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Fiduciary Duties – Indemnification, Prepetition and Pursuing Actions Before Filing*

*Mr. Richard M. Cieri, Mr. David Fischer &
Ms. Judith Greenstone Miller*

MR. CIERI: We are going to do this one a little differently. I have a Power Point presentation, and we're going to go through it, but we're not going to just go through it and not have any discussion. In fact, what I'd like to do is try to provoke discussion on almost every page of the presentation. I hope we have people from the audience who also will participate in the discussion because I think there are really very interesting issues we could discuss in terms of fiduciary duties and how you handle fiduciary responsibilities when you're insolvent or within that mythical zone of insolvency.

In a vast majority of the cases those of us who do mainly debtor's work are brought in prepetition. And if we're not brought in that early, those are probably the cases we shouldn't be involved in. When I approach a debtor and its management team, I say, one of my jobs is to protect you to make sure there's a good record that you fulfilled your fiduciary duties and responsibilities. And that is because, if you look at the first bullet point, anything a director or an officer does prepetition, prior to filing the bankruptcy case, is going to be subject to review with 20/20 hindsight.

Actually, there are lawyers who will go into financially troubled companies and tell the members of the board to resign. I actually think that is bad advice. The problem a board faces is not after the case has commenced, because as everybody knows, out-of-the-ordinary-course transactions actually need bankruptcy court approval.

The problem is just prior to the filing of the case or when the company is operating in the zone of insolvency and you don't have a court to approve a transaction, that's when directors and officers could get into the most trouble. How do our panelists feel about that statement?

* This is an edited version of the transcript from the second panel at the DEPAUL BUSINESS AND COMMERCIAL LAW JOURNAL SYMPOSIUM, *Mega-Bankruptcies: Representing Creditors and Debtors in Large Bankruptcies*, held on April 10, 2003.

MR. FISCHER: Well, I think that it puts an innocent, outside director in a horrible spot because you have this notion of a zone of insolvency and then there is the fiduciary duty that a director has to its shareholders. As the company gets into the zone of insolvency and actually becomes insolvent, that fiduciary duty shifts to a duty to the creditors. No director really knows how to handle it. Nobody knows really what to do, and everybody gets very nervous.

And if you think about it, it's a shift that just puts people in never, never land. And then couple that with questions that may arise regarding benefits to insiders. For example, the debtor needs to be reorganized. You're getting ready to do it. You do what you should do, which is take the debtor through the grill of what the schedules are going to look like. The debtor discovers there are gargantuan insider preferences.

I guess the directors, who would have to disgorge these preferences, have a little bit of a problem if they decide not to file the case because of the preferences out there.

MR. CIERI: The answer to the question is clear; the directors absolutely have an obligation to commence the case in order to protect the preference state. Now, it may be real hard for the directors to do that; as lawyers we try to protect our directors by constructing a good process, a process that hopefully in 20/20 hindsight people can understand and the directors can utilize and defend their approvals with if it later turns out that they made a mistake. However, I believe that you can never defend a failure to pursue an avoidance action.

MS. MILLER: The other thing that I know you suggested that we're going to get to is, on the one hand, it's clear when you're not insolvent that the obligations flow to the shareholders. It's also clear when you're insolvent that the duties only go to the creditors. But what about in that zone of insolvency?

MR. CIERI: We're going to get there.

MR. BIENENSTOCK: Well, is it so clear that once you're insolvent, the duties only go to creditors?

MR. CIERI: Martin, I'm going to get there because I actually remember a very well-written article by your predecessor, Mr. Miller that in a footnote discusses whether or not the fiduciary duties of directors of an insolvent corporation completely shift from shareholders to creditors, so I'm going to prompt you on that.

But I just want to get back to the first question, whether it is the right thing for directors to resign if they find themselves in financial distress.

MR. FISCHER: Well, from the perspective of what's best for them and how they can protect themselves once they're in court, it seems to me, as you pointed out, they're in great shape. It's before that where there are issues, but I don't think resigning helps. But on the other hand, if you're truly an outside director and you don't know what's going on, things can be happening that can get you in trouble.

MR. CIERI: Which is why I suggested they're better off staying on and monitoring the situation.

MR. KIESELSTEIN: And I agree with Rick. The taint and perception that the captain of the ship abandoning his helm leaving all his passengers on board to sink will come back and haunt you. I think if you stay around and do your level best to manage the situation, at the end of the day, you've got a better chance of escaping liability, headaches aside.

MR. CIERI: Does anybody believe that you have a legal obligation to stay on the board?

MR. KIESELSTEIN: You mean, is it a breach in and of itself to leave?

MR. CIERI: Yes.

MR. FISCHER: I think a case could be made that maybe you do.

HON. FITZGERALD: What if you've taken a position that's adamantly opposed to what the majority of inside directors are doing, and they won't listen? I don't see how it could be a breach for you to resign under those circumstances.

MR. CIERI: I tend to agree.

MS. MILLER: I want to agree with that. You want to establish a record, though, and be able to justify after the fact whatever decision you have made; so that if it comes back to bite you, you have something to support it.

MR. CIERI: The second bullet point raises the question of what happens to a director's fiduciary duties when there's a parent wholly-owned subsidiary relationship.

For example, if you have a parent corporation that has a variety of businesses and the board of the now insolvent subsidiary shares common directors with the parent corporation or is completely under the control of the inside parent corporation directors, what does a director

of a now insolvent wholly-owned subsidiary do? Do you, as the advisor to that wholly-owned subsidiary, suggest that the board be changed immediately, or do you say let's work through it and see what happens?

How do the panelists feel about that?

MR. BAIRD: Just to complicate things and foreshadow the next session, for each question you could also ask about the lawyer. If you're a lawyer for the parent and subsidiary, what are your responsibilities and how do you straighten those out?

MR. CIERI: Well, actually, let me answer that one because I have an interesting situation where I have a power company that owns a bunch of regulated utilities throughout the country. They are an independent power producer which is having financial difficulties. I represented both the parent and a subsidiary for the longest period of time and attempted to engage an out-of-court workout.

What happened then was the creditors came to me and said the perception is that you have a conflict, and you will find in these situations, I think Professor, that you can never beat perception, and you just have to resign.

But what do you do with the board? Do you change the board or when you show up on the scene do you just keep the same directors? I'll tell you what I've done. I've told the subsidiary board to stay in place and to see how things develop and to see if a real conflict actually exists between the parent and subsidiary.

But I also suggest to them that they have to understand that their ability to get the protections in the business judgment world are probably very limited.

MR. FISCHER: I wouldn't want to serve on that board, in that instance.

MR. CIERI: Well, if you were getting indemnified from the parent you might.

MR. FISCHER: How big is the parent?

HON. FITZGERALD: Even then, though, you're still subject to lawsuits. I have a whole lot of lawsuits, pending right now, alleging breach of fiduciary obligations as a result of the fact there are common boards. They're tough. They're very difficult issues to address.

MR. CIERI: Okay. Obviously what is really important here is that as a lawyer, you have to understand in advising a board that any time a company files for bankruptcy, that prepetition decisions made by that board will be subject to 20/20 hindsight.

And what is most difficult for a board, and, again, I'm going to throw it to the panelists, what do you do in the situation in which the company is teetering on the edge of bankruptcy, but you decide to try and do a rescue financing by securing up prepetition debt in order to get some new out of court financing?

A good example, by the way, is *Federal Mogul* where the directors made a decision to secure old money prior in the hopes of avoiding a Chapter 11 filing, yet the company subsequently filed.

MR. KIESELSTEIN: Did they get new money, Rick? Or was it basically forbearance?

MR. CIERI: It was probably forbearance.

MR. FISCHER: I think the question has to go a little further than that. What additional value did the person putting the money in receive? Furthermore, is somebody in 20/20 hindsight going to say that they did something untoward as a result of their rescue plan, even though there should be the cardinal rule that new money always rules.

MR. CIERI: Now, what David is referring to is, does the director breach its fiduciary duties by engaging in the process of securing old money?

Did the company receive reasonably equivalent value in exchange for that old money or for forbearance or for some amount of new money to secure old money?

MR. BAIRD: It's antecedent debt.

MR. FISCHER: But I'm talking about you putting in new money. Let's suppose that you're an old creditor or an old shareholder who puts in new money. Furthermore, let's suppose that you want the deal the new money would get in this situation. However, when held under the microscope the deal looks bad because you were the old money and you were a director. You're at risk and you're at greater risk because of your relationship to the debtor, than Warren Buffet who you brought in and who was just going to put the money in. Perception is reality.

MR. CIERI: But the point is, this is a difficult fiduciary duty issue for a director because do you try to avoid bankruptcy by securing old money, getting forbearance in exchange or getting some amount of new money, or are you in effect breaching your fiduciary duties by doing so?

I think the next slide is pretty easy. Next will we address Martin's question, and then I will open it up to everybody else.

The one thing we do know is that if you are a solvent corporation, you owe your fiduciary responsibilities to your shareholders. There are a few states that have statutes allowing directors to take into account the interests of other constituencies. But all in all, with a solvent corporation, fiduciary duties are owed to the shareholders.

Now, what about an insolvent corporation? This is a question lawyers struggle with. Some lawyers will tell you that upon insolvency, your fiduciary duties shift solely to your creditors. Others would say, well, partially, and it's something over which I think a lot of debate exists. Martin?

MR. BIENENSTOCK: Well, first, in or out of bankruptcy, the shareholders continue to elect directors so it seems somewhat of an empty ill-conceived gesture if the directors are supposed to serve a different constituency.

Second, you can't talk about this in many cases as if it's static because it's not static. If you take the case of *Global Marine* which was a Houston Chapter 11 case in the late '80s. The company was hopelessly insolvent. A couple of years later it was number one on Fortune's list of fast-growing equity value companies. It went from insolvency to immense solvency.

The Western Union Company, which was in Chapter 11, through the name New Valley, went in its Chapter 11 case from insolvent to solvent. The shareholders ended up taking away more than a hundred million dollars.

While I think there is a legitimate prospect that the focal point, or the fulcrum, can move from insolvency back to solvency, it is very dangerous to say that the directors owe no duties to shareholders.

But this really begs the question of "So what." What are they supposed to do differently? And I think the way they normally deal with that is their job is maximizing the value of the company, and where it makes a difference who they owe a duty to, it's usually a risk level. It's clear that if you're in that zone, it's no time to declare dividends, solvent or not. And it's clear it's no time to give away assets to friends, but that's sort of obvious stuff.

When it comes to debating a business proposition, some creditors might say, don't do it if there's a downside because we'll pay the downside whereas the upside would go to the shareholders. The shareholders would say do it because if there's an upside, we would get it.

The only court that I've seen give a crisp answer to this, is in the—
MR. CIERI: *Credit Lyonnais*.

MR. BIENENSTOCK: — *Credit Lyonnais* case is where Justice Allen or Chancellor Allen in his I think it's footnote 5 posits—

MR. CIERI: No, I think it's footnote 7. I'm kidding.

MR. BIENENSTOCK: He posits the situation that the only asset a company has is a \$50 million judgment it just won, and it has about \$14 million worth of creditors. There's a 25 percent chance of affirmance. There's a, say, 50 percent chance that it will be reduced to 4 million and a 25 percent chance that it will be reversed. And you multiply out all the probabilities and add up the expected value, and it turns out the expected result is \$15 million, and they're given a \$14 million offer to settle the appeal. Should the directors take it or not? And Chancellor Allen says, no, because the expected value is 15, and that would be unfair to shareholders.

Frankly, I don't subscribe to that because there was over a 50 percent chance that you'd lose and it would be creditors affected. But that's the way he did it. That's the only decision I've seen that comes to grips with the big question and says here's how you answer it.

MR. CIERI: Well, do you think, Martin, it doesn't really matter who the duties are owed to, whether it's shareholders or creditors as long as directors take actions to maximize the value of the enterprise?

MR. BIENENSTOCK: Yes. I think Judge Ambro's, of the Third Circuit, decision in *United Artists* where he said it's okay for an estate to indemnify financial advisors against negligence supports your statement. He stated that a decision of what is negligence, should borrow from the business judgment rule. You should make sure that the directors and officers were disinterested, made themselves aware of all of the alternatives, and had a rational process to choose the one that maximized value.

I think if you go through those steps, whether your duty is to creditors or shareholders, you're going to be fine.

MR. KIESELSTEIN: But doesn't that raise an issue in the nonpublic company context? We represent a lot of private equity firms in our practice, and you often have the situation where the private equity sponsor designates three, four members of the board. It may be their equity is flushed. They're wearing their directors' hat. They're not wearing their constituents' hat. And they are evaluating alternatives about whether you can salvage a situation or not.

Maybe someone says they're playing with the house's money. Maybe someone says they're not disinterested, and it's going to be an absolute fairness type of test and not business judgment.

So what your director does, depends on who he is or she is and how they are going to be perceived in the litigation that is likely to come down the road.

MR. FISCHER: What is your director's duty?

MR. CIERI: Which means process, right? You need to make sure that the process is documented in order to protect those directors. I'm sorry, David.

MR. FISCHER: What's the director's duty when, in this long period of time, in this well-orchestrated bankruptcy you start amassing the first day motions? Does the director tell the company to pay everything COD?

And let's take the case where your client is the private equity firm, and they know they're going to file. They don't know exactly when, but it's going to be sometime in the next two, three weeks, or a month. Do they have to be concerned about trade debt that they're amassing and not going to pay for?

MR. BIENENSTOCK: Well, you see, they do if you set it up as you did, which is why we don't set it up that way. We make it very clear to the company and the directors they don't know that they are going to file, and they are not going to know until they vote on the resolution, which will be a few hours before we file.

We do this because we're going to look for every alternative to filing with banks and exchange offers and out of court things.

MR. FISCHER: That's the record you will create, but I've got to believe that the person on the jury isn't going to buy it. It has always really troubled me as to what you do building up. How do you advise a director building up to when you know you're going to file.

MR. BIENENSTOCK: That's simple. We tell our directors, "when you know you're going to file, you're not going to take on credit. You're not going to take credit that you know you're not going to pay." It's as simple as that. There are criminal laws against doing that.

MR. FISCHER: I agree.

MR. KIESELSTEIN: Although truth be told, there are reclamation claims in bankruptcy because people are ordering—you're ordering product—

MR. FISCHER: People do that.

HON. FITZGERALD: Almost every retail store has to boost the product up because they're going to go on COD or have to have a

letter of credit posted the day they file. As you said, in fact, as soon as the word gets out that they're going to file.

MR. KIESELSTEIN: And build their inventory while they go.

HON. FITZGERALD: And they have to build their inventory while they can, or they have no chance of reorganizing later.

MR. FISCHER: There's a death spiral. And, secondly, I think depending upon how you say what you say, there can be securities issues—

HON. FITZGERALD: There could be, sure.

MR. BIENENSTOCK: I'll ask the next thing. Under Sarbanes-Oxley,¹ once you make the decision that you're crossing, don't you have to make a public disclosure?

MR. CIERI: I think you're absolutely right.

MR. FISCHER: I think you're right.

MR. BIENENSTOCK: Right or wrong?

MR. CIERI: Right.

MR. BIENENSTOCK: That's what I was afraid you said.

MR. FISCHER: And it's a real sticky situation as to how you can evaluate that option, give the law firm \$3 million to get going, and then say, "But I wasn't really sure I was going to do it."

MR. CIERI: Well, that wasn't really clear. I was serious. To sort of just move on a little bit, I think as Martin said, the real key issue, whether insolvent, solvent and working that zone is being able to demonstrate that directors are taking action that maximizes the value of the estate. In 20/20 hindsight, your directors have to be in a position to overcome the skepticism of a jury regarding their activity.

We're just going to talk a second about the business judgment rule, and then I'm going to ask Marc a question because Kirkland & Ellis, Marc's firm, does represent a lot of private equity funds.

All of you know what the business judgment rule is. In fact, it's a presumption that directors act in good faith and in the best interest of the corporation. Directors have to breach one of their duties, either the duty of care or the duty of loyalty to not receive the benefits of the business judgment rule's protection.

It is an imperfect shield, and it's imperfect for a couple of reasons. It mostly boils down to the fact that a director's duties, in the context

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

of an insolvency situation are again going to be evaluated with 20/20 hindsight. As a result, when we advise boards of directors, we tell them when you take an action, you should assume that you're not going to have the protections of the business judgment rule.

There are some cases out there I want to alert you to. I don't know if anybody thinks they are viable law, but there's some old Delaware case law that, in effect, say if you're a director of an insolvent corporation, you should be held to the duties of a strict trustee.

Now, the question I have for Marc is, what do you do in your situation where you're representing private equity in a portfolio company that's having financial troubles?

MR. KIESELSTEIN: Well, Rick and I, we were involved in a case recently, a prepackaged case in the Northern District, where Rick actually served, I guess, as our backup primary counsel in the event we were disqualified, but also as special counsel.

You have to be able to separate out your relationship with your private equity client from your relationship with the debtor company in general. In that particular situation, there was a recapitalization of the company a couple of years before the case was filed where the people who were sitting on the board, or their entities that they represented, took a lot of money out of the business, and things turned out in a bad way.

When you're representing the company, you have to just make it very clear who you're representing, what you're representing, what you're not representing, send your private equity directors and your private equity clients off to get other counsel, maintain a strict wall of separation, and don't have people who work on the transaction working on your workout.

As far as the directors go, your advice to them is that they have to, at all times, have the hat of a director on and not walk into the director's room thinking and acting like they're there to protect the interests of the equity holder, the stakeholder.

MR. FISCHER: To get hired, how expansive was your affidavit?

MR. KIESELSTEIN: Oh, we laid it all out there, and we'll talk about this in the next section, but full disclosure is the rule and then let the chips fall where they may.

MS. MILLER: And, in fact, I was involved recently in an out-of-court workout where the equity fund retained their counsel that they had been using pre workout and specifically went and got new independent counsel to serve as counsel for the debtor to make sure that they didn't have to worry about any of the advice that had been given, any

of the disclosures that had been made. It really created a good wall on a go-forward basis where you didn't have to worry about making those kinds of disclosures.

MR. KIESELSTEIN: And we considered doing it that way, ducking out early on and representing the equity, but we had represented the company for a number of years, knew the business extremely well, and they were loath to have someone who wasn't as familiar take them through the process. We had Rick standing by to do that and he would have done it if need be.

MR. CIERI: But they were loath to use me.

MR. KIESELSTEIN: That's not true, not true at all.

MR. CIERI: Let me ask you a question about the next slide. Everybody obviously knows what preference law is. And the question is, do directors breach their fiduciary duty when they favor one group of creditors over another? Is it a breach of fiduciary duty to secure some old money and not all the old money, or is the only remedy preference?

And, again, there is this very undefined view out there that directors have this duty to treat everybody fairly. What exactly does that mean? Does anybody have a response?

HON. FITZGERALD: Who is the everybody? You know, what happens in a mass tort case where you've got all this contingent liability out there that you don't even know, do you have an obligation to treat that potential group fairly?

MS. MILLER: But ultimately do you justify it because by preferring a particular group, you're able to maximize value that ultimately can result in the turn around?

MR. FISCHER: Because they're going to give you new money.

MS. MILLER: That's right.

MR. FISCHER: And the tort claimants probably aren't going to give you the new money.

MS. MILLER: You're going to get consideration for it.

MR. FISCHER: But I think you can't just secure the old money without procuring the benefit from the old money.

MR. BAIRD: What's the legal theory of why they don't do that, just so we're—

MR. CIERI: Breach of fiduciary duty because in effect you're preferring one group of creditors over another. Or in the situation David's

positing regarding you secure some old money, not all the old money, the company has subsequently filed, have the directors committed a fraudulent conveyance because you didn't get enough—you didn't get reasonably equivalent value?

MR. BAIRD: But if you're making a transfer on account of antecedent debt, you've got value as far as fraudulent conveyance now is concerned.

HON. FITZGERALD: Correct. But the issue may not be a breach of duty of care. It may be a breach of the duty of loyalty. That's why I asked the question who is it that you have to be fair to? Because you can go through your due diligence. You can make a rational decision. Forget business judgment, just a rational, fair decision that securing this money is the benefit not just for now but for the future, for the organization.

But if you then somehow or other, in the process of doing that treat one group of creditors less favorably than another, have you breached your duty of loyalty?

MR. BIENENSTOCK: You might as well ask, is it wrong to pay off some creditors that are owed the money?

MR. CIERI: Yes.

HON. FITZGERALD: Yes.

MR. BIENENSTOCK: And the preference statute only goes so far. The case that I think comes closest to answering these questions is Judge Walrath's decision last year in *Coram Healthcare* where she denied confirmation for lack of good faith on the ground that the control person who had been pivotal in proposing the plan prepetition had paid interest to some creditors. And she said when you're heading into Chapter 11, you should be conserving your cash not using it to pay interest.

And I guess there might be a little liability ultimately assessed against him for having done that. But that's the only time I've seen someone be actually charged and held liable for paying a creditor and not all creditors.

But the argument wasn't you didn't pay all the rest. The argument was that you shouldn't have paid anyone. You should have saved it for Chapter 11.

MR. CIERI: I'm going to shift gears just a little bit, and then I'm going to actually ask a question and not participate in discussion because of interests I may have in the discussions.

There is much case law suggesting that director fiduciary duties shift based upon the solvency of a corporation. The question is how you measure solvency.

And you hear about two tests, the balance sheet test and the equity or cash flow test. The idea behind the balance sheet test is you write up your assets to their fair value and you write them down, and the liabilities side you don't only deal with liabilities that are recognized by GAAP, you also deal with contingent liabilities that may not be on the balance sheet.

The equity or cash flow test looks as to whether or not the corporation can pay its debts as they come due, and even in that test, you really do look at the true value of the assets or the true value of the liabilities.

And at least when we're advising clients, and I'm sure it's probably true with the other panelists, we always tell companies to take a very conservative approach in determining their solvency and create a record, again, to be able to defend their conclusions.

But the question I have for our panelists is, how do you measure contingent liabilities in your solvency analysis? Clearly there's a lot of case law out there that says—or at least we all thought that the way you measure contingent liabilities was you take the maximum amount of liabilities discounted by the probability of its actual occurrence. Recent case law now developing in the Third Circuit suggests perhaps a different approach.

Where is this all going? I'm not getting an answer.

MR. BAIRD: Just so we're clear, when you talk about case law development in the Third Circuit, do you mean the *Sealed Air* or do you mean something else?

MR. CIERI: Yes, *Sealed Air*.

HON. FITZGERALD: *Sealed Air*, in case the group doesn't know what it is, decided that you measure the contingent liability as it actually happened on a particular date. You can't look to what you knew or reasonably should have known was your liability. You have to take what your actual liability was and apply it retrospectively to the date you're looking at. That's the effect.

MR. CIERI: Well, let me just state the two ends of how you look at things.

Some case law, very few cases, and they are just wrong, say you actually take the face amount of the liabilities, and you don't discount them. That's crazy. I mean, when you have a lawsuit filed against you

for \$10 billion, and there's a 1 percent chance that party will win, you should not have to place on your hypothetical balance sheet \$10 billion liability.

On the other end, which was the approach that I think most of us thought was the right one, you take that \$10 billion lawsuit, and you discount it by the probability of its success. And if it's 1 percent, you probably won't even put it on your balance sheet because it's such a low, low probability. But if it's 10 or 20 percent, your hypothetical balance sheet should reflect that liability.

Now, *Sealed Air* says when you're dealing with mass tort claims, you have to assume, for purposes of determining solvency, that that injury actually occurred. You don't discount that claim by the probability that it will actually be asserted. So what does that mean?

MR. KIESELSTEIN: Then does that put it in the class of cases you said were wrong?

MR. CIERI: Yes.

MR. KIESELSTEIN: Okay.

MR. CIERI: So what does that mean for directors of corporations that have large contingent judgments that have been asserted against them or directors of corporations that have mass tort problems?

HON. FITZGERALD: Their D & O insurance better be paid up. That's what it means.

MR. FISCHER: It means it can't be.

MR. BAIRD: But you have to be careful. *Sealed Air* was a preliminary decision. The case was settled before it went to trial.

In any event, the Seventh Circuit law is quite different. Moreover, the problem in *Sealed Air* was peculiar. You had a shoveling of assets from one firm to another firm with the hope that the assets you shoveled would be insulated from any subsequent mass tort liability.

So you already have a firm that knows it has mass tort liability—

MR. CIERI: I don't know. I think I am hearing you say that you don't like this decision, but you like Judge Grady's decision in *K-Mart*.

MR. BAIRD: No, I didn't say I liked Judge Grady's decision. I said you couldn't be surprised by it.

MR. FISCHER: If we were to take a vote, we all thought you were on the side of you liked it. Just teasing.

MR. CIERI: If you're a director of Philip Morris today, do you make a dividend payment?

HON. FITZGERALD: I don't think so.

MS. MILLER: I don't think so.

MR. CIERI: Why?

HON. FITZGERALD: They're still selling cigarettes.

MR. KIESELSTEIN: What about McDonald's, there's going to be obesity lawsuits.

MR. CIERI: But let's stay with the— again, and I really have to be careful how I participate in this discussion, but do you make a dividend payment or not if you're a director of Philip Morris in light of the judgment or in light of all these lawsuits that are pending against them? Martin?

MR. BIENENSTOCK: Well, Rick, I can't imagine that the courts in Illinois are going to look favorably on varying the bonding standards if Philip Morris purports to declare a dividend. Now, the shareholders might be clamoring that possession is 90 percent of the law; give us the money. But I think that's the surest way to make sure that it's driven into bankruptcy and doesn't get some type of bonding remedy because no trial court could stand for that if they really want to appeal while staying out of Chapter 11, which they likely want to do.

Also, if the amount of the judgment makes them insolvent—I mean, it is a judgment. It's not like it is contingent liability. It's a judgment. It's real today, and there's no two ways about it. Now, I don't know enough about their financial statements to know if that alone makes them insolvent. If it does, you clearly can't declare a dividend.

MR. FISCHER: What's the effect of the punitive damage decision of a few days ago on the 12 billion?

MR. BIENENSTOCK: Well, who knows what the Supreme Court's decision will do to Philip Morris.

MS. MILLER: How do you even reorganize someone when they're continuing to commit the wrong? It's not like the bad behavior that the lawsuits are being brought up on and on which judgments are being issued has been cured.

MR. FISCHER: I'm not a smoker, and I don't want my children to smoke, but I'm not sure that it's true that continuing to sell cigarettes, given the notoriety that everyone who smokes cigarettes now knows the problems, means you're continuing to commit the wrong.

MR. CIERI: Well, I just want to focus on the question, though, of solvency. What does a director of a corporation that has a large judg-

ment against it or numerous lawsuits relating to a product that it sold in the past do?

MR. KIESELSTEIN: But there's an even thornier issue, Rick. April 15th is when companies report to the PBGC on their pension liabilities, and the market hasn't rebounded. And there's tons of underfunded plans out there for companies that people otherwise think of as rock solid. I mean, some people think General Motors, if you look at pension liabilities, has real issues from the balance sheet. I have no idea whether they do or they don't, but is that an issue where they ought to be thinking about holding back on their dividends under that theory? I mean, pension liabilities, that's—if the market doesn't turn around, is an obligation that's out there.

MR. CIERI: So you're suggesting, Marc, that under the cash flow test of solvency, a corporation's director needs to look at the amortization payments that may need to be made to the PBGC?

MR. KIESELSTEIN: Sure. Why not?

MR. FISCHER: I think the real thing with the cigarette industry had been that for so many years they succeeded in defending those cases, and now I don't know how many verdicts they have against them, but it is likely not that many. And the question is, can the directors say, well, just because I got one, does that mean I'm going to lose the other cases or I'm going to win the other cases? Because they always won them for a long period of time, and that was their argument.

HON. FITZGERALD: But this may not be the best type of analysis to look at because the issues are somewhat unique in that industry. Part of their injunction says they can't market to teenagers, and then you look at Joe Camel smoking cigarettes on TV. I mean, who is the marketing directed to if it's not to a younger set?

And I'm not—it's not a pejorative statement one way or another, it's just I've seen an ad like that, and I wonder whether they're setting—the industry itself appreciates what its own potential liability at some point may be. And I think it's a legitimate question to ask whether under those circumstances facing judgments with many lawsuits pending a director knowing that its company is still marketing, regardless of how, ought to be paying a dividend. Because as long as there's marketing, there are going to be lawsuits.

Now, will they be successful? I don't know, but they have experts who evaluate the potential risks and upside, and the question is, is that going to have to be disclosed? I would say it probably does.

MR. CIERI: But is it fair to say—and this is a problem that's not just unique to Philip Morris. It's a problem that every corporation who has a mass tort problem faces.

GARY LEWIS: Question. I'm a member of a board of directors, and the question comes up with reference to a dividend. There is insurance. There's a cash flow. And even if there is a large judgment against the corporation, I am going to say that judgment will be settled at 75 percent or 65 percent or somewhere down the road. If I have reason to believe that with prospective cash flow, even if we don't make it, we'll come close to meeting that obligation, I would probably vote to approve a dividend to be issued feeling that if worse comes to worse, that's what you've got directors' insurance for.

GARY LEWIS: So my personal assets aren't really going to get affected. If there was a risk as to my personal assets, then I'd probably resign.

GARY PLOTKIN: But the D & O insurance now is much more restrictive than it was three or five years ago, and you may not have coverage, and that's a problem.

MR. CIERI: And, also, I always think it's difficult to go home and explain to your significant other why you're being sued.

MR. FISCHER: You can probably explain it to her, but never your children.

MR. BIENENSTOCK: Rick, I just wanted to mention one other thing. Going back to Judge Wolin's decision in *Sealed Air*, the decision I think could stand for something that might be more palatable to you because I'm not sure he was really talking about discounting the likelihood of claims. He was saying you can look backwards, in fact, you have to and count the liability that existed at that time that you know of.

Now, what makes that decision very unique and potentially useful in the asbestos bankruptcies is that the liability he was talking about is what we all call future claims; at the time they were determining solvency had the company gone into Chapter 11 at that moment, its liability, its claims, would have been separate from the future claims because the future claims were held by people who had been exposed to asbestos prepetition but by and large had not manifested injury at that time of the *Sealed Air* transaction.

And as I understood his decision, he was saying that asbestos is now so well known as a potential and basically bad substance. Everyone who worked in shipyards, construction sites, and the like with asbestos knows they did, that they can no longer be considered not claims, and,

therefore, not part of the liability picture, but that they are all now present claims.

I really wonder based on his decision whether you can now go into a Chapter 11 case with an asbestos manufacturer and say you don't need a § 524(g) injunction against future claims because there are none. They're all present based on Judge Wolin's analysis.

HON. FITZGERALD: In that opinion, though, I think the difficulty is the transaction took place in 1996, and he's applying what you know in 2002, which is when the opinion came down, retrospectively to 1996. And I agree there was an evaluation issue. That's what the trial was going to be about, but they settled. So I agree with you about the discount. I don't think he gets into the discount issue in that opinion. But the retrospective application I think is quite difficult to apply.

MR. BIENENSTOCK: Except that in the asbestos industry, we've had models going back to the late '80s that project future claims. They often do not project enough of them, but they've projected them. So even in '96 they had a projection of future claims. The question was whether you count that in determining your solvency, and he's saying you have to.