I. Corporate Governance and Insolvency Regimes

A. Introduction—the Goals of Corporate Governance Law and Bankruptcy

1. Solvent corporations are run by directors for the benefit of stockholders

The term “corporate governance” has multiple definitions and meanings. As used in this portfolio, corporate governance law refers to the law governing the power, rights, authority and responsibilities that those who run a business enterprise (directors, corporate officers and managers) have vis-à-vis those who provide capital to a business enterprise (stockholders, lenders and other creditors).

The corporate governance of insolvent and troubled entities starts with corporate governance law in general. The primary source of corporate governance law is state corporate and alternative business organization law, supplemented by federal securities law and exchange listing rules. State corporation law centers on the relationship between the corporation's stockholders and directors. A creditor's role in the governance of a healthy corporation is limited and largely a matter of contract. Although the corporation is run for the benefit of its stockholders, its directors and officers are responsible for the management of the corporation's affairs. The stockholders' role in governing the corporation is limited to voting on the election of directors and fundamental transactions, such as mergers.

Although it is not without its critics, the main criterion for evaluating the performance of a healthy corporation and its directors is their ability to maximize the long term market value of the corporation for the benefit of its stockholders. As set forth nearly a hundred years ago, in Dodge v. Ford Motor Co.: [A] business corporation is organized and carried on primarily for the profit of the stockholders. The power of the directors is to be employed for that end. The discretion of directors is to be exercised in choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, to the non-distribution of profits among stockholders in order to devote them to other purposes.

As shown by the 1986 Revlon decision and the countless cases that have applied it since, the norm of maximizing stockholder value remains alive and well under Delaware corporation law. Directors of a Delaware corporation do not owe duties to other stakeholders and constituencies—creditors, suppliers, employees, communities in which the corporation does business. Reflecting the primacy of equity, Delaware courts are protective of common stockholders when their rights clash with those of preferred stockholders and creditors.

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1 For ease of discussion, this portfolio will refer for the most part to “corporations“ rather than alternative business entities such as limited partnerships, limited liability companies or business trusts. Where a matter is specifically pertinent to an alternative business entity, the portfolio refers to it specifically.


2. How insolvency impacts corporate governance

Financial distress and insolvency change things. Because the terms “financial distress” and “insolvency” mean different things in different contexts, it is worthwhile to define these terms before talking about how they impact corporate governance.

The term “financial distress” has been used to describe a wide range of problems facing a corporation, from a temporary liquidity crisis to a total collapse of the market for a corporation's business. As used in this portfolio, the term “financial distress” has a more limited usage. A corporation in financial distress has positive cash flow (typically expressed in terms of EBITDA—i.e., “earnings before interest, taxes, depreciation and amortization”) or reasonable prospects for positive cash flow (e.g., a pharmaceutical start-up with years of negative cash flow but FDA approval of its drug on the horizon), but it is carrying too much debt. If liberated from its capital structure, the corporation would have positive value that may be worth preserving for the benefit of the corporation's stakeholders.

A corporation in “economic distress,” by contrast, has negative cash flow and no reasonable prospects for positive cash flow. Any value it has to its stakeholders is diminishing day by day as its cash is consumed without being replenished.

When used to describe an individual or firm, the term “insolvency” is commonly understood as an inability to pay one's debts, often as a result of financial distress. As a legal term of art, the term “insolvent” can mean either that (a) one cannot pay one's debts as they come due (known as “cash-flow insolvency” or “equity insolvency”),

6 or (b) the sum of one's debts exceeds the total value of one's assets (known as “balance-sheet insolvency” or “accounting insolvency”).7 In colonial-era England, “insolvency” laws were designed to help debtors, who could invoke them voluntarily, as distinct from “bankruptcy” laws, which were designed to help creditors round up a debtor's assets and could be invoked only by creditors.8

The best (possibly only) option for a corporation in economic distress may be to liquidate, which can be accomplished in or out of bankruptcy. In contrast, a corporation in financial distress may want to restructure its debts or market its assets (or both), which can also be accomplished in or out of bankruptcy. If a restructuring or sale is not possible, the corporation may have to liquidate, which, depending on the circumstances, could be accomplished on either an orderly basis or a “fire sale” basis, in or out of bankruptcy.

In sum, whatever the business strategy (restructuring, sale or liquidation), both bankruptcy and non-bankruptcy legal options may be available to pursue it. As used in this portfolio, the phrase “insolvency law” will refer broadly to the body of state and federal law governing the creditor-creditor relationship in the context of a debtor's actual or perceived financial distress, regardless of the debtor's “insolvency” and regardless whether the particular law is debtor- or creditor-oriented. The phrase “bankruptcy law,” a subset of “insolvency law,” will refer to the body of federal statutory and procedural law promulgated under the Bankruptcy Clause of the United States Constitution, as interpreted by the courts.

As a corporation becomes insolvent or files for bankruptcy, the general corporate governance principles described above are recast by the reality that stakeholders' interests in the corporation shift, and the distressed corporation may not be able to continue to operate and meet all of its obligations to all its stakeholders. As a corporation nears insolvency, the position and incentives of key stakeholders in the corporation frequently shift, sometimes

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6 See, e.g., Unif. Fraudulent Conveyance Act § 2(1) (1918); see also Unif. Fraudulent Transfer Act § 2(b) (1984) (presuming insolvency where debtor is generally not paying debts as they become due).


8 David A. Skeel, Jr., Debt's Dominion 27 (2001).

9 State insolvency remedies such as dissolution, receivers, arrangements for the benefit of creditors, and foreclosure are discussed in State Law Insolvency and Dissolution Proceedings, § II-I below.

10 U.S. Const. art. I, § 8, cl. 4 (the “Bankruptcy Clause”).
dramatically.

- Equity may find itself out of the money and without means or incentive to use the stockholder franchise to elect the board or approve fundamental transactions. Out-of-the-money equity may favor a riskier and more long-term path for the insolvent corporation than that favored by the corporation's creditors, many of whom may not be looking beyond repayment of what is owed to them.

- Creditors' contractual rights under lending agreements, particularly when secured by liens, may make the creditors the true economic owners of the distressed corporation and the parties with the greatest interest in the corporation's reorganization or liquidation.

- Moreover, there may be conflicts between equity holders or creditors at different levels of priority in the capital structure. Common stockholders may lose control in favor of preferred stockholders as a corporation acknowledges its financial distress. Junior creditors may favor riskier strategies than senior creditors who feel as though repayment of their credit is secure.

- In addition, due to the active market for trading in the debt of distressed companies, there may be conflicts between creditors at the same level of priority in the capital structure who have different cost bases in the debt and, often, different investment horizons. Creditors who buy into their position at a steep discount with a short investment horizon may favor near-term liquidation of the debtor—even at a “fire sale” price—if it would yield them their targeted internal rate of return within the targeted time frame.

Directors and officers may therefore find themselves with conflicting duties to different groups of creditors and stockholders in guiding the corporation back to solvency or through reorganization. Those directors and officers may be facing the specter of liability for the decisions that led to the corporation's distress.

To address these shifting interests, timeframes and realities, insolvency law in general, and federal bankruptcy law in particular, seeks to achieve goals that go well beyond, and in some instances may conflict with, the goal of long term wealth maximization for the benefit of the stockholders.

- First, bankruptcy law seeks to provide a troubled business with a “fresh start.”11 The debtor is trapped in a capital structure that threatens to strangle the business. In the case of reorganization, the business continues with a new capital structure. In the case of liquidation, the debtor's business is no more, but the assets are free, with hope for more productive uses.

- Second, bankruptcy law respects seniority within the debtor’s capital structure. Lienholders are entitled to “adequate protection” of their in rem interests throughout the bankruptcy case, and, absent their consent to the contrary, they must receive the value of their liens, or an “indubitable equivalent,” in any Chapter 11 plan. And the so-called “absolute priority rule” provides that in a Chapter 11 plan, lower classes of creditors and stockholders cannot be paid anything unless higher classes have either been paid in full or consent to their treatment.12

- Third, bankruptcy law seeks to preserve the value of the debtor’s estate.13 The goal is to ensure that the value will be as much as possible to satisfy the claims of the debtor’s creditors, and perhaps even have something left over for its stockholders.


Even though many of the general corporate governance concepts and their application carry through to the governance of an insolvent corporation, or even a corporation that has filed for bankruptcy, those concepts are modified, sometimes dramatically, by bankruptcy law and its aims. The most significant changes reflect the critical role that creditors and the bankruptcy courts play in the corporate governance of a debtor. Creditors have far greater power to affect the governance of the corporation after it has become insolvent or has filed for bankruptcy. Most state corporation law recognizes the standing of a creditor to bring derivative claims once a corporation is insolvent. Federal bankruptcy law adds to the creditors' power by giving it standing to challenge a debtor's actions while reorganizing, the right to vote on a Chapter 11 plan, and representation in the form of a statutory committee of creditors.

Federal bankruptcy law also puts the bankruptcy courts in the center of governance by giving the courts the power to review and approve key decisions concerning the management of the debtor's business. For example, directors remain in charge of managing a bankrupt corporation's business, but any non-ordinary course transaction needs court approval. Stockholders retain the power to elect the debtor's directors, but the bankruptcy court can overturn this right if the election threatens the debtor's reorganization, or if the debtor is insolvent such that the stockholders have no real economic stake in the debtor's governance.

With these sometimes competing corporate governance goals in mind, this portfolio next reviews the fundamental sources of corporate governance law and bankruptcy law.

B. Sources of Corporate Governance Law
The main body of law governing internal affairs of corporations (and alternative business entities such as limited partnerships and limited liability companies) is state law—corporation and business entity codes and case law. However, because securities of public companies are traded on a national market, there is a body of federal law in the form of statutes concerning securities, and regulations promulgated by the Securities and Exchange Commission, that impact corporate governance.

1. Applicable state and federal law

   a. Fiduciary duties

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14 See Reorganizing in Bankruptcy, 109 CPS §IV and Emerging From Bankruptcy, 109 CPS §V, below.

15 See Direction and Management While Reorganizing Under Chapter 11, 109 CPS §IV-A below.

16 See Changing the Debtor's Management During a Reorganization, 109 CPS §IV-B below.

17 E.g., The Delaware General Corporation Law (DGCL), DEL. CODE ANN. tit. 8, §§ 101 to 398; The Delaware Limited Partnership Act, DEL. CODE ANN. tit. 6, §§ 17-101 to 17-1111; The Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, §§ 18-101 to 18-1109; and The Delaware Statutory Trust Act, DEL. CODE ANN. tit. 12, §§ 3801 to 3863. For the sake of simplicity, this portfolio discusses the corporation and business entity law of Delaware. It does so because Delaware has the most extensive case law in this area and has become the “lingua franca” corporate law. Jesse M. Fried et al., Delaware Law as Lingua Franca: Theory and Evidence, Harvard Public Law Working Paper No. 12-38 (Oct. 9, 2012), available at http://ssrn.com/abstract=2117967. There are, of course, other sources of state corporation law, including other states’ corporation codes as well as the Model Business Corporation Act and the ALI Principles of Corporate Governance.

Under Delaware corporation law, a corporation is managed by its directors. Directors may delegate day-to-day management and operation of a corporation, but they may not abdicate their authority and obligation to be the prime decision makers for corporation. The discharge of a director's duties is guided by fiduciary principles that have been developed and explained by judicial decision.

(1) Duty of care
Directors of a corporation are obligated to act with due care and on an informed basis in decision making. In addition, directors must exercise due care in providing oversight when delegating certain aspects of their responsibilities. This portfolio focuses on decision making by the directors of a distressed company (e.g., decisions to sell assets, merger or dissolve) and does not explore in detail how directors discharge their risk monitoring function or obligation to provide general oversight of a company (e.g., developing appropriate policies to insure legal compliance). Gross negligence is the standard in the decision making context. Gross negligence has been held to mean "reckless indifference to or deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason."

Factors showing potential breach of the duty of care issues include: (1) undue haste in decision making, (2) lack of board preparation, (3) lack of questioning or involvement by the board, and (4) lack of care in dealing with documents.

In the decision making context, directors must inform themselves of all material information reasonably available to them before making a business decision; if they do so, they may take advantage of the business judgment rule, which presumes that they performed their duties properly. This duty to inform one's self means that the board must gather relevant material and advice and have sufficient opportunity to consider it before acting. Under § 141(e) of the Delaware General Corporation Law (DGCL), directors are entitled to rely on the “records of the corporation” and on information, opinions, reports, or statements by any other person when the director reasonably believes that

19 Del. Code Ann. tit. 8, §141(a) (“the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors”).


21 Smith v. VanGorkom, 488 A.2d 858, 873 (Del. 1985) (finding that directors had not acted with due care in approving an agreement and merger).


26 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that “to invoke the [business judgment] rule’s protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them”), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000). For more on the business judgment rule, see Business judgment standard, 109 CPS §1-B2, below.
(i) the person has been selected with reasonable care; and (ii) the information, opinions, reports, or statements are within that person’s professional or expert competence. 27 Reports provided by experts or officers must be facially credible.

Significantly, duty of care does not require that the director follow a “best practices” approach. 28 The procedures necessary to satisfy the duty of care often depend on context. 29 In some instances, a board will need to move quickly in response to an emergent situation such as a hostile takeover attempt or a financial crunch. 30 Nor does the duty of care require any particular actions or any “blueprint” or “road map.” 31 The depth of the directors’ knowledge of the affairs of the corporation can affect the duty of care. 32

(2) Duty of loyalty
In managing the corporation, directors are charged with representing the true owners of the corporation, the stockholders, and not using their positions as directors to represent their own interests or other interests that are inconsistent with the best interest of the corporation and its stockholders. 33 Thus, the duty of loyalty prohibits directors from standing on both sides of a transaction or deriving any personal benefit through self-dealing. 34 The duty of loyalty prohibits a director, officer or controlling stockholder from usurping an opportunity that rightfully belongs to the corporation—the so-called “corporate-opportunity doctrine.” 35 Similarly, when a controlling stockholder is on both sides of a transaction with the corporation, and thus may receive a benefit that other directors cannot.

27 DEL. CODE ANN. tit. 8, §141(e); see In re Walt Disney Derivative Litig., 906 A.2d 27, 59–60 (Del. 2006) (holding that members of a board’s compensation committee properly relied on information provided to them by the compensation expert and by other directors).

28 Id. at 58.

29 In re Cogent, Inc. S’holder Litig., 7 A.3d 487, 497, n.22 (Del. Ch. 2010) (citing Paramount Commc’ns v. QVC Network, 637 A.2d 34, 45 (Del. 1994)) (noting that the “reasonableness of the directors’ decision [is] viewed from the point in time during which the directors acted “).

30 Citron v. Fairchild Camera and Instrument Corp., 569 A.2d 53, 67 (Del. 1989) (“We conclude that the time constraints placed on the Fairchild board were not the board’s making and did compromise its deliberative process under VanGorkom. ”).


32 S. Muoio & Co. LLC v. Hallmark Entm’t Invs. Co., No. 4729-CC, 2011 BL 83649, at *16 n.112 (Del. Ch. Mar. 9, 2011) (holding that there was no requirement that a special committee obtain a formal fairness opinion concerning a recapitalization transaction, particularly in light of the strength of the advice it received), aff’d, 35 A.3d 419 (Del. 2011) (table decision).


stockholders will not receive, it implicates a potential breach of duty of loyalty.\textsuperscript{36} For example, when a controlling stockholder seeks to buyout the minority stockholders, a so-called “squeeze-out” transaction, it raises duty of loyalty concerns. The duty of loyalty also prohibits directors from misusing confidential corporate information to benefit themselves or others.\textsuperscript{37}

Conflicts of interest can also arise when a director is not independent or is beholden to the majority stockholder or where a controlling stockholder dominates the board of directors.\textsuperscript{38} “[I]ndependence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”\textsuperscript{39} When a director is controlled by another, these extraneous considerations and influences may exist. Control may exist when a director is so under an interested party’s influence that the director's discretion is “sterilized.”\textsuperscript{40} Control may also occur where a director is in fact dominated by another party and domination can occur through force of will.\textsuperscript{41}

A director's duty to act in good faith is a subsidiary element of the duty of loyalty.\textsuperscript{42} Although the definition of “good faith” remains murky, Delaware courts have provided a framework that they will apply to analyze whether a director's actions are in good faith.

First, “subjective bad faith,” which includes director conduct that is “motivated by an actual intent to do harm” or a “state of mind affirmatively operating with a furtive design or ill will” will not be good faith.\textsuperscript{43} Second, it will be bad faith when the fiduciary intentionally acts with a purpose other than that of advancing the best interest of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.\textsuperscript{44} Under those circumstances, the director would breach the duty of loyalty even absent a conflict of interest. By comparison, even grossly negligent conduct by itself does not rise to the level of bad faith and does not implicate a breach of the duty of loyalty.\textsuperscript{45} Bad faith conduct requires more than “reckless indifference or actions that are without the bounds of reason.” It requires an “intentional dereliction of duty or conscious disregard for one's
The duty of loyalty also imposes a duty of disclosure on the part of directors. Directors have an obligation to disclose information that is material to a transaction submitted for stockholder approval. A director must also refrain from disseminating false information about the corporation. Directors also have an obligation to deal candidly with their fellow directors. This includes a duty to disclose that a director is seeking to divert a corporate opportunity from the corporation.

As discussed in more detail in later chapters, issues implicating the duty of loyalty are common in transactions involving a distressed corporation. Transactions between a corporation and entities in which the corporation's directors have an interest, including lending, capital infusions, recapitalizations, going private transactions and transactions in which the old owners will have an interest in the new corporation, all may raise loyalty issues. Conflict transactions in turn will raise the following issues:

- Has the conflict been disclosed?
- Was the transaction reviewed by disinterested and independent decision makers?
- Was a fair process employed to approve the transaction?

It is important to note that Delaware law does not prohibit conflict transactions. Under § 144, an interested director transaction will not be void or voidable merely because those approving it are conflicted, if it is approved on a fully informed basis, either by majority of the disinterested directors or by stockholders, or if it is fair to the corporation.

(3) Exculpation and good faith
In discharging the duty of care, most boards of directors of Delaware corporations are protected by an exculpatory provision in the corporation's certificate of incorporation pursuant to § 102(b)(7) of the DGCL. The so-called “102(b)(7) provisions ” typically protect directors from claims for damages arising out of breaches of duty of care, including gross negligence. Breaches of the duty of loyalty, acts or omissions not in good faith which involve intentional misconduct or a knowing violation of law, unlawful dividends under § 174 of the DGCL, and any

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48 Id. at 9.


51 See *Sources of Conflict of Interest—Common Scenarios Director and Officer*, § II-C, below.

52 *Del. Code Ann.* tit. 8, § 144.


transaction from which the director derived an impersonal benefit cannot be exculpated under § 102(b)(7).\textsuperscript{55}

(4) Elimination of fiduciary duties in the alternative entity context

Members and managers of LLC’s and general partners of limited partnerships owe default fiduciary duties with the same breadth and force as those owed by directors to corporations.\textsuperscript{56} However, they may contract to eliminate all fiduciary duties.\textsuperscript{57} As a result, the scope and nature of fiduciary duties that managing members, managers, or general partners owe to alternative entities depend on the governing documents (typically the LLC or LP agreement) of the entity. Alternatively, an entity's governing documents may provide for fiduciary duties or standards of review similar to those provided under the corporation law.\textsuperscript{58} This can be true even if the LLC agreement or a limited partnership agreement does not “use magic words, such as ‘entire fairness’ or ‘fiduciary duties[,]’”\textsuperscript{59}

Alternative entities may not, however, eliminate the duty of good faith and fair dealing.\textsuperscript{60} The duty of good faith and fair dealing “requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party from receiving the fruits of the bargain.”\textsuperscript{61}


\textsuperscript{56} Through statutory amendments to the Del. Code Ann. tit. 6, § 18-1104 enacted in 2013 (it was made clear that default fiduciary duties exist unless eliminated. Prior to the statutory changes there was considerable debate in case law about whether default fiduciary duties existed and what needed to be done to eliminate them. See, e.g., Feeley v. NHAOCG, LLC, 62 A.3d 649, 660–63 (Del. Ch. 2012) (citing Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 851 (Del. Ch. 2012) (addressing fiduciary duties of LLC managers)). But see also Gatz Props., LLC v. Auriga Capital Corp., 2012 Del. LEXIS 577, at *29 n.62 (Del. 2012) (stating that the question of whether the statute imposes default fiduciary duties has not been decided by the Delaware Supreme Court).

\textsuperscript{57} Del. Code Ann. tit. 6,§ 18-1101 (“To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement[].”)


\textsuperscript{59} Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1213 (Del. 2012); see also, Brinckerhoff v. Enbridge Energy Co., No. 5526-VCN, 2012 BL 131816, at *2–3 (Del. Ch. May 25, 2012) (noting that court had previously interpreted “language akin to that in Article 6.6(e) [of a joint venture agreement] as requiring something similar, if not equivalent, to entire fairness review, ” even though the words “entire fairness “ were not used, and rejecting defendants' argument on a motion to dismiss that investment banker's opinion satisfied that standard).

\textsuperscript{60} See Del. Code Ann. tit. 6, § 18-1101(c) (“To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”).

\textsuperscript{61} Nemec v. Shrader, 991 A.2d 1120, 1128 (Del. 2010) (quoting Kuroda v. SPIJS Holdings, L.L.C., 971 A.2d 872, 888 (Del. Ch. 2009)).
Nevertheless, the duty of good faith and fair dealing cannot override express contractual terms. Therefore, although the duty cannot be modified or eliminated, parties to an alternative entity's governing documents can modify the effect of the duty through detailed contracting. For example, the Delaware Supreme Court has rejected claims that a corporation breached the duty of good faith and fair dealing by exercising an option to redeem a retiree's stock at time that was advantageous for the corporation and in accordance with the corporation's contractual redemption rights.\(^6\) Where an alternative entity's governing documents “eliminate[] fiduciary duties as part of a detailed contractual governance scheme, Delaware courts [are] more hesitant to resort to the implied covenant “ of good faith and fair dealing.\(^6\)

b. Key state law statutory provisions

Turning back to corporations, as discussed above, § 141 of the DGCL allocates the oversight and management of a corporation to its board. However, it also grants stockholders tools and rights to oversee the board, the most important being the power to vote in director elections and on fundamental transactions.

(1) Board's power to manage

A board's power to manage under § 141 is broad and encompassing. A board is permitted to delegate management of the corporation to officers, but the board remains responsible for overseeing those officers.\(^6\)^4 Sections 151, 152, 153, 157, 161 and 166 of the DGCL “confirm the board's exclusive authority to issue stock and regulate a corporation's capital structure.”\(^6\)^5 Stock purportedly issued without board approval is void.\(^6\)^6 A board can even interfere with prospective stockholders' purchase of stock in the corporation, if doing so is necessary to protect the corporation.\(^6\)

A board cannot contractually jettison its role as the ultimate decision maker; any limitation on the board's authority must be set forth in the corporation's certificate of incorporation.\(^6\)^8 Other limitations on a board's authority are void where they might require the board to act or to not act in breach of the board's fiduciary duties.\(^6\)

Thus, courts have invalidated contractual or bylaw provisions preventing a board from removing a poison pill\(^7\) or considering higher

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\(^6\) Nemec, 991 A.2d at 1128.

\(^6\) Nemec, 991 A.2d at 1128.

\(^6\)^3 Lonergan v. EPE Holdings LLC, 5 A.3d 1008, 1018 (Del. Ch. 2010).


\(^6\) See, e.g., STAAR Surgical Co. v. Waggoner, 588 A.2d 1130, 1136 (Del. 1991).


\(^6\) Quickturn Design Sys. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998).


\(^6\) See Quickturn Design Sys., 721 A.2d at 1291.
offers for corporate control, and courts have said that an employment contract would be invalid if it prevented the board from overseeing a CEO's management. Even stockholders cannot approve bylaws restricting the board's ability to oversee the corporation. Absent a disabling conflict, the board has the authority to pursue or to block the corporation's pursuit of litigation.

(2) Statutory stockholder rights

Although the stockholders do not have the right to manage the corporation, they enjoy important governance rights under the DGCL. Most importantly, stockholders have the power to elect who is on the board. Stockholders have a statutory right to compel an annual meeting for the purpose of electing directors at least once every 13 months, even where the corporation is in bankruptcy or cannot distribute proxy materials. In fact, the Delaware Court of Chancery has noted that it is in circumstances in which the corporation is in the most troubled position that the need to respect the stockholders' right to an annual meeting is the greatest. Under § 141(k), a director or the entire board of directors may be removed, with or without cause, by the holders of the majority of the shares entitled to vote at an election of directors, except when the corporation's certificate of incorporation provides otherwise, as in the case of a classified board, where only a portion of the directors are elected each year (sometimes called a "staggered board").

Stockholders have the power to affect the rules by which the corporation is governed through the power to amend or repeal bylaws and the right to vote on any amendment to the corporation's certificate of incorporation. Stockholder approval is required for certain fundamental transactions, such as mergers (§ 251), a sale of

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71 See Paramount Commc'ns v. QVC Network, 637 A.2d 34, 51 (Del. 1994) (internal citations omitted) (holding that a no-shop provision that purportedly prevented the Paramount board from soliciting or discussing any competing transaction "could not validly define or limit the fiduciary duties of the Paramount directors, " because "[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable. ").


75 See Del. Code Ann. tit. 8, § 211.


77 See Newcastle Partners, L.P. v. Vesta Ins. Grp., Inc., 887 A.2d 975, 982 (Del. Ch. 2005).


79 Del. Code Ann. tit. 8, § 109(a). Although stockholders can, through stockholder enacted bylaws, regulate the process and procedures through which a board acts, they may not enact bylaws that mandate how a board should decide specific substantive business decisions.


substantially all of the corporation's assets (§ 271), or dissolution (§ 275). But these actions must first be initiated by the board.

Stockholders also enjoy significant, albeit limited, information rights. Section 220 of the DGCL entitles every stockholder to demand that a corporation produce books and records for any purpose reasonably related to the stockholder's stock ownership. The stockholder is entitled to receive the stock ledger upon showing either a record or beneficial stockholding. A stockholder can obtain other books and records upon showing that the books and records are essential to a proper purpose, such as organizing a proxy contest, selling stock or investigating potential wrongdoing by corporate fiduciaries. The scope of a books and records request is narrower than discovery in litigation: “courts [] circumscribe orders granting inspection `with rifled precision.'” However, stockholders can use a books and records action to gather information necessary to bring a complaint, and a decision has held this may include the right to receive email, including a CEO's emails sent on the CEO's personal account if they are “necessary and essential “ to the investigation. Moreover, when a board seeks stockholder action, such as a vote on a fundamental transaction or to amend the certificate of incorporation, it triggers an obligation to disclose information material to the stockholders' decision.

Stockholders of a corporation have the right and standing to pursue derivative litigation on behalf of a corporation where “the stockholder has demanded that the directors pursue the corporate claim and they have wrongfully refused to do so or where demand is excused because the directors are incapable of making an impartial decision regarding such litigation.”

2. Standards of review of a board's decisions

Delaware courts are loathe to second guess a board's business judgment unless there is a good reason to do so—usually a structural or actual conflict of interest or other apparent procedural defect in the board's decision making process. This balance of deference to management and willingness to review is shown by three levels of scrutiny Delaware courts apply when reviewing a challenge to a board's decisions. “Absent a showing of personal

82 DEL. CODE ANN. tit. 8, § 271.
83 DEL. CODE ANN. tit. 8, § 275.
86 Id. (quoting Security First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 570 (Del. 1997)).
87 Amalgamated Bank, et al. v. Yahoo! Inc., C.A. No. 10774-VCL, *59-60 (Del. Ch. Feb. 2, 2016). The Court of Chancery's order that emails that Yahoo's CEO sent on her personal account be produced was stayed while Yahoo appealed the decision. While on appeal, the action was dismissed pursuant to agreement of the parties. As a result, the Delaware Supreme Court has yet to speak on the issue of whether records under § 220 may include emails sent though an officer's or director's personal account.
88 Stroud v. Grace, 606 A.2d 75, 84 (Del. 1992) (the board has a duty of disclosure, which requires it “to disclose fully and fairly all material information within the board's control when it seeks shareholder action.”)
89 Lambrecht v. O'Neal, 3 A.3d 277, 282 (Del. 2010).
financial interest, a board of directors is presumed to act in accordance with their fiduciary duties to the corporation. Where that presumption applies, a court reviewing the challenged conduct will apply the deferential business judgment rule. In contrast, if a personal financial interest is shown, the exacting entire fairness standard applies. Courts apply intermediate scrutiny to the sale of control of the corporation, actions to interfere with control of the corporation, or actions to interfere with the stockholder franchise, because these decisions implicate control of the corporation rather than the business of the corporation.

a. Business judgment standard

“‘The business judgment standard . . . is `a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.’” 91 When reviewing a board's decision under the business judgment standard, “a court will not substitute its judgment for that of the board if the … decision can be attributed to any rational business purpose.”

A court reviewing a board decision applies the business judgment standard unless the plaintiff can show either that a majority of the board was interested in the transaction or that the decision falls into one of the categories triggering intermediate scrutiny. A director appearing on both sides of the transaction or expecting to receive some personal benefit from it other than a benefit which devolves upon the corporation or the stockholders generally is interested in the transaction. 94 Typically, a determination that the business judgment standard applies to a transaction entitles director defendants to dismissal of any claims alleging breaches of the duty of care and seeking monetary damages.

b. Entire fairness

The entire fairness standard has two components: fair dealing and fair price. 96 “These prongs are not independent and the Court does not focus on each of them individually. Rather, the Court `determines entire fairness based on all aspects of the entire transaction,'” 97 “Fair dealing involves `questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.'” 98 “Fair price involves questions of `the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other


93 Id. at 706 (modification in original) (quoting Unocal v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).


97 Id. at *11 (quoting Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 746 (Del. Ch. 2007)).

98 Id. at *11 (quoting Emerald Partners v. Berlin, 787 A.2d 85, 97 (Del. 2001)).
elements that affect the intrinsic or inherent value of a corporation's stock. ’’

The entire fairness standard applies where either a majority of the board is interested in a transaction or where a corporation's controlling stockholder stands on the other side of the transaction. Where entire fairness review applies, director defendants generally cannot obtain dismissal on the pleadings because “by definition, the inherently interested nature of those transactions is inextricably intertwined with issues of loyalty.”

Once the plaintiff has demonstrated that a transaction is subject to entire fairness review, the defendants initially bear the burden of proving entire fairness. But, by putting certain procedural protections in place the burden will return to the plaintiffs to demonstrate that the transaction was not entirely fair or the standard will return to business judgment depending on whether the transaction involved an interested board or a controlling stockholder. In the case of transactions involving an interested or non-independent director, if the defendants demonstrate that the transaction was approved by a duly formed and properly empowered and functioning independent special committee or conditioned on a correctly formulated majority of the minority provision, the burden will return to the plaintiffs to demonstrate that the transaction was not entirely fair or the standard will return to business judgment.

\[\text{In controller buyouts, the business judgment standard of review will be applied if and only if: }\]
\(\text{(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.}\]

\[\text{Intermediate standards of review arising in connection with fundamental transactions}\]

The remaining level of scrutiny, intermediate scrutiny, is a set of three somewhat different standards. Intermediate scrutiny is more searching than the business judgment standard, but less exacting than entire fairness review. Generally speaking, each form of intermediate scrutiny requires the directors to “bear the burden of persuasion to show that their motivations were proper and not selfish “ and that “their actions were reasonable in relation to their legitimate objective. “The three typical circumstances in which intermediate scrutiny applies are a sale of the

\[\text{99 Id.}\]

\[\text{100 See Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994).}\]

\[\text{101 Emerald Partners, 787 A.2d at 93.}\]

\[\text{102 Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 460 (Del. Ch. 2011).}\]

\[\text{103 See e.g., Puma v. Marriott, 283 A.2d 693, 696 (Del.Ch.1971) ( “[S]ince the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uninformed opinion for that of the experienced, independent board members.... ”); Solomon v. Armstrong, 747 A.2d 1098, 1115 (Del. Ch. 1999), aff’d, 746 A.2d 277 (Del. 2000) (“Thus, in a classic self-dealing transaction the effect of a fully-informed shareholder vote in favor of that particular transaction is to maintain the business judgment rule’s presumptions.”); DEL. CODE ANN. tit. 8, § 144(a)(2) (providing statutory safe harbor for transactions involving interested directors).}\]


\[\text{105 Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 810 (Del. Ch. 2007).}\]
corporation, defensive action by the board, or action interfering with the stockholder franchise. Each of the intermediate standards of review is named for the case which first articulated it.

(1) Revlon principles applicable to a change in control
Revlon, Inc. v. MacAndrew's & Forbes Holdings, Inc. articulated the principle that where a sale of control of a corporation is inevitable, “[t]he duty of the board . . . change[s] from the preservation of [the corporation] as a corporate entity to the maximization of the corporation's value at a sale for the stockholders' benefit.”106 Revlon scrutiny has two key elements.

Revlon emphasizes that the board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise. “107 Although Revlon directs the board to maximize the ultimate payment to stockholders, a board can take into account varying non-financial elements of offers, such as certainty of closing, consistent with its obligations under Revlon.108 A company selling itself in a change of control transaction is not required to shop itself to fulfill its duty to seek the highest immediate value. As the Delaware Supreme court explained:

“… Revlon and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties, and an independent board is entitled to use its business judgment to decide to enter into a strategic transaction that promises great benefit, even when it creates certain risks. When a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal, we cannot conclude that the board likely violated its Revlon duties.”109

Under Revlon, courts apply “a heightened standard of reasonableness review, rather than the laxer standard of rationality review applicable under the business judgment rule. In practical terms, this meant that this court has more room to intervene than in a business judgment rule case and could, if it determined that the directors had acted unreasonably, issue an appropriate remedy. “110 Revlon scrutiny does not entail a court second guessing reasonable, but debatable, tactical choices made in good faith. Instead, it focuses on preventing a board from pursuing “a selfish or idiosyncratic desire by the board to tilt the playing field towards a particular bidder for reasons unrelated to the stockholders' ability to get top dollar.”111

(2) Unocal/Unitrin principles applicable to defensive measures
Under UnocalCorp. v. Mesa Petroleum Co., where a corporation's board of directors employs defensive measures in response to a perceived threat to corporate policy and effectiveness which touches on issues of control, the court, before applying the business judgment rule, must determine that (1) the directors had a reasonable basis for believing that a threat to corporate policy and effectiveness existed, and (2) the defensive measures adopted were a proportionate response to that threat.112 A defensive measure is per se not proportional if it is either preclusive, in


107 Malpiede v. Townson, 780 A.2d 1075, 1083 (Del. 2001).

108 In re Cogent, Inc. S’holder Litig., 7 A.3d 487, 500 (Del. Ch. 2010).


111 Id. at 100–1001.

that it makes “‘makes a bidder’s ability to wage a successful proxy contest and gain control either mathematically impossible or realistically unattainable,’ “or coercive, in that it is “‘aimed at cramming down on its shareholders a management-sponsored alternative.’ “ Enhanced scrutiny under the Unocal standard applies to defensive actions because “when a board implements anti-takeover measures there arises the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . . . ‘”

(3) Blasius standard applicable to interference with the stockholder vote

Blasius Indus. v. Atlas Corp. established the rule that where a corporate board acts for “the primary purpose of impeding the exercise of stockholder voting power . . . the board bears the heavy burden of demonstrating a compelling justification for such action.” The Court explained that:

A board’s decision to [interfere with stockholder voting] does not involve the exercise of the corporation’s power over its property, or with respect to its rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation. . . . Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal.

Even “the incumbent board of directors’ good faith beliefs [are] not a proper basis for interfering with the stockholder franchise in a contested election for successor directors.” Rather, in order to survive Blasius scrutiny, the directors must demonstrate a compelling justification for their interference.

3. Creditors’ governance rights are limited and contractual

Outside of bankruptcy, where stockholders have statutory governance rights and are owed fiduciary duties, creditors have only contractual governance rights and are owed only contractual obligations. The limited exception to this principal is that the creditors of an insolvent corporation are granted standing to enforce the fiduciary duties that the directors owe to the corporation. Even where a corporation is insolvent, its directors’ duties remain to the corporation and its stockholders.

C. Federal Securities Laws Impacting Governance

Corporate governance is also shaped by an extensive and complex regulatory regime under the U.S. federal securities laws. Federal securities laws require specific periodic disclosures from the board to stockholders. The traditional focus of federal securities laws and regulation has been a disclosure by a corporation to its stockholders.

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116 Id. at 659–660.


119 See discussion in Directors Duties in the 'Zone of Insolvency' and Insolvency, 109 CPS §II-B, below.
of information, particularly financial information, relevant to trading of securities. Periodic reports include annual report 10-K and quarterly report 10-Q.

The federal securities laws also require disclosure to stockholders in connection with specific transactions or events. Before it can hold a stockholder vote on director elections or a fundamental transaction, the corporation will need to make disclosure to its stockholders so the vote can be informed. Under § 14(a) of the Exchange Act and Regulation 14A, a corporation is required to file an annual proxy statement providing stockholders with information regarding matters to be voted on at the corporation's annual stockholder's meeting, solicit proxies of stockholders to make voting at the meeting more convenient, and provide information about a corporation's corporate governance and compensation policies in related matters. The annual proxy requires significant disclosure concerning the make-up of the board of directors and leadership, and executive compensation. Similarly, a corporation seeking a stockholder vote on a fundamental transaction or an acquirer making an exchange or tender offer must provide disclosure. In addition to annual and quarterly disclosure required under § 13(a)(2) of the Exchange Act, companies must file a current report on Form 8-K to disclose the occurrence of certain events affecting its financial condition, the trading of its securities, matters related to its accountant's financial statements, changes in control, departures of directors or certain officers, and amendments to the corporation's organizational documents, as well as other disclosures.

Large stockholders who seek to influence the management of a corporation or acquire a large stake in it are required to make disclosures. Sections 13(d) and (g) of the Exchange Act also require management and large stockholders in a corporation to report changes in their ownership or trading in the corporation's securities. Specifically, beneficial owners of greater than 5 percent of a public corporation's registered equity securities are subject to ownership reporting obligations under § 13. These reporting obligations were adopted to alert the public corporation and the market place in general to large, rapid accumulations of registered equity securities which could represent a potential change in corporate control.

Public corporation's directors, executive officers, and greater than 10 percent beneficial stockholders are also subject to ownership reporting obligations and trading restrictions under § 16 of the Exchange Act. Section 16 is designed to deter corporate insiders from trading on material nonpublic information for their personal gain. Under §

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120 The reporting requirements often have effects beyond disclosure. For example, the SEC's requirements that companies make disclosures about conflict minerals, executive compensation, or environmental policies may also serve to dissuade companies from using conflict minerals, awarding excessive executive compensation, or pursuing environmental policies that are unpopular. In this sense, the disclosure has an effect on substantive corporate policy as well.


122 See 17 C.F.R. §§ 240.14a-1 through 14a-21 (Regulation 14A, Solicitation of proxies) and 17 C.F.R. §240.14a-101 (Schedule 14A, Information required in proxy statement).

123 15 U.S.C. § 78n(a); 17 C.F.R. §§ 240.14a-3 (Information to be furnished to security holders); 17 C.F.R. §§ 240.14a-4 (Requirements as to proxy).

124 15 U.S.C. § 78n(d) and (e).


126 17 C.F.R. § 240.13a-11 (Current reports on Form 8-K); 17 C.F.R. § 249.308.

16, insiders are required to publicly report their ownership of and transactions involving the corporation's equity securities. Moreover, insiders are subject to strict liability for profits realized from short-sale trades in the corporation's equities securities and are prohibited from selling those securities short.

D. Sources of Bankruptcy Law
When a corporation files for bankruptcy, the requirements of state corporation law and federal securities law continue, except to the extent they are specifically displaced by the Bankruptcy Code. Those requirements are joined by additional requirements under federal bankruptcy law. To the extent that state corporation law conflicts with bankruptcy law, bankruptcy law controls. The key alterations that bankruptcy law introduces to the corporate governance equation are (i) expanded creditor standing to challenge the decision making process of the bankrupt business, and (ii) judicial review of any non-ordinary course decisions.

1. Federal bankruptcy law
Among the enumerated powers of the federal government in Article I of the United States Constitution is the power of Congress to “establish . . . uniform laws on the subject of Bankruptcies throughout the United States.” In the more than 200 years since the initial ratification of the Constitution, bankruptcy law had several iterations, the most notable precursor being the Bankruptcy Act of 1898, still referred to by bankruptcy practitioners as the “Act.” The bankruptcy law we know today is a product of the Bankruptcy Reform Act of 1978 (known in bankruptcy circles simply as “the Code”). The Code made significant changes from the Act that directly impact the corporate governance of a bankrupt corporation. Specifically, the Code brought bankruptcy under judicial administration (eliminating the “referee” position and creating bankruptcy courts), eliminated mandatory trustee appointment for public companies, and significantly diminished the SEC’s role in the bankruptcy process. While the Code has entirely supplanted the Act as a matter of statutory law, the Supreme Court has noted that “[w]hen Congress amends the bankruptcy laws, it does not write on a clean slate,” and thus, pre-Code practice can be pertinent to interpretation of the Code. As a result, decisional law under the Act retains some vitality in modern bankruptcy practice.

Under the Code, some form of bankruptcy relief is generally available to any “person,” other than an insurance corporation or bank, that “has a domicile, a place of business, or property in the United States.”

128 See U.S. CONST. art. VI, cl. 2 (federal statutes within Congress’s enumerated powers are “the supreme law of the land”); accord DEL. CODE ANN. tit. 8, § 303(a) (stating: “(a) Any corporation of this State, an order for relief with respect to which has been entered pursuant to the Federal Bankruptcy Code, 11 U.S.C. § 101 et seq., or any successor statute, may put into effect and carry out any decrees and orders of the court or judge in such bankruptcy proceeding and may take any corporate action provided or directed by such decrees and orders, without further action by its directors or stockholders. Such power and authority may be exercised, and such corporate action may be taken, as may be directed by such decrees or orders, by the trustee or trustees of such corporation appointed or elected in the bankruptcy proceeding (or a majority thereof), or if none be appointed or elected and acting, by designated officers of the corporation, or by a representative appointed by the court or judge, with like effect as if exercised and taken by unanimous action of the directors and stockholders of the corporation”).

129 U.S. CONST. art. I, § 8, cl. 4.


133 See 11 U.S.C. § 109(a), (b) and (d). The Bankruptcy Code also provides relief for municipalities in certain circumstances. 11 U.S.C. § 109(c).
term of art that expressly encompasses “individual, partnership, and corporation,” but it is also generally understood to encompass limited liability companies. Relief is automatic upon the filing of a voluntary petition, and insolvency is not required.

2. Bankruptcy—liquidations and reorganizations
A corporation has two basic options in bankruptcy: liquidation under Chapter 7 of the Code, or a proceeding to liquidate or reorganize under Chapter 11 of the Code. While Chapter 11 proceedings are often referred to as “reorganization” proceedings, as discussed below, reorganization is but one possible outcome of a Chapter 11 proceeding.

a. Chapter 7 liquidation
Corporate governance is very simple in a Chapter 7 proceeding. Upon filing, the debtor's board of directors is divested of power to manage the debtor's business and assets. A trustee is appointed (or elected by creditors, if creditors holding at least 20 percent of the unsecured claims against the debtor request an election) to collect the debtor's assets, liquidate them, and distribute the proceeds to creditors in accordance with the Code's distribution and priority scheme. The trustee is charged with investigating the debtor's financial affairs, and is vested with the power to “avoid” certain pre-bankruptcy property transfers and unperfected liens, and recover the transferred property (or money's worth) for the benefit of the bankruptcy estate. It is presumed that the debtor's business will cease, but the bankruptcy court can authorize the trustee to operate the debtor's business for a limited time period. The debtor continues to exist as a legal entity during and after the Chapter 7 case (unless dissolved under applicable non-bankruptcy law) but does not receive a discharge from its indebtedness or retain any assets (save for whatever assets may have been abandoned by the trustee during the bankruptcy case).

b. Chapter 11 “reorganization”
By contrast, corporate governance in a Chapter 11 proceeding is complex. In a Chapter 11 proceeding, the debtor acts as the legal representative of its bankruptcy estate (a “debtor in possession”) and is vested with most the rights and powers of a Chapter 7 trustee, including the avoidance powers. It is presumed that the debtor's business will


135 11 U.S.C. § 301(b).

136 Compare 11 U.S.C. § 109(c)(3) (requiring a municipality to be insolvent as a precondition to being a debtor under chapter 9 of the Bankruptcy Code), with 11 U.S.C. § 109(b) and (d) (including no such requirement for Chapter 7 or Chapter 11 relief).

137 In addition to Chapter 7 and Chapter 11 proceedings, equity and regulatory receiverships are remedies available under federal law. They are discussed in Planning for and Deciding to File for Bankruptcy, 109 CPS §III below.

138 11 U.S.C. §§ 701(a)(1), 702(b), 704(a)(1) and 726.


141 11 U.S.C. §§ 1101(1) and 1107.
continue to be operated by its management, but the bankruptcy court can order otherwise on request by a party in interest. The debtor’s board of directors remains in control of managing the debtor’s business and assets. Significantly, stockholders retain their rights under state corporation law to elect and remove directors during the pendency of the bankruptcy. The debtor must be managed for the benefit of the estate and its various creditors.

Although all non-ordinary course decisions of debtor’s board and officers are subject to review by the bankruptcy court, many bankruptcy court decisions purport to apply a “business judgment” standard that mirrors (practically if not literally) the business judgment rule. As discussed below in § IV, in reviewing a debtor’s decision to borrow, enter into a stalking horse asset purchase agreement, sell its assets, assume or reject a contract or lease, or enter into a settlement of litigation, bankruptcy courts will make findings about a decision’s “fairness” or “reasonableness,” yet at the same time refer to the debtor’s “business judgment.” For corporation law purists this may seem like a bit of misnomer. In corporation law, the business judgment rule reflects a policy of judicial abstention from reviewing a board’s decision for reasonableness or fairness. In truth, the term “business judgment” is applied with different effects and consequences in corporation law cases than in bankruptcy cases. Regardless of the context, the invocation of the business judgment rule usually reflects a judge’s recognition that a judge is not an expert businessperson and should defer, to one degree or another, to the decision-making process of the directors charged with managing the corporation.

Assuming there is sufficient interest among the creditor body, an official committee of unsecured creditors is appointed. The committee is authorized to consult with the debtor concerning the administration of the case and the formulation of a Chapter 11 plan, to investigate the debtor’s financial affairs or any other matter pertinent to the case, and to “perform such other services as are in the interest of “unsecured creditors.” The debtor and the committee are authorized to retain counsel and other professionals in connection with the Chapter 11 case, and the debtor is authorized to retain professionals to assist in the operation of its business, which professionals are compensated by the bankruptcy estate, on a priority basis, as expenses of administration. In certain circumstances additional committees, including an official committee of equity holders, may be appointed.

Chapter 11 is not intended to go on forever. The ultimate goal of a Chapter 11 proceeding is confirmation of a Chapter 11 plan for the debtor that classifies and specifies the treatment of claims against and equity interests in the debtor. Subject to certain exceptions, confirmation of a plan discharges the debtor from any debts that arose prior to confirmation, in exchange for the treatment provided to such debts in the plan. A confirmed plan is binding on the


143 In extreme cases (involving, e.g., gross mismanagement or fraud), the bankruptcy court may appoint a Chapter 11 trustee, who displaces existing management and takes charge of day-to-day control of the debtor's affairs. See Removal of board through appointment of a trustee, 109 CPS §IV-B3, below.


145 See More opportunities for judicial review and less deference to management, 109 CPS §IV-A1, below.


147 11 U.S.C. §§ 1102(a)(1) and 1103(c).

148 11 U.S.C. §§ 327(a), (b) and (e), 330(a)(1), 503(b)(2) and 507(a)(2).

149 See More parties have standing to challenge management's decisions, 109 CPS §IV-A2, below.

debtor and all creditors, regardless whether such creditors voted in favor of the plan. While a Chapter 11 plan may provide for the reorganization of the debtor and continuation of the debtor's post-petition, it is not required to. For instance, a plan could provide for the merger or consolidation of the debtor into another entity, the sale of the debtor's assets, or, where the debtor's assets have already been sold prior to confirmation of the plan, the transfer of the sale proceeds and any remaining assets to a liquidating trust. However, in a liquidating plan, the debtor will not receive a discharge of its indebtedness.

The debtor and its board have significant control rights over the reorganization process. The debtor has the exclusive right to file a plan for the first 120 days of a Chapter 11 case (subject to extension to a total of 18 months), and the exclusive right to solicit acceptances of a plan for the first 180 days of a Chapter 11 case (subject to extension to a total of 20 months). If the debtor's exclusivity period expires (or is terminated by the bankruptcy court on request of a party in interest), any party in interest to the Chapter 11 case can file a Chapter 11 plan. The plan proponent prepares and disseminates a disclosure statement with respect to its plan, which must contain "adequate information" (as determined by the bankruptcy court) to permit creditors to vote intelligently on the plan.

The creditors and equity holders vote on whether to confirm the plan, subject to court approval. In general, a plan will be confirmed if (i) it is accepted by at least one class of creditors whose rights are altered by the plan; (ii) the bankruptcy court finds it is feasible, in that the debtor will not need further financial restructuring after confirmation of the plan; (iii) with respect to any dissenting creditor, the plan provides no worse of a recovery than the creditor would receive in a Chapter 7 liquidation of the debtor; and (iv) the plan "does not discriminate unfairly, and is fair and equitable, " with respect to any non-accepting class of creditors. The "fair and equitable " requirement, also known as the "cram down " standard, is different for secured and unsecured claims, and is discussed further below in Chapter V.

3. Jurisdiction and power of federal courts in bankruptcy
The bankruptcy court's role in the debtor's governance while in reorganization is pervasive and potent. This potency reflects the breadth and exclusivity of the bankruptcy court's jurisdiction, the power of the automatic stay, and the breadth of a bankruptcy court's injunctive powers.

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152 See 11 U.S.C. § 1123(a)(5)(B), (C) and (D).


154 11 U.S.C. § 1121(b), (c)(3) and (d)(2).

155 11 U.S.C. § 1121(c) and (d).

156 11 U.S.C. § 1125(a)(1) and (b).

157 11 U.S.C. § 1129(a)(7), (8) and (b)(1). “Acceptance “ by a class of claims means that creditors holding more than one half in number and two thirds in amount of the claims voting in that class have accepted the plan. 11 U.S.C. § 1126(c).

158 See Section 1129 cram-down, 109 CPS §V-C1f(2), below.
a. Bankruptcy court jurisdiction

Federal district courts have both “original and exclusive jurisdiction of all [bankruptcy] cases,” and “original but not exclusive jurisdiction of all civil proceedings arising under [the Code], or arising in or related to cases under [the Code].”\(^{159}\) This jurisdiction is very broad, as it is generally accepted that a civil proceeding is “related to” a bankruptcy case if “the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy.”\(^{160}\) The federal district court in which a bankruptcy case is pending also has “exclusive jurisdiction . . . of all of the property, wherever located, of the debtor as of the commencement of such case, and of property of the estate,”\(^{161}\) and can exercise personal jurisdiction over any party having constitutional “minimum contacts” with the U.S.\(^{162}\) All of the foregoing jurisdiction is referred to herein as “federal bankruptcy jurisdiction.”

28 U.S.C. § 157(a) permits each federal district court to “refer” all bankruptcy cases and civil proceedings over which it has federal bankruptcy jurisdiction to the bankruptcy court for the district. Every district court has done so, by means of a standing order of reference that automatically directs the referred matters to the clerk for the bankruptcy court. On motion by a party in interest, the district court may withdrawn the reference of a particular proceeding to the bankruptcy court. And as with any order of the district court, the reference order may be withdrawn entirely or otherwise modified. 28 U.S.C. § 157(b) provides that a bankruptcy court may hear and determine all “core proceedings arising under [the Code], or arising in a case under [the Code], “ that are referred to it by the district court, subject to appellate review by the district court. The bankruptcy court can also hear non-core “proceedings referred to it by the district court (i.e., proceedings “related to” a bankruptcy case, but not “arising under” the Code or “arising in” a bankruptcy case). But with respect to non-core proceedings, the bankruptcy court can only submit proposed findings of fact and conclusions of law to the district court, which are subject to review de novo as to any matters that are the subject of a timely and specific objection. 28 U.S.C. § 157(b)(2) provides a non-exhaustive list of proceedings considered by Congress to be “core” and subject to final determination by the bankruptcy courts.\(^{163}\)

b. The automatic stay

Commencement of a bankruptcy case creates an estate consisting of all legal and equitable interests of the debtor in property, “wherever located and by whomever held.”\(^{164}\) Subject to certain exceptions, the petition commencing the bankruptcy case “operates as a stay, applicable to all entities, “ of any action or proceeding against the debtor to

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\(^{159}\) 28 U.S.C. § 1334(a) & (b); Stern v. Marshall, 131 S. Ct. 2594, 2603 (2011).

\(^{160}\) Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984) (emphasis added); In re G. S. F. Corp., 938 F.2d 1467, 1475 (1st Cir. 1991); In re Gardner, 913 F.2d 1515, 1518 (10th Cir. 1990); In re Lemco Gypsum, Inc., 910 F.2d 784, 788 & n.19 (11th Cir. 1990); Robinson v. Michigan Consol. Gas Co., 918 F.2d 579, 583–584 (6th Cir. 1990); In re Fietz, 852 F.2d 455, 457 (9th Cir. 1988); In re Dogpatch U.S.A., Inc., 810 F.2d 782, 786 (8th Cir. 1987); In re Wood, 825 F.2d 90, 93 (5th 1987); A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1002, n. 11 (4th Cir. 1986), cert. denied, 479 U.S. 876 (1986). But see In re Turner, 724 F.2d 338, 341 (2d Cir. 1983) (applies “conceivability “ portion of Pacor without further discussion); In re Xonics, Inc., 813 F.2d 127, 131 (7th Cir. 1987) (holding that a dispute is “related to “ the bankruptcy if it “affects the amount of property available for distribution or the allocation of property among creditors,” but citing Pacor among others).

\(^{161}\) 28 U.S.C. § 1334(e).


recover a prepetition claim, to obtain or exercise control over property of the estate, or to create or perfect a lien in property of the estate, among other things. This “automatic stay” operates as an injunction. Thus, acts taken in violation of the stay are void and without legal effect. And willful violations of the stay are punishable as contempt of the bankruptcy court.

The automatic stay is one of the most fundamental debtor and creditor protections in the Code. It protects the debtor from the collection efforts of its creditors, providing a “breathing spell” from the financial pressures that drove it into bankruptcy. And it protects creditors from each other, preventing the “race to the courthouse” that would ensue in the absence of the stay and reward the most diligent creditors with disproportionate shares of the debtor’s assets.

c. Equitable and injunctive powers
The bankruptcy court is a court of equity, and may “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Code],” including preliminary and permanent injunctive relief. Thus, for example, bankruptcy courts have used their equitable and injunctive powers (i) to extend the coverage of the automatic stay to non-debtor affiliates, officers, or directors, during the pendency of the Chapter 11 case; (ii) to release claims against non-debtor third parties whose contributions to the Chapter 11 plan are essential to the debtor’s reorganization; and (iii) to prohibit trading in the equity of, or claims against, a debtor so as to prevent a change of control that might vitiates the debtor’s ability to carry forward deductions for net operating losses to future tax years.


166 See Kalb v. Feurstein, 308 U.S. 433 (1940) (holding that state court judgment in violation of Act’s stay provisions was void and subject to collateral attack); see also, e.g., In re Soares, 107 F.3d 969, 976 (1st Cir. 1997) (actions taken in violation of automatic stay are void); In re Siciliano, 13 F.3d 748, 750 (3d Cir. 1994) (same); In re Schwartz, 954 F.2d 569, 571 (9th Cir. 1992) (same); 48th St. Steakhouse, Inc. v. Rockefeller Group, Inc. (In re 48th St. Steakhouse, Inc.), 835 F.2d 427, 431 (2d Cir. 1987) (same), cert. denied, 485 U.S. 1035, (1988).

167 Jove Engineering, Inc v. IRS, 92 F.3d 1539, 1555–57 (11th Cir. 1996).


E. How to Use this Portfolio
With this general framework of state corporation law, federal securities laws, and federal bankruptcy law in mind, we move on to the four main parts of this portfolio. Chapter II will examine the corporate governance issues that arise as a corporation heads towards financial distress or insolvency. Chapter III reviews corporate governance issues that arise when planning for and deciding to file for bankruptcy. Chapter IV reviews corporate governance issues while a corporation is in bankruptcy. Chapter V reviews corporate governance issues when a corporation emerges from bankruptcy.