts to release third parties from liability in certain, and very limited circumstances if the release is "appropriate" and not inconsistent with any other provision of the Bankruptcy Code, including § 524(e). The Court believes this interpretation is consistent with, and fully respects, the dictates of the Tenth Circuit as set forth in *Western Real Estate*.")

Recent Developments

1. *In re Midway Gold U.S., Inc.*, 15-16835 (Bankr. D. Colo)

- Notes that Tenth Circuit authority does not constitute a per se prohibition against third party releases, finding that releases may be appropriate in certain limited circumstances on a case by case basis.
- The court cautions that releases must be "narrowly tailored to apply only to claims arising out of or in connection with the reorganization itself, and not to matters which would have no effect upon the estate. Otherwise, the releases in question may be beyond the jurisdiction of the bankruptcy court and its authority to finally adjudicate such matters."
- Consent of the releasing parties to the releases, if such releases are beyond the jurisdiction of the court, will not permit confirmation or approval of an otherwise problematic release.
- The court also states that "releases may not provide nondebtors with "blanket immunity" for all times, transgressions and omissions and may not include immunity from gross negligence or willful misconduct[,]" stating that "it is not the intention of this court to permit non-debtors to purchase immunity from unrelated torts, no matter how substantial their contribution to a debtor's reorganization."
- While the court indicated a willingness to approve certain exculpation provisions, the court denied confirmation of the plan because of the inclusion of third-party releases not satisfying the stringent criteria articulated by the court.

2. *In re Caesars Entm't Operating Co., Inc.*, 15-01145 (Bankr. N.D. Ill.)

- The United States Trustee objected to confirmation of the debtors' plan on the basis that such plan included impermissible third-party releases under Seventh Circuit precedent.
- No other party in interest objected to confirmation on the basis of the proposed third-party releases, a fact that the bankruptcy court highlighted in a pre-confirmation status conference.
- Notwithstanding the bankruptcy court's seeming lack of receptivity to the expressed concerns of the United States Trustee, the debtors agreed to amendments to the plan narrowing the scope of the releases to consensually resolve the UST's objection.

3. *In re Vanguard Natural Resources, LLC, et al.*, 17-30560 (Bankr. S.D. Tex.)

- On July 18, 2017, the Bankruptcy Court for the Southern District of Texas confirmed the Debtors' Modified Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code notwithstanding such plan's inclusion of broad third-party releases. [ECF Dkt. No. 1109-1].
- Notwithstanding the objection of the United States Trustee's Office, which highlighted Fifth Circuit precedent unfavorable to consideration of third-party releases, the bankruptcy court entered the confirmation order finding that the court had jurisdiction to approve the injunction, exculpation, and releases set forth in the plan and that such provisions constituted an integral part of the Debtors' plan and were necessary and appropriate for the implementation of the plan. [ECF Dkt. No. 1109, ¶ OOO].
- The confirmation order further contained findings that the releases, injunction, and exculpation provisions were fair, equitable, reasonable, and in the best interests of the debtors and the Debtors' estates, creditors, and equity holders. [ECF Dkt. No. 1109, ¶ PPP].

4. *In re FirstEnergy Solutions Corp., et al.*, 18-50757 (Bankr. N.D. Ohio)

- On April 11, 2019, the Bankruptcy Court for the Northern District of Ohio entered an order denying approval of a disclosure statement "[d]ue to the breadth and ambiguity of the nonconsensual third-party releases proposed in Section VIII.E. of the Plan," concluding that such releases rendered the plan "patently unconfirmable under 11 U.S.C. § 1123(b)(6), as that provision is applied in the Sixth Circuit" under Dow Corning. Concluding that solicitation of the plan would thus be futile, the court declined to approve the disclosure statement.
- The court's decision was announced at a hearing held April 4, 2019, concluding significant and substantive briefing by numerous constituencies. A further written opinion more fully setting forth the reasoning of the court is anticipated as of the date of these materials [ECF Dkt. No. 2500].
- Several constituencies objected to the broad, nonconsensual third-party releases on the basis that such releases (1) exceeded the subject matter jurisdiction of the bankruptcy court; and (2) did not satisfy the Dow Corning standards.
- Parties in interest expressed significant concern in briefing that the nonconsensual releases, as drafted, released non-debtor parties from independent and non-derivative liabilities, including significant environmental liabilities.
- The Debtors, in an omnibus response, asserted the propriety of the releases and the belief that objections to the releases more properly constituted a confirmation issue.

5. *In re Specialty Retail Shops Holding Corp., et al.*, 19-80064 (Bankr. D. Neb.)

- Confirmation of the Debtors' Second Amended Chapter 11 Plan was denied on May 30, 2019. [ECF Dkt. No. 1483].
- Ruling from the bench, Judge Saladino indicated that nonconsensual third-party releases are not, in his view, per se improper, and may, if properly tailored, be appropriate in certain unique and unusual circumstances. In ascertaining whether unique and unusual circumstances existed, Judge Saladino declined to apply the 'Master Mortgage' factors, instead asking whether the circumstances present warranted extraordinary relief.
- Notwithstanding his finding that the insiders worked hard and tirelessly in difficult circumstances to bring about a potential resolution to the bankruptcy case, good faith efforts are no more than what is expected of insiders and thus insufficient without more to warrant the extraordinary relief of a nonconsensual release. In so holding, Judge Saladino suggested that the proposed nonconsensual release and exculpation of SunCap may have, by itself, been appropriate under this standard given SunCap's additional and substantial contributions to the plan and restructuring process.
- The confirmation hearing occurred in the context of a cramdown situation, with non-priority unsecured creditors expected to receive no distribution. The only value in the plan for non-priority unsecured creditors consisted of a waiver of preference claims. All objections to confirmation were either resolved or withdrawn prior to the confirmation hearing, except that of one significant prepetition creditor.
- Judge Saladino expressed skepticism that the releases of preference actions could constitute value in exchange for the proposed third-party releases, and sensitivity to the likely lack of overlap between constituencies who would benefit from a waiver of preference actions and those being asked to release claims against the third parties.

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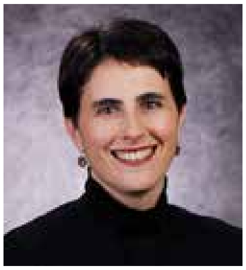

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DIP Financing

Materials by A.J. Webb
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I. GENERAL OVERVIEW OF DIP FINANCING LOCAL RULES

a. A number of bankruptcy courts have adopted local rules governing DIP financing.
b. Therefore, local rules should be consulted when preparing, filing, and serving motions obtain DIP financing.
c. These rules may:
  - **i.** Require that debtors disclose or highlight certain provisions, so the court does not have to search hundreds of pages to find important or notable provisions.
  - **ii.** Require that debtors identify provisions that the court does not generally permit, except in unusual or exceptional circumstances, or provide that certain provisions are "unenforceable."
  - **iii.** Require that febtors identify provisions that the court normally allows.
  - **iv.** Impose additional or modified service requirements.

d. The below provisions might be considered controversial and may meet resistance from the bankruptcy court. Some courts state that such provisions should not be included in a DIP motion at all:

1. **Cross-collateralization**
   - **a.** The form of cross-collateralization that has come under intense judicial scrutiny occurs when a post-petition lender who is also a prepetition creditor of the debtor requires the debtor to secure the entire amount of its pre-petition debt with all of the debtor's post-petition assets as a condition to extending post-petition credit.
   - **b.** This is often done without regard to: (1) the amount of post-petition loans actually made by the lender to the debtor, (2) whether the lender's prepetition claim is over-secured or under-secured, and (3) the amount of adequate protection to which the lender might be entitled, based on the actual usage and diminution of its collateral.
   - **c.** The wholesale cross-collateralization of prepetition debt with post-petition assets can affect a massive preference in favor of the pre-petition creditor if the pre-petition creditor is under-collateralized.
2. **Waivers of rights to surcharge collateral**
   - **a.** Debtor must show that the benefit to the secured creditors is direct and quantifiable.
3. **Liens on avoidance actions**
   - **a.** May prove to be an empty security.

4. **Professional fee carveouts**
   a. Courts scrutinize carveouts that are exceptionally large or that provide disparate treatment to professionals retained by creditors' committees and those retained by the debtor.
5. **Priming of liens**
   a. The granting of priming liens is generally considered an extraordinary measure. A debtor bears the burden of showing that existing liens are adequately protected.
   b. To prove that the interest of those holding existing liens are adequately protected, the court must be sure that the proposed financing will provide the pre-petition secured creditor with the same level of protection it would have had if there had not been a post-petition financing.

II. LOCAL RULES ON OBTAINING DIP FINANCING

A. Bankruptcy Court for the Eastern District of Kentucky

a. Overview of LBR 4001-2
- **i.** DIP motion must contain –
  1. Total amount of funds requested
  2. Specific uses to which funds will be put
  3. A proposed budget
  4. Amount of debt asserted to be owed to any secured creditor
  5. The value of the collateral
  6. Any proposal for providing adequate protection
- **ii.** DIP motion must be served on –
  1. All creditors who assert an interest in collateral
  2. Any taxing authority that has a claim against the debtor
  3. Counsel to any appointed committee/to the creditors or, if none the debtor's list of top 20 largest creditors
  4. Any parties who have filed a request for service
  5. The U.S. Trustee
- **iii.** The following provisions are unenforceable –
  1. Any acknowledgement of the validity, amount, perfection, priority, extent or enforceability of the secured claim, if the agreement/order purports to bind any party other than the debtor
  2. Any releases of liability for the creditor's alleged prepetition torts or breaches of contract, waiver of avoidance actions or waiver of defenses by the debtor or estate representative
  3. Any post-petition lien which purports to secure any claim of a secured creditor other than:

- **a.** (1) a claim arising from post-petition advances which constitute an additional non-replacement extension of credit; or
- **b.** (2) a claim representing the diminution in value of the secured claim after the commencement of the case
- **c.** Any grant of security interest in lien avoidance power recoveries
- **d.** Any provision granting a creditor relief from the automatic stay without further order or hearing upon the breach of the proposed order

iv. However, the court may order enforcement of the above terms if –

- **1.** The proposed order specifically states that such terms are included; and
- **2.** The terms are set forth "conspicuously"

v. Emergency Hearing requests –

- **1.** Must state nature of the emergency requiring an expedited hearing/determination
- **2.** Must include documentation of collateral interests

B. Bankruptcy Court for the Southern District of Ohio

a. Overview of LBR 4001-3

i. DIP motion must contain –

- **1.** A statement in support of the feasibility of DIP financing
- **2.** A description of the item to purchased or collateral affected by the credit agreement
- **3.** A description of any other party whose interest in the collateral could be affected
- **4.** The reasons the debtor needs the credit
- **5.** The financing terms, including the interest rate
- **6.** A description of adequate protection
- **7.** Copies of all documents under which affected parties' interest was created or perfected (if unavailable, debtor shall make best effort to obtain)

ii. Emergency Hearing requests –

- **1.** If debtor asserts an immediate need for obtaining credit, court may schedule a preliminary hearing only after notice is provided to any entity claiming an interest in the collateral affected by the credit.

C. Bankruptcy Court for the Southern District of Indiana

a. Overview of LBR B-4001-2

i. DIP motion must contain –

1. Total dollar amount requested
2. Proposed budget
3. Estimated value of the collateral
4. Maximum borrowing available on an interim and final basis
5. Borrowing conditions
6. Interest rates/fees/costs/other expenses to be borne by the debtor
7. Maturity
8. Limitations on the use of funds
9. Events of default
10. Other protections afforded under 11U.S.C. §§ 363/364

ii. DIP motion must disclose –
1. Provisions that grant cross-collateralization protection (other than replacement liens or other adequate protection) to the pre-petition secured creditor
2. Provisions that provide disparate treatment for professionals retained by a creditors' committee from that provided for the professionals retained by the debtor
3. Provisions that prime any secured lien without consent of the lien holder
4. Provisions that call for the payment of fees/costs by the debtor other than reasonable attorney's fees for loan documentation
5. Provisions that limit, restrict, or otherwise affect the terms of a proposed plan

iii. Absent "extraordinary circumstances" prohibited provisions will not be approved.

III. TRENDS IN DIP FINANCING: RETAIL AND OIL AND GAS

a. As interest rates increase, it is expected that the number of corporate bankruptcies around the world will begin to accelerate in 2019. We see two major types of bankruptcies emerging: retail and oil and gas.

b. We can expect debtors to seek out innovative financing solutions to ensure maximum payment to creditors.

A. Retail Trends

a. The retail sector has been hit hard by high leverage, increasing real estate costs, and on-line competition.

i. **Split-Lien Structure:** Recently, many retail debtors have paired a revolving ABL DIP facility with a term loan DIP facility. The ABL lenders have a first-priority lien on the borrowing base assets, including accounts receivable and inventory. The term lenders have a first-priority lien on other assets, including real estate and intellectual property. Each lender group also typically has a second-priority lien on the other creditors' pool of collateral.

ii. **Multidraw Term Loans:** Loans drawn in increments upon achievement of certain milestones that carry reduced interest costs over time as a result of lower funded indebtedness.

iii. **Pre-planned Bankruptcies:** Many recent retailers have begun bankruptcy proceedings with a planned, often pre-negotiated, balance sheet restructuring/quick exit from bankruptcy. Sometimes, these bankrupt retailers will already have obtained exit financing before filing.

iv. **Roll-ups:** Frequently used. Courts may scrutinize roll-ups to determine whether the pre-petition lenders are extending significant new money or are simply refinancing pre-petition debt and whether a robust marketing effort was undertaken before determining the roll-up was necessary to obtain DIP financing.

v. **Collateral:** Almost all retail DIP facilities include asset collateral packages.

vi. **Pricing and Fees:** Interest rates generally range from 250 to 450 basis points over LIBOR for revolvers and from 500 basis points over LIBOR to a fixed rate of up to 12% for new money term loans.

vii. **Maturities and Milestones:** Since retail bankruptcies are generally quick, retail DIP facilities generally include short maturities and aggressive deadlines to accomplish milestones (ranging from 4-12 months).

B. Oil and Gas Trends

a. The recent decline in oil prices have also driven new filings in the oil and gas industry. Approximately 40 companies in the oil and gas industry filed bankruptcy in the US in 2018.

i. **Roll-Up of Pre-petition Obligations:** Approximately half of the 2018 DIP financing facilities included a roll-up of some or all of the debtor's pre-petition secured obligations.

ii. **DIP Make Whole Premiums:** Although not typically a feature of DIP financing facilities, Gastar Exploration Inc. sought approval of a DIP facility that included a make whole premium worth approximately $50.5M.

iii. **"Upfront" or "Commitment" Fees:** With percentages ranging from 1-3.75% of the aggregate loan amount, several oil and gas bankruptcies featured DIP facilities requiring payment of certain "upfront" or "commitment" fees, payable to the DIP lender.

iv. **Adequate Protection:** Many of the 2018 DIP financing facilities provided adequate protection payments to certain pre-petition secured creditors, typically in the form of payment of monthly interest at the non-default rate.

v. **Milestones:** Almost all of the 2018 DIP financing facilities includes milestones by which the debtor had to meet certain obligations related to either the sale of its assets or the confirmation of a plan. Half of them required the debtor to consummate a sale within a certain period after the petition date (ranging from 40 days to 150 days).

IV. SIGNIFICANT CASE

a. The following recent case provides an example of controversial DIP financing provisions observed by a 6th Circuit court:

i. ***In re Packard Square LLC*, 574 B.R. 107 (Bankr. E.D. Mich. 2017):** Chapter 11 debtor failed to satisfy burden of showing that there was adequate protection of pre-petition interest holders for post-petition financing of proposed priming lien for $22 million. The debtor could not show that the liens against a proposed construction project were less than those asserted by the pre-petition secured lender Furthermore, the DIP loan was based on future increase in the value of the collateral which would result when mixed-use development project was completed, and residential units and retail spaces were leased. Because the project was far from completed and there was inherent uncertainty about the future value of the collateral, the court could not approve the DIP loan.

Emergency Sales

Materials by Laura Davis Jones
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Emergency Sales - Why Aren't Directors and Officers Exposed for Undue Delay

The law on potential liability of directors and officers of troubled companies for imprudently prolonging the life of a business or delaying a bankruptcy filing has grown somewhat clearer over the last dozen or so years, mostly to the detriment of plaintiff creditors or their representatives. Delaware and most other jurisdictions have rejected the concepts of direct fiduciary duties to creditors, a "zone of insolvency" in which those duties take effect, and "deepening insolvency" as an independent tort. It may also be that creditors of an LLC cannot obtain standing to pursue breach of fiduciary duties at all. The edges of the law are not sharp, however, and exposure may still exist where a delay in seeking bankruptcy protection can be characterized as violating the standard duties of care owed to the corporation.

Fiduciary Duties of Directors and Officers

Directors and officers[1] owe what is sometimes called the "triad" of fiduciary duties to the corporation: the duties of loyalty, care and good faith.[2] The duty of loyalty prohibits a corporate director from engaging in self-dealing or usurping corporate opportunities. The duty of care requires a director in managing the corporation's affairs to exercise the degree of care that an "ordinarily careful and prudent [person] would use in similar circumstances." The duty of good faith may in substance be subsumed by the other two: "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[3]

Deference to directors' business decisions and an umbrella of safety in which to make them is reflected in the "business judgment rule," which confers protection from personal liability by means of a "presumption that directors are acting independently, in good faith and with due care in making a business decision."[4] So long as those requirements are met, an officer's decision or director's authorization, made in good faith, protected even if "substantively wrong, . . . 'stupid,' . . . 'egregious' or 'irrational.'"[5]

Ohio law is consistent on all scores. Ohio Rev. Code § 1701.59 requires a director to perform his duties "in good faith, in a manner the director reasonably believes to be in or not opposed to the best interests of the corporation, and with the care that an ordinarily prudent person in a like position would use under similar circumstances." Ohio Rev. Code § 1701.59(B). A director who performs his duties in accordance with this standard shall have no liability imposed because of his position as director of the corporation. Ohio Rev. Code § 1701.59(C).

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[1] Officers have the same duties and are subject to the standard of care as directors. *See, e.g., Liquidating Tr. of the Amcast Unsecured Creditor Liquidating Tr. v. Baker (In re Amcast Indus. Corp.)*, 365 B.R. 91, 103 (Bankr. S.D. Ohio 2007) ("Although the fiduciary obligations of officers of a corporation have not been so codified, Ohio courts impose a similar common law duty on officers. . . . Because officers, like directors, have a fiduciary duty to the corporation and are held to a similar standard in Ohio, the court will focus the remainder of its analysis on a director's standard of care.").

[2] *See, e.g.*, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc*., 506 A.2d 173, 179 (Del. 1986); *In re USACafes, L.P. Litig*., 600 A.2d 43, 48 (Del. Ch. 1991).

[3] *Stone ex. rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[4] *Brazen v. Bell Atl. Corp*., 695 A.2d 43, 49 (Del. 1997).

[5] *In re Caremark Int'l Inc. Derivative Litig*., 698 A.2d 959, 967 (Del. Ch. 1996).

As *Amcast* observed, this limitation on a director's liability essentially codifies the business judgment rule.[6]

Prior to the Delaware Supreme Court's seminal decision in *Gheewalla,*[7] many courts in Delaware and elsewhere had held that upon insolvency (or even entering a "zone of insolvency"), directors' fiduciary duties expand to include both creditors and shareholders.[8] *Gheewalla* clarified that, upon actual insolvency, directors continue to owe their duties to the corporation, and not directly to creditors. At that point, however, creditor interests must be taken into account. "When a corporation is insolvent . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."[9] Directors have a duty "to maximize the value of the insolvent corporation for the benefit of all those having an interest in it," creditors or shareholders.[10] A breach of that duty may be enforced by a creditor or creditor representative with derivative standing, but not by a direct claim.[11] No duty is owed directly to any individual creditor.[12]

Thirty-two states, including Ohio,[13] have "constituency statutes" identifying classes of constituents that courts may consider in addition to the interests of shareholders of an insolvent corporation. The Ohio Revised Code, for example, mandates that the director consider the "interests of the corporation's shareholders," and further provides that, "in the director's discretion, [a director] ***may*** consider the following:

> (1) The interests of the corporation's employees, suppliers, ***creditors,*** and customers;
>
> (2) The economy of the state and nation;
>
> (3) Community and societal considerations;
>
> (4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation.

Ohio Rev. Code § 1701.59(E) (emphasis added). "This section codifies the general rule that corporate directors owe their fiduciary obligation directly to the corporation and its shareholders, not to any creditors of the corporation."[14]

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[6] *Amcast*, 365 B.R. at 103.
[7] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007).
[8] *See, e.g., Geyer v. Ingersoll Publ'ns Co*., 621 A.2d 784, 789 (Del. Ch. 1992).
[9] *Gheewalla* 930 A.2d at 101.
[10] *Id*. at 103.
[11] *Id*.
[12] *Id*. at 102.
[13] OHIO REV. CODE ANN. § 1701.59(E) (West 1999).
[14] *Amcast*, 365 B.R. at 104.

After an extensive review of Ohio common law and statutes on directors' duties inside and outside of insolvency, the Ohio court in *Amcast* ruled that, per the statute, directors had the option but were ***not required*** to consider creditor interests even in insolvency.

> [A] director has no distinct legal obligation directly to creditors, separate from the corporate entity as a whole, even when a corporation has reached the point of insolvency. The court concludes that while a company operates outside a pending dissolution, receivership, bankruptcy, or similar formal insolvency proceeding the directors' fiduciary obligations remain to the corporation and its shareholders and they are under no obligation to treat the corporate assets as a "trust" that must be liquidated on behalf of creditors. The court concurs with the analysis in *PHD, Inc.* that the explicit language of Ohio Rev. Code § 1701.59(E) forecloses any claim against a director for breach of a fiduciary duty directly to creditors upon insolvency. 2004 U.S. Dist. LEXIS 29406, 2004 WL 3721325, at *5.[15]

Furthermore, while the managers of a limited liability company and the general partner of a limited partnership owe the same fiduciary duties as corporate directors, Delaware courts have held that LLC creditors have no standing – even derivative standing – to sue LLC management.[16] In addition, the uniform codes permit modifying or even eliminating fiduciary duties for both LLCs and LPs to a greater extent than for corporations.

In any scenario, the business judgment rule still applies. "Because the fact of insolvency does not change the primary object of the directors' duties, which is the firm itself, the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms."[17] "[E]ven when [a company is] insolvent, the board [is] entitled to exercise a good faith business judgment to continue to operate the business if it believed that was what would maximize . . . value."[18]

The Disappearing Zone of Insolvency

Pre-*Gheewalla*, some courts had held not just that directors could owe duties directly to creditors, but that those duties commenced when the company entered the "zone of insolvency." *Gheewalla* rejected that concept, holding that ***actual*** insolvency is what triggers the shift in duties.[19] "When a solvent corporation is navigating in the zone of insolvency, the focus for

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[15] *Amcast*, 365 B.R. at 109-110. *See also In re ATP Oil & Gas Corp.*, 2017 U.S. App. LEXIS 21337, *7 (5th Cir. Oct. 27, 2017) ("Officers and directors of [an operating corporate debtor] have fiduciary duties to the corporation — not the corporation's creditors" under Texas law, dismissing chapter 7 trustee's complaint).
[16] *CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010), *aff'd*, 28 A.3d 1037 (Del. 2011) (holding that Delaware's LLC Act limits standing to pursue derivative claims to holders of membership interests in the LLC or their assignees).
[17] *In re Hechinger*, 327 B.R. 537, 549 (D. Del 2005) (internal quotation and citation omitted).
[18] *Shandler v. DLJ Merch. Banking, Inc.*, C.A. No. 4797-VCS, 2010 WL 2929654, at *14 (Del. Ch. July 26, 2010).
[19] *Gheewalla*,930 A.2d at 101.

Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[20] With the line drawn between solvency and actual insolvency, an allegation that "misconduct propelled the Debtors into insolvency, which ultimately led to the filing of its bankruptcy cases" was deemed insufficient to trigger any duty to creditors.[21]

No Independent Claim for "Wrongful Prolongation" or "Undue Delay" or "Deepening Insolvency"

Whether a claim for breach of fiduciary duty is styled as "wrongfully prolonging" a business, or for "deepening insolvency," or for "undue delay" in commencing a bankruptcy case, modern authority does not recognize such claims unless they are part of or accompanied by conduct that falls outside the business judgment rule.

Absent such facts, as a rule, directors do "not have a duty to protect creditors of an insolvent corporation at the expense of the corporation and its shareholders . . . . [D]irectors are not liable for decisions they make and actions they take in an effort to prolong the corporation's viability, even in the face of insolvency." *In re Midway Games Inc*., 428 B.R. 303, 315-316 (Bankr. D. Del. 2010) (citing *Gheewalla*). Thus Delaware does not recognize a cause of action for "deepening insolvency." *See Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P*., 906 A.2d 168, 174 (Del. Ch. 2006) ("Delaware law does not recognize this catchy term[--deepening insolvency--]as a cause of action, because catchy though the term may be, it does not express a coherent concept.").

Trenwick did clarify that Delaware law may permit recovery for damages for a failure to cease operations if another theory of liability gives rise to a cause of action. *Id*. ("Existing equitable causes of action for breach of fiduciary duty . . . are the appropriate means by which to challenge the actions of boards of insolvent corporations.").[22]

Starting with *Amcast*, Ohio cases have followed *Trenwick*:

> The court determines that, at its best, the deepening insolvency theory is redundant of traditional causes of action recognized under Ohio law. At its worst, the theory is inconsistent with principles of fiduciary responsibility and the business judgment rule codified in Ohio. For these reasons, the court

[20] *Id*.
[21] *In re Tropicana Entm't, LLC*, 520 B.R. 455, 471 (Bankr. D. Del. 2014).
[22] *See also Rafool v. Goldfarb Corp. (In re Fleming Packaging Corp.)*, Nos. 03-82408, 04-8166, 2005 Bankr. LEXIS 1740, at *33-34 (Bankr. C.D. Ill. Aug. 26, 2005) ("A director's fiduciary duties already prohibit the kind of conduct that forms the basis for deepening insolvency claims. The open question is whether the damages recoverable under deepening insolvency will differ from those recoverable for breach of fiduciary duty.")

> concludes that Ohio courts would not recognize deepening insolvency as an independent cause of action.[23]

The *Amcast* court did see deepening insolvency as being useful as a measure of damages.[24] Likewise, the Southern District of Ohio bankruptcy court in *NCFE* dismissed as duplicative a deepening insolvency claim that was based on the same conduct that allegedly constituted a breach of other fiduciary duties, and treated the theory as a measure of damages.[25]

A recent (2017) Ohio state court decision employed the same reasoning, finding that claims for "waste" and "deepening insolvency" and "wrongful prolongation of corporate existence" are not cognizable under Ohio law, but, importantly, stating: "although the respective headings utilized in Cohen's complaint on these claims are not independent causes of action under Ohio law, the nature of the waste and deepening insolvency claims, if true, may still constitute a breach of fiduciary duty." *Cohen v. Dulay*, 2017-Ohio-6973, ¶ 25, 94 N.E.3d 1167, 1175-76 (Ct. App.) (citing, among others, *Amcast* and *NCFE*).

Authority from New York is the same:

> Prolonging an insolvent corporation's life, without more, will not result in liability…. Instead, one seeking to recover for 'deepening insolvency' must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.[26]

Kittay v. Atl. Bank (In re Glob. Serv. Grp. LLC), 316 B.R. 451, 465 (Bankr. S.D.N.Y. 2004). Once again, though, the court preserved the possibility that a valid claim could be asserted, stating that "[i]f the Complaint included this allegation, these claims might be legally sufficient. The prolongation of Global's operations would smack of self-dealing, constitute a breach of fiduciary duty, and open up recovery under the theory of "deepening insolvency."

Also from the Southern District of New York*:*

> There is no authority that supports Plaintiffs' position that there is a blanket duty to liquidate upon insolvency, untempered by the business judgment rule. Plaintiffs have not cited any case in the United States that supports this bald proposition.… It has never been the law in the United States that directors are not afforded

[23] *Amcast*, 365 B.R. at 118-19.
[24] *Id*. at 119 n.19 ("While declining to recognize deepening insolvency as a valid cause of action, the court believes that the concept may be useful as a measure of damages for breach of fiduciary duty or commission of an actionable tort.").
[25] *Unencumbered Assets Tr. v. JP Morgan Chase Bank (In re Nat'l Century Fin. Enters.)*, 604 F. Supp. 2d 1128, 1153 (S.D. Ohio 2009).
[26] *Kittay v. Atl. Bank (In re Glob. Serv. Grp. LLC)*, 316 B.R. 451, 465 (Bankr. S.D.N.Y. 2004).

> significant discretion as to whether an insolvent company can "work out" its problems or should file a bankruptcy petition.[27]

Is Delay Still Relevant?

The converse proposition is that while wrongful prolongation and deepening insolvency and undue delay may not constitute standalone claims for relief, they may nonetheless be characterized as part of a course of conduct falling outside the business judgment rule and therefore supporting separate claims for breach of fiduciary duty, or in the case of deepening insolvency may have continued relevant as a measure of damages. As noted, above, several of the foregoing authorities expressly contemplate this possibility.

As discussed in a 2019 decision from the Northern District of Ohio:

> [T]hese cases do not pronounce the theory universally unacceptable. *See, e.g., In re Parmalat Securities Litigation*, 501 F. Supp. 2d 560, 573-78 (S.D.N.Y. 2007) (declining to rule that delayed liquidation can never be a form of corporate harm but finding that the pleadings raised only speculation of harm). In fact, it appears that deepening insolvency may be a viable theory for damages under Ohio law. *See In re Nat'l Century Fin. Enters. Inc. Inv. Litig.*, 604 F. Supp. 2d 1128, 1153 (S.D. Ohio 2009) (finding that in Ohio, allegations of deepening insolvency "is best viewed as a measure of damages to bankrupt entities"); *cf. Cohen v. Dulay*, 94 N.E.3d 1167, 1175-76 (Ohio Ct. App. 2017) (finding the theory of deepening insolvency is not recognized as an independent cause of action, but merged the plaintiff's claims of deepening insolvency into the plaintiff's breach of fiduciary duty cause of action).[28]

In a 2008 Minnesota bankruptcy case, for example, the claim was that “the defendants wrongfully prolonged the life of SACC specifically to enrich themselves through wasteful consulting contracts, and to use corporate assets to ward off personal liability for SEC violations.”[29] The court denied summary judgment, explaining: “The defendants argue that they are protected by the "business judgment rule" and an exculpatory clause in SACC's articles of incorporation. But, these do not protect officers and directors of an insolvent corporation from self-dealing to the detriment of the corporation.[30]

Simplexity: In this context may be seen a fairly recent Delaware bankruptcy court decision that may give hope to potential plaintiffs. On January 5, 2017, Judge Kevin Gross issued a decision denying a motion to dismiss a claim for breach of fiduciary duty by not filing a

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[27] *RSL COM Primecall, Inc. v. Beckoff (In re RSL COM Primecall, Inc.)*, Nos. 01-11457, 01-11469 (ALG), 03-2176 (ALG), 2003 Bankr. LEXIS 1635, at *28-29 (Bankr. S.D.N.Y. Dec. 11, 2003). *See also Torch Liquidating Tr. v. Stockstill*, 561 F.3d 377, 391 n.16 (5th Cir. 2009).

[28] *Ch Liquidation Associat Liquidation Tr. v. Genesis Healthcare Sys.*, No. 5:18 CV 752, 2019 U.S. Dist. LEXIS 42150, at *28 (N.D. Ohio Feb. 12, 2019).

[29] *Sec. Asset Capital Corp. v. Tenney (In re Sec. Asset Capital Corp.),* 390 B.R. 636, 648 (Bankr. D. Minn. 2008).

[30] *Id*. (citing *Continuing Creditors' Committee of Star Telecommunications Inc., v. Edgecomb*, 385 F. Supp. 2d 449, 462 (D. Del. 2004) (citing Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001)); NRS §78.037).

bankruptcy petition earlier to preserve assets. In the case of *In re Simplexity, LLC*, a chapter 7 trustee sued 11 directors, officers and managers and the debtor's sponsor, Versa, for "grossly negligent refusal" to protect the company and seek chapter 11 protection to minimize potential claims against the debtor. The trustee requested damages exceeding $40 million, an amount equal to claims against the estate and the return of certain pre-petition asset transfers to Versa during the year before the chapter 11 filing. As described by the court, "[p]rincipally, the Trustee claims that the Defendants overlooked or deliberately ignored the facts and failed to file for bankruptcy protection. All of Debtors' cash was held at FTB which swept the cash. Only thereafter did Debtors file for bankruptcy. The Trustee alleges that in the face of FTB's warnings, the Defendants failed to act to protect Debtors' assets." *In re Simplexity*, Nos. 14-10569(KG), 16-50212(KG), 2017 Bankr. LEXIS 37, at *13 (Bankr. D. Del. Jan. 5, 2017).

Rejecting the argument that such allegations amounted to no more than an untenable "deepening insolvency" claim, the court found these allegations sufficient to state a claim for relief.

> The Defendants argue that the Trustee's claims are in reality deepening insolvency claims, and that deepening insolvency does not state a claim upon which relief can be granted. That is the law in Delaware. *See, North Am. Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A. 2d 92 (Del. 2007); and *Trenwick Am. Litigation Trust v. Ernst & Young L.L.P.*, 906 A.2d 168 (Del. Ch. 2006). The holdings of Delaware courts dealing with the issue center on the following, as noted by the Versa Defendants:
>
> > Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate.
>
> *Trenwick*, 906 A. 2d at 204.
>
> > If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.
>
> *Id*. at 205.
>
> The Court does not read the Trustee's claims as deepening insolvency claims. Instead, the claims ask why given the notice by FTB that it was about to shut Simplexity down did the Defendants not file for bankruptcy and thereby ameliorate the harm. It was the action or inaction in the face of insolvency itself, not deepening insolvency, that the Trustee complains about. Was it gross negligence, disloyalty, or disregard of the law that resulted in

> Defendants' inaction? As the Court reads the Complaint, that is what the Trustee is alleging. Therefore, this adversary proceeding is about the Defendant's failure to act in the face of insolvency, and does not implicate deepening insolvency.

In re Simplexity, Nos. 14-10569(KG), 16-50212(KG), 2017 Bankr. LEXIS 37, at *23-24 (Bankr. D. Del. Jan. 5, 2017). While *Simplexity* was only a ruling on a motion to dismiss, it offers support for the proposition that a failure to seek bankruptcy protection, in appropriate circumstances, may be characterized as a dereliction of duty so severe as to fall outside the protection of the business judgment rule.

Measure of Damages: As noted, courts such as *Amcast* and NCFE contemplated that deepening insolvency may be used a measure of damages.[31] While sometimes accepted in theory, it has gained at best mixed acceptance in practice.[32]

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[31] *Amcast*. 365 B.R. at 119 n.19; *NCFE*, 604 F.Supp.2d at 1153.

[32] *See, e.g., Thabault v. Chait*, 541 F.3d 512, 521 (3d Cir. 2008) ("whether deepening insolvency constitutes a valid theory of damages for a harm is a matter that is uniquely subject to state law principles" and approving damages as consistent with state law); *Official Comm. of Unsecured Creditors v. Hendricks (In re Dwight's Piano Co.)*, 424 B.R. 260, 287 (S.D. Ohio 2009) ("deepening insolvency is a valid measure of damages for breach of a fiduciary duty") (citing *In re The Brown Schools*, 386 B.R. 37, 48 (Bankr. D. Del. 2008); *Vieira v. AGM II, LLC (In re Worldwide Wholesale Lumber, Inc.)*, 378 B.R. 120, 127 (Bankr. D.S.C. 2007) (listing cases). *Compare Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355, 363 (5th Cir. 2009) (rejecting "deepening insolvency" as a measure of damages); *Bondi v. Citigroup, Inc.*, 423 N.J. Super. 377, 438, 32 A.3d 1158, 1194 (Super. Ct. App. Div. 2011) ("We affirm the order dismissing the deepening insolvency cause of action and the separate order barring Bondi from seeking deepening insolvency damages").

A Financial Advisor's Perspective

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Even the most talented business executives have difficulty acknowledging that their organization may be in imminent danger of failing. Rarely do they recognize or acknowledge their own role in corporate failure. As a result, as difficulties arise, they rarely hire turnaround professionals. Sometimes, a strong, courageous and involved board will see fit to seek interim management assistance. More often, the company's bankers or secured creditors will force the company to hire a turnaround professional in return for a line accommodation, a forbearance agreement or a covenant waiver. Even companies which are highly valued in the public markets routinely ignore danger signs and allow the cancer of failure to grow unchecked.

The engagement of restructuring professionals at the earliest signs of business distress is critical in determining all restructuring options and choosing the best path. Turnaround professionals are almost always engaged after their clients' organizations have weakened substantially. There are recurring themes that turnaround professionals see with each engagement. Companies which wish to avoid the involvement of interim management and the ignominy of failure can do much to help themselves by identifying problems early and preventing the onset of operational damage and cash burn. However, some levels of distress may be unpreventable, even in strong companies with seasoned and talented management teams.

In order to effectively plan for a distressed businesses Chapter 11 filing, it's important for legal and financial advisors to understand the events leading up to and drivers of financial and operational challenges. As businesses face challenges beyond their capabilities and comprehension, management teams and the board of directors usually reach out to their accounting firms and their outside counsel for guidance. Secured creditors may also be involved due to covenant violations and events of default. The secured creditors may have even downgraded the borrower and/or pushed the loans into workout.

At this stage, businesses are often introduced to both legal and financial restructuring professionals to aid in assessing and implementing restructuring options.

Three restructuring paths are almost always to restructure, sell or liquidate the business.

- Restructure
  - Highest value for creditors
  - Higher risk and may require capital
  - Longer time frame
  - Must have ability to implement turnaround
  - Benefits employees, creditors, customers, vendors
  - Can be accomplished in or out of court

- Sell
  - Market determination of value available for creditors
  - Requires capital to maintain operations during sale
  - Shorter time frame with definitive end date
  - Benefits some employees, creditors, customers and vendors

  - Can be accomplished in or out of court
  - Chapter 11 process allows for contract rejection

- Liquidate
  - Lowest value for creditors
  - Low risk and minimal capital requirement
  - Extended time frame to fully wind down operations
  - Management may lose control of the process
  - Preferred by secured creditors
  - Can be accomplished in or out of court

Whether the turnaround is to occur in a court process or out of court, the benefits of dedicated restructuring professionals many. Debtors, first and foremost, have a business to run and restructuring activities usually not their top priority. When the restructuring takes top priority from the management team, the business suffers as both day-to-day and longer term strategic activities do not get the full attention they require. Benefits of having a dedicated restructuring team include:

- Restructuring focus – Restructuring demands are separate from day to day operational demands – Having professionals focused on restructuring allows management to focus on day to day operations and longer term business strategy.

- Speed – Professionals ensure the restructuring activities are carried forth efficiently and effectively, with minimal disruption to the business.

- Independent assessment – Third party validation in evaluation of restructuring options including stakeholder communication, short and long term financing requirements, capital structure assessment, and developing feasible restructuring plans.

- Risk management – Identification of financial and operational events that may occur during the restructuring in order to avoid or mitigate potential disruptions, distractions or circumstances that may negatively impact restructuring.

- Communication – Development and coordination of a communication plan to ensure that internal and external communications are clear, consistent and effective and that the communications process is orderly.

- Contingency planning – Development of contingency plans in the event that restructuring activities are less than projected – sale/Chapter 11 filing/liquidation.

Pre Chapter 11 restructuring activities are often as important as activities during a Chapter 11 and should be taken on with the guidance of restructuring professionals in order to ensure success during the Chapter 11 reorganization process. As the debtor slips into distress, the restructuring financial advisor is instrumental helping the company to avoid bankruptcy or if Chapter 11 is required, survive the process. When bankruptcy becomes necessary, the hiring of the right restructuring financial advisor maximizes the chance that the company will survive Chapter 11 intact and avoid liquidation. Instead of defeat, the decision to hire a turnaround manager is usually the first step in returning to profitability and success. As restructuring counsel works with the debtor to plan the Chapter 11 filing, restructuring financial advisors are also working with the debtor on several activities all of which are focused on the successful execution of the debtor's restructuring plan. Benefits from a seasoned restructuring financial advisor include:

- <u>Accurate financials and projections</u> - Companies in distress need to have especially accurate financials, cash projections, and performance projections, as well as tight cash controls and restructuring financial advisors are skilled in quickly assessing crisis situations, developing accurate financials and projections, and navigating debtors through restructurings.

- <u>Exit strategies and contingency plans</u> – The debtor must quickly to develop an exit strategy – whether this involves recapitalizing the company, restructuring debts, filing chapter 11, or selling the company or certain non-performing divisions. Advisors are experienced in developing feasible exit strategies.

- <u>Dedicated restructuring professionals who work solely for and advise the debtor</u> - Many companies in distress don't understand that their bank, suppliers and other stakeholders may have already hired restructuring/bankruptcy counsel to handle negotiations while the company is still using its own management team or ordinary course professionals to advise them on restructuring matters. Debtors must have seasoned and skilled restructuring professionals who solely represent the company's interests. The benefits far outweigh the costs.

- <u>Insurance for directors and officers</u> – Directors and officers risk personal liability to when the company enters the zone of insolvency; every decision is scrutinized with a fine-toothed comb after the fact. One way for officers and directors to help prevent being second-guessed later is to hire a restructuring financial advisor, who advises on exit strategies, and whose advice the board relies on. This coverage is invaluable for directors and officers.

- <u>Professional testimony</u> - In order to avoid, or limit, testimony by officers and directors in Chapter 11 proceedings, the company can appoint its restructuring financial advisors as CROs who can provide professional testimony on behalf of the debtor. CROs experienced at testifying and are considered experts on financial issues, and accordingly, they can usually take the witness stand for the company.

- <u>Negotiations with creditors</u> – Restructuring financial advisors provide third party credibility to the company's creditor base and bring a clear, objective point of view to each and every restructuring. Management may have damaged creditor relationships as financial and operational performance declined and will benefit from restructuring financial advisors serving as intermediaries between the debtor and its creditors.

- Sound restructuring advice – As stated above, the restructuring financial advisor is able to bring calm and clarity to distressed situations. The company's board and management can focus on day to day and longer term ordinary course activities while its restructuring professionals lead the restructuring activities and help navigate the debtor to solid footing.

During the Chapter 11 process, debtors will work with restructuring professionals to address several issues that may arise in a bankruptcy which include, but are not limited to: determining venue for filing, financing operations during a bankruptcy, incenting and retaining key employees, re-negotiating executory contracts, selling assets free and clear of liens and encumbrances, all along while ensuring that the directors and officers are meeting their fiduciary duties. Before exploring how to best utilize the Chapter 11 process in a restructuring, the debtor must have carefully planned for and be prepared for its time in a bankruptcy process.

Once the debtor's restructuring plan is developed and vetted by its professionals, the Chapter 11 strategies can be formulated. A debtor's restructuring has its best chance of being successful with the help of dedicated and experienced legal and financial restructuring professionals. Without such guidance, the benefits of an in court restructuring and the maximization of value to all stakeholders may not be fully realized.