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THE TWILIGHT ZONE OF INSOLVENCY: HOW A DIRECTOR'S FIDUCIARY DUTIES CAN CHANGE WHEN TIMES ARE TOUGH

By: Jennifer Ancona Semko

You are about to enter a world—a world where everything is not as it seems. John Smith, age forty-five. Occupation: Chairman of the Board. John has found himself in a world where company debts are difficult to pay, where liabilities exceed assets. He is about to learn that, in this world, his duties, and his potential liability, are expanded. In this world, even creditors command his loyalty, good faith, and care. He has entered a sort of Twilight Zone—a place known as . . . The Zone of Insolvency.

We are all comfortable with the general rule that directors and officers of a corporation owe fiduciary duties to the corporation's shareholders. It is probably one of the first legal truisms we learned in law school. Less

(continued on page 2)

RECENTLY ENACTED BANKRUPTCY REFORM PROVISIONS CONTAIN IMPORTANT CHANGES AFFECTING BANKRUPTCY LITIGATION

By: John R Burns and Mark A. Werling

Litigation of issues in business bankruptcies will be significantly affected by provision of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

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well known is that the beneficiaries of these fiduciary duties can change when a company falls upon difficult financial times. Once a company becomes insolvent, the fiduciary duties of its officers and directors are expanded to include not only shareholders, but the company's creditors as well. More recently, courts have held that these expanded fiduciary duties are triggered even when the corporation, not yet insolvent, *approaches* insolvency—thus entering the amorphous "zone of insolvency." Exactly when a company enters "the zone" is not clearly defined by the jurisprudence and can be difficult to pinpoint. But when these expanded duties are triggered, directors and officers face what can be a delicate task—balancing the interests of multiple parties, even when those interests may conflict.

Officers and directors of a financially healthy company owe to that company and its shareholders duties of due care, good faith, and loyalty.[1] This means that a director or officer must be fully informed and exercise ordinary care in making business decisions. He or she must also act in good faith, in the company's best interests, without engaging in self-dealing or usurping corporate opportunities. A director or officer who breaches his or her fiduciary duties may face a lawsuit for damages resulting from the breach.[2] Moreover, in such circumstances the officer or director also may lose the presumptive protection of the business judgment rule, placing the burden on the officer/director to prove the fairness of the transaction to avoid liability.[3]

Directors of a solvent company generally owe creditors no duties beyond the relevant contractual terms governing the debt.[4] Creditors typically cannot bring

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fiduciary duty claims against those directors and officers, which allows directors and officers instead to focus primarily on pursuing business strategies in the best interests of the shareholders.[5] When the corporation becomes insolvent, however, many jurisdictions extend fiduciary duty protection to creditors, in some cases reasoning that the directors and officers of insolvent corporations act as "trustees," managing the company's assets for the benefit of the creditors.[6] Some courts have considered this shift justifiable because, in insolvency, creditors replace shareholders as the residual risk-bearers of the corporation. Because in insolvency the shareholders' equity is worthless, at least for the time being, the creditor bears the risk of poor management decision.[7]

Entering the Zone Expands Fiduciary Duties to Creditors

As recently as the early 1990s, courts began to expand the application of directors' and officers' fiduciary duties to creditors at an even earlier stage, finding that creditors are owed fiduciary duties as soon as the corporation enters the "vicinity" or "zone" of insolvency. This expansion stemmed from a 1991 decision of the Delaware Chancery Court in *Credit Lyonnais Bank Nederland, N. V. v. Pathe Communications Corp.,*[8] in which the court dismissed a majority shareholder's claim that the management of MGM-Pathe Communications Co. (MGM) had breached its fiduciary duties to him by failing to facilitate certain asset sale transactions. MGM was in financial dire straits, having just come out of bankruptcy after the controlling shareholder ceded control of the corporation to a creditor in exchange for more loans. Under the contract with the creditor, the shareholder was to regain control when the debt was paid down to a certain amount. To this end, the shareholder demanded that the corporate managers designated by the lender sell certain assets to pay down the loan, but the managers refused, and the breach of fiduciary duty claim resulted.

In concluding that the managers had not breached their fiduciary duties to the controlling shareholder, the court observed that the management group had acted "prudently" from the point of view of the company as a whole and was "appropriately mindful" of the potential conflicting interests of the shareholder and the corporation.[9] In oft-quoted language that would become the basis for future court decisions recognizing an expansion of fiduciary duties to creditors, the court reasoned that "[a]t least where a corporation is operating on the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[10] In a footnote, the court expounded upon this point, observing that directors managing a corporation in the vicinity of insolvency may face situations in which the best course of action may not be the path that the shareholders, creditors, or any single corporate constituency would choose. Thus, the best decisions will not be made by directors who think they owe duties only to shareholders, but by those who take into consideration the "community of interests that the corporation represent."[11]

. . . directors and officers are best advised to consider the interests of the entire corporate enterprise, including creditors, when making decisions in the zone.

While the *Credit Lyonnais* decision did not involve a fiduciary duty claim by a creditor and did not purport to create an affirmative right of action for creditors, the ruling has been cited as a basis for recognizing a creditor's right to sue for breach of fiduciary protections.[12] For example, a New York bankruptcy judge recently found the officers and directors of a company in the "zone of insolvency" personally liable for more than $40 million in challenged transactions that had diverted funds away from the company's creditors.[13] On the other hand, an October 2004 Delaware Chancery Court decision, and some commentators, have argued that the *Credit Lyonnais* decision is being applied too expansively, and that the decision was intended to provide a shield to directors of companies in the zone of insolvency against shareholder claims, not a sword for the use of company creditors.[14] It remains to be seen whether this criticism will erode the recognition of fiduciary duty protections for creditors of companies in the zone of insolvency. But in the meantime, directors and officers are best advised to consider the interests of the entire corporate enterprise, including creditors, when making decisions in the zone.

When Does a Corporation Enter the Zone?

Unfortunately, it is not clear exactly when a corporation enters the zone of insolvency. The *Credit Lyonnais* decision did not address the issue, and even jurisprudential tests for insolvency-in-fact are varied. Delaware defines insolvency in two ways. First, a company may be insolvent if it fails the "balance sheet insolvency test," which considers whether its total liabilities exceed its total assets.[15] Another test (sometimes called the "equitable insolvency test") examines whether a corporation is unable to pay its debts as they become due.[16] A New York bankruptcy court recently favored yet another test, the "cash flow and capital adequacy method," which looks to a company's future ability to pay its debts and fund its business requirements for working capital and capital expenditures.[17] Still other decisions have found companies to be in the zone of insolvency when the directors approve a transaction leaving the corporation unreasonably undercapitalized.[18] One California court (applying Maryland law) presumed insolvency from the fact that the corporation filed for bankruptcy four days after consummation of a challenged insider transaction.[19] Identifying the appropriate standard for evaluating corporate solvency can therefore be difficult, and applying such a test is clearly a fact-intensive inquiry. Thus, directors and officers of companies in weak financial positions should consult financial and legal advisers at an early stage.

Who Reigns in the Zone— Creditors or Shareholders?

Management of corporations in the zone of insolvency may find themselves at a crossroads—do they act to preserve asset value (in the best interests of the creditors)? Or do they act so as to maximize enterprise value, even at great risk (in the best interests of the shareholders)? *Credit Lyonnais* clearly instructed directors and officers to act in the best interests of the corporate enterprise as a whole, not favoring any particular fiduciary group. Subsequent to *Credit Lyonnais,* the Delaware Chancery Court has emphasized that, even when a corporation is insolvent or in the zone of insolvency, Delaware law does not permit directors to place creditor interests ahead of the interests of shareholders.[20] Some other courts have held that directors and officers must seek to act in the best interests of the corporation itself, so as to maximize the corporation's long-term wealth-creating capacity[21] and that the views of creditors are entitled to "special" but not "exclusive" consideration.[22] Other courts, however, have held that directors and officers of insolvent corporations owe fiduciary duties only to creditors.[23]

Guidance for Directors and Officers in the Zone

There is no one-size-fits-all solution for directors and officers whose companies are facing tough financial times and who wish to avoid exposure to fiduciary duty claims brought by company creditors. Directors and officers concerned about creditor claims should ensure that their corporation's bylaws or other governing documents provide for director and officer indemnification, backed by adequate D&O liability insurance coverage. The nature and scope of the fiduciary duties owed to creditors will be governed by the law of the state in which the company is incorporated, and it is therefore advisable to seek the advice of an attorney familiar with that state's corporate laws. Directors should follow corporate formalities, hold regular, formal board meetings, and stay informed regarding the corporation's financial status. If publicly traded, the corporation's Audit Committee would be well suited to the task of monitoring the corporation's financial condition. Even though not required of privately held companies, establishing such a committee is advisable. The board of directors should obtain full and frank financial information before approving any transaction, particularly if it appears that the corporation is operating in the zone of insolvency. The board's decision and board minutes should acknowledge their consideration of their expanded fiduciary duties to creditors. When making decisions that involve a significant risk to the corporation's assets, the board should obtain fairness opinions from advisors and the advice of counsel. Where possible, it may be wise to obtain creditors' input and/or consent to the transaction at issue. Ideally, the interests of the shareholders and creditors will be aligned. If this is not the case, directors and officers face what can be a daunting task—acting in the best interests of the corporate enterprise. *Welcome to the Twilight Zone.*

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Endnotes

1. *See, e.g.,* Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998). This article cites primarily to the well-developed and well-regarded laws of the State of Delaware. *See, e.g.,* IBS Fin. Corp. v. Seidman & Assocs., L.L.C., 136 F.3d 940, 949-50 (3d Cir. 1998); International Ins. Co. v. Johns, 874 F.2d 1447, 1459 n. 22 (11th Cir. 1989); Dynamics Corp. of America v. CTS Corp., 805 F.2d 705,718 (7th Cir. 1986).

2. Though directors of Delaware corporations may face personal liability for breach of their duties of loyalty and good faith, Delaware statutory law allows corporations to eliminate or limit the

personal liability of its directors for monetary damages resulting from breach of the duty of care. 8 Del. C. 9 102(b)(7).

[3] *See, e.g.,* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 (Del. 1995); Polk v. Good, 507 A.2d 531, 536 (Del. 1986).

[4] *See, e.g.,* U.S. Bank National Assn. v. US. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947 (Del. Ch. 2004) (citing Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 417 (Del. Ch. 1999)); Geyer v. Ingersoll Publications Co., 621 A.2d 784,787 (Del. Ch. 1992).

[5] Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004) (citing *Geyer,* 621 A.2d at 787).

[6] *See, e.g.,* Credit Agricole Indosuez v. Rossiyskiy Kredit Bank, 708 N.Y.S.2d 25,31 (2000); Geren v. Quantum Chem. Corp., No. 95-7454, 1995 U.S. App. LEXIS 399 12 at * 3 (2d Cir. Dec. 13, 1995); *see also Geyer,* 621 A.2d at 787 (recognizing insolvency as an exception to general rule that directors owe no fiduciary duties to creditors); *see also* Royce de R. Barondes, *Fiduciary Duties of Officer and Directors of Distressed Corporations,* 7 GEO. MASON L. REV. 45,63-64 (1998) (summarizing cases).

[7] *See, e.g., Production Resources,* 863 A.2d at 790-92; *In re* Ben Franklin Retail Stores, Inc., 225 B.R. 646, 653 (N.D. Ill. 1998).

[8] No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

[9] *Id.* at *108.

[10] *Id.*

[11] *Id.*

[12] *See, e.g., US. Bank Nat'l. Assn.,* 864 A.2d at 930; Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003); Brandt v. Hicks, Muse & Co., 208 B.R. 288 (Bankr. D. Mass. 1997), *aff'd.* 242 F.3d 6 (1st Cir. 2001); Roselink Investors, L.L.C. v. Wilf, No. 01-7176, 2004 US. Dist. LEXIS 6905 (S.D.N.Y. May 19, 2004) (recognizing creditors' right to claim breach, but finding creditors failed to establish facts sufficient to rebut presumption of business judgment rule); Weaver v. Kellogg, 216 B.R. 563, 582-84 (S.D. Tex. 1997).

[13] Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003).

[14] *See Production Resources Group,* 863 A.2d at 787; de R. Barondes, *supra note* 6.

[15] *See, e.g., US. Bank Nut '1 Assn.,* 864 A.2d at 57 *(citing Geyer,* 621 A.2d at 789). This approach is similar to those of the Bankruptcy Code, 11 US. C. 9 101(32)(A), and the Internal Revenue Code ("the excess of liabilities over the fair market value of assets"), 26 U.S.C. 9 108(d)(3).

[16] *See, e.g., Geyer,* 621 A.2d at 789.

[17] *Pereira,* 294 B.R. at 520.

[18] *See, e.g., In re* Healthco Int'l., Inc., 208 B.R. 288,302 (Bankr. D. Mass. 1997).

[19] *In re* Mortgage & Realty Trust, 195 B.R. 740, 751 (Bankr. C.D. Cal. 1996); *see also* New York Credit Men's Adjustment Bureau, Inc. v. Weiss, 305 N.Y.

1, 5 (1953) (creating a presumption of insolvency where the corporation was technically solvent).

20. Adlerstein v. Wertheimer, No. 19101,2002 Del. Ch. LEXIS 13 (Del. Ch. Jan. 25, 2002).

21. Hechinger Invest. Co. v. Fleet Retail Finance Group, 274 B.R. 71, 89 (D. Del. 2002).

22. *In re* Adelphia Commun. Corp., No. 02-41729, 2003 Bankr. LEXIS 1281 at *114-15 (Bankr. S.D.N.Y. Mar. 4, 2003) (holding that directors were required to give "special [though not exclusive] weight" to the views of creditors); *see also In re* Global Crossing Ltd., 295 B.R. 726, 745 (Bankr. S.D.N.Y. 2003) (holding that creditors' interests should be considered, as long as they are not given "undue weight").

23. *See, e.g.*, F.D.I.C. v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1992).

CROSS-BORDER INSOLVENCIES: When Should a U.S. Debtor be Filing Ancillary Proceedings in Canada?

By: Brett Harrison and Bob Rajan

In today's modern commerce, it is not uncommon for U.S. companies to have business operations or assets in multiple jurisdictions including Canada. When a multinational company becomes insolvent and files for Chapter 11 protection in the United States, the Canadian aspect is often easy to overlook and the restructuring is typically dictated by the American courts. Nevertheless, it is important to remember that Canadian judicial recognition is important when seeking to protect assets located in Canada or realize on them as part of a restructuring. This article outlines when U.S. debtors should consider commencing ancillary proceedings in Canada and the issues relevant to such proceedings.

Canadian Legislative Framework

In Canada, two regimes have been developed to deal with insolvency law: the *Companies' Creditors Arrangement Act* ("CCAA") and the *Bankruptcy and Insolvency Act* ("BIA"). The CCAA is legislation that is used in large complex restructurings, while the BIA is used mainly for smaller restructurings and liquidations.

In contrast to Chapter 11 of the Bankruptcy Code, the CCAA has only 22 sections and is driven largely by case law, allowing judges great flexibility. The BIA on the other hand is a more structured piece of legislation. Both the CCAA and the BIA contain provisions dealing with the recognition of foreign proceedings.

Depending on the circumstances of a U.S. company who has filed for Chapter 11 protection, three options are available to it when deciding how to deal with its Canadian operations and/or assets. First, if there are significant operations or assets in Canada, the company may want to consider initiating a full CCAA proceeding. However, this process involves simultaneously duplicating many procedures in Canada that are happening in the U.S. In most cases, this should be avoided if possible because of the additional expense for the company and the creditors. Second, the company could file a notice of intention to file a proposal under the BIA. Under the BIA, a negotiation process could take place between the company and its creditors in an attempt to reorganize finances. Finally, ancillary proceedings can be initiated under § 18.6 of the CCAA. This option is likely to be chosen in situations where the company's main operations are in the U.S. but there are subsidiary operations and assets in Canada, since it is less expensive and allows control over the restructuring to remain in the hands of the U.S. courts. Therefore, although it will depend on the circumstances, U.S. debtors should strongly consider implementing ancillary procedures when they have operations and/or assets in Canada.

Section 18.6 Proceedings

Section 18.6 of the CCAA was enacted in 1997 to deal with international insolvencies. It is used in situations where the primary operations and assets of a company are located in a foreign jurisdiction, but there may be subsidiary operations or assets in Canada. In these situations, the company will want to protect all of its assets worldwide. Therefore, rather than initiating concurrent proceedings in Canada, § 18.6 allows the debtor to file in its "home" jurisdiction and simply have those proceedings recognized and approved by the Canadian court.

For §18.6 to apply there must be a "foreign proceeding" in place which is defined under § 18.6(1) of the CCAA as: "a judicial or administrative proceeding commenced outside Canada in respect of a debtor under a law relating to bankruptcy or insolvency and dealing with the collective interests of creditors generally."[1] It is important to establish an actual connection between the foreign proceedings and the Canadian operations or assets. A debtor who has filed a Chapter 11 proceeding in the U.S. with operations and assets in Canada complies with the definition.

Canadian courts have generally, in the proper circumstances, recognized the principle of comity when a foreign proceeding has been initiated. This means that the Canadian courts have been willing to accede their position to the foreign courts. In *Re Matlack Inc.*, a stay of proceedings was granted pursuant to §18.6 of the CCAA. Mr. Justice Farley stated that, "the Court's recognition of a foreign proceeding should depend on whether there is a real and substantial connection between the matter and the jurisdiction"[2] and that the connection should be based on "considerations of order, predictability and fairness rather than on a mechanical analysis of connections between the matter and the jurisdiction."[3] In this case, granting the stay ensured creditors in Canada could not seize assets ahead of creditors in the U.S. This was done under the principle of comity because the Canadian court felt that this would ensure all the stakeholders were treated equitably.

Under the CCAA, Canadian courts have broad powers and flexibility to make an order "on such terms and conditions as the court considers appropriate in the circumstances."[4] They have the power to adapt the foreign order and can apply foreign rules to the Canadian operations and assets in an extremely flexible manner. Section 18.6(4) of the CCAA explicitly provides that:

> Nothing in this section prevents the court, on the application of a foreign representative or any other interested person, from applying such legal or equitable rules governing the recognition of foreign insolvency orders and assistance to foreign representatives as are not consistent with the provisions of this Act.

Therefore, the only thing preventing Canadian courts from recognizing a foreign order is that it must be consistent with Canada's laws.

In *Re Babcock & Wilcox Canada Ltd.*, a case where the Canadian court was asked to recognize a Chapter 11 proceeding initiated by a U.S. parent company to stay related claims against the Canadian subsidiary, Mr. Justice Farley pointed out that the definition of foreign proceedings contains no specific requirement that the Canadian entity also be insolvent. He wrote in his decision that § 18.6(4) leaves open an option for a solvent Canadian company to seek assistance and protection in regards to foreign proceedings against its parent company. Section 18.6(4) provides for ancillary relief to the Canadian operations and assets upon the application of a "foreign representative" or an "interested party."[5] Farley allows for a Canadian subsidiary to fall within the definition of interested party, thereby allowing the application for an ancillary proceeding available to a Canadian subsidiary.

Justice Farley also set out some hallmark factors to provide guidance as to how § 18.6 of the CCAA should be applied. He held that:

- Comity and cooperation between courts should be encouraged;

- The foreign legislation should be respected in any analysis unless there is a radical divergence from Canadian law;

- Stakeholders should be treated equitably, and where reasonably possible, common stakeholders should be treated equally;

- Reorganized should be as one global unit and therefore one jurisdiction should be encouraged to assume principal authority over the reorganization;

- The role of the courts will vary depending on the location of a company's principal operations and assets, the location of stakeholders, the ability of the laws in each jurisdiction to address the main issues**,** any undue prejudice and any other factors appropriate in the circumstances;

- If one country has an ancillary role, then the court in that jurisdiction should be kept informed of any developments and the shareholders in that jurisdiction should be provided with equal access; and

- All affected stakeholders, regardless of jurisdiction should receive notice of the order and have an opportunity to return to court to review and potentially change it.

The recent case of *Re Core-Mark International Inc*. is an example of § 18.6 successfully harmonizing U.S.-Canada insolvency proceedings. Core-Mark, a Delaware company, filed for Chapter 11 protection in the United States, simultaneously with its parent company, Fleming Companies, Inc. The immediate concern for Core-Mark was the protection of its assets and a quick emergence from bankruptcy. At the time of its Chapter 11 filing, Core-Mark had significant operations in Canada.

Among Core-Mark's initial concerns were protecting its Canadian assets. The company had relationships with major suppliers who threatened to take COD payments for new products and apply those payments to old debt. There was also concern that U.S. creditors would take action against Core-Mark's assets in Canada, which would frustrate the ability of the company to reorganize in the U.S. Therefore, shortly after its U.S. filing, Core-Mark filed an application under section 18.6 of the CCAA in Canada and was granted ancillary relief, including a stay of proceedings. The Canadian court recognized that:

- The majority of the business was conducted in the U.S. so the Canadian proceedings should be ancillary;

- The U.S. claims process would treat Canadian residents equally;

- The U.S. reorganization included the Canadian operations and intended to reorganize as a global unit;

- The Canadian court received adequate notice of the U.S. proceedings; and

- The Canadian creditors received notice of Core-Mark's intentions.

During the proceedings, all orders in the U.S. bankruptcy that had a significant impact on the Canadian creditors were disclosed to the Canadian creditors, and the more significant orders were specially recognized by the Canadian Court. For example, the Canadian Court was asked to, and did, adopt the U.S. claims process and bar date. This is a good example of how a Chapter 11 proceeding successfully utilized s.18.6 of the CCAA for the benefit of all stakeholders.

The Future

In June 2005, legislation was introduced to revise the CCAA and the BIA.[7] Part of the legislation is an attempt to encourage international courts to cooperate with each other by incorporating the United Nations Commission on International Trade Law's Model Law on Cross-Border Insolvency. The adoption of the Model Law will afford foreign representatives greater rights and powers regarding the possession and distribution of a debtor's assets than they currently have. Similar action has been taken in other jurisdictions around the world in an attempt to balance legislation of several countries while recognizing the need for companies to not only grow but have the ability to restructure globally.

The goal of the recent Canadian legislation is just that - to increase the statutory guidance the CCCA provides in international insolvencies. The drafters feel that more predictability and consistency is necessary. The intention is not to restrict the CCAA and hinder its flexibility, but rather to improve its administration.[7] Due to the fact that this legislation is still in its first reading, it is still too early to comment on its potential enactment, but, as in the U.S., there may be significant changes in the future for Canadian insolvency legislation.

Conclusion

In conclusion, some important points to understand about § 18.6 of the CCAA for a company that has filed for Chapter 11 protection in the U.S. are:

- Canadian courts generally would like to help foster comity between jurisdictions and significant flexibility to do so exists under §18.6. The key criterion for application under §18.6 application is that there is a "real and substantial connection" between the matter and the jurisdiction. The underlying goal is to treat all stakeholders equitably;

- It is important not to forget to recognize Canada's sovereignty. Canadian insolvency rules are drastically different than those of the U.S. and if the Canadian court is to grant ancillary proceedings, it wants to be involved early in the process. Canadian courts prefer to use their system even in an ancillary role because then they can ensure Canadian legal processes and principles are respected and all creditors are treated equitably. Therefore, the earlier the Canadian court is involved, the easier it will be for it to coordinate with the U.S. order, and the faster the protection will be available for the Canadian assets; and

- Although it is likely that Canadian courts will continue to defer to the U.S., the extent to which it will do so, is questionable. This is why it is important to understand Canadian bankruptcy law in order to maximize the benefit to a U.S. company in Chapter 11 protection. Canadian policies are developing to be more inline with U.S. legislation, but Canada is not there yet and U.S. legislation is expected to significantly change with the enactment of certain new rules that become effective on October 17th of this year. Yet, there are still rulings that are possible in the U.S. that cannot be done or have not been attempted in Canada. A Canadian bankruptcy lawyer along with an insolvency consultant should be sought to deal with any complex cross border reorganization.

Endnotes

[1] R.S.C. 1985, c. C-36, § 18.6(1).

[2] (2001), 26 C.B.R. (4th) 45 (Ont. S.C.J.) at para 5.

[3] *Ibid*. at para 5.

[4] *CCAA* § 18.6(3).

[5] (2000), 18 C.B.R. (4th) 157 (Ont. S.C.J.) at para 13-14.

[6] Bill C-55, An Act to establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts, lst Session, 38th Parl., 2005.

[7] Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act; Report of the Standing Senate Committee on Banking, Trade and Commerce, November 2003.

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SIDEBAR:

Young Lawyer Practice Pointer

"I don't practice in New York–why should I read this?"

Corporate law statutes of many different states often follow, if not simply duplicate, corporate law provisions of states like New York, Delaware and others. Often there is no legislative history or other statutory reference that suggests the similarity between your state and a "model" state's statute. A computer search using the actual language of your statute often will produce results from your state, the "model" state and other states following the "model" state's language. Case law in these other jurisdictions will help fill holes in your research if there is no case law in your state on the specific subject.

LIMITING THE BANKRUPTCY "LOOK BACK" UNDER THE NEW YORK AND SIMILAR LLC STATUTES

By: Gary A. Goodman and Kwame Cain

LLC statutes of New York and states with similar statutes appear to significantly limit a creditor's ability to assert a fraudulent transfer claim against limited liability companies while enhancing the attractiveness of the LLC a form of organization by comparison with the limited partnership or corporate form.

The fraudulent transfer law proscribes transactions intended to hinder, delay or defraud creditors. It addresses transactions in which the debtor, by engaging in a transaction, had a specific intent to prevent or interfere improperly with collection efforts in order to retain some benefit for the debtor. Thus, a transaction intended primarily to hide assets from creditors, or to put assets beyond creditors' reach but within the debtor's reach, could easily be viewed as one intended to hinder, delay or defraud. Fraudulent transfer laws serve three major purposes. First, they are designed to preserve and retrieve the debtor's assets for the benefit of creditors as a body. Second, such laws promote sound creditor relations outside of bankruptcy and help to deter attempts to evade the just claims of creditors. Third, fraudulent transfer rules serve to protect legitimate creditors by consciously allocating the risk that a transaction may be tainted to the transferees.

A fraudulent transfer challenge may be brought either directly under Chapter 11 of Title 11 of the United States Code,[1] (the Bankruptcy Code) - through Section 548 of the Bankruptcy Code - or by invocation of the applicable state fraudulent transfer statute - through Section 544(b) of the Bankruptcy Code. Although a Bankruptcy Code challenge may seek to recover as a fraudulent transfer any distribution made within one year before bankruptcy, a state-law fraudulent transfer challenge may reach back for a much longer period, four years from the time of distribution in most states and six years under New York law.

However, in *In re Die Fliedermaus LLC*, a New York bankruptcy court recently ruled that the fraudulent transfer reach back is more limited for a distribution made by a limited liability company (LLC) organized in New York to its members.[2] The court in *Fliedermaus* held that, rather than six years, a three-year "look back" or limitations period applied to claims alleging fraudulent transfer and breach of operating agreement to the extent that a party sought to avoid or recover under New York law alleging wrongful distributions made by a debtor LLC.

Fliedermaus Facts And Background

Between 1996 and 2001, Die Fliedermaus (the debtor) operated a bar and cabaret located in New York City under the name Le Bar Bat. As a result of a decline in the restaurant business in New York City and liabilities stemming from a lawsuit by certain former employees, the debtor filed for Chapter 11 relief on Oct. 4, 2001. On the basis of allegations by the former employees that the debtor had falsely reported its income, and that certain of the debtor's members (the defendants) had moved the debtor's assets outside the reach of creditors, the court directed the appointment of an examiner to investigate whether the debtor's income had been accurately reported, whether there had been gross mismanagement of the debtor’s operations and whether any avoidance actions should be brought. On Sept. 23, 2003, the examiner submitted his report.

The examiner's report severely criticized the debtor's business practices and the controls installed to manage and record cash flow. Based on his inspection, the examiner surmised that the debtor had likely operated at a loss for the entire period from 1997 to 2001, despite reporting otherwise to the Internal Revenue Service. The examiner also suggested there were potential causes of action against the defendants arising from the debtor’s payment of distributions to them. The examiner concluded that the debtor had likely been insolvent when these distributions were made and that the transfers might be avoidable. Following the examiner’s report, an operating trustee was appointed. After the sale of substantially all of the debtor’s assets, the case was converted to a Chapter 7 liquidation.

The trustee commenced an adversary proceeding against the defendants seeking to avoid the distributions as fraudulent transfers, and also alleging breach of fiduciary duty and violation of debtor’s operating agreement. Pursuant to Sections 548 and 544(b) of the Bankruptcy Code and Sections 270-279 of the New York Debtor Creditor Law (the DCL), the trustee charged that the defendants had received fraudulent transfers intentionally or constructively, paying themselves distributions while aware that the debtor was either insolvent or would be made insolvent by the distribution. The trustee also relied on Section 273-a of the DCL, which further provides that the distributions were fraudulent transfers because they were made in order to move assets out of the reach of potential judgment creditors.

The defendants sought to dismiss the adversary proceeding by asserting three arguments:

- First, they did not receive any distributions during the one-year “look back” period for fraudulent transfers under federal law, as provided in Section 548 of the Bankruptcy Code;
- Second, the debtor was not insolvent at the time of any of the distributions; and,
- Third, New York Limited Liability Company Law (the LLCL) provided a safe harbor for certain distributions made to members of an LLC and that certain claims by the trustee are barred by a three-year limitations or “look back” provision provided in the LLCL.

***Fliedermaus* Holding**

The court dismissed each of the defendants’ arguments, However, it also dismissed the trustee’s fraudulent transfer claim insofar as he sought to recapture distributions made before the three-year look back period provided for in the LLCL. The court explained that Section 508(c) of the LLCL provides that a “member who receives a wrongful distribution from a LLC shall have no liability under [the LLCL] *or other applicable law”* - which the court construed to encompass New York’s fraudulent transfer statutes - for the amount of the distribution after the expiration of three years from the date of the distribution.

The court posited that Section 508(c) provides a special limitations period for any state-based action to recover a "wrongful distribution" pursuant to Section 544(b), whether under the LLCL or other state law. In coming to this conclusion, the court examined Section 508 of the LLCL in its entirety. The court noted that Section 508(a) prohibits an LLC from making a distribution to a member while its liabilities exceed the fair market value of its assets. Further, Section 508(b) provides that a member who receives a distribution in violation of Section 508(a) and who knew at the time that the distribution violated Section 508(a) would be liable to the LLC. The court also explained that, subject to Section 508(c), Section 508(b) "shall not affect any obligation or liability of a member under the operating agreement or other applicable law for the amount of a distribution." Thus, the court identified that Section 508(b) contains a savings clause, which makes it clear that Sections 508(a) and (b) do not override liability under the operating agreement or other "applicable law," but it provides that liability is expressly subject to the three-year limitations period in Section 508(c). Accordingly, the court ruled, it was the intent of the New York legislature that claims under the DCL and contractual claims for the recovery of distributions be preserved but only as limited by Section 508(c).

CONCLUSION

Fraudulent transfer actions under Bankruptcy Code Section 548 or Section 544(b) are among the many weapons available to a bankruptcy estate to set aside pre-petition transactions for the benefit of creditors. Although subject to appeal, the *Fliedermaus* decision appears to significantly limit this weapon for creditors while enhancing the attractiveness of the LLC as a form of organization by comparison with the limited partnership or corporate form in New York and those other states using a similar LLC statute. In addition, although LLCs span a range of business classifications, they remain the primary investment vehicle for real estate-related ventures. Thus, if not reversed, the *Fliedermaus* decision will certainly present a significant obstacle for creditors seeking to prevent a debtor-LLC from improperly interfering with collection efforts by hiding assets from creditors.

Endnotes

[1] 11 U.S.C. § 101 *et seq.*

[2] Adv. No. 04-04306 (Bankr. S.D. New York, March 30, 2005) (Gropper, B.J.).

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(continued from page 1 - Recently Enacted Bankruptcy Reform Provisions)

The recent amendments to the Bankruptcy Code drew much media attention because of dramatic changes to personal bankruptcy law. Lost in that media attention were the significant changes to Bankruptcy Code provisions affecting bankruptcy litigation.

Chapter 11 Changes Affecting Bankruptcy Litigation

Nearly every business involved in sales or manufacturing will encounter the bankruptcy law when a customer or vendor files a Chapter 11 bankruptcy petition and most of those encounters have the potential to lead to litigation. This article is intended to highlight a few of the changes. Common areas of litigation are: leases to bankrupt entities, preference recovery litigation and reclamation claims. Changes to the Bankruptcy Code strengthen a commercial landlord's position in dealing with a tenant that files bankruptcy. Most businesses engaged in the sale of commercial goods have encountered the demand for return of payments made within 90 days of bankruptcy —"preferences"— and the amendments make it easier to defend such actions.[1] A seller's right to reclaim goods delivered shortly before bankruptcy has been expanded.[2]

BAPCPA amendments also change a number of provisions affecting debtor entities in bankruptcy and the litigation of claims by and against debtor entities. Employee wage claims having priority were doubled in amount to $10,000 and in time to amounts due 180 days prior to filing.[3] The ability of a debtor to pay key employees a bonus for remaining with the company after the filing of a bankruptcy petition — "KERP" bonuses — are significantly limited by the changes.[4] The ability of a bankruptcy trustee, creditors Committee or individual creditor to recover fraudulent transfers or transfers to a trust created by the debtor within 10 years of bankruptcy have been strengthened.[5] These changes will generally strengthen the rights of creditors and impose greater restrictions on debtors than existing law.

The provisions dealing with "preference" litigation are particularly significant. Many companies have been sued, at some point, to return payments they received from a bankrupt entity shortly before its Chapter 11 filing. Previously, to defend such a case, the non-bankrupt company was required to prove, often with an expert witness, that the payment was made according to "ordinary" terms between the parties as well the "ordinary" customs of the debtor's industry.[6] Under the amendments, the recipient of such payments need only prove one of the two forms of "ordinariness."[7] As a practical matter, this will decrease the number of preference complaints filed nationwide and make it simpler to defend these actions.

Landlords dealing with bankrupt tenants are frequently concerned with the length of time the debtor can wait before deciding whether to continue or reject the lease. The new amendments place tighter restrictions on tenants, which should cause these decisions to be made sooner.[8] One of the most significant changes for vendors shipping goods on the eve of bankruptcy is what law governs their right to retrieve those goods under the Uniform Commercial Code.[9] The new amendments more than double the time period to exercise such "reclamation" rights.[10]

For debtors, the changes will likely cause a shorter stay in Chapter 11. Under current law, the debtor has the exclusive right to file a plan of reorganization for the first 120 days of its case, which is often extended with permission of the Bankruptcy Court.[11] Under the new amendments, the exclusivity period is limited to 18 months.[12] This change means creditors will achieve greater certainty, at an earlier point in the case, about potential repayments of their debt, although in some cases this could prevent debtors from achieving an otherwise obtainable reorganization.

BAPCPA also significantly enhances the rights of creditors to transfer a case from Chapter 11 to Chapter 7 of the Bankruptcy Code. The grounds for seeking this relief have been expanded under the amendments, and the time period for achieving it shortened.[13] This change, like the shortening of exclusivity periods, will cause some reduction to the number of Chapter 11 cases and shorten the period debtors have to attempt a reorganization.

In summary, BAPCPA will significantly impact business debtors and those who deal with them. Most changes become effective October 17, 2005. The amendments are designed, in part, to reduce perceived abuses in business bankruptcy cases. By limiting the period of time that the debtor has the exclusive right to file a plan of reorganization, the amendment will force debtor to file plans sooner than many are filed today. While that change should help reduce the cost of a Chapter 11 bankruptcy case, it might have the unintended consequence of forcing a reorganizing company out of bankruptcy protection before it has fully stabilized its business. The provision that increases the amounts payable to employees that are given priority in payment over general unsecured trade creditors might cause some vendors to be even less willing to extend credit to businesses that the vendor perceives to be in financial distress.

Direct Appeals of Bankruptcy Decisions to the Courts of Appeals

Buried deep within the technical amendments of the BAPCPA is a provision permitting direct appeals from bankruptcy courts to circuit courts of appeal.[14] This section amends the present appellate provisions of 28 U.S.C. § 158(d)(2) and might prove to be one of the most significant provisions of BAPCPA for bankruptcy litigators. Far removed from the debates that raged in the mid-1970s over the propriety of direct appeals from a non-Article III court to the courts of appeal, the new provisions address the need to accelerate resolution of significant issues in ordinary bankruptcy cases, or even ordinary issues in significant bankruptcy cases. It is likely that this provision will generate a substantial volume of appellate authority as the certification and authorization provisions are interpreted by the several courts of appeal over the next few years.

> . . . Congress seemed intent on streamlining appeals, consistent with its general effort to shorten the bankruptcy process.

Expressing concern for the "time and cost" of present appellate practices,[15] BAPCPA allows certain cases to bypass the district court or bankruptcy appellate panel and be decided on direct appeal by the circuit courts of appeal. Although the legislative history is sparse, Congress seemed intent on streamlining appeals, consistent with its general effort to shorten the bankruptcy process. Other changes consistent with this goal include tighter restrictions on exclusivity periods in Chapter 11 cases and extensions of lease rejection decisions for certain types of tenants.

BAPCPA implements a two-step procedure for direct appeals to circuit court. First, the party must make the request to the bankruptcy court, district court, or bankruptcy appellate panel. Requests for direct appeals must be made within sixty days of a final order being entered. Practitioners should note, however, that the ten day rule for appeals to the district court or bankruptcy appellate panel under Bankruptcy Rule 8002 still applies. A conventional appeal should therefore be taken first, followed by a request for certification and a stay of the lower court proceedings.

The "final decision, judgment, order, or decree" of a bankruptcy court, district court, or bankruptcy appellate panel must be certified as meeting certain criteria described in the statute to be eligible for direct appeal.[16] A direct appeal is possible if, on the court's own motion or at the request of a party, a finding is made that:

1) there is no controlling decision in the circuit or from the Supreme Court on the question of law at issue, or if the matter is of public importance;

2) the decision involves a question of law that requires the resolution of conflicting decisions; or

3) an immediate appeal may materially advance the progress of the case.

Certification can also be accomplished without such findings, if a majority of the appellants and appellees jointly certify that at least one of the above criteria is met. In that case, a request for certification "shall" be granted. In other words, the parties can agree that the standards for certification have been satisfied, even if the lower court might have disagreed had the request been made by a single party.

Next, the circuit court must decide whether to accept the appeal. BAPCPA provides no specific guidance on the standard circuit courts should use in making these determinations. The House Report indicates that the new procedures are designed to quickly settle "unresolved questions of law where there is a need to establish clear binding precedent at the court of appeals level."[17] It also notes that direct appeals should "rarely be used" in fact-intensive issues where binding precedent exists. This statement suggests that circuit courts will have broad discretion in deciding which bankruptcy court orders they choose to accept. It also suggests that circuits having relatively fewer established precedents could approach this issue differently than other circuits.

BAPCPA approaches the problem differently and is intended to create a system that promotes judicial efficiency and reduces the time necessary to move any particular decision from the bankruptcy court through a court of appeals. At least as early as 2001, Congress began considering ways to facilitate direct appeals, notwithstanding concerns from some commentators that these revisions will re-open settled questions about the constitutionality of the bankruptcy system. Taken as a whole, the BAPCPA provisions are intended to streamline the bankruptcy process and reduce the overall cost of bankruptcy proceedings, particularly complex chapter 11 reorganization cases. With that purpose in mind, we are likely to see the number of direct appeals increase as judges and practitioners become accustomed to the new procedure.

Endnotes

1. BAPCPA §§ 403, 409, 1213, 1222

2. BAPCPA § 1227

3. BAPCPA § 1401

4. BAPCPA § 331

5. BAPCPA § 1402

6. 11 U.S.C. § 547(c)(2)

7. BAPCPA § 409

8. BAPCPA § 404

9. BAPCPA § 406

10. BAPCPA § 1227

11. 11 U.S.C. § 1121(d)

12. BAPCPA § 411

13. BAPCPA § 442

14. BAPCPA § 1233(a)(2)(B)

15. H.R. Rep. No. 109-31, pt. I, at 148, §1233 (2005)

16. Pub. L. No. 109-8, at § 2.

17. H.R. Rep. No. 109-31, at 148

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MESSAGE FROM THE CHAIRS

Stephen B. Porterfield and Kathleen B. Burke

Welcome to the latest edition of Bankruptcy Litigation. Allow us to introduce our new Co-chair, Kathleen Burke, of Jones Day in Cleveland. We also take this opportunity to express our gratitude to Stuart Glick, outgoing Co-chair, for the many years of service he has dedicated to this Committee, including the leadership he has shown the last three years as Co-chair, but also several years of prior service editing our newsletter, coordinating programs, and generally increasing the membership and visibility of our Committee.

We are currently making plans for the upcoming year, and welcome your involvement. There are several ways for you to be involved in the Committee. We appreciate articles for the newsletter and ideas for our meeting programs. Please call or email us with ideas or suggestions as to how we can better serve our membership. We hope you enjoy the new look of our newsletter and look forward to its continuing evolution.

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