

ABI CENTRAL STATES CONFERENCE – 2006¹

BREAK-UP FEES

THE IMPACT OF INSOLVENT ESTATES ARISING FROM §363(b) SALES

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Appendix A: Excerpt from 2003 Outline on Business Judgment Rule as it applies to Officers and Directors Liability.

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I. Break-Up / Termination Fees

A. *Standards*

Several standards exist with respect to the evaluation of break-up fees in bankruptcy asset sales. One standard uses the business judgment rule as its foundation. *See In re Integrated Resources, Inc.*, 147 B.R. 650 (Bankr. S.D.N.Y. 1992) (court approved motion for order allowing debtor to agree to break-up fees) (followed by, *inter alia*, *In re Global Crossing Ltd.*, 295 B.R. 726 (Bankr. S.D.N.Y. 2003) and *In re APP Plus*, 223 B.R. 870, 1998 Bankr. LEXIS 1073 (Bankr. E.D.N.Y. 1998) (court approved break-up fee agreed to by the first offerer and trustee of chapter 11 estate), and rejected in *In re America West Airlines*, 166 B.R. 908 (Bankr. D. Ariz. 1994) (court denied break-up fee previously agreed to by the debtor and a prospective buyer)). The court in *Integrated Resources* held that there are three questions for courts to consider when authorizing break-up fees:

- (1) Is the relationship of the parties who negotiated the break-up fee tainted by self-dealing or manipulation?
- (2) Does the fee hamper, rather than encourage, bidding?
- (3) Is the amount of the fee unreasonable relative to the proposed purchase price?

Another standard looks to whether the interest of all parties concerned are best served by the fee (the “best interests of the estate” test.) *See S.N.A. Nut Company*, 186 B.R. 98 (Bankr. N.D. Ill. 1995) (holding that no break-up fee allowed when debtor and prospective buyer previously agreed to fee only in the event that the prospective buyer was outbid.) The court in *S.N.A. Nut* held that “bankruptcy courts should carefully scrutinize breakup fees to be sure that, following the underlying policy guiding § 363, revenues will be maximized. As stated by another court, in another context, defining best interests of the estate, “The prime criterion for assessing the interests of the estate is the maximization of its value....” (citations omitted.) *S.N.A. Nut* is followed by, *inter alia*, *In re Tiara Motorcoach Corp.*, 212 B.R. 133 (Bankr. N.D. Ind. 1997) (court denied break-up fees agreed to by debtor and prospective buyer since, among other reasons, the agreement was found in a non-binding letter of intent).

Yet another standard looks to the general administrative expense jurisprudence of section 503(b) in evaluating break up fees. See *O'Brien Env'tl. Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999). *O'Brien* is the most followed standard, followed by, *inter alia*, *In re AppliedTheory Corp.*, 312 B.R. 225 (Bankr. S.D.N.Y. 2004); *In re Homelife Corp.*, 2002 U.S. Dist. LEXIS 17915 (D. Del. Sept. 20, 2002); *Cech v. Crescent Hills Coal Co. (In re Shannopin Mining Co.)*, 2002 U.S. Dist. LEXIS 15731 (W.D. Pa. 2002); *In re DVI, Inc.*, 308 B.R. 703 (Bankr. D. Del. 2004); *In re Insilco Techs., Inc.*, 309 B.R. 111 (Bankr. D. Del. 2004); *In re G-I Holdings, Inc.*, 308 B.R. 196 (Bankr. D.N.J. 2004); *In re Waste Sys. Int'l, Inc.*, 280 B.R. 824 (Bankr. D. Del. 2002); *In re Am. Appliance*, 272 B.R. 587 (Bankr. D.N.J. 2002); *Novacare Holdings, Inc. v. Mariner Post-Acute Network, Inc. (In re Mariner Post-Acute Network Inc.)*, 267 B.R. 46 (Bankr. D. Del. 2001); *In re Kitty Hawk, Inc.*, 2003 Bankr. LEXIS 859 (Bankr. N.D. Tex. July 29, 2003); *AgriProcessors, Inc. v. Iowa Quality Beef Supply Network, L.L.C. (In re Tama Beef Packing, Inc.)*, 290 B.R. 90 (B.A.P. 8th Cir. 2003).

Two Sixth Circuit cases employ the “best interests of the estate” standard. In *In re Hupp Indus., Inc.*, 140 B.R. 191, 196 (Bankr. N.D. Ohio 1992), cited approvingly in *In re S.N.A. Nut Co., supra*, the court explicitly rejected the business judgment standard, and applied a strict test for approving break up fees, holding that incentive fees must be “carefully scrutinized in § 363(b) sales to insure that the debtor’s estate is not unduly burdened and that the relative rights of the parties in interest are protected.” The court listed seven factors to be considered in evaluating breakup fees:

- 1) Whether the fee requested correlates with a maximization of value to the debtor’s estate;
- 2) Whether the underlying negotiated agreement is an arms-length transaction between the debtor’s estate and the negotiating acquire
- 3) Whether the principal secured creditors and the official creditors committee are supportive of the concession;

- 4) Whether the subject break-up fee constitutes a fair and reasonable percentage of the proposed purchase price;
- 5) Whether the dollar amount of the break-up fee is so substantial that it provides a “chilling effect” on other potential bidders;
- 6) The existence of available safeguards beneficial to the debtor’s estate; and
- 7) Whether there exists a substantial adverse impact upon unsecured creditors, where such creditors are in opposition to the break-up fee.

The *Hupp* court found that most of those standards were satisfied. However, it nevertheless refused to approve the fee because it was required to be paid whether or not the proposed sale closed, and for that reason the court found that it unduly burdened the estate.

Another Sixth Circuit case, this time citing *S.N.A. Nut* approvingly for authority, is *In re Big Rivers Elec. Corp.*, 233 B.R. 726 (Bankr. W.D. Ky. 1998), which held that “at a minimum, any such clauses (in this case, a “window shop” clause in an omnibus creditor agreement entered into just prior to bankruptcy) must be subject to the strictest scrutiny by a Bankruptcy Court before the process of approving the underlying transaction begins. The debtor must demonstrate that the inclusion of a “window shop” clause, or similar clause, in an agreement provides a significant benefit to the debtor, which would not be realized absent the “window shop” clause”).

B. Examples of Approved Termination Fees

Termination fees, at least in the Eastern District of Michigan, hover between 1% and 3%.

1. *In re Awrey Bakeries, Inc.*, Case No. 05-43106 (approving break-up fee of 3%)

2. *In re Trim Trends Co., LLC.*, Case No. 05-56108
(approving break-up fee of 3%)
3. *In re American International Corporation*, Case No. 05-47794 (Approving break-up fee of 2%)
4. *In re Oxford Automotive, Inc.*, Case No. 04-74377
(Approving Reimbursement Fee not to exceed 1% of purchase price)
5. *In re Uniboring Co., Inc.*, Case No. 05-58779 (Approving Termination Fee of approximately 1%, denying later request to increase Termination Fee to 3% of Purchase Price plus estimated cure costs to be paid by purchaser).

II. § 363(B) Sales, Insolvent Estates, And Financial Exposure To Professionals Officers And Directors

A. *The Problem*

So many of the chapter 11 cases that are currently being filed are solely for the purpose of selling substantially all of the assets of a business as a going concern that such cases have become to be known as “Chapter 363” cases. Typically, Debtors that file Chapter 363 cases obtain enough financing to allow the Debtors to proceed down one of two paths. One where the goal is an organized wind-down which allows production to continue long enough for customers to either find new vendors or otherwise satisfy customers’ requirements. The other path is to proceed toward a sale so that the business can be sold for a going concern premium. Pre-Petition lenders are willing to continue lending so long as their position is either somehow improved or at least protected. When a case is filed, little thought is given to the issue of whether there is enough financing to cover all administrative claims. **The law has developed in such a way to expose both bankruptcy professionals and officers and directors of debtors to liability.** This outline deals with the consequences of the failure to plan for such expenses.

B. *The Standard for the Approval of Sales Under §363*

The standard for sales under §363 are well-developed. The case most often cited allowing for the sale of substantially all of the assets under §363(b) is *In re Lionel Corporation*, 722 F.2d 1303 (5th Cir. 1985). *Stephens Industries, Inc. v. McClung*, 789 F.2d 386 (6th Cir. 1986) adopted the reasoning of *Lionel*, stating that the legal standard for approving a §363 sale is that there must be a “sound business purpose” for the sale to be allowed to occur outside of a plan.

Some of the cases arising out of the 6th and 7th Circuit applying Stephens are the following:

In re Weatherly Frozen Food Group, Inc., 149 B.R. 480 (Bankr. N.D. Ohio, 1992) (extensive testimony regarding the good faith nature of the transaction, the support of secured creditors, support of the union, the necessity of a quick sale to preserve the sale opportunity from the only buyer over a two year period; the Court summarized the Lionel factors as 1) sound business reason, 2) accurate and reasonable notice, 3) adequate price (based on evidence that there was only one viable buyer), and 4) good faith.)

In re Fremont Battery Company, 73 B.R. 277 (Bankr. N.D. Ohio, 1987) (a case in which a secured creditor was credit bidding a specific amount. If no one outbid the secured creditor, the secured creditor would, instead of receiving the assets, receive the stock of the debtor, allowing the secured creditor to preserve a net operating loss carryforward. Unsecured creditors were receiving nothing. The Court said that because the NOL was not “a depreciating asset such as that presented in *Lionel* and *Stephens* case,” a §363 (b) sale would not be approved.)

In re Country Manor of Kenton, Inc., 172 B.R. 217 (Bankr. N.D. Ohio, 1994) (where the price is too low and a lack of adequate marketing is evident, the standard of good faith has not been met)

In re Embrace Systems Corporation, 178 B.R. 112 (Bankr. W.D. Mich., 1995) (After a four day trial, a bidder that was excluded from the due diligence process

was able to show that the debtor's activities were not consistent with obtaining the highest and best price. In this case, the objecting creditor/hopeful bidder had purchased a claim in order to not be denied standing)

C. Why Do Most Estates Become Insolvent When the Goal is Selling the Assets?

There are many reasons. Budgets are prepared with only the cash needs in mind. Thus there may be expenses that accrue in the case prior to the sale that are not covered in a budget. Examples may include the following:

- Under §365(d)(1) rents on real or personal property may not be paid for sixty days
- Under the BAPCPA, a number of administrative claims may arise that may not necessarily get paid, the most outstanding example is the conversion of unsecured claim for creditors who ship in the 20 days prior to the petition date into administrative claims.
- Similarly, the BAPCPA has required more cash to be spent, such as payments to utilities in cash and raising the pre-petition wage and benefit priority to \$10,000.
- Because of the creditor-friendly preference law changes, recoveries of monies for the estate are reduced.
- A large issue in most cases are the self- (read, "un-") funded medical plans. These plans, typically administered by third party administrators, will continue to receive claims for several months after the sale is complete, leaving in many instances, large administrative claims.

- Other employee benefits, taxes, insurance, and accounts payable accrued but not paid during the administration of the case prior to the sale.

D. Liability of Officers, Directors and Others

Attached to this Outline as Appendix A is a portion of an outline that was prepared by the writer of this outline for a 2003 ABI Central States Seminar. It discusses cases involving the concept of business judgment as it protects or does not protect an insider, officer, director and others. The reason that this is relevant is that the case law is developing in a way that an insolvent chapter 11 estate can result in liability to officers, directors and others who aid and abet in the torts that are basis for such liabilities.

In re LTV Steel Company, Inc., 333 B.R. 397 (Bankr. N.D. Ohio, 2005) is a startling that stands for the proposition that there is a cause of action for post-petition deepening insolvency (that is, allowing an estate to incur debt that is not ultimately paid). The case arose on a motion by an Administrative Creditors' Committee's (which replaced an unsecured creditors' committee), which sought to allow the Committee to bring an action against directors and officers. The theories the Committee asserted were breach of duty of care, breach of duty of loyalty, negligent misrepresentation and fraud (in obtaining post-petition credit), post-petition deepening insolvency, and corporate waste. The standard in the Sixth Circuit for allowing a Committee to pursue a claim is that the Committee has made a colorable claim. The defendants asserted various defenses, including the business judgment rule. (The defendants also asserted that everything that was done in the case was subject to orders by the Court, and review by various parties in interest.) The Bankruptcy Court held, citing Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 917 (Del., 2003) (discussed in the attached outline), that in certain circumstances the business judgment rule is subject to enhanced scrutiny to ensure that the actions of the defendants were reasonable before the business judgment test is applies. The Court refused to dismiss any of the causes of action. A good, short article strongly criticizing the LTC decision by Russell C. Silberglied is, "LTV and Post-Petition Deepening Insolvency: The Next Big Wave," 25 Feb. Am. Bankr. Inst. J. 1.

While LTV is a very large case, with much at stake in the litigation, an angry group of administrative creditors might be willing to bring a similar action in a smaller case. If a debtor files a case solely for the purpose of engaging in a §363 sale, and is losing money that is funded by DIP loans, the chances are high that there will not be enough money to pay all administrative creditors. This section is included in this Outline to point out that there can be real consequences to officers and directors in a chapter 11 where there are substantial unpaid administrative costs.

E. Disgorgement of Professional Fees/The Specter of Specker

Several recent cases have examined in what circumstances section 726(b) of the Bankruptcy Code requires disgorgement of professional fees and retainers in order to allow administrative creditors to share equally in the property of an administratively insolvent estate.

1. Specker Motor Sales Co. v. Saul Eisen, 300 B.R. 687 (Bankr. W.D. Mich. 2003) aff'd by 393 F.3d 659 (6th Cir. December 17, 2004).

a. Holding: Disgorgement of attorney's interim fees pursuant to 11 U.S.C. §726(b) is required when a bankruptcy estate was found to be administratively insolvent in order to achieve pro-rata distribution among administrative expense claimants.

b. Summary of Facts: The Debtor's attorney was paid a \$10,000 pre-petition retainer², which was approved by the Court. Prior to the filing of the attorney's final fee application, the case was converted to chapter 7. The attorney's final fee application, in the amount of \$17,343.10, was approved by the court and the attorney was allowed to retain the \$10,000 retainer as interim compensation. When the remaining assets were liquidated by the Chapter 7 trustee, the court determined that there were unpaid administrative claims in the amount of \$204,799.74, and only \$11,494.67 remaining in the estate. The court required the attorney to disgorge his \$10,000 retainer. The attorney's pro-rata share was \$973.41.

² Though the *Specker* opinions do not contain a clear record regarding whether the retainer was given pre or post-petition, the *US Flow* court examined the record and confirmed that it was a pre-petition retainer at issue in *Specker. In re U.S. Flow Corporation*, 332 B.R. 792, 795, n.7 (Bankr. W.D. Mich. 2005).

c. Analysis: The Sixth Circuit distinguished *United States v. Schottenstein, Zox, & Dunn (In re Unitcast)*, 219 B.R. 741 (6th Cir. B.A.P. (Ohio) 1998) and found that the holding in *Unitcast*³ had the effect of creating a super-priority category, above the hierarchy of §507(a), for interim compensation paid to professionals under §331, in contravention of the priorities set forth in the Bankruptcy Code. In other words, the *Specker* court disagreed with the *Unitcast* court to the extent that *Unitcast* held that disgorgement was not mandatory to ensure pro-rata distribution among administrative creditors.

The Sixth Circuit did not reach the merits of the attorney's public policy arguments because the court found that §726(b) is not ambiguous regarding the requirement of pro-rata distribution. *Specker*, 393 F.3d at 664. The court stated “[e]quality of distribution among creditors is a central policy of the Bankruptcy Code. According to that policy, creditors of equal priority should receive pro rata shares of the debtor's property.” *Specker*, 393 F.3d at 664 (citing *Begier v. Internal Revenue Service*, 496 U.S. 53, 58 (1990)). The Sixth Circuit concluded its opinion with this notable quote “[a]s the district court stated, **“counsel is a gambler in [bankruptcy] proceedings like every other administrative creditor.”** Id.

2. *In re US Flow Corporation*, 332 B.R. 792 (Bankr. W.D. Mich. 2005)(*Gregg, J.*)

a. Holding: Professionals paid from a court-approved carve-out from a secured lender's collateral, which liens were never challenged, are not required to disgorge the negotiated carve-out upon a determination that the estate is administratively insolvent.

b. Summary of Facts: The Chapter 11 case was filed and was converted shortly thereafter to a Chapter 7 case. In a court-approved interim financing order, a \$55,000 carve-out for Chapter 11 court-appointed professionals was created. The order expressly recognized that the \$55,000 carve-out was superior to the secured creditor's interests in the

³ In *Unitcast* the court found that “nothing in 726(b) ...compels the trustees of administratively insolvent estates to reach back through the prior administrative periods to recover (only) payments to professionals, that disgorgement then transforms into (unpayable) ‘administrative expenses’” and further noted that to permit such disgorgement would subordinate professionals when an estate is administratively insolvent. *Id.* at 753.

collateral. The order also provided that the rights and obligations of the debtor and the secured creditors “shall survive termination” and further provided that “the [order] does not create any rights for the benefit of any third party, creditor, or direct, indirect, or incidental beneficiary.” After conversion, the United States Trustee requested the court to determine that the carve-out was property of the chapter 7 bankruptcy estate, to be distributed in accordance with the priorities set forth in the Bankruptcy Code.

c. Analysis: The *US Flow* court distinguished *Specker*, stating that *Specker* stands for the narrow proposition that “prepetition retainers, which are considered property of the estate, shall be disgorged to achieve pro-rata distribution between similarly situated creditors, when a chapter 11 case later proves to be administratively insolvent.” *US Flow*, 332 B.R. at 795. In contrast to *Specker*, the debtor’s attorney in *US Flow* was not similarly situated, as it was protected by a carve-out, which the Court found was not property of the debtor’s bankruptcy estate. *See Id.* at 798. To counter the argument that it is inequitable to pay the debtor’s attorney in full via the carve-out when other administrative creditors are receiving none or only a small portion of their administrative expense claims, the *US Flow* court noted that creditors are not without options – they could have objected to or appealed the interim financing order or negotiated similar agreements on their behalf. Furthermore, the court stated that it believes that it would be “unfair to require the court-appointed professionals to lose their entitlement to the carve-out funds after they relied on a final non-appealable court order.” *Id.*

3. *In re Dick Cepek, Inc.*, 2006 WL 851188 (9th Cir. B.A.P. April 10, 2006)

a. Holding: professionals with valid pre-petition security retainers (*see* various retainer types below) that have been properly documented, disclosed and approved by the bankruptcy court, cannot be required to surrender such retainer in the interest of equal treatment under 11 U.S.C. §726(b).

b. Summary of Facts: Prior to the filing of the bankruptcy petition, the debtor’s attorney received a retainer from the debtor in the amount of \$84,955.85 (the “Retainer”). The attorney disclosed the Retainer to the court, the creditors and the United States Trustee. At no time did the attorney represent that he held a security retainer or was an otherwise secured creditor. The attorney drew on the Retainer during the case. The case was

converted and the Chapter 7 trustee filed a report stating that the estate was administratively insolvent. The court, *sua sponte*, raised the issue of whether disgorgement of the Retainer was required by section 726(b) to allow all administrative expense claimants to share equally. The Bankruptcy Court, relying on *Specker*, ruled that the attorney was required to disgorge the retainer. The trustee and the attorney disagreed as to whether the bankruptcy judge ruled that the retainer was a “security retainer.”

c. Analysis: The court distinguished *Specker* by noting that none of the *Specker* decisions considered the nature of the retainer held by the attorney, but merely stated that the retainer was “held in trust for the estate, and remains property of the estate.” *Ceppek*, 2006 WL at *7 (citing *Specker*, 393 F.3d at 663). The court reviewed several opinions which held that security retainers are protected from disgorgement. The court cited *In re Burnside Steel Foundary Co.*, 90 B.R. 942, 944 (Bankr. N.D. Ill.) (explained more fully below) (holding that a retainer is not subject to the provisions of 726(b) because “[section] 726 only affects distribution priorities among holders of unsecured claims, and an attorney with a retainer is, to the extent of the retainer, the holder of a secured claim) and *In re Zukoski*, 237 B.R. 194, 198 (Bankr. M.D. Fla. 1998) (holding that when a case is converted from chapter 7 to chapter 11, a security interest in the retainer allows a Chapter 11 professional to “avoid the subordination provisions of section 726(b) to the extent that services were provided and approved by the bankruptcy court.”)

While the court determined that, in general, an attorney holding a security retainer is not per se disqualified as “disinterested,” it did not find that the attorney at issue was necessarily entitled to the funds, and the case was remanded to decide whether the attorney made adequate disclosure of his security retainer. *See See In re K & R Mining, Inc.*, 105 B.R. 394, 397-98 (Bankr. N.D. Ohio) (stating that attorneys “possesses a security interest in the retainer to secure payment of its attorneys fees and expenses; attorney is not disqualified as “not disinterested” merely because it holds a security interest in the retainer funds”); and *In re Burnside*, 90 B.R. at 944 (stating that attorney who receives a pre-petition retainer to insure payment of fees to be earned in the Chapter 11 case ... becomes a secured creditor, secured by a possessory security interest in cash”).

It is notable that one of the judges from the three judge bankruptcy appellate panel, wrote a scathing dissent regarding what the judge believed to be the inequity inherent in allowing attorneys to take security retainers in the bankruptcy cases that they filed. The judge viewed this practice as turning the priorities set forth in the Bankruptcy Code on their head, especially when a case is converted from a Chapter 11 proceeding to a Chapter 7 proceeding, where the fees of the administration of the Chapter 7 case are to take the highest priority.

4. *In re Appalachian Star Ventures, Inc. 2006 Bankr. LEXIS 454 (Bankr. E.D. Tenn. March 9, 2006)*

a. Holding: Because an attorney with a lien in the form of a retainer is not similarly situated with other administrative claimants, disgorgement is not required by 11 U.S.C. § 726(b).

b. Summary of Facts: The attorney was given a \$15,000 pre-petition retainer, which he disclosed in connection with his retention application. The attorney was subsequently awarded interim fees in the amount of \$15,000, to be paid from the retainer held in escrow. The case was later converted and the available funds were sufficient to pay the chapter 7 administrative expenses, but not the chapter 11 administrative expenses. The chapter 7 trustee brought a motion, based on section 726(b) of the Bankruptcy Code and the *Specker* opinion which requested that the court require the attorney to disgorge his retainer so that it could be distributed pro rata among all of the chapter 11 administrative claimants.

c. Analysis: The court followed the lead of the *US Flow* court in recognizing that the *Specker* decision was a narrow one. The court followed several other courts⁴ that have found that a state law lien prevents section 726(b) from coming into play. *Appalachian Star Ventures, 2006 Bankr. LEXIS at *11.*

⁴ See *Weinman Cohen & Niebrugge, P.C. v. Peters (In re Printcrafters, Inc.)*, 233 B.R. 113, 120 (D. Col. 1999) (because under Colorado law a law firm had a lien on the prepetition retainer paid to it, the law firm was not required to share the retainer with other administrative claimants); *In re Pannebaker Custom Cabinet Corp.*, 198 B.R. 453, 460 (Bankr. M.D. Pa. 1996) (unless excessive or unreasonable, retainer not subject to disgorgement to achieve parity amount administrative claimants due to attorney's superior priority as secured creditor); *In re Printing*

5. *In re Karel Company (Matz v. Hoseman)*, 197 B.R. 635 (N.D. Ill. 1996).

a. Holding: District Court affirmed decision of Judge Wedoff which ordered certain professionals to disgorge interim fees awarded post-petition, holding that the fees were subject to disgorgement under section 726, as the estate was administratively insolvent.

b. Summary of Facts: Attorneys for the Official Committee of Unsecured Creditors (the “Committee”) received a \$50,000 retainer post-petition in a Chapter 11 case, which was subsequently converted into an administratively insolvent Chapter 7 case. The movants, the U.S. Trustee and the Chapter 7 trustee, filed a motion to compel the Committee attorneys to turnover interim fees that were awarded in the Chapter 11 case, but agreed prior to the hearing on the motion to permit the attorneys to keep that portion of the interim fees that were allowed specifically as retainers. The court wondered aloud in a footnote whether such an agreement was supported by law, however, “despite the existence of authority to the contrary, we will bind the appellees to this concession.” *Id.* at 638.

c. Analysis: The court upheld the Bankruptcy Court’s right to order disgorgement of fees, and rejected the professionals’ argument that because the Bankruptcy Code does not explicitly provide for the disgorgement of professional fees, the court was without authority to do so. The court stated that interim fee awards under section 331 are not final, and are subject to later review. The court held that whether the authority to disgorge interim fees

Dimensions, Inc. 153 B.R. 715, 719 (Bankr. D. Md. 1993) (counsel not required to share prepetition retainer pro rata with other administrative claimants where retainer is treated as security or held in trust); *In re North Bay Tractor, Inc.* 191 B.R. 186 (Bankr. N.D. Cal. 1996) (attorney’s interest in retainer is “is the nature of a security interest, assuring the attorney of a minimum fee in the case” and to require attorney to disgorge the retainer so that other claimants of equal priority receive equal dividends would “undermine the purpose of retainers”); *Matter of K&R Mining, Inc.* 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989)(noting that retainer paid to chapter 11 debtor’s attorney enables the attorney “to avoid the subordination of the Chapter 11 expenses of administration to those incurred in administering the Chapter 7 estate mandated by §726(b)”); *In re Kinderhaus Corp.*, 58 B.R. 94, 97 (Bankr. D. Minn. 1986) (“A prepetition retainer held in trust by debtor’s attorney . . . is not ordinarily available as a source of payment for other administrative expense claims under 11 U.S.C. §503(b) . . .”); *cf In re Cottrell Intern. LLC*, 2000 Bankr. LEXIS 1093, *4 (Bankr. D. Col. July 19, 2000)(permitting postpetition retainer to debtor’s attorney to stand as security for payment of fees allowed by court, but noting that under 11 U.S.C. §328, an order allowing employment terms such as the payment of the retainer, remains reviewable by the court any may be modified (with result of possible disgorgement) if, within the language of the statute, “the terms and conditions prove to have been improvident . . .”).

arose under section 105(a), 726, or elsewhere in the Code, “it is without cavil that the bankruptcy court has the power to disgorge interim professional fees.” The court also rejected the attorney’s argument that disgorgement will discourage attorneys from taking on bankruptcy work. The court held that the risk of disgorgement is well known and has been “adequately accounted for by professionals.”

F. Disgorgement of Retainers

1. In re Production Associates, Ltd., 264 B.R. 180 (Bankr. N.D. Ill. 2001).

a. Holding: Court ordered evidentiary hearing to make determination of the nature of the professional’s retainer (classic retainer, security retainer, or advance payment retainer), to determine whether retainer was property of the estate and whether retainer was subject to disgorgement.

b. Summary of Facts: After debtor converted his Chapter 11 bankruptcy to one under Chapter 7, the court requested that all professional persons who performed services in connection with the Chapter 11 case file an application for compensation. Debtor's counsel failed to file an application for compensation by the appropriate deadline, but instead filed an application authorizing his employment, in which he characterized his retainer as an advance fee retainer, which he said could also be considered a classic retainer, citing *McDonald Bros.* (discussed *infra*) as authority for the proposition that such a retainer was not property of the estate, which fact would excuse him from filing a fee application.

c. Analysis: The court took great exception to the attorney’s assertions with respect to his retainer and his obligation to file a fee application. The court first described the various types of retainers:

Under a classic retainer agreement, the client agrees to pay a fixed sum to have the attorney available to perform legal work that may arise during a specified period of time. An essential characteristic of the classic retainer is that it is earned by the lawyer upon receipt, without the lawyer being required to provide any legal services. The retainer is merely consideration for the lawyer agreeing not to

represent another during the specified time period. Another important feature of a classic retainer is that the client retains no interest in the payment after the payment is made.

....

Under a security retainer agreement, the attorney holds the funds advanced by the client to cover future legal work. The funds are not a present payment. Rather, the funds remain property of the client until the lawyer applies the funds to services rendered. Any unearned funds are returned to the client upon termination of the representation.

....

Under advance fee agreements, the attorney receives payment in advance for legal work to be performed in the future. The retainer may represent a full payment covering all services to be performed for the client, or the payment may be a partial payment which will be augmented by the client once services equal to the payment amount have been rendered. The difference between an advance retainer and a security retainer is that the advance retainer is intended as a present payment to the lawyer for his agreement to represent the client. However, the payment is refundable if the representation ends before services equal to the payment amount are performed.

(*id.* at 185)(citations omitted).

The court discussed the holding in *McDonald (infra)*, relied upon by the attorney, as the minority view on the issue of whether prepetition retainers are property of the estate. The court described the majority position on the issue in this way:

Most bankruptcy courts have concluded that a prepetition retainer paid by a debtor to counsel is security for, or held in trust for, payment of fees and cost to be incurred." *In re Printcrafters Inc.*, 233 B.R. 113, 118 (Bankr. D.Co. 1999) (citing *In re Printing Dimensions Inc.*, 153 B.R. 715, 719 (Bankr. D. Md. 1993)); *In re Hathaway Ranch Partnership*, 116 B.R. 208, 217 (Bankr. C.D. Ca. 1990) (advanced fee payments are always property of the estate no matter how they are described).

Those majority opinions have adopted a per se rule which bars classic retainer agreements in bankruptcy. *In re NBI Inc.*, 129 B.R. 212, 223 (Bankr. D. Co. 1991) (stating that classic retainers "nullify" the protections the Code provides for the debtor and creditors). According to those opinions, it does not matter that state law allows attorneys to contract with their clients for a classic retainer. They reason that bankruptcy courts must oversee payments made by debtors to their attorneys, and agreements between debtors and their counsel are not binding on the court because only the court can determine the extent of counsel's interest in a prepetition retainer. *Id.* at 225 (freedom of contract is limited in the context of bankruptcy); *In re Chapel Gate Apartments*, 64 B.R. 569, 574 (Bankr. N.D. Tx. 1986) (terms of agreement between debtor and counsel are not binding on court). The majority view holds that classic retainers "usurp" the bankruptcy court's authority under Sections 327, 328(a), 329, 330, and 331 of the Code and corresponding Bankruptcy Rules. *NBI*, 129 B.R. at 223; *Chapel Gate*, 64 B.R. at 573 (stating that allowing an attorney to draw against a retainer at will would "emasculate" § 331 of the Code).

The court ordered an evidentiary hearing to determine the precise nature of the retainer. The court followed the precedent of *McDonald Bros.* and *Sheridan*, both discussed

below, and held that if the attorney could demonstrate facts proving that the retainer was a “classic retainer,” the attorney would be permitted to keep the retainer without applying to the court for payment, however the attorney may nevertheless be subject to sanctions under Rule 2016 for failing to timely disclose the retainer.

2. *In re McDonald Bros. Construction, Inc.*, 114 B.R. 989 (Bankr. N.D. Ill. 1990) (also discussion *In re Sheridan*, 215 B.R. 144, 146 (Bankr. N.D. Ill. 1996))

a. Holding: Judge Wedoff's opinion in *McDonald* held that counsel who had received an advance payment retainer did not have to apply to the court for authorization to draw on the retainer. *McDonald*, 114 B.R. at 1003. The court's decision was based on review of Illinois law which was found to allow attorneys to treat "classic" and "advance payment retainers" as property of the attorney. *Id.* at 1001-02. The court reasoned that because the client retains no interest in an advanced payment retainer, the retainer is not estate property. Therefore, the attorney is only required to disclose the payment under Section 329, and is not subject to Sections 330 and 331 of the Code. *Id.* at 1002 (citing *In re Fulton*, 80 B.R. 1009, 1011 (Bankr. D. Neb. 1988)).

b. Summary of Facts: In *McDonald*, debtor's counsel disclosed receipt of a \$ 12,500 prepetition retainer, which would be applied to work already performed and to work that would be performed in the future. Counsel further stated that in the event that the entire retainer was not used during the course of the representation the unearned funds would be returned to the debtor. Thus, according to Debtor's counsel, the retainer involved was an advanced payment retainer.

c. Analysis: The key to the court's analysis in *McDonald* was the premise that state law, not the Code, determined the extent of a debtor's interest in the advanced payment retainer. "It has long been recognized that 'Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law' and that state laws are suspended only to the extent of actual conflict with the [bankruptcy] system." 114 B.R. at 996. However, in *In re Sheridan*, 215 B.R. 144, 146 (Bankr. N.D. Ill. 1996), Judge Barliant took exception to the court's analysis in *McDonald*, finding that the Illinois state court opinions relied on in *McDonald* all involved classic or fixed fee retainers, not advance payment retainers.

Sheridan also pointed out that while *McDonald* relied on an Illinois State Bar Association Advisory Opinion to the effect that advanced payment retainers are property of the lawyer, there was another Advisory Opinion opining that unearned funds given as security for legal work are not the property of the attorney. *Sheridan* agreed with *McDonald's* analysis that state contract law determines a debtor's interest under an advanced retainer agreement. However, *Sheridan* also held that no matter how the retainer is characterized under state law, whether as a classic or advanced retainer, if the debtor retains an interest in the funds when the bankruptcy commences, then under bankruptcy law the funds are property of the estate. Therefore, the opinion concluded that an advanced payment retainer is property of the estate because the debtor retains an interest in the funds not due for fees, and as such the debtor's lawyer had to comply with Sections 330 and 331 before any fees could be collected from the retainer. *Sheridan* distinguished "advanced payment retainers" as well as "security retainers," in which the debtor also retains an interest in the payment, from classic retainers where the payment becomes property of the lawyer as soon as it is made.

3. *In re Burnside Steel Foundry, 90 B.R. 942 (Bankr. N.D. Ill. 1988).*

a. Holding: Court approved attorneys late-filed fee application and permitted attorneys to draw awarded fees from its pre-petition retainer, but held that the attorneys' approved fees were limited in amount to the amount of the pre-petition retainer, because the fee application was not filed timely pursuant to Rule 2017.

b. Summary of Facts: Attorneys received a \$35,000 prior to filing a Chapter 11 case on behalf of the debtor. The case was subsequently converted to a case under Chapter 7. The attorneys continued to represent the debtor in the Chapter 7. Attorneys failed to file a final fee application prior to closing, and failed to account of or dispose of its retainer. After the case was closed, the court re-opened the case and ordered the attorneys to show cause why it should not be required to refund the retainer to the estate.

c. Analysis: The court stated that although the issue was, at the time of the case, an issue of first impression, the problem presented in the case was a common one. The court first discussed the difference between retainers taken by attorneys pre-petition to

secure future payment of fees in the bankruptcy case, and those retainers meant to be payment in full for all contemplated services to be rendered. The court stated that

In general, Chapter 11 retainers are not flat fees for all services to be performed in a specific case. Instead, Chapter 11 retainers are usually held by an attorney as security for the payment of fees for professional services to be rendered when requested by a client.

....

[W]hat emerges from the case law is that the word “retainer” is ambiguous when used in the context of a payment by a debtor to an attorney before the filing of a contemplated bankruptcy petition.

....

The best evidence [of the purpose of the retainer] would, of course, be a carefully drawn retainer agreement. However, none has been produced here. Therefore, the Court is left to ascertain the parties’ intentions from the circumstances surrounding the payment.

Id. at 945.

The court stated that an attorney who receives a security retainer pre-petition “becomes a secured creditor secured by a possessory security interest in cash,” and is able to “avoid the subordination of the Chapter 11 expenses of administration to those incurred in administering the Chapter 7 estate mandated by § 726(b) of the Bankruptcy Code,” because section 726 “only affects distribution priorities among holders of unsecured claims, and an attorney with a retainer is, to the extent of the retainer, the holder of a secured claim.”

The court noted that a security retainer is property of the estate until awarded to the attorney pursuant to section 330. Because the retainer is property of the estate until the fees are awarded, the retainer, if excessive, can be subject to turnover pursuant to section 329, and must also be turned over if the court finds that pursuant to section 363 the attorney can be provided with other adequate assurance of payment.

G. Conclusion: Only Questions

Should the Court make inquiry whether an estate will be solvent after a § 363 (b) sale of substantially all of the assets? Is such an inquiry consistent with the sound business purpose test of Stephens?

Should the insolvency of chapter 11 estates become the financial burden of officers and directors of the debtor, especially if they believe that they are meeting their fiduciary duties by achieving the highest and best price for the business by selling it as a going concern? Why would anyone want to expose themselves to such liability rather than simply closing the doors?

Finally, will the Courts of Appeals recognize the efforts (much appreciated by practitioners) of Bankruptcy Courts to find exceptions to Specker, or will the Courts of Appeals view the disgorgement decisions as policy notwithstanding the characterization of fees as security retainers or carve-outs? Are the professionals in bankruptcy cases required to be gamblers, gambling with their fees?

APPENDIX A

II. Fiduciary Duties Of Directors, Officers, And Controlling Shareholders' When Company Is In The Vicinity Of Insolvency.

Under Illinois and Michigan law, a director of a corporation owes duties of care and loyalty to a corporation and its shareholders. *Stamp v. Touche Ross & Co.*, 636 N.E.2d 616, 620 (Ill. App. Ct. 1993); *Michigan Compiled Laws 450.1541a*. Similarly, a manager of a limited liability company owes fiduciary duties to the company and its members. 805 ILCS 180/15-3; *MCLA 450.4404*. Once a corporation enters the “vicinity of insolvency,”⁵ these fiduciary duties extend to creditors of the corporation or company as well. See *In re Joy Recovery Tech. Corp.*, 286 B.R. 54, 81 (Bankr. N.D. Ill. 2002).

A. *Duty of Care.*

A director must discharge the duties of her position in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner reasonably believed to be in the best interests of the corporation. *Stamp*, 636 N.E.2d at 620; *MCL 450.1541a(a)*. Illinois and Michigan courts have held that directors satisfy their duty of care by taking steps such as the following:

- Fully informing themselves of various alternatives and their impact on the company and its shareholders;
- Understanding the terms and structure of any proposed transaction;
- Carefully considering material presented to them;
- Carefully listening to the presentations and asking questions concerning the presentations as well as the materials presented;
- Considering the various biases, if any, of those making presentations in order to determine the weight to ascribe to the various views or pieces of advice and recommendations from those advisors; and
- Acting only after having had an opportunity to review the materials,

⁵ Courts that use the phrase “vicinity of insolvency,” or related phrases like “zone of insolvency,” have not provided clear guidelines that will allow a company to determine when it enters this vicinity. One court opined that the phrase “vicinity of insolvency” seems to refer to the extent of the risk that creditors will not be paid, rather than balance sheet insolvency. *In re Ben Franklin Retail Stores, Inc.*, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998). Courts have defined “insolvency” to include balance sheet insolvency (*i.e.*, when liabilities exceed assets) and a debtor’s inability to pay its debts as they become due in the usual course of business. For example, one court concluded that a company was insolvent when it defaulted on an accelerated loan payment due to its principal lender and on its obligations to its principal supplier. *Odyssey Partners L.P. v. Fleming Cos.*, 735 A.2d 386 (Del. Ch. 1999).

having all questions satisfactorily answered and having duly considered all relevant information.

B. Duty of Loyalty.

The duty of loyalty requires that directors act on behalf of the corporation and its shareholders. The duty also extends to the corporation's creditors once the corporation is in the vicinity of insolvency. The duty of loyalty requires directors to:

- Refrain from self-dealing;
- Have no conflict of interest when making decisions for the corporation;
- Not usurp corporate opportunities;
- Not engage in any act that provides the director with an improper personal benefit or that injures those on whose behalf the director is acting (*i.e.*, the corporation, the creditors and the shareholders); and
- Not prevent stockholders from effectively exercising their right to vote contrary to the will of the board.

C. Business Judgment Rule.

Courts are reluctant to second-guess the decisions made by directors. Consequently, directors generally benefit from what is called the "business judgment rule." Under the business judgment rule, board decisions are presumed to have been made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company. These concepts continue to apply when a company is in the vicinity of insolvency. *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

At least one Delaware court has emphasized the importance of a board of directors' decision-making process when making significant corporate decisions while the company is operating in the vicinity of insolvency. Relevant factors include whether:

- independent directors approved the transaction;
- the board acted in good faith;
- the board was well informed of the available alternatives to try to bring about the long-term business plan of the board;
- the board's actions appeared reasonable in relation to the goal of achieving a valid business plan; and
- while the board could not assure that the financial restructuring transaction would achieve that goal, the transaction offered several attributes that

permitted the board reasonably to conclude that it was the only available alternative.

Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997)(resolving a conflict between the financial interests of the holders of convertible preferred stock with a liquidation preference and the interests of the holders of common stock); see *Omnicare*, 818 A.2d 914 (approval of defensive devices by independent committee of board enhances board's argument that it had reasonable grounds for believing that danger to corporation and stockholders existed if merger transaction was not consummated).

D. *Interested Director Transactions.*

When a person (or a company affiliated with the person) is involved in a transaction that also involves the company for which the person serves as a director, the transaction is referred to as an “interested director transaction.” Transactions in which a director is determined to have an interest (which determination is left to the courts) may not, because of the interest, be voided or result in damages if the interested director establishes any of the following:

- The transaction was fair to the corporation at the time entered into;
- The material facts of the transaction and the director's interest were disclosed or known to the board or a committee of the board (or, under Michigan law, the independent directors) and a majority of the board or committee (or independent directors) who had no interest in the transaction approved the transaction; or
- The material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and a majority of shareholders who had no interest in the transaction approved the transaction.

Section 545a of the Michigan Business Corporation Act (“MBCA”) provides for the appointment of an “independent director” to authorize interested director transactions. An independent director owes the corporation the same fiduciary duties that other directors owe the corporation. Section 107(3) of the MBCA provides the requirements that a director must meet in order to be considered “independent.”⁶ If the “independent director”

⁶ An “independent director” is one who: (a) is elected by the shareholders; (b) is designated as an independent director by the board or shareholders; (c) has at least 5 years of business, legal or financial experience, or other equivalent experience; (d) is not, and during the 3 years prior to being designated as an independent director has not been, any of the following: (i) an officer or employee of the corporation or any affiliate of the corporation; (ii) engaged in any business transaction for profit or series of transactions for profit, including banking, legal, or consulting services, involving more than \$10,000 with the corporation or any affiliate of the corporation; and (iii) an affiliate, executive officer, general partner, or member of the immediate family of any person that had the status or engaged in a transaction described above; (e) does not propose to enter into a relationship or transaction described above; and (f) does not have an aggregate of more than 3 years of service as a director of the corporation, whether or not as an

mechanism described above is not available, then the director who had an interest in the transaction will be required to show that the transaction was fair to the corporation at the time it was entered.

Ratification of an interested-director transaction in accordance with the referenced Illinois and Michigan statutes may not provide a defense when a creditor attempts to have the transaction set aside. Even if directors satisfy their fiduciary duties, transactions are not immune from attack by creditors on alternative theories, such as fraudulent conveyance, which have different elements than those based on breach of fiduciary duty.

E. Recent Cases.

1. *Technic Eng'g v. Basic Envirotech, Inc.*, 53 F. Supp. 2d 1007 (N.D. Ill. 1999).

This case involved a classic fraudulent conveyance between two corporations controlled by the same family. Due to the existence of a large claim against one corporation, its assets were transferred to a sister corporation. In addition to the normal fraudulent conveyance claims, the plaintiff asserted a claim against family members who were officers or directors and one family member who was neither an officer nor director. Applying Illinois law, the court reached the following conclusions:

- a. Directors occupy a fiduciary relationship towards creditors when the corporation becomes insolvent;
- b. Officers owe the same fiduciary duty;
- c. With regard to the family member who was not an officer or director, Illinois law was held to recognize liability for inducement or participation in breaches of fiduciary duties.

Query: With such broad liability exposure for inducing or participating in a breach of fiduciary duty, are counsel similarly at risk?

2. *In re Ben Franklin Retail Stores, Inc.*, 2000 WL 28266 (N.D. Ill. 1999).

This court in this case, contrary to the holding in *Technic Engineering*, refused to extend to an officer a fiduciary duty.

3. *Official Comm. of Asbestos Claimants of G-I Holding v. Heyman*, 277 B.R. 20 (S.D.N.Y. 2002).

This case extended the fiduciary duty owed by directors to controlling

independent director. The Michigan LLC Act does *not* have a comparable provision for the appointment of an “independent manager.”

shareholders. In this case, a corporation, G-I Holding, Inc., became insolvent because of the claims of persons exposed or injured by asbestos produced by the company. G-I Holding, Inc. spun off certain of its valuable subsidiaries by distributing the shares in the subsidiaries to the shareholders of G-I Holding, Inc. During the chapter 11 of G-I Holdings, Inc., the court granted the committee the power to, among other things, bring an action against the controlling shareholder. Looking at New York law, the court stated that the elements for breach of fiduciary duty are the existence of the fiduciary relationship and the breach of the fiduciary duty. The court held that the plaintiffs stated a cause of action based upon its assertions that the defendant was the controlling shareholder of the debtor, that the debtor was either insolvent at the time of the distribution of the subsidiary stock or rendered insolvent thereby, and the transfer violated the defendant's fiduciary duties to the debtor's creditors.

4. *Hechinger Investment Co. of Delaware, 274 B.R. 71 (D. Del. 2002).*

This case arose out of a failed LBO through a complex series of transactions. Hechinger acquired Builder's Square through a series of temporary loans that were repaid through a permanent \$600 million secured credit facility to consummate a leveraged buyout. The primary beneficiaries of the leverage buyout were the shareholders of the combined Hechinger/Builder's Square company. Among other claims, the two families controlling the outstanding stock of Hechinger were sued based on a claim of breach of fiduciary duty. The court denied a motion to dismiss, holding that one of the two controlling families (the Hechinger family) voted for the transactions leading to the leveraged buyout and therefore would be liable for breach of their fiduciary obligations to creditors. The other family (the England family) had signed an irrevocable voting trust giving the Hechinger family the right to vote the England family's shares. The court refused to extend a claim of breach of fiduciary duty to the England family shareholders.

5. *Keenan Lumber Company, Inc. v. Perry, 560 S.E. 2d 817 (N.C. App. 2002).*

This case involved an appeal from a trial court holding a director liable for breach of his fiduciary duties to a creditor. After receiving recommendations to liquidate by an expert, and after the corporation was insolvent, the corporation continued to make purchases on credit. The court of appeals, finding the trial court's jury instructions on the issues to be too narrow, stated the following propositions:

a. To find that a director owes fiduciary duties to creditors, the corporation must be winding up or dissolving. There is no fiduciary duty the corporation is still prosecuting its business in good faith, with a reasonable prospect and expectation of continuing to do so.

b. Factors that a trial of fact should look for to make such a determination are (i) whether the corporation was insolvent, or nearly insolvent, on a balance sheet basis; (ii) whether the corporation was cash flow insolvent; (iii) whether the corporation was making plans to cease doing business; (iv) whether the corporation was liquidating its assets

with the deal going out of business; and (v) whether the corporation was still prosecuting its business in good faith, with a reasonable prospect and expectation of continuing to do so.

Once a fiduciary duty is established under the foregoing test, a director is generally prohibited from taking advantage of his intimate knowledge of the corporate affairs for his own benefit and to the detriment of the creditors to whom he owes the duty. Additionally, all creditors in the same class must be treated equally. Notwithstanding this due equality of treatment, secured creditors, even if guaranteed by the director, may be paid in preference of unsecured creditors.

6. *In re Elite Mktg. Enter., Inc.*, 2001 WL 1669229 (Bankr. N.D. Ill. 2001).

A corporation, and later a chapter 7 debtor, falsified accounts receivable. Upon learning of the falsification, American National Bank informed the debtor that it must repay the entire secured indebtedness owing to the bank. American National modified its loan agreement with the debtor to create the appearance of compliance with the terms of existing loans. The borrower's president then negotiated a new line of credit with Cole Taylor Bank and ANB was paid off. In addition to preference and fraudulent conveyance claims, the trustee asserted that the bank was liable because ANB induced the former borrower's president and majority shareholder to breach his fiduciary duty to the debtor. ANB did this by prompting the president to secure alternate financing despite its knowledge of the president's wrongdoing, by modifying its loan agreement with the debtor and failing to declare default on the loan, and by enforcing its rights under the agreement in an effort to preserve the debtor's appearance as a creditworthy business. Because both the debtor and unsecured creditors were injured, and because the new loan permitted the former president to steal additional funds from the corporation and increase the amount of unsecured debt, the court held that the trustee stated a cause of action and refused to dismiss the complaint under Rule 12 (B)(6).

7. *Official Comm. of Unsecured Creditors v. Lozinski (In re High Strength Steel, Inc.)*, 269 B.R. 560 (Bankr. D. Del. 2001).

In this case, a holding company, that eventually became the debtor, and two other related companies jointly and severally borrowed money from PNC bank. The debtor received little benefit from the loan, but pledged all of its assets as security for the loan. The sole director/shareholder of the holding company guaranteed approximately 50% of the loans to the three corporations. After the debtors became insolvent, the sole director/shareholder/guarantor caused the debtor to liquidate its assets and pay a substantial portion of the debt owed to PNC. The trustee asserted a claim against the sole director/shareholder/guarantor, claiming that he breached his fiduciary duty by causing the debtor to pay PNC's indebtedness. The fact that the debtor paid all of the PNC debt rather than causing the co-obligors to pay their share of that debt, if proven, was sufficient to obtain a judgment for breach of fiduciary duty. PNC was sued by the trustee for aiding and abetting the sole director/shareholder/guarantor's breach of fiduciary duty. The court denied a Rule 12(b)(6) motion to dismiss, stating that the elements for aiding and abetting a breach of fiduciary duty are (i) a breach of fiduciary duty owed to another and, (ii) knowledge of the breach by the aidor and

abettor, and (iii) substantial assistance or encouragement by the aidor or abettor in affecting that breach. To support the latter point, the trustee pointed to a letter written to PNC by the sole director/shareholder/guarantor stating that he was pleased that PNC agreed with the course of action of causing the debtor to pay all of most of the indebtedness owed to PNC. The court stated, “from that letter, we can reasonably infer that PNC’s involvement went beyond a good faith effort to collect money which was owed to it.” The court said that whether the letter or other evidence rose to a level of “substantial assistance or encouragement” was an issue to be determined after trial.

8. *In re Sharp International Corp.*, 281 B.R. 506 (Bankr. E.D.N.Y. 2002).

The debtor’s principals committed massive fraud by grossly overstating sales and creating fictional accounts receivable. When its lender discovered the fraud, the lender gave the debtor some time to sell bonds to investors. Through its fraud, the debtor was able to sell bonds and substantially pay down the bank’s loan. A suit was commenced by the trustee against the bank, alleging that it aided and abetted the corporation’s officers and directors in (i) defrauding the new investors, and (ii) permitting the debtor to disburse large amounts of money to companies that provided no consideration to the debtor. Even though the bank had hired a fraud examiner and verified that accounts receivable were fictitious, the court held that the pleadings fell short of stating a cause of action for aiding and abetting a breach of fiduciary duty. The court looked to the issue of whether the bank provided substantial assistance to the primary violator (the insiders). Looking at New York law, the court said that a defendant “affirmatively assists, helps conceal, or by virtue of failing to act when required to do so, enables the fraud to proceed.” An action of an alleged aider or abettor constitutes substantial assistance only if the defendant owes a fiduciary duty directly to the plaintiff. The fact that one of the bank’s officers dodged telephone calls from the new investors constitutes no more than inaction. Because the relationship of the borrower and bank was not a fiduciary relationship, the bank had the right to defend the case on the basis of its inaction.

9. *Willner’s Fuel Distributors, Inc. v. Noreen*, 882 P.2d 399 (Alaska 1994).

In this case, an insolvent corporation was involuntarily dissolved under state law. The corporation and its principal shareholder subsequently obtained a sum of money in settlement of an unrelated lawsuit. The money was deposited into the trust account of the attorney who represented both the corporation and its shareholder. The money was ultimately disbursed to the shareholder. A judgment creditor of the dissolved corporation then brought suit against the attorney based on breach of fiduciary duty. The court stated as follows:

By way of summation, we hold that if an attorney represents both the dissolved and insolvent corporation and the director or officer of that firm, and if the attorney controls corporate assets, then the attorney must protect the financial rights of creditors to these assets where he or she knows or should know that the director or officer intends to interfere with creditors’ claims through an improper distribution of these assets. To do otherwise would sanction a

class of wrongs without a remedy. Accordingly, as a matter of law, we hold that [the common attorney for the individual and corporation] was not entitled to summary judgment.

Although the decision did not state that the attorney owed a fiduciary duty to creditors, it did allow a creditor to assert a claim for the attorney's alleged breach of fiduciary duty to the corporation, on behalf of all creditors.

10. *Helm Financial Corp. v. MNVA Railroad, Inc.*, 212 F.3d 1076 (8th Cir. 2000); *Bank of America v. Mussleman*, 222 F. Supp. 2d 792 (E.D. Va. 2002).

Both of these cases stand for the proposition that officers and directors cannot be held liable for breach of fiduciary duties in the absence of self dealing. *See, e.g., Bank of America at 800* (summarizing several cases that have examined this issue).