

BANKRUPT SUBSIDIARIES: THE CHALLENGES TO THE PARENT OF LEGAL SEPARATION

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The financial distress of a subsidiary can be a difficult event for its parent company. When the subsidiary faces the prospect of a bankruptcy filing, the parent likely will need to address many more issues than simply its lost investment in the subsidiary. Unpaid creditors of the subsidiary instinctively may look to the parent as a target to recover on their claims under any number of legal theories, including piercing the corporate veil, breach of fiduciary duty, and deepening insolvency. The parent also may find that it has exposure to the subsidiary's creditors under various state and federal statutes, or under contracts among the parties. In addition, untangling the affairs of the parent and subsidiary, if the latter is going to reorganize under chapter 11 and be owned by its creditors, can be difficult. All of these issues may, in fact, lead to financial challenges for the parent itself. Parent companies thus are well advised to consider their potential exposure to a subsidiary's creditors not only once the subsidiary actually faces financial distress, but well in advance as a matter of prudent corporate planning. If a subsidiary ultimately is forced to file for chapter 11, however, the bankruptcy laws do provide unique procedures to resolve any existing or potential litigation between the parent and the subsidiary's creditors and to permit the parent to obtain a clean break from the subsidiary's financial problems.

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INTRODUCTION

Corporations increasingly operate a variety of businesses through a complex structure of corporate subsidiaries. Even if wholly-owned, these subsidiaries, at least in part, may have their own separate management, creditors, business plans, facilities, and strategies. In fact, while a subsidiary often will operate in the same general industry as the other companies owned by the parent, the subsidiary's business may be very different than the parent's core business. The parent's business may be foreign, while the subsidiary's business is domestic. The parent generally may operate manufacturing businesses, while the subsidiary is a distributor. The parent may be heavily regulated, while the subsidiary operates an unregulated business. Or the parent and subsidiary may simply have very different products or services.

When the subsidiary does not operate in the same line of business as the parent, the parent may tend to view the subsidiary more as an investment rather than an integral part of its core business, and management of the parent and subsidiary may not have a close working relationship. However, these two aspects of the relationship between the parent and the subsidiary may render the parent unprepared for the challenges that arise when the subsidiary becomes financially distressed. The parent will focus often on whether to continue infusing capital into a failing and insolvent subsidiary, or whether future investment in the subsidiary cannot be justified. The calculus tends to be a decision as to whether expending new funds will save a prior investment, which, absent new capital, will almost surely be lost. When the decision is made that the parent cannot justify providing new capital to a failing subsidiary, often the bankruptcy of that subsidiary is a likely result.

The parent that believes that its troubles are limited to the loss of its investment in the subsidiary may be seriously mistaken, however. Not having had a close relationship with the subsidiary, and perhaps not being fully aware of the legal and operational problems the subsidiary soon will face, the parent may underestimate the legal and operational complexity typically associated with a parent's attempt to separate itself from a subsidiary that has filed, or will soon file, for bankruptcy protection. In fact, many of these problems, if not properly addressed, may have materially adverse consequences for the parent's own business.

Additionally, similar issues often exist for private equity funds owning a large number of portfolio companies. Unlike a publicly traded parent of a

corporate family, the private equity fund likely will not have integrated operations or intercompany transactions with the distressed subsidiary, nor will it have extensive contractual relationships with the subsidiary, other than to evidence the private equity fund's equity ownership and any debt financing. However, as the parent of the distressed subsidiary and the party controlling its board of directors, the private equity fund remains a potential target for the subsidiary's unpaid creditors. It also may have statutory liability to the subsidiary's creditors in certain circumstances, such as where a state or federal statute imposes liability on any member of a corporate group.

The purpose of this Article is to identify the difficult issues that a parent faces, both inside and outside a bankruptcy proceeding, when one of its subsidiaries faces serious financial distress. The Article also discusses some of the courses of action that a parent may take in this situation. The proper course of action for any parent, however, typically is based on the particular facts and circumstances of the situation in which it finds itself and is not susceptible to a rigid formulation. Furthermore, some of the decisions that a parent must make require difficult legal and business judgments. It is very difficult to determine meaningfully whether these decisions are "right" or "wrong" not only before, but even after the decisions have been made and implemented. The key for the parent, instead, is to identify the relevant issues as early as possible. Otherwise, the parent may be in a chronically defensive posture and risk that the problems of its subsidiary will become serious problems of its own.

A parent company also should consider the issues identified and discussed in this Article as a matter of prudent corporate planning well before a subsidiary faces any financial distress. In establishing subsidiaries as large or potentially independent enterprises, the parent should at all times consider what exposure the parent itself may have to the subsidiary and its creditors if that enterprise does not succeed. Once financial distress occurs, it simply may be too late to extract the parent from potential liability to the subsidiary's creditors if the parent has not adequately planned for, and properly limited its exposure to, that risk well in advance.

I. FIRST RECOGNITION: THE PARENT NEED NOT BE LIABLE TO HAVE A PROBLEM

When it is clear that a subsidiary is nearing insolvency and may be facing bankruptcy proceedings, the parent should conduct a thorough analysis to understand the extent to which it could be held liable for the debts of the

subsidiary. As the subsidiary likely will be unable to repay its own debts in full, creditors of the subsidiary naturally may look to the parent for repayment. The nature of the parent's potential liability to the subsidiary's creditors may be based on contractual, statutory, or common law theories of liability.

Even where the parent would appear to have little or no legal liability for the subsidiary's debts, the subsidiary's creditors may possess leverage sufficient to force the parent to reach some compromise requiring the parent's contributions to help satisfy those liabilities. For instance, the parent and the subsidiary may have many of the same suppliers, and these parties may not accept the parent's argument that it is not legally responsible for the subsidiary's debts to such vendors. Instead, the vendors will attempt to extract some consideration from the parent in exchange for accepting losses because of the subsidiary.

Additionally, where the unpaid debts of the subsidiary are substantial, the subsidiary's creditors may threaten legal action such as attempting to "pierce" the subsidiary's corporate veil or suing under one of various legal theories, such as breach of fiduciary duty or deepening insolvency,¹ each of which is discussed below. Once the subsidiary has filed for chapter 11, these creditors will be represented by a creditors' committee in the subsidiary's bankruptcy, and the committee's fees will be paid by the subsidiary's bankruptcy estate. As a result, at least by this point, the subsidiary's creditors will be sufficiently organized and funded to sue the parent, if necessary.

The parent may believe that it should have no liability under a corporate veil-piercing or other legal theory. However, as long as the subsidiary's creditors have some colorable basis to sue, the parent must face the difficult decision of whether to settle with the creditors. Aside from the time and cost of defending a suit—where the liability of the parent would be large if it lost the litigation—the detrimental "overhang" for the parent's business created by the litigation may be real and material, even where the parent insists that it will prevail. A business's capital providers, including banks, equity investors, and material trade creditors, as well as significant customers, do not like to see large and complicated contingent liabilities on their business partners' balance

¹ As discussed in further detail below, the Delaware Supreme Court affirmed an opinion of the Delaware Court of Chancery which refused to recognize deepening insolvency as a cause of action under Delaware law. *See Trenwick Am. Litig. Trust v. Billett*, No. 495, 2006, 2007 WL 2317768, at *1 (Del. Aug. 14, 2007), *aff'g* 906 A.2d 168 (Del. Ch. 2006) (affirming, without discussion, the Court of Chancery opinion "on the basis of and for the reasons assigned" in such opinion).

sheet. The existence of such liabilities may lead to potentially endless conversations and questions. Although such liabilities are difficult to quantify, the parent's business partners may demand higher prices or otherwise worse business terms because they perceive more risk in dealing with the parent.

If the parent is a public company, it may be required to disclose its potential liability to the subsidiary's creditors in its public filings. While the disclosure may be limited to a footnote in a Securities and Exchange Commission filing, the fact of the potential liability will be public. The parent's auditors, in certain cases, may require the parent to institute a reserve for the litigation. If the potential liability is sufficiently large, at least the fact that the parent made a reserve for the litigation will be known, thereby giving credence to the notion that the parent has actual liability.

The parent's more sophisticated capital providers also will at least implicitly recognize an important fact: if the parent and the subsidiary's creditors end up in litigation, many of the key witnesses will be from the subsidiary's current or former management. In a veil-piercing or breach of fiduciary duty lawsuit, for example, important facts may include what the parent's management told the subsidiary regarding its financial intentions, goals, and plans for the subsidiary, and what the subsidiary's management told its creditors regarding the relationship between the parent and the subsidiary.² For instance, the subsidiary's creditors may allege that the parent assured them payment if the subsidiary became insolvent. If disputed, testimony of the subsidiary's management may be critically important on this point.

Where the parent and the subsidiary lack a close working relationship, or worse, where their relationship has become strained, the risk increases that the testimony of the subsidiary's management in the litigation could be detrimental to the parent. In certain circumstances, the meaning of various statements that have been made by the parent to or about the subsidiary's creditors, or the motives of the parent in taking various actions, may be subject to interpretation. Where the parent and subsidiary's management have not had a common understanding of how each operate, the risk of misinterpretation may be significant.

² See, e.g., *Foxmeyer Drug Co. v. Gen. Elec. Capital Corp.* (*In re Foxmeyer Corp.*), 290 B.R. 229, 237–41 (Bankr. D. Del. 2003) (looking to the parent corporation's representations to the subsidiary's creditors in a veil-piercing action).

Additionally, the insolvent subsidiary's management may begin to appreciate that the subsidiary is effectively no longer owned by the parent but will be owned by its creditors. In fact, in insolvency or the "zone of insolvency," the fiduciary duties of the subsidiary's board may extend to its creditors.³ Further, creditors in a chapter 11 case will likely receive stock in the reorganized subsidiary, while the parent's old stock will likely be cancelled. Under such circumstances, the subsidiary's management will begin to view the subsidiary's creditors as its owners, and more pointedly, as the ones that will decide whether the subsidiary's existing management will remain after a chapter 11 reorganization. These dynamics, of course, may make the parent feel particularly uncomfortable entering into litigation with the subsidiary's creditors, especially knowing the subsidiary's management may be key witnesses at trial.

As a public company, the parent's difficulty in managing expectations and perceptions for such litigation is not limited to the parent's capital providers, suppliers, and customers. For instance, publicly traded companies often have publicly issued debt rated by Standard & Poor's, Moody's, Duff & Phelps, or Fitch. The overhang created by veil-piercing or other litigation involving potentially large liabilities may cause such rating agencies to downgrade the public debt of the parent, or at least put the parent's debt on "negative watch."

The rating agencies have been criticized for failing to foresee financial crises—in this decade, for example, with respect to the 2007 subprime mortgage "meltdown," and with respect to key chapter 11 cases, such as that of Enron Corporation.⁴ The rating agencies, as a result, may be conservative in

³ The Delaware Supreme Court recently held that creditors of a Delaware corporation have no right to bring a direct claim for breach of fiduciary duty against directors and officers of a solvent corporation navigating in the zone of insolvency and that the directors' and officers' fiduciary duties are always to the corporation, but may be enforced by the shareholders or the corporation's creditors when the corporation is insolvent. *See* *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 94 (Del. 2007) ("[T]he creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."). Prior to *North American Catholic*, Delaware courts had held that in the vicinity of insolvency, the board's fiduciary duties extended to creditors. *See, e.g.,* *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790–91 (Del. Ch. 2004) ("When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors."); *Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'n Corp.*, No. 12150, 1991 WL 277613, at *1155 n.55 (Del. Ch. Dec. 30, 1991) ("[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency," the board must consider the community of interests constituting the corporation; a director is mistaken "who thinks he owes duties directly to shareholders only.").

⁴ *See, e.g.,* *A Sea of Red as the Banks Face Major Embarrassment*, SUNDAY TELEGRAPH, Dec. 2, 2001, at 5; Vance Cariaga, *Credit Agencies, Banks, Buyers Share Blame for Subprime Mess*, INVESTOR'S BUS.

reacting to news of potential litigation and may take ratings action that the parent believes to be precipitous. The rating agencies are expert in adjusting the credit ratings of a company based on financial performance, debt load, and other straight economic factors. They may be less expert in calibrating a company's proper debt rating based on potential litigation exposure, which may be very difficult to understand. Under such circumstances, the parent may spend significant time attempting to convince rating agencies that it has no liability for the subsidiary's debts. Given the apparent highly complex legal and factual issues involved, however, the parent also may find its efforts frustratingly ineffectual. Indeed, there are so many "rungs" in a rating agency's ladder that the agency may believe downgrading a company one or two notches is only making a small adjustment to the company's credit profile.⁵ However, the effect on the parent likely will be magnified if the downgrade is perceived as a result of the potential litigation.

In addition, some of a company's material contracts may be tied to its credit rating, and a downgrade could cost the company significant funds in pricing under those contracts. In the end, where the parent truly believes that it has little chance of being held liable to the subsidiary's creditors, the parent may decide that the proper course is to be vindicated in the courts. This decision is perfectly reasonable and defensible. Alternatively, however, depending on very practical, near-term considerations, the parent instead may decide that some reasonable settlement with the subsidiary's creditors is the better course of action.

II. RING-FENCING THE PARENT: UNDERSTANDING POTENTIAL LIABILITY TO A SUBSIDIARY'S CREDITORS

The parent, of course, will not be prepared to assess whether and under what circumstances it is willing to settle with the subsidiary's creditors until it

DAILY, Aug. 17, 2007, at A1; *Deals & Deal Makers: Bids and Offers*, WALL ST. J., Dec. 27, 2002, at C5; Bethany McLean & Doris Burke, *The Geeks Who Rule the World*, FORTUNE, Dec. 24, 2001, at 93; Robert Schroeder & Aaron Lucchetti, *Moving the Market: Credit Raters Face Heat; Moody's is Sued by a Fund*, WALL ST. J., Sept. 27, 2007, at C3; *Suing Rating Agencies*, FIN. TIMES, Sept. 18, 2007, at 20; Gregory Zuckerman & Jathon Sapsford, *Fall of a Power Giant: Downgrade of Enron to Junk May Have Come Too Late—Critics Say Rating Agencies Failed to Give Investors Early Warning—Deal Makers Turn to Deal Breakers as Dynegy Pulls Out of Merger Talks*, ASIAN WALL ST. J., Nov. 30, 2001, at 12.

⁵ For instance, Standard & Poor's has numerous separate levels from a rating of AAA to D, and it can put a company on negative watch without changing its rating at all. By contrast, a firm which makes recommendations on a company's stock may only have a few "ratings," such as "Strong Buy," "Buy or Accumulate," "Hold," and "Sell."

fully understands its potential liability for the subsidiary's debts. The parent's first task, then, is to conduct a thorough analysis of the parent's potential contractual, statutory, and common law exposure to the subsidiary and its creditors. The parent's prudent corporate planning would have undertaken this analysis both when the subsidiary was established and throughout its existence and growth, and especially when the financial prospects of the subsidiary began to wane. Regardless of whether the parent has been, or in fact truly needed to be, proactive in this manner, a full analysis of such issues at this point is essential.

A. Contractual Analysis

Aside from joint programs between the parent and subsidiary, such as employee benefit and insurance plans, analyzing the parent's contractual liabilities to the subsidiary generally is fairly straightforward.⁶ For instance, the parent may have directly guaranteed various debts owed by the subsidiary to third parties or may have indemnified a third party from any losses suffered in connection with the subsidiary. In addition, the parent and subsidiary may have jointly entered into contracts with third parties, with the legal effect on the parent being similar to a guaranty. Joint contracts raise the problem that a bankruptcy or the insolvency of the subsidiary may constitute a default under the contract, permitting the third party to cease performance or exercise some other right or remedy. While the third party may not truly care that the subsidiary has filed for bankruptcy if the parent is fully liable for all obligations under the agreement, it may take advantage of the default to attempt to renegotiate terms if the current terms are favorable to the parent.

Alternatively, the subsidiary, understanding that it is near a bankruptcy filing and that the parent effectively stands as a guarantor under the agreement, may attempt to order the maximum goods or services possible under the contract even though it would never order at that level in the ordinary course of business. This approach would permit the subsidiary to "stock up" on the relevant goods or services in preparation for the bankruptcy filing, when the subsidiary's access under the agreement may be more limited, and have the parent pay the bill once the subsidiary files for chapter 11. The contract may have been written at a time when the parent and subsidiary were more of an integrated unit, so that the risk of the subsidiary ordering at the parent's

⁶ Potential issues arising under benefit plans and insurance shared by the parent and subsidiary are discussed below in Part B.

expense was never contemplated. With the parent and subsidiary now under separate management, the risk may become real even though the subsidiary is still owned by the parent.

As the parent reviews its contractual liability for the subsidiary's debts, it should simultaneously undertake two related contractual analyses. The parent should understand (i) the likelihood of "cross-defaults," where the subsidiary's bankruptcy or insolvency causes defaults under the parent's own contracts and (ii) the parent's own credit exposure to the subsidiary under contracts between the two entities. The focus of the first issue is different than the situation described above, where the parent and subsidiary have jointly contracted with a third party, although the issue also may arise in that situation. The parent should be most concerned when a material contract of the parent provides that the agreement is in default if the subsidiary, for instance, files for bankruptcy.

1. Cross-Defaults

A contract of the parent, such as a loan agreement, may provide that a bankruptcy filing by any "material" subsidiary of the parent will result in a default under the loan agreement or other contract. Depending on the definition of "material" and the size of the subsidiary, the subsidiary's bankruptcy filing may trigger a default in a contract of the parent. Sometimes, such cross-defaults may be indirect. For instance, a material contract of the parent may provide that there is a default under the agreement if there is a default by the parent or any controlled subsidiary under any other material contract of any such entity. Again, the concept of "material" will likely be defined in the agreement. As a result, if the subsidiary defaults on a material contract of its own, there could be a cross-default to a contract of the parent. Even if the subsidiary is not in default of a relevant contract before it files for chapter 11, the chapter 11 filing itself is almost certain to be a default.

Section 365(e) of the Bankruptcy Code prevents parties to the subsidiary's contracts from enforcing a default against the subsidiary triggered solely by the subsidiary's bankruptcy filing.⁷ However, the fact that the default is not enforceable against the subsidiary does not necessarily mean that a cross-default does not occur in a contract of the parent. The parent's contract may state that there is a default when a material contract of the subsidiary is in default. If the subsidiary's contract states that it is in default if the subsidiary

⁷ 11 U.S.C. § 365(e) (2006).

files for bankruptcy, then a cross-default may occur with respect to the parent even if the default in the subsidiary's contract is unenforceable against the subsidiary.

Certain other cross-defaults may be even more hidden. For instance, a typical credit agreement will contain a provision that the agreement is in default if a "Reportable Event" under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"),⁸ occurs with respect to any employee benefit plan of the parent or any affiliate. In some cases, the "Reportable Event" must have a certain financial impact, such as a "material adverse effect" on the parent for it to be a default. A "Reportable Event" typically will be like those defined in § 4043(c) of ERISA, or the regulations issued thereunder, where the notice requirements to the Pension Benefit Guaranty Corporation ("PBGC") have not been waived.⁹ Reportable Events under § 4043(c) of ERISA and the regulations issued thereunder include the bankruptcy filing of an affiliate of the parent that is in the parent's "controlled group."¹⁰

The purpose of this type of loan agreement default is to protect lenders to the parent in those situations where a subsidiary or affiliate of the parent may be terminating a "qualified" defined benefit pension plan. Because, under ERISA, all entities in the parent's "controlled group" are jointly and severally liable for any unfunded liabilities upon termination of such plans,¹¹ the risk to the parent's lenders if a Reportable Event occurs is that such event is a precursor to the parent being required to fund pension deficit liability of the affiliate upon the termination of the affiliate's benefit plan. This could be a substantial additional liability for the parent. If the terminated plan is fully funded, however, there will be no additional liability to the parent.

The point, however, is that the subsidiary's bankruptcy filing, through the Reportable Event default in the parent's credit agreement, may unintentionally create a default under that agreement, thereby giving the parent's lenders the right to cease providing loans to the parent and to immediately accelerate all existing loans. The parent, of course, may be very strong financially so that there is absolutely no need for the parent's lenders to take such action. However, unless the parent obtains an immediate full waiver of the default, it

⁸ See 29 U.S.C. § 1001 (2006).

⁹ See ERISA § 4043(c), 29 U.S.C. § 1343 (2006).

¹⁰ See *id.*

¹¹ *Id.* § 1362(a).

may be required to promptly file an 8-K report with the SEC disclosing the existence of the default. Given that many public companies have large syndicated bank groups with numerous participant financial institutions, obtaining a default waiver may take some period of time, such that the parent will not be able to avoid the filing of an 8-K disclosing the existence of the default.

The 8-K filing could have a material negative effect on the parent, at least in the near term. In its 8-K filing, the parent may only be able to state that it “expects” the waiver, and the uncertainty may have some negative effect on the parent’s stock price until obtained. Second, the parent’s lenders may be concerned that they do not know the full extent to which the parent may be liable for the debts of the subsidiary. As a result, the waiver may not be forthcoming pending the ability of the parent’s lenders to explore the issue. Finally, even if the parent’s lenders grant the parent a waiver, it may come at a cost. The most basic cost would simply be a waiver or amendment fee. In addition, however, the parent’s lenders could take the opportunity to revisit certain terms of the parent’s credit agreement, or even renegotiate the agreement.

2. Credit Exposure to the Subsidiary

The other aspect of the parent’s contractual analysis is a review of the parent’s own credit exposure to the subsidiary. As discussed above, the parent and subsidiary may have jointly contracted with a third party, and the parent will be liable for the subsidiary’s debts under such contract. The more common situation, however, will be where the parent has contracted to provide a good or service directly to the subsidiary and is, therefore, a creditor of the subsidiary. For instance, the parent may have an intercompany services agreement with all of its subsidiaries whereby it provides certain overhead or similar services to the subsidiaries. These contracts permit the entire corporate family to obtain goods or services on a more efficient or less expensive basis than any of the companies could achieve on its own. The goods or services obtained may include items such as legal services, office space, communications, accounting services, benefit plans, cash management services, and insurance. Finally, of course, the parent may simply be a lender to the subsidiary, a situation that is not uncommon in both corporate groups and between private equity funds and their portfolio companies.

Contracts where the parent is the creditor and the subsidiary is the debtor raise a number of issues. First, like any creditor relationship, the parent will want to limit its exposure to the subsidiary to the greatest extent possible, because once the subsidiary files for bankruptcy the parent will be an unsecured creditor of the subsidiary (except to the extent that it has security or valid rights of setoff or recoupment). Working against the parent's desire to minimize its credit exposure to the subsidiary is preference law, as well as the possibility that some or all of the parent's claims against the subsidiary may be subject to subordination, recharacterization as equity, or disallowance.

a. Preference Law

Under the Bankruptcy Code, the subsidiary may avoid any transfer of the subsidiary's property made to or for the benefit of the parent, on account of an antecedent debt, during the one year period prior to the subsidiary's bankruptcy filing, and while the subsidiary was insolvent, if such transfer enables the parent to receive more than it would in a chapter 7 case for the subsidiary.¹² Such payments may include payments on account of intercompany debt, payments made pursuant to contractual agreements, and indemnification payments. In addition, the subsidiary may argue that if the parent files consolidated tax returns, the provision of certain tax benefits, such as net operating losses to the parent, may be avoidable as a preferential transfer of property.

Avoidable payments or transfers need not have been made directly to the parent. For instance, payments made by the subsidiary to third parties on debt guaranteed by the parent may be avoidable preferences to the parent if the payments reduced the parent's exposure on the guaranty.¹³ In addition, preference law covers more than just payments. If, for example, the parent attempted to have the subsidiary provide it with security for a preexisting unsecured debt so that the parent would be a secured creditor in the subsidiary bankruptcy, the grant of the security interest could be an avoidable preferential transfer.

¹² Under the Bankruptcy Code, there is a rebuttable presumption that the subsidiary was insolvent during the ninety day period prior to the bankruptcy. 11 U.S.C. § 547(f) (2006).

¹³ See *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186, 1194-99 (7th Cir. 1989), *superseded by statute*, Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (codified as amended at 11 U.S.C. §§ 547, 550 (2006)).

Creditors subject to a preference lawsuit may have several defenses available to them. Three defenses most likely to be relevant to the parent are that the transfer (i) was intended to be and was in fact a substantially contemporaneous exchange for new value given to the subsidiary, (ii) was the payment of a debt incurred in the ordinary course of business and either made in the ordinary course of business between the subsidiary and the parent or made according to ordinary business terms, or (iii) was followed by additional new value given by the parent to the subsidiary that was unpaid or not secured by an otherwise unavoidable lien.¹⁴ Pending the resolution of any preference suit, the prepetition claims of the parent in the subsidiary's bankruptcy may be disallowed under § 502(d) of the Bankruptcy Code until the parent "returns" any preferences.¹⁵ Several courts have held that § 502(d) applies without the debtor actually having obtained a preference judgment against a preference defendant.¹⁶ As long as the plaintiff can show that preference liability exists, it may be able to have any claim of the preference defendant (here the parent) in the bankruptcy proceeding disallowed until the defendant returns the preference.

For the typical creditor, it generally is better to receive a preferential payment and assert defenses to any later preference suit than not to receive payment at all. For a controlling shareholder such as the parent, however, by obtaining funds from the subsidiary outside the ordinary course of business, the parent may be faced not only with a preference action but with an additional allegation of a breach of fiduciary duty.¹⁷ The parent also should know that the Bankruptcy Code is not the only source of preference law. Most

¹⁴ See 11 U.S.C. § 547(c)(1), (2), (4).

¹⁵ 11 U.S.C. § 502(d) provides as follows:

[T]he court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

¹⁶ See, e.g., *In re Stoecker*, 143 B.R. 118, 131 (Bankr. N.D. Ill. 1992), *aff'd in part and vacated in part*, 143 B.R. 879 (N.D. Ill. 1992), *aff'd in part and vacated in part*, 5 F.3d 1022 (7th Cir. 1993) (stating the trustee may invoke § 502(d) to disallow secured claims as formally potentially voidable preferential transfers under § 547, even though he is precluded from filing such avoidance actions); *In re Mid Atl. Fund, Inc.*, 60 B.R. 604, 611 (Bankr. S.D.N.Y. 1986) (stating that § 502(d) may be invoked even though the trustee did not commence a preference action).

¹⁷ It is not uncommon for a trustee or committee to allege a preferential transfer along with a breach of the duties of care and loyalty to the corporation. See, e.g., *Schnelling v. Crawford (In re James River Coal Co.)*, 360 B.R. 139, 150 (Bankr. E.D. Va. 2007); *Official Comm. of Unsecured Creditors v. Foss (In re Felt Mfg. Co.)*, 371 B.R. 589, 604 (Bankr. D.N.H. 2007).

states have an “insider preference statute” as part of the state’s fraudulent transfer or conveyance law. Under the Bankruptcy Code, the subsidiary can sue the parent for preference either under § 547, the Code’s preference statute, or pursuant to § 544(b) of the Bankruptcy Code, which essentially incorporates the relevant state’s insider preference statute.¹⁸

The fraudulent transfer law in most states today is an enactment of the model Uniform Fraudulent Transfer Act (“UFTA”). The UFTA modernized the early 1900s model Uniform Fraudulent Conveyance Act (“UFCA”), which had been enacted in most states prior to the UFTA.¹⁹ The preference provisions of the UFTA, including the defenses to preference, are very similar to those of the Bankruptcy Code, so the parent likely will not face additional preference liability as a result of the subsidiary being able to bring a preference claim against the parent under the UFTA.²⁰ The UFTA does, however, lack the “contemporaneous exchange for new value” defense to preference found in § 547(c)(1) of the Bankruptcy Code.²¹ As a result, this defense will not be available to the parent in a preference suit covered by the UFTA. Although the UFCA does not have a preference provision, payments to insiders on account of an antecedent debt may be challenged in some cases as being fraudulent

¹⁸ 11 U.S.C. § 544(b)(1) provides as follows:

Except as provided in paragraph (2) [limited exception for charitable contributions], the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

¹⁹ While most states had enacted the UFCA, certain states instead had a form of the Statute of 13 Elizabeth, which was passed by the British Parliament in 1570 and made illegal and void any transfer made for the purpose of hindering, delaying, or defrauding creditors. 13 Eliz., c. 5 (1570) (Eng.).

As of 2008, forty-three states and the District of Columbia had enacted some form of the UFTA. *See generally* UNIF. FRAUDULENT TRANSFER ACT REFERENCES & ANNOTATIONS (Thomson/West 2007). Two states still operated under a form of the UFCA. *See id.* The remaining states have a version of the Statute of Elizabeth or some other form of fraudulent conveyance law. *Id.*

²⁰ *See In re Felt Mfg. Co.*, 371 B.R. at 634 (“The UFTA is similar to 11 U.S.C. § 548 of the Bankruptcy Code”) (citing *Schreiber v. Emerson*, 244 B.R. 1, 38 (Bankr. D.N.H. 1999)); *Martino v. Edison Worldwide Capital (In re Randy)*, 189 B.R. 425, 443 (Bankr. N.D. Ill. 1995) (“The provisions of the UFTA essentially parallel § 548 of the Code.”).

²¹ 11 U.S.C. § 547(c)(1) provides as follows:

The trustee may not avoid under this section a transfer to the extent that such transfer was (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor and (B) in fact a substantially contemporaneous exchange.

conveyances to the extent that the payments were not made in good faith for fair consideration.²²

b. Equitable Subordination

Another risk for the parent is that some of the debt that the subsidiary has incurred to the parent will be subordinated in a subsidiary bankruptcy case. Section 510(c) of the Bankruptcy Code provides that a court may equitably subordinate any claim to other claims in the case.²³ Although the Bankruptcy Code does not specify the standards necessary to equitably subordinate a claim, most courts apply the test announced by the Fifth Circuit in *Mobile Steel*.²⁴ Under the *Mobile Steel* test, a claim can be equitably subordinated if: (i) the claimant has engaged in some type of inequitable conduct; (ii) the misconduct has resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim is not inconsistent with the provisions of the Bankruptcy Code.²⁵ A breach of fiduciary duty is inequitable conduct that may warrant equitable subordination.²⁶

²² Generally the satisfaction of a preexisting debt does not constitute a fraudulent conveyance (although it may be a preference). However, it should be noted that “New York courts have carved out one exception to the rule that preferential payments of pre-existing obligations are not fraudulent conveyances: preferences to a debtor corporation’s shareholders, officers, or directors are deemed not to be transfers for fair consideration.” *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 634–35 (2d Cir. 1995) (citing *Farm Stores, Inc. v. Sch. Feeding Corp.*, 477 N.Y.S.2d 374, 378 (N.Y. App. Div. 1984)).

²³ 11 U.S.C. § 510(c).

²⁴ *Benjamin v. Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 700 (5th Cir. 1977).

²⁵ *Id.*; see also *In re SI Restructuring, Inc.*, 532 F.3d 355, 360 (5th Cir. 2008) (citing *In re Mobile Steel Co.* and clarifying that it adds the requirement that “a claim should be subordinated only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct.”). But see *In re Felt Mfg. Co.*, 371 B.R. at 624 n.6 (“The adoption of § 510(c) of the Bankruptcy Code in 1978 may very well have rendered the third element of the *Mobile Steel* test moot.”) (citing *Blasbalg v. Tarro (In re Hyperion Enters.)*, 158 B.R. 555, 560 (Bankr. D.R.I. 1993)).

²⁶ See, e.g., *Sender v. Bronze Group (In re Hedged-Invs. Assocs.)*, 380 F.3d 1292, 1301 (10th Cir. 2004) (“‘Inequitable conduct’ for subordination purposes encompasses . . . breach of fiduciary duties”); Official Unsecured Creditors Comm. of Valley-Vulcan Mold Co. v. Ampco-Pittsburgh Corp. (*In re Valley-Vulcan Mold Co.*), 5 Fed. Appx. 396, 401 (6th Cir. 2001) (“A court may equitably subordinate a claim where . . . the claimant is guilty of inequitable conduct such as . . . breach of fiduciary duty.”); *Citicorp Venture Capital v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 987–90 (3d Cir. 1998) (affirming the bankruptcy court’s decision that the appellee’s breach of the fiduciary duty of disclosure was inequitable conduct and ample enough to support a subordination claim). Equitable subordination, however, may be inappropriate in the absence of actual harm. *In re SI Restructuring, Inc.*, 532 F.3d at 361 (“[E]quitable subordination is remedial, not penal, and in the absence of actual harm, equitable subordination is inappropriate.”).

For insiders such as the parent, the risk of equitable subordination is considerably greater than for non-insiders because courts will apply stricter standards when judging the conduct of insiders.²⁷ Insiders must demonstrate the fairness of the challenged transaction,²⁸ whereas a debtor challenging a non-insider's conduct "must prove more egregious conduct such as fraud, spoliation or overreaching, and prove it with particularity."²⁹

The mere fact of an insider relationship between a debtor and a claimant is not enough for equitable subordination,³⁰ nor is the fact that the claimant was under-capitalized.³¹ If, however, an insider makes a loan to an undercapitalized corporate debtor, that may suffice for equitable subordination.³² Examples of inequitable conduct by an insider parent-creditor include: (i) causing other creditors to extend new credit to the subsidiary, (ii) causing such creditors to abstain from collecting on past debts when the parent knew or should have known that the subsidiary was in financial trouble and undercapitalized,³³ or (iii) obtaining a lien on the debtor's assets while failing to stop the subsidiary from issuing debt to others despite knowing the subsidiary was failing.³⁴ Ultimately, a court's analysis of inequitable conduct focuses on the entire fact pattern. Even acts that, in isolation, would not be deemed inequitable may be found to be inequitable conduct when part of a broader pattern of alleged misdealing.³⁵

²⁷ See, for example, *In re Hedged-Investments*, 380 F.3d at 1301–02, holding:

When examining a transaction for evidence of inequitable conduct, this Circuit has joined other Courts of Appeals in applying different levels of scrutiny to "insiders" and "non-insiders" of the debtor corporation. Where the claimant is an insider or a fiduciary, the party seeking subordination need only show some unfair conduct, and a degree of culpability, on the part of the insider. If the claimant is not an insider or a fiduciary, however, the party seeking subordination must "demonstrate even more egregious conduct such as gross misconduct tantamount to fraud, misrepresentation, overreaching or spoliation" (citations omitted).

²⁸ *Allied E. States Maint. Corp. v. Miller (In re Lemco Gypsum, Inc.)*, 911 F.2d 1553, 1557 (11th Cir. 1990) ("[O]nce the party seeking equitable subordination presents material evidence of unfair conduct, the insider-claimant can rescue its claims from subordination only by proving the good faith and fairness of its dealings with the debtor.").

²⁹ *Estes v. N & D Props., Inc. (In re N & D Props., Inc.)*, 799 F.2d 726, 731 (11th Cir. 1986).

³⁰ *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 745 (6th Cir. 2001); *In re Lifschultz Fast Freight*, 132 F.3d 339, 345 (7th Cir. 1997) ("That the insiders made a secured loan to the company is not wrongful per se An insider to a company is free to lend money to it . . .").

³¹ *In re AutoStyle Plastics*, 269 F.3d at 747; *Fabricators, Inc. v. Technical Fabricators, Inc. (In re Fabricators, Inc.)*, 926 F.2d 1458, 1467 (5th Cir. 1991).

³² See *In re AutoStyle Plastics*, 269 F.3d at 747.

³³ *In re Fabricators, Inc.*, 926 F.2d at 1467.

³⁴ *Monzack v. ADB Investors (In re EMB Assocs., Inc.)*, 92 B.R. 9, 17 (Bankr. D.R.I. 1988).

³⁵ See, for example, *In re Fabricators, Inc.*, 926 F.2d at 1467–68, stating:

c. Recharacterization as Equity

A further risk to the parent is the recharacterization of its debt against the subsidiary as equity. Recharacterization of parent debt can lead to the same result as subordination but is based on a somewhat different theory. Subordination looks at the parent's actions that may have harmed the subsidiary as a basis for subordination. By contrast, recharacterization is an attempt to treat claims of the parent against the subsidiary fundamentally as equity interests. The theory behind recharacterization is that the parent and subsidiary intended the funding of the subsidiary to be an equity infusion even though they drafted the relevant agreements as loans or other extensions of credit. Factors that courts examine in determining whether to recharacterize debt as equity include: (i) the names given to instruments, if any, evidencing the debt; (ii) the presence or absence of a fixed maturity date and amortization schedule; (iii) the presence or absence of a fixed rate of interest and interest payments; (iv) the source of repayments; (v) the adequacy or inadequacy of capitalization for the subsidiary; (vi) identity of interest between the parent and subsidiary; (vii) security, if any, obtained for the advances; (viii) the subsidiary's ability to obtain financing from outside lending institutions; (ix) the extent to which the advances were subordinated to the claims of outside creditors; (x) the extent to which the advances were used to acquire capital assets; and (xi) the presence or absence of a sinking fund to provide repayments.³⁶

While § 510(c) of the Bankruptcy Code does not itself authorize the recharacterization of claims as equity, bankruptcy courts have found the power to order recharacterization by analogy to § 510(c) and as part of the bankruptcy court's equitable jurisdiction to enforce substance over form.³⁷ In addition, the

The bankruptcy court found that TFI acted inequitably by obtaining a lien on Fabricators' assets to secure its capital contributions If taking the security were the only basis for the finding of inequitable conduct in this case, we might be inclined to [refuse to subordinate the debt]. However, obtaining the liens was not merely an isolated act, but was one step interconnected with a series of actions by TFI to gain an advantage over the position of other creditors.

³⁶ Cohen v. KB Mezzanine Fund II, LP (*In re* SubMicron Sys. Corp.), 432 F.3d 448, 455–56 n.8 (3d Cir. 2006) (recognizing that several courts have adopted a variety of multi-factor tests, including the factors listed, but ultimately concluding that no such “mechanistic scorecard suffices”).

³⁷ See *Pepper v. Litton*, 308 U.S. 295, 305 (1939) (noting that a bankruptcy court's equitable powers are “invoked to the end that fraud will not prevail, that substance will not give way to form”); *Moglia v. Quantum Indus. Partners, LDC* (*In re* Outboard Marine Corp.), No. 02-C-1594, 2003 WL 21697357, at *2 (N.D. Ill. July 22, 2003) (holding that “a bankruptcy court has the authority to recharacterize a debt as equity”). However, a

legal impact of recharacterization on the parent generally is the same as subordination—the parent’s claims will be paid only after all of the subsidiary’s creditors have been paid in full and, therefore, likely will not be paid at all in a subsidiary bankruptcy.

One type of debt owed by the subsidiary to the parent that is often susceptible to recharacterization is any intercompany loan balances between them and any payments made for intercompany services. Corporate families often have arrangements in which cash is centralized within the parent and the various transfers of cash between the subsidiaries and the parent are treated on the companies’ books as intercompany loans. The subsidiary’s creditors may argue that the transfers of cash to the subsidiary from the parent should not be treated as loans for a variety of reasons, potentially including the alleged undercapitalization of the subsidiary. In addition, if there are no formal loan agreements between the parent and subsidiary, but only simple notations in the parent’s books and records, the subsidiary’s creditors may argue that the transfers were never intended to be loans in the first instance. Finally, for similar reasons, the creditors may argue that the provision of services by the parent to the subsidiary should have been at no cost since the services benefited the parent as the owner of the subsidiary.

More troubling for the parent is that the power of the subsidiary and its creditors to recharacterize a subsidiary’s obligations to the parent in a bankruptcy of the subsidiary may not be limited to obligations that remain outstanding at the time the subsidiary files for bankruptcy. Again, the fundamental premise of a recharacterization suit is that the supposed debt owed by the subsidiary is fundamentally an equity interest. As a result, if the subsidiary’s creditors can recharacterize as equity interests debt formerly owed by the subsidiary to the parent and paid prior to the bankruptcy, then the payments on account of that “equity” arguably are not payments of debt but are instead stock redemptions by the subsidiary. The legal result is that in bankruptcy the subsidiary can seek to recover such payments as fraudulent conveyances rather than as preferences.

The Bankruptcy Code’s fraudulent conveyance provisions enable a debtor to recover a transfer of property either: (i) if the transfer was made or an

court’s power to recharacterize debt by analogy to § 510(c) is not universally accepted. *See* Unsecured Creditors’ Comm. of Pac. Express, Inc. v. Pioneer Commercial Funding Corp. (*In re* Pac. Express, Inc.), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986) (holding that recharacterization cannot occur outside § 510(c)’s equitable subordination provisions).

obligation incurred with actual intent to hinder, delay, or defraud creditors (i.e., actual fraud);³⁸ or (ii) if the debtor did not receive reasonably equivalent value and, at the time of transfer, was insolvent, had unreasonably small capital, or intended to incur debts beyond the debtor's ability to pay such debts as they matured (i.e., constructive fraud).³⁹ A transfer is constructively fraudulent because it prejudices the creditors of the debtor and does not require any particular "intent" or fault on behalf of a nondebtor party. Payment of dividends or stock redemptions made to shareholders when a debtor is insolvent is a classic example of a constructively fraudulent transfer.⁴⁰

There are two major differences between the law of preference and the law of fraudulent conveyances that increase the parent's exposure to the subsidiary if payments to the parent are recharacterized as dividends. First, there are no "ordinary course of business" or "subsequent new value" defenses to a fraudulent conveyance suit as there are to preference suits. All the subsidiary would need to show in a fraudulent conveyance suit is that it was insolvent at the time the stock was redeemed.⁴¹ The fact that the payments may have been in the ordinary course of business or that the parent provided new value to the subsidiary after distributing dividends would be irrelevant. Second, preference

³⁸ 11 U.S.C. § 548 (a)(1)(A) (2006). The Bankruptcy Code does not set forth factors to be considered in assessing whether a transfer was made with the intent to hinder, delay or defraud creditors. A nonexclusive list of factors, however, is set forth in the UFTA, and bankruptcy courts may look to those factors, among others, in determining intent. These badges of fraud are: (i) transfers to an insider; (ii) retention by the debtor of post-transfer control or possession of the property; (iii) concealment of the transfer; (iv) debtor threatened with lawsuits prior to transfer; (v) transfer of substantially all of the debtor's assets; (vi) the debtor absconding; (vii) the debtor removing or concealing assets; (viii) the transfer occurring before or shortly after a substantial debt is incurred; (ix) the debtor transferring the essential assets of the business to a lienor who then transfers those assets to an insider of the debtor; (x) the debtor not receiving reasonably equivalent value or consideration for the transfer; and (ix) the debtor being insolvent before or shortly after the transfer. UFTA § 4 (1984); *Brown v. Third Nat'l Bank (In re Sherman)*, 67 F.3d 1348, 1354 (8th Cir. 1995); *Helms v. Roti (In re Roti)*, 271 B.R. 281, 294 (Bankr. N.D. Ill. 2002).

³⁹ 11 U.S.C. § 548 (a)(1)(B).

⁴⁰ In such situations, the directors may face liability under state law for issuance of an illegal dividend. *See* DEL. CODE ANN. tit. 8, §§ 170, 174 (West 2008).

⁴¹ Technically, the subsidiary would also need to show that it did not receive reasonably equivalent value for the stock redemption, but the law of fraudulent conveyance is such that distributions to shareholders essentially are deemed not to have received reasonably equivalent value. *See, e.g., Sherman v. FSC Realty LLC (In re Brentwood Lexford Partners, LLC)*, 292 B.R. 255, 267 (Bankr. N.D. Tex. 2003) ("The court finds that the distributions were made to the equity holders of BLP on account of their equity interest and not to the individuals on account of services rendered. The distributions amounted to dividends. As a result, BLP did not receive reasonably equivalent value for the distributions."); *Daley v. Chang (In re Joy Recovery Tech. Corp.)*, 286 B.R. 54, 75 (Bankr. N.D. Ill. 2002) ("[S]tock redemptions are treated as dividends to shareholders which return no value to the company.") (citing *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 136 (Bankr. D. Mass. 1989)).

law covers any payments to an insider (such as the parent) only within the year prior to the subsidiary's bankruptcy filing. By contrast, state fraudulent conveyance law typically reaches payments for a period of four to six years prior to the bankruptcy filing.⁴² Again, however, the payments can be recovered as constructive fraudulent conveyances only if the subsidiary was insolvent at the time of transfer.

d. Equitable Disallowance

Finally, a parent's debt against the subsidiary may be subject to "equitable disallowance." Equitable disallowance is a remedy that disallows a claim (as opposed to merely subordinating the claim) based on inequitable conduct. The remedy was recognized under the predecessor to the Bankruptcy Code.⁴³ However, it is unclear whether equitable disallowance has survived the enactment of the Bankruptcy Code.⁴⁴ Even if the doctrine has survived, if the parent is the sole equity holder of the debtor, the difference between equitable subordination (which can be used to subordinate claims) and equitable disallowance may be of little practical difference because the equity holder is entitled to a recovery only after the satisfaction of the subsidiary's other claims in full.

⁴² However, the debtor has the ability to avoid only transfers that could be avoided by a creditor holding an allowed claim against the debtor. Under § 548 of the Bankruptcy Code (which reaches back two years), the trustee need not identify a specific creditor who has standing to bring a fraudulent conveyance action for a past transaction. Proposed amendments to the statute would extend this two year period to a ten year period. S. 452, 110th Cong. § 201 (1st Sess. 2007). Nonetheless, under various state statutes, certain creditors may be able to avoid a transfer going back more than six years. For instance, in New Jersey, the State generally can recover avoidable transfers going back 10 years. See N.J. STAT. ANN. § 2A:14-1.2(a) (West 2001) (requiring a civil action to be commenced within ten years of the accrual of the cause of action "[e]xcept where a limitations provision expressly and specifically applies to actions commenced by the State or where a longer limitations period would otherwise apply, and subject to any statutory provisions or common law rules extending limitations periods").

See also *G-I Holdings, Inc. v. Those Parties Listed on Exhibit A (In re G-I Holdings, Inc.)*, 313 B.R. 612, 634–35 (Bankr. D.N.J. 2004) (holding that "the ten-year statute of limitations available to the New Jersey Department of Environmental Protection . . . operates in favor of the Estate Representative"). In addition, in cases of actual fraud, the otherwise applicable statute of limitations may be extended by a discovery period.

⁴³ *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 991 n.7 (3d Cir. 1998) ("The rationale of *Pepper [v. Litton]*, 308 U.S. 295 (1939) would suggest that under pre-Code law a bankruptcy court was authorized to disallow a portion of the fiduciary's claim when that would produce an equitable result.").

⁴⁴ *Id.* at 991 ("We find it unnecessary here to resolve the issue as to whether equitable 'disallowance' remains an available remedy."). But see *Adelphia Commc'ns Corp. v. Bank of Am., N.A. (In re Adelphia Commc'ns Corp.)*, 365 B.R. 24, 73 (Bankr. S.D.N.Y. 2007) ("But in this Court's view, equitable disallowance is permissible under *Pepper*, just as equitable subordination is.").

B. Analysis of Joint Programs: Employee Benefit Plans

While the issues a parent may face under general commercial contracts with a bankrupt subsidiary are fairly straightforward, the issues that arise under joint programs between the parent and subsidiary tend to be much more complicated. Often, a parent will consolidate various programs throughout its corporate family into one master program administered by the parent. The most common examples are employee benefit and insurance programs. The exact arrangements between the companies will differ among various corporate families. However, in general, the parent likely will administer the program internally, will procure necessary third party services or contracts, and will allocate the costs of the programs to the various subsidiaries based on some formula.

For joint employee benefit plans, it is important to understand from the outset that the parent may have direct liability for any obligation the plan has to the subsidiary's employees. While for internal purposes the companies may account for liabilities under the plan as being the responsibilities of various subsidiaries within the corporate family, as a legal matter there may be only one plan to which all entities in the corporate family are liable. The parent may have reimbursement rights against the subsidiary under the relevant agreements or applicable law, but that is a matter between the two companies. In addition, for various "qualified" defined benefit pension plans, under ERISA all companies in the relevant "controlled group" are jointly and severally liable for certain obligations under the benefit plan. For these plans, even if the parent is not directly liable under the terms of the plan itself, it may be so under ERISA.⁴⁵

A chapter 11 bankruptcy filing by the subsidiary typically will result in a reorganization plan leaving the parent little or no interest in the subsidiary after the bankruptcy. The subsidiary likely will be unable to pay its creditors in full, and thus, the parent likely will not be entitled to retain its equity interests in the

⁴⁵ The most serious issue for the parent under ERISA is its potential "controlled group" liability for obligations arising under its bankrupt subsidiary's separate qualified defined benefit pension plans. Under a joint plan, presumably the parent has received monies from the subsidiary to fund most or all of the obligations under the plan associated with the subsidiary's employees. A distinct subsidiary plan, however, will have been separately administered and funded by the subsidiary and may be woefully underfunded if the subsidiary has been facing financial difficulties for some time. If the subsidiary terminates the benefit plan, the PBGC will have the right to recover the appropriate funding deficiency from any company in the subsidiary's controlled group, including the parent. Only defined benefit plans, however, are subject to the protection and requirements of the PBGC.

reorganized entity. As a result, the parent and subsidiary will need to separate their respective portions of the corporate family's joint employee benefit plans by the time of the effective date of the subsidiary's chapter 11 reorganization plan. The parent, therefore, faces the dual challenge of attempting to limit its exposure to the subsidiary's employees and of separating out those employees from its employee benefits plans with a minimum of confusion, cost, and liability.

Not surprisingly, separating employee benefit plans can be very complicated. Since the parent will be maintaining its master benefit programs with its other subsidiaries, one option is that the bankrupt subsidiary's portion of the employee benefit plans will be "spun out" to the reorganized subsidiary. This typically means either that the subsidiary's portion is literally spun out to itself, or that the subsidiary's existing liability is retained by the current plan and the reorganized subsidiary establishes a new employee benefit plan for future liabilities. The employee benefit plans at issue typically include so-called "welfare plans"—which provide life, disability, medical, and dental benefits—and both qualified and nonqualified pension and retiree benefit plans.

1. Welfare Plans

Separating welfare programs, such as various health care and related plans, tends to create more administrative headaches for the parent and the subsidiary than legal difficulties. Often these plans are mostly self insured, and most of the benefits accrued under such plans are short term. The subsidiary can fairly easily establish its own welfare plans once it is no longer owned by the parent. The parent and subsidiary mostly need only to administer and pay claims after separation for activities occurring prior to the separation.⁴⁶ The parent and subsidiary may find that it is easier for all parties if the parent continues to administer these legacy claims even after the entities have been separated to avoid confusion to employees, providers, and other parties involved.

The parent should understand, however, that as the administrator of such programs, and assuming that the programs are self insured, it is taking a credit risk in waiting for reimbursement from the subsidiary after paying the relevant benefits itself. Once the subsidiary exits chapter 11, this risk should be diminished as, presumably, the subsidiary will be more financially sound after

⁴⁶ Liabilities, if any, for prereorganization retirees and COBRA beneficiaries who were former employees of the subsidiary, however, may present additional complications.

its reorganization. This risk is greater, however, before and during the subsidiary's bankruptcy case. Before the subsidiary's bankruptcy, there is a risk that the parent will fund the subsidiary's benefits without obtaining reimbursement prior to the bankruptcy filing. Once the subsidiary files bankruptcy, the parent will simply have a general unsecured claim against the subsidiary for reimbursement.⁴⁷

During the bankruptcy case, the parent should have the right to administrative expense priority for any amounts advanced on behalf of the subsidiary for postpetition employee benefits.⁴⁸ Such amounts rank ahead of the subsidiary's prepetition unsecured creditors, but behind the subsidiary's secured creditors. Notwithstanding the fact that such claims are junior to the subsidiary's debt secured by collateral, they must be paid in full and in cash on the effective date of the subsidiary's chapter 11 plan or the plan should not be confirmed. Additionally, in general, the subsidiary should pay such claims in full and in cash in the ordinary course as they arise during the bankruptcy. If the subsidiary stops promptly reimbursing the parent, the parent likely could cease its own performance, although the matter might have to be settled in the bankruptcy court, which could be costly and timeconsuming.⁴⁹ The parent's right to cease performance also assumes that it has a contractual or other right to reimbursement from the subsidiary. Again, if the parent is the "sole" owner of the plan, it may have direct liability to the plan on account of the

⁴⁷ While some of the claims paid by the parent may be benefit claims of the subsidiary's employees and thereby entitled to priority treatment in the bankruptcy pursuant to § 507(a)(4) of the Bankruptcy Code, the parent does not succeed to that priority by paying the employees' priority claims. Section 507(d) of the Bankruptcy Code provides that "[a]n entity that is subrogated to the rights of a holder of a [priority] claim of a kind . . . is not subrogated to the right of the holder of such claim to priority." 11 U.S.C. § 507(d) (2006).

⁴⁸ It is not clear, however, that the parent would have an administrative claim for post-petition funding of prepetition benefits.

⁴⁹ If the agreement between the parent and subsidiary pursuant to which the parent advances funds is an "executory contract," then the bankruptcy law is generally that such agreement is binding on the parent during the bankruptcy, although the subsidiary may, with court approval, reject the agreement. 11 U.S.C. § 365. As a result, the parent will need to perform under the agreement notwithstanding the bankruptcy. Since the parent is advancing monies under the agreement, the parent could take the position that the agreement is a "contract to make a loan, or extend other debt financing or financial accommodations" pursuant to § 365(c)(2) of the Bankruptcy Code. Such agreements cannot be assumed by the subsidiary without the consent of the parent; thus, the parent could file a motion seeking immediate termination of the agreements as being unassumable in the subsidiary's bankruptcy. *Id.* at § 365(c)(2). The Ninth Circuit, however, has held that "Section 365(c)(2) . . . prohibits the assumption of all financial accommodation contracts with no reference to the consent of the non-debtor party to the contract." *Transamerica Commercial Fin. Corp. v. Citibank, N.A. (In re Sun Runner Marine, Inc.)*, 945 F.2d 1089, 1092 (9th Cir. 1991). The case law regarding what constitutes a "financial accommodation" or similar contract is still fairly sparse. However, courts tend to find that only agreements where the primary element of the agreement is financing are financial accommodation contracts. *See, e.g., In re United Airlines, Inc.*, 368 F.3d 720, 724–26 (7th Cir. 2004).

subsidiary's employees, but its rights to reimbursement from the subsidiaries, while understood as a matter of practice, may not be adequately documented as a matter of law.

The parent has significant credit risk if the subsidiary cannot reorganize and its bankruptcy case is converted to a chapter 7 liquidation. If the proceeds of the liquidation are insufficient to pay secured claims, there will be nothing left to pay administrative expense claims. Likewise, if the subsidiary's assets are sold and the case is then converted to a chapter 7 to distribute the sale proceeds to secured creditors only, unreimbursed administrative expense claims of the parent may never be paid.

2. *Qualified Pension and Retirement Benefit Plans*

Compared to welfare plans, pension and retirement benefit plans can be very difficult to separate, and their separations raise a host of legal issues. The primary issue that the parent and subsidiary typically will face regarding "qualified" employee benefit plans⁵⁰ is whether either to spin out the portion of the joint plan attributable to the subsidiary's employees, or, instead, retain those liabilities (and freeze the subsidiary employees' benefits) in the joint plan and have the subsidiary start new plans effective on the date of its bankruptcy reorganization. These are the same issues that the seller and buyer of a subsidiary face in a corporate transaction. However, what happens if the parent and subsidiary cannot agree on the proper manner to separate the benefit plans? If the seller and buyer cannot reach an agreement in a sale process, then no transaction may occur. However, since the parent and subsidiary will be separated under the subsidiary's plan of reorganization in any case, if the parent and subsidiary cannot agree during the chapter 11 case, the matter may have to be resolved through litigation. This presents a scenario where the legal rights of the parties may be unclear.

To "spin out" a qualified defined benefit pension plan under the Internal Revenue Code, the value of the assets in each resulting plan after the spin out must not be less than the present value of the benefits before the spin out to which the participants in that resulting plan would have received had the joint plan terminated immediately prior to the spin out.⁵¹ To determine this, assets

⁵⁰ A "qualified" employee benefit plan is a pension, profit sharing, or stock bonus plan that meets the qualification requirements of § 401(a) of the Internal Revenue Code of 1986, as amended. 26 U.S.C. § 401(a) (2006).

⁵¹ 26 C.F.R. § 1.414(l)-1(n) (2008).

until exhausted must be assigned or allocated to participants in the joint plan by participant priority categories prescribed by PBGC rules under ERISA § 4044 on plan terminations. Additionally, actuarial assumptions for this purpose must be made about, among other things, the likely investment return on the assets in the plan over time, the timing of pension and retirement benefits to beneficiaries under the plan, and the extent to which benefits potentially available under the plan will vest.

Importantly, where the parent is transferring part of its joint plan to the subsidiary—who will then operate the plan on a stand-alone basis—the Internal Revenue Code requires that actuarial assumptions used to assign assets to the PBGC plan termination participant priority categories be “reasonable.”⁵² For this purpose, the Internal Revenue Code deems as reasonable the same assumptions to value liabilities as it uses to calculate the existence of any funding deficiency in a qualified defined benefit pension plan when it is terminated.⁵³ Because the PBGC has a claim under ERISA against the plan’s sponsor (as well as any company in the sponsor’s “controlled group”) equal to the amount of such funding deficiency when a qualified defined benefit pension plan is terminated,⁵⁴ the assumptions that ERISA prescribes in a termination scenario tend to ensure that the liability has not been underestimated. In other words, the amount of assets that the parent will need to allocate to the spun out plan will tend to be higher than if actuarial assumptions to value liabilities in a continuing plan had been employed.

As a result, the parent may discover that in order to spin out the subsidiary plan it may have to transfer assets that differ significantly from what had been allocated to the subsidiary on an accounting cost or other internal basis. This is because on an ongoing plan funding basis the actuarial assumptions required are less stringent than the assumptions required to determine plan funding on a termination basis and the assets need not be allocated among participants on a PBGC plan termination priority category basis. If the joint plan were underfunded, this may result in either of the parent’s plan or the spinoff plan being underfunded to a larger extent than had been anticipated, which could call into question the feasibility of spinning out the subsidiary plan.

⁵² *Id.* § 1.414(l)-1(n)(1). An exception to this general rule exists where the assets spun off during a plan year are less than 3% of the plan’s assets. In such case, the transfer may be made using reasonable actuarial assumptions to present value the secured benefits being spun off. *Id.* § 1.414(l)-1(n)(2).

⁵³ *Id.* § 1.414(l)-1(n)(1).

⁵⁴ 29 U.S.C. § 1362(a) (2006).

Even if the joint plan were overfunded on an ongoing basis, transferring a portion of the plan to the subsidiary may create additional issues. First, of course, some of that overfunding would be needed to fully fund the plan using termination basis actuarial assumptions. Second, if for some reason the spin out were to occur while the subsidiary is still part of the parent's controlled group, then a pro rata portion of the overfunding must be transferred to the new subsidiary plan as provided in the Internal Revenue Code,⁵⁵ and there might be a dispute between the parent and the subsidiary as to who is entitled to the overfunding. The resolution of that dispute could depend on an analysis of the assets contributed by the parent, the subsidiary, and other participants in the joint plan and the accrued liabilities associated with each such entity. This analysis likely could be expensive, timeconsuming, and inconclusive where the parent and subsidiary attempt to use different actuarial or other assumptions to justify their positions.

These various complexities may lead the parent to determine that no portion of the joint qualified employee benefit plan should be transferred to the subsidiary. Instead, upon the effective date of the subsidiary's chapter 11 reorganization plan, the subsidiary would create completely new stand-alone benefit plans. Any benefits that the subsidiary's employees have accrued under the parent's joint plan will remain obligations of that joint plan. The employees will also accrue future benefits under the subsidiary's new benefit plans on an ongoing basis, and these benefits will be the sole obligation of the reorganized subsidiary.

While seemingly efficient, this approach raises its own practical and legal issues. First, the subsidiary's employees now will be covered under two separate sets of benefit plans: (i) the parent's joint plan for benefits accrued prior to the effective date of the subsidiary's reorganization and (ii) the subsidiary's new plans for benefits accrued after that date. This arrangement, of course, has the potential for creating confusion and administrative difficulties. Second, the companies will need to address complicating issues such as employees who may not have fully vested at the time of separation.⁵⁶ For example, imagine someone who has been employed by the subsidiary for one year at the time the parent and subsidiary separate and who will only vest in retirement benefits if employed by the subsidiary for four additional years.

⁵⁵ 26 U.S.C. § 414(l)(2) (2006).

⁵⁶ Other issues that are likely to arise are the joint plan's responsibility for early retirement subsidies, disability benefits, or benefits based on a final average pay formula that participants may become entitled to under the subsidiary's new plan but which are attributable to service while participating in the joint plan.

In this example, the subsidiary may request that the employee be deemed fully vested in the parent's joint plan for one year at the time the companies separate to ensure that the employee receives credit for the one year of service. However, the joint plan may have been funded by the subsidiary with less than one year of benefits for this employee, since the likelihood that the employee would have remained employed by the subsidiary for the entire five year period will be significantly less than one hundred percent. Therefore, to fully vest the employee may require additional contributions to the plan that the parent will be unwilling to make from its own funds. Similarly, the subsidiary may request that if the employee remains employed with the subsidiary for the entire five year period, then the parent will pay twenty percent of the vested benefits. However, again the subsidiary may have funded the joint plan with less than twenty percent of the benefits payable if the employee remains with the subsidiary for five years, since the actuarial chances of that occurring at the time may have been less than twenty percent.

The parent may aver that it will pay the percentage of the benefits to the employee equal to the portion of the funding it has received from the subsidiary. The subsidiary, of course, will counter that if the employee leaves its employment so that no benefits are due, the parent should return the past contributions to the subsidiary. While this might be an appropriate arrangement, it is administratively complicated and may be difficult to implement within the rules and regulations prescribed by ERISA.

In addition, it is possible that the Internal Revenue Service could interpret the arrangement between the parent and the subsidiary as a "partial termination" of the joint pension plan under ERISA.⁵⁷ By that interpretation, all employees of the subsidiary would be deemed to have been fully vested under the plan, thereby creating a significant liability that would need to be allocated between the parent and subsidiary. The foregoing complex issues create the specter that the parent and subsidiary simply may not agree about how to separate the subsidiary's employees out of the parent's joint qualified plans. Without an agreement, the parties may end up litigating over their respective rights and obligations, both of which may be highly uncertain.

⁵⁷ *Id.* § 411(d)(3).

3. *Non-Qualified Plans*

Problems may also arise between the parent and the subsidiary regarding the allocation of liabilities under non-qualified plans. These would include plans such as supplemental retirement and other similar plans. Unlike qualified plans, non-qualified plans do not impose joint and several liability on a controlled group. In addition, non-qualified plans are rarely funded. Instead, they merely represent a claim by the employee against the relevant employer. Unfortunately, where corporate families have joint non-qualified plans, it may be somewhat difficult to determine against which employer or employers the employees have claims. While ERISA would not make the parent liable for claims of the subsidiary's employees, the plan itself might do so, either by not addressing the liabilities allocated among participating controlled group members or by providing an allocation that does not fully shift the cost of the subsidiary's employee benefits to the subsidiary.

C. Analysis of Joint Programs: Insurance Programs

Another area where the parent may be operating a joint program for all of its subsidiaries, including its now bankrupt subsidiary, is insurance. The insurance program typically will involve general business insurance, such as casualty and liability insurance covering all of the entities in the corporate family, as well as director and officer insurance.

Business insurance tends not to raise serious issues when one of the corporate family members files for bankruptcy. Each of the corporate members typically files its own claims with the insurer for the relevant casualty or liability, and the insurance company reimburses the company, subject to any per occurrence deductible and any overall policy cap for each occurrence or for all occurrences in a given policy year. However, an insurance company may realize that once the subsidiary files for bankruptcy the policy becomes part of the subsidiary's bankruptcy estate. As a result, to the extent that the insurance company may be depleting the insurance available to the subsidiary by paying claims of the other corporate family members, the insurance company arguably could be violating the automatic stay in the subsidiary's bankruptcy case.⁵⁸ For instance, if the corporate family is close to

⁵⁸ See, for example, *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001–02 (4th Cir. 1986), holding:

Any action in which the judgment may diminish [an] “important asset” is unquestionably subject to a stay Accordingly actions “related to” the bankruptcy proceedings against the insurer or against officers or employees of the debtor who may be entitled to indemnification under such

reaching its aggregate policy limit under an insurance policy, paying claims to insureds other than the subsidiary may have the effect of leaving the subsidiary without a right to insurance reimbursement once the policy limit is reached.

These issues are magnified in the context of director and officer insurance. Financial difficulties that led the subsidiary to file for bankruptcy also may give rise to various lawsuits against the subsidiary's directors and officers for causing, or failing to adequately disclose under the securities laws the financial situation of the subsidiary, or for alleged breaches of fiduciary duty or other common law responsibilities. As a result, there may be a flood of claims against the subsidiary's officers and directors, and against the subsidiary itself. These claims potentially are covered by the corporate family's director and officer insurance policy, and the insurance company may rightly believe that there is a risk that the policy will be exhausted. As a result, once the subsidiary has filed for bankruptcy, the insurance company may refuse to reimburse any entity covered by the policy (other than the subsidiary) absent approval of the subsidiary's bankruptcy court. Such entities would include the other members of the corporate family and, more importantly, the directors and officers of the parent and such other corporations. Again, the insurance company would not want to risk that it would be sued for violating the automatic stay in the subsidiary's bankruptcy case by depleting insurance proceeds potentially available to the subsidiary and its creditors as a result of paying claims under the policy to entities other than the subsidiary.

The bankruptcy of the subsidiary, therefore, may create a situation where the parent's officers and directors are unable to access their own policies. This may be particularly troubling since it is possible that these directors and officers could be subject to suit as a result of the subsidiary's chapter 11 filing. As described in Part F of this Section below, the creditors of the subsidiary may argue that the parent, as controlling shareholder of the subsidiary, and the parent's directors and officers, had fiduciary duties to the subsidiary's creditors once the subsidiary entered the "zone of insolvency." The creditors might allege that these duties were breached by various actions that the parent and its directors and officers took or failed to take. Furthermore, in this financial situation, shareholders of the parent itself might be suing the parent's officers and directors under the securities laws for failure to adequately disclose the financial difficulties of the subsidiary if the bankruptcy of that subsidiary has

policy or who qualify as additional insureds under the policy are to be stayed under section 362(a)(3).

had a material negative impact on the parent's stock price. These lawsuits will lead the parent's directors and officers to seek reimbursement from the corporate family's directors' and officers' insurance policy. Absent access to this policy, the directors and officers would thus be left exposed, except to the extent that the parent had indemnified these parties for such liability. In that case, it would be the parent and not the subsidiary that would have the legal exposure. The parent, however, potentially would be unable to access its own insurance coverage.

While it may be somewhat surprising that there is a risk that the parent and its officers and directors could not access the corporate family's joint director and officer insurance policy, this result is a function of the typical structure of these policies. There are three basic types of director's and officer's insurance coverage: (i) direct coverage for the directors and officers, (ii) indemnification coverage for the corporation, and (iii) so-called "entity coverage" for the corporation. Direct coverage is the coverage that runs directly to the relevant officers and directors and is the primary purpose of the insurance policy. As a result, it is found in essentially all director's and officer's insurance policies. Indemnification coverage runs to the corporation and reimburses the corporation for indemnity payments made to the directors and officers for some of the same types of acts otherwise covered by the director's and officer's insurance. This coverage essentially permits the directors and officers to look directly to the corporation and to let the corporation deal with the complexities of obtaining reimbursement from the insurance company. Finally, entity coverage runs directly to the corporation and insures the corporation for its own losses. Entity coverage was created at least in part to avoid the need in a lawsuit against the directors and officers to apportion liability between such parties and the corporation itself. Since all the entities are covered under the same policy, the insurance company pays under the policy as long as one of the parties was found liable. Further, payments under the policy are made without regard to the extent of the respective liability of the corporation's directors and officers and the corporation itself.

Upon the bankruptcy filing of an insured corporation, however, the inclusion of both indemnification coverage and entity coverage in the director and officer insurance policy may have the effect of making the policy a direct asset of the insured corporation's bankruptcy estate. If the policy covers only the corporation's officers and directors, most courts have held that even if the policy were somehow property of the estate, the proceeds of the policy would

be solely property of the insured directors and officers.⁵⁹ As a result, the bankruptcy of the corporation would not affect the right of its directors and officers to access the policy. The same result should be true with respect to a joint director and officer insurance policy that insures only the officers and directors of the parent and of the other members of the corporate family, including the subsidiary.

However, once the subsidiary itself is a named insured under the joint policy, the policy may become an asset of the subsidiary's bankruptcy estate.⁶⁰ While it is an asset that is shared with other entities, including the parent and the directors and officers of the other corporations in the corporate family, the creditors of the subsidiary will take the position that the asset should be preserved for their benefit. To do so, to the extent necessary, the insurance company would not be authorized to pay any claims under the policy other than to the subsidiary, and the various rights and interests in the policy would be managed by the court in the subsidiary's bankruptcy. For instance, if the direct, indemnification, and entity coverages are subject to a common policy cap, payments by the insurance company under the direct coverage to any directors or officers would have the effect of potentially depleting the indemnification and entity coverage available to the subsidiary. Therefore, the subsidiary's creditors will assert that such payments should not be made, at least not without bankruptcy court approval.

How the bankruptcy court ultimately will sort out the various rights to the insurance policy is still a matter of developing law. For instance, while a number of courts have confirmed that policies containing indemnification coverage are property of the estate,⁶¹ the recent trend is to recognize that the

⁵⁹ *Houston v. Edgeworth (In re Edgeworth)*, 993 F.2d 51, 56 (5th Cir. 1993) (“[W]hen the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.”); *La. World Exposition, Inc. v. Fed. Ins. Co. (In re La. World Exposition, Inc.)*, 832 F.2d 1391, 1401 (5th Cir. 1987) (The bankruptcy “‘proceeds concept’ does not give the bankrupt’s estate property the debtor would not own if it were solvent.”); *Duval v. Gleason*, No. 90-0242, 1990 WL 261364, at *4-7 (N.D. Cal. Oct. 19, 1990) (holding D & O insurance is property of the estate; the proceeds, however, are not estate property); *Ochs v. Lipson (In re First Cent. Fin. Corp.)*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999) (“While a majority of courts consider a D & O policy estate property, . . . there is an increasing view that a distinction should be drawn when considering treatment of proceeds arising under such policies.”); *In re Daisy Sys. Sec. Litig.*, 132 B.R. 752, 755 (Bankr. N.D. Cal. 1991) (finding proceeds from D & O policy not to be estate property because the directors and officers were the primary beneficiaries under the plan).

⁶⁰ *See generally In re Allied Digital Techs. Corp.*, 306 B.R. 505, 512 (Bankr. D. Del. 2004).

⁶¹ *Id.* at 512. Encapsulating its view of existing law, the court in *In re Allied Digital Technologies Corp.* stated:

directors and officers insured under such policies perhaps should have primary rights.⁶² However, the courts are not consistent in this trend.⁶³ In addition, the courts have only barely begun to even address the effect of entity coverage on the rights of officers and directors under a policy which includes such coverage.⁶⁴

The Court concludes that when a debtor's liability insurance policy provides direct coverage to the debtor the proceeds are property of the estate, because the proceeds are payable to the debtor. Further, when the liability insurance policy only provides direct coverage to the directors and officers the proceeds are not property of the estate. However, when there is coverage for the directors and officers and the debtor, the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution. Lastly, when the liability policy provides the debtor with indemnification coverage but indemnification either has not occurred, is hypothetical, or speculative, the proceeds are not property of the bankruptcy estate.

Id. See also Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp. (*In re* Minoco Group of Cos., Ltd.), 799 F.2d 517, 519 (9th Cir. 1986) (holding that policies are property of the estate because the policies insure the corporation against indemnity claims); Aetna Cas. & Surety Co. v. Jasmine, Ltd. (*In re* Jasmine, Ltd.), 258 B.R. 119, 128 (D.N.J. 2000); *In re* Sacred Heart Hosp. of Norristown, 182 B.R. 413, 419–21 (Bankr. E.D. Pa. 1995); Circle K Corp. v. Marks (*In re* Circle K Corp.), 121 B.R. 257, 259 (Bankr. D. Ariz. 1990) (“*Louisiana World* appears distinguishable as it primarily focused on director-officer liability coverage, not indemnification coverage. Thus, that court had no need to address the issue confronted by the [court]: Whether the policy protects against a diminution of estate assets.”).

⁶² The Bankruptcy Court for the District of Delaware has held that, where an insurance policy provided indemnification coverage, but indemnification did not occur, was speculative or hypothetical, the proceeds were not property of the estate. *In re Allied Digital Tech. Corp.*, 306 B.R. at 512. The District Court of the Southern District of New York has held that, where an insurance policy covered indemnification payments required to be made to directors and officers under a bankrupt company's bylaws, but no such payments had yet been made or contemplated, the company had no property interest in the proceeds of the policy, and thus these proceeds were not covered by the automatic stay. *In re Adelpia Commc'ns Corp.*, 298 B.R. 49, 54–55 (S.D.N.Y. 2003).

⁶³ Compare *In re Minoco Group of Cos. Ltd.*, 799 F.2d at 519 (holding policies and proceeds are the property of the bankruptcy estate because the policies insured the corporation against indemnity claims) with *In re Daisy Sys. Sec. Litig.*, 132 B.R. at 755 (holding proceeds are not estate property because the directors and officers are the primary beneficiaries of the D & O insurance policy).

⁶⁴ One court noted:

The allocation of D & O policy proceeds between directors and an entity where both claim coverage is a fairly novel issue. [T]his Court has not found a single bankruptcy case where the court has been asked to purely allocate D & O proceeds between a debtor entity and its directors and officers.

Nat'l Century Fin. Enters., Inc. v. Gulf Ins. Co. (In re Nat'l Century Fin. Enters., Inc.), No. 02-65235, 2005 Bankr. LEXIS 1052, at *23 (Bankr. S.D. Ohio Jan. 10, 2005). The court reasoned that, as a result of the large claims held by NCFE, if a prorated distribution of the policy between NCFE and the officers was made, the directors and officers would be left with virtually nothing. *Id.* at *29. The court held that “[n]ot only would a strict proration be inequitable, but it would subvert the actual intent of D & O insurance policies, which are primarily for the benefit of directors and officers.” *Id.* at *29–30. However, the policy specifically provided for entity coverage. Thus, the court held that the

As a result of these issues, the parent may wish to separate the subsidiary and its directors and officers from the parent's joint director and officer insurance policy prior to the subsidiary's bankruptcy filing. Indeed, this would be prudent based on the analysis outlined above. However, at the time the parent recognizes that it may wish to take this course of action, the market for director and officer insurance for the subsidiary may have changed dramatically. The financial distress of an entity typically results in dramatically increased cost for director and officer coverage since insurance companies know that such financial distress often is also associated with significant litigation against the subsidiary's directors and officers. As a result, a parent should consider whether it ever wants to share director and officer liability insurance with a subsidiary that has any aspect of financial distress, even if the chances of the subsidiary filing bankruptcy appear remote.

Another key issue, then, for the subsidiary is whether the parent has some obligation to continue including the subsidiary in the parent's director and officer insurance program. This obligation could arise from intercompany agreements, including an overhead services agreement, or from some common law duty.⁶⁵ Even absent such an obligation, the parent may be required to at least purchase tail coverage at the subsidiary's expense once the current director and officer insurance policy is to lapse. This coverage will allow the subsidiary and its officers and directors to continue to file claims against the policy arising from actions taken before the expiration of the policy through the end of the term of the tail coverage. Consequently, because the total number and amount of claims asserted against a subsidiary and covered by the policy cannot be known until the tail period expires, the extent to which a subsidiary will have an interest in the parent's policy will be subject to uncertainty.

Finally, the parent should be concerned about one additional issue arising under the joint director and officer insurance policy. The majority of these policies have what is known as the "insured vs. insured" exception to coverage, which provides that there is no coverage if one insured sues another

proper balance is to make a 70 percent distribution of the Proceeds to the directors for their defense costs and a 30 percent distribution to the Unencumbered Assets Trust (essentially NCFE's creditors) to allow it to recoup the myriad of costs it has incurred as a result of NCFE's (and its directors) financial irresponsibility and perhaps fraud.

Id. at *30–31.

⁶⁵ For common law potential obligations of a controlling shareholder parent to its subsidiary or the subsidiary's creditors, see Part F below.

insured. The rationale behind such exclusion is prevention of collusive lawsuits between insureds for the purpose of accessing insurance proceeds. However, for the reasons described in Part F below, the subsidiary may have certain causes of action against the parent and its officers and directors such as breach of fiduciary duty, which is covered by the insurance policy. Because the parent, its directors and officers, and the subsidiary are all insureds under the policy, the insured vs. insured exception may prevent the parent and its directors and officers from being insured for such a suit. Again, the directors and officers may be indemnified by the parent for any resulting losses, meaning that it would only be the parent that would be without a right of reimbursement in such a situation.

The case law does not provide clear guidance on whether courts would enforce the insured vs. insured exception in bankruptcy. There are policy arguments for disallowing the exception, namely that (i) the subsidiary, acting essentially as a bankruptcy trustee, represents the creditors of the corporation, not the corporation; and (ii) the exclusion exists to prevent collusion between the company and the officers and directors, whereas the subsidiary is in an adversarial position to the parent's officers and directors. Nevertheless, not all courts that have considered this issue have found these arguments convincing.

Earlier cases held that the insured vs. insured exception applied to a suit by a bankrupt company against other insureds under the policy because the debtor brought the claims on behalf of the company.⁶⁶ By contrast, the majority of the recent cases reject that reasoning. Mindful of the policy arguments presented above, these later cases stand for the proposition that the insured vs. insured exception is not applicable to a debtor in bankruptcy, and the policy covers the claims brought by such a debtor.⁶⁷ Some of the cases, however, turn on vagaries of the language of the insurance contract.

⁶⁶ Nat'l Union Fire Ins. Co. of Pittsburgh v. Olympia Holding Corp., No. 1:94-CV-2081, 1996 WL 33415761, at *7 (N.D. Ga. June 4, 1996) ("The bankruptcy trustee stands in the shoes of the debtor corporation . . ."); Reliance Ins. Co. of Ill. v. Weis, 148 B.R. 575, 583 (E.D. Mo. 1992).

⁶⁷ See *Alstrin v. St. Paul Mercury Insurance Co.*, 179 F. Supp. 2d 376, 404 (D. Del. 2002), stating:

The court agrees with the D & O plaintiffs and the Estate Representative that the "insured v. insured" exclusion should not apply to claims brought by a bankruptcy Estate Representative against the former directors and officers of the Debtor where the Debtor is the insured entity, because the Debtor's Estate Representative . . . and the Debtor . . . are separate entities.

See also *Cohen v. National Union Fire Insurance (In re County Seat Stories, Inc.)*, 280 B.R. 319, 324–29 (Bankr. S.D.N.Y. 2002), stating:

This Court agrees with the defendant that the Trustee is asserting claims that *belonged* to County Seat as of the date of filing its bankruptcy petition. However, the Court does not agree that by

D. Analysis of Joint Programs: Tax Programs

Quite frequently, tax matters also create complexities for a parent when one of its subsidiaries becomes insolvent and must file for bankruptcy. The principal source of potential conflict when the parent and the subsidiary do not join in filing a consolidated federal income tax return is the parent's desire to obtain a tax benefit from writing off its investment in the subsidiary and the subsidiary's ability to preserve its tax losses for the benefit of its future owners (i.e., the subsidiary's creditors). When the parent and the subsidiary join in filing a consolidated federal income tax return, potential conflicts can arise about which entity, parent or subsidiary, is entitled to tax refunds. The presence of a tax sharing agreement between parent and subsidiary may dictate the result.

To claim a worthless stock deduction for the stock of a consolidated subsidiary, the parent must satisfy the requirements of the consolidated return regulations that govern worthless stock deductions. As a general proposition, worthlessness is deferred under the regulations until an effective reorganization plan prompts the cancellation of the parent's stock in the subsidiary, after which time the subsidiary is no longer a member of the parent group.⁶⁸ When

virtue of the trustee asserting claims that at one time belonged to the Debtor, he merely stands in the shoes of the Debtor or has somehow assumed the identity of the Debtor.

See also *Gray v. Executive Risk Indemnity, Inc. (In re Molten Metal Technology, Inc.)*, 271 B.R. 711, 730–31 (Bankr. D. Mass. 2002), stating:

But even if the Trustee, standing in the shoes of the Debtor, were in some valid sense asserting a direct claim against the Insurers for coverage, this argument would fail for a second reason: that the insured-versus-insured exclusion is triggered only when the Debtor brings a claim, and here that has not happened.

See also *Rieser v. Baudendistel (In re Buckeye Countrymark, Inc.)*, 251 B.R. 835, 840–41 (Bankr. S.D. Ohio 2000), stating:

[T]he very purpose of an “insured vs. insured” exclusion does not apply to adversarial claims brought by the Trustee against the Debtor’s directors, officers and managers When the plaintiff is not the corporation but a bankruptcy trustee acting as a genuinely adverse party to the defendant officers and directors, there is no threat of collusion. Under these circumstances, an “insured vs. insured” exclusion does not excuse the insurance companies from coverage.

But see *Terry v. Fed. Ins. Co. (In re R.J. Reynolds-Patrick Country Mem’l Hosp., Inc.)*, 315 B.R. 674, 680–81 (Bankr. W.D. Va. 2003) (holding that the insured v. insured exclusion prohibited coverage for a lawsuit against the former directors and officers of the debtor where the plan provided for the creation of a trust and the debtor voluntarily assigned its claims against the directors and officers to the trust).

⁶⁸ Treas. Reg. §§ 1.1502-80(c), 1.1502-19(c) (2006). These regulations were recently modified to make clear that a worthless stock deduction could be claimed with respect to the stock of a consolidated subsidiary that successfully reorganizes and continues to operate under new ownership.

the parent claims a worthless stock deduction with respect to a consolidated subsidiary, the loss is usually an ordinary loss for federal income tax purposes.⁶⁹ Ordinary losses may be used to offset the parent's income from other sources for the year, carried back two years to generate a refund of taxes previously paid, or carried forward up to twenty years to offset parent income in future years.⁷⁰ Ordinary losses are only available for domestic (United States) subsidiaries, and the subsidiary which is claiming the losses must be directly owned by the parent.⁷¹ If an intermediate corporation holds the subsidiary stock, the intermediate corporation would claim the worthless stock deduction. Ordinary losses are also reserved for subsidiaries actively engaged in a business. If the subsidiary derives ten percent or more of its gross revenues from passive sources such as interest, dividends and certain rents, the associated loss generally will be capital.⁷²

The consolidated return regulations now reduce any net operating losses that the consolidated subsidiary would otherwise carry forward following emergence from bankruptcy by the amount of the parent's worthless stock deduction, apparently without regard to whether the parent actually claims the deduction.⁷³ The extent to which the subsidiary can benefit from any losses that remain after this reduction depends on a number of factors, including the amount of debt cancellation that occurs under the subsidiary's plan of reorganization and the value of the reorganized subsidiary. Debt cancellation generally results in the reduction of the subsidiary's tax attributes, starting with its unused losses.⁷⁴ Any losses remaining after debt cancellation will be subject to an annual limitation if, as is generally the case, the subsidiary undergoes an ownership change as a result of its plan of reorganization.⁷⁵

Worthless stock deductions with respect to the stock of a subsidiary that is not consolidated can create tension with the subsidiary's creditors. The parent

⁶⁹ 26 U.S.C. § 165(g)(3) (2006).

⁷⁰ *Id.* § 172.

⁷¹ *Id.* § 165(g)(3)(A).

⁷² *Id.* § 165(g)(3)(B).

⁷³ Treas. Reg. § 1.1502-35(d) (generally effective Sept. 17, 2008).

⁷⁴ 26 U.S.C. § 108(b).

⁷⁵ *Id.* § 382. This section, one of the most complex in the Internal Revenue Code, provides generally that if ownership of more than fifty percent of the corporation changes hands, the corporation's losses will be subject to an annual limitation equal to roughly five percent of the value of the corporation at the time of the change. Two special rules apply to corporations in bankruptcy. Under the first rule, the value of the corporation is measured after its debts are restructured pursuant to the plan. Under the second, alternative rule, the corporation's net operating losses are reduced but the annual limitation does not apply. *See Id.* § 382(l)(5)-(l)(6).

must claim a worthless stock deduction in the year in which the subsidiary's stock becomes worthless as an economic matter. Worthlessness is not deferred until the plan is effective because the consolidated return regulations do not apply, and could occur well before the subsidiary's reorganization plan is effective—even before the petition is filed. To claim the worthless stock deduction, the parent must demonstrate that it has a tax basis in the subsidiary stock, that the stock had value at the beginning of the year in which the deduction is claimed, and that the stock had no value at the end of that year. Worthlessness requires two factual showings for federal income tax purposes. First, there must be evidence the subsidiary's stock would produce no recovery for equity if the subsidiary were liquidated. Second, the subsidiary cannot have any prospect of returning to solvency and profitability at some future date. A bankruptcy filing may be evidence of worthlessness but generally will not itself establish that the subsidiary's stock has no value.

If the parent claims a worthless stock deduction for a nonconsolidated subsidiary before the plan is effective, the deduction may eliminate the subsidiary's unused losses.⁷⁶ To the extent those losses may be of value to the subsidiary following its reorganization, the subsidiary's creditors may seek to prevent the parent from claiming the worthless stock deduction until the plan of reorganization becomes effective.

First, as discussed below, there is law suggesting that a controlling shareholder may have fiduciary duties to the creditors of a subsidiary.⁷⁷ Taking a worthless stock deduction, which could have the effect of destroying a valuable asset of the subsidiary, arguably could be contrary to any such fiduciary duties.

⁷⁶ *Id.* § 382(g)(4)(D). This section deems the parent's treating the subsidiary's stock as worthless to be an ownership change. Because the ownership change occurs when the subsidiary has no value, the annual limitation on its losses is zero.

⁷⁷ See *Teleglobe Commc'ns USA, Inc. v. BCE, Inc.* (*In re Teleglobe Commc'ns Corp.*), 493 F.3d 345, 367 (3d Cir. 2007) (stating that if the subsidiary is insolvent, whoever controls the subsidiary is required to protect the interests of the subsidiary's creditors); Official Comm. of Unsecured Creditors of *Hechinger Inv. Co. of Del. v. Fleet Retail Fin. Group* (*In re Hechinger Inv. Co. of Del.*), 280 B.R. 90, 94 (D. Del. 2002) ("Delaware case law suggested that controlling shareholders may be liable to creditors for breach of fiduciary duty . . ."); *Weaver v. Kellogg*, 216 B.R. 563, 583 (S.D. Tex. 1997) ("[F]iduciary obligation on a dominant or controlling stockholder or stockholders is not just for the protection of the corporation or its other stockholders, but extends to corporate creditors as well" when the rights of creditors are involved.); Official Comm. of Unsecured Creditors of *High Strength Steel, Inc. v. Lozinski* (*In re High Strength Steel Inc.*), 269 B.R. 560, 569 (Bankr. D. Del. 2001) ("That fiduciary duty requires that the controlling shareholder(s) and director(s) of the debtor maximize the value of the assets for payment of unsecured creditors.").

Second, even if the parent takes a worthless stock deduction prior to the subsidiary's chapter 11 filing, such deduction could potentially be undone. For instance, in the subsidiary's chapter 11 case, the subsidiary's creditors could seek to unwind the taking of the worthless stock deduction as a fraudulent conveyance. Courts have held that an entity's net operating losses constitute interests in property.⁷⁸ In addition, numerous cases indicate that when a debtor takes a tax deduction or makes an election, the action can be considered a transfer.⁷⁹ Consequently, it can be argued that the taking of a worthless stock deduction by the parent when the subsidiary is insolvent constitutes a transfer of an interest of the subsidiary's property for no consideration to the subsidiary and therefore is a fraudulent conveyance.⁸⁰

Occasionally, a parent company may not be interested in taking a worthless stock deduction. Instead, the parent might rather sell for a nominal price or donate its stock in a subsidiary that is on the eve of bankruptcy. The driving force behind the parent's desire to effectively give away its worthless stock in the subsidiary is that the parent will no longer be a controlling shareholder of the subsidiary and will thereby rid itself of any continuing duties to the subsidiary or its creditors. Of course, this strategy has the downside of causing the parent to lose any control over the actions of the subsidiary. Even more to the parent's detriment, the transfer of the parent's stock could itself be viewed as a fraudulent conveyance or a breach of fiduciary duty because of the potentially adverse tax consequence such a transfer would have for the subsidiary.

For federal income tax purposes, the sale of the subsidiary for a nominal sum would generally give rise to a capital loss, which the parent could apply only against capital gains from other transactions. The transfer of the stock for no consideration (or outright abandonment of the stock) will also give rise to a

⁷⁸ *Segal v. Rochelle*, 382 U.S. 375, 378–81 (1966) (finding that net operating loss carryback was property of the debtor's estate under predecessor to the Bankruptcy Code); Official Comm. of Unsecured Creditors v. PSS S.S. Co. (*In re Prudential Lines*), 928 F.2d 565, 572 (2d Cir. 1991) ("The fact that the right to a NOL carryforward is intangible and has not yet been reduced to a tax refund also does not exclude it from the definition of property of the estate."); *Gibson v. United States (In re Russell)*, 927 F.2d 413, 418 (8th Cir. 1991) (stating that the right to carry forward NOLs is a property interest of the estate).

⁷⁹ *Feiler v. Towers (In re Feiler)*, 230 B.R. 164, 171 (B.A.P. 9th Cir. 1999); *Bakersfield Westar, Inc. v. Saunders (In re Bakersfield Westar, Inc.)*, 226 B.R. 227, 236 (B.A.P. 9th Cir. 1998); *Guinn v. Lines (In re Trans-Lines W. Inc.)*, 203 B.R. 653, 666 (Bankr. E.D. Tenn. 1996).

⁸⁰ In fact, courts have found a fraudulent transfer where a debtor makes a subchapter S revocation or a repitition election to carry forward net operating losses. *In re Feiler*, 230 B.R. at 171; *In re Bakersfield Westar, Inc.*, 226 B.R. at 236; *In re Trans-Lines W. Inc.*, 203 B.R. at 666.

capital loss.⁸¹ A transfer of either type, however, would trigger an ownership change, which could severely limit or even eliminate the subsidiary's unused net operating losses.⁸² Once again, the creditors may object or seek to undo the transfer.

Tax refunds can pose complications between the parent and its subsidiary when they comprise or are part of a consolidated group. A question arises as to who is entitled to the immediate benefit (i.e., cash) from losses generated at the subsidiary level. If the parent and the subsidiary are party to a tax sharing agreement that deals with this issue, the agreement will generally govern unless the agreement can be challenged. If the corporations are not party to a tax sharing agreement, then the answer depends on the facts and circumstances giving rise to the refund.

Consolidated groups usually have either a formal tax sharing agreement or a specific course of dealing with respect to taxes. Under most of these arrangements, the parent and each subsidiary determine their taxable income or loss for the taxable year on a stand-alone basis. The parent then serves as a clearinghouse of sorts—billing subsidiaries with taxable income for their stand-alone taxes, paying cash to subsidiaries with taxable losses in amounts equal to the refunds they would have received had they filed on a stand-alone basis, and paying any excess to the IRS. The intragroup payments compensate the loss-making subsidiaries for the use of their losses by the profit-making subsidiaries. Intragroup payments may or may not be made if the group's losses exceed its taxable income. Under these circumstances, the group is not currently able to use all of the losses.

Under the stand-alone approach employed by many tax sharing agreements, an actual tax refund would go to the subsidiary that would have been entitled to it had it filed tax returns on its own. For example, if Subsidiary X generated \$2,000,000 of taxable income in 2006 and a \$2,000,000 loss in 2007, a stand-alone Subsidiary X would have carried the 2007 loss back to 2006 to generate a federal income tax refund of approximately \$700,000. The consolidated group's tax sharing agreement would often provide that Subsidiary X is entitled to the refund, even though the IRS pays the refund to the parent. On

⁸¹ Some taxpayers previously took the position that abandonment gives rise to an ordinary loss under § 165(a) even if the subsidiary does not qualify for ordinary loss treatment under § 165(g)(3). Effective March 2008, however, abandonment losses are capital losses unless the § 165(g)(3) affiliation and business receipts tests are satisfied. Treas. Reg. § 1.165-5(i).

⁸² 26 U.S.C. § 382 (2006).

the other hand, the tax sharing agreement could provide that the parent keeps all refunds.

Case law demonstrates that courts generally respect tax allocation or tax sharing agreements even if the terms of the agreements may be somewhat unfavorable to the subsidiary.⁸³ However, if the parent implements a tax sharing agreement unfavorable to the subsidiary after the subsidiary's financial difficulties become apparent, the subsidiary's creditors may ultimately argue that such agreement should be voided either as a fraudulent transfer, as a breach of the parent's fiduciary duties, or on some other basis indicating that the parent has committed an act of overreaching.

If the group has no tax sharing agreement or regular course of dealing, then entitlement to the refund generally depends on (i) which entity's losses are being used to generate the refund, (ii) which entity's income gave rise to the prior tax liability, and (iii) which entity actually paid the tax which is now sought to be refunded. The easy case is if the prior income and current losses are each attributable to the subsidiary, and the subsidiary also paid the prior tax. In this instance, the refund is likely the property of the subsidiary.⁸⁴ However, the refund might not belong to the subsidiary if the subsidiary's losses were used to generate the refund and the prior year's income was from another member of the corporate group. Similarly, the refund might not belong to the subsidiary if the prior year's taxes were paid by another member of the group.⁸⁵ Since there may be several different permutations of the relevant facts, the parent and the subsidiary may sharply disagree as to which entity is entitled to all or any part of certain tax refunds.⁸⁶

⁸³ See *Franklin Sav. Corp. v. Franklin Sav. Ass'n (In re Franklin Sav. Corp.)*, 159 B.R. 9, 29–33 (Bankr. D. Kan. 1993), *aff'd*, 182 B.R. 859, 865 (D. Kan. 1995) (tax allocation agreement upheld even though the effect of such agreement was that the subsidiary was not entitled to a tax refund which resulted from offsetting the subsidiary's losses against its own prior income); see also *Superintendent of Ins. for New York v. First Cent. Fin. Corp. (In re First Cent. Fin. Corp.)*, 269 B.R. 481 (Bankr. E.D.N.Y. 2001), *aff'd*, 377 F.3d 209 (2d Cir. 2004).

⁸⁴ See, e.g., *W. Dealer Mgmt., Inc. v. England (In re Bob Richards Chrysler-Plymouth Corp.)*, 473 F.2d 262, 264–65 (9th Cir. 1973).

⁸⁵ *Jump v. Manchester Life & Cas. Mgmt. Corp.*, 579 F.2d 449, 452–54 (8th Cir. 1978) (refund did not belong to subsidiary where the prior year's income was that of an affiliate, which also paid the prior year's tax).

⁸⁶ See, e.g., *FDIC v. Brandt (In re Fla. Park Banks, Inc.)*, 110 B.R. 986, 987–89 (Bankr. M.D. Fla. 1990) (FDIC, as successor to bankrupt thrift, successfully argued that it was entitled to the entire refund payable to corporate group, even though entities other than the subsidiary had losses that could be carried back to generate the refund, because the subsidiary's losses alone were sufficient to generate the entire refund and the tax refunded originally was paid by the subsidiary).

These complexities aside, the parent and the troubled subsidiary have a common interest in maximizing the tax benefits to be obtained from the subsidiary's financial difficulties. Sometimes this maximization may involve the parent claiming a worthless stock deduction and compensating the subsidiary for the elimination of its loss carryovers. In other cases, maximization may require postponing the worthless stock deduction to make the most of the subsidiary's losses.

E. Statutory Control Group Liability

Under certain statutes, the parent may find itself responsible for the acts or omissions of its subsidiaries even without common law liabilities such as alter ego liability or veil-piercing. As described below, in some cases the parent may have strict liability for the debts of the parent under "control group" state and federal liability statutes. In these circumstances, the actions or inaction of the parent may not matter. Instead, the parent is liable simply as a result of being the parent of the subsidiary. Private equity funds should be particularly concerned about this type of liability, especially where the relevant statutes or regulations allow the creditor to "pierce" through ownership levels in the private equity fund to find entities with substantial assets. Other statutes instead will impose liability on a parent for the debts of the subsidiary only where the parent has taken certain actions, such as controlling or actively assisting the activities that give rise to the claim against the subsidiary.

1. Federal Securities Laws

A parent can be held secondarily liable for primary violations of the federal securities laws by its subsidiary under § 15 of the Securities Act of 1933 (the "Securities Act") or § 20 of the Securities Exchange Act of 1934 (the "Exchange Act"), as well as under various common law doctrines (e.g., conspiracy).⁸⁷ Section 15 imposes secondary liability on controlling persons for primary liability of controlled persons under § 11 and § 12 of the Securities Act. Sections 11 and 12 are the basic private liability provisions of the Securities Act and are designed to protect buyers in a securities offering.⁸⁸ Section 20 imposes secondary liability on controlling persons for primary liabilities of controlled persons under any provision of the Exchange Act.⁸⁹

⁸⁷ The Securities Act is codified at 15 U.S.C. § 77a-77aa (2006). The Exchange Act is codified at 15 U.S.C. § 78a (2006).

⁸⁸ 15 U.S.C. § 77o.

⁸⁹ *Id.* § 78t.

Certainly the most important liability provision under the Exchange Act is Rule 10b-5, which was promulgated under § 10(b) of the Exchange Act. It prohibits use of any means of interstate commerce to (i) employ any device, scheme or artifice to defraud, (ii) make material misstatements or omissions, or (iii) engage in any course of business that operates as a fraud against any person, in connection with the purchase or sale of any security or securities-based agreement.⁹⁰

Because § 15 and § 20 are secondary liability provisions, it is necessary for a primary violation to be established before liability under those provisions can be imposed against a controlling person. Under the federal securities laws, “control” is defined as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”⁹¹ While there has been debate over who meets this standard, controlling shareholders, directors, and even lenders can be controlling persons when they have the power or potential power to influence the affairs of the controlled person. For example, the Ninth Circuit reversed a dismissal of allegations that Texas Pacific Group (“TPG”) and Continental Airlines were controlling persons of America West Airlines for purposes of a claim under § 20. The court focused on the facts that TPG and Continental had been shareholders of America West since 1994, were the largest shareholders (together owning over fifty percent of the company), had the power to elect a majority of the America West board, and had some of their own officers serving as directors of America West.⁹²

There is a split among the circuits as to whether a plaintiff must establish that the defendant was a “culpable participant” in the alleged violation to qualify as a “controlling person” for purposes of § 15 or § 20.⁹³ In addition, while neither § 15 nor § 20 contains any scienter (or even negligence) requirement, § 15 states that the controlling person is not liable if such person

⁹⁰ 17 C.F.R. § 240.10b-5 (2008).

⁹¹ *Id.* § 230.405.

⁹² No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 945–46 (9th Cir. 2003).

⁹³ Compare *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992) (requiring no culpable participation, only ability to control) with *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974) (requiring a showing that the controlling person was “in some meaningful sense [a] culpable participant[] in the fraud perpetrated by [the] controlled person[.]”) (quoting *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973)). See also *In re Globalstar Secs. Litig.*, No. 01 Civ. 1748, 2003 WL 22953163, at *12 (S.D.N.Y. Dec. 15, 2003) (“A bare allegation of ownership of a large block of stock or the status of a person as a corporate officer of a controlled entity is not enough to establish liability under section 20(a).”).

had no knowledge or reason to know the facts that establish the liability of the controlled person. Likewise, § 20 provides that the controlling person is not liable if such person acted in good faith and did not induce the acts on which the liability of the controlled person is based.⁹⁴ Courts have found that these are affirmative defenses that must be established by the defendants.⁹⁵

Therefore, in the parent-subsidary context, while ownership of a large block of stock may not be sufficient to establish control, parent participation in the business affairs of its subsidiary through parent officers serving in a director or officer capacity at the subsidiary could potentially subject the parent to controlling person liability under § 15 or § 20. These liabilities would typically be alleged in a case where the subsidiary has publicly traded debt or equity securities and a plaintiff alleges that false statements were made by the subsidiary either in connection with the offering of securities or in the subsidiary's periodic SEC reports following the offering.

2. CERCLA

Under certain circumstances, the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA")⁹⁶ imposes liability on a parent corporation due to the unlawful waste disposal activities of its subsidiary. A parent corporation deemed an "operator," as defined below, may face direct liability due to its subsidiary company's actions.⁹⁷ Further, CERCLA may impose indirect liability upon a parent corporation deemed an "owner" on account of its subsidiary's actions when the parent's actions satisfy traditional veil-piercing standards.⁹⁸ Because veil-piercing will be discussed later in this article, the discussion that follows focuses solely on CERCLA's direct "operator" liability.

The Supreme Court has ruled that in order for the government to hold a parent company directly liable under CERCLA as an "operator," it must "manage, direct, or conduct [the subsidiary's] operations specifically related to pollution, that is, operations having to do with the leakage or disposal of hazardous waste, or decisions about compliance with environmental regulations."⁹⁹ Although the Court has not established definitively the degree

⁹⁴ 15 U.S.C. §§ 77o, 78t (2006).

⁹⁵ *See, e.g.*, *Carpenter v. Harris, Upham & Co.*, 594 F.2d 388, 394 (4th Cir. 1979).

⁹⁶ 42 U.S.C. § 9601 (2006).

⁹⁷ *Id.*

⁹⁸ *Id.* § 9607(a)(2); *United States v. Bestfoods*, 524 U.S. 51, 64–65 (1998).

⁹⁹ *Bestfoods*, 524 U.S. at 66–67.

of control necessary, it is clear that a parent must exercise actual control over its subsidiary and its hazardous waste management before CERCLA imposes direct liability.¹⁰⁰ When applying the actual control test, lower courts generally focus on the extent to which the parent corporation participated in the subsidiary's management.¹⁰¹ Generally, however, neither general control over the subsidiary nor the mere existence of authority to control the subsidiary is enough to establish a parent company as an "operator."¹⁰²

3. ERISA

A parent corporation may also be liable for a subsidiary's violations of the Employee Retirement Income Security Act ("ERISA"). Congress enacted ERISA to regulate employer-sponsored employee benefit programs.¹⁰³ The statute also created the PBGC, which provides insurance to guarantee benefits for covered employees of inadequately funded, terminated, and qualified defined benefit pension plans.¹⁰⁴ Employers maintaining qualified defined benefit pension plans pay premiums into a pool, and upon plan termination, the PBGC pays vested benefits to affected employees from that pool in accordance with statutory guidelines.¹⁰⁵

When an employer terminates such a pension plan, ERISA sweeps under its provisions all members of a control group, which is, among other things, comprised of constituent companies of a corporate group connected through ownership of a "controlling interest" with a common parent organization.¹⁰⁶

¹⁰⁰ *Id.*; PHILLIP I. BLUMBERG, THE LAW OF CORPORATE GROUPS: STATUTORY LAW-GENERAL § 18.02.2 (1989).

¹⁰¹ *FMC Corp. v. Aero Indus., Inc.*, 998 F.2d 842, 846 (10th Cir. 1993) (actual control test met when manufacturer personally participated in any conduct that violated CERCLA).

See also *Jacksonville Electric Authority v. Bernuth Corp.*, 996 F.2d 1107, 1110 (11th Cir. 1993), stating:

[A] parent corporation may be held liable as an operator of its subsidiary's business only when it "exercises actual and pervasive control of the subsidiary to the extent of actually involving itself in the daily operations of the subsidiary. Actual involvement in decisions regarding the disposal of hazardous substances is a sufficient, but not a necessary, condition to the imposition of operator liability."

¹⁰² *FMC Corp.*, 998 F.2d at 846.

¹⁰³ 29 U.S.C. § 1101 (2006).

¹⁰⁴ *Id.* § 1301.

¹⁰⁵ Israel Goldowitz, *ERISA and Bankruptcy: A Comfortable Coexistence*, 23 AM. BANKR. INST. J. 8, 56 (Dec. 2004–Jan. 2005).

¹⁰⁶ 29 U.S.C. § 1301(b)(1) states that "all employees of trades or businesses . . . which are under common control shall be treated as employed by a single employer and all such trades or businesses as a single employer." ERISA grants all rule-making power to the PBGC, which has promulgated regulations that give

According to PBGC regulations, a “controlling interest” in a corporation is “ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation.”¹⁰⁷

ERISA imposes joint and several liability on any person who, upon termination of a plan, is a contributing sponsor of the plan or a member of the person’s controlled group. The PBGC may impose a lien upon all property and rights to property belonging to members of the controlled group.¹⁰⁸ Liable persons are responsible to the PBGC for the shortfall between promised benefit liabilities and plan assets, or, as the statute states, the “total amount of the unfunded benefit liabilities . . . to all participants and beneficiaries under the plan, together with interest.”¹⁰⁹ Consequently, all affiliated corporations face PBGC liability when an inadequately funded plan terminates, provided that the eighty percent control test is satisfied.¹¹⁰

A parent and its controlled group may also find themselves liable for COBRA continuation coverage obligations of a subsidiary’s health plans. ERISA imposes joint and several liability on an employer and each member of its controlled group to provide COBRA continuation coverage required under any active or retiree group health plan.¹¹¹ Thus, a parent and its controlled group may be liable for a bankrupt subsidiary’s COBRA obligations as long as the parent or other controlled group member maintains a group health plan.

4. *National Labor Relations Act*

A parent corporation may find itself liable under the National Labor Relations Act (the “NLRA”) as an “employer” for the unfair labor practices of

further definition to these terms. The section also provides that the regulations promulgated pursuant to the statute will be coexistent with the Treasury Regulations pertaining to § 414(c) of the Internal Revenue Code. “Common control” under the treasury regulations is defined as “one or more chains or organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization.” 26 C.F.R. § 1.414(c)-2 (2008); *see* PBGC v. Ouimet Corp., 630 F.2d 4, 11 (1st Cir. 1980).

¹⁰⁷ 29 C.F.R. § 4001.3 (2008), *incorporating* 26 C.F.R. § 1.414(c)-2(b)(2)(i)(A).

¹⁰⁸ 29 U.S.C. § 1368 (2006).

¹⁰⁹ *Id.* § 1362(b)(1)(A).

¹¹⁰ *Ouimet Corp.*, 630 F.2d at 12.

¹¹¹ *See* 29 U.S.C. § 1161.

its subsidiary.¹¹² Under the statute, an “employer” includes “any person acting as an agent of an employer.”¹¹³ In resolving whether or not, for liability purposes, a parent, along with its subsidiary, should be considered an “employer,” the National Labor Relations Board has developed a general test that weighs the following factors: (i) some functional interrelation of operations; (ii) centralized control of labor relations; (iii) common management; and (iv) common ownership or financial control.¹¹⁴ None of these factors is controlling alone, but courts often stress the first three.¹¹⁵

In dealing with the single-employer question, some courts have held that “participation” by the parent company—i.e., benefiting from a subsidiary’s unfair labor practice or the parent’s participation in the actual violating acts—may be enough to impose liability upon the parent.¹¹⁶ The court in *Majestic Molded Products Inc. v. NLRB*, for example, addressed the situation where a company committed an unfair labor practice by denying its employees access to unions and subsequently laying off its employees. This company shared its plant location, as well as a “common policy and front for labor matters designed to serve joint rather than separate interests,” with a sister corporation.¹¹⁷ Because the company’s unfair labor practice was most likely intended to, and in fact did, benefit both companies by discouraging employees in both organizations from becoming members of the union, the court found both affiliates liable under the statute.¹¹⁸

Other courts take a different approach, however, and do not explicitly consider the “participation” by the affiliate company in the unfair labor practice, but rather determine whether the companies otherwise constitute a “single employer.” In these cases, courts consider the existence of common officers and directors; the parent’s participation in the formulation of the subsidiary’s labor policy; and other factors supporting the close interrelationship of the parent and subsidiary.¹¹⁹

¹¹² *Id.* §§ 151–69; see *Package Serv. Co. v. NLRB*, 113 F.3d 845, 846–47 (8th Cir. 1997) (commonly owned corporations can be found to be a single employer whose revenues could be combined for purposes of the NLRA); *Majestic Molded Prods., Inc. v. NLRB*, 330 F.2d 603, 607 (2d Cir. 1964).

¹¹³ 29 U.S.C. § 152(2).

¹¹⁴ *Package Serv. Co.*, 113 F.3d at 846–47.

¹¹⁵ *Id.* at 847.

¹¹⁶ See *Majestic Molded Prods.*, 330 F.2d at 607.

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *NLRB v. Int’l Measurement & Control Co.*, 978 F.2d 334, 339 (7th Cir. 1992) (concluding that four businesses run by employer’s principals were one where they operated as an integrated enterprise and exerted significant control over the discharged employees); *NLRB v. Lipman Bros., Inc.*, 355 F.2d 15, 21 (1st Cir.

F. Common Law Liabilities

1. In General

While contractual and joint plan obligations create risk and uncertainty for the parent, the largest potential liability for the parent may arise as a result of various nonbankruptcy common law causes of action. Bankruptcy Code causes of action, such as preference and fraudulent conveyance actions, merely seek either the recovery of property of the debtor transferred to another party or the reduction of such party's claims against the debtor. Moreover, Bankruptcy Code causes of action typically do not assert damages. By contrast, many nonbankruptcy causes of action can be used to seek significant affirmative recoveries against the parent for amounts in excess of the amounts transferred, including seeking to make the parent liable for the subsidiary's debt. These various causes of action are discussed below.

2. Veil-Piercing, Alter Ego, and Other Theories

When a subsidiary is unable to pay its debts, its creditors may seek to impose liability on the parent. Upon the subsidiary's bankruptcy filing, one argument the subsidiary's creditors may raise is that the parent should be liable for the subsidiary's debts on the basis of veil-piercing, alter ego, or some other liability theory. These are serious causes of action for the parent to face because they involve significant exposure. Because of the potential impact on the parent, these causes of action are typically given the most focus by the subsidiary and its creditors.

Generally, parent corporations are not liable for the acts of subsidiaries, a principle "deeply 'ingrained in our economic and legal systems.'"¹²⁰ Under state law, as a general rule, shareholders of corporations are not liable for the corporation's debts.¹²¹ Nevertheless, courts have discussed various

1966) (court concluded companies were joint employers with common officers, ownership, directors and operators and constituted a single enterprise; said directors and operators formulated and administered a common labor policy for all respondents and affected the employees of all respondents); *NLRB v. Winn Dixie Stores, Inc.*, 341 F.2d 750, 752 (6th Cir. 1965) (concluding that the companies which had common officers, directors, and operators who formulated and administered a common labor policy for both respondents, were joint employers).

¹²⁰ *United States v. Bestfoods*, 524 U.S. 51, 61 (1998) (quoting William O. Douglas & Carrol M. Shanks, *Insulation from Liability Through Subsidiary Corporations*, 39 *YALE L.J.* 193, 193 (1929)).

¹²¹ *See, e.g., LeBoeuf, Lamb, Greene, & MacRae, L.L.P. v. Worsham*, 185 F.3d 61, 66 (2d Cir. 1999) ("[U]nder New York law (and probably the law of all states), '[a] principal attribute of, and in many cases the

circumstances in which the parent may be liable for the debts of its subsidiary. Those circumstances justifying the imposition of liability upon the parent tend to require a showing of injustice, unfairness,¹²² or control and domination by the parent.¹²³ Generally, in cases where these circumstances are present, the parent and subsidiary are treated as not having a separate corporate existence.¹²⁴

By appealing to the “piercing the corporate veil” doctrine or the “alter ego,” “instrumentality,” or “identity” doctrine, the plaintiff seeks to make the parent liable for the subsidiary’s debts. While there may be some differences among the causes of action under these various theories, “the formulations are generally similar, and courts rarely distinguish them.”¹²⁵ For example, one court reviewed case law from the Third Circuit and concluded that courts often use the two phrases “interchangeably to describe the basis on which a corporation’s formal existence will be disregarded. . . . The alter ego doctrine supplies the rationale for a court’s decision to pierce the corporate veil.”¹²⁶ Despite the similarities in the theories, there are, however, minor differences in the application of these theories of liability across jurisdictions. For example, there are differences of opinion as to “whether an element of ‘fraudulent intent,’ inequitable conduct, or injustice is explicitly required.”¹²⁷

major reason for, the corporate form of business association is the elimination of personal shareholder liability.”) (quoting *We’re Assocs. Co. v. Cohen, Stracher & Bloom, P.C.*, 480 N.E.2d 357, 359 (N.Y. 1985)).

¹²² *Pearson v. Component Tech. Corp.*, 247 F.3d 471, 484 (3d Cir. 2001) (citing *New Jersey Dep’t of Envtl. Prot. v. Ventron Corp.*, 468 A.2d 150, 164 (N.J. 1983)).

¹²³ *Id.* (citing *Zubik v. Zubik*, 384 F.2d 267, 272 (3d Cir. 1967)).

¹²⁴ *See id.* at 484, 485 n.2. In addition, the subsidiary may seek to substantively consolidate its bankruptcy estate with that of the parent. In a substantive consolidation, the assets and liabilities of the consolidated entities are treated as one. While it is possible for a debtor to be substantively consolidated with a nondebtor, if the subsidiary succeeds on the veil-piercing, alter ego, or similar theories for making the parent liable for the subsidiary’s debt, there is no need to pursue consolidation because the creditors of the subsidiary will have a direct claim against the parent.

¹²⁵ *Id.* at 485 n.2; *Corporate Aviation Concepts, Inc. v. Multi-Svc. Aviation Corp.*, No. 03-3020, 2005 WL 562767, at *5 & n.12 (E.D. Pa. Mar. 8, 2005). For example, the corporate veil may be pierced where: (1) the parent exercised such control that the subsidiary became a mere instrumentality of the parent; (2) the parent uses such control to commit a fraud or other wrong; and (3) the fraud or wrong results in an unjust loss or injury to the creditor. *Wm. Passalacqua Builders, Inc. v. Resnick Developers S., Inc.*, 933 F.2d 131, 138 (2d Cir. 1991). Some courts have even refused to countenance the “theoretical difference” between the veil-piercing and alter ego doctrines, stating that “the distinction . . . between alter ego doctrine and piercing the corporate veil is nonexistent.” *In re Equip. Lessors of Pa., Inc.*, No. 98-4752, 1999 WL 391390, at *3 (E.D. Pa. May 26, 1999).

¹²⁶ *In re Equip. Lessors of Pa., Inc.*, 1999 WL 391390, at *2-3.

¹²⁷ *Pearson*, 247 F.3d at 485 n.2 (citing PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW* § 6.02, at 115 (1987)).

Courts typically review the entire relationship between parent and subsidiary when determining whether to disregard the corporate entity, as there is “no definitive test for piercing the corporate veil.”¹²⁸ However, the lack of respect for corporate formalities, as well as overlapping employees, will tend to weigh in favor of piercing the corporate veil. In *Wm. Passalacqua Builders*, the Second Circuit Court of Appeals overturned the entry of a directed verdict for the defendants and held that a jury could find sufficient grounds for veil-piercing in the case of a “family real estate business [that] consisted of various partnerships and corporations, all controlled either directly or indirectly by family members.”¹²⁹ The company in question had separate books, maintained separate bank accounts, and filed separate tax returns (except when consolidated legally with other affiliated companies). Moreover, there was no evidence of any fraud by the family members or any of the corporations they controlled, a fact plaintiffs conceded. The main deviation from corporate formalities consisted of the fact that the company “had no employees except its officers—many of whom were also the officers and employees of the other corporate defendants—and neither held regular meetings, nor elected officers and directors as required by its certificate of incorporation.”¹³⁰

The court noted that the subsidiary in question “did not issue its shares timely” and “was severely undercapitalized during the [relevant] period . . . having only \$10 in capital.”¹³¹ The court also found blurred lines of corporate control and responsibility, representations to third parties by employees of one

¹²⁸ *Plastipak Packaging, Inc. v. DePasquale*, 75 F. App'x 86, 88 (3d Cir. 2003). Among the factors that courts may consider are: (1) the absence of corporate formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, election of directors, keeping corporate records; (2) inadequate capitalization; (3) whether funds are put in and taken out of the subsidiary for the parent's own purposes rather than the subsidiary's purposes; (4) overlap in ownership, officers, directors and personnel between the parent and subsidiary; (5) common office space, address, and telephone number; (6) the amount of business discretion displayed by the subsidiary; (7) whether the subsidiary dealt with the parent at arm's length; (8) whether the parent treated the subsidiary as an independent profit center; (9) the payment or guarantee by the subsidiary of debts of the parent or of other subsidiaries in the group; (10) whether the subsidiary in question possessed property that the parent used as if were its own; and (11) the payment of dividends. *Wm. Passalacqua Builders, Inc.*, 933 F.2d at 139 (listing most of the above factors); *United States v. Pisani*, 646 F.2d 83, 88 (3d Cir. 1981) (listing additional factors) (citing *DeWitt Truck Bros. v. W. Ray Flemming Fruit Co.*, 540 F.2d 681, 687 (4th Cir. 1976)). Although the presence of each factor is not required to pierce the corporate veil, the creditor seeking to hold the parent liable for the subsidiary's debt must show “[a]ctual domination, rather than the opportunity to exercise control” on the part of the parent. *Williams v. McAllister Bros. Inc.*, 534 F.2d 19, 21 (2d Cir. 1976). To these “relationship” factors, some courts add an element of fraud or inequitable conduct to justify piercing the corporate veil. See *supra* note 127 and accompanying text.

¹²⁹ *Wm. Passalacqua Builders*, 933 F.2d at 139.

¹³⁰ *Id.*

¹³¹ *Id.*

corporation that they occupied a position in a different corporation, and a high degree of financial intermingling among the various entities.

In addition, the corporations did not deal at arms length with each other. . . . Nor were the . . . corporations treated as individual profit centers. Profit calculations were compiled that suggested that the distinctions between corporations were artificial, and it was actually the profit to the entire collection of [family]-controlled corporations—as opposed to each separate entity—that was being calculated for the family to review.¹³²

Based on these factors, and despite the absence of fraud and the mostly adequate corporate bookkeeping, the court decided to submit the veil-piercing question to the jury.¹³³

While the test varies from state to state, in general similar factors are the subject of an inquiry under the alter ego theory.

Under the alter ego doctrine, “when the corporation is the mere instrumentality or business conduit of another corporation or person, the corporate form may be disregarded.” 1 William Meade Fletcher et al., *Fletcher Cyclopedia of the Law of Private Corporations* § 41.10 (perm. ed. rev. vol. 1999). This doctrine allows a court to impose liability on a second individual or corporation when a plaintiff has made out a cause of action against a primary defendant corporation. *See id.* The case of two affiliated corporations, such as a parent-subsidiary relationship, presents a “common situation ripe for piercing the corporate veil.” *Id.* If two corporations have an identity of corporate officers and shareholders, and in addition they commingle their assets and business affairs, a court may conclude that the technical legal separateness of the two entities should be ignored.¹³⁴

In sum, a parent corporation that fails to uphold the separate corporate nature of its subsidiary, or that controls and dominates its subsidiary at the expense of others, may be liable for the subsidiary’s debts. A parent concerned about the financial well-being of its subsidiary may consider performing its own veil piercing analysis to determine whether it has any exposure and how any exposure may be remedied. For example, the integration of the operations (or certain aspects such as marketing) between the parent and subsidiary may

¹³² *Id.* at 140.

¹³³ *Id.*

¹³⁴ *Huennekens v. Gilcom Corp. (In re SunSport, Inc.)*, 260 B.R. 88, 107–08 (Bankr. E.D. Va. 2000).

be economically efficient. However, the parent should consider whether those activities are increasing the risk of veil-piercing or alter ego liability.

In addition to the better known veil-piercing and alter ego theories, the subsidiary's creditors may seek to impose liability upon the parent corporation on the basis of agency law. Some courts, looking to Delaware law, for example, have distinguished between two forms of agency theory liability, one that is akin to alter ego theory, and one more closely drawn from principles of agency doctrine that requires a relationship between the corporations and the cause of action:

Where there is general domination and control by a corporate parent over its subsidiary, courts are especially prone to substitute the term "agent" for "alter ego." Again this Court must emphasize the distinction between such an agency theory, and [a] pure agency theory

. . . .

. . . Where an agency or alter ego relationship is premised upon the parent's domination and control, such domination and control may be general in nature and "need not have any particular relationship to the cause of action being asserted." In contrast, a plaintiff wishing to hold a parent corporation liable under the pure agency theory "must demonstrate a relationship between the corporations and the cause of action." "Under this [pure agency] theory, total domination or general alter ego criteria need not be proven."¹³⁵

Under a "pure" agency theory of liability, the parent is liable for the subsidiary's acts not because the two corporations are alter egos of each other, but because, although possessing distinct legal personalities, the two stand in the relation of a principal and its agent. The subsidiary acts as the parent's agent and therefore, assuming there is a sufficient connection between the challenged conduct and the cause of action, binds the parent to transactions entered into with third parties.¹³⁶ Accordingly, the parent must be cognizant that even if all corporate formalities are observed and there is no question of

¹³⁵ Mobil Oil Corp. v. Linear Films, Inc., 718 F. Supp. 260, 266 n.10 (D. Del. 1989) (citations omitted).

¹³⁶ For a discussion of the "pure" agency theory in the parent and subsidiary context, see *Transcontinental Insurance Co. v. Road One, Inc.*, No. 1:04-CV-273, 2006 WL 36884, at *6-11 (E.D. Tenn. Jan. 5, 2006). See also *Pearson v. Component Tech. Corp.*, 247 F.3d 471, 488 n.5 (3d Cir. 2001) (noting the application of the agency theory in the parent and subsidiary context and citing cases as examples).

the separateness between the parent and its subsidiary, the parent could face a challenge on a pure agency theory based on the actions of its subsidiary.¹³⁷

3. Breach of Fiduciary Duty

Unlike the veil-piercing, alter ego, and agency theories that seek to impose liability on the parent for the obligations of the subsidiary, a breach of fiduciary duty action seeks to recover funds from the parent or the subsidiary's directors or to unwind transactions between the parent and the subsidiary. Fiduciary duties include the duty of care, the duty of loyalty, and, in some jurisdictions, the duty of disclosure. Even though the parent's ultimate exposure to damages arising from a breach of fiduciary duty action generally will be less than in an alter ego or veil-piercing action, those damages may still be substantial and may be easier to establish than an alter ego or veil-piercing claim.

Directors and officers of a company may owe a fiduciary duty to its creditors when the company is in the vicinity of insolvency, or, at least, the duties owed by such parties to the corporation may be enforced by the corporation's creditors.¹³⁸ In the common scenario where an officer or a

¹³⁷ See *Transcon. Ins. Co.*, 2006 WL 36884, at *6–11 (discussing theory under Delaware law and holding that sufficient issues of fact existed sufficient to preclude the granting of a motion for summary judgment on the pure agency theory). The court later ruled against the plaintiff on this issue finding that no actual or apparent authority existed. *Transcon. Ins. Co. v. Roadone, Inc.*, No. 1:04-CV-273, 2006 WL 587599, at *4 (E.D. Tenn. Mar. 10, 2006). Because of the requirement that there be a connection between the cause of action and the challenged conduct, liability under an agency theory may be “narrower” and limited to the specific challenged transactions.

¹³⁸ In its recent opinion in *In re World Health Alternatives, Inc.*, 385 B.R. 576 (Bankr. D. Del. 2008), the Bankruptcy Court for the District of Delaware established that, according to Delaware and Florida law, “both officers and directors owe fiduciary duties to the corporation.” *Id.* at 592 (“To date, the fiduciary duties of officers have been assumed to be identical to those of directors. With respect to directors, those duties include the duty of care and the duty of loyalty.”) (quoting *In re Walt Disney Co. Derivative Litigation*, No. Civ. A. 15452, 2004 WL 2050138, at *3 (Del. Ch. Sept. 10, 2004)).

Whether the fiduciary duties actually shift entirely to creditors is not settled. Compare *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976–77 (4th Cir. 1982) (holding that the directors' duties shift entirely to creditors) with *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007) (“[I]ndividual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors,” but they may bring derivative claims on behalf of the insolvent corporation.) (original emphasis removed). Prior to *Gheewalla*, Delaware courts had held that in the vicinity of insolvency, the board's fiduciary duties extended to creditors. See, e.g., *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790–91 (Del. Ch. 2004); *Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'n Corp.*, No. 12150, 1991 WL 277613, at *1155 n.55 (Del. Ch. Dec. 30, 1991); see also *Weaver v. Kellogg*, 216 B.R. 563, 583–84 (S.D. Tex. 1997) (stating that creditors of an insolvent corporation could bring a breach of fiduciary duty claim against the corporation's directors only if (a) the company was in the “vicinity of insolvency” at the

director of the parent serves also as a director of the subsidiary, that person is subject to mandatory dual loyalty to both corporations. This dual loyalty is latent so long as the subsidiary is outside the zone of insolvency, for the individual's fiduciary duties as a director of the subsidiary will run to the parent as shareholder. However, once the subsidiary enters the vicinity of insolvency, the dual loyalty may develop into an open and irreconcilable conflict of interest.¹³⁹ The parent itself, in addition to individuals serving on the subsidiary's board of directors, may owe similar fiduciary duties to the subsidiary or its creditors. The extent, if any, of such fiduciary duties is unclear,¹⁴⁰ with some courts stating that controlling shareholders also owe a fiduciary duty to the company's creditors when it is in the vicinity of insolvency, at least under some circumstances.¹⁴¹

time of the challenged transaction, (b) the transaction led to the corporation's insolvency, or (c) the transaction was a fraudulent conveyance).

The Delaware Court of Chancery relied on *Gheewalla* in explaining parties' agreement to dismiss a direct action filed by a creditor against company directors for breach of fiduciary duty. *Nelson v. Emerson*, No. 2937-VCS, 2008 WL 1961150, at *6 n.29 (Del. Ch. May 6, 2008). The Delaware Supreme Court later explained its rationale for its holding in *Gheewalla*, explaining that "*Gheewalla* confers standing upon creditors to bring a derivative action [for breach of fiduciary duty] where the corporation is insolvent . . . because the shareholders of an insolvent corporation no longer have an economic interest in the corporate entity—only its creditors have that interest." *Schoon v. Smith*, No. 554-2006, 2008 WL 375826, at *6 n.46 (Del. Feb. 12, 2008).

¹³⁹ Compare this with *Management Technologies, Inc. v. Morris*, 961 F. Supp. 640, 645 (S.D.N.Y. 1997), where the court stated:

While Edison, in his capacities as a director of [the two subsidiaries] Holdings and Trading, well may have owed duties under English law to creditors, at least given the perilous financial circumstances of those companies, he held those positions as the representative of the sole shareholder of the parent, MTi, and doubtless owed a duty to MTi as well.

¹⁴⁰ See Official Comm. of Unsecured Creditors of Hechinger Inv. Co. v. Fleet Retail Fin. Group (*In re Hechinger Inv. Co.*), 280 B.R. 90, 94 (D. Del. 2002) (stating that "Delaware case law suggested that controlling shareholders may be liable to creditors for breach of fiduciary duty" but acknowledging "that due to the lack of Delaware case law directly on point, the precise question is a novel question of law whose proper resolution may not be beyond dispute"). In *Gheewalla*, the Supreme Court of Delaware limited the scope of parties to whom directors of a corporation directly owe fiduciary duties to exclude the corporation's creditors. Under Delaware law, creditors only have standing to advance derivative breach of fiduciary duty claims against corporate directors that belong to the corporation itself. *Nelson*, 2008 WL 1961150, at *9 n.59 (citing *Gheewalla*, 930 A.2d at 99, 101–02, 103). This opinion suggests that a parent corporation, much further removed from a subsidiary's creditors than the directors of the subsidiary, also would not owe fiduciary duties to a subsidiary's creditors, though the precise question still has yet to be resolved.

¹⁴¹ See *Weaver*, 216 B.R. at 583 ("[F]iduciary obligation on a dominant or controlling stockholder or stockholders is not just for the protection of the corporation or its other stockholders, but extends to corporate creditors as well" when the rights of creditors are involved) (citing *Pepper v. Litton*, 308 U.S. 295, 306–07 (1939)). But see *Gheewalla*, 930 A.2d at 103 ("[I]ndividual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors."); Official Comm. of the Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., No 97 Civ. 9261, 1999 WL 754015, at *3–6

In evaluating whether the parent and its designees on the subsidiary's board have acted in accordance with their fiduciary duty in matters that may affect the parent, some courts have noted that the business judgment rule may not apply when the corporation is insolvent.¹⁴² By contrast, there is authority supporting the presumption of the business judgment rule where the subsidiary is insolvent.¹⁴³ Based upon this line of cases, the subsidiary's creditors would simply step into the subsidiary's corporate shoes when bringing an action for breach of fiduciary duty against its controlling shareholders and are thus bound to the same standards. "It would be puzzling," reasoned the court in *Production Resources Group, LLC*, "if, in insolvency, the equitable law of corporations expands the rights of firms to recover against their directors so to better protect creditors, who, unlike shareholders, typically have the opportunity to bargain and contract for additional protections to secure their positions."¹⁴⁴ Rather, "[t]he firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims to rectify that injury."¹⁴⁵

In general, the subsidiary and its creditors will closely examine the decisions made by the parent (and its director designees) to determine whether there are viable causes of action for breach of fiduciary duty. Directors, however, typically will enjoy the presumption of the business judgment rule, and thus, their decisions are shielded from being second-guessed after the fact.

(S.D.N.Y. Sept. 24, 1999) (citing to the business judgment rule and dismissing breach of fiduciary actions against board and controlling shareholders based upon theory that the defendants kept the company "limping along" after it had become clear that the company was in a financial crisis).

¹⁴² See, e.g., *Mims v. Kennedy Capital Mgmt., Inc. (In re Performance Nutrition, Inc.)*, 239 B.R. 93, 111 (Bankr. N.D. Tex. 1999) (noting that the business judgment rule may be wholly inapplicable in a case where the corporation is insolvent); *Unsecured Creditors Comm. v. Gen. Homes Corp. (In re Gen. Homes Corp.)*, 199 B.R. 148, 151–52 (S.D. Tex. 1996) (suggesting that the business judgment rule does not apply to a conservatorship). That, in turn, suggests that the rule would not apply to a wind-down of an insolvent corporation. The *General Homes Corp.* holding was narrowed in *Floyd v. Hefner*, No. H-03-5693, 2006 WL 2844245, at *1 (S.D. Tex. Sept. 29, 2006), to apply "only to corporations that are already the subject of a bankruptcy proceeding." *Id.* at *15.

¹⁴³ Official Comm. of Unsecured Creditors of RSL COM Primecall, Inc. v. Beckoff (*In re RSL COM Primecall, Inc.*), 2003 Bankr. LEXIS 1635, at *31 (Bankr. S.D.N.Y. Dec. 11, 2003) (holding that plaintiffs had no substantial support for the proposition that a director's decision to postpone a bankruptcy filing and attempt to "work out" a financial problem is not subject to the business judgment rule).

¹⁴⁴ *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 794 (Del. Ch. 2004).

¹⁴⁵ *Id.* at 792. The *Production Resources* reasoning has been followed by subsequent cases in Delaware and New York. See, e.g., *Gheewalla*, 930 A.2d at 92; *Continuing Creditors' Comm. of Star Telecomms., Inc. v. Edgcomb*, 385 F. Supp. 2d 449 (D. Del. 2004); *Adelphia Commc'ns Corp. v. Rigas (In re Adelphia Commc'ns Corp.)*, 323 B.R. 345, 386 n.140 (Bankr. S.D.N.Y. 2005).

However, if the directors are not disinterested or lack independence,¹⁴⁶ the directors may need to demonstrate that any transaction involving the parent was fair and reasonable to the subsidiary.¹⁴⁷

Accordingly, in preparing for a chapter 11 filing of its subsidiary, the parent company may consider undertaking procedural defenses at the subsidiary level similar to those it would adopt in any inherently self-interested transaction, such as an MBO or squeeze-out merger. Thus, for example, it could consider ensuring that the key bankruptcy-related decisions of the subsidiary (most saliently, when to file for chapter 11 protection) are reviewed by independent directors on the subsidiary's board with "real bargaining power that it can exercise with the majority shareholder on an arms length basis."¹⁴⁸ Other badges of fairness may include independent legal and financial counsel for the subsidiary. As in any self-interested transaction, such measures may not alter the "entire fairness" standard, should a court choose to apply it, but will shift the burden of proof to the challenging party.¹⁴⁹

¹⁴⁶ See, e.g., *Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 208 B.R. 288, 303–10 (Bankr. D. Mass. 1997) (holding that directors who stood to gain from the sale of their shares in an LBO were involved in the transaction and owed fiduciary duties to creditors because company was in vicinity of insolvency, and so the directors had the burden of proving fairness of the LBO without the benefit of the business judgment rule).

¹⁴⁷ In its recent opinion in *In re The Brown Schools*, the Bankruptcy Court for the District of Delaware separated its analysis of Delaware case law regarding breach of fiduciary duty into two categories: claims alleging a breach of duty of care and claims alleging a breach of duty of loyalty. *Miller v. McCown De Leeuw & Co. (In re The Brown Sch.)*, No. 05-10841, 2008 WL 1849790, at *1 (Bankr. D. Del. Apr. 24, 2008). According to the court, under Delaware law, the business judgment rule can be overcome in an alleged duty of care violation only if the plaintiff can prove the defendant was grossly negligent. However, the burden shifts to the defendant to prove the fairness of the transaction in a breach of duty of loyalty claim if the plaintiff can "prove that the defendant was on both sides of the transaction." *Id.* at *6–7. See also *In re Radnor Holdings Corp.*, 353 B.R. 820, 842 (Bankr. D. Del. 2006) (noting that plaintiff's complaint alleged only duty of care violations); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000) (concluding that gross negligence is necessary to hold a director liable for breach of the duty of care under the business judgment rule); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding that "when directors of a Delaware corporation are on both sides of a transaction," the burden shifts to the defendant to prove the transaction was fair).

¹⁴⁸ *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994) (quoting *Rabkin v. Olin Corp.*, No. 7547, 1990 WL 47468, at *6 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990)).

¹⁴⁹ See *id.* (citing *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 938 n.7 (Del. 1985); *Weinberger*, 457 A.2d at 709–10 n.7; *Rabkin*, 1990 WL 47468, at *6) (finding that the existence of either an independent bargaining structure between the parent and subsidiary or an independent special committee with real bargaining power to influence the terms of the merger can shift the burden of proving fairness to the challenger).

4. *Deepening Insolvency*

Under the theory of deepening insolvency, a corporation may bring a cause of action against those responsible for the wrongful expansion of the debtor's liabilities and prolongation of corporate life to the detriment of the corporation and its creditors.¹⁵⁰ The theory has not been universally accepted and, as discussed below, the Supreme Court of Delaware recently affirmed, without a written opinion, a Delaware Court of Chancery opinion which refused to recognize deepening insolvency as a cause of action.¹⁵¹ To the extent that deepening insolvency remains as a viable independent cause of action or as a theory of damages,¹⁵² it may pose a challenge for the parent corporation. Therefore, a brief synopsis of the evolution of the theory of deepening insolvency is set forth below.¹⁵³

The leading appellate decision to recognize the validity of deepening insolvency is the Third Circuit's decision in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*¹⁵⁴ Noting that the theory was "essentially sound" and had been increasingly accepted,¹⁵⁵ the Third Circuit concluded that Pennsylvania would recognize such a cause of action based upon its "venerable principle" that the law should provide a remedy where an injury exists.¹⁵⁶ The deepening insolvency cause of action would provide a remedy for, among other things, legal and administrative costs incurred due to increased insolvency, operational limitations created by the corporation's financial straits, damage to the corporation's third-party relations as a result of

¹⁵⁰ Some courts have noted that incurring additional debt does not actually increase insolvency; rather, it increases liabilities and assets by equal amounts. Similarly, an equity investment actually lessens rather than increases insolvency. See, e.g., *Seitz v. Detweiler (In re CitX Corp.)*, 448 F.3d 672, 677-78 (3d Cir. 2006); Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC. (*In re Radnor Holdings Corp.*), 353 B.R. 820, 842 (Bankr. D. Del. 2006); *Alberts v. Tuft (In re Greater Se. Cmty. Hosp. Corp. I)*, 353 B.R. 324, 335 n.7 (Bankr. D.D.C. 2006).

¹⁵¹ See *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438, 438 (Del. 2007).

¹⁵² See *In re The Brown Sch.*, 2008 WL 1849790, at *4 (denying defendants' motion to dismiss claim for breach of the fiduciary duty of loyalty seeking deepening insolvency damages after concluding that deepening insolvency is a valid theory of damages for a breach of fiduciary duty claim, despite the fact that Delaware does not recognize an independent cause of action for deepening insolvency).

¹⁵³ The phrase "deepening insolvency" appears to have originated with the Seventh Circuit's decision in *Schacht v. Brown*, where the court stated that the "corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability." *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983).

¹⁵⁴ Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 349-50 (3d Cir. 2001).

¹⁵⁵ *Id.* at 349.

¹⁵⁶ *Id.* at 349, 351.

impending bankruptcy, and the dissipation of corporate assets, in each case caused by a wrongful prolonging of the corporation's life or increase in its liabilities.¹⁵⁷

Perhaps the most vexing problem for the courts related to deepening insolvency has been its classification: Is "deepening insolvency" an independent tort, or rather an ill-defined measure of damages available to a corporation seeking judgment on another tort, such as breach of fiduciary duty, fraud, or negligence? Courts are split on this issue. Shortly after *Lafferty*, the Bankruptcy Court for the District of Delaware summarily concluded that Delaware law would recognize a deepening insolvency cause of action.¹⁵⁸ The Delaware bankruptcy court later also found that the *Lafferty* court had held that deepening insolvency was a cause of action, not a measure of damages, and that its elements, though not clearly delineated, included fraud.¹⁵⁹

The opinion of the Bankruptcy Court for the Middle District of Tennessee in *In re Del-Met Corp.*¹⁶⁰ demonstrates the confusion surrounding the nature of deepening insolvency. The court at first appeared to conclude that deepening insolvency is a tort, referring to defendants' "domination and control of the debtors [which] gave rise to duties," whose breach resulted in a "tortious injury."¹⁶¹ However, the court also refers to New York and Delaware

¹⁵⁷ *Id.* at 349–50.

¹⁵⁸ Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (*In re Exide Techs., Inc.*), 299 B.R. 732, 751–52 (Bankr. D. Del. 2003). The Delaware Supreme Court later cleared this confusion in *Trenwick American Litigation Trust v. Billett*, 931 A.2d 438, 438 (Del. 2007), in which the court affirmed the opinion of the Delaware Court of Chancery that deepening insolvency was not an independent cause of action under Delaware law. See *infra* notes 171–75 and accompanying text. In the recent *In re The Brown Schools* opinion, the Bankruptcy Court for the District of Delaware endorsed *Trenwick* and dismissed a deepening of insolvency claim. *In re The Brown Sch.*, No. 05-10841, 2008 WL 1849790, at *4 (Bankr. D. Del. Apr. 24, 2008).

¹⁵⁹ OHC Liquidation Trust v. Credit Suisse First Boston (*In re Oakwood Homes Corp.*), 340 B.R. 510, 531–34 (Bankr. D. Del. 2006). Since the Third Circuit's decision in *CitX* and the Delaware Court of Chancery's decision in *Trenwick*, discussed *infra* note 170 and accompanying text, the bankruptcy court has held that directors of insolvent companies, just like those of solvent companies, are protected by the business judgment rule. Thus, their good faith business decisions resulting in greater corporate debt cannot be challenged by creditors under a "deepening insolvency" theory, which result is consistent with the *Trenwick* decision, as affirmed by the Delaware Supreme Court. See Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners (*In re Radnor Holdings Corp.*), 353 B.R. 820, 842–44 (Bankr. D. Del. 2006).

¹⁶⁰ *Limor v. Buerger (In re Del-Met Corp.)*, 322 B.R. 781 (Bankr. M.D. Tenn. 2005).

¹⁶¹ *Id.* at 815.

decisions recognizing deepening insolvency as “a breach of the fiduciary duties owed to a corporation by its officers and directors.”¹⁶²

Further, the Third Circuit limited the scope of its *Lafferty* decision in *In re CitX Corp., Inc.*¹⁶³ The court clarified that, although *Lafferty* described deepening insolvency as both a type and theory of injury, it “never held that [deepening insolvency] was a valid theory of damages for an independent cause of action.”¹⁶⁴ Deepening insolvency could not provide a measure for corporate damage where an independent action, such as malpractice or fraud, was the source of a firm’s remedy. Rather, the Third Circuit stated that *Lafferty* spoke in terms of a deepening insolvency cause of action¹⁶⁵ and that cause of action was limited to fraudulent, not merely negligent, conduct.¹⁶⁶ Thus, the Third Circuit affirmed the existence of a deepening insolvency cause of action, but limited that cause of action by requiring fraud as one of its elements.

In a frequently cited opinion, the Bankruptcy Court for the Southern District of New York found that the distinction between deepening insolvency as a tort or as a damage metric might be unnecessary.¹⁶⁷ In *In re Global Service Group LLC*, the court noted that, in order to recover under a deepening insolvency theory, one must demonstrate that the defendant “prolonged the

¹⁶² *Id.* Indeed, the Bankruptcy Court for the Northern District of Texas interpreted the court in *Del-Met* to have “concluded that ‘deepening insolvency’ was not a tort, but an actionable breach of a separate duty owed to a corporation.” Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re VarTec Telecom, Inc.*), 335 B.R. 631, 641 (Bankr. N.D. Tex. 2005). Similar confusion can be seen in the Ninth Circuit’s opinion in *Smith v. Arthur Andersen, LLP.*, 421 F.3d 989 (9th Cir. 2005). The Ninth Circuit recognized a “cognizable harm” under Arizona law where defendants caused the corporation to continue operating and expending assets by incurring “spurious debt,” but refused to make any general statements regarding deepening insolvency theory “because it is difficult to grasp exactly what the theory entails.” *Id.* at 1003–04.

¹⁶³ *Seitz v. Detweiler (In re CitX Corp.)*, 448 F.3d 672 (3d Cir. 2006).

¹⁶⁴ *Id.* at 677.

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 681. Notwithstanding the Third Circuit’s attempted clarification of *Lafferty*, confusion still persists. For example, the Bankruptcy Court for the District of Columbia rejected *CitX*’s reasoning, finding that *Lafferty* made no sense unless deepening insolvency was a theory of damages. *Alberts v. Tuft (In re Greater Se. Cmty. Hosp. Corp., I)*, 353 B.R. 324, 337 (Bankr. D.D.C. 2006). Furthermore, the D.C. court found that *CitX*’s decision to restrict deepening insolvency to fraud was arbitrary, permitting directors to engage in all manner of grossly negligent and harmful conduct short of fraud with impunity. *Id.* Rather the court “prefer[red] to treat deepening insolvency as the theory of harm [i.e., damages] that it was always meant to be,” while “rely[ing] on other, more established . . . common law causes of action to ascertain whether the defendants . . . engaged in a legal wrong.” *Id.* at 338.

¹⁶⁷ *Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group LLC)*, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt."¹⁶⁸ The *Global Service Group* court found that no absolute duty existed to dissolve an insolvent corporation; fiduciaries might, in good faith and under the auspices of the business judgment rule, determine that the company should continue operations in order to maximize long term value. Similarly, lenders might loan funds to an insolvent company without necessarily aiding and abetting managerial misfeasance.¹⁶⁹

The "deepening insolvency" concept has come under increasing attack. In the decision of *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,¹⁷⁰ which was affirmed without a written opinion by the Delaware Supreme Court,¹⁷¹ the Delaware Court of Chancery held that "Delaware law does not recognize th[e] catchy term [deepening insolvency] as a cause of action, because . . . it does not express a coherent concept."¹⁷² There was no reason in the court's view to prohibit directors from exercising their business judgment regardless of a corporation's insolvency; rather, insolvency should be merely one contextual factor in considering the fulfillment of fiduciary duties.¹⁷³ Existing causes of action such as breach of fiduciary duty and fraud provided adequate protection for the insolvent corporation, and if a cause of action could not be stated under those existing theories, an allegation of greater insolvency could not rectify this defect.¹⁷⁴ As noted above, the Delaware Supreme Court affirmed the *Trenwick* decision without issuing a separate written opinion based upon the reasons assigned in the Chancery Court opinion.¹⁷⁵

Other courts have also voiced their skepticism regarding deepening insolvency's viability. The Southern District of New York refused to recognize a separate tort of deepening insolvency under North Carolina law, noting that any compensable harm caused under the theory would already be covered by claims for breach of fiduciary duty and aiding and abetting that

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 459–61.

¹⁷⁰ *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006).

¹⁷¹ *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

¹⁷² *Ernst & Young*, 906 A.2d at 174.

¹⁷³ *Id.* at 204–06.

¹⁷⁴ *Id.*

¹⁷⁵ *Billett*, 931 A.2d at 438. As noted *supra* note 158, the Bankruptcy Court for the District of Delaware has endorsed the *Trenwick* opinion in its dismissal of a deepening of insolvency claim. *In re The Brown Sch.*, No. 05-10841, 2008 WL 1849790, at *4 (Bankr. D. Del. Apr. 24, 2008).

breach.¹⁷⁶ The Bankruptcy Court for the Northern District of Texas spoke at length about deepening insolvency in *In re VarTec Telecom, Inc.*¹⁷⁷ After surveying *Lafferty, Exide, Global Service Group*, and *Del-Met*, the court found that there was no need to recognize a new tort of deepening insolvency under Texas law, for “if you honestly treat deepening insolvency as a tort, it collapses into already existing torts, be it a breach of fiduciary duty, accounting malpractice, or some other cause of action.”¹⁷⁸ In *In re Avado Brands, Inc.*, the bankruptcy court reached the same result under Georgia law, citing the decision in *VarTec, CitX*, and the Chancery Court opinion in *Trenwick* and stating that “[t]he trend seems to be a rejection of deepening insolvency as a theory of liability in general.”¹⁷⁹

While deepening insolvency may not exist as a separate tort, to the extent it remains valid it poses two challenges to the parent. First, as a result of the theory, the parent may face exposure for one last round of financing in an attempt to turn around the subsidiary’s business. If that last capital infusion fails, the subsidiary may argue that the parent deepened its insolvency and may try to assert some ulterior motive by the parent (in addition to simply protecting its equity investment) for doing so.¹⁸⁰ Second, parent corporations should also be cognizant of the deepening insolvency theory where they can control the timing of the subsidiary’s bankruptcy filing, as the timing of the bankruptcy itself may be reviewed under a heightened standard and may give rise to a breach of fiduciary duty lawsuit against the parent. The breach of fiduciary duty claim might itself be sufficient to support damages under the “deepening insolvency” theory in some jurisdictions.¹⁸¹

¹⁷⁶ *Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.)*, 383 F. Supp. 2d 587, 601–02 (S.D.N.Y. 2005).

¹⁷⁷ Official Comm. of Unsecured Creditors of *VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (In re VarTec Telecom, Inc.)*, 335 B.R. 631, 636–46 (Bankr. N.D. Tex. 2005).

¹⁷⁸ *Id.* at 644 (citations omitted); *see also* *Liquidating Trs. v. Baker (In re Amcast Indus. Corp.)*, 365 B.R. 91, 115–19 (Bankr. S.D. Ohio 2007) (“[A]t its best, the deepening insolvency theory is redundant of traditional causes of action [such as breach of fiduciary duty] recognized under Ohio law. At its worst, the theory is inconsistent with principles of fiduciary responsibility and the business judgment rule codified in Ohio.”); *Schnelling v. Crawford (In re James River Coal Co.)*, 360 B.R. 139, 177–80 (Bankr. E.D. Va. 2007) (refusing to recognize a deepening insolvency cause of action under Virginia law; any wrong plaintiff sought to redress could be dealt with under a breach of fiduciary duty claim, and insolvency did not change the duty owed by directors or the protection they received under the business judgment rule).

¹⁷⁹ *Kaye v. Dupree (In re Avado Brands, Inc.)*, 358 B.R. 868, 888 (Bankr. N.D. Tex. 2006).

¹⁸⁰ Of course, the parent may also be criticized for failing to put in the last round of financing that, from the subsidiary’s perspective, could have saved the company.

¹⁸¹ *See In re The Brown Sch.*, No. 05-10841, 2008 WL 1849790, at *7–9 (Bankr. D. Del. Apr. 24, 2008) (concluding that deepening insolvency is a valid theory of damages for an alleged breach of the fiduciary duty of loyalty, even though there is no independent cause of action for deepening insolvency under Delaware law).

These risks can be addressed by the parent carefully documenting the process pursuant to which it provides, or does not provide, additional financing to the subsidiary, and the process pursuant to which the subsidiary's decision to file bankruptcy is made. A good board process that carefully analyzes the subsidiary's situation and the reasons for its determination whether and when to file for bankruptcy or to accept additional financing may be helpful to the parent in proving that the parent had no ulterior motive in either action to support either a breach of fiduciary duty or deepening insolvency claim.

III. PREPARATIONS FOR A SUBSIDIARY CHAPTER 11

Assuming that the subsidiary will have to file for chapter 11 protection, this Section discusses the preparations that the parent may need to take to prepare itself and the subsidiary for the filing.

A. *Accounting and Reporting Issues*

One of the issues that the parent will face as it prepares for a subsidiary chapter 11 filing is whether and when it can effectively deconsolidate the subsidiary from its financial reporting for SEC and other purposes. The benefit to doing so likely will be significant. The subsidiary likely will be incurring substantial operating losses and taking substantial charges. When consolidated with the parent's other business operations, these losses and charges will substantially impair the corporate family's financial performance. If the corporate family can cause a deconsolidation of the subsidiary for accounting and reporting purposes, the corporate family will be able to clearly show its financial performance separate and apart from the distressed subsidiary.

Before the parent can actually deconsolidate the subsidiary for reporting purposes, the parent likely will want to start reporting the separate results of the distressed subsidiary and the rest of the corporate family as part of the parent's consolidated financial statements. While the consolidated statements ultimately will have to combine the results of the subsidiary with the remainder of the corporate family, separately reporting the subsidiary's results will at least enable third parties to better understand the extent to which the family's financial results have been impaired by the losses and charges at the subsidiary. Of course, completely deconsolidating the subsidiary's results from the parent's financial statements will benefit the parent even more.

Under what conditions a parent can deconsolidate the financial results of a wholly-owned subsidiary from the parent's financial statements is an issue governed by various authorities within the accounting profession. Clearly, if upon the effective date of a chapter 11 plan of reorganization for the subsidiary, the parent no longer has an equity interest in the subsidiary, then at that time the parent will no longer need to include the subsidiary's financial results in the parent's consolidated financial statements. The question that arises is whether the parent can deconsolidate the subsidiary's results at some earlier point in time.

The guidance on this issue appears to be derived initially from Accounting Research Bulletin No. 51, "Consolidated Financial Statements" ("ARB 51"), which was adopted by the Committee on Accounting Procedures of the AICPA in 1959.¹⁸² ARB 51 states:

The purpose of consolidated [financial] statements is to present, primarily for the benefit of the shareholders and creditors of the parent company, the results of operations and the financial position of a parent company and its subsidiaries essentially as if the group were a single company with one or more branches or divisions. There is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.¹⁸³

ARB 51 then describes what constitutes a "controlling financial interest" sufficient to warrant consolidated financial reporting: "The usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company is a condition pointing towards consolidation."¹⁸⁴ ARB 51, however, provides various exceptions to this general rule, including "where control is likely to be temporary, or where it does not rest with the majority owners (as, for instance, where the subsidiary is in legal reorganization or in bankruptcy)."¹⁸⁵

¹⁸² *Consolidated Financial Statements*, ACCT. RES. BULL. NO. 51 (Am. Inst. Certified Pub. Accountants, New York, N.Y.), 1959.

¹⁸³ *Id.*

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* The exceptions to the general rule were amended by *Statement of Financial Accounting Standards No. 94* issued in 1988, but not in a manner that affects the analysis of whether and when to deconsolidate an insolvent subsidiary as a result of that insolvency or an actual or impending bankruptcy filing.

ARB 51, therefore, suggests that a parent can deconsolidate its distressed subsidiary for financial reporting purposes upon the subsidiary filing for chapter 11. A number of parent companies have done exactly that. It should be noted, however, that the parent's ability to deconsolidate its subsidiary upon a bankruptcy filing for the subsidiary is not certain. For instance, the current Bankruptcy Code was not in existence when ARB 51 was issued in 1959. ARB 51's drafters may have viewed a parent's control over a bankrupt subsidiary to be much less under then applicable bankruptcy law—the Bankruptcy Act of 1898—than may be the case under the current Bankruptcy Code. Even when a subsidiary files for chapter 11 today, its board of directors typically will remain in place notwithstanding the filing, and the parent will retain the ability to elect and remove such directors. While this result also occurred under Chapter XI of the Bankruptcy Act of 1898, at least theoretically many large companies would have been expected to file under Chapter X of the Bankruptcy Act, which instead required that a trustee be appointed effectively to replace the debtor's board of directors.¹⁸⁶ As a result, the Securities and Exchange Commission may challenge the decision of a parent to deconsolidate its subsidiary upon the subsidiary's bankruptcy filing. Instead, the SEC may take the position that the subsidiary cannot be deconsolidated until the effective date of the subsidiary's chapter 11 plan, when the parent likely will lose its majority equity interests in the subsidiary. Of course, if the parent does not lose its majority equity interests in the subsidiary under the plan, the subsidiary will not be deconsolidated. The potential that the parent may decide to retain control of the subsidiary under the plan is another reason why the SEC may determine that deconsolidation should not occur until at least the structure of that plan has been finalized.

If the parent desires to deconsolidate the subsidiary upon the subsidiary's bankruptcy filing, it may be able to do so if it can show that it will not be attempting to maintain majority control over the subsidiary under the subsidiary's chapter 11 reorganization plan. While the parent may continue to have the right to elect the subsidiary's board of directors during its bankruptcy, as explained above, the fiduciary duty of that board may be primarily owed to the subsidiary's creditors and not to the parent shareholder. Thus, while the parent may have the right to elect the directors, the directors may not be

¹⁸⁶ See Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners After BAPCPA*, 80 AM. BANKR. L.J. 289, 293 (2006) (noting that the SEC's long-espoused position was that only Chapter X was available for public companies).

beholden to the parent, thereby rendering ineffectual the parent's ability to control the subsidiary through the subsidiary's board.

In addition, once the subsidiary has filed for chapter 11, it cannot enter into transactions outside of the ordinary course of business without bankruptcy court approval. These transactions would include, for instance, financings, asset sales, and establishing certain compensation plans. Court approval is subject not only to the views of the bankruptcy judge, but also the views of the subsidiary's creditor constituencies. Failure to convince these constituencies of the propriety of a transaction outside the ordinary course of business may lead them to object to the transaction before the bankruptcy court and for the court to deny the transaction. As a result, the parent cannot cause the subsidiary to enter into material transactions once the subsidiary has filed for chapter 11 without the approval of the bankruptcy court and often without the agreement of the subsidiary's creditor constituencies. Again, the parent's ability to exercise control over the subsidiary is therefore significantly reduced.

Finally, the only manner in which the subsidiary can exit its chapter 11 proceeding is to confirm a chapter 11 plan, which likely will provide for a complete restructuring of the subsidiary's business and capital structure. To be approved by the bankruptcy court, the plan generally must (i) satisfy various standards for confirmation set forth in the Bankruptcy Code and (ii) receive the required votes of the subsidiary's creditor classes. While the parent shareholder also may have the right to vote on the plan, the plan can be confirmed even if the parent votes against the plan as long as the plan meets the various confirmation standards set forth in the Bankruptcy Code. As such, the subsidiary's ultimate emergence from chapter 11 is dependent on approval by the bankruptcy court and the subsidiary's creditors, not the parent shareholder. Again, then, the parent's "control" over the subsidiary has been greatly reduced.

It should be noted that ARB 51 lends some support to the ability of a parent to deconsolidate its insolvent subsidiary even prior to the subsidiary's bankruptcy filing. For instance, it states that deconsolidation may not be required where the parent's control is "temporary." If it is clear that the subsidiary will be filing for chapter 11 in the near future, arguably the parent's control is temporary if the parent is deemed not to have sufficient control to continue to require consolidation once the filing occurs. In addition, once the subsidiary has entered the "zone of insolvency," the fiduciary duties of its board may extend to the subsidiary's creditors, so that the parent's ability to

control the subsidiary could be reduced even without a bankruptcy filing. The actual mechanisms described above, whereby the Bankruptcy Code removes some control over the subsidiary from the parent and rests such control in the bankruptcy court and the subsidiary's creditors, will not be in place, however. As a result, it is difficult to state whether a parent can actually deconsolidate its insolvent subsidiary for financial reporting solely as a result of that insolvency or the prospect of its future bankruptcy filing.¹⁸⁷

B. Separation of Cash Management Systems

Parent and subsidiary companies often employ a consolidated cash management system for ease of administration. By the time the subsidiary commences a bankruptcy case, however, the parent may want to develop a cash management system that is separate and apart from that of the subsidiary. When a company files for bankruptcy, the debtor company must comply with certain administrative guidelines promulgated by the Office of the United States Trustee (the "U.S. Trustee Guidelines"). Most notably, for purposes of this Article, are the guidelines relating to the debtor's banking and investment policies. The U.S. Trustee Guidelines require that upon commencement of a bankruptcy case, the debtor must immediately close all of its bank accounts and establish new bank accounts as debtor in possession. The filing date is the line of demarcation between the company prepetition and the newly established bankruptcy estate that is created upon the commencement of the bankruptcy case. The debtor also must notify the Office of the U.S. Trustee of each financial institution that will be holding estate funds and provide the U.S. Trustee with access to information regarding these accounts. The debtor must open the account under its name and identify itself on the account as debtor in possession. All checks must contain the words "Debtor in Possession" along with the company name.

¹⁸⁷ See Financial Accounting Standards Board, Emerging Issues Task Force in 1996. Financial Accounting Standards Board, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights*, EITF 96-16 (2005), available at <http://www.fasb.org/pdf/abs96-16.pdf> (last visited Nov. 15, 2008). EITF recognizes that even if a parent corporation owns a majority of the voting interests in a subsidiary, consolidated financial reporting may not be required where the rights granted to minority shareholders are sufficiently significant to call into question whether the parent actually controls the subsidiary. The subsidiary's creditors, through their potential right to have the board of directors of the subsidiary act in their best interest, may have sufficient "control" over the subsidiary to be in an analogous position to the minority shareholders contemplated by EITF 96-16.

Needless to say, these requirements can be burdensome and disruptive to a debtor's business operations. As a result, it is typical for a debtor to ask the bankruptcy court to permit it to continue to use its current cash management system, notwithstanding the U.S. Trustee Guidelines. Generally, the debtor will argue that it has been using the current system for a number of years and that it is similar to those systems commonly employed by companies of comparable structure. The subsidiary also will contend that its current system provides for numerous benefits, including the ability to (i) control and monitor corporate funds, (ii) ensure cash availability, and (iii) reduce administrative expenses by facilitating the movement of funds and the development of timely and accurate account balance and information presentation. A debtor usually will demonstrate for the bankruptcy court that it would be overly burdensome for it to establish an entirely new system of accounts and a new cash management and disbursement system. The debtor will show further that having to establish a new cash management system as set forth in the U.S. Trustee Guidelines would severely disrupt and damage business operations and impair the debtor's ability to stabilize its business. Moreover, the debtor will ask the bankruptcy court to permit it to continue to use its current stock of checks and business forms without having to include the legend "Debtor in Possession" on each form or check.

Depending on the jurisdiction, bankruptcy courts may be receptive to these arguments and will permit the debtor to continue to operate under its current cash management system. Although the debtor likely will not have to open new accounts, some courts require the debtor to either stamp "Debtor in Possession" on each check and business form or require that the debtor add "Debtor in Possession" to the company name when ordering new checks and forms after it depletes the current supply.

As a result, a parent corporation would be prudent to establish its own cash management system that is separate from the debtor's system so that it does not get hamstrung by the subsidiary's bankruptcy process. Given the U.S. Trustee Guidelines, a U.S. Trustee in any event would likely demand that the parent and the subsidiary segregate accounts so that the subsidiary has full dominion and control over its own funds in bankruptcy.

C. Protecting Privileged Communications

In a typical corporate group, the same in-house attorneys may represent the entire corporate family. Such an arrangement has numerous practical

benefits—i.e., the attorneys are familiar with the corporate structure and know details useful in undertakings among the parent and a subsidiary or between sister corporations. When a financially distressed subsidiary nears bankruptcy, however, the relationship between the parent and the subsidiary's creditors may become adverse. If litigation ensues, the creditors of the subsidiary may claim that various information distributed by or to in-house counsel is discoverable by such creditors because the in-house attorneys represented the entire corporate family. Put simply, the creditors may argue that although the information is protected against disclosure to third parties by the attorney-client privilege, the privilege cannot be invoked against joint clients of in-house counsel, including the subsidiary.

The Third Circuit recently addressed this issue in *In re Teleglobe Communications, Inc.*,¹⁸⁸ where it held, among other things, that a debtor could not obtain privileged documents of the nondebtor parent *solely* because the corporate family used the same in-house counsel. If the in-house counsel, however, jointly represented the subsidiary and the parent on a matter central to the litigation between the subsidiary (through its creditors) and the parent, *Teleglobe* stands for the proposition that the attorney-client privilege would not apply, and the parent would have to surrender the documents related to that representation to the subsidiary's creditors.¹⁸⁹

¹⁸⁸ *Teleglobe USA, Inc. v. BCE, Inc. (In re Teleglobe Commc'ns, Inc.)*, 493 F.3d 345 (3d Cir. 2007); *see also* *United States v. Under Seal # 4 (In re Grand Jury Subpoena # 06-1)*, No. 07-1889, 2008 U.S. App. LEXIS 8618 (4th Cir. Apr. 21, 2008) (holding that subsidiary lacked standing to intervene to quash a subpoena served on counsel to the parent and subsidiary because the subsidiary did not share a joint privilege with the parent in the communications at issue); *625 Milwaukee, LLC v. Switch & Data Facilities Co., LLC.*, No. 06-0727, 2008 U.S. Dist. LEXIS 1943, at *6 (E.D. Wis. Feb. 29, 2008) (“[N]o attorney-client privilege exists between two joint clients when they become adverse to each other in litigation.”).

¹⁸⁹ *See Teleglobe*, 493 F.3d 345. In *Teleglobe*, chapter 11 debtors (“Debtors”), the wholly-owned subsidiaries of *Teleglobe, Inc.* (“*Teleglobe*”), commenced an action against *Bell Canada Enterprises, Inc.* (“*BCE*”), *Teleglobe*'s parent, alleging that *BCE*'s actions led to *Teleglobe*'s financial distress. According to the Debtors, in late 2000, *BCE* directed *Teleglobe* to accelerate the development of a fiber optic network and pledged its financial support in the endeavor. *Teleglobe* borrowed \$2.4 billion from banks and bondholders. After exhausting the funds, *BCE* approved an \$850 million equity infusion for *Teleglobe*. Around that time, *BCE* began to reassess *Teleglobe*'s future. In April 2001, *BCE* opted to discontinue *Teleglobe*'s funding. Within weeks, *Teleglobe* and the Debtors filed for restructuring relief in Canada, and the Debtors also filed for chapter 11 relief in the United States. The Debtors sued *BCE* under numerous theories, including breach of fiduciary duties, misrepresentation, and estoppel. *See id.* at 354.

The parties became embroiled in numerous discovery disputes. In response to a motion to compel production of documents by *BCE* brought by the Debtors, *BCE* indicated that it had produced all documents related to *Teleglobe* other than those reflecting legal advice to *BCE* solely. The Debtors argued, among other things, that there had been a broad joint representation between *BCE* and *Teleglobe* and that, as a result, the documents should be available to all of the parties. The Special Master initially sided with *BCE*, but upon an in camera review of certain documents that *BCE* claimed as privileged, the Special Master stated that he

In *Teleglobe*, the Third Circuit took the opportunity to summarize the law on privilege. The court explained that the joint-client or co-client privilege, which applies when two or more clients hire the same attorney to represent them on a matter of common interest, closely resembles the issues presented by modern in-house counsel.¹⁹⁰ Under the joint-client doctrine, communications between co-clients and their attorneys are protected by the privilege against parties outside the joint representation, but are available amongst the co-clients in adverse litigation. The court observed that where parent and subsidiary companies may find that their interests have diverged, the parent should secure separate representation for the subsidiary, as maintaining joint representation could risk the forced production of documents to its subsidiary in potential later adverse litigation.¹⁹¹ Nonetheless, in-house counsel for the corporate family can still jointly represent the parent and the subsidiary on matters apart from those that might become adverse.¹⁹² Thus, the court advised that in-house counsel could take steps to protect a parent company's privilege by carefully entering into joint representations only when necessary, limiting the scope of such representations and separating counsel on matters in which subsidiaries' interests are or may become adverse to the parent.¹⁹³

IV. IMPLEMENTING A SETTLEMENT THROUGH CHAPTER 11

As described above, before or after the subsidiary files for chapter 11 protection, the subsidiary or its creditors may assert that the parent is liable for the subsidiary's financial distress or liabilities under numerous theories. Rather than litigating the claims, the parent may determine that negotiating a settlement with the subsidiary would best serve its interests. In this Section,

believed that the in-house attorneys jointly represented BCE and Teleglobe on issues relating to Teleglobe's abandonment. The Special Master then reviewed all 800 documents on the privilege log in camera and stated that the documents revealed a broad, joint representation of BCE and Teleglobe by BCE's in-house attorneys and that all documents, even those prepared by outside counsel solely for BCE, were discoverable. The district court affirmed. *See id.* at 357.

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 358.

¹⁹² *Id.*

¹⁹³ *See id.* at 374. Applying this result to the facts, the Third Circuit held that it was improper to order BCE to produce all documents without a finding that BCE and the *Debtors* (not Teleglobe) were parties to a joint representation. *Id.* at 387. Further, Teleglobe could not effectively waive the privilege, because a joint client cannot waive the privilege for a third party without the consent of the other joint client. Moreover, the court held that the fact that documents prepared by outside counsel to BCE were funneled through in-house counsel had no significance to the privilege issue. What mattered was the scope of any joint representation among BCE and the Debtors. *Id.* at 362.

we discuss the benefits of implementing such a settlement through the chapter 11 process. Those benefits include the ability to obtain court approval for (A) releases of causes of action the subsidiary may hold against the parent, and (B) in some jurisdictions, releases for causes of action that otherwise belong to creditors.

A. Advantages and Costs of a Settlement Through Chapter 11

The bankruptcy process provides exceptional and uniquely strong tools for the parent and the subsidiary to implement a settlement. Once a settlement is reached between the parent and the subsidiary, implementing the settlement through a chapter 11 plan will enable the parent to obtain peace of mind that generally cannot be obtained outside of bankruptcy. The main benefit of the chapter 11 process is the ability to bind creditors and interest holders to court-approved releases pursuant to a chapter 11 plan. A confirmed chapter 11 plan is binding on all creditors and interest holders, whether or not they voted to accept the plan.¹⁹⁴ Thus, a chapter 11 plan settlement will bring greater certainty of claims resolution for the parent than can be obtained by a settlement outside of bankruptcy.

In particular, chapter 11 consolidates various causes of action in the subsidiary in its capacity as debtor in possession. Thus, the subsidiary can be the exclusive agent for prosecuting and, at the appropriate time, settling and releasing those causes of action. For example, the subsidiary will have the exclusive right to prosecute and settle causes of action that outside of bankruptcy would be brought derivatively—such as breach of fiduciary duty claims—and actions that would normally be brought by creditors—such as fraudulent conveyance actions and, in most jurisdictions, veil-piercing and alter ego actions.

The subsidiary's bankruptcy estate (or the creditors' committee acting on the estate's behalf) can only settle causes of action that the estate owns. It is generally well established that the debtor in bankruptcy (i.e., the subsidiary) cannot prosecute causes of action that are personal to creditors, except for certain avoidance actions that the Bankruptcy Code specifically authorizes the debtor to bring. Rather, the debtor can only bring causes of action that belong to the estate. Thus, understanding who owns a cause of action (either the

¹⁹⁴ 11 U.S.C. § 1141(a) (2006).

subsidiary's bankruptcy estate or creditors individually) is critical in determining what actions the subsidiary can release in bankruptcy.

From the parent's perspective, who owns (and therefore has the authority to settle and release) the cause of action is an important issue. Thus, if the parent is involved in prebankruptcy negotiations with the subsidiary or its creditors, the parent should carefully analyze the potential venues for the subsidiary's chapter 11 proceeding with respect to each jurisdiction's precedent surrounding the issue of ownership of relevant causes of action. As a result, venue may be a critical area of discussion in the prebankruptcy negotiations.

In determining whether the debtor can assert (and therefore release or settle) a cause of action, courts look to state law.¹⁹⁵ Causes of action that typically may be asserted by the debtor include those which can be asserted derivatively by shareholders (or creditors) on behalf of the corporation, such as breach of fiduciary duty claims.¹⁹⁶ Derivative breach of fiduciary duty claims allege harm to the corporation (such as corporate waste or mismanagement) and seek recoveries that would flow to the corporation.¹⁹⁷ Furthermore, if the cause of action belongs to the debtor, no other creditors may pursue it.¹⁹⁸

Identifying owners of other causes of action is not always clear. For example, whether a debtor can prosecute veil-piercing or alter ego actions is a question that has somewhat divided the courts. For most courts, the relevant inquiry is whether, under state law, these causes of action also belong to the corporation. Although most nonbankruptcy cases involve creditors of the subsidiary trying to pierce the corporate veil or to find a parent as the alter ego of the subsidiary, many courts have held that, under state law, these causes of action also can be asserted by the subsidiary itself if they do not involve a harm

¹⁹⁵ Under 11 U.S.C. § 541(a)(1), the property of the estate includes all legal or equitable interests of the debtor, including causes of action. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 356 (3d Cir. 2001). “[O]nce a property interest has passed to the estate, it is subject to the same limitations imposed upon the debtor by applicable nonbankruptcy law.” *Integrated Solutions, Inc. v. Serv. Support Specialties*, 124 F.3d 487, 492 (3d Cir. 1997). *See Notinger v. Costa (In re Robotic Vision Sys.)*, 374 B.R. 36, 45 (Bankr. D.N.H. 2007) (“In determining whether the Trustee has stated valid causes of action against the defendants for breach of fiduciary duty, the Court must look to [state] law . . .”).

¹⁹⁶ *Official Comm. of Unsecured Creditors v. Foss (In re Felt Mfg. Co.)*, 371 B.R. 589, 611 (Bankr. D.N.H. 2007) (“Once a corporation is insolvent, its directors owe a fiduciary duty to the corporation’s creditors and creditors have standing to maintain derivative claims for breaches of fiduciary duty.”).

¹⁹⁷ *Id.*

¹⁹⁸ *Official Comm. of Unsecured Creditors of Norstan Apparel Shops, Inc. v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 81 (Bankr. E.D.N.Y. 2007) (“In the bankruptcy context, where the injury resulting from breach of an officer or director’s fiduciary duty is to all creditors as a class, the claim may only be brought by a trustee or the debtor in possession.”).

particular to a creditor. However, not all courts have found that a corporation can assert such generalized causes of action.¹⁹⁹

B. Releases Under a Chapter 11 Plan

Bankruptcy releases implemented pursuant to a chapter 11 plan can be divided into two principal categories: (1) estate releases and (2) third party releases.²⁰⁰ Estate releases are releases by the bankruptcy estate of claims that the bankruptcy estate possesses. The other type of release that may be obtained in a chapter 11 case is a third-party release. A third-party release prevents one nondebtor party from prosecuting claims against another nondebtor. Involuntary third-party releases are controversial and are difficult to obtain. The standard that must be met to obtain either an estate release or a third-party release depends on the jurisdiction.

1. Estate Releases

Estate releases are the most common releases in bankruptcy. The release of an estate cause of action is a disposition of property of the estate.²⁰¹ Typically, releases are granted in connection with a settlement in which the estate receives consideration for the release. However, a court may confirm a bankruptcy plan providing for releases even absent specific consideration being provided to the estate.²⁰²

¹⁹⁹ The Second, Fourth, Fifth, and Seventh Circuits have held that, under the applicable state law, alter ego actions belong to the corporate debtor. *Schimmelpenninck v. Byrne (In re Schimmelpenninck)*, 183 F.3d 347 (5th Cir. 1999); *Kalb, Voorhis & Co. v. Am. Fin. Corp.*, 8 F.3d 130 (2d Cir. 1993); *St. Paul Fire & Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688 (2d Cir. 1989); *Steyr-Daimler-Puch of Am. Corp. v. Pappas*, 852 F.2d 132 (4th Cir. 1988); *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339 (7th Cir. 1987). The Sixth and Eighth Circuits have held to the contrary, finding that, under applicable state law, such causes of action do not belong to the debtor. *Spartan Tube & Steel v. Himmelspach (In re RCS Engineered Prods. Co.)*, 102 F.3d 223, 226 (6th Cir. 1996) (“[U]nder Michigan law a subsidiary does not have standing to sue its shareholders or its parent company under an alter ego theory.”); *Mixon v. Anderson (In re Ozark Rest. Equip. Co.)*, 816 F.2d 1222, 1226 n.7 (8th Cir. 1987) (stating that Arkansas law does not give the debtor standing to assert an alter ego claim, although it may be allowed in other states). The Ninth Circuit has held that alter ego claims do not belong to the debtor, *Williams v. Cal. 1st Bank*, 859 F.2d 664, 667 (9th Cir. 1988), but lower courts within the Ninth Circuit have limited that holding to alter ego claims asserting a peculiar injury. *See, e.g., Trs. of the Bricklayers Local 7 Pension Trust v. Stileitaliano Int’l*, No. C-04-952, 2004 U.S. Dist. LEXIS 15928, at *10 (C.D. Cal. Aug. 6, 2004).

²⁰⁰ Exculpation, which will also be discussed, is a narrow form of third-party release.

²⁰¹ *See W.R. Huff Asset Mgmt. Co. v. HSBC Bank USA (In re PWS Holding Corp.)*, 228 F.3d 224, 238 (3d Cir. 2000).

²⁰² *See id.* (release of insiders of claims that had dubious value). Releases of low value claims may be necessary to obtain the support of important constituencies.

The subsidiary may seek a compromise or settlement involving releases of the parent prior to confirmation of the chapter 11 plan. Alternatively, the chapter 11 plan may itself provide for the settlement of claims belonging to the estate.²⁰³ Compromises and settlements by the estate are governed by Bankruptcy Rule 9019. Rule 9019 provides that the court, on a motion by the debtor (here, the subsidiary) and after a notice and a hearing, may approve a compromise or settlement.²⁰⁴ In considering whether to approve a settlement, the bankruptcy court must exercise its independent judgment that the settlement is fair and reasonable. The bankruptcy court cannot merely rubber-stamp the proposed settlement, but may take into account the opinion of the debtor as to the fairness and reasonableness of the settlement.²⁰⁵ In determining whether to approve a settlement, the court does not need to determine the legal and factual issues presented.²⁰⁶ Instead, the court should canvass the issues and see whether the settlement falls below the lowest point in the range of reasonableness.²⁰⁷

2. *Third-Party Releases*

Third-party releases can be divided into two categories: consensual (or voluntary) and nonconsensual (or involuntary). Voluntary third-party releases are those in which the party bound by the third party release has consented, by some affirmative act, to the imposition of the third-party release. Typically, this is done by a creditor voting to accept the subsidiary's plan of

²⁰³ 11 U.S.C. § 1123(b)(3).

²⁰⁴ FED. R. BANKR. PROC. 9019.

²⁰⁵ *Nellis v. Shugrue*, 165 B.R. 115, 122 (S.D.N.Y. 1994).

²⁰⁶ *In re Penn Cent. Transp. Co.*, 596 F.2d 1102, 1114 (3d Cir. 1979) (stating that to approve a proposed settlement, the court must *only* conclude that the settlement falls within a reasonable range of litigation possibilities).

²⁰⁷ *ACC Bondholder Group v. Adelpia Commc'ns Corp. (In re Adelpia Commc'ns Corp.)*, 361 B.R. 337, 357 (S.D.N.Y. 2007) (stating that the settlement standard requires only that the bankruptcy court "canvass the issues and see whether the settlement fall[s] below the lowest point in the range of reasonableness") (internal quotations omitted). In considering the reasonableness of a settlement, courts typically consider four factors: (i) the probability of success in the litigation; (ii) the attendant delay, cost, and expense of litigation; (iii) the likelihood of collecting a judgment; and (iv) the paramount interest of creditors. *See, e.g., Fry's Metals, Inc. v. Gibbons (In re RFE Indus., Inc.)*, 283 F.3d 159, 165 (3d Cir. 2002). Other courts have identified a similar set of factors, such as: (a) the balance between the likelihood of success compared to the present and future benefits offered by the settlement; (b) prospect of complex and protracted litigation if settlement is not approved; (c) proportion of the class members who do not object or who affirmatively support the proposed settlement; (d) the competency and experience of counsel who support the settlement; (e) the relative benefits to be received by individuals or groups within the class; (f) the nature and breadth of releases to be obtained by officers and directors; and (g) the extent to which settlement is the product of arm's length bargaining. *See Nellis*, 165 B.R. at 122.

reorganization on its plan ballot or, in some instances, by making a separate election to release the parent on its ballot.²⁰⁸ Voluntary third-party releases are generally not controversial, even in those jurisdictions that seem to prohibit involuntary third party releases.²⁰⁹

Involuntary third-party releases compel a nondebtor to give up claims it may have against another nondebtor simply because the party whose claim is being released is a creditor or interest holder in a debtor. Involuntary third-party releases appear to be prohibited in several circuits, as discussed below. Even where those releases are permitted, a party seeking a third-party release should be prepared for contested litigation over the propriety of the release.

The controversial nature of involuntary third-party releases may be best seen by the split among circuit courts of appeals that have considered whether such releases are permissible.²¹⁰ The Ninth and Tenth Circuits have concluded that involuntary third-party releases that would permanently enjoin actions against nondebtors generally are prohibited by § 524 of the Bankruptcy Code.²¹¹ The Fifth Circuit Court of Appeals held that the bankruptcy court had

²⁰⁸ While the procedures necessary to solicit releases of a parent by a subsidiary's creditors under the subsidiary's plan of reorganization are beyond the scope of this Article, the procedures themselves can raise complicated administrative issues in the bankruptcy case. In particular, the parent will want to know, for purposes of any potential later litigation, which creditors released it. This issue can become complicated, for instance when some creditors are holders of publicly-traded debt, as such trades occur often and individual holders generally do not submit separate plan ballots in a chapter 11 case. Debt trading in general raises issues of whether the original holder of the debt or its transferee should receive the consideration given by the parent to the subsidiary's bankruptcy estate in exchange for a release, especially where applicable law provides that any potential action against the parent would not transfer with the claim. Finally, how the consideration given by the parent should be divided among creditors who grant a release to the parent can become difficult to decide, since the percentage of these creditors' claims to all claims against the subsidiary may not be known for years until the subsidiary liquidates all asserted claims against it.

²⁰⁹ *Deutsche Bank AG, London Branch v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142 (2d Cir. 2005) ("Nondebtor releases may also be tolerated if the affected creditors consent.") (citing *In re Specialty Equip. Cos.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("Accordingly, courts have found releases that are consensual and non-coercive to be in accord with the strictures of the Bankruptcy Code."); *Billington v. Winograde (In re Hotel Mt. Lassen, Inc.)*, 207 B.R. 935, 941 n.7 (Bankr. E.D. Cal. 1997). *But see* *Bill Roderick Distrib. Inc. v. A.J. Mackay Co. (In re A.J. Mackay Co.)*, 50 B.R. 756, 761 (D. Utah 1985) (bankruptcy court cannot enforce provisions of a confirmed plan purporting to enjoin creditor from pursuing nondebtor even where creditor was deemed to have accepted the plan).

²¹⁰ *See Airadigm Commc'n, Inc. v. FCC (In re Airadigm Commc'n, Inc.)*, 519 F.3d 640, 655–56 (7th Cir. 2008) (reviewing the various opinions that have considered whether such releases are permissible).

²¹¹ *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401 (9th Cir. 1995) (11 U.S.C. § 524(e) "precludes bankruptcy courts from discharging the liabilities of nondebtors."); *Am. Hardwoods, Inc. v. Deutsche Credit Corp. (In re Am. Hardwoods, Inc.)*, 885 F.2d 621, 626 (9th Cir. 1989) (concluding the specific provisions of § 524 displace the bankruptcy court's equitable power to enjoin claims against nondebtors); *accord* *Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. of Tulsa (In re W. Real*

no jurisdiction to consider the propriety of a permanent injunction relieving the nondebtor from liability to third parties because the third-party action sought to be enjoined was not sufficiently related to the bankruptcy.²¹² The Fourth and Sixth Circuits have permitted third-party releases in cases where substantial contributions by the nondebtor releasee have been made.²¹³ Previously, the Second Circuit had permitted involuntary third-party releases where the court found that the release was important to the chapter 11 plan and where the parties covered by the release were necessary to the plan.²¹⁴ In early 2008, however, the Second Circuit struck down an involuntary third-party release in the long-running Johns-Manville Corporation chapter 11 case because the release did not sufficiently impact “the res of the bankruptcy estate,” and in so doing potentially signaled a shift in that Circuit’s position on the issue.²¹⁵

Estate Fund, Inc.), 922 F.2d 592, 602 (10th Cir. 1990) (following *American Hardwoods* and holding that permanent injunction that effectively relieves nondebtor of liability to a creditor “improperly insulate[s] nondebtors in violation of section 524(e)”).

²¹² *Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 756 (5th Cir. 1995) (involving third-party bad faith tort claims brought by one of the debtor’s former directors and its excess D & O carrier against an insurance company).

²¹³ The Fourth Circuit upheld third-party releases where they were necessary for the reorganization and supported by consideration, provided in part by the nondebtors. *Dalkon Shield Claimants Trust v. Reiser* (*In re A.H. Robins Co.*), 972 F.2d 77 (4th Cir. 1992). In *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002), the Sixth Circuit held that third-party releases were permissible if: (1) there is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) the nondebtor has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) the impacted class, or classes, has overwhelmingly voted to accept the plan; (5) the plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full; and (7) the bankruptcy court made a record of specific factual findings that support its conclusions.

²¹⁴ *SEC v. Drexel Burnham Lambert Group, Inc.* (*In re Drexel Burnham Lambert Group, Inc.*), 960 F.2d 285, 293 (2d Cir. 1992). The Second Circuit has rejected “material contribution” by the nondebtor party to the estate as sufficient to justify a nondebtor release, but had reaffirmed its position that the minimum requirement is that the release itself is important to the plan. *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 143 (2d Cir. 2005).

²¹⁵ *Johns-Manville Corp. v. Chubb Indem. Ins. Co.* (*In re Johns-Manville Corp.*), 517 F.3d 52 (2d Cir. 2008). The *Johns-Manville* case arose out of an attempt by various of Manville’s asbestos personal-injury claimants to bring conspiracy and breach of duty claims against Travelers Insurance Company. The order confirming Manville’s 1986 plan of reorganization, in exchange for Travelers’ contribution to the trust being funded under the plan, contained an injunction that prohibited Manville’s asbestos creditors from ever suing Travelers on account of claims that were “based upon, arose out of, or related to” Manville’s insurance. Notwithstanding the injunction, various asbestos claimants later filed suit against Travelers, purportedly unrelated to the insurance policies it had issued to Manville. Following a settlement of the suit approved by the bankruptcy court, certain other plaintiffs appealed the bankruptcy court’s reaffirmation of the 1986 injunction up to the court of appeals. The Second Circuit ultimately held that “a bankruptcy court only has

Recently, the Seventh Circuit found an involuntary third-party release to be appropriate and held that the bankruptcy court has broad equity power to issue such a release.²¹⁶ Similarly, the Eleventh Circuit has permitted a release in the context of a settlement.²¹⁷

Other courts have not directly addressed the issue of whether involuntary third-party releases are permissible. Both the District of Columbia Circuit and Third Circuit have invalidated releases for lack of separate consideration. The District of Columbia Circuit did not directly raise the issue of when and under what circumstances a release would be appropriate, and the Third Circuit expressly did not answer that question.²¹⁸

Whether the parent can obtain an involuntary third-party release thus tends to depend on the district in which the subsidiary's bankruptcy case is filed, the ability to show that unusual circumstances exist in the bankruptcy case, and that the consideration being provided to the estate is necessary to the reorganization. For example, many of the decisions approving third-party releases are mass tort type cases, such as *Dow* and *Robins*,²¹⁹ where the third-party release was arguably critical to a complicated reorganization precipitated by extensive litigation. Other decisions involve debtor partnerships where the partners making a contribution are seeking a release for their liability on

jurisdiction to enjoin third-party, non-debtor claims that directly affect the res of the bankruptcy estate" and that the claims at issue against Travelers did not directly affect the insurance policy "res." *Id.* at 66.

While the Second Circuit may not have believed that it was effectuating a material change or clarification in the law on involuntary third-party releases, the *Johns-Manville* opinion certainly could be interpreted as having done so. Prior to the *Johns-Manville* decision, the Second Circuit had not issued an opinion on involuntary third-party releases that turned on the jurisdictional issue that lay at the heart of the Second Circuit's ruling in *Johns-Manville*. Prior to the *Johns-Manville* decision, however, the Second Circuit did signal its reluctance to issue nonconsensual third-party releases. In *In re Metromedia Fiber Network, Inc.*, the Second Circuit explained that while third-party releases are appropriate when they play "an important part in the debtor's reorganization plan, . . . it is clear that such a release is proper only in rare cases." *In re Metromedia Fiber Network, Inc.*, 416 F.3d at 142.

²¹⁶ *In re Airadigm Commc'ns, Inc.*, 519 F.3d 640 (7th Cir. 2008) (holding that the bankruptcy court has "residual authority" pursuant to, among other things, § 1123(b)(5) of the Bankruptcy Code, that permits it to release third parties from liability creditors if the release is "appropriate" and not inconsistent with the Bankruptcy Code). Prior to *Airadigm*, the Seventh Circuit had never ruled on the issue. Instead, it ruled in *In re Specialty Equipment Co.*, 3 F.3d 1043 (7th Cir. 1993), that consensual third-party releases were permissible, although the language of its opinion potentially suggested a negative view of involuntary third-party releases.

²¹⁷ *Shearson Lehman Bros. v. Munford, Inc. (In re Munford, Inc.)*, 97 F.3d 449, 455 (11th Cir. 1996).

²¹⁸ The Third Circuit held that, under the most flexible tests, involuntary releases must be fair and necessary to the reorganization, with such conclusions being supported by specific factual findings. *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 214 (3d Cir. 2000).

²¹⁹ *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648 (6th Cir. 2002); *Dalkon Shield Claimants Trust v. Reiser (In re A.H. Robins Co.)*, 972 F.2d 77 (4th Cir. 1992).

account of their being partners.²²⁰ Even in the most flexible jurisdictions, such as the Seventh Circuit, the third-party releases must be important to the reorganization.²²¹

Certain specific arguments that creditors may make against involuntary third-party releases are set forth below.

a. The Bankruptcy Court Does Not Have Jurisdiction to Grant the Releases

Creditors may challenge third-party releases on the ground that the bankruptcy court lacks jurisdiction to hear the matter. The argument that the bankruptcy court lacks jurisdiction has been rejected in at least one case on the basis of the Supreme Court's decision in *Celotex v. Edwards*, where the Supreme Court stated that proceedings "related to" a bankruptcy proceeding include "suits between third parties which have an effect on the bankruptcy estate."²²² The Supreme Court's expansive definition of "related to" jurisdiction would appear broad enough to cover third-party releases, especially such releases integral to settlements that are fundamental to the debtor's reorganization. Other courts, however, have rejected the notion that a settlement agreement itself can create "related to" jurisdiction (even with an indemnification provision), reasoning that there must be jurisdiction over the dispute that is independent of the bankruptcy case.²²³

²²⁰ See, e.g., Greer v. Gaston & Snow (*In re Gaston & Snow*), No. 93-8517, 1996 WL 694421 (S.D.N.Y. Dec. 4, 1996); *In re Keck, Mahin & Cate*, 241 B.R. 583 (Bankr. N.D. Ill. 1999).

²²¹ *In re Airadigm Commc'ns*, 519 F.3d 640.

²²² *In re Dow Corning*, 255 B.R. 445, 486 (E.D. Mich. 2000), *aff'd*, 280 F.3d 648 (6th Cir. 2002) (citing *Celotex Corp. v. Edwards*, 514 U.S. 300, 308 n.5 (1995)). In *Dow Corning*, the court rejected the argument that the bankruptcy court lacked jurisdiction to impose third-party releases because the releases in that case fell within the "related to" jurisdiction of the bankruptcy court. Most circuits have adopted the test in *Pacor, Inc. v. Higgins*, which stated that a matter is related to a bankruptcy if "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." *Pacor, Inc. v. Higgins*, 743 F.2d 984, 994 (3d Cir. 1984), *overruled on other grounds by* *Things Remembered, Inc. v. Petrarca*, 516 U.S. 124 (1995), *as recognized in* *In re Fed.-Mogul Global, Inc.*, 300 F.3d 368, 385 n.9 (3d Cir. 2002). An action is related to a bankruptcy if it could alter a "debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and . . . in any way impacts upon the handling and administration of the bankrupt estate." *Id.* For arguments that the bankruptcy court does not have jurisdiction, see Ralph Brubaker, *Nondebtor Releases and Injunctions in Chapter 11: Revising Jurisdictional Precepts and the Forgotten Callaway v. Benton Case*, 72 AM. BANKR. L.J. 1 (Winter 1998).

²²³ *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 754-55 (5th Cir. 1995) (bankruptcy court lacked jurisdiction to impose injunction as part of a settlement where there was no jurisdiction absent the settlement). *Zale* involved an attempt to enjoin claims of non-creditors against a nondebtor. According to the court, the bankruptcy court lacked jurisdiction over conditions to a settlement that do not bear on the court's duties to preserve the estate and protect creditors. The court ruled that the settlement agreement (through an indemnity)

b. The Bankruptcy Court Lacks the Power to Release

In addition to the jurisdictional argument set forth above, a creditor or other interested party may oppose a proposed third-party release and argue that the bankruptcy court lacks the power to enjoin third-party actions. First, the creditor may argue that the Bankruptcy Code, particularly § 524, does not specifically authorize such releases.²²⁴ Moreover, the creditor may argue that the releases are not proper exercises of the bankruptcy court's general equitable powers, as the use of such powers is "confined within the broad boundaries of traditional equitable relief"²²⁵ and the third-party releases do not fall within those confines.²²⁶

This latter argument generally has been rejected by the courts addressing this issue.²²⁷ In those cases, the courts reasoned that § 105(a) of the Bankruptcy Code grants the bankruptcy courts the power to issue any order necessary or appropriate to carry out the provisions of the Bankruptcy Code. Because of this grant of statutory power, "the bankruptcy court is not confined to traditional equity jurisprudence" and thus can grant an injunction.²²⁸

Creditors have made an additional argument that the Bankruptcy Code precludes the bankruptcy court from granting a third-party release. This

could not create jurisdiction to enjoin the claims. *Zale* may be distinguished because the parties the court sought to enjoin were not creditors in the bankruptcy case, but the court's reasoning does not appear to turn on that fact. *Zale* does not address the impact of the failure to provide the releases on the estate. See also *Johns-Manville Corp. v. Chubb Indem. Ins. Co.* (*In re Johns-Manville Corp.*), 517 F.3d 52 (2d Cir. 2008) (rejecting the third-party releases because the nondebtor claims did not directly affect the rest of the bankruptcy estate).

²²⁴ *In re Airadigm Commc'ns, Inc.*, 519 F.3d at 656 ("The nub of the [circuit split] concerns two interrelated questions. . . . The first is whether § 524(e) of the bankruptcy code bars a bankruptcy court from releasing non-debtors from liability to a creditor without the creditor's consent.").

²²⁵ *Grupo Mexicano de Desarrollo v. Alliance Bond Fund, Inc.*, 527 U.S. 308, 322 (1999).

²²⁶ *Id.* at 318 (noting that the general equity jurisdiction of the federal courts is limited to the "jurisdiction in equity exercised by the High Court of Chancery in England at the time of the adoption of the Constitution and the enactment of the original Judiciary Act, 1789"); see also *In re Airadigm Commc'ns, Inc.*, 519 F.3d at 656 ("The nub of the [circuit split] concerns two interrelated questions. . . . The second related question dividing the circuits is whether Congress affirmatively gave the bankruptcy court the power to release third parties from a creditor's claims without the creditor's consent.").

²²⁷ *In re Airadigm Commc'ns, Inc.*, 519 F.3d at 640; *In re Dow Coming*, 280 F.3d 648, 657–58 (6th Cir. 2002).

²²⁸ Thus, if a third party release is appropriate in a chapter 11 plan under 11 U.S.C. § 1123(b)(6), the court has power to issue an injunction. A party opposing the relief may question whether § 105(a) of the Bankruptcy Code should be construed so broadly. Other courts have noted that § 105(a) is not a roving commission to do equity. *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc.* (*In re Dairy Mart Convenience Stores, Inc.*), 351 F.3d 86, 92 (2d Cir. 2003) ("[Section 105(a)] does not 'authorize the bankruptcy courts to create substantive rights that are otherwise unavailable under applicable law, or constitute a roving commission to do equity.'").

argument is based on a negative inference that can be drawn from two subsections of § 524 of the Bankruptcy Code. Section 524(e) of the Bankruptcy Code provides that the “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.”²²⁹ Also, in 1994, Congress enacted § 524(g) of the Bankruptcy Code, which expressly authorizes, in limited circumstances, the issuance of injunctions precluding asbestos-related litigation against nondebtor third parties.

Creditors have argued that § 524(e), particularly in light of § 524(g), forbids the issuance of a third-party release. In *Lowenschuss*, the Ninth Circuit stated that the express grant of authority in § 524(g) “reinforces the conclusion that § 524(e) denies such authority in other, non-asbestos, cases.”²³⁰ Outside the Ninth Circuit, parties may argue that the older line of cases, such as *Drexel* and *Robbins*, were decided prior to the enactment of § 524(g) and thus should be reconsidered.²³¹

Courts, however, generally recognize that § 524(e) provides that the discharge of the debtor does not affect the liability of other parties. These courts reason that § 524(e) does not expressly prohibit a court, in connection with a chapter 11 plan, from releasing or enjoining claims against third parties.²³² Furthermore, the negative implication drawn from § 524(g) appears incorrect from the legislative history because no inference as to § 524(e) can be drawn from the enactment of § 524(g). The House Committee Report states that in enacting § 524(g) of the Bankruptcy Code, Congress adopted a rule of construction

to make clear that the special rule devised for the asbestos claim/trust injunction mechanism is not intended to alter any authority bankruptcy courts may already have to issue injunctions in connection with a plan or reorganization. . . . The Committee expresses no opinion as to how much authority a bankruptcy court may generally have under its traditional equitable powers to issue an enforceable injunction of this kind.²³³

²²⁹ 11 U.S.C. § 524(e) (2006).

²³⁰ *Resorts Int'l Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1402 n.6 (9th Cir. 1995).

²³¹ See *supra* notes 213–14 and corresponding text.

²³² *In re Airadigm Commc'ns, Inc.*, 519 F.3d at 640 (“The natural reading of [§ 524(e)] does not foreclose a third-party release from a creditor’s claims. . . . In any event, § 524(e) does not purport to limit the bankruptcy court’s powers to release a non-debtor from a creditor’s claims.”).

²³³ 140 CONG. REC. H10752-01, H10766 (1994) (statement of Rep. Brooks).

This rule of construction is a part of the law passed by Congress, although it was not codified in title 11.²³⁴

c. Classification and Unfair Discrimination Arguments

Section 1122(a) of the Bankruptcy Code provides that a claim may be placed in a particular class only if it is substantially similar to the other claims in that class. Section 1123(a)(4) provides that each holder of a claim in a class must receive the same treatment, unless a particular holder agrees to less favorable treatment.

If a plan places a creditor who holds a direct claim against the parent that is to be released under the plan in the same class as other creditors who have no such claim against the parent, then the creditor may argue that the plan violates either § 1122(a) or § 1123(a)(4). The facts of the D.C. Circuit's decision in *AOV Industries* best demonstrate the argument.²³⁵ In *AOV*, the plan provided that all creditors agreeing to release certain parties would receive additional consideration. One creditor that had a pending direct claim objected to the plan on the grounds that it violated § 1123(a)(4) because it was giving up a direct claim to receive the same recovery as creditors who were giving up only indirect claims.²³⁶ The court found this to constitute disparate treatment. The court found that if it is disparate treatment for creditors to receive different percentage payments, it is likewise disparate treatment to tender more valuable consideration for the same percentage recovery.²³⁷

One argument against the *AOV* holding is that § 1123(a)(4) of the Bankruptcy Code requires only that each claim in a particular class receive substantially equal treatment. This is consistent with the focus of that section on claims, not creditors. Thus, so long as the percentage recovery on account of each claim against the debtor is the same, there should be no violation of § 1123(a)(4). In any case, *AOV* has been criticized and has not been strictly followed.²³⁸ For instance, courts have found that § 1123(a)(4) only requires an

²³⁴ Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, tit. I, § 111(b), 108 Stat. 4106 (approved Oct. 22, 1994, H.R. 5116, 103d Cong. (2d Sess. 1994)).

²³⁵ *In re AOV Indus., Inc.*, 792 F.2d 1140, 1142-45 (D.C. Cir. 1986).

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *In re Dow Corning Corp.*, 255 B.R. 445, 497 (E.D. Mich. 2000) ("Requiring a bankruptcy court to inquire as to the amount of consideration involved in each . . . disputed and unliquidated personal injury claim, especially in a mass tort situation, would be . . . unrealistic, unworkable and . . . unduly burdensome . . . for the court . . .").

approximate measure of equality, not precisely the same treatment in all respects.²³⁹ Thus, “even though some class members may have stronger claims, or stronger defenses than others, they may be classified together so long as their claims are substantially similar and their treatment is approximately equal.”²⁴⁰

CONCLUSION

The thicket of issues facing the parent of a distressed subsidiary dictates that the parent plan for and carefully consider such issues as early as possible, potentially well before the subsidiary’s financial distress becomes acute. For the reasons noted, the economic loss by the parent of its investment in the subsidiary, while disappointing, is only one of many issues that the parent will face. More complicated issues will include reducing the parent’s credit exposure to the subsidiary and particularly the subsidiary’s creditors. Where the subsidiary ultimately is forced to file for bankruptcy, the parent’s actions leading up to that event likely will be closely reviewed by the subsidiary’s creditors. In order to attempt to obtain full payment on their claims, these creditors may seek to assert liability against the parent as a result of contractual obligations to the subsidiary, joint plans and programs between the companies, various state and federal statutes, or under a variety of common law theories including veil-piercing and breach of fiduciary duty.

Where the subsidiary’s creditors are aggressive, the parent ultimately may be faced with a decision as to whether to fight any litigation brought by the creditors, or instead to settle the asserted liability and put any exposure of the parent to the subsidiary and its creditors behind it for good. While chapter 11 provides the creditors with a forum to fund and pursue litigation against the parent, it also provides unique procedures that may permit the parent, in exchange for some consideration, to be fully released from any liability to the subsidiary’s creditors in a manner not available outside of chapter 11. Regardless of the circumstance, however, the parent likely will be required to face difficult decisions as to how to best manage the challenges created by the financial distress of its subsidiary.

²³⁹ *In re Resorts Int’l, Inc.*, 145 B.R. 412, 448 (Bankr. D.N.J. 1990).

²⁴⁰ *Id.*