Proper Burial:
How to Advise Your Corporate Clients When the End is Near

Bar Association of San Francisco

April 27, 2011

PIVOTPOINTLAW
A Professional Corporation

GOALS

- **Avoid or minimize director/officer liabilities**
- **Appropriate vehicle to bring company to an end**
- **If possible, maximize recovery for creditors**

AGENDA

- **Five hypos on director/officer fiduciary obligations**
- **Three common ways to bring an end to a corporation**
  - ❑ Corporate dissolution
  - ❑ Chapter 7 bankruptcy
  - ❑ Assignment for benefit of creditors (“ABC”)

Director/Officer Fiduciary Obligations

HYPOTHETICAL #1

- **Technology, Inc., Delaware corporation**
- **$300,000 in cash**
- **$1.5M owed to creditors**
- **Never been profitable; IP of dubious value**
- **$100,000-$150,000/ month burn rate; maybe last 2-3 months**
- **Creditors**
  - ❑ A few have filed suits to collect against company
- **Bob (founder, CEO, director, and shareholder)**
  - ❑ Wants to keep pursuing business lead which could generate much-needed revenue; “Never give up!”
- **Board**
  - ❑ Concerned about fiduciary obligations to creditors
  - ❑ Concerned about making decisions that might make company more insolvent than it is right now
  - ❑ Board seeks your advice

HYPOTHETICAL #1: ANALYSIS

- ***Credit Lyonnais Bank Nederland NV v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991)**
  - Directors of corporation that is insolvent or in the "zone of insolvency" owed fiduciary obligations to the "community of interests" that includes creditors
  - Shareholders with nothing to lose might take undue risk with the remaining corporate assets, at the expense of creditors
  - But how do you reconcile obligations owing to shareholders and creditors, who may have different agendas?
  - Confusions about what kind of conduct might give rise to personal liability

HYPOTHETICAL #1: ANALYSIS (CONT'D)

- ***North Atlantic Catholic Educational Programming, Inc. v. Gheewalla et al.*, 930 A.2d 92 (Del. 2007). Two key rulings:**

  - ❑ Whether the corporation is in the zone of insolvency or actually insolvent, creditors may not bring direct action against the directors for breach of fiduciary duty
  - ❑ When the corporation is in fact insolvent, creditors have standing to maintain derivative claims against directors on behalf of the corporation for breach of fiduciary duties

HYPOTHETICAL #1: ANALYSIS (CONT'D)

- ***Gheewalla* significant for two reasons:**
  - ❑ Eliminates "zone of insolvency"
  - ❑ Clarifies that corporation is the target of fiduciary obligations whether corporation is insolvent or not
- **"It is well settled that directors owe fiduciary duty to the corporation. When a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative action on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholder as the residual beneficiaries of any increase in value."**

HYPOTHETICAL #1: ANALYSIS (CONT'D)

- ***Trenwick America Litigation Trust v. Ernst & Young LLP et al.*, 931 A.2d 438 (Del. 2007)**

  - ❑ No cause of action for deepening insolvency exists
  - ❑ Affirms that even in insolvent corporation, directors' conduct still scrutinized using business judgment rule
    - "If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success… Rather, in such a scenario the directors are protected by the business judgment rule."
    - "If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy."

HYPOTHETICAL #1: ANALYSIS (CONT'D)

- **In summary, *Gheewalla* and *Trenwick* clarify:**
  - ❑ Directors/officers owe fiduciary duties to corporation; the only change is who gets to enforce derivative claims
  - ❑ Directors/officers may pursue good faith, value-maximizing strategy for the corporation, even when corporation is insolvent
  - ❑ Such decisions protected by business judgment rule so long as directors/officers act with diligence, loyalty, and honesty

HYPOTHETICAL #2

- **Technology, Inc., CA corporation, involved in litigation with Berg**
- **Technology sought outside financing to continue operations, but financing contingent upon settlement with Berg**
- **Parties settled their disputes**
  - ❑ Berg became company's biggest creditor
- **Berg offered plan to derive value from the company's NOL by reorganizing under the Bankruptcy Code (if financing was not obtained)**
- **Technology failed to get financing**
- **Board**
  - ❑ Skeptical of Berg's plan
  - ❑ Prefers to have company enter into an ABC
  - ❑ Concerned about its fiduciary obligations to the company's creditors, including Berg
  - ❑ Board seeks your advice

HYPOTHETICAL #2: ANALYSIS

- ***Berg & Berg Enterprises, LLC v. Boyle*, 178 Cal. App. 4th 1020 (Cal. App. 2009):**

  - Under California law, directors of a corporation do not owe a fiduciary duty to creditors solely by virtue of the corporation operating in the "zone of insolvency"
  - When a California corporation becomes insolvent, under the long-standing "trust fund doctrine", the scope of a director's duty is limited to avoiding actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims. This would include acts that involve self-dealing or the preferential treatment of creditors

HYPOTHETICAL #2: ANALYSIS (CONT'D)

- ***Berg & Berg* rulings consistent with *Gheewalla* & *Trenwick***
  - ❑ No "zone of insolvency"
  - ❑ No direct fiduciary obligations to creditors
  - ❑ Use business judgment rule to examine director/officer conduct; focusing on avoiding dissipation, self-dealing, preferences

HYPOTHETICAL #3

- **Technology, Inc. in financial distress**
- **JP Rock, one of the VC investors**
  - ❑ Preferred shareholder
  - ❑ Offers $1M short-term loan
  - ❑ If company liquidated, would be entitled to be paid 2x loan principal, plus any accrued but unpaid interest
- **Loan negotiated on behalf of the company by Bob**
  - ❑ Bob is a Technology director and JP Rock employee
  - ❑ Connection well-known to the board
  - ❑ Bob and the other JP Rock-affiliated directors excuse themselves from the board's deliberation
- **The board seeks your advice**

HYPOTHETICAL #3: ANALYSIS

- ***CDX Liquidating Trust v. Venrock Associates*, No. 10-1953 (7th Cir. March 29, 2011) (Judge Posner)**

  - ❑ The transaction tainted by self-dealing
  - ❑ Mere disclosure of conflict does not excuse breach of fiduciary duty
    - "The accusation is that the directors were disloyal. They persuaded the district judge that disclosure of a conflict excuses a breach of fiduciary duty. It does not. It just excuses the conflict."
  - ❑ Upon a showing of disloyalty, presumption created by business judgment rule is rebutted, and the defendant has the burden to show fairness of the transaction, i.e., the lack of causation

HYPOTHETICAL #4

- **Technology, Inc. running out of cash**
- **Rather than paying employee wages, Bob, the CEO, is using remaining cash to pay down an unsecured business loan**
- **Bob signed a personal guaranty on that loan**

HYPOTHETICAL #4: ANALYSIS

- **“Preference” is any payment of antecedent debt made during the 90-day period immediately preceding bankruptcy filing, while debtor was or presumed to be insolvent**
- **Preference claims may be asserted against the creditor for whose benefit preferences were made**
- **When preference defendant is an insider, the reachback period extends to one year before the bankruptcy filing**

HYPOTHETICAL #5

- **Technology, Inc. in financial distress**
- **To keep its top management's morale high, board awards officers "special bonuses" that would double their salaries if any of the following occurs**
  - ❑ if they are terminated without cause
  - ❑ if the company undergoes a change of control (including, without limitation, a sale of all or substantially all of its assets) and they are let go within six months thereafter
  - ❑ if the Board elects to have the company cease operations, dissolve, file for bankruptcy, or seek similar relief.

HYPOTHETICAL #5: ANALYSIS

- **The bonuses potentially voidable as fraudulent transfers**
- **A transfer is "constructively fraudulent" if debtor did not receive reasonably equivalent value, while the debtor was insolvent or became insolvent as a result of the transfer**
- **May be asserted under section 544 or 548 of the Bankruptcy Code**
- **The reachback period is 4 years under section 544 and 2 years under section 548**
- **No need to prove insolvency of the debtor, if the transfer being challenged is a transfer made to or for the benefit of an insider pursuant to an employment contract, provided the contract was not made in the ordinary course of business**

Corporate Dissolution

INITIATING DISSOLUTION PROCEEDINGS

- **Shareholders representing 50% or more of the voting power of the corporation may initiate a voluntary dissolution**
  - A majority is not required. No action is required by the board of directors.
- **Board of Directors may initiate a voluntary dissolution without shareholder approval**
  - If an order for relief has been entered under Chapter 7 bankruptcy;
  - If corporation has disposed of all of its assets and has not conducted any business for a period of 5 years; or
  - If corporation has not issued any shares.

TWO-STEP PROCEDURE: WIND UP & DISSOLVE

- **<u>Step One</u>: After appropriate approval to dissolve has been obtained, corporation files a Certificate of Election to wind up and dissolve.**
  - ❑ Generally, the Board of Directors supervises the liquidation of the corporation and the payment of or provision for its debts and liabilities.
  - ❑ Corporation must cease carrying on business except to the extent necessary for the beneficial winding up of the business and preservation of goodwill pending a sale of the business or assets.
  - ❑ Notice must be given to the non-approving shareholders and all known creditors and claimants.
  - ❑ Generally there will be no court proceedings in connection with voluntary dissolution. There is the possibility, however, that any shareholder holding more that 5% of the outstanding shares in any particular class, or three or more creditors, may petition a court to supervise the dissolution.

TWO-STEP PROCEDURE: WIND UP & DISSOLVE (CONT'D)

- **<u>Step Two</u>: Corporation files a Certificate of Dissolution.**
  - ❑ When corporation is completely wound up, board of directors may file a Certificate of Dissolution.
  - ❑ Upon filing, the corporation ceases, except for the purpose of prosecuting and defending actions by or against it and enabling it to collect and discharge obligations, collect, dispose of and convey its property, but not for the purpose of continuing business except as is necessary for the winding up.
  - ❑ The corporation shall continue to exist indefinitely for the purpose being sued in a quiet title action.

WINDING UP

- **Franchise taxes must be paid up and final tax return must be filed. The tax return may be filed after the filing of the certificate of dissolution.**
- **Adequate provision must be made for known and unknown debts and liabilities. Two ways (not exclusive) to establish adequacy:**
  - ❑ Good faith assumption or guarantee of debt or liability by a financially responsible party, and board determines in good faith and with reasonable care that assumption or guarantee is adequate.
  - ❑ Amount of debt or liability is deposited with State Controller.

WINDING UP (CONT'D)

- **Distribution to shareholders**
  - ❑ May be done in accordance with liquidation preferences, if any.
  - ❑ Plan of liquidation not in accordance with liquidation preferences may be adopted if approved by board and majority of each class of shares.
- **Notice must be given within 20 days of adoption of plan to all shareholders with a liquidation preference.**
- **Dissenters with a liquidation preference are entitled to be paid amount of liquidation preference if they file a demand for payment within 30 days after mailing of notice of adoption of plan of liquidation.**
- **Board may abandon plan of liquidation if any such demand is filed.**

POST-DISSOLUTION LIABILITY

- **Shareholder Liability**
  - ❑ Shareholders are liable for up to the amount of assets distributed to them upon dissolution.
  - ❑ Causes of action against shareholders are extinguished unless commenced prior to the earlier of the expiration of the statute of limitations applicable to the cause of action or 4 years after the effective date of dissolution.
- **As previously mentioned, corporation exists indefinitely for purpose of being sued in any quiet title action.**

Chapter 7 Bankruptcy

WHAT IS CHAPTER 7 BANKRUPTCY

- **Liquidation proceedings under federal bankruptcy law**
- **Trustee appointed from panel trustees**
- **Federal statutory distribution scheme**
  - ❑ Secured claims get paid from collateral; deficiency claims are unsecured
  - ❑ Unsecured claims get paid from unencumbered assets on pro rata basis, but certain claims have priority
    - Tax claims
    - Wage claims

WHY CHOOSE LIQUIDATION THROUGH CHAPTER 7

- **Prevent creditor race; preserve assets for distribution**
  - ❑ Automatic Stay
  - ❑ Tax and wage priority claims
  - ❑ Creditors in same class get pro rata distribution
- **Bankruptcy limitations on certain claims, like landlord claims**
  - ❑ Section 502(b)(6): landlord claim for unpaid rent capped at greater of (a) one year's rent or (b) 15% of the rent due on the remaining lease term, not to exceed 3 years
- **Great way to sell assets**
  - ❑ Trustee sale
  - ❑ Free and clear of liens and encumbrances
  - ❑ Forced assignment without 3rd party consent
- **Power to void certain prepetition transfers**
- **But bankruptcy invites third-party scrutiny of pre-bankruptcy conduct**

Assignment for Benefit of Creditors

WHAT IS AN ABC?

- **Liquidation proceedings under state law**
- **Assets transferred to an assignee who will act as fiduciary to administer the assets**
- **Distribution scheme based on state law**

ABC VS. CHAPTER 7

- **Speed**
  - ABC in CA is not court-supervised; sale may be done more quickly
- **Choice of fiduciary based on qualifications**
  - A chapter 7 trustee is randomly assigned by the Office of the U.S. Trustee. The company can select the assignee based on specific qualifications
- **Approval process** Second level
  - ABC requires board and shareholder approval; bankruptcy requires only board approval. ABC not practical for publicly held companies.
- **Distribution scheme differs slightly**
  - For example, priority amount for employee wage claim is $4,300 per employee v. $10,950 per employee as permitted under Bankruptcy Code

ABC VS. CHAPTER 7 (CONT'D)

- **No cap on claims**
  - ❑ No cap on landlord claim for breach of real estate lease
- **No ability to sell free and clear**
  - ❑ Therefore, lienholder consent is necessary.
- **No ability to force assignment of leases and contracts**
  - ❑ Therefore, consent of other contract party is necessary
- **Ability to void transfers**
  - ❑ *Sherwood Partners Inc. v. Lycos*, 394 F.3d 1198 (9th Cir. 2005) held that assignee cannot bring preference actions under California law because of federal preemption
  - ❑ CA state courts have refused to follow 9th Cir. See *Credit Managers Ass'n of California v. Countrywide Home Loans, Inc.*, 144 Cal. App. 4th 590 (2006), review denied, and *Haberbush v. Cummins Family Ltd. Partnership*, 138 Cal. App. 4th 1630 (2006).