Delaware Views from the Bench and Bar

November 3, 2008

Third Circuit Update

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Exhibit 1

In re Winstar Commc'ns, Inc., 378 B.R. (Bankr. D. Del. 2007)

Delaware 2008 Views from the Bench and Bar

<u>In re Winstar Commc'ns, Inc.</u>, 378 B.R. 756 (Bankr. D. Del. 2007)

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Introduction

In In re Winstar Commc'ns, Inc., 378 B.R. 756 (Bankr. D. Del. 2007), the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") denied, without prejudice, a motion of special counsel and a consultant to assign a portion of their anticipated contingency fees.

Issue

Whether section 504 of title 11 of the United States Code (the "Bankruptcy Code") prohibits professionals employed under the Bankruptcy Code from entering into a risk-mitigating hedge of a contingency fee that has been earned, subject to appeal and bankruptcy court approval.

Facts

On April 18, 2001, Winstar Communications, Inc. and Winstar Wireless, Inc. (the "Debtors") filed petitions for relief under chapter 11 of the Bankruptcy Code. Winstar, 378 B.R. at 758. On January 24, 2002, the Bankruptcy Court entered an order converting the chapter 11 cases to chapter 7 cases. Id. Christine C. Schubert was appointed as Chapter 7 Trustee ("Trustee") of these cases. Id.

The Trustee subsequently engaged Herrick Feinstein LLP ("Herrick") as special litigation counsel to represent the Trustee in an adversary proceeding (the "Lucent Proceeding") against Lucent Technologies, Inc. ("Lucent"). Winstar, 378 B.R. at 758. By order dated March 18, 2003, the Bankruptcy Court modified Herrick's fee arrangement as special counsel for the Trustee, and authorized the Trustee's employment of Impala Partners, LLC ("Impala") as a special litigation consultant. Under the terms of its modified retention, Herrick was entitled to receive a contingency fee for its services rendered through entry of judgment in the Lucent Proceeding. Id. Impala was also entitled to receive a contingency fee in the Lucent Proceeding. Id. at 759.

On December 28, 2005, the Bankruptcy Court entered judgment in the Lucent Proceeding in favor of the Trustee for approximately $300 million. Winstar, 378 B.R. at 759. Lucent posted a bond and took an appeal to the United States District Court for the District of Delaware, which affirmed the decision of the Bankruptcy Court. Id. The matter has since been appealed to the Court of Appeals for the Third Circuit. Id.

While the judgment was on appeal to the Third Circuit, Herrick and Impala entered into an agreement (the "Agreement") to assign a portion of their anticipated contingency fees to Credit Suisse Loan Funding LLC ("CS"). Winstar, 378 B.R. at 759. The Agreement provided that: (a) CS would pay Herrick and Impala an undisclosed fixed price (the "Purchase Price") for the assignment of a portion of their contingency fees, regardless of the amount of contingency fees awarded; (b) Herrick and Impala would pay CS the actual amount of contingency fees awarded up to $10 million and would share the fees in excess of $10 million in accordance with their respective court-approved retention agreements; (c) CS had no right to object to the Trustee's settlement or other disposition of the Lucent Proceeding; and (d) the assignment did

not become "operative" until final court approval of Herrick's and Impala's contingency fees. Id.

On April 7, 2007, Herrick and Impala filed a motion for the authority to enter into the Agreement, which motion is the subject of the order discussed herein. Winstar, 378 B.R. at 759.

Decision

The Bankruptcy Court began its analysis by reviewing section 504 of the Bankruptcy Code, which provides that "a person receiving compensation for reimbursement under section 503(b)(2) or 503(b)(4) of the Bankruptcy Code may not share or agree to share (1) any such compensation or reimbursement with another person; or (2) any compensation or reimbursement received by another person under such sections." 11 U.S.C. § 504; Winstar, 378 B.R. at 759-60. The Bankruptcy Court then noted that section 504 of the Bankruptcy Code "provides only two exceptions [to this prohibition:] partners or associates in the same professional association, partnership or corporation may share compensation inter se; and attorneys for petitioning creditors that join in a petition commencing an involuntary case may share compensation." 11 U.S.C. § 504; Winstar, 378 B.R. at 759-60. The Bankruptcy Court stated that the policy reasons behind the prohibition contained in section 504 of the Bankruptcy Code included that: (a) sharing of compensation can inflate the amount of compensation sought and subjects the professional to outside influences over which the court has no control, which tends to transfer from the court some degree of power over allowance and expenditures; (b) referral fees should be prevented as should the participation by the professionals who have not been retained by the bankruptcy court; and (c) retention of professionals engaged in bankruptcy cases should be encouraged to attend to their duty as officers of the bankruptcy court rather than treating their interest in the bankruptcy cases as matters of trade and commerce. Id. at 760.

Herrick and Impala argued that the Agreement did not violate the policy behind section 504 of the Bankruptcy Code because (a) there was no incentive to inflate fees because (i) the contingency fees were earned upon the entry of the $300 million judgment and (ii) the parties had agreed that compensation earned in connection with the appeal would be calculated separately from the fees earned in the Lucent Proceeding, (b) undue influence was not a factor because CS specifically agreed that it had no right to object to any settlement of the Lucent Proceeding and (c) there was no sharing of fees under the Agreement because the Agreement only became operative once the Bankruptcy Court deemed the fees finally earned. Winstar, 378 B.R. at 760-61. The United States Trustee argued that section 504 of the Bankruptcy Code prohibits the sale of contingency fees, as it is a matter of trade and commerce. Id. at 761.

The Bankruptcy Court, upon considering the arguments above, found that there is no ambiguity under section 504 of the Bankruptcy Code and focused its analysis around the plain meaning of section 504 of the Bankruptcy Code. Winstar, 378 B.R. at 760-61. Specifically, the Bankruptcy Court focused on the definition of the word "share" as set forth in the statute. Id. Citing to Merriam-Webster OnLine, the Bankruptcy Court defined the word share as "to divide and distribute in shares: apportion" or to "to grant or give a share in." Id. The Bankruptcy Court found that the Agreement, by its terms, indisputably "apportioned" any award of fees to Herrick and Impala with CS and provided that Herrick and Impala would "grant or give [to CS] a share

in" any contingency fees awarded. Id. The Bankruptcy Court then concluded that there was no question that the Agreement fell within the prohibition of section 504 of the Bankruptcy Code. Id.

However, the Bankruptcy Court sympathized with Herrick's and Impala's effort to mitigate their risk. In *dicta* the Bankruptcy Court stated that (a) it did not disagree that the transaction does not violate the public policy argument and (b) professionals should not be discouraged from developing creative methods to attract and support law firms that undertake complex and expensive litigation on behalf of a debtor's estate or to provide the downside protection normally available in the market place via insurance or hedges in comparable economic situations. Winstar, 378 B.R. at 761. Accordingly, the Bankruptcy Court denied the Application without prejudice noting that "the parties may very well be able to structure a transaction that does not run afoul of the § 504 prohibition." Id. at 761 n.5.

Post Opinion History

On May 30, 2008, Herrick and Impala filed a motion asking the Bankruptcy Court to enter an order approving a new and separate hedging agreement (the "Second Agreement") with CS. The Second Agreement was different than the first in that it was drafted as an insurance policy and required Herrick and Impala to make payments to purchase hedge protection against a reduced fee recovery. The Bankruptcy Court issued an order approving this transaction on June 27, 2008.

Issues to Consider

1. Dictionary Definition versus Legislative Intent

The word "share" in section 504 of the Bankruptcy Code is not defined by the Bankruptcy Code. Therefore, the Bankruptcy Court in Winstar turned to Merriam-Webster OnLine Dictionary's definition of the word "share" in determining that the Agreement was a fee sharing agreement. In *dicta* the Bankruptcy Court provides that the Agreement did not violate the public policy behind section 504 of the Bankruptcy Code, yet the Bankruptcy Court still did not approve the Agreement. Winstar, 378 B.R. at 761. Judge Carey obviously believed that the dictionary definition left little ambiguity and, therefore, obviated his reliance on the legislative intent.

2. Potential Expansive Application to More Common Fee Awards

Although the facts of Winstar are narrow, it is interesting to consider that many, if not most, fees for court-appointed professionals in bankruptcies have a contingent element to them. Could, for instance, a debtor's counsel hedge the risk of administrative insolvency or delay in payment by assigning/hedging his rights to waive an interim compensation award? Would such an arrangement be a "sharing"?

Colliers opines that hedging transactions related to interim fee awards may be prohibited. See 4-504 Collier on Bankruptcy, ¶¶ 504.01[1], 504.02[1] at 504-3 – 504-5 (Alan N. Resnick & Harry J. Sommer, 15th ed. rev. 2008). Specifically, Collier's states that (a) section 504 of the Bankruptcy Code prevents the sharing of any compensation "received" pursuant to

subsections 503(b)(2) and (b)(4) of the Bankruptcy Code and (b) the prohibition of sharing fees is "mandatory and preemptory" and prevents the treating of bankruptcy cases as "matters of traffic." Id. The word "received" in Collier's would include fees already awarded. Therefore, pursuant to Colliers, it could be argued that even fees awarded by the Bankruptcy Court are subject to the mandatory prohibition of fee sharing, which, pursuant to Winstar, includes any hedging transactions.

3. Hedge versus Insurance

Is there a material difference between the Agreement denied by the Bankruptcy Court and the Second Agreement approved by the Bankruptcy Court? Under the Agreement, the Winstar lawyers agreed to pay certain amounts in the future as a hedge; whereas, in the Second Agreement, Winstar paid certain amounts in advance as "insurance."

Other Relevant Authority

- In re Hepner, No. 05-80136, 2007 Bankr. LEXIS 226 (Bankr. S.D. Tex. Jan. 16, 2007) – The bankruptcy court in Hepner found that a referral fee constituted fee sharing under section 504 of the Bankruptcy Code.

- In re Worldwide Direct, Inc., 316 B.R. 637 (Bankr. D. Del. 2004) - The bankruptcy court in Worldwide Direct held that contract attorneys or paralegals employed by a firm employed by the bankruptcy court are considered associated with that firm for fee sharing purposes, thus the payment of fees to contract attorneys or paralegals do not violate section 504 of the Bankruptcy Code.

- In re Peterson, No. 04-01469, 2004 Bankr. LEXIS 1275 (Bankr. D. Idaho Aug. 25, 2004) – The bankruptcy court in Peterson held that the sharing of fees with a contract attorney is prohibited fee sharing under section 504 of the Bankruptcy Code.

- In re Greer, 271 B.R. 426 (Bankr. D. Mass. 2002) – In Greer, the bankruptcy court struck down a fee sharing agreement in which one attorney paid another non-firm affiliated attorney to represent the former's clients at their 341 meeting.

- Del. Lawyers' Rules of Prof. Conduct. R. 1.5(e) (2008) – Rule 1.5(e) of the Delaware Lawyers' Rules of Professional Conduct provides, "A division of fee between lawyers who are not in the same firm may be made only if: (1) the client is advised in writing of and does not object to the participation of all the lawyers involved; and (2) the total fee is reasonable."

Exhibit 2

In re Teleglobe Communs. Corp., 493 F.3d 345, 2007 (3d Cir. Del. 2007)

Case Study

In re Teleglobe Communs. Corp., 493 F.3d 345, 2007 (3d Cir. Del. 2007)

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1. Introduction

Joint legal representation has always presented a unique set of attorney-client privilege problems. In an age of multinationals with centralized management and operations, the in-house legal department adds an additional layer of complexity to this terrain. The Third Circuit addressed joint representation in the context of the modern in-house legal department in *In re Teleglobe Communs. Corp.*, 493 F.3d 345, 2007 (3d Cir. Del. 2007). In this case the Third Circuit treats the law of privilege in a comprehensive manner that demystifies the rules of joint representation and provides practical advice regarding how joint representation rules affect in-house counsel's provision of legal services.

2. Facts and Procedural Background

Teleglobe, Inc. ("Teleglobe"), a Canadian company, was a wholly-owned subsidiary of Bell Canada Enterprises, Inc. ("BCE"). Like many other companies at this time, BCE anticipated explosive growth in the demand for high-speed digital services and directed Teleglobe to accelerate its production of GlobeSystem, a state-of-the-art fiber optic network. Teleglobe and its U.S. subsidiaries (collectively, the "Debtors") borrowed $2.4 billion from banks and bondholders to fund the development of GlobeSystem.[1]

BCE's confidence in the Teleglobe/GlobeSystem investment was already declining by the end of 2001 but BCE agreed to continue funding the project. At the same time, BCE started to assess its options for Teleglobe in an effort that was dubbed "Project X." In April 2001, BCE decided not to continue investing in GlobeSystem and within a few weeks Teleglobe and the affiliated Debtors filed for bankruptcy relief.[2] The Debtors sued BCE for various causes of action, including breach of contract, breach of fiduciary duties, estoppel, and misrepresentations, based on the theory that BCE's divestiture of Teleglobe amounted to "corporate abandonment."[3]

In the bankruptcy proceedings in Delaware, the Debtors sought production of documents related to Project X and BCE's decision to stop financing Teleglobe. In response to the discovery requests, BCE produced a privilege log and marked 98 documents as protected by a "common interest privilege." When the Debtors moved to compel production, BCE responded that the documents were privileged because "BCE attorneys consulted with attorneys, officers, or employees of Teleglobe, Inc. or its subsidiaries to discuss or provide legal advice in matters where BCE and Teleglobe, Inc. (or its subsidiaries) shared a common legal interest."[4] BCE agreed to produce the "common interest" documents on its privilege log but argued that the rest of the documents designated as privileged should remain privileged because they represented advice provided solely to BCE and were not part of any joint representation with Teleglobe or the Debtors.

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[1] *In re Teleglobe Communs. Corp.*, 493 F.3d at 353.

[2] *Id.* at 354. Teleglobe filed for relief under the Canadian Companies' Creditors Arrangement Act in Ontario while the Debtors filed for Chapter 11 relief in Delaware.

[3] *Id.*

[4] *Id.*

The discovery dispute was referred to a Special Master who conducted an *in camera* review of the documents over which BCE asserted privilege. The Special Master ordered BCE to produce all the documents on its privilege log. The District Court affirmed the Special Master's ruling and held that: (1) as discussed above, BCE made a binding agreement to disclose all communications generated as part of a BCE/Teleglobe joint representation, so finding a joint representation between the two was all that was needed; (2) the Debtors, as wholly owned subsidiaries of Teleglobe, were parties to the joint representation as a matter of law; and (3) even the documents that fell outside of the joint representation (*i.e.,* were produced by outside counsel) must be disclosed because they were shared with BCE's in-house attorneys, who jointly represented Teleglobe.[5]

On appeal, the Third Circuit reversed and remanded to the District Court for additional fact-finding and held that the District Court could compel BCE to produce the disputed documents only if it found that BCE and the Debtors were jointly represented by the same attorneys on a matter of common interest that was the subject-matter of the disputed documents. Section 3 below explains the legal analysis that formed the basis of the Court's decision and section 4 explains how the Court applied this legal framework to BCE's discovery dispute with the Debtors.

3. Applicable Law - Rules of Joint Representation and Attorney Client Privilege

The Court's analysis of the applicable law started with a review of the basic principles of attorney-client privilege and the rule of disclosure, which holds that disclosure of privileged information to a third party generally waives the privilege.[6] The analysis then turned to a discussion of two commonly confused concepts of joint representation: (1) the co-client (or joint-client) privilege, and (2) the community-of-interest (or common-interest) privilege.

(a) The "Co-Client" (or "Joint-Client") Privilege[7]

The "co-client" or "joint-client" privilege applies where two or more individuals with an identical or nearly identical, legal interest retain the same attorney to represent their shared interest.[8] The scope of the co-client relationship is limited by the scope of the clients' shared legal interest. While written agreements limiting the scope of a joint representation might be preferable, parties are not required to undertake this formality so long as they understand the limitations of their relationship.[9] The joint-client relationship is terminated when the lawyer is discharged, withdraws or when the interests of the parties have so clearly diverged that it is no longer possible to justify using common attorneys.[10]

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5 *Id.* The District Court's decision is reported as *In re Teleglobe Communs Corp.,* No. Civ. 04-1266-SLR, 2006 U.S. Dist. LEXIS 48367, (D. Del. June 2, 2006).

6 *In re Teleglobe Communs. Corp.*, 493 F.3d at 359-361.

7 The terms "co-client" and "joint-client" are used interchangeably here.

8 *In re Teleglobe Communs. Corp.*, 493 F.3d at 363-4 and 366.

9 *Id.* at 363.

10 *Id.* at 362.

When co-clients and their common attorneys communicate with one another, those communications are privileged. Waiver of this privilege is bilateral rather than unilateral. This means that the consent of all the co-clients is required to waive privilege over the communications within the co-client representation. A client may unilaterally waive the privilege as to its own communications with a joint attorney, so long as those communications are only the communications of the waiving client and do not concern any of the other co-clients.[11]

(b) The "Community of Interest" (or "Common Interest") Privilege

The "community of interest" privilege arises where different attorneys represent different clients with similar legal interests. The two most important features of this privilege are: (1) to prevent waiver as to third parties, the communication must be between the attorneys and *not* between the clients who share the common interest; and (2) the clients must share substantially similar legal interests.[12] The Court explained that this case did not involve the community of interest privilege because this dispute revolved around different members of the same corporate family using a common set of attorneys. Nevertheless, the Court included a discussion of the community of interest privilege for the sake of clarity and completeness.[13]

(c) Adverse Litigation Exception[14]

As noted above, both the co-client privilege and the community of interest privilege are based on the clients' overlapping interests. When these interests diverge, which may happen frequently in the common corporate context of a spin-off, sale or insolvency, the default rule is that *all* communications made in the course of the joint representation are discoverable.[15] As soon as the joint attorney sees its clients' interests begin to diverge, he is ethically obliged to end the joint representation. If the joint attorney fails to do so and continues to represent both clients, the law will not penalize the clients for their lawyer's lapse of judgment and the privilege will remain intact despite the fact that the clients are now adverse to one another.[16]

The section that follows explains how the Court applied these concepts to BCE's discovery dispute with the Debtors.

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[11] *Id.*

[12] *Id.* at 365-366.

[13] *Id.* at 363 and 365.

[14] While the Court's discussion focuses on the joint-client privilege, the summary introducing its discussion of the law makes clear that the adverse litigation exception applies to both the co-client and community of interest privileges. *See In re Teleglobe Communs. Corp.*, 493 F.3d at 359.

[15] *Id.* at 366.

[16] *Id.* at 368 (citing *Eureka Inv. Corp. v. Chicago Title Ins. Co.,* 743 F.2d 932 (D.C.Cir.1984)).

4. Decision - BCE Documents Are Privileged Unless Debtors Are Co-Clients

The Court held that where a parent and subsidiary share the legal services of a centralized in-house legal department, the clients and the attorney have created a co-client relationship, not a community of interest relationship.[17] The Court therefore rejected the District Court's finding that the Debtors and BCE were in a "community of interest" relationship because a community of interest relationship is only created where the parties are represented by separate attorneys.[18]

Further, in a co-client relationship, one client cannot unilaterally waive the privilege over communications within the joint-client relationship.[19] Thus, Teleglobe's waiver of its privilege rights in favor of the Debtors in the Canadian bankruptcy proceedings did not act to waive BCE's privilege rights flowing from their joint representation by BCE's in-house lawyers. A waiver of privilege over joint-client communications can only be effected if *all* the co-clients join in the waiver.[20]

The Court addressed two additional findings of the District Court. The first finding was that because BCE funneled all of the contested documents through in-house counsel who were jointly representing Teleglobe, the disputed documents had become discoverable as part of the BCE/Teleglobe joint representation. The Court disagreed, explaining that when BCE hired outside counsel to provide advice to it on divestiture issues, it reasonably expected that those communications would be privileged. If, as here, the communications were outside the scope of the joint representation, then sharing them with a conflicted joint attorney is irrelevant, even if the conflicted attorney acted improperly in accepting the communications. The Court therefore rejected this argument.[21]

The second finding was that because BCE agreed to produce the documents related to the BCE/Teleglobe joint representation, it had waived its right to dispute production of the other documents on its privilege log. The Court explained that this theory of waiver ("implied prospective waiver of privilege") did not apply to BCE. Implied prospective waiver of privilege

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[17] *Id.* at 372.

[18] *Id.* at 378.

[19] *Id.* at 379.

[20] *Id.*

[21] *Id.* at 380-1. An additional argument raised by the Debtors was that they should have access to the disputed documents under the fiduciary exception to the attorney-client privilege as articulated in *Garner v. Wolfinbarger,* 430 F.2d 1093 (5th Cir.1970). The core holding of *Garner* is that shareholders of a corporation may "invade" the corporation's privilege in order to prove fiduciary breaches by those in control of the corporation upon a showing of good cause. The Debtors argued that since BCE controlled the Debtors while they were insolvent, it owed fiduciary duties to the Debtors of which their creditors (not BCE) were the primary beneficiaries. The problem with this argument was that it was premised on the Debtor's insolvency. Only when the Debtors became insolvent would BCE have owed any fiduciary duties to the creditors in this case; *before* insolvency, any fiduciary duties would have flowed back up to BCE for its sole benefit. Since the Debtors did not present evidence regarding the date of their insolvency the Court could not determine when and to whom BCE might have owed any fiduciary duties. The Court left this issue open for resolution by the District Court.

only applies where a party selectively discloses privileged documents and the partial disclosure would work to the disadvantage of the other party. In these circumstances a court may find that the disclosing party has waived its privilege as to all the documents that it contends are privileged. Here, the Debtors did not explain what improper benefit BCE sought by disclosing the BCE/Teleglobe joint representation documents and the argument therefore failed.[22] The Court therefore rejected this argument as well.

Based on its analysis of the District Court's findings and the rules of joint representation, the Court reversed the District Court's findings and remanded for additional factual findings regarding whether BCE and the Debtors were jointly represented by the same attorneys on a matter of common interest that is the subject-matter of those documents.

As noted earlier, the Court also provided guidance regarding the proper functioning of an in-house legal department representing multiple clients whose interests may be perfectly aligned in one moment, only to diverge in the next. The section below summarizes the Court's "practice pointers" for balancing joint representation with maintenance of the attorney-client privilege.

5. Practice Pointers

While the Court directed its advice on properly managing a joint representation to in-house counsel, private practitioners will find the advice equally useful, particularly if they find themselves dealing with more than one member of the same corporate family on a matter of common interest.

(a) The joint representation of a parent and subsidiary, whether by the company's in-house legal department or outside counsel, results in the formation of a co-client relationship. When clients in a joint representation relationship become adverse to one another the default rule is that *all* communications made in the course of the joint representation are discoverable.

(b) While joint representation is an efficiency that makes sense in the modern corporation, counsel should be careful to employ joint representation only where necessary and, once initiated, to diligently scan the horizon for potentially divergent interests between its co-clients.

(c) Counsel must be clear about the scope of parent-subsidiary joint representations. By narrowly defining the scope of the joint representation, they can leave themselves free to advise the parent *alone* on the substance and ramifications of important transactions without risking giving up the privilege in subsequent adverse litigation.

(d) When counsel sees the interests of the parent and subsidiary begin to diverge, the most prudent course of action is for the parent to secure separate representation for the subsidiary. When exactly separate representation should be secured will depend on the circumstances but counsel should err on the side of separate representation when in doubt.

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[22] *Id.* at 374-8.

6. References and Related Articles

References

Eureka Inv. Corp. v. Chicago Title Ins. Co., 743 F.2d 932 (D.C.Cir.1984)

Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir.1970)

In re Teleglobe Communs Corp., No. Civ. 04-1266-SLR, 2006 U.S. Dist. LEXIS 48367, (D. Del. June 2, 2006)

Related Articles

Kevin P. Allen, *In re Teleglobe: The Attorney Client Privilege and In-House Counsel*, 17 No. 11 Andrews' Prof. Liab. Litig. Rep. 13 (2008).

Robert B. Cummings, *Get Your Own Lawyer! An Analysis of In-House Counsel Advising Across The Corporate Structure After Teleglobe*, 21 Geo. J. Legal Ethics 683 (2008).

Jonathan Friedland and Mike Xu, *All in the Family--A Lesson in Proper Tailoring from* Teleglobe, 2008 No. 2 Norton Bankr. L. Adviser 1.

Exhibit 3

Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.) 388 B.R. 548 (Bankr. D. Del.) PJW)

Delaware Views From The Bench and Bar

Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.)
388 B.R. 548 (Bankr. D. Del.) (PJW)

The United States Bankruptcy Court for the District of Delaware refused to dismiss breach of fiduciary duty claims against a debtor's directors, officers and restructuring officer for allegedly abdicating their duties and selling substantially all of the debtor's assets on the eve of bankruptcy. In so holding, the Court passed on important issues of Delaware corporate law, including the duty of loyalty and its relationship to the obligation of good faith, the effect of a DGCL section 102(b)(7) exculpatory provision and the minimum facts that a plaintiff must plead under the Twombly standard to establish a claim for breach of fiduciary duty.

General Background

Debtors Bridgeport Holdings Inc. and its affiliates ("Debtors") filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code on September 10, 2003. The Court confirmed the Debtors' Plan of Distribution on September 24, 2004. The plan created a liquidating trust ("Trust") to which the Debtors assigned all their causes of action under chapter 5 of the Bankruptcy Code.

On December 11, 2007, the Trust filed a complaint against the Debtors' officers and directors ("D&O Defendants") and Lawrence J. Raemakers ("Raemakers"), a restructuring professional at Alix Partners. The Trust alleged that the D&O Defendants and Raemakers breached their fiduciary duties to the Debtors for acts arising out of a sale of the Debtors' assets to CDW Corporation ("CDW") on September 9, 2003, one day before filing for bankruptcy. The D&O Defendants and Raemakers each moved to dismiss the complaint. The Court's opinion resolved the two motions to dismiss.

Alleged Factual Background[1]

In January 2000, Debtors were acquired by a group of investors in a leveraged buyout and became indebted to a syndicate of financial institutions. Over the next year, the Debtors along with other companies in the technology sector experienced a significant downturn in their business because of, among other things, the bursting of the dot-com bubble. Because of lack of revenues and a significant debt load, the Debtors were forced to twice renegotiate the terms of their credit agreement between 2000 and 2002.

By mid-2002, the D&O Defendants had identified certain "M&A alternatives" such as a merger that might help the Debtors improve their financial position, but failed to engage the Debtors in any of these alternatives. Between the end of 2002 and March 2003, the Debtors were in breach of their credit agreement and were facing a severe liquidity crisis. In

[1] The facts described herein are drawn from the Court's opinion, which cited from the facts alleged in the Trust's complaint. Because of the procedural posture of the case -- resolution of a motion to dismiss -- the facts, although alleged and not yet proven, are taken as true.

April 2003, they negotiated a restructuring of their debt facility. In June 2003, the lenders urged the Debtors to hire a restructuring professional, but the Debtors did not do so for another two months. In July 2003, the Debtors' financial condition deteriorated to the point where key employees began joining competitors and it became very difficult to do business on credit terms.

On August 5, 2003, the D&O Defendants approved the retention of Alix Partners as the Debtors' restructuring advisor. At an August 8, 2003 board meeting, the Debtors discussed their options and decided to "execute upon a 'sell' strategy." But rather than commence a competitive bidding process, defendant Wilson called upon his "long time acquaintance" John Edwardson ("Edwardson"), the CEO of CDW, and requested that Edwardson talk to York, another director, "seriously and quickly about [the Debtors]." A few days later, York and Edwardson met to discuss the sale of the Debtors to CDW. As of that date, the Debtors had not contacted any other company to discuss a possible transaction.

The Debtors waited two more weeks from the date they approved the retention of Alix Partners to the date they actually did so. On August 18, 2003, they formally retained Alix Partners and appointed Raemakers as CEO. Raemakers commenced on August 19, 2008, at which point (the Trust alleges) the D&O Defendants abdicated crucial decision making authority to Raemakers and utterly failed to supervise him.

By August 22, 2003, Raemakers determined to sell the Debtors' assets. But instead of commencing a competitive bidding process, Raemakers seized upon the CDW opportunity. The Debtors never hired an investment banker to shop the deal. On August 27, 2003, CDW commenced due diligence. After conducting due diligence over labor day weekend, the parties agreed on a "handshake deal" to sell the company for $28,000,000 on September 2, 2003. As it turned out, CDW valued the assets at $126,000,000, and analysts characterized the transaction as a "steal." Part of the Debtors' handshake deal" obligated them to negotiate exclusively with CDW.

Raemakers only made contact with one other potential acquirer, PC Connection, but only provided it with limited due diligence materials. Moreover, as of September 2, the Debtors stopped providing PC Connection with due diligence materials because of their exclusivity agreement with CDW. PC Connection was never able to make its final and best offer.

Raemakers made cursory calls to Dell and Apple, and no calls to other potential bidders such as Office Depot, which, after the sale closed, wrote a letter to the Debtors indicating that it was not informed of any opportunity to bid on the Debtors, that it would have had a serious interest in bidding, and that it had the resources to do so. Moreover, Office Depot had previously expressed an interest in acquisitions in the Debtors' industry. Other competitors and potential purchasers such as PC Mall expressed that they would have been interested in bidding, but didn't find out about the sale until after it was consummated.

In 2005, the Trust sued CDW to avoid the sale as a fraudulent transfer. CDW settled for $25,000,000. On December 11, 2008, the Trust sued the D&O Defendants and Raemakers.

The Parties' Arguments

The Trust argued the D&O Defendants' failure to sell the company earlier, along with their abdication of responsibility to Raemakers, culminated in the uninformed and hurried sale of the Debtors' assets for an unreasonably low price. In approving the "fire sale," the D&O Defendants acted in bad faith and breached their fiduciary duties to the Debtors. Their acquiescence to Raemakers' rushed and ineffective marketing efforts and flawed sale process harmed the Debtors, its shareholders, and its creditors by resulting in the sale of the assets, valued by the buyer at $126,000,000, for only $28,000,000.

The Trust's complaint contained 6 Counts: Count I alleged that the D&O Defendants breached their duty of loyalty and acted in bad faith. Count II alleged that the D&O Defendants breached their duty of care and acted in bad faith. Counts III and IV alleged that certain of the D&O Defendants breached their fiduciary duties solely in their capacities as officers of the Debtors. Count V alleged that Raemakers breached his fiduciary duties of loyalty and due care and acted in bad faith. Count VI alleged corporate waste by all defendants.

The Trust alleged that these breaches were evident from four **"Challenged Actions:"**

(a) The D&O Defendants' failing to sell the Debtors' assets earlier, before a liquidity crisis;

(b) The D&O Defendants' failing to hire a turnaround professional earlier in 2003, when their lenders so urged;

(c) The D&O Defendants abdicating all their responsibility to Raemakers and then failing to supervise him; and

(d) The D&O Defendants acquiescing in Raemakers' decision to sell the Debtors' assets quickly, immediately before filing for bankruptcy, rather than in a court-supervised section 363 sale.

The D&O Defendants and Raemakers moved to dismiss the complaint because, among other things:

(a) The Statute of limitations barred the Trust from suing for events that happened before August 17, 2003 (three years before the date on which the parties entered into a tolling agreement);

(b) The complaint failed to allege facts to support a breach of the duty of loyalty;

(c) The Debtors' section 102(b)(7) exculpatory provision protected the defendants from damages for breach of the duty of due care;

(d) The complaint failed to allege facts sufficient to support claims against certain defendants sued solely in their capacity as officers; and

(e) The complaint failed to allege facts sufficient to support the claim of waste.

The Court's Decision.

The Court dismissed (1) the claim of waste; (2) the claims against officers; and (3) claims barred by the statute of limitations (Challenged Actions (a) and (b) above). It did not dismiss the breach of fiduciary duty claims to the extent that they were based on actions within the limitations period (Challenged Actions (c) and (d) above).

Statute of Limitations

- The Delaware statute of limitations for breach of fiduciary duty claims is three years. The parties entered into a tolling agreement effective as of August 17, 2006. Thus, the limitations period covered acts or omissions occurring on or after August 17, 2003.

- The D&O Defendants argued that Challenged Actions (a) and (b) -- their failure to hire a restructuring professional or to sell the company earlier in 2003 -- occurred before the tolling date, and thus were time barred.

- The Trust argued that rather than splitting its claims into four separate Challenged Acts, they should be viewed as a continuous wrong for which the statute of limitations did not begin to run until the date of the last wrongful act.

- The Court agreed with the D&O Defendants. The complaint itself characterized the Challenged Actions as four separate alleged wrongs, not as one continuous wrong. A breach of fiduciary duty accrues at the time of the wrongful act. Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 860 A.2d 312, 319. Here, the basis of the first two Challenged Actions was their timing -- that the Debtors did not sell or hire a restructuring professional earlier than they did. Thus, the omissions giving rise to the first two Challenged Actions occurred at the very latest by early August 2003, which is still before the tolling date.

- Moreover, the Court found that "where a plaintiff brings a claim based upon multiple allegedly wrongful acts, a court considers each act in turn in applying the statute of limitations." Thus, the Trust could not attempt to incorporate the first two Challenged Actions into the later two. Any cause of action based upon a Challenged Act accrued at the time of the wrongful act or omission, and thus any claim arising out of the first two Challenged Acts were time barred because the omission giving rise to them occurred in early 2003, before the August 17, 2003 tolling date.

Breach of the Duty of Loyalty

- The D&O Defendants argued that a duty of loyalty claim can only be sustained where directors and officers act (1) out of self-interest or (2) without independence. Since the complaint here didn't allege either, all breach of the duty of loyalty counts should be dismissed.

- The Court disagreed. The Delaware Supreme Court recently recognized that the duty of loyalty encompasses the obligation to act in good faith. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006). Directors breach their obligation of good faith (and hence their duty of loyalty) when they "fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities." See also Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003) ("A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.").

- Here, although the complaint did not allege that the D&O Defendants were self-interested or lacked independence, it did allege that they abdicated their duties and failed to monitor Raemakers, who sold the company without conducting a competitive sales process and without even obtaining a valuation. Taken as true, this was a violation of the obligation of good faith and hence of the duty of loyalty because it evidenced the type of willful blindness that is indicative of a "conscious disregard for one's responsibilities."

Duty of Care, Section 102(b)(7), and the Business Judgment Rule

- The D&O Defendants argued that the company's DGCL section 102(b)(7) exculpatory provision required the court to dismiss the Trust's duty of care claims. The Debtors' certificate of incorporation contained the following exculpatory provision:

> A director of the Corporation shall have no personal liability to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except (i) for any breach of the director's duty of loyalty to the Corporation or its stockholders, (ii) for any act or omission not in good faith or which involves intentional misconduct of a knowing violation of the law, (iii) for the unlawful payment of dividends or unlawful stock repurchases under Section 174 of the General Corporation Law of the State of Delaware, as the same exists or hereafter may be amended or (iv) for any transaction from which the director derived an improper benefit.

- The D&O Defendants relied heavily on a District of Delaware case, IT Litig. Trust v. D'Aniello (In re IT Group Inc.), No. 04-1268, 2005 U.S. Dist. LEXIS 27869, * 39, (D. Del. Nov. 15, 2005). The IT Group court dismissed a duty of care claim

because of the existence of an exculpatory provision in the corporate charter, even though the complaint also alleged duty of loyalty claims.

- The Trust argued that the result in IT Group was wrong and that an exculpatory provision can only defeat a due care claim when it is the exclusive claim, and that here, it was not the exclusive claim, since the complaint also alleged duty of loyalty claims.

- The Court agreed with the Trust. A court can only dismiss a duty of care claim when it is the exclusive claim. Here, the Trust sufficiently alleged breaches of loyalty, so that the duty of care claim was not an exclusive claim. The Court, "with all due respect to our District Court," declined to follow the IT Group holding, since it incorrectly interpreted Delaware state law. See Malpiede v. Townson, 780 A.2d 1075, 1095 (Del. 2001) (because complaint did not properly invoke good faith or loyalty claims, all that remained were due care claims, which were defeated by the section 102(b)(7) provision). If a complaint sufficiently alleges duty of loyalty claims in addition to duty of care claims, then the section 102(b)(7) provision does not defeat the duty of care claims, at least in a motion to dismiss.

- As for the D&O Defendants' argument that they were protected by the business judgment rule, the Court found that the complaint alleged facts sufficient to overcome the protections of the rule. Such facts included the fact that the D&O Defendants proceeded with the sale without knowing what price other prospective purchasers would have been willing to pay. Moreover, given the fact that the transaction contemplated the sale of the company, the board was obligated to secure the transaction offering the best value reasonably available. McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000). Instead, the facts taken as true showed that the D&O Defendants conducted a rushed sale without informing themselves of all material information reasonably available to them.

Officer Duty of Care

- The Court held that the complaint failed to allege facts sufficient to support duty of care claims against the officer-defendants. The complaint never identified which offices any of the officer-defendants held. Without knowing a particular officer's responsibilities, it was impossible to discern whether he exercised due care in his capacity as holder of that office. For this same reason, the Trust's Caremark claim against the officers for lack of oversight over Raemakers failed too. Generic corporate officers have no duty to oversee a company's CEO.

- This was not a situation like in Boles v. Filipowski (In re Enivid), 345 B.R. 426 (Bankr. D. Mass. 2006), where the 113-page complaint contained much more detail about the officers, including their positions and their communications with the company's directors, and which made allegations officer by officer. The complaint here did not contain the kind of detailed facts as the Enivid complaint. Therefore, it was insufficient to survive the motions to dismiss.

Waste

- To succeed in proving waste, a plaintiff must plead facts showing an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation received adequate consideration. Official Comm. of Unsecured Creditors of Integrated Health Servs., Inc. v. Elkins, 2004 Del. Ch. LEXIS 122, No. 20-228-NC, *65 (Del. Ch. Aug. 24, 2004).

- Only extraordinary circumstances can justify a finding of waste. Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000) ("Most often the claim is associated with a transfer of corporate assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift. If, however, there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky") (emphasis in original).

- The Court dismissed the waste claim. The complaint did not allege facts sufficient to support the conclusion that no reasonable person would find $28 million adequate for the Debtors' assets. Given the fact that the Debtors' financial position was plummeting, it was possible that a reasonable person might conclude that the sale price was adequate under the circumstances.

Summary

The Bridgeport opinion helps clarify the minimum requirements for alleging facts sufficient to support a breach of fiduciary duty claim and survive a motion to dismiss under the standards set forth in Bell Atlantic Corp. v. Twombly, 127 S.Ct. 1955 (2007). Before Twombly, courts applied a lenient standard to complaints, only dismissing them for failure to state a claim where "it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." Id. at 1968. After Twombly, a plaintiff must allege "enough facts to state a claim for relief that is plausible on its face." Id. at 1974. Where plaintiffs "have not nudged their claims across the line from the conceivable to plausible, their complaint must be dismissed." Id.

With regard to the duty of loyalty, such facts need not be allegations of self-interest or lack of independence. The concept of loyalty under Delaware law is broader than that. The duty of loyalty subsumes the obligation of good faith, such that alleging facts sufficient to establish plausible grounds for a claim of bad faith -- facts showing a willful blindness or conscious disregard for one's duties -- are enough to support a breach of duty of loyalty claim and survive a motion to dismiss.

As for the duty of care, the facts must establish plausible grounds that directors did not use reasonable care and consider all material information available, such that they were grossly negligent in making the decision. Although a section 102(b)(7) exculpatory provision might protect the directors from the due care claims at a later stage in the case, it does not do so

in the motion to dismiss stage where the due care claim is not the only viable claim supported by the complaint.

Finally, with regard to asserting claims against officers, the opinion is instructive on how much detail is needed to survive a motion to dismiss. At the very least, the complaint should distinguish among officers individually and not lump them as a group. It should state their positions and express with detail any communications or links that the individual officer had to the wrongful act giving rise to the claim. In the end, mere labels will not do, nor will a formulaic recitation of the elements of a cause of action.

Exhibit 4

In re Buffets Holdings, Inc. 387 B.R. 115 (Bankr. D. Del. 2008) (MFW)

Delaware Views From The Bench and Bar

In re Buffets Holdings, Inc

.387 B.R. 115 (Bankr. D. Del. 2008) (MFW)

The United States Bankruptcy Court for the District of Delaware recently decided that a debtor could not assume and/or reject certain individual leases for non-residential property which were subject to a master lease. See In re Buffets Holdings, Inc., 387 B.R. 115 (Bankr. D. Del. 2008) (MFW).

General Background

Debtors Buffets Holdings, Inc. *et al*. (collectively, "Debtors") filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code on January 22, 2008 in the United States Bankruptcy Court for the District of Delaware (the "Court"). Debtors filed a motion to assume and/or reject certain individual leases for non-residential real property between Debtors and FP1 LLC and FP2 LLC, respectively (collectively, "FP"). The individual leases in question constituted some, but not all, of the leases subject to certain master lease agreements between Debtors and FP. FP objected to Debtors' motions and the Court conducted an evidentiary hearing regarding the threshold severability issue after discovery and briefing by Debtors, FP and the Official Committee of Unsecured Creditors (the "Committee").[1]

Factual Background[2]

Debtors comprised the nation's largest steak-buffet restaurant chain and the second largest restaurant company in the family dining segment of the restaurant industry. Prior to their petition dates, Debtors wanted to recapitalize, replace their secured debt and issue a dividend to shareholders. Accordingly, Debtors sold certain of their restaurants and, if owned by Debtors, the ground on which they stood, leased back those facilities and used the proceeds from these transactions to (among other things) refinance their debt and pay a dividend. FP was one of the parties to the sale/leaseback transactions with Debtors.

With regard to the FP-related transactions, Debtors preferred to structure their leasebacks on an individual lease basis. FP, however, insisted that they be in the form of master leases. After negotiation, Debtors agreed to the master lease structure because they valued the overall terms offered by FP and treatment of the transaction as an operating lease. Each FP-related master lease included several individual leases. Rent under each master lease was due as a lump sum, Debtor's obligation to pay rent under each master lease was joint and several and all rent was due and payable to FP even if Debtors were unable to use one or more properties during

[1] Debtors were represented by Pauline K. Morgan and Joel A. Waite, of Young, Conaway Stargatt & Taylor, LLP and Susheel Kirpalani and James C. Teece of Quinn, Emanuel, Urquhart, Oliver & Hedges, LLP. FP was represented by Mark D. Collins and Marcos A. Ramos of Richards, Layton & Finger, P.A. and Shalom Kohn and Alan M. Unger of Sidley Austin LLP. The Committee was represented by Alan J. Kornfeld and Curtis A. Hehn of Pachulski Stang Ziehl & Jones LLP.

[2] The facts described herein are drawn from the Court's opinion.

the lease term. Debtors were permitted to assign or substitute a lease subject to the master lease only with FP's consent. Upon default, FP -- not Debtors -- had the option to declare the entire master lease in default or to treat only the underlying lease in default. Finally, while the term of each master lease was close to an average of the term of each underlying lease, the obligation to pay rent under the master lease extended (in some cases) beyond the end of an individual lease.

The Parties' Arguments

Debtors and the Committee argued that the following facts and law demonstrated the parties' intent to create a severable master lease:

- Apportionable Rent. Exhbit B to each master lease apportioned the aggregate rent due under the master lease to each of the underlying leases. According to Debtors, this was a critical fact in support of severability because state law is replete with cases stating that apportionment of price is a factor in favor of severability. See, e.g., Altra Corp. v. Chemtoy Corp. (In re Chemtoy Corp.), 19 B.R. 475, 481 (N.D. Ill. 1982) (an agreement is severable where "one party's performance consists of several distinct and separate items and the price to be paid by the other party is apportioned to each of the items performed").

- FP's ability to sever. FP had the right to divide or consolidate individual leases and create new master leases or sell the underlying property relating to an individual lease, thereby severing it from the master lease. Further, FP had the right to agree to substitute leases subject to the master lease.

- FP's Conduct. Prior to the bankruptcy filing, FP agreed to substitute the leases subject to the master lease. Although that substitution never occurred due to the bankruptcy filing, Debtors argued it was evidence of the parties' intent to create a severable agreement.

- Cross-Default Provisions. The master leases provided that (1) the obligation to pay rent was joint and severable and (2) upon default, FP could choose to declare a default as against an individual lease or the entire master lease. Debtors argued that these provisions were mere cross-default provisions or credit enhancements that would not be enforceable under section 365(f). The Committee also argued that the fact that FP could exercise its rights against only one property evidenced the divisibility of the contract.

- Essential to Debtors' Reorganization: Debtors and the Committee argued that the requested relief was consistent with the remedial purposes of the Bankruptcy Code and necessary to facilitate Debtors' reorganization. They also argued that Debtors' rehabilitation would be harmed absent the requested relief.

Not surprisingly, FP had a different view of the relevant facts and law, arguing that the parties' clear intent was to create a unitary master lease:

- FP's Consent Required to Sever. FP argued that all the provisions that allowed for severance of an underlying property were exercisable only by FP, or only with FP's consent, and thus evidenced the parties' intent to treat the master lease as unitary except

in very special circumstances.

- Joint and Several Liability of Rent. Under each master lease, rent was paid as a lump sum and each tenant was jointly and severally liable for the entire rent due under the master lease.

- Fixed Rent - No Reductions Allowed. All rent was due on a master lease even if one or more underlying properties were condemned, destroyed, or if the ground lease was terminated. The aggregate rent would not be reduced to reflect any of those changes.

- Average Duration. The duration of each master lease was close to an average of the terms of its underlying leases -- but even where an underlying lease terminated before the master lease, rent under the master lease was not reduced.

- Prior Dealings. FP's insistence on a master lease structure, and Debtors knowing and intentional acceptance of that structure, reflected the intent to create a unitary agreement.

The Court's Decision

The Court held that the master leases were unitary agreements and therefore the underlying leases could not be severed and individually assumed or rejected:

- The Express Terms of the Master Leases Indicated an Intent to Create a Unitary Agreement:

  - Apportionable Rent. Although the ability to apportion consideration to different parts of a contract is a factor in favor of severability, it is not a conclusive fact. At bottom, what matters is the intent of the parties. See In re United Air Lines, Inc. 453 F.3d 463, 468, 470 (7th Cir. 2006) ("even if the parties entered a multi-part contract, that contract cannot be severed after the fact if the parties entered it 'as a single whole, so that there would have been no bargain whatever, if any promise or set of promises were struck out").

  - FP's Right to Sever. Although FP could, in certain circumstances, exercise a right to sever the master leases, that did not mean that the parties intended the master leases to be separate agreements for all purposes. The Court found that the relevant facts demonstrated the opposite: each master lease was intended to be an integrated agreement except for a few specifically defined circumstances.

  - Debtors' Conduct. The Court was unconvinced by the fact that FP had agreed to the substitution of another property for an underlying lease (which, had the substitution been consummated, would have removed the individual underlying lease from the master lease). Instead, it found that Debtors' conduct -- specifically, seeking permission from FP to make the substitution -- constituted an implicit recognition that the master leases were not severable and that special permission was needed to remove individual leases from the master lease.

- Cross-Defaults vs. Economic Interdependence. Cross-default provisions are not per se invalid under section 365. They may be valid if the agreements linked by the cross-default are economically interdependent. The Shaw Group, Inc. v. Bechtel Jacobs Co., LLC (In re IT Group, Inc.), 350 B.R. 166, 179-80 (Bankr. D. Del. 2006). Here, the Court found that the individual leases incorporated by the master leases were economically interdependent. FP's economic interest was not in each separate lease -- instead, its interest was in the total package, as evidenced by the fact that rent was due jointly and severally by all the tenants regardless of what happens to the individual leases, such as destruction or condemnation of the underlying properties. Thus, to allow Debtors to sever an underlying lease and lower the aggregate rent under the master lease would deny FP the essence of its bargain.

- Relevant Circumstances Supported Intent to Create a Unitary Agreement:

  - The Court also was convinced by the fact that the master lease structure resulted from a negotiated give-and-take. The evidence -- live and deposition testimony and relevant documents -- supported the conclusion that FP would not have proceeded with the deal without the master lease structure.

  - FP was not the original lessor under the leases, and was not in the business of financing individual restaurant leases. The purpose of the master leases was not to consolidate several agreements that FP already had with the Debtors. Instead, it was being asked by the Debtors to monetize their leases, and in exchange for doing that at the price that it did, FP insisted on the leases being bundled to maximize its return. It was an essential term of their agreement.

  - The evidence also supported the conclusion that Debtors tried to negotiate away from the master lease structure, but ultimately decided to move forward with the transactions with FP subject to the master lease structure.

General Legal Standards

The following are certain general standards of law which may apply to a request to assume or reject an unexpired lease:

- Assumption/Rejection. A debtor may assume or reject an unexpired non-residential real property lease under section 365 of the Bankruptcy Code. "The authority to reject an executory contract is vital to the basic purpose to a chapter 11 reorganization, because rejection can release the debtor's estate from burdensome obligations that can impede a successful reorganization." N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984).

- *Cum Onere* Principle. If a debtor decides to assume a lease, it must generally assume all the terms of the lease, good and bad, and may not pick and choose only favorable terms to be assumed. See In re Italian Cook Oil Corp., 190 F.2d 994, 997 (3d Cir. 1951) ("The [debtor], however, may not blow hot and cold. If he accepts the contract he accepts it *cum onere*. If he receives the benefits he must adopt the burdens. He cannot accept one

and reject the other"); In re ANC Rental Corp., Inc., 277 B.R. 226, 238-39 (Bankr D. Del. 2002) ("section 365(f) … requires that a debtor assume the contract *cum onere* without any change")(citing In re Italian Cook Oil Corp.).

- Severability. Since a debtor must assume or reject an agreement in its entirety, it becomes important to determine whether an agreement with several parts -- such as a master lease with over twenty underlying leases -- is an indivisible agreement or is in fact several agreements bundled together.
  - State Law Controls. Whether an unexpired lease or an executory contract is an indivisible unitary agreement or is several agreements is a question of state law. In re T & H Diner, Inc., 108 B.R. 448, 453 (D.N.J. 1989).
  - States Law Looks to Intent. In Buffets, Illinois law applied to determine whether the master leases were severable. Illinois courts (like most other state courts) look to the parties' intent -- did they intend a unitary agreement, or did they intend separate contracts even though they are bundled together in one agreement? See Super Stop Petroleum, Inc. v. Clark Retail Enters. (In re Clark Retail Enters.), 308 B.R. 869, 888 (Bankr. N.D. Ill. 2004) (test under Illinois law is intent of the parties, which is gleaned from (1) the terms of the agreement, (2) the circumstances of the transaction and (3) the subject matter of the agreement).

Other Case Law

The following cases also considered severability in the master lease context:

- In re FFP Operating Partners, LP, 2004 Bankr. LEXIS 1192 (Bankr. N.D. Tex. 2004)
  - Facts: One lease covered 20 properties. Exhibit A to the lease contained a legal description of each piece of property. Exhibit B to the lease prorated the base rent among the 20 properties. The lease was originally for 22 properties, but by agreement of the parties, 2 properties were severed out of the lease.
- Held: The lease was severable, because:
  - The lessor had right to sell any single piece of property in the lease, suggesting that a property could be severed.
  - Upon destruction or condemnation of an individual real property, the lease was not terminated -- instead, rent was reduced based upon the proportionate rent charged for that property. The court held that this evidenced an intent to create a severable contract, and was not just a situation in which the parties were trying to created severability in only isolated circumstances.
  - Although lease spoke in the singular, calling itself a 'lease,' there was a provision within it that stated that use of the singular shall include the plural.

- Rent was easily apportionable.

- Clark Retail Enters., Inc., 308 B.R. 869 (Bankr. N.D. Ill. 2004)
  - Found that a contract to sell 81 stores was divisible on a store by store basis, because:
    - The stores were priced separately, with a separate bid price for each store.
    - The sale of each property had to be authorized by separate court order.
    - The buyer had to conduct due diligence and execute bidding documents unique to each store.
    - Each store came with separate warranties, inspections and closing documents.
    - The properties were not uniform -- each property contained various fixtures, some were subject to liens, others were not.
- In re Cafeteria Operators, L.P., 299 B.R. 384 (Bankr. N.D. Tex. 2003)
  - The Court held that a master sublease agreement was severable because:
    - Although payment was made in a lump sum, the agreement provided for the apportionment of rent.
    - The master sublease contained a rent reduction provision in case an underlying property was destroyed.
    - The term (duration) of the underlying subleases varied.
    - Upon default of an individual sublease, the lessor had the option of not treating the entire sublease as being in default and instead was entitled to re-enter the individual property.
    - Upon certain circumstances, the lessee could sub-sublease the property, thereby severing it from the master sublease.
- In re Convenience USA, Inc., 2002 Bankr. LEXIS 348 (Bankr. M.D.N.C. 2000)
  - The Court held that a master lease agreement covering 27 individual leases was divisible, because:
    - Rent was apportioned and assigned to each of the 27 leases.
    - The landlord had the unfettered right to sell one or more underlying leases.
    - Upon sale or destruction of an underlying leased property, the aggregate rent due under the master lease would be reduced to account for the sold/destroyed properties.
    - A condemned property is automatically severed from the master lease.
    - The tenants' obligations to pay rent was not joint and several.

Summary

The issue of severability is a fact intensive inquiry. The facts that appear to have been the most persuasive to the Buffets Court were the facts showing that the individual leases incorporated into each master lease were economically interdependent. That is, unlike a typical landlord, who has separate interests in each of his leases, FP had one overriding interest -- its interest in receiving a specified aggregate amount of rent under each master lease regardless of the underlying individual leases or any default, termination or destruction of premises related to such individual leases. For the Buffets Court, the interdependent nature of the underlying leases elevated the master lease from a collection of separate, divisible leases protected by cross-default provisions to a single, unitary agreement.

Exhibit 5

In e Exide Technologies, No. 07-2230, 2008 WL 4277298 (3d Cir. Sept. 19, 2008)

In re Seven Fields Development Corporation, 505 F.3d 237 (3d Cir. 2007)

Delaware 2008 Views from the Bench and Bar

In re Exide Technologies, No. 07-2230, 2008 WL 4277298 (3d Cir. Sept. 19, 2008)

In re Seven Fields Development Corporation, 505 F.3d 237 (3d Cir. 2007)

Alan W. Kornberg

In re Exide Technologies, No. 07-2230, 2008 WL 4277298 (3d Cir. Sept. 19, 2008)

I. Summary of Case

A. Facts

In June 2000, Pacific Dunlop Holdings (USA), Inc. and its foreign affiliates sold their respective interests in a global automotive and industrial battery business to Exide Technologies and its foreign subsidiaries.[1] Following the closing of the sale, the Pacific Dunlop entities sued the Exide entities for breach of contract, unjust enrichment, and conversion in Illinois state court, the forum specified in their agreement.[2] After discovery had begun, Exide Technologies, but none of its foreign subsidiaries, filed for chapter 11 relief in the Bankruptcy Court for the District of Delaware.[3]

The Pacific Dunlop foreign affiliates continued to prosecute their claims against the Exide foreign subsidiaries in state court.[4] The Exide foreign subsidiaries removed the state case to bankruptcy court in Illinois, where the case was then transferred to the Bankruptcy Court for the District of Delaware overseeing Exide's chapter 11 case.[5] The Pacific Dunlop foreign affiliates moved for remand of their claims against the non-debtor Exide entities to state court or, in the alternative, abstention by the bankruptcy court.[6] Meanwhile, a claims bar date had been set in Exide's chapter 11 case and the Pacific Dunlop foreign affiliates filed proofs of claim.[7] Such claims against Exide were described as contingent upon not being able to recover from the non-debtor Exide entities based on the state law claims.[8]

The bankruptcy court denied the motion to remand finding that the Pacific Dunlop foreign affiliates' claims against the non-debtor Exide entities were core proceedings under 28 U.S.C. § 1334(b).[9] The court accepted Exide's argument that the underlying sales agreement unambiguously provided that Exide was the sole indemnitor for losses caused by breach of the agreement and, therefore, the exclusive remedy for the Pacific Dunlop foreign entities was a direct claim against Exide.[10] The court also held that the filing of proofs of claim by the Pacific Dunlop foreign affiliates made the proceedings core. The district court affirmed the decision of the bankruptcy court.[11]

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[1] *In re Exide Technologies*, 2008 WL 4277298 at *1.
[2] *Id.*
[3] *Id.* at *2.
[4] *Id.*
[5] *Id.* at *2, *4.
[6] *Id.* at *3.
[7] *Id.* at *4.
[8] *Id.*
[9] *Id.* at *6.
[10] *Id.* at *5.
[11] *Id.* at *7.

B. Legal Analysis

Under 28 U.S.C. § 1334(b), bankruptcy courts have core jurisdiction over cases "under" title 11, that is, the bankruptcy petition, proceedings "arising under title 11" and proceedings "arising in" a bankruptcy case.[12] Non-core jurisdiction involves proceedings "related to" a bankruptcy case such that "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy."[13] While the bankruptcy court will have jurisdiction to hear both core and non-core matters, the court can issue orders and enter judgments only in core proceedings.[14]

The dispositive issue in *Exide* is whether the state law claims against the non-debtor Exide foreign entities are core proceedings.[15] If they are non-core proceedings, abstention and enforcement of the forum selection clause is appropriate.[16] In evaluating whether a claim is core in the Third Circuit, a court must first look to the illustrative list of core proceedings found in 28 U.S.C. § 157(b)(2).[17] The proceeding also will be considered core if it invokes a substantive right provided by title 11 or if the claim, by its nature, could arise only in the context of a bankruptcy case.[18] Each claim within the same cause of action must be analyzed individually and each claim alone must satisfy the two-step test in order to be considered a core proceeding.[19]

The court of appeals addressed the following three grounds in finding that the claims at issue between the non-debtors were not core:

1. Indemnification: The court held that if Exide is the sole indemnitor under the sales agreement and the only proper defendant from which the Pacific Dunlop foreign affiliates can seek relief, then the state law claims against the non-debtor defendants would be core proceedings.[20] However, the court of appeals found that the bankruptcy court had insufficient evidence to conclude that the indemnification clause unambiguously designated Exide as the exclusive party responsible for any claims and remanded the issue.[21]

2. Proofs of Claim: Filing proofs of claim does not convert state law claims against a non-debtor into a core proceeding.[22] The court's review of the case law showed that filing a proof of claim may cause claims against non-debtors to be treated as "related to" proceedings.[23] However, there would be core jurisdiction only if the indemnification clause

[12] *Id.* at *8.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.* at *13.
[21] *Id.* at *13-14.
[22] *Id.* at *15.
[23] *Id.* at *15-17.

designated the debtor as the only indemnitor, making the subject matter of the proofs of claim the same as the state law action.[24]

3. Intertwinement Theory: The court also rejected the Exide foreign entities' contention that a state court action involving debtors and non-debtors becomes core if the core and non-core claims are "'so intertwined' that merely to 'disentangle' them would be 'co-extensive with a resolution of the merits of the disputes.'"[25] In doing so, the court explicitly overruled the "intertwinement" theory adopted in *In re RBGSC Inv. Corp.*, 253 B.R. 369 (E.D. Pa. 2000).[26]

II. Related Cases

A. In re Holiday RV Superstores, Inc., 362 B.R. 126 (D. Del. 2007)

By filing a proof of claim, plaintiffs' state court claim was not transformed from a non-core proceeding into a core proceeding.

B. CIT Communications Finance Corp. v. Level 3 Communications, LLC, 483 F.Supp. 2d 380 (D. Del. 2007)

The plaintiff's state claim was unrelated to the bankruptcy case and plaintiff's filing of a proof of claim did not change the fact that the plaintiff alleged two separate contractual breaches against the debtor and non-debtor.

C. In re Best Reception Systems, Inc., 220 B.R. 932 (Bankr. E.D. Tenn. 1998)

The court stated that "actions asserted by those plaintiffs who filed actions against non-debtor parties exclusively, regardless of whether they filed a proof of claim," are "presumptively non-core."

D. In re ACI-HDT Supply Co., 205 B.R. 231 (B.A.P. 9th Cir. 1997)

The court held that state claims against non-debtor parties for conduct arising pre-petition were not core proceedings. The court noted that a Ninth Circuit decision finding state court actions against trustees and their attorneys for conduct arising out of administering the estate were core proceedings because they were inextricably intertwined with the bankruptcy and was likely confined only to those narrow facts.

III. Practice Points

- An indemnification clause will provide a basis for core jurisdiction only if the clause clearly states that the debtor is solely liable for all claims against affiliated non-debtors to the transaction.

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[24] *Id.* at *18.
[25] *Id.*
[26] *Id.* at *20.

- The mere filing of a proof of claim will not confer core jurisdiction over state law claims against non-debtors.
- The "intertwinement" theory of core jurisdiction is no longer valid in the Third Circuit.

In re Seven Fields Development Corporation, 505 F.3d 237 (3d Cir. 2007)

I. Summary of Case

A. Facts

Several debtor corporations engaged in real estate development filed for chapter 11 relief in 1986.[1] Ernst & Young, retained by the debtors with approval of the Bankruptcy Court for the Western District of Pennsylvania, opined that the debtors were insolvent.[2] Based on such advice, and with the approval of the debtors and the creditors committee, the court confirmed a reorganization plan that merged the debtor corporations into one surviving entity, Seven Fields.[3] Following confirmation, Seven Fields liquidated its assets and made distributions to creditors, but the liquidation was insufficient to pay all claims in full.[4]

Certain shareholders of Seven Fields filed a professional malpractice claim against Ernst & Young in state court alleging that Ernst and Young's negligence and misrepresentations about the solvency of the debtor corporations and the amount of their liabilities caused the sale of Seven Fields' assets in a manner that was not in their best interests.[5] Ernst & Young filed a notice of removal with the clerk of the bankruptcy court removing the state case to the Bankruptcy Court for the Western District of Pennsylvania.[6] The bankruptcy court granted Ernst & Young's motion to dismiss the malpractice claims and denied the shareholders' motion to remand the case to state court.[7] The district court affirmed the bankruptcy court's decision and the shareholders appealed, challenging the jurisdiction of the bankruptcy court based on improper removal procedures, lack of subject matter jurisdiction, and failure to abstain from reaching a decision.[8]

B. Legal Analysis

1. Court of Appeals Jurisdiction

The Court of Appeals for the Third Circuit had jurisdiction to decide whether the bankruptcy court had subject matter jurisdiction because courts of appeal must ensure that bankruptcy and district courts do not exceed the authority granted to them by Congress and Article III of the Constitution.[9] However, the court decided it did not have jurisdiction to review the procedural defects relating to removal and the bankruptcy court's failure to abstain.

Relying on the bankruptcy removal statute, 28 U.S.C. § 1452(b),[10] the court found the procedural defects alleged by the shareholders – that Ernst & Young did not seek to reopen the

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[1] *In re Seven Fields*, 505 F.3d at 239-40.
[2] *Id.* at 240.
[3] *Id.*
[4] *Id.* at 240-41.
[5] *Id.* at 241-42.
[6] *Id.* at 242.
[7] *Id.*
[8] *Id.* at 243.
[9] *Id.* at 248.
[10] *Id.* at 245.

bankruptcy case before filing its notice of removal and that Ernst & Young improperly filed the notice of removal directly with the bankruptcy court instead of the district court – were "equitable grounds" for the bankruptcy court's decision not to remand.[11] Under section 1452(b), "the court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground" and any order remanding or not remanding such claim cannot be reviewed by courts of appeal.[12]

Relying on 28 U.S.C. § 1334(d), as amended in 1994, the court found it lacked jurisdiction to review the district court's affirmance of the bankruptcy court decision not to abstain. Such version of the statute provides that any decision to abstain or not to abstain permissively is not reviewable, while the earlier provides that decisions not to abstain permissively are reviewable.[13] Even though the chapter 11 petition in this case was filed in 1986, the court considered the malpractice claim brought in 2004 a separate proceeding, or a sub-action within the case, permitting it to apply the 1994 version of the statute.[14] Section 1334(d) provides that appeals of decisions not to exercise mandatory abstention are permitted.[15] However, under section 1334(c)(2), mandatory abstention applies only to "a proceeding based upon a State law cause of action related to a case under title 11 but not arising under title 11 or arising in a case under title 11."[16] Because the bankruptcy court exercised core jurisdiction, there was no mandatory abstention requirement.[17]

2. Subject Matter Jurisdiction of the Bankruptcy Court

The court held that the bankruptcy court had subject matter jurisdiction because the post-confirmation malpractice claim was a core proceeding. The professional malpractice claim invoked "arising in" jurisdiction because the alleged conduct on which the claim was based occurred during the chapter 11 case and implicated the integrity of the entire bankruptcy process.[18] In addition, section 157(b)(2) specifically provides that core proceedings include "matters concerning the administration of the estate" and "other proceedings affecting the liquidation of the assets of the estate."[19] The court concluded that the type of alleged misconduct by Ernst & Young during the bankruptcy process that was relied upon in confirming the reorganization plan and approving fees satisfied the requirements of "arising in" jurisdiction.[20] The court also noted that there was no need to determine whether the bankruptcy court had non-core jurisdiction in the post-confirmation context when core jurisdiction is satisfied.[21]

The court also clarified that the "close nexus" test for "related to" non-core jurisdiction applies in any claim or cause of action filed post-confirmation, regardless of when the conduct giving rise to the claim or cause of action occurred, resolving a split among courts within the

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[11] *Id.* at 246.
[12] *Id.* at 245. *See* 28 U.S.C. § 1452(b).
[13] *Id.* at 249.
[14] *Id.* at 250.
[15] *Id.* at 249.
[16] *Id.* at 251.
[17] *Id.*
[18] *Id.* at 261-262.
[19] *Id.* at 262.
[20] *Id.* at 262-263.
[21] *Id.* at 263.

circuit.[22] Generally, federal courts have "related to" jurisdiction to hear a proceeding if "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." However, the court formulated the "close nexus" test for the post-confirmation context because a debtor's estate no longer exists after confirmation and could not possibly be affected by a post-confirmation dispute.[23] Under the "close nexus" test, the court asks "whether there is a close nexus to the bankruptcy plan or proceeding sufficient to uphold the bankruptcy court's jurisdiction over the matter."[24] In *Seven Fields*, the court made clear the "close nexus" test should be used to determine jurisdiction in all claims filed post-confirmation.

II. <u>Related Cases</u>

A. <u>In re Southmark Corp., 163 F. 3d 925 (5th Cir. 1999)</u>

1. In contrast with the Third Circuit, the Fifth Circuit held that courts should look to the filing date of the bankruptcy petition to determine which version of § 1334 applies.

2. However, the court reached the same conclusions that professional misconduct arising pre-confirmation that implicates the integrity of the bankruptcy process falls within the "arising in" jurisdiction of the bankruptcy court.

B. <u>In re Pegasus Gold Corp., 394 F.3d 1189 (9th Cir. 2005)</u>

The Ninth Circuit, which adopted the "close nexus" test, applies the test with respect to claims raised post-confirmation involving pre-confirmation conduct.

C. <u>Capitol Hill Group v. Pillsbury Winthrop Shaw Pittman, LLP, No. 07-1936 (RCL), 2008 WL 2690731 (D.D.C. July 2, 2008)</u>

The bankruptcy court had "arising in" jurisdiction over a state law professional malpractice claim where the bankruptcy court had approved retention of the defendant as legal counsel and made the legal fees subject to its approval.

D. <u>In re Nutraquest, Inc., No. 06-1726 (GEB), 2007 WL 3311725 (Bankr. D.N.J. Nov. 5, 2007)</u>

Although the court was asked to interpret a confirmed plan, the claim was rooted in a personal injury action where the conduct arose pre-confirmation, but was filed post-petition. The personal injury claim lacked the same type of impact on the bankruptcy process as the malpractice suit at issue in *Seven Fields* and was not considered a core proceeding.

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[22] *Id.* at 264-65, 263.
[23] *Id.* at 265. *See Resorts Int'l, Inc. Litig. Trust* v. *Price Waterhouse*, 372 F.3d 154, 165 (3d Cir. 2004).
[24] *Id.* at 258 (quoting *Resorts*, 372 F.3d at 166-67).

III. Practice Points

- The Court of Appeals for the Third Circuit will not review decisions involving permissive abstention in proceedings that relate to cases in which the bankruptcy petition was filed before the enactment of the 1994 Amendments to 28 U.S.C. § 1334(d).

- Professional malpractice claims filed post-petition, where the alleged misconduct occurred during the bankruptcy process and implicated the integrity of the bankruptcy process, are core proceedings.

- The "close nexus" test must be applied to all claims filed post-confirmation, regardless of when the conduct giving rise to the claim arose, to determine whether the bankruptcy court has non-core, "related to" jurisdiction.