**INSIDE:** Attorney-Client Privilege, Executive Compensation, Duties of Directors, and More

# Delaware Lawyer

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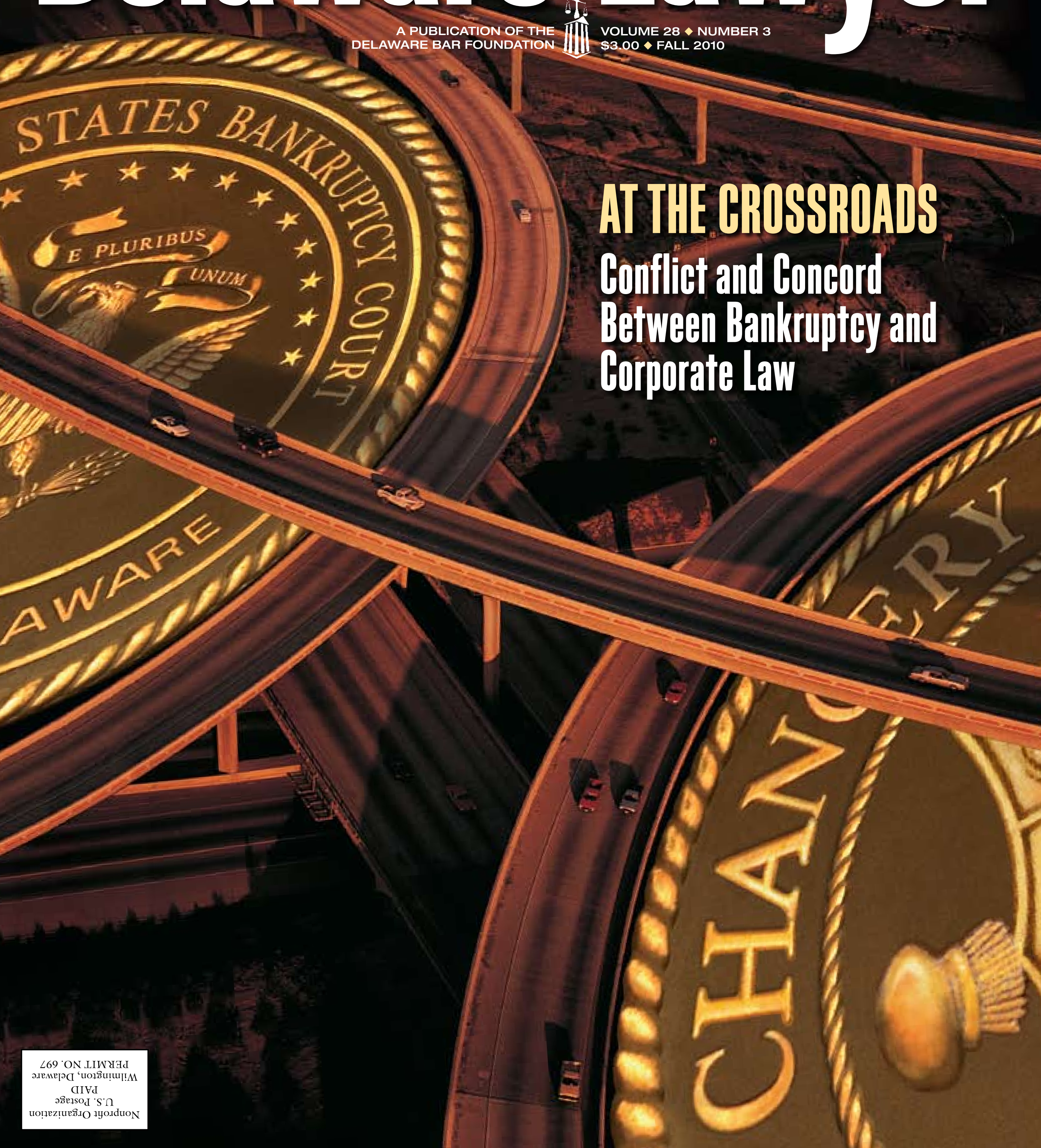


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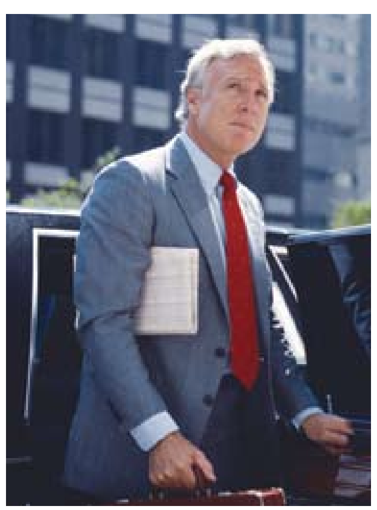

## EDITORS' NOTE

Gregory W. Werkheiser, Edward B. Micheletti

We are honored that the Board of Editors has chosen us to shepherd this important issue exploring the crossroads of bankruptcy law and corporate law. This issue is an outgrowth of a recent seminar organized by Larry Hamermesh and the Widener Law Institute of Delaware Corporate and Business Law. We (together with many others) were involved in the planning of that program, which provided an excellent treatment of this subject matter. At its conclusion, however, it was clear to us that there was still much more to be said.

Our goal for this issue is to foster a better understanding of the differences — but more so the similarities — of two separate legal fields whose practitioners, as Larry Hamermesh incisively points out in his article, are often "siloed" and perhaps too frequently unaware of the opportunities to borrow from a neighboring area of the law in the service of their respective clients.

We have experienced this in our respective practices in bankruptcy and corporate restructuring (Greg) and corporate litigation (Ed). Indeed, although we have both been practicing for more than a decade, neither of us can remember ever crossing the street (literally) to appear in the other's home court.

Why this should be so is not immediately obvious. Both the Court of Chancery and bankruptcy courts are tribunals that, historically at least, have been largely guided by the application of equitable principles. Furthermore, while the Bankruptcy Code often conflicts with and preempts contradictory state laws, there are large swaths of state corporate law that it does not displace. One would expect to find that there are many opportunities for practitioners of bankruptcy law and corporate law to collaborate.

And, increasingly, this is true. The last decade has seen an explosion of distressed M&A transactions, many of which have been implemented (and sometimes unwound or dissected) through our own Delaware Bankruptcy Court. Conversely, as Vice Chancellor Laster observes in his article about state law receiverships (insight we are honored to have as part of this issue), parties are more frequently looking, out of cost considerations and other reasons, to Delaware's state courts as an alternative when confronted with a distressed business.

The permutations that bring federal bankruptcy law and state corporate law together and, frequently, in conflict are innumerable. This issue explores just a few of them. In addition to the articles mentioned above, Francis Pileggi and Jeffrey Schlerf examine recent developments from Delaware concerning the duties of directors and managers of distressed entities. Harry Bryans looks at the impact of bankruptcy on the attorney-client privilege. And, Gregg Galardi and Bruce Grohsgal tackle the vexing issue of executive compensation.

We hope this issue helps open the silo doors in Delaware on two important practice areas that may benefit from continued collaboration.

Gregory W. Werkheiser    Edward B. Micheletti

# Delaware Lawyer

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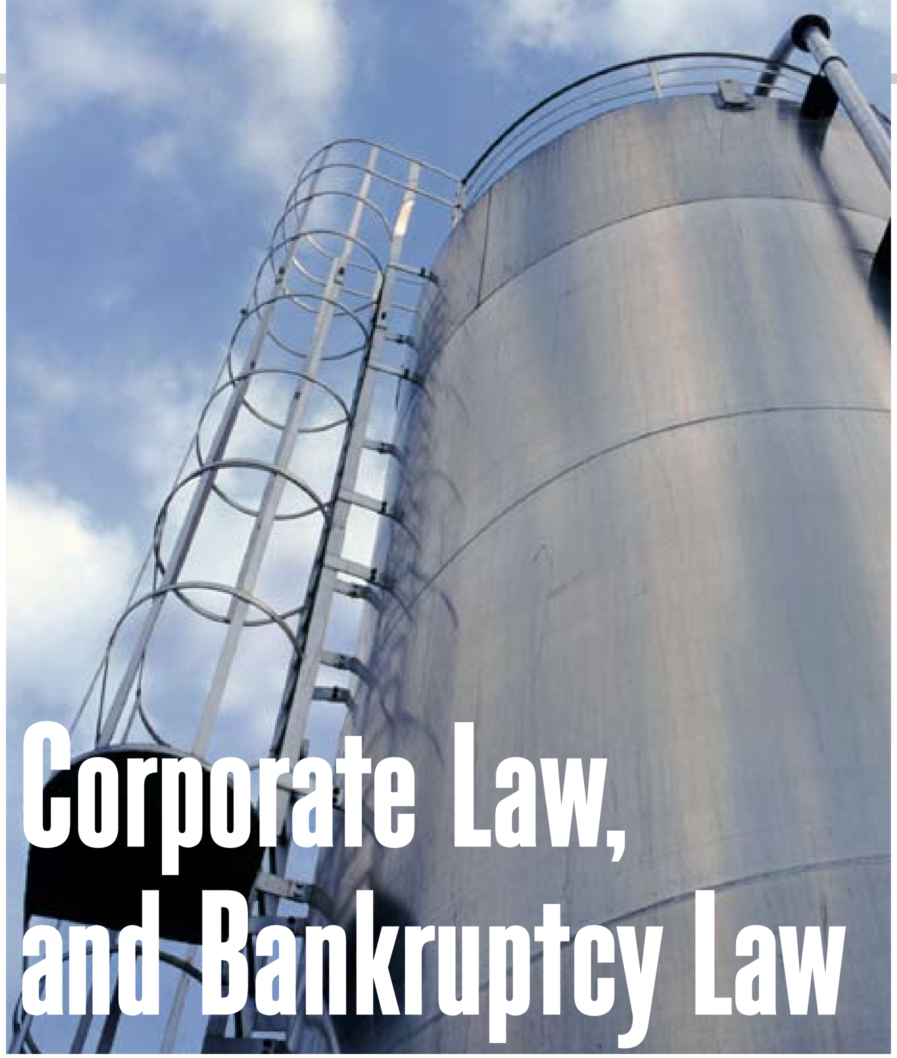
Lawrence A. Hamermesh



# Silos, Corporate Law, and Bankruptcy Law

**Delaware state courts and bankruptcy courts routinely handle business valuations — but not necessarily in the same way.**

At my current place of employment there is frequent talk about "silos." Where unrelated to agribusiness or missiles, that term is usually derogatory, referring to the tendency of specialists within larger groups to limit their attention to their own area of knowledge. The failure to reach out to and share knowledge with others in different silos makes the group as a whole less effective.

We have silos in the Delaware Bar: I speak from personally having stayed comfortably inside one of them to an extent that almost surely exceeds the norm. The silos that motivate this article are the ones that have separated those of us whose practice has focused on Delaware corporate law and litigation (primarily in the Court of Chancery and the Delaware Supreme Court) and those whose practice has focused on bankruptcy law and litigation (primarily in the Bankruptcy Court for the District of Delaware).

Just to illustrate, consider some recent statistics supplied by the Delaware State Bar Association: as of August 2010, the DSBA's Corporation Law Section had 495 members; the Bankruptcy Section had 304 members; yet the two sections had only 40 lawyers in common.

This is a crude measure of mutual professional isolation, of course, but it makes me think that I have lots of company as a siloed member of the Corporation Law Section.

That perception, in fact, was the genesis of the program presented in May 2010 at Widener Law School, when four panels, each addressing a different subject and each including representatives from a bankruptcy practice or Court and a representative from either the Court of Chancery or the Delaware Supreme Court, came together to share views about how the two distinct areas of practice encounter and address issues that arise in both practice settings.

The explicit intent of this program was to bring lawyers and judges in these two settings together in the hope that sharing insights about their respective practices might enhance their grasp of their own field.

The panel on which I participated, along with Judge Brendan Shannon, Vice Chancellor Travis Laster, Bob Stearn, Marty Lessner, and William "Tuck" Hardie from the investment banking firm Houlihan Lokey, addressed the subject of business valuation.

That subject figured prominently in my private practice before I joined the faculty at Widener, and it is one on which I have written a fair bit as a professor.[1] Apart from an occasional glimpse as a teacher into how the bankruptcy courts handle the subject, however, my exposure to business valuation has focused exclusively on valuation for purposes of Delaware corporate law.

Nevertheless, I was dimly aware that the bankruptcy courts regularly face business valuation issues, and resolve them with tools that are essentially the same as those used in business valuation disputes in the Delaware state courts.

A discounted cash flow analysis looks more or less the same in bankruptcy court as it does in the Court of Chancery: it requires a forecast of near-term cash flows, an estimate of business value at the conclusion of the forecast period, and a discount rate to reduce those estimates of future value to a present value.[2]

Thus, a recent decision from the Court of Chancery about estimating the equity risk premium in determining an appropriate discount rate[3] ought to be of use as well to judges and practitioners in the bankruptcy courts.

Both sets of courts are familiar, moreover, with the use of value ratios derived from markets — either share markets or business acquisition markets — as a tool for estimating the value of the business under consideration.[4]

Getting past these superficial similarities, however, required our panel, as the first order of business, to identify and differentiate the contexts in which the two sets of courts are called upon to engage in the business valuation exercise.

For the Court of Chancery, that exercise occurs most frequently in appraisal proceedings, in which the governing statute calls upon the court to determine and award the "fair value" of the shares of stockholders who object to the terms of a merger that has already occurred.[5]

In some cases, and perhaps even in the same proceeding as a statutory appraisal case, the Court of Chancery is called upon to determine whether the price paid in a merger is "fair," for purposes of the fiduciary duty doctrine of "entire fairness" that requires the court to assess the overall fairness (in terms of both price and process) of a merger in which the transaction proponents' duty of loyalty is implicated.[6]

More rarely, the court may need to evaluate a corporation's solvency, for purposes of determining the standing of creditors to pursue a claim on behalf of the corporation asserting a breach of fiduciary duty by the directors or officers.[7] As with the statutory appraisal and entire fairness cases, this business valuation exercise generally looks backward, to a time when alleged breaches of fiduciary duties occurred.

The bankruptcy courts also retrospectively address the issue of solvency of a business when they examine whether to undo (avoid) transfers of assets that occur shortly before the filing of a petition in bankruptcy.[8]

More regularly, however, bankruptcy courts engage in business valuation in a forward-looking, transactional context. Sometimes, for example, the valuation is relevant in assessing the fairness of a proposed plan of reorganization: depending on what the court thinks the enterprise is worth upon reorganization, a proposed allocation of debt and equity of the reorganized firm will (or will not) be perceived as fair and equitable with respect to those with pre-existing claims against the firm.[9]

By way of further example, a bankruptcy court may need to value the debtor enterprise's assets to determine whether a creditor whose claim is secured by all of those assets is receiving value at least equivalent to the amount of its claim.[10]

With this contextual introduction in place, I can now share some preliminary impressions that ensued from my first peek outside the silo. These impressions are just that: impressions, and not deeply researched assessments of the comparisons between corporate law and bankruptcy law in regard to business valuation. If these impressions deserve anything, the most likely candidate is further study. Still, they are what intrigued me, so here goes.

As Chief Judge Kevin Carey has explained, "There are many approaches to valuation, but value 'gathers its meaning in a particular situation from the purpose for which a valuation is being made.'"[11] The differing contexts for valuation seem to give rise to three notable differences in the approach to valuation issues taken by the Delaware state courts and the bankruptcy court:

- "Fair value" under state corporate law and enterprise value for purposes of bankruptcy law are concepts that ultimately serve very different purposes. The state courts' definition of "fair value" as "going concern value" — perhaps shaped by the explicit statutory exclusion of any "element of value arising from the accomplishment or expectation of the merger" — appears to exclude from the determination of "fair value" the value of synergies that might be achieved if the enterprise were acquired by a strategic buyer. By defining "fair value" as "what has been taken from the shareholder" in the merger,[12] the state courts' valuation rules essentially deny merger-derived gains to those who object to the transaction. In contrast, and while bankruptcy courts also sometimes rely on the concept of "going concern value," there seems to be nothing in bankruptcy law that would deny claimants an allocation under a plan of reorganization based on what the business could be sold for — including acquisition synergies; indeed, reorganization proceedings not uncommonly are resolved through the sale of the debtor enterprise.[13] Valuations always have to be guided by their respective legal purpose and rationale, and care must be taken not to import concepts or techniques across silos without assessing consistency with those legal purposes and rationales.

• Businesses subject to valuation differ as between state court and bankruptcy court proceedings. In state court valuation proceedings, the businesses being valued run the gamut from declining or distressed firms to firms that are notably successful. It is an inherent feature of bankruptcy valuations, however, that the firm has recently been insolvent, or at least close to it, and valuations that suggest large amounts of equity in excess of the full value of creditor claims are at least suspect, if not thoroughly implausible. My instinctive reaction to this difference would have been to expect that the bankruptcy courts would shrink from relying on valuations based on market ratios (such as price-earnings ratios) observed in companies (especially publicly traded companies) that are by and large successful, out of concern that a recently less successful firm not be overvalued. Similarly, I would have expected the bankruptcy courts' assessment of an appropriate discount rate in a discounted cash flow analysis would acknowledge the risks associated with the precarious circumstances involved in entering into and emerging from reorganization proceedings. To the contrary, however, and while Delaware state courts focus their "fair value" determinations on the "operative reality" of the business being appraised,[14] bankruptcy courts have expressed concern that the "operative reality" of companies in bankruptcy — i.e., a recent track record of financial distress — should not result in unduly low valuations that deprive certain classes of claims (usually junior claimants) of the benefit of reasonably foreseeable future earnings potential.[15] In short, valuation techniques are sensitive creatures that need to be coaxed to adjust to the setting in which they are applied.

• Finally, and at the serious risk of overstatement, it strikes me that the bankruptcy courts are more inclined or open to the use of market-based measures of value than their state counterparts. Given the contexts in which they conduct their valuation work, state courts may well be justified in hesitating to accept share market prices as a measure of "fair value."[16] While the state courts do from time to time allow market transactions to guide "fair value" determinations,[17] bankruptcy valuation case law appears much more receptive to giving effect to values reflected in market transactions.[18] Perhaps this difference, to the extent it exists, stems from the fact that Delaware state court valuation proceedings frequently take place in a context involving a controlling stockholder, in which neither the acquisition market nor the share market is robust.

Nevertheless, and despite these differences, the participants in our valuation panel noted some interesting similarities, mostly procedural, in the valuation efforts of the two sets of courts:

• All of the panelists acknowledged the formidable costs of the valuation exercise. In both settings, valuation is fact-intensive, centered on expert testimony that involves nuanced judgments that can nevertheless dramatically skew valuation results, and readily capable of consuming large amounts of judicial time and effort. Neither the state courts nor the bankruptcy courts seem to have found a way to avoid these grim facts of judicial life, as they relate to business valuation exercises.

• Not surprisingly, then, another common theme observed in the two legal settings in which business valuation occurs is judicial discomfort with the exercise. Especially where called upon to pronounce a specific dollar amount as the value of a business, both sets of courts have publicly expressed frustration with the task of evaluating conflicting and radically disparate (or, as former Chancellor Allen described them, "absurdly differing") claims of competing experts.[19]

• Yet despite the judges' frustration, both sets of courts have exhibited considerable (and I believe commendable) reluctance to rely on independent valuation professionals to handle the task.[20] They both appear to acknowledge that the judiciary must be sensitive to the rationales and parameters of the law that establishes the need for the valuation of businesses, and that courts steeped in those rationales and parameters are best equipped to perform the valuation task with due regard to them.

Perhaps the most valuable lesson from the cross-silo exchange about business valuation is simply the recognition that the valuation exercise is frequent in both corporate and bankruptcy law, and that judges and practitioners in both areas might profit from regular attention to current issues presented in the two parallel systems. ◆

FOOTNOTES

1. *Rationalizing Appraisal Standards in Compulsory Buyouts*, 51 B.C. L. Rev. 1021 (2009); *The Short and Puzzling Life of the "Implicit Minority Discount in Delaware Appraisal Law*, 156 U. Pa. L. Rev. 1 (2007); *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 J. Corp. L. 119 (2005) (all with Michael L. Wachter).

2. *See, e.g., Onti, Inc. v. Integra Bank*, 751 A.2d 904, 917 (Del. Ch. 1999); *In re Exide Technologies*, 303 B.R. 48, 63 (Bankr. D. Del. 2003).

3. *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 514-518 (Del. Ch. 2010).

4. *See, e.g., Borruso v. Commc'ns Telesystems Int'l*, 753 A.2d 451 (Del. Ch. 1999); *Exide Technologies*, 303 B.R. at 61-63.

5. 8 *Del. C.* § 262(h).

6. *See, e.g., Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 940 (Del. 1985).

7. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-102 (Del. 2007).

8. 11 U.S.C. §547(b); *see also, e.g., Travelers Int'l. AG v. Trans World Airlines, Inc.*, 134 F.3d 188 (3d Cir. 1998).

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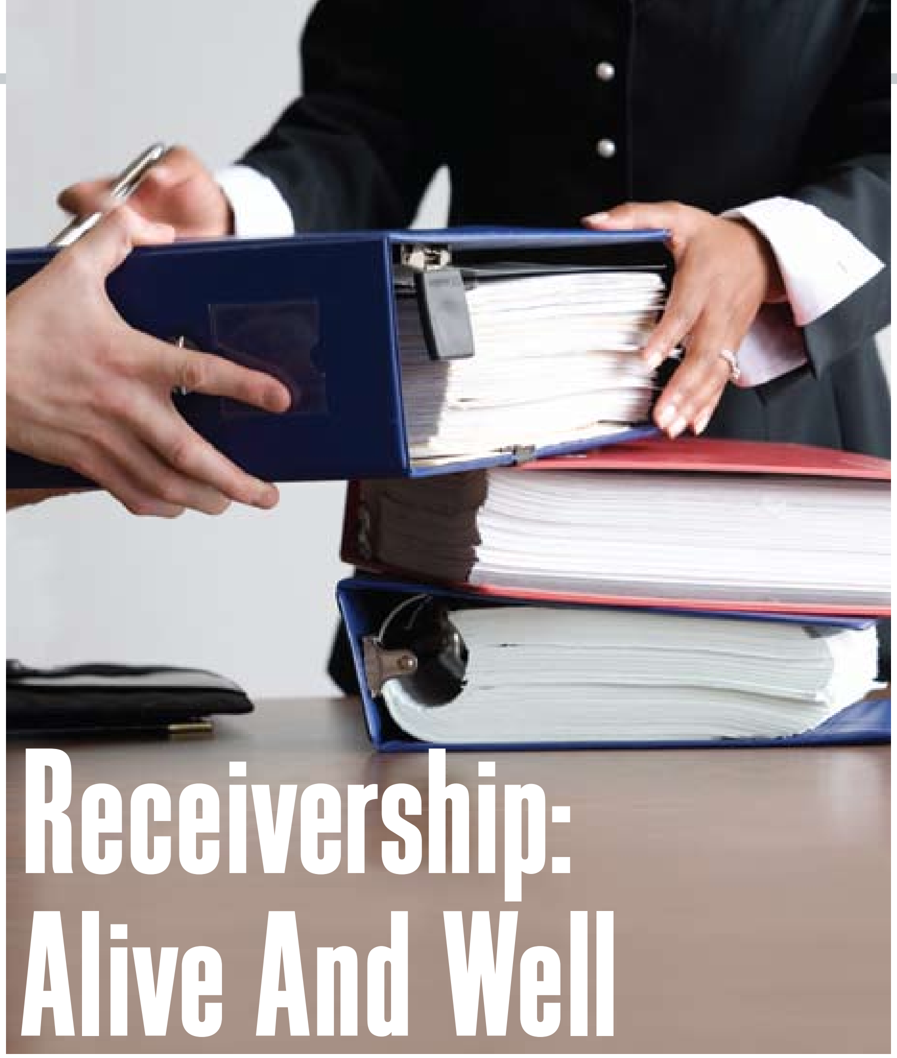
Honorable J. Travis Laster



# The Chancery Receivership: Alive And Well

Receivership proceedings in the Court of Chancery are re-emerging as a viable alternative to bankruptcy for some businesses.

In the early and mid-20th century, receivership proceedings were a prominent component of the Court of Chancery's docket. Then, with the passage of the Bankruptcy Reform Act of 1978, the focus of insolvency-related work shifted to the federal bankruptcy courts.[1] But the state court proceeding did not disappear, and receiverships appear to be making a tentative comeback.

Though the number of receivership cases in the Court of Chancery remains far from overwhelming, the first decade of the 21st century saw a consistent level of filings sufficient to suggest circumstances in which clients prefer state court. According to leading practitioners, the principal reasons to file for a receiver in the Court of Chancery are speed, low cost, and the flexibility of the remedy.

### The Nature Of The State Court Receivership Proceeding

A receivership is the court-supervised winding-up of an entity's operations and existence. Under Delaware law, a creditor or stockholder of an insolvent corporation can petition the Court of Chancery to appoint a receiver.[2] Following dissolution, a receiver may be appointed "on application of any creditor, stockholder or director of the corporation, or any other person who shows good cause therefor."[3]

A receiver also may be appointed if there is deadlock at the board or stockholder level, or if "[t]he corporation has abandoned its business and has failed within a reasonable time to take steps to dissolve, liquidate or distribute its assets."[4]

In extreme circumstances, a receiver can be appointed *pendente lite* for a solvent corporation,[5] or the Court of Chancery may impose a receiver as a sanction for failing to obey a court order.[6]

A receiver also may be appointed to administer and enforce any compromise or arrangement between the corporation and its creditors or stockholders to the extent authorized by a provision in the original certificate of incorporation. [7]

Alternative entity statutes generally authorize a creditor, partner, limited liability company (LLC) member, or LLC manager to seek the appointment of a receiver upon a showing of "good cause."[8] The Court of Chancery also has the power to order "judicial supervision of the winding up" of an alternative entity for "cause shown."[9] These provisions operate in conjunction with the Court's authority to decree dissolution of an alternative entity whenever "it is not reasonably practicable to carry on" the business of the entity in conformity with its constitutive document.[10]

### The Historical Prevalence of Receiverships

The pivotal event in the history of receivership law was the enactment in 1978 of the modern Bankruptcy Code. Before the Bankruptcy Code, bankruptcy was largely handled on a state-by-state basis. During the early and mid-20th century, the Delaware courts saw a large number of receivership petitions, and many Delaware receivership decisions date from the pre-Bankruptcy Code period.[11]

The title of a leading treatise — *Delaware Corporations and Receiverships* — gives some indication of the prominence of the practice area. First authored by Josiah Marvel, one of the animating forces behind the original General Corporation Law, the book went through six editions between 1923 and 1939. [12] None of the current Delaware law treatises elevate receiverships to a place of honor in the title.

Another indication of the prominence of the practice area was the adoption in 1951 of Court of Chancery Rules 148-168, which specifically address receiverships for corporations and other entities. The major non-Delaware treatises on state court receivership proceedings date from well before the Bankruptcy Code.[13]

The arrival of the Bankruptcy Code changed the landscape of insolvency-related proceedings by introducing a uniform set of federal rules. The power wielded by a federal bankruptcy judge greatly exceeds the reach of a state court judge. Most notably, the Bankruptcy Code provides for the creation of a bankruptcy estate comprised, subject to narrow exceptions, of all legal or equitable interests of the debtor in property as of the commencement of the case "wherever located and by whomever held."[14]

Of equal importance, the filing of a bankruptcy petition operates as an automatic stay that, subject to certain exceptions, immediately halts all proceedings anywhere in the world against the debtor or entity and its assets.[15] A state court cannot provide similar relief.

The federal bankruptcy court also can exercise jurisdiction over any assets of the debtor located anywhere in the United States.[16] The state court lacks similarly expansive jurisdiction.

Notwithstanding efforts by Delaware practitioners to extol the benefits of state court receivership proceedings,[17] the focus shifted to the federal bankruptcy courts.

### Receivership Proceedings Today

Despite the unqualified success of its federal cousin, the state court receivership proceeding persisted. And it survives today. Filing statistics available since the advent of e-filing in late 2003 show seven receivership petitions filed in 2004 and 10 to 13 per year from 2005 to 2009. Eleven petitions were filed in the first six months of 2010.

An unscientific search on Westlaw for receivership decisions identifies 108 between 2000 and 2009, with another five decisions to date in 2010. Although the numbers are by no means earth-shattering, they suggest a relatively steady flow of receivership cases.

Why might a petitioner prefer a Delaware receivership proceeding? According to Greg Varallo, a corporate litigator with Richards, Layton & Finger, P.A., the key drivers are speed and cost. He notes that "federal bankruptcy reorganization has become so expensive, that there are companies which are 'too poor to go bankrupt.'"

Kurt Heyman of Proctor Heyman LLP adds that procedural impediments to a federal filing can lead a client to take the state court route. In contrast to the Delaware statutes, which permit a single creditor or equity holder to petition for a receiver, commencing an involuntary bankruptcy case when the debtor has 12 or more qualifying creditors generally requires three petitioning creditors with aggregate qualifying unsecured claims of at least $13,475.[18]

The path to filing a voluntary bankruptcy petition for an entity also might be blocked by a deadlock or by a corporate governance provision that requires an unattainable super-majority vote for a bankruptcy filing.

Under these circumstances, the more flexible Delaware receivership statutes can offer a path forward. Ironically, the filing of a receivership proceeding may itself open the door to a bankruptcy filing, because the Bankruptcy Code expressly recognizes the right of disgruntled parties in interest to force a debtor into bankruptcy in certain circumstances once a receiver has been appointed.[19]

Another attractive feature of the Delaware proceeding is its flexibility, both in terms of structuring the work of the receiver and in determining who takes charge of the debtor. It was observed in 1981 that "[t]he Court of Chancery rules are very flexible and can be and are varied, in almost every case, by the court in order to meet the requirements of a particular situation."[20]

That observation remains true in 2010. Jim Patton of Young Conaway Stargatt & Taylor, LLP explains that in a receivership, the Court of Chancery is not bound by the elaborate scheme of priorities among creditors imposed by the Bankruptcy Code, but rather is "free to impose rules of distribution that are appropriate under the particular circumstances of the case."

He notes that under the Bankruptcy Code, a debtor faces several deadlines, such as the obligation to assume or reject all its executory contracts within the first 210 days of the case. No specific deadlines are imposed by state law.

Patton also cites the possibility of a judicially implemented compromise between a corporation and its creditors pursuant to Section 302 of the General Corporation Law, which he describes as "a truly tantalizing alternative to the prepackaged chapter 11."

The flexibility of a state court receivership proceeding extends to the party put in control of the debtor. In lieu of a bankruptcy trustee, whose duties and powers are generally prescribed by statute, the Court of Chancery has discretion to appoint a receiver particularly suited to the facts of the case. Because the Court of Chancery does not have a stable of receivers on call, parties typically propose their own.

Tony Clark, a litigator with a national corporate and restructuring practice at Skadden, Arps, Slate, Meagher and Flom LLP, notes that creditors who are undersecured may work with a debtor to implement a friendly foreclosure and have a mutually acceptable receiver appointed in the interim. Even in contested receiverships, a party who successfully applies for a receiver can often end up with one of its proposed candidates in charge.

Although parties can propose their own candidates, the question of whom to appoint remains one for the Court. The Court of Chancery is acutely sensitive to the risk of actual and potential conflicts, and thus the Court has an evident preference for individuals with established reputations who have earned the Court's confidence.

Not surprisingly, experienced Chancery practitioners frequently serve as receivers. Individuals from outside of Delaware may serve in conjunction with a local Delaware receiver.

The receivership petitions that have crossed my desk in my short time on the bench exemplify the considerations cited by practitioners. The petitions seem to come in three flavors. The first type is brought by a single creditor seeking the appointment of a receiver under a loan document or because the debtor is insolvent. The second type seeks the dissolution of an alternative entity and the concomitant appointment of a receiver. The last type is a catch-all for efforts by practitioners to employ the flexible receivership remedy in creative circumstances.

Single creditor petitions appear designed to take advantage of the speed and low cost of the state court proceeding. The attractiveness of receiverships for lenders received a boost in 2000 from *Dover Associates Joint Ventures v. Ingram*.[22] In that case, then Vice Chancellor, now Chief Justice Steele enforced a creditor's contractual right to the appointment of a receiver following the debtor's default under a loan agreement, even absent circumstances that otherwise would support the appointment of a receiver in equity.

For creditors who took note of *Dover Associates* and included remedial receivership provisions in their credit agreements, a state court action for specific enforcement offers a relatively fast and inexpensive alternative. Even without a contractual right to a receiver, a state court action may be attractive for a single large creditor.

The second type of receivership petition reflects how a lack of alternatives can lead parties to the receivership remedy. Non-controlling investors in alternative entities frequently file petitions seeking judicial dissolution of the entity and the appointment of a receiver. The Court of Chancery has issued a series of recent decisions adjudicating these claims.[23]

While the petitions have largely been unsuccessful, the filings are not surprising. If a non-controlling investor did not bargain for specific exit or control rights, a petition for judicial dissolution and the appointment of a receiver may be the only point of leverage available.

Particularly for small investments, parties may choose rationally not to craft extensive agreements because the upfront costs would be excessive. And no matter how frequently courts admonish parties to anticipate issues and bargain for contractual solutions, humans lack perfect foresight. There inevitably will be unanticipated situations, and those will be the situations most likely to be litigated. After all, if the parties anticipated a situation and contracted for it, then litigation should be unnecessary, or at least less likely.

With alternative entity statutes providing few default provisions, and with many entity agreements opting to eliminate fiduciary duties that otherwise could be used to fill gaps, judicial dissolution often is the only remedy available when a relationship sours or the business founders. Notwithstanding the adverse case law, I expect to continue to see these petitions.

The final catch-all category reflects the flexibility of the receivership remedy. In one recent decision, an equity holder sought a receiver to pursue claims belonging to a dissolved entity within the three-year period established by 8 *Del. C.* § 278 during which corporate existence continues post-dissolution for purposes of winding up the corporation's affairs including filing and defending lawsuits. The Court of Chancery appointed a receiver, and the Delaware Supreme Court affirmed.[22]

Creditors also have sought the appointment of a receiver where a foreclosure proceeding could trigger a change of control and risk impairing the value of the collateral.

### Conclusion

State court receivership proceedings appear to be re-emerging as a viable alternative in the practitioner's procedural playbook. Although nothing in the limited data or anecdotal evidence suggests a shift away from bankruptcy court as the primary venue for insolvency-related work, there appear to be scenarios where parties prefer the state court route. If the trend continues, it may be time to update Josiah Marvel's treatise. ◆

FOOTNOTES

1. Pub. L. No. 95-598, 92 Stat. 2549 (as amended, the "Bankruptcy Code").
2. 8 *Del. C.* § 291.
3. 8 *Del. C.* § 279.
4. 8 *Del. C.* § 226(a)(1)-(3). Section 226 authorizes the appointment under these circumstances of "1 or more persons to be custodians and, if the corporation is insolvent, to be receivers ... ." *Id.*, § 226(a).
5. *See, e.g., Tansey v. Oil Producing Royalties, Inc.*, 133 A.2d 141, 147 (Del. Ch. 1957) (appointing receiver to liquidate corporation after prolonged and extreme mismanagement).
6. 8 *Del. C.* § 322.
7. *See* 8 *Del. C.* §§ 102(b)(2) & 302.
8. *See* 6 *Del. C.* §§ 17-805 (limited partner-

(CONTINUED ON PAGE 28)





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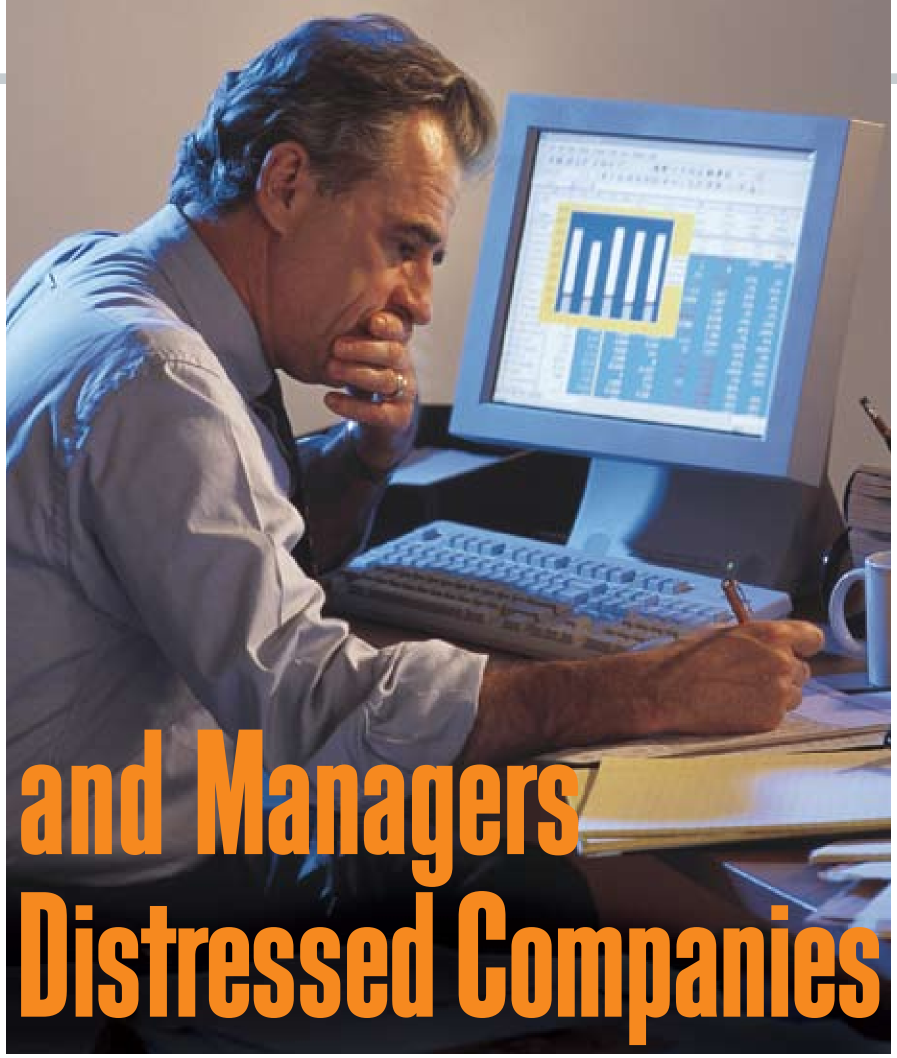


# Duties of Directors and Managers of Distressed Companies

A review of cases from Delaware's Supreme Court, Court of Chancery and Bankruptcy Court.

This article examines selected recent cases from Delaware that address the fiduciary duties of directors and managers of distressed companies, and the standards employed when reviewing the actions of directors whose companies are insolvent. The first part will summarize Delaware Supreme Court and Court of Chancery cases, and the second part will address Bankruptcy Court cases.

### Court of Chancery Decisions

Several recent decisions from the Delaware Court of Chancery provide practical insights into the standards used to review the conduct of directors who, for example, are confronted with the choice of either: (i) filing for bankruptcy; or (ii) continuing the company by means of additional financing or a sale or combination with another company.

Those choices were the subject of judicial review, each resulting in opposite outcomes, in *Binks v. DSL.net, Inc.*[1] and *Gentile v. Rossette*.[2] As will be evident from these and other cases mentioned in this article,[3] if a board satisfies the prerequisites for enjoying the benefits of the deferential business judgment rule, the courts are not likely to second-guess the decision of a board dealing with an insolvent company.

In *Binks*, the board faced the quintessential dilemma of those who govern a failing or insolvent company: whether to cut one's losses and file for bankruptcy or seek additional financing, with or without a strategic partner. The board in the *Binks* case chose the latter option and a diluted shareholder, whose $1.5 million investment became worth only $24,000, took issue with the board's decision.

The court rejected the plaintiff's

argument that bankruptcy was the preferable option, explaining that "'because there can be several reasoned ways to try to maximize value, the court cannot find fault so long as the directors chose a *reasoned* course of action.'"[4] Moreover, the court held that the board's conclusion that the financing transaction was preferable to bankruptcy was within the exercise of its business judgment, and the plaintiff's argument to the contrary did not state a claim that the board "utterly failed" to obtain the best price for the shareholders. As a result, the court granted the defendants' motion to dismiss.

By comparison, in *Gentile v. Rossette*, a controlling shareholder and director confronted with a similar "life or death" business situation did not fare as well after judicial scrutiny.

The *Gentile* case involved the rights and duties of shareholders and directors in the aftermath of a failed commercial venture. The company involved was SinglePoint Financial, Inc. The controlling shareholder, Rossette, was the only source of funding keeping the company afloat during its short and unprofitable existence.

Although the company was kept alive long enough to be purchased, within several months of the acquisition the purchaser filed for bankruptcy and the shares received as consideration by SinglePoint's former shareholders became worthless.

Prior to the sale, however, Rossette and SinglePoint's only other board member decided to improve the company's balance sheet by converting much of its debt into common stock (the "Debt Conversion"). As a result of the Debt Conversion, Rossette's equity share in SinglePoint increased from 61% to 95%.

Former minority shareholders challenged the Debt Conversion as an improper dilution of their voting and economic rights. Addressing whether the directors violated their fiduciary duties by approving the Debt Conversion, the court found that the facts demonstrated a "classic example of self-dealing by a controlling shareholder," due to Rossette's ability to determine the price of the Debt Conversion for his own benefit.

Although the only other member of the board may have been independent, he failed to follow the procedure necessary to enjoy the benefit of his independence. The court explained that: (1) this director was not acting as a one-member special committee (however inadvisable such a one-member committee would be);[5] (2) he received no independent legal or financial guidance; (3) he possessed no information from which to determine what a fair conversion price would have been; (4) there was no fairness opinion to support the pricing; and (5) when only one member of a two-person board is independent, the board is not considered independent and disinterested.

> The business judgment rule protected the board's decision to keep the company afloat during insolvency even if their strategy was not successful.

Thus, under the circumstances, the burden of justifying the Debt Conversion fell upon the directors under the entire fairness standard.[6] The sole independent director invoked the provisions of the company charter that would exculpate him from liability from money damages caused by his breach of fiduciary duty as long as he acted neither disloyally nor in bad faith.[7] The exculpatory provision pursuant to DGCL Section 102(b)(7) protected the independent director from a claim for money damages, but by contrast, the court concluded that Rossette was personally liable for money damages in a six-figure amount.

In *Shandler v. DLJ Merchant Banking Inc.*, the Court of Chancery addressed fiduciary duty claims that the bankruptcy court dismissed as a non-core proceeding.[8] In *Shandler*, the trustee alleged that a controlling stockholder — who controlled the board and was also a creditor — waited too long to file a chapter 11 bankruptcy. The Court of Chancery rejected the arguments of the trustee about the allegedly improper delay in filing bankruptcy, at times describing the complaint as incoherent and contradictory.

The court's nearly 50-page opinion describes in comprehensive detail the factual and legal support for its reasoning, but a few abbreviated bullet points highlight why the court rejected the arguments that the delay in filing for bankruptcy and the financial maneuvering by the board in the interim, was not a breach of fiduciary duty: (i) the business judgment rule protected the board's decision to keep the company afloat during insolvency even if their strategy was not successful and even if their strategy resulted in greater debt and financial distress for the company;[9] (ii) there was no reasonable inference that the delay in filing for bankruptcy benefited the majority shareholder inappropriately; and (iii) the trustee was not in a position to argue that the majority shareholder benefited itself as a senior creditor to the detriment of other creditors — even if there were a reasonable basis to infer as much from the allegations.[10]

The only claim that survived the defendant's motion to dismiss against the board had nothing to do with the financial distress or bankruptcy of the company, but survived because of the board's inability, at the early pleading stage, to establish the entire fairness of the sale of a division to an affiliated entity. This same transaction was also the basis for the survival of a claim against the company's financial advisor, for aiding and abetting a breach of the fiduciary duty of loyalty regarding the sale to an affiliated entity.

The Delaware Supreme Court — in an opinion which can no longer be described as "recent" — made it clear that the claims against directors of an insolvent company are derivative only, and the duty to creditors is triggered only when a company becomes insolvent; as opposed to when the company is operating in the (amorphous and undefined) "zone of insolvency."[11] This important decision ended years of discussion in decisional law and scholarly work regarding a "zone of insolvency," and created a "brighter line" on the subject of insolvency.

In addition, no article on the intersection of Delaware corporation law and creditor's rights would be complete without at least passing reference to the *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.* decision of the Court of Chancery, affirmed by the Delaware Supreme Court, which held that there is no cause of action in Delaware for a claim of "deepening insolvency."[12] The application of that decision is described in more detail in the next section summarizing recent Bankruptcy Court decisions.

### Bankruptcy Decisions

Decisions by the Delaware Bankruptcy Court regarding fiduciary duties of directors and officers are consistent with corporate law precepts under state law. Delaware bankruptcy judges consistently adhere to corporate law decisions by the Delaware state courts.

The Delaware Bankruptcy Court has had several occasions to apply *Trenwick*. The judges generally have rejected deepening insolvency claims no matter how alleged. In *Troll Communications*, Chief Judge Kevin Carey found that while the complaint did not expressly state such a claim, plaintiff alleged defendants "caused the corporate life of the debtors to be artificially extended beyond the point of economic viability."[13] The Court dismissed the claim.[14] However, Judge Carey added that the theory's rejection "'does not absolve directors of insolvent corporations of responsibility,' because a plaintiff retains the ability to bring an action for breach of fiduciary duty or fraud."[15]

Judge Brendan Shannon ruled similarly in *In re Fedders North America Inc.*[16] Fedders' former officers and directors were sued for breaches of fiduciary duty for, *inter alia*, approving financing of $90 million which turned out to be insufficient to avoid bankruptcy. The complaint alleged defendants approved this because they were "terrified of losing control of the family business and of losing their substantial salaries, bonus compensation and other perks."[17]

Plaintiff also challenged the adoption of "change in control" agreements and management compensation. The court held that a corporation's insolvency does not mean directors and officers "cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery."[18] Judge Shannon emphasized: "[s]imply alleging that a corporation was insolvent and took on further debt to continue operating is not enough to plead a claim for breach of fiduciary duty."[19]

> An aggrieved creditor cannot "side-step" deepening insolvency through fiduciary duty claims.

In the case of *In re Brown Schools*,[20] Judge Mary Walrath took a different approach regarding "disguised" claims for deepening insolvency by distinguishing the duties of care from duties of loyalty.[21] The Court also ruled that deepening insolvency was a valid theory of damages for breach of fiduciary duty.[22]

Judge Kevin Gross rejected a deepening insolvency claim and addressed other corporate governance issues in *In re Midway Games Inc.*[23] Pre-bankruptcy, the debtor defaulted on its bank financing. The Board formed a special committee to specifically explore and oversee negotiations with one of the controlling shareholders ("Redstone Defendants"). A $90-million loan from the Redstone Defendants resulted. The business continued to struggle and the Redstone Defendants would later sell their equity and loan interests for only $100,000. This change in control meant the debtor lost up to $700 million in net operating losses. Yet, these defendants wrote off their own losses.

After the bankruptcy filing, the creditors' committee was granted standing and sued the directors, alleging they shirked their fiduciary duties and only served the Redstone Defendants. Judge Gross found: "The clear upshot of the Committee's claims against the Board Defendants is that Midway should have filed for bankruptcy ... . Delaware law does not support such claims."[24]

The Court underscored that directors are not liable for prolonging the life of an insolvent company, and an aggrieved creditor could not "side-step" deepening insolvency through fiduciary duty claims.[25]

Judge Gross also addressed the duty of loyalty. The Court applied the established Delaware fiduciary duty law principle that, even without self dealing, directors could breach their duty of loyalty by failing to discharge their fiduciary duties in good faith.[26] Plaintiff specifically alleged a "failure to act" in violation of the Board's oversight obligation under *Caremark*.[27] The directors argued they acted in good faith.

The Court agreed: "[t]he Committee has not alleged that the Debtor suffered harm. The Redstone Defendants' infusion of money into the failing company did not damage Debtor, on whose behalf the Committee is acting."[28] The Court further held: "... the Redstone Defendants had the unfettered right to dispose of their Midway interests as they saw fit."[29]

A board's oversight obligations were further addressed by Judge Peter Walsh in *In re Bridgeport Holdings, Inc.*,[30] and *In re World Health Alternatives, Inc.*[31] In *Bridgeport Holdings*, the company, at the height of the dot-com boom, was acquired in a leveraged buyout. The company's financial situation began to deteriorate. Rounds of loan defaults and loan amendments began. Later, "M&A alternatives" were identified for the directors and officers but largely ignored as the company spiraled downward.

Eventually, its lender urged the company to retain a restructuring advisor. At the same time, the company finally made a strategic decision to sell. Yet, the only immediate action taken was contact with a defendant's acquaintance at CDW. Finally, a restructuring advisor was formally retained as the COO.

But matters only got worse. There was no sale process: (a) the COO did not hire an investment banker; (b) potential strategic buyers were stymied/ignored; (c) no financial buyers were considered; and (d) the COO quickly favored CDW as the buyer, striking a deal in two weeks. The CDW sale immediately closed at a "fire sale" price. Then the company filed for bankruptcy. Subsequently, a trust sued former directors and officers.

Judge Walsh found that a claim for breach of loyalty may be premised upon a failure to act in good faith — even if the director or officer did not act out of self-interest or was independent.[32] The Court then found sufficient support for such claims against the directors: "by abdicating crucial decision-making authority to [the COO], and then failing adequately to monitor his execution of a 'sell strategy,' resulting in an abbreviated and unenforced sale process; and approving the sale to CDW for grossly inadequate consideration."[33]

Finally, in *World Health*, Judge Walsh addressed fiduciary duty claims against an officer, former general counsel and VP of operations. World Health, a public company, provided healthcare staffing services nationwide. After raising approximately $45 million, the company made eight acquisitions. Thereafter the company's CEO engaged in fraudulent transactions that led to an admission that the company's financial reporting had been false and misleading. After this fraud was uncovered, the company hired a turnaround firm and endured an SEC investigation and securities class action suit, leading to bankruptcy.

In this decision the so-called *Caremark* line of cases was extended to an officer for the first time. The trustee alleged that general counsel breached his fiduciary duties by "failing to implement any internal monitoring system and/or failing to utilize such system as is required by *Caremark*."[34]

In denying dismissal, Judge Walsh cited the material misrepresentations within SEC filings. An SEC rule under Sarbanes-Oxley imposed an affirmative duty upon general counsel to inspect the truthfulness of SEC filings. The Court found that defendant as general counsel "had a duty to know or should have known of these corporate wrong doings and reported such breaches of fiduciary duties by the management."[35]

Defendant had argued that *Caremark* duties did not extend beyond directors to "employees," but the Court found defendant to be not just an employee, but an officer in two respects. Judge Walsh also denied dismissal of a corporate waste claim.

### Conclusion

In summary, both Delaware state and bankruptcy courts have had occasion in recent years to apply corporate governance principles in the context of insolvent companies. The difficult economic climate businesses continue to experience should result in a growing body of case law in this area. ◆

FOOTNOTES

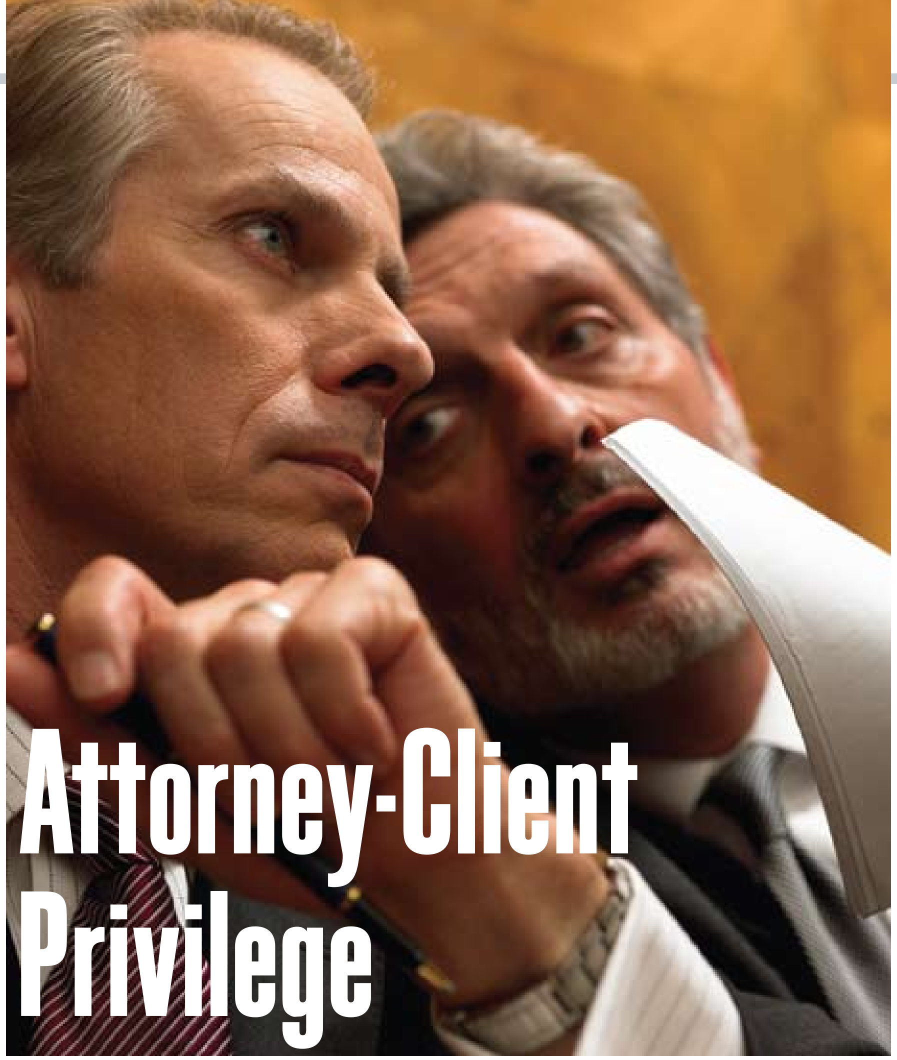
1. C.A. No. 2823-VCN, 2010 WL 1713629 (Del. Ch. Apr. 29, 2010).
2. C.A. No. 20213-VCN, 2010 WL 2171613 (Del. Ch. May 28, 2010).
3. For a list of more than 50 decisions from the Delaware Supreme Court and Court of Chancery within the recent past that have bankruptcy aspects, *see* http://www.bankruptcylitigationblog.com/archives/litigation-lore-delawares-premier-blogger-wins-important-motion-before-delawares-judge-walsh-imposing-the-caremark-fiduciary-duty-on-corporate-general-counsel.html. The link is to a post by Chicago bankruptcy lawyer, Steve Jakubowski, who compiled the list of cases in 2008 based on summaries found at www.delawarelitigation.com.
4. *Binks*, 2010 WL 1713629, at *9 (quoting *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 115 (Del. Ch. 2007)) (emphasis original).
5. *Gentile*, 2010 WL 2171613, at *7 n.36.
6. *Id.* at *8.
7. *Id.* at *12.
8. C.A. No. 4797-VCS, 2010 WL 2929654 (Del. Ch. July 26, 2010).
9. *Shandler*, 2010 WL 2929654, at *14; *see also Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006) *aff'd mem.* 931 A.2d 438 (Del. 2007) (TABLE).
10. *Shandler*, 2010 WL 2929654, at *14; *see also N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007).
11. *Gheewalla*, 930 A.2d at 99.
12. *See Trenwick Am. Litig. Trust*, 906 A.2d 168; *see generally Prod. Res. Grp., LLC v. NCT Grp., Inc.*, 863 A.2d 772, 790, n.57 (Del. Ch. 2004) (when directors are faced with competing interests of creditors and stockholders, the directors' duties are: "to the firm, and their duty is to responsibly maximize its value, a duty that might require passing a strategy that neither the stockholders nor the creditors would prefer.").
13. 385 B.R. 110, 121 (Bankr. D. Del. 2008).
14. *Id.* at 122.
15. *Id.* (quoting *Trenwick,* 906 A.2d at 205).
16. 405 B.R. 527 (Bankr. D. Del. 2009).
17. *Id.* at 542.
18. *Id.* at 541 (quoting *Trenwick*, 906 A.2d at 174).
19. *Id.*
20. 386 B.R. 37 (Bankr. D. Del. 2008).
21. *Id.* at 46.
22. *Id.* at 48, distinguishing *Seitz v. Detweiler, Hershey and Associates, P.C. (In re CitX Corp.)*, 448 F.3d 672, 677-78 (3d Cir. 2006)).
23. 428 B.R. 303 (Bankr. D. Del. 2010).
24. *Id.* at 315. (quoting *Trenwick*, 906 A.2d at 168, 218).
25. *Id.* at 316.
26. *Id.* at 318. (citing *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).
27. *See generally In re Caremark Int'l Deriv. Lit.*, 698 A.2d 959, 971 (Del. Ch. 1996) ("sustained or systematic failure of the board to exercise oversight").
28. *In re Fedders N. Am., Inc.*, 405 B.R. at 319.
29. *Id.*
30. 388 B.R. 548 (Bankr. D. Del. 2008).
31. 385 B.R. at 576.
32. 388 B.R. at 564 (citing *Stone*, 911 A.2d at 370).
33. *Id.* at 565.
34. 385 B.R. at 590 (citing *Caremark*, 698 A.2d at 967).
35. *Id.* at 591.





Henry Sill Bryans

# Bankruptcy and the Attorney-Client Privilege



**Lawyers counseling clients in financial distress may need to brush up on the finer points of privilege.**

You sit down on your back patio with a brief sigh. It's a beautiful, clear, early June evening. Friday night to boot. You are looking forward to your first weekend out of the office in over three months.

*What a rocky ride. Your best client, TurboCurrent. Seven weeks of round-the-clock workout negotiations. No closure. A free-fall chapter 11 filing. Then, just four weeks ago, the court appointed a trustee. And now, a grand jury is supposedly going to take a look at Paul Jones, TurboCurrent's CEO. The best ray of hope on that one is that you directed Paul to your old law school buddy, Charlie Black. Sharpest white collar guy in the state. Charlie should be able to make that mess go away. Your lovely spouse comes down the steps with a gin and tonic in one hand, a phone in the other, and a frown on her beautiful face.*

*"Who is it?"*

*"I think it's Paul and he sounds pretty upset," she says.*

*You take the phone reluctantly. "Paul, how are you?"*

*"Peter, get this. Charlie just told me that the AUSA thinks he can get his hands on those spreadsheets that I sent you a couple a weeks before we filed. The ones that I marked block caps "PRIVILEGED" at your direction. I told Charlie no way. I told him that I hadn't wanted to put 'em together. I told him that you said that you needed to see the whole picture. I told him that you said they would be privileged and that I, as CEO, could make sure that TurboCurrent never waived the privilege. You know and I know that it would be an unhappy day if the feds got those spreadsheets."*

*"Paul. Paul. Slow down. What spreadsheets are you talking about? The ones that seem to reflect double pledges?"*

*"Yup. Those. And get this. Charlie says that the AUSA told him that I no longer control TurboCurrent's privilege. Something about the trustee's powers, or something. I know you and I never talked about that. What's this guy smokin' anyway?"*

Lawyers of varying disciplines are frequently called upon to counsel clients in financial distress. Indeed, those who focus on that area of practice frequently have a background in both business law and litigation. Like Peter in the vignette above, all good lawyers are cognizant of the essential elements of the attorney-client privilege as set out by Judge Wyzanski more than a half century ago in *United States v. United Shoe Machinery Corp.*:

(1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of a bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client.[1]

Although Judge Wyzanski's summary might beg the question, the prevailing modern view is that, if the requisite confidentiality is maintained, the privilege also protects communications from an attorney to a client when made in the course of giving legal advice.[2]

It is also well settled that, in normal circumstances, a corporation has standing to assert the privilege with respect to communications from corporate representatives, made by or at the direction of corporate superiors, for the purpose of securing legal advice to the corporation.[3]

All of that said, now well-settled case law, as well as relatively common practices, produce a range of somewhat particularized rules with respect to the control of the client's privilege relating to prepetition communications following the commencement of a bankruptcy case.

In the vignette above, we might infer that Peter, as a seasoned practitioner, knew of these more particularized rules but failed to take them into account, or at least to advise Paul of them, when he requested that Paul prepare the potentially incriminating spreadsheets.

### Control of Privilege in Business Bankruptcies Prior to Appointment of a Trustee

If, following the commencement of a case under chapter 11, a corporate debtor remains in possession, the debtor's management bears essentially the same fiduciary obligation to creditors and shareholders as would a trustee for a debtor not in possession.[4]

Justice Marshall has stated that "the willingness of courts to leave debtors in possession 'is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee.'"[5]

Under the construct set out above, although a debtor-in-possession may initially retain control of the debtor's attorney-client privilege relating to prepetition communications, the ability to assert the privilege may be influenced by the debtor's fiduciary responsibilities.

### Control of Privilege in Business Bankruptcies After Appointment of a Trustee

Section 1104(a) of the Bankruptcy Code provides for the appointment of a trustee in a case filed under chapter 11 for, among other things, "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management ... or similar cause" or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."

That said, trustee appointments in cases under chapter 11 are relatively rare. On the other hand, if the bankruptcy has been filed under chapter 7, or if the case is subsequently converted to a proceeding under chapter 7, Sections 701 and 702 of the Bankruptcy Code provide respectively for the appointment or election of a trustee.

In our vignette above, Peter may well have sensed that grounds existed for the appointment of a trustee in TurboCurrent's chapter 11 filing.

In *Commodity Futures Trading Commission. v. Weintraub*, the Supreme Court explained: "Because the attorney-client privilege is controlled, outside of bankruptcy, by a corporation's management, the actor whose duties most closely resemble those of management should control the privilege in bankruptcy, unless such a result interferes with policies underlying the bankruptcy laws."[6]

The Court reasoned further that "[i]n light of the Code's allocation of responsibilities, it is clear that the trustee plays the role most closely analogous to that of a solvent corporation's management."[7] *Weintraub* has been cited countless times by courts for its main holding, and remains controlling law in the context of entity bankruptcies. But, as will be seen below, its underlying rationale is not transferrable to individual bankruptcies.

Now Peter doubtlessly had a longstanding relationship with Paul. Perhaps Peter was also acting as Paul's personal counsel,[8] in which event Paul should be able to assert the privilege in his own name. That argument is frequently made, but the facts rarely support such a conclusion and the courts have not generally been receptive to it.

For starters, it is unlikely that Paul could produce an engagement letter from Peter's firm for personal legal services (except, perhaps for personal matters unrelated to Peter's role as CEO of TurboCurrent), or an invoice from Peter's firm for such services, or a check that Paul had written to Peter's firm for such services.

Beyond that, courts have set out a series of hurdles that Paul would likely be unable to negotiate. For example, in *In re Bevill, Bressler, & Schulman Asset Mgmt. Corp.*,[9] the Third Circuit was presented with a claim by corporate officers, in the face of a waiver of the corporation's attorney-client privilege by the trustee, that they had a separate, personal attorney-client privilege in communications that they had made to corporate counsel.

The *Bevill* court held that "any privilege that exists as to a corporate officer's role and functions within the corporation belongs to the corporation, not the officer." *Bevill* then adopted a five-part test that must be satisfied before a corporate officer or employee could successfully assert a personal attorney-client privilege:

First, they must show they approached [counsel] for the purpose of seeking legal advice. Second, they must demonstrate that when they approached [counsel] they made it clear that they were seeking legal advice in their individual rather than in their representative capacities. Third, they must demonstrate that the [counsel] saw fit to communicate with them in their individual capacities, knowing that a possible conflict could arise. Fourth, they must prove that their conversations with [counsel] were confidential. And, fifth, they must show that the substance of their conversations with [counsel] did not concern matters within the company or the general affairs of the company.[10]

The *Bevill* test has been expressly adopted in a number, but not all, of the other circuit courts. Some courts have interpreted the fifth test in a manner slightly less harsh to the individual.[11] Under our facts, it seems highly unlikely that Paul would prevail on all five hurdles in the *Bevill* test, and particularly the last, with respect to the spreadsheets. Even in jurisdictions that do not follow *Bevill*, Paul has a hard, uphill battle.

Nonetheless, Paul was the corporate representative of TurboCurrent at the time Peter requested that the spreadsheets be prepared and, in that capacity, he was likely entitled to some fair warning from his counsel of the potential effect of *Weintraub* if the workout was unsuccessful and if the cards played out in the manner that they subsequently did.

### Of and Concerning Examiners

Under Section 1104(c) of the Bankruptcy Code, if a court does not appoint a trustee it may, after notice and a hearing, appoint an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of "fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor."

An examiner does not have the statutory power that a trustee has under Section 1108 of the Bankruptcy Code "to operate the debtor's business" or the power under Section 363(c) of the Bankruptcy Code to use, sell or lease the debtor's assets in the ordinary course of business without court approval.

Thus, on the face of the statute, the rationale that the *Weintraub* court used to analogize a trustee to the debtor's management is not readily applicable to an examiner. Absent special circumstances,[12] an examiner would not ordinarily, solely by reason of such appointment, control the debtor's attorney-client privilege relating to prepetition communications.

That said, many examiners are expressly given such power in the order appointing them because the debtor's new board of directors desires to be forthcoming and cooperative with the court and creditors.[13] In large bankruptcy cases marked by allegations of fraud, such negotiated examiner orders are not uncommon and can provide a viable alternative to the appointment of a chapter 11 trustee or the conversion of a case to chapter 7 (and the necessary subsequent appointment of a trustee).

### Personal Bankruptcies

The rationale applied by the *Weintraub* court is inapposite in a personal bankruptcy. The *Weintraub* court stated that "[i]f control over that privilege passes to a trustee [in a personal bankruptcy], it must be under some theory different from the one that we embrace in this case."[14]

For purposes of this article, it is sufficient to note that bankruptcy courts have reached marked different results on the ability of a trustee to control the attorney-client privilege relating to the prepetition communications of an individual debtor.

Though some courts have taken a fairly flat-footed position that an individual debtor retains control of the privilege, at least in the first instance,[15] others reflect the view that control of the privilege uniformly divests to the trustee.[16] Still others have balanced the value to the estate of permitting the trustee to control the individual debtor's attorney-client privilege against the harm to the debtor in doing so.[17]

When counseling an individual contemplating personal bankruptcy, it is obviously necessary to understand the controlling case law in the jurisdiction in which the client would file, recognizing that different judges within the same district may have different views on this issue.

### Conclusion

Advising clients in financial difficulty can be exhausting and stressful, especially for lawyers who do not make their living primarily in the restructuring field. Many difficult factual and legal issues come into play, and negotiations with creditors and others are often intense.

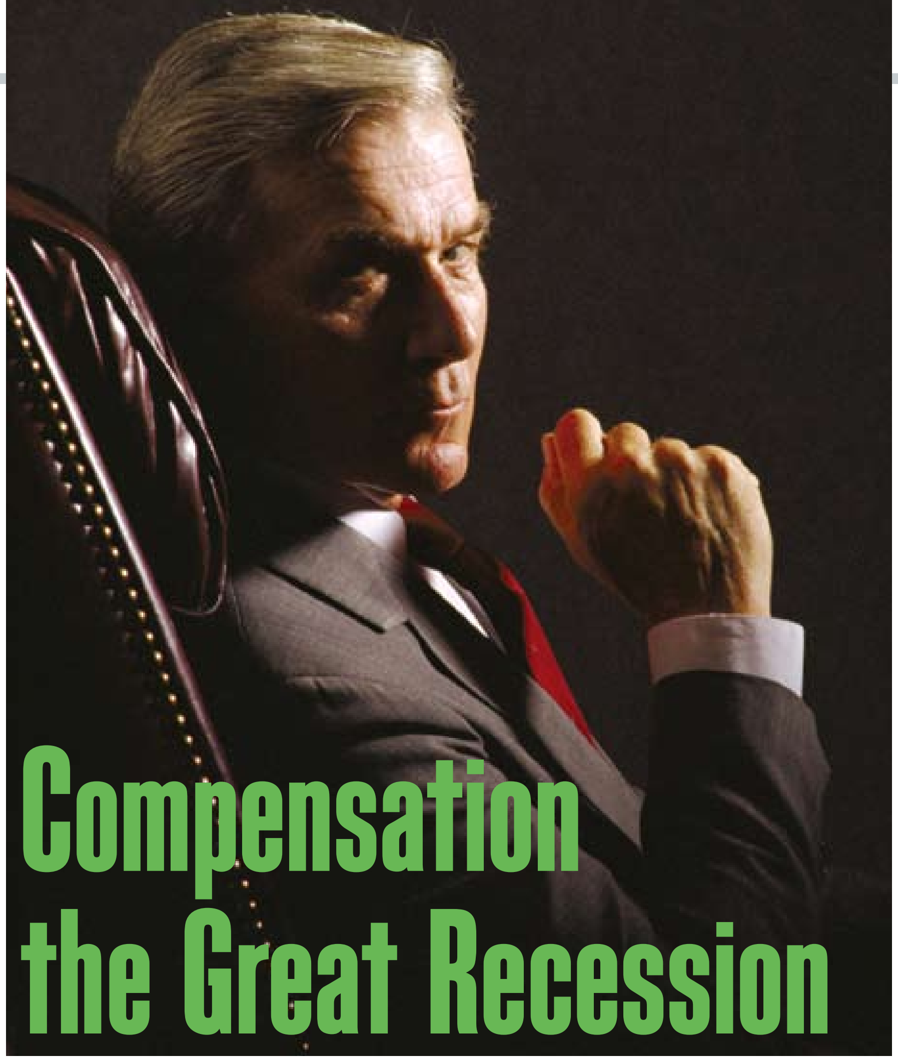
In that context, the client's attorney-client privilege is not likely an item high on the list of many lawyers who find themselves in such a role. But it should be. All lawyers advising financially distressed clients need to understand — and clearly communicate to the client — the potential loss of control of the client's attorney-privilege relating to prepetition communications that could result from the commencement of a bankruptcy proceeding.

That potential loss of control is not a reason to cease the candid give and take necessary between lawyer and client in attempting to work through a client's financial travails. Nor is it a reason not to commence a case in bankruptcy if the facts otherwise warrant it.

It is, however, a reason for both clients facing a potential bankruptcy, and their counsel, to proceed with caution. Both client and counsel must acknowledge that the presumed confidential exchanges of information and advice between client and lawyer that the attorney-client privilege seeks to protect may become subject to the control of a relative stranger with a substantially different agenda than the client had at the time that legal counsel was provided. ◆

(CONTINUED ON PAGE 28)

Gregg M. Galardi
Bruce Grohsgal



# Executive Compensation and the Great Recession

Fundamental policy differences between Delaware corporate law and federal law have shaped their respective approaches to executive compensation.[1]

"One of the great, as-yet-unsolved problems in the country today is executive compensation and how it is determined." [2]

— *SEC Chairman William Donaldson, 2003*

Since executive compensation came into national focus in the 1930s, lawmakers and courts in the United States have attempted to adequately address issues raised by this vexing topic.[3] Most recently, public outcry over perceived inequities arising out of the financial crisis have prompted federal regulators to implement unprecedented limits on the compensation of certain company executives.

These new federal regulations illustrate a fundamental difference in the policies behind Delaware corporate law and federal law on the issues surrounding executive compensation.

This article discusses select aspects of two types of executive compensation laws: (1) Delaware corporate law on executive compensation and (2) federal law on executive compensation at financially troubled companies. This article then briefly discusses the fundamental differences between the approaches these two types of law have taken in regard to executive compensation, and, finally, articulates some of the arguments for and against each approach.

## Delaware Corporate Law On Executive Compensation

"Directors have the power, authority, and wide discretion to make decisions on executive compensation" under existing Delaware law.[4] Delaware law has historically recognized two primary duties that directors owe to the corporation they serve: the duty of care and the duty of loyalty.[5]

The duty of loyalty applies where a director, officer or controlling shareholder has a financial conflict of interest that poses "a serious risk that this personal interest would cause her to make a decision that was not in the best interests of the corporation."[6]

The duty of care is governed by the business judgment rule, which affords considerable deference to directors. "The court presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'"[7]

The outer limit of the duty of care in compensation cases traditionally has been the doctrine of waste, under which a court will not defer to a board's decision because the compensation bears no reasonable relationship to the value of the services rendered.[8] Yet, "cases in which it is possible to demonstrate 'waste' are — like the Loch Ness Monster — so rare as to be possibly nonexistent."[9]

The Delaware Supreme Court and Chancery Court explored executive compensation's outer limits when they considered the Disney board's decisions (i) to approve the hiring of Michael Ovitz as president (and second in command to the CEO, Michael Eisner) of the company under a contract that contained very generous terms, and (ii) after the board was reconstituted, the approval of a 'no-fault' termination of Ovitz's brief employment that resulted in the payment to Ovitz of more than $130 million. After setting forth examples of "bad faith" activity, the Delaware Supreme Court stated that "the sheer size of the payout to Ovitz, as alleged, pushes the envelope of judicial respect for the business judgment of directors in making compensation decisions."[10]

Yet Ovitz's compensation and the directors' good faith were upheld, notwithstanding the board's being "stacked" with friends of the CEO, Eisner.[11] The Delaware Supreme Court has since noted that reasonable doubts as to director independence may arise because of "a particularly close or intimate personal or business affinity."[12] In *Stone v. Ritter*, decided subsequently, the Delaware Supreme Court characterized "good faith" discussed in Disney as a subsidiary element of the duty of loyalty.[13]

## Federal Law On Executive Compensation — EESA and AARA

The Emergency Economic Stabilization Act Of 2008 (the "EESA") and the American Recovery And Reinvestment Act Of 2009 (the "ARRA") have implemented substantial restrictions on the ability of certain financially troubled companies to exercise their business judgment in regard to executive compensation.

In 2008, the EESA was signed into law.[14] The EESA instituted a number of restrictions on the compensation that companies which received money through the federal Troubled Asset Relief Program ("TARP") could pay to their executives while the company still had outstanding TARP obligations. Those restrictions included limitations on golden parachute payments and reductions to the amount of executive compensation which was deductible for purposes of federal taxation.[15]

The outer limit of the duty of care in compensation cases traditionally has been the doctrine of waste.

In 2009 the ARRA amended the EESA by expanding executive compensation limits for TARP-participating companies. The ARRA limited certain incentive-based executive, golden parachute payments, and luxury expenditures.[16] Further, it required establishment of both independent board compensation committees and systems giving shareholders the opportunity to cast non-binding "say on pay" votes to approve compensation of executives.[17]

Notably, a similar non-binding "say on pay" requirement, along with other executive compensation-related legislation, was recently passed as part of the Dodd-Frank Act for all publicly traded companies.[18]

Last, the ARRA empowered the Treasury Department to promulgate limits on executive compensation at TARP-participating companies.[19] The Treasury Department, acting under this authority, has generally imposed a salary cap of $500,000 (exclusive of long-term restricted stock) for executives who work at companies receiving "exceptional assistance" under the TARP program.[20]

## The Bankruptcy Code

Key employee retention, severance and bonus programs (often called "KERPs") were common in bankruptcy cases prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The rationale for KERP programs was the debtor's need to retain key employees during a period of great business insecurity when employees are most likely to accept employment elsewhere, in order to maximize the likelihood of a successful reorganization and the value of the debtor's estate for the benefit of its creditors.

Court approval has always been required for a debtor's implementation of a post-petition KERP program. Pre-BAPCPA, KERPs usually were considered under the business judgment standard of Bankruptcy Code section 363(b).[21]

The effort to amend the law affecting KERPs, as part of BAPCPA, arose late in the legislative process under the section "Preventing Corporate Bankruptcy Abuse." A representative of the United Steel Workers of America, AFL-CIO, testified on the amendment and argued that when workers employed by a bankrupt company learn of them, "it puts our bankruptcy system in a bad light and often makes the difficult choices required in bankruptcy even harder to achieve."[22]

BAPCPA's amendment to Bankruptcy Code section 503(c) expressly excludes many proposed KERP and severance plan payments to "insiders" — a term that typically captures most officers and directors — from section 503(b) administrative claim status. The effect of denying administrative claim status to any such payments under section 503(b) of the Bankruptcy Code can be severe.

At least one court has held in a pre-BAPCPA decision that the "holder of a post-petition 'claim' that is not entitled to administrative expense priority" is not a creditor, cannot file a proof of claim, cannot "by definition" have an allowed claim (even a general unsecured claim), and cannot demand a plan distribution.[23]

The KERP amendments to the Bankruptcy Code have resulted in debtors proposing management and other employee incentive plans ("MIPs"), instead of the key employee retention or severance plans that were more common prior to the 2005 BAPCPA amendments. MIPs require the debtor to reach certain, usually economic, benchmarks prior to the payment of bonuses to the management.

The Bankruptcy Court in most cases must approve a MIP under Bankruptcy Code section 363(b)(1).[24] Most battles for the approval of a MIP have been over whether the proposed benchmarks that trigger the incentive payments are set high enough that the management and other employees must reach to achieve them, and the Bankruptcy Courts have been sensitive to the fact that a MIP with too low a benchmark is nothing more than a disguised KERP or severance plan.[25]

As a result, the BAPCPA KERP amendments arguably resulted in considerably greater pay for performance in bankruptcy cases than had existed prior to their enactment. Generalizing these requirements to compensation of executives of non-bankrupt companies is problematic, however, if only because most MIPs are focused only on the short-term demands on the company (e.g., the immediate goal of a going concern sale of the enterprise), and especially because of the unique requirement of prior court approval in a bankruptcy case.

### Conflicting Approaches

Delaware law, and most modern corporate law, has shown justifiable deference to market forces and to the decisions of directors who act for the enterprise in the marketplace. The rule arguably is no different in the area of executive compensation: if corporations need to pay well in order to recruit the best talent, they should be allowed to do so.

In certain circumstances, a high degree of skill could provide a huge benefit, whether in a competitive sport or in a business context. Additionally, one could argue that there is a market for executive services, and that it is appropriate to adopt the prevailing wage for a particular "skill set."[26]

> The KERP amendments arguably resulted in considerably greater pay for performance in bankruptcy cases than had existed prior to their enactment.

The Delaware courts' deference to the business judgment of the board is an acknowledgment of the ultimate value of market forces. The value of such market forces, however, has been sharply criticized by federal regulators. Indeed, a distrust of market forces appears to be the basis for the recent federal regulations discussed above. Therefore, the fundamental bases for Delaware law and federal law appear to be at odds.

Professors Lucian Bebchuk and Jesse Fried have forcibly argued that boards of directors do not in fact negotiate executive pay at arm's-length; but, rather, companies delegate the task of working out the details of executive compensation packages to compensation committees composed of directors who are not truly independent.[27]

By setting high executive compensation, independent directors risk a corresponding reduction in the value of their stock holdings and damage to reputation for integrity, but Bebchuk and Fried reason that an independent director's holdings are usually "insignificant" and that a "reputation for challenging CEO compensation is likely to be viewed as a minus, not a plus, by other firms' [board] nominating committees."[28]

Moreover, compensation consultants typically rely on comparables in advising their corporate clients on compensation matters. In turn, companies have had a marked tendency to compensate chief executives at levels somewhat above the mean or median of the range of pay packages for similar executives, thereby naturally ratcheting up pay overall.

Further, as Vice Chancellor Strine notes, the power of individual shareholders to limit executive compensation is restrained by the fact that "the equity of public corporations is often owned, not by the end-user investors, but by another form of agency, a mutual fund, or other institutional investor. It is these intermediaries who vote corporate stock and apply pressure to public company operating boards."[29]

Strine points out that "these so-called stockholders may disproportionately strengthen the hand of activist institutions that have short-term or non-financial objectives that are at odds with the interests of individual index fund investors."[30]

The ever-present and justifiable reticence of the courts to countermand a board's business judgment, the dynamics of board decision-making in the area of executive compensation, and the absence in widely-held corporations of significant shareholder blocks willing or able to affect outcomes by replacing directors who might better protect shareholders' interests, all suggest that the solution to the problem of executive compensation (if there is one) may lie elsewhere than in the rules that generally govern review of decisions made by directors in the boardroom. Yet prior statutory fixes have proven ineffectual.

Some have argued that new limits on executive compensation would do little to avoid financial instability going forward because "[t]o the extent that compensation contributed to increasingly riskier investment activities, executive compensation was only a small contributing factor. Everyone from rank-and-file local loan officers at commercial banks to financial industry CEOs and GSE [e.g., Fannie Mae] executives had a stake in originating and securitizing prime and subprime mortgages … ."[31]

In that same vein, it has been argued that the deregulation of the financial industry generally, including home mortgage lending, and the emergence of new markets that are opaque and poorly regulated — such as the $60-trillion credit default swaps market — may have been more significant causal factors, and transparency and re-regulation the more effective remedy.[32]

Some have rejected all mandatory executive compensation regulation and instead called upon executives to voluntarily reduce their compensation and "remedy the executive compensation [problem, if any] on its own — to 'heal thyself.'"[33]

### Conclusion

Former Chancellor Allen has posed the question of what function we want executive pay to serve and how we decide whether or not there is problem with it.[34] If, in response to that question, we decide that we want executives' pay to serve the function of maximizing the long-term success of the enterprise that they serve, then it is difficult in the midst of the present economic downturn to deny that there is a problem that needs fixing.

The most significant break-downs are both substantive and procedural. Substantively, pay is too often tied to performance incentives that exist in name only. More dangerously, it is tied to short-term gains, encouraging excessive risk-taking over the longer term, such as AIG's entering into tens of billions of dollars of credit default swaps that were "profitable" (and triggered the payment of significant employee bonuses) only until the underlying instruments that AIG had insured with the swaps defaulted and AIG faced its own demise absent the government's (and taxpayers') bailout.

Procedurally, there is a strong argument that the group dynamics of the modern boardroom and the absence of effective shareholder influence (albeit of an institutional nature itself) impede beneficial executive compensation arrangements, and that existing and most proposed law do not address these concerns.

If action is to be taken, the high-wire act for the state and federal courts, legislatures and other regulators will be to find the balance between supplanting the board's business judgment with their own and channeling that judgment in a positive direction. ◆

*The views expressed herein are not necessarily shared by the firms with which the authors are associated.*

## FOOTNOTES

1. This article is based on a panel discussion, and materials distributed in connection therewith, which took place at Widener Law School on May 24, 2010, on the topic of "The Intersection of Federal Bankruptcy and State Corporate Law." The discussion was moderated by Juliet M. Moringiello and the panelists, in addition to the authors of this article, included Charles M. Elson, Michelle M. Harner, the Honorable Brendan L. Shannon, and the Honorable Leo E. Strine, Jr. The authors would like to thank Joshua J. Bugay and Jarrett K. Vine for their help with this article.
2. SEC Chairman William Donaldson, 2003, quoted in Lucian A. Bebchuk and Jesse M. Fried, Pay Without Performance: The Unfilled Promise Of Executive Compensation 1 (2004) (hereinafter, "Pay Without Performance").
3. Harwell Wells, "No Man Can Be Worth $1,000,000 A Year": The Fight Over Executive Compensation In 1930s America, 44 U. Rich. L. Rev. 689 (January 2010).
4. *Brehm v. Eisner*, 746 A.2d 244, 262 (Del. 2000).
5. Claire Hill and Brett McDonnell, Executive Compensation and the Optimal Penumbra of Delaware Corporation Law, 4 Va. L. & Bus. Rev. 333, 338 (Fall 2009).
6. *Id.* at 338-339.
7. *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009) (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).
8. *See e.g., Brehm v. Eisner*, 746 A.2d at 259-263 (Del. 2000). *See also Steiner v. Meyerson*, 1995 WL 441999 at 1 (Del.Ch. July 19, 1995).
9. Pay Without Performance, *supra*, at n. 2 (citing *Steyner v. Meyerson*, 1995 WL 441999 (Del. Ch. July 19, 1995).
10. *Brehm v. Eisner*, 746 A.2d at 249.
11. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 & 760 (Del. Ch. 2005).
12. *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004).
13. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369-370 (Del. 2006).
14. As noted herein, several provisions of the EESA have been amended by the ARRA. To obtain a copy of the un-amended provisions of the EESA, refer to 122 Stat. 3765.
15. EESA, 122 Stat. 3765 (2008).
16. ARRA, 12 U.S.C.A. § 5221.
17. ARRA, 12 U.S.C.A. § 5221.
18. Dodd-Frank Wall Street Reform And Consumer Protection Act, Pub.L. 111-203, 124 Stat. 1376 (2010), Subtitle E--Accountability and Executive Compensation.
19. ARRA, 12 U.S.C.A. § 5221.
20. 31 C.F.R. § 30.
21. 11 U.S.C. § 363(b).
22. Testimony of Dave McCall, Director, United Steel Workers of America, AFLCIO, to the U.S. Senate Committee on the Judiciary, "Bankruptcy Reform," February 10, 2005 available at http://judiciary.senate.gov/hearings/testimony.cfm?id=1381&wit_id=3994 (last visited September 9, 2010).
23. *In re Ockerlund Construction Company*, 308 B.R. 325, 331-332 (Bankr. N.D. Ill. 2004).
24. 11 U.S.C. § 363(b)(1).
25. Post-BAPCPA cases involving MIPs, KERPs and severance plans include: *In re Nellson Nutraceutical, Inc.*, 369 B.R. 778 (Bankr. D. Del. 2007); *In re Dana Corp.*, 358 B.R. 567 (Bankr. S.D.N.Y. 2006); and *In re Airway Indus., Inc.*, 354 B.R. 82 (Bankr. W.D. Pa. 2006).
26. Miriam A. Cherry and Jarrod Wong, Clawbacks: Prospective Contract Measures in an Era of Excessive Executive Compensation and Ponzi Schemes, 94 Minn. L. Rev. 368, 378-379 (Dec. 2009).
27. Pay Without Performance, at 23-44.
28. *Id.*, at 34-36.
29. Leo E. Strine, Jr., Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance, 33 J. Corp. L. 1, 7 (Fall 2009).
30. *Id.*
31. Janice Kay McClendon, The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, And Corporate Greed Provide A Wake-Up Call For Reforming Executive Compensation, 12 U. Pa. J. Bus. L. 131, 136 (Fall 2009).
32. *Id.*
33. Nathan Knutt, Executive Compensation Regulation: Corporate America, Heal Thyself, 47 Ariz. L. Rev. 493, 495 (2005), citing Luke 4:23 (King James) ("Physician, Heal Thyself").
34. Practitioner Notes, Current Issues in Executive Compensation, 3 N.Y.U. J. L. & Bus. 519, 520-521 (Spring 2007).

## SILOS, CORPORATE LAW, AND BANKRUPTCY LAW (from page 10)

9. 11 U.S.C. §1129(b); *see also, e.g., In re Zenith Elecs. Corp.*, 241 B.R. 92, 105-07 (Bankr. D. Del. 1999).

10. 11 U.S.C. §1129(b)(2)(A)(i)(II).

11. *Exide Technologies*, 303 B.R. at 65, *quoting Grp. of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.R. Co.*, 318 U.S. 523, 540 (1943).

12. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996).

13. As exemplified recently by the auction sale of the firm that owns the Philadelphia Inquirer. *See* Sophia Pearson, *et al.*, "Philadelphia Inquirer Lenders' $139 Million Bid Wins Auction" (April 29, 2010) (available at http://www.businessweek.com/news/2010-04-29/philadelphia-inquirer-lenders-139-million-bid-wins-auction.html).

14. *M.G. Bancorp, Inc. v. LeBeau*, 737 A.2d 513, 525 (Del. 1999).

15. *Exide Technologies*, 303 B.R. at 65, *citing Matter of Penn Central Transp. Co.*, 596 F.2d 1102, 1115-16 (3d Cir. 1979).

16. I have so contended. *See Rationalizing Appraisal Standards, supra*, 50 B.C. L. Rev. at 1034-1037.

17. *See, e.g., Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 357-358 (Del. Ch. 2004); *Applebaum v. Avaya, Inc.*, 812 A.2d 880, 889-890 (Del. 2002); *but cf. Global GT LP v. Golden Telecom, Inc.*, 993 A.2d at 508.

18. *See, e.g., VFB LLC v. Campbell Soup Co.*, No. Civ. A. 02-137, 2005 U.S. Dist. LEXIS 19999, 2005 WL 2234606, at *22 (D. Del. Sept. 13, 2005), *aff'd* 482 F.3d 624, 633 (3d Cir. 2007) (for purposes of evaluating debtor company's solvency, company's stock price is an "ideal datapoint" for determining value, and "[a]bsent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'").

19. *See, e.g., Gonsalves v. Straight Arrow Publishers, Inc.*, 1996 Del. Ch. LEXIS 144, *2 (Del. Ch., Nov. 27, 1996), rev'd, 701 A.2d 357 (Del. 1997); *Exide Technologies*, 303 B.R. at 59 (although both experts used similar methods, "the end results of their valuations were far from similar.").

20. *See, e.g., Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 310-311 (Del. Ch. 2006).

## THE CHANCERY RECEIVERSHIP: ALIVE AND WELL (from page 16)

ship), & 18-805 (limited liability company).

9. *See* 6 *Del. C.* §§ 15-803 (general partnership), 17-803 (limited partnership), 18-803 (limited liability company).

10. *See* 6 *Del. C.* §§ 15-801(5) (general partnership), 17-802 (limited partnership), 18-802 (limited liability company).

11. A 1982 article by then-practitioner, now Justice Jack B. Jacobs provides an overview of the extensive decisional law. *See* Jack B. Jacobs, *Delaware Receivers and Trustees: Unsung Ministers of Corporate Last Rites*, 7 Del. J. Corp. L. 251 (1982) [hereinafter *Last Rites*].

12. *See* Josiah Marvel, Delaware Corporations & Receiverships (6th ed. 1939). The fifth and sixth editions were published by members of the Marvel, Morford & Logan firm after Mr. Marvel's death.

13. *See, e.g.*, Ralph E. Clark, Law of Receivers (3d ed. 1959); William A. Alderson, A Practical Treatise on the Law of Receivers (1905); Charles Beach Fisk, A Practical Treatise on the Law of Receivers (2d ed. 1897); James L. High, A Treatise on the Law of Receivers (3d ed. 1894); James Fraser Gluck, The Law of Receivers of Corporations (1891).

14. 11 U.S.C. § 541 ("Property of the estate").

15. 11 U.S.C. § 362 ("Automatic stay").

16. 28 U.S.C. § 1334(e).

17. *See, e.g.*, Jacobs, *Last Rights, supra*; Jack B. Jacobs, *Receivership Practice in the Delaware Courts*, 6 Del. J. Corp. L. 487 (1981) [hereinafter *Receivership Practice*].

18. 11 U.S.C. § 303(b).

19. *See* 11 U.S.C. § 303(h)(2).

20. *See* Jacobs, *Receivership Practice, supra*, at 487.

21. *See* 11 U.S.C. § 704 ("Duties of trustee"), & 11 U.S.C. § 1106 ("Duties of trustee and examiner").

22. 768 A.2d 971 (Del. Ch. 2000).

23. *See In re Arrow Inv. Advisors, LLC*, 2009 WL 1101682, at *2 (Del. Ch. Apr. 23, 2009); *Spellman v. Katz*, 2009 WL 418302, at *3 (Del. Ch. Feb. 6, 2009); *In re Seneca Inv. LLC*, 970 A.2d 259 (Del. Ch. 2008); *In re Silver Leaf, L.L.C*, 2005 WL 2045641, at *10 (Del. Ch. Aug. 18, 2005); *Apple Computer, Inc. v. Exponential Tech., Inc.*, 1999 WL 39547, at *8-9 (Del. Ch. Jan. 21, 1999) *Giancarlo v. OG Corp.*, 1989 WL 72022, at *2-4 (Del. Ch. June 23,1989).

24. *In re Texas E. Overseas, Inc.*, 2009 WL 4270799 (Del. Ch. Nov. 30, 2010), *aff'd mem.* 2010 WL 318266 (Del. June 24, 2010).

## BANKRUPTCY AND THE ATTORNEY-CLIENT PRIVILEGE (from page 23)

*These materials do not constitute and should not be relied upon as legal advice. The views expressed in these materials are those of the author and do not necessarily reflect the views or policies of his employer.*

FOOTNOTES

1. 89 F.Supp. 357, 359 (D. Mass. 1950).

2. *See, e.g.*, Unif. R. Evid. 502(b)(1); Restatement (Third) of the Law Governing Lawyers §68 (2000); *In re LTV Sec. Litig.*, 89 F.R.D. 595, 602-603 (N.D. Tex. 1981). But *see, e.g., Nationwide Mut. Ins. Co. v. Fleming*, 924 A.2d 1259, 1268-69 (Pa. Super. 2007), *aff'd by an equally divided court*, 992 A.2d 65 (Pa. Jan 29, 2010) (construing a Pennsylvania statute on the attorney-client privilege to a more limited result).

3. *Upjohn Co. v. U.S.*, 449 U.S. 383 (1981).

4. *Wolf v. Weinstein*, 372 U.S. 633, 649-652 (1963).

5. *Commodity Futures Trading Comm'n. v. Weintraub*, 471 U.S. 343, 355 (1985) (quoting *Wolf*, 372 U.S. at 651).

6. *Weintraub*, 471 U.S. at 351-52.

7. *Id.* at 355.

8. Although Model Rules of Prof'l Conduct R. 1.13 (a) provides that a lawyer for an organization represents the organization and not, by reason of such engagement, its constituents, including members of management, paragraph (g) of the Rule permits simultaneous representation of members of management so long as (1) there is no conflict with the organization, or (2) consents to such representation are obtained in the manner there provided.

9. 805 F.2d 120 (3d Cir. 1986).

10. *Id.* at 123 (quoting *In re Grand Jury Investigation*, No. 83-30557, 575 F.Supp. 777 (N.D. Ga.1983)).

11. *See, e.g., U.S. v. Stein*, 463 F. Supp. 2d 469 (S.D.N.Y. 2006).

12. *See, e.g., In re Boileau & Johnson, Inc.*, 736 F.2d 503 (9th Cir. 1984).

13. *See* Martin J. Bienenstock, *et al., Response To "Routine Illegality In Bankruptcy Court, Big-Case Fee Practices,"* 83 Am. Bankr. L.J. 549, 554 (Fall 2009) (describing the appointment of the examiner in the Enron bankruptcy proceeding).

14. *Weintraub*, 471 U.S. at 356-57.

15. *See, e.g., McClarty v. Gudenau*, 166 B.R. 101 (E.D. Mich. 1994).

16. *See, e.g., In re Smith*, 24 B.R. 3, 4 (Bankr. S.D. Fla. 1982).

17. *See, e.g., In re Bazemore*, 216 B.R. 1020 (Bank. M.D. Fla. 1988) (vesting the trustee with control of the privilege on a discrete issue because there was a potential benefit to the estate and the debtor would not be harmed); *S.E.C. v. Marker*, No. 1:02CV01109, 2006 WL 288426 (M.D.N.C. Feb. 6, 2006) (denying a receiver control based on a similar balancing analysis).

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