Young Conaway Stargatt & Taylor, LLP

DELAWARE TRANSACTIONAL & CORPORATE LAW Update

SPRING 2006

IN THIS ISSUE

DISSOLUTION AND DISTRIBUTION PLANS

by James P. Hughes, Jr.

When a Delaware corporation dissolves, practitioners face two choices in advising their clients: adopt a distribution plan with minimal notice requirements, or follow a more complicated statutory scheme that requires greater notice but also offers greater protection for directors. Our firm's experience in two matters, *Molecular Staging* and *Holographix*, suggests that the more complicated procedure is less daunting than the statutory provisions might suggest.

A dissolved company's choices are set forth in Subchapter X of the Delaware General Corporation Law, the section of the corporate code that concerns sale of assets, dissolution and winding up. Section 278 of the code establishes a period of at least three years after dissolution during which a corporation is deemed to be "continued." During the three-year period, a dissolved corporation's directors can elect to follow procedures set forth in § 280 and § 281(a) of the code, or § 281(b) of the code.

(Continued on p. 2)

DELAWARE ATTORNEY POWELL JOINS ELITE COMPANY IN COMMERCIAL FINANCE LAW

Norman M. Powell, a partner in the Business Planning, Transactions and Restructuring Section of Young Conaway Stargatt & Taylor, LLP, has become only the second Delaware attorney inducted as a Fellow in the American College of Commercial Finance Lawyers (ACCFL), joining previous inductee, the Honorable Thomas L. Ambro (circuit judge, United States Court of Appeals for the Third Circuit).

Norman M. Powell

Powell was inducted into the College in a special ceremony in Tampa, Florida on Saturday, April 8, 2006, during the ACCFL annual meeting. Election to the College is limited to commercial finance lawyers, jurists and academics who have not only achieved preeminence in the field of commercial finance law, but who also have contributed significantly to the education of others in commercial finance law through teaching, lecturing or published writings.

(Continued on p. 3)

Dissolution and Distribution Plans
(continued from page 1)

Section 281(b), often described as the default provision, governs every corporate dissolution that does not pursue the procedures under §§ 280 and 281(a). Section 281(b) requires a distribution plan to be adopted, but there is no notice requirement. For a small, dissolved company where directors are certain that there are no remaining claims, a § 281(b) procedure may be attractive, particularly as the distribution plan adopted by the directors or receiver can be simple. For example, some dissolved corporations will adopt a plan of dissolution pursuant to § 281(b) that provides as follows:

> RESOLVED, that if for any reason, this corporation does not follow the procedures described in § 280 for the payment and distribution to claimants and stockholders, then and in that event, this corporation hereby adopts a plan of distribution, in accordance with § 281(b) of the Delaware General Corporation Law (the "Section 281(b) Plan"), which Section 281(b) Plan shall be as follows:
>
> 1. The categories of claims set out in § 281(b) shall be paid in full if there are sufficient assets; and
>
> 2. If there are insufficient assets, such claims and obligations shall be paid or provided for according to their priority and, among claims of equity priority, ratably to the extent of assets legally available therefore; and
>
> 3. Any remaining assets, if any, shall be distributed to the stockholders of this corporation.

The simplicity of a § 281(b) distribution plan makes it a frequent choice for companies with either few claimants, or those facing unmatured, contingent or speculative claims. *Cf. In re Delta Holdings*, C.A. No. 18604, 2004 Del. Ch. LEXIS 104 (Del. Ch. July 26, 2004). But adopting such a distribution plan carries an inherent risk: to afford a protection from personal liability for the adopting directors, the § 281(b) plan must be construed as having made "reasonable" provisions for a company's claimants. Thus, a director approving a § 281(b) plan will always face potential exposure that a Delaware court will later deem a plan "unreasonable." As the Court of Chancery has observed, § 281(b) "may present a risky situation for corporate directors regardless of their good faith and due care." *In re Rego*, 623 A.2d 92, 97 (Del. Ch. 1992).

For that reason, dissolved companies may decide to opt for the more rigorous procedures of § 280 and § 281(a), even if they have no known remaining claims. Recent experience suggests that the procedures required under those statutes are not as complicated as an initial reading of the statute might suggest. *See In re Molecular Staging, Inc.*, C.A. No. 1453-N (Del. Ch. Jan. 3, 2006) (Order) (granting petition to establish security of $25,000 for unknown claims and barring any claims receiving actual notice pursuant to § 280); *In re Holographix Inc.*, C.A. NO. 18521-N (Del. Ch. Jan. 17, 2001) (Order) (granting petition barring claims with notice and establishing security of $10,000 for unknown claims).

Molecular Staging is illustrative. The company had no known claims yet opted for the more rigorous procedures of § 280 and § 281(a). Those procedures essentially required the company to do four things. First, the company had to mail notice to each known claimant. Second, it had to disclose in the notice the aggregate amount of all distributions made for each of the three years prior to dissolution. Third, it had to publish notice for two consecutive weeks in a local newspaper and at least once in a national newspaper (because it had assets in excess of $10 million). Fourth, it had to petition the Court of Chancery for a determination as to the amount of security required to compensate a claimant. (Case law suggests that in making a security determination, the Court of Chancery favors a "conservative" approach that closely scrutinizes the adequacy of the proposed

(continued on p. 3)

Dissolution and Distribution Plans ...
(continued from page 2)

security. *See Delta Holdings* (ordering a dissolved company to obtain suitable D&O policy to protect the interests of former directors seeking indemnification); *Rego* (finding security inadequate).

The benefits of following the § 280 procedures can be found in § 281(a), which provides that directors who cause a company to follow the requirements of § 280 and otherwise pay claims and post the necessary security shall have, in the absence of fraud, their judgment deemed "conclusive," i.e., protected. (Of course, even that protection may not completely insulate directors, as they still have an obligation to properly wind up the affairs of the company. *Gans v. MDR Liquidating Corp.*, C.A. No. 9630, 1990 Del. Ch. LEXIS 3 (Del. Ch. Jan. 10, 1990).

In *Molecular Staging*, the directors' knowledge that the Company faced virtually no claims might have made it ripe for a § 281(b) selection. Nevertheless, the directors elected to comply with the notice and security provisions in order to obtain the protection of §281(a). As it turned out, Molecular received one written claim, which it then resolved. Once that claim was resolved, the Court approved an order barring all other claims and approving a $25,000 security for any unknown claims. Despite the seeming obstacles created by what, at first blush, appears to be a very complicated statutory scheme, complying with the statute proved to be fairly straightforward: (1) mailing notice to potential claimants (including newspaper notice), (2) disclosing prior distributions, (3) posting a small bond and (4) petitioning the Court.

As *Molecular Staging* and *Holographix* demonstrate, even dissolved companies with relatively few claims are often well served by undergoing the procedures required by § 280 and § 281(a) of the corporate code as a means of protecting the directors. As the *RegO* decision suggests, a § 281(b) distribution plan may create more risk than most directors are willing to bear.) †

Delaware Attorney Powell ...
(continued from page 1)

The ACCFL, founded in 1991 by a group of lawyers active on the Commercial Financial Services Committee of the Business Law Section of the American Bar Association, is a professional organization dedicated to promoting the field of commercial finance law through education, legislative reform and the recognition of distinguished practitioners, jurists and academics. The College offers a venue to promote and celebrate outstanding achievement and advances in the field of commercial finance law.

Nomination for Fellow is by invitation only and each Fellow must be approved by the ACCFL Board of Regents. Qualification requirements include the highest ethical and moral standards and excellent character; substantial experience in the field of commercial finance law; and repeated and substantial contributions to the promotion of learning and scholarship in commercial finance law through teaching, lecturing or published writings. †

STATUTORY CLARIFICATION REGARDING SALES OF ALL OR SUBSTANTIALLY ALL ASSETS OF A DELAWARE CORPORATION

by John J. Paschetto

The sale of all or substantially all of the assets of a Delaware corporation is among the fundamental changes that require stockholder approval under the Delaware General Corporation Law (the "DGCL"). Section 271(a) of the DGCL provides that a corporation may "sell, lease or exchange all or substantially all of its property and assets . . . when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon[.]"

(continued on p. 6)

RECENT DEVELOPMENTS

by James P. Hughes, Jr.

In our Winter 2005 issue, we wrote about the importance of appropriate dispute resolution provisions in LLC and LP agreements. On January 10, 2006, the Delaware Court of Chancery issued a decision, *Willie Gary LLC v. James & Jackson LLC*, 2006 Del. Ch. LEXIS 3, that shed further light on the issue. The LLC agreement in question provided for the arbitrability of certain disputes as well as the right to injunctive relief: "[a]ny conflict or claim arising out of or relating to this Agreement… shall be settled by arbitration… the nonbreaching Members shall be entitled to injunctive relief to prevent breaches of the provisions of this Agreement."

In the first instance, the Court held that this provision did not give an arbitrator the power to decide whether a claim was arbitrable and suggested that parties so intending should state in the agreement: "Any dispute among the parties regarding whether a claim or controversy must be arbitrated shall be decided by an arbitrator under the AAA Rules."

More importantly, the Court held that the reference to injunctive relief in the dispute resolution provision entitled the plaintiff to seek an injunction from the Court and was not merely a provision designed to specifically enforce an arbitration award or provide a "safety valve." The case therefore suggests that under Delaware law an injunction provision in an LLC agreement will be enforced in spite of a broad provision mandating that all disputes be resolved through arbitration. *Cf. Cleveland v. Trapalis,* 2003 U.S. Dist. LEXIS 25528 (D. Or. July 30, 2003) (staying claims for injunctive relief pending resolution of arbitration).

* * *

In our Spring 2005 newsletter, we examined indemnification and advancement provisions in LLC agreements. On January 23, 2006, the Delaware Court of Chancery issued a decision *DeLucca v. KKAT Management, L.L.C.*, 2006 Del. Ch. LEXIS 19, distinguishing advancement in the corporate and LLC contexts. Plaintiff sought advancement for fees and expenses from the affiliates of her former employer. The affiliates opposed advancement, arguing that they could not be liable where the alleged harm was to the plaintiff's employer and not to the investors of the affiliates. They argued that plaintiff was not acting in a "corporate capacity" on behalf of the affiliates. But the Court held that the broad terms of the advancement provisions in the affiliates' LLC agreements entitled her to advancement. The Court focused in particular on what it called the "capacious and generous" terms of the advancement provision, and its use of "far-reaching terms often used by lawyers when they wish to capture the broadest possible universe." Those words included "in connection with or arising out of or related to: (A) this Agreement or the operations or affairs of the Company…" The Court concluded that if the parties' intent had been to limit advancement to claims for damages by investors, it could have crafted a narrower indemnification provision: "[T]his is yet another case in which defendants in an advancement case seek to escape the consequences of their own contractual freedom." †

LIMITATION OF FIDUCIARY DUTIES IN ALTERNATIVE ENTITIES

by James J. Gallagher

The rights and duties of those who own and manage Delaware limited liability companies and limited partnerships can be contractually shaped to a much greater degree than is permitted with a Delaware corporation. Even though Delaware's Limited Liability Company Act (6 Del. C. §§ 18-101 – 18-1109) and its version of the Uniform Limited Partnership Act (6 Del. C. §§ 17 -101 – 17-1111) provide default rules that the contracting parties can (intentionally or not) fall back on, almost all of those default rules may be modified in an LLC or limited partnership agreement.

(continued on p. 5)

Limitation of Fiduciary Duties . . .

(continued from p. 4)

The Delaware LLC Act and Limited Partnership Act also enable the contracting parties to modify their common-law fiduciary duties, and associated liability, to one another. (See 6 Del. C. §§ 17-1101, 18-1101.) As discussed below, the steps leading to adoption of the statutory provisions allowing such a modification show how the Delaware legislature and judiciary interact to clarify the State's business-entity laws and to respond to the needs of investors and entrepreneurs.

Limitation of Liability in the Corporate Context

A similar interaction between the Delaware legislature and judiciary occurred in the corporate-law context in the mid-1980s. The Delaware Supreme Court's ruling in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), was widely viewed as an enlargement of directors' liability for breaches of their fiduciary duty of care. (See, for example, the discussion in William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1300 n.49 (2001).) Premiums for directors' and officers' insurance rose markedly following the *Smith* decision. The Delaware legislature responded to the D&O insurance crisis by amending the State's corporation law to permit stockholders and directors to agree, in effect, to insulate directors from monetary liability for duty-of-care breaches. (8 Del. C. § 102(b)(7).)

Specifically, § 102(b)(7) permits the inclusion in a certificate of incorporation of a provision eliminating or limiting a director's personal monetary liability for breaches of fiduciary duty, other than liability for breaches of the duty of loyalty, acts or omissions not in good faith, acts or omissions involving intentional misconduct or a knowing violation of law, unlawful payment of dividends, dealing in the corporation's stock contrary to 8 Del. C. § 160, or transactions from which the director derives an improper personal benefit. Since directors do not have the power to amend their corporation's certificate unilaterally once stock has been issued and paid for, the stockholders must "agree" to a § 102(b)(7) limitation of liability either by a majority (or greater) vote (8 Del. C. § 242) or by choosing to buy stock in a corporation whose certificate (which is part of the public record) already contains such a limitation.

Flexibility Afforded to LLCs and Limited Partnerships

The Delaware LLC Act and Limited Partnership Act now permit not only a much broader limitation of liability than is possible under the corporation law but also the near-total elimination of fiduciary duties. This is consistent with the Acts as a whole, which generally allow the parties' LLC or limited partnership agreements to govern. (*See, e.g.*, 6 Del. C. § 17-1101(c) ("It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements."); 6 Del. C. § 18-1101(b) (the same with respect to LLC agreements).

Delaware courts have respected the contractual choices made by alternative-entity owners and managers. In *Walker v. Resource Development Co. Ltd., LLC* (DE), 791 A.2d 799 (Del. Ch. 2000), for example, the Court of Chancery aptly stated (after summarizing judicial and treatise authority) that "LLC members' rights begin with and typically end with the Operating Agreement." Moreover, specifically with reference to fiduciary duties, Chancellor William Chandler has held that "a claim of breach of fiduciary duty must first be analyzed in terms of the operative governing instrument — the partnership agreement." *Sonet v. Timber Co., L.P.*, 722 A.2d 319, 324 (Del. Ch. 1998). A general partner, the Chancellor noted, has a fiduciary duty to act in the interests of the limited partnership and the limited partners, "*unless limited by the partnership agreement* . . . . Thus, I think it a correct statement of law that principles of contract preempt fiduciary principles where the parties to a limited partnership have made their intentions to do so plain" (*id.* at 324 (emphasis in original)).

(continued on page 6)

Limitation of Fiduciary Duties . . .
(continued from p. 5)

In 2002, however, the Delaware Supreme Court opined that the Limited Partnership Act did not permit the complete elimination of fiduciary duties. *In Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 167 (Del. 2002), the court felt "constrained" to correct a "questionable statutory interpretation" by the Court of Chancery, which had at least twice stated that the Act allowed the contracting parties to "eliminate" their fiduciary duties. The Supreme Court emphasized *in dictum* that § 17 1101 of the Act allowed parties to expand or restrict, but not eliminate, fiduciary duties.

The Delaware legislature responded to the Gotham Partners dictum by amending, as of August 1, 2004, the Limited Partnership Act and LLC Act to make clear that fiduciary duties and liability respecting such entities may be almost entirely eliminated. The only remaining limitations are that limited partnership and LLC agreements may not eliminate "the implied contractual covenant of good faith and fair dealing" (6 Del. C. §§ 17-1101(d), 18-1101(c)) or "liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing" (6 Del. C. §§ 17-1101(f), 18-1101(e)).

To take advantage of the flexibility provided by the LLC Act and Limited Partnership Act, partners, members, managers, and others who may be bound by an operating agreement should make themselves aware of the default rules provided by the Acts and must clearly express their intentions if they depart from the default rules. In other words (to paraphrase the Court of Chancery), "[U]nder Delaware law, while partners [and members and managers] are free to limit their fiduciary duties by contract, the parties to a limited partnership [or LLC] must make plain their intention to do so." *Werner v. Miller Technology Management, L.P.*, 831 A.2d 318, 333 (Del. Ch. 2003). †

Statutory Clarification ...
(continued from p. 3)

A body of caselaw has developed that aids practitioners in determining whether a given sale involves "substantially all" of a corporation's assets and thus triggers the need for a stockholder vote. Until recently, however, uncertainty has surrounded the question whether the sale of all of a wholly owned subsidiary's assets can implicate Section 271. In other words, where the assets of a wholly owned subsidiary form substantially all of the assets of the parent and subsidiary on a consolidated basis, does Section 271 require that the stockholders of the parent approve the sale of the subsidiary's assets?

In 2005, Delaware amended Section 271 to make clear that the assets of a wholly owned subsidiary will be considered assets of the parent for purposes of determining whether stockholder approval of an asset sale is needed. The details of the amendment are discussed below.

Competing Interpretations of Section 271

Before the 2005 amendment to Section 271, arguments were made for both sides of the question involving the sale of a subsidiary's assets. Undoubtedly, the sale of the stock that a parent owned in a subsidiary would have implicated Section 271 where the subsidiary represented substantially all of the assets of the consolidated parent and subsidiary, because that stock was an asset of the parent. However, if the subsidiary itself sold its assets, then the parent would be keeping the stock in the subsidiary, and it was the subsidiary, not the parent, that needed to satisfy the requirements of Section 271. To satisfy those requirements, the subsidiary would have required the approval of its stockholder — the parent — but not the approval of the parent's stockholders, since the parent was not selling any assets. Moreover, a corporation's decision on how to vote stock it owns in another corporation comes within the management authority of its board of directors and (absent unusual circumstances) need not be submitted to the stockholders.

(continued on p. 7)

Statutory Clarification . . .

(continued from p. 6)

Hack v. BMG Equities Corp., C.A. No. 12098, 1991 Del. Ch. LEXIS 102 (Del. Ch. June 10, 1991).

The argument in favor of requiring approval by the parent's stockholders before the subsidiary could sell all of its assets was based on the theory that a court should look to the substance of a transaction rather than its form. When, for example, the parent was a holding company whose only significant assets were shares of stock in an operating subsidiary, it would defeat the purpose of Section 271 to allow the parent, without any input from its stockholders, to transform the nature of its business from holding an operating company to holding a company that simply owned the cash payment received for its operating assets. In such a situation, it was argued, the effect of the sale of the subsidiary's assets was no different from a sale of the stock the parent held in the subsidiary. Since approval by the parent's stockholders was required for the latter, it would be inconsistent not to require approval by the parent's stockholders for the former.

The counterargument, however, had support in caselaw and other authorities. On several occasions, the Delaware Court of Chancery had expressed doubt that a parent's stockholders were entitled to vote on the sale of all of a wholly owned subsidiary's assets. In *J.P. Griffin v. Mediatrics, Inc.*, C.A. No. 4056, 1973 Del. Ch. LEXIS 153 (Del. Ch. Jan. 30, 1973), the court declined to order interim injunctive relief where a stockholder of a parent corporation sought to prevent the sale of a wholly owned subsidiary's assets. The court reasoned that the stockholder was unlikely to succeed on the merits because, given that the parent had voted its stock in the subsidiary in favor of the sale, "the provisions of 8 Del. C. § 271 would appear to have been met."

Similarly, in *Auerbach v. Earth Energy Systems, Inc.*, C.A. No. 8568, 1986 Del. Ch. LEXIS 448 (Del. Ch. Aug. 19, 1986), the court observed that a stockholder of a parent corporation may not have standing to challenge under Section 271 the sale of all of a subsidiary's assets. In *Box v. Telephonics Office Technologies, Inc.*, C.A. No. 13045, 1993 Del. Ch. LEXIS 272 (Del. Ch. Dec. 30, 1993), the court recognized the issue but did not decide it, stating nevertheless that approval by the parent's stockholders would be required if a plaintiff showed that the corporate veil between the subsidiary and the parent should be pierced.

Further support for the argument against requiring the parent's stockholders' approval can be found in a 1976 article by Andrew Moore, who later became a justice on the Delaware Supreme Court. The article noted that transfer of all or substantially all of the assets of a parent corporation to a wholly owned subsidiary "will effectively deprive the [parent's] stockholders of their right to consent under Section 271 if the directors of [the subsidiary] decide to sell all or substantially all of its assets, since stockholder approval by [the parent] would be readily available....."). Andrew Moore, The Sale of All or Substantially All Corporate Assets under Section 271 of the Delaware Code, 1 Del. J. Corp. L. 56, 61 (1976). Practitioners favoring this position could also point to Delaware courts' history of literalness in construing the DGCL and their consistent refusal to ignore the separateness of parent and subsidiary corporations unless the state's high standard for piercing the corporate veil has been satisfied. An opinion issued in mid-2004, however, cast doubt on whether the Court of Chancery would enforce a literal reading of Section 271 as applied to a subsidiary's sale of assets.

The Hollinger Decision Changes the Landscape

In Hollinger Inc. v. Hollinger Int'l, Inc., 858 A.2d 342 (Del. Ch. 2004), a stockholder of Hollinger International sought to preliminarily enjoin the sale of one of Hollinger International's indirect wholly owned subsidiaries. The stockholder argued that the sale of the subsidiary would require approval by the ultimate parent's stockholders under Section 271, even though several wholly

About the Update

The *Delaware Transactional & Corporate Law Update* is published semi-annually by the **Business Planning, Transactions & Restructuring** section of **Young Conaway Stargatt & Taylor, LLP**.

Young Conaway, based in Wilmington, Delaware, is among the state's largest law firms, with nearly 100 attorneys in 10 practice sections that include bankruptcy, corporate, intellectual property, employment law, tax, banking and real estate practices.

The Business Planning, Transactions & Restructuring section handles matters arising at every stage in the formation, growth and development of corporations, limited liability companies, limited partnerships and other types of entities. The section's attorneys combine experience in Delaware corporate law, alternative-entity law, tax, commercial transactions and bankruptcy reorganizations.

To receive a complimentary subscription to this publication, please send an e-mail with your contact information to info@ycst.com or visit our web site at www.YoungConaway.com. To opt out of an e-mail subscription, please send your name and e-mail address with "unsubscribe to bptr newsletter" in the subject line to info@ycst.com.

Members of the Business Planning, Transactions & Restructuring Section

Craig D. Grear, Partner. Mr. Grear has made numerous presentations nationally and internationally on a variety of Delaware business law topics, including alternative entities and Delaware holding companies. He is a 1989 graduate of Georgetown University Law Center. (302) 571-6612 • cgrear@ycst.com

James P. Hughes, Jr., Partner. Mr. Hughes has litigated numerous matters in the Delaware Court of Chancery and served as in-house counsel at an Internet company. He is a 1992 graduate of the University of Pennsylvania Law School.
(302) 571-6670 • jhughes@ycst.com

James J. Gallagher, Associate. Mr. Gallagher has written about issues including indemnification and fiduciary duties in the alternative-entity context. He is a 2004 graduate of the University of Pennsylvania Law School. (302) 571-5002 • jgallagher@ycst.com

John J. Paschetto, Partner. Mr. Paschetto has contributed to several books on corporate takeovers and the limitation of director liability. He is a 1998 graduate of Harvard Law School.
(302) 571-6608 • jpaschetto@ycst.com

Norman M. Powell, Partner. Mr. Powell _______. He is a 1989 graduate of Villanova University.
(302) 571-6629 • npowell@ycst.com

Young Conaway Stargatt & Taylor, LLP
P.O. Box 391
1000 West Street
17th Floor
Wilmington, Delaware 19801
(302) 571-6600
www.YoungConaway.com