



Letter from the President

Dear Members and Friends:

With the kids headed back to school and vacation fading into warm memory, it's time to find something new to which we can look forward. For me it's the Annual Turnaround Management Association Convention set for October 7 through October 9 in Phoenix, Arizona.

If you're a longtime Turnaround Management Association member, as I am, you probably know what these conventions are all about, and they are great. For TMA devotees, let me assure you the Phoenix convention will be all that you have come to expect from a TMA convention and much, much more.

But if you've never been to a TMA convention, or you haven't been in a while, this is the year to give it a try. They will have a slew of knowledgeable speakers, educational forums, and an exceptional exhibit hall.

Above all, the TMA annual convention will be a place where leaders converge, notably those integral people who make decisions for our industry. These are the people who influence what the turnaround sector will look like tomorrow and in the years to come. They develop the technology, policy, agenda, and services that are critical to turnaround management.

Not only will these leaders be on hand, but they will answer your questions, address your concerns, and debate the issues that matter. The annual convention is the place where we will move forward on important issues with your input.

No doubt you've heard me say that we all can accomplish more through collaboration than we ever could hope to achieve alone. We've demonstrated this by our commitment to viewing the entire TMA membership as an extension of our individual practices. I've also often talked about the importance of speaking with one voice. Ultimately, that is the foundation of turnaround management.

With that in mind, we should remember that if we want to come together on important issues,

[Continued on page 2...](#)

Uncovering Hidden Value by Monetizing Corporate-Owned Life Insurance Policies

By Brad Naso and Doug Himmel, *Melville Capital, LLC*

More than ever, today's turbulent economic climate requires that troubled companies, either reorganizing or liquidating, observe the duty to maximize the value of their estates and assets. In recent years, insolvency professionals have realized that monetizing life insurance assets, commonly overlooked in the often frenzied world in which we operate, is an option which may make a significant difference to the case. As discussed below, life insurance policies are assets that can result in meaningful financial distributions to creditors, or can conceivably fund a turnaround or bankruptcy exit plan. As such, professionals should evaluate their engagements to ensure that these hidden assets are successfully uncovered.

Corporate owned life insurance policies, also known as "key person" policies, have long been an integral part of Corporate America. Typically, companies pay the insurance premiums on a key person policy in return for being designated as the beneficiary of the policy. While this practice is an effective device to mitigate the financial impact associated with the death of a key executive, it often has little or no value to a company going through liquidation or reorganization where new management is being put in place.

Until recently, if it was determined that a policy was no longer needed or wanted, there were three options for the policy owner: (i) allow the policy to lapse to save the premium; (ii) continue to pay the premiums and keep the policy in place; or (iii) surrender the policy to the issuing insurance company for the "cash surrender value."

The cash surrender value is typically not an accurate reflection on the fair market value of a policy, and with the emergence of the Life Settlement option, it is not uncommon for a company to realize three to five times the cash settlement value through the sale of a policy into the secondary market.

Mechanics of a Life Settlement

A Life Settlement is the sale of an existing life insurance policy from the current owner (the company, if it is a key person policy) to institutional investors, such as commercial and investment banks, pension and hedge

we need to have representatives from all the various disciplines that serve our industry. For that reason, and to emphasize the spirit of inclusion, convention organizers have endeavored to invite individuals from other disciplines. We're encouraging them to come to the convention as well. How many of us have started our career in turnaround management by attending a TMA event?

The exhibition hall is another exciting place to see all of the vendors that you expect to find, as well as some new ones that you've never seen at a TMA convention before – offering a chance to see a whole range of products and services of interest to TMA professionals.

The educational forums will again be excellent. They will address important ethical and technical topics, to take place in an interactive environment, with more opportunities for discussion between presenters and participants. The Turnaround Management Association Convention is to be a place where there's a real change through open and meaningful conversation.

Please join me in Phoenix at the Annual TMA convention. I can't wait to see you there!

Joseph L. Palazzi, CTTMA President



Joseph L. Palazzi is the president and founder of Elm City Partners LLC, a company which specializes in the field of corporate renewal with performing and under performing companies

throughout North America.

Joe has over 25 years of domestic and international leadership and consulting experience in the construction, software, electrical, electronic, and consumer goods industries.

For more information about Elm City Partners, please visit: www.elmcitypartnersllc.com.

funds and insurance companies. These investors purchase the policy with a one time lump-sum payment to the owner of the policy and then assume responsibility for the payments of all future insurance premiums.

All policies, including universal life, variable universal life and even convertible term policies are eligible for a Life Settlement. In fact, term policies, which often are not included on a debtor's schedules of assets and liabilities, can prove to be the most valuable of these hidden assets. Since term policies do not accrue cash value, they are often cancelled or even worse, allowed to lapse for non-payment in the weeks leading up to a bankruptcy filing. However, the vast majority of term policies contain a conversion feature, which provides the owner with the right to convert from a term policy to a permanent policy. Upon exercise of the conversion right, a debtor can then consummate a Life Settlement and extract value from an otherwise worthless asset.

To qualify for the Life Settlement option, the general rule of thumb is the insured must be over 65 years of age, with at least \$500,000 of life insurance coverage. There are many factors, including age, gender, health of the insured, and the size and type of the policy that influence the ultimate purchase price of the policy. Life Settlement Brokers perform a comprehensive analysis to determine the value of a policy.

Conclusion:

In scenarios where insurance assets exist, the policy should not be arbitrarily surrendered for the cash surrender value or allowed to lapse without a true appraisal of its fair market value. These organizations and individuals should consult a Life Settlement Broker who has Insolvency related experience to assess the true fair market value of such policies and thus obtain the highest monetary value for those assets.



Brad Naso is a Vice President, Policy Acquisition, at Melville Capital, LLC in Los Angeles, CA. For further information on this summary, contact Brad Naso at Bnaso@melvillecapital.com, (310) 943 5372.



Doug Himmel is a Managing Director/Partner at Melville Capital, LLC in Los Angeles, CA. For further information on this summary, contact Doug Himmel at dhimmel@melvillecapital.com, (310) 943 5370.

STATE CORNER: Amendments to the Connecticut Business Corporation Act

By David A. Swerdloff and Elida Salcedo, *Day Pitney LLP*

The Connecticut General Assembly has passed legislation to update the Connecticut Business Corporation Act (CBCA), which governs stock corporations formed under Connecticut law. Public Act 09-55 was signed by Governor Jodi Rell on May 20, 2009. It takes effect on October 1, 2009. Public Act 09-55 is part of an ongoing process of modifying Connecticut's corporation statutes to keep them current with changes in the Model Business Corporation Act (Model Act), which became effective in Connecticut in 1997. Several of the amendments described below are intended to provide greater flexibility to public corporations in their shareholder relations and in the management of their business.

Majority Voting

Prior to adoption of the amendments, the CBCA provided that the Board of Directors was elected by a plurality of the votes cast, unless the certificate of incorporation provided otherwise.^[1] Adoption of a majority voting standard, often recommended by institutional investors and others, required either an amendment to the certificate of incorporation or adoption of a majority voting policy that may not have been enforceable if director nominees failed to receive a majority vote. Under the amendments, public corporations may elect under their bylaws to adopt a majority voting plan for the Board of Directors. This would avoid the need for shareholder approval of amendment of the certificate of incorporation, as the Board of Directors alone can adopt or repeal bylaws.

Following the Model Act, the new Connecticut regimen will authorize bylaw changes to permit each shareholder to vote "for" or "against" each shareholder nominee or to abstain. The plurality vote requirement remains, but only for a limited term. Nominees would be elected to the board if they received a plurality of the votes cast, but they would be elected for a term of only 90 days or until their successor is selected by the Board of Directors, whichever is earlier. The usual rule that directors serve until their successors are elected and qualified would not apply.

The amendments expressly authorize a public company to obtain an irrevocable resignation from its director nominees in advance, to take effect only if a nominee fails to receive a

majority vote. The director filling the vacancy created by the director resignation would be subject to reelection at the next annual meeting, even if the term for that directorship would otherwise have been for more than one year, as in the case of a staggered board. The Board of Directors can fill the vacancy with any qualified person, including the director who received more "against" than "for" votes.

Majority voting would not be available if the director election were contested or if there were more than one nominee for the director position. In addition, a public company cannot adopt majority voting bylaws if its Certificate of Incorporation: (1) specifically prohibits the adoption of such bylaw provisions; (2) alters the plurality voting default rule; or (3) provides for cumulative voting.

Involuntary Dissolution

Connecticut currently allows shareholders to seek the involuntary dissolution of a corporation under circumstances involving deadlock or significant abuse of power by controlling directors or shareholders.^[2] Among other things, the CBCA permits shareholders to commence a dissolution proceeding if the directors or those in control of the corporation have acted in a manner that is illegal, oppressive, or fraudulent or if the corporate assets have been misapplied or wasted. The CBCA requires the court to dissolve the corporation if either the directors are deadlocked in the corporation's management and the shareholders have been unable to break the deadlock or the shareholders are deadlocked in the election of directors.^[3] Under the amendments, judicial dissolution is never mandatory. Shareholders seeking dissolution because of deadlock of the directors must demonstrate that irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders.

Perhaps most relevant, shareholders of public companies will no longer be permitted to seek judicial dissolution unless the corporation has abandoned its business and failed, within a reasonable time, to liquidate or dissolve the corporation. In light of other remedies for breach of fiduciary duty, and in light of the ability of shareholders to sell their shares if they



are dissatisfied with management, the risk of permitting shareholders to sue to dissolve a public company would be disproportionate to the potential benefits. In the context of a private company, without a market for the sale of a dissatisfied shareholder's shares, resort to litigation could irreparably damage the personal relationships among the shareholders and management, leaving dissolution as the best available remedy.[4] Recognizing this possibility, the commentary to the Model Act has suggested that courts take into account the number of shareholders and the nature of the trading market for the shares in determining whether to order an involuntary dissolution.[5]

Written Consent of Shareholders; Annual Meetings

The CBCA currently permits shareholders to act by written consent without holding a meeting, if permitted by the Certificate of Incorporation. However, the consents do not become effective immediately. Notice of action taken by less than unanimous written consent must be given to the non-consenting shareholders at least 20 days before the effective date of the consents. Holders of at least 10 percent of the outstanding shares may object, in which case a shareholder meeting is required.[6] Under the amendments, action taken by less than unanimous written consent of shareholders will become effective immediately. The corporation must give written notice of the action to its non-consenting shareholders within 10 days after the shareholder action has been taken, but that does not affect the validity of the consents. Failure to give notice within the required time period will not invalidate or delay the effectiveness of the shareholder action. The amendments do not change the requirement that shareholder action by less than unanimous written consent must be authorized expressly by the Certificate of Incorporation.

Directors can be elected by less than unanimous written consent under the amendments, subject to certain exceptions. If the certificate of incorporation requires cumulative voting, directors can be elected only at a meeting or by unanimous written consent. Corporations will be excused from the obligation to hold an annual meeting of shareholders if directors are elected by written consent.

Electronic Distribution of Annual Reports; Householding

The amendments permit publicly held Connecticut corporations to make their annual financial statements available to shareholders on the Internet, pursuant to

regulations adopted by the US Securities and Exchange Commission (SEC), rather than having to mail financial statements each year. This provision was not taken from the MBCA, but was designed to permit public companies to save on distribution costs in accordance with SEC notice and access rules.

Householding of annual reports and other financial statements also is authorized expressly under the amendments. Public companies may deliver a single copy of reports to a household if multiple shareholders share a common address and consent to such delivery arrangements. Again, this is consistent with SEC regulations.

Appraisal Rights

The amendments include new provisions on appraisal rights. Connecticut has not followed the Model Act in this area. Appraisal remains the exclusive remedy for dissenting shareholders with respect to corporate actions that create appraisal rights.[7] This approach was not changed by the amendments.

The CBCA currently denies appraisal rights to holders of listed securities and securities traded in organized markets with at least 2,000 shareholders and at least \$20 million in market value, provided the holders receive cash for their shares.[8] The amendments clarify an exception that grants appraisal rights to holders of public company securities if the corporate action is an "interested transaction." A new definition of "interested transaction" is added for this limited purpose. While the definition is quite detailed, it generally includes transactions with any person who, during the one-year period prior to approval by the Board of Directors of the corporate action, beneficially owned 20 percent or more of the voting power of the company, or had the power to cause the appointment of 25 percent or more of the Board of Directors, or was a senior executive or director of the corporation or its affiliates who would receive, as a result of the corporate action, a financial benefit generally not available to other shareholders as such (other than benefits related to employment, consulting, or retirement that are not more favorable than those previously existing).

The amendments also add an exception denying appraisal rights to holders of securities issued by open-end management investment companies registered with the SEC and subject to redemption at net asset value.



Miscellaneous Amendments

The amendments include additional provisions designed to update the CBCA, consistent with the Model Act. Many of these changes are semantic, such as the addition of a uniform definition of “expenses” that expressly includes “reasonable counsel fees.”

Conclusion

Connecticut has regularly updated its corporation statutes to maintain flexibility and to keep its corporation laws consistent with the laws of other Model Act jurisdictions. This permits courts and practitioners to interpret the law in accordance with the commentary to the Model Act and the interpretations of other Model Act states. Public Act 09-55 provides Connecticut public companies with additional tools to maintain best practices in light of changing guidelines for management and shareholders.

NOTES

[1] Conn. Gen. Stat. §33-712.

[2] *Id.* § 33-896(b).

[3] *Id.* § 33-896(b).

[4] Model Bus. Corp. Act. § 14.30 cmt. 2 (Fourth Edition).

[5] *Id.*

[6] Conn. Gen. Stat. § 33-698(a).

[7] *Id.* § 33-856(d).

[8] *Id.* § 33-856(b).



David Swerdloff, co-chair of Day Pitney's Corporate and Business Law Department, assists business clients from formation through the growth and sale of the company. Areas of particular interest include mergers and acquisitions, joint ventures, minority shareholder rights, and governance of pass-through entities.



Elida Salcedo, an associate in Day Pitney's Corporate and Business Law Department, practices in the areas of mergers, acquisitions and joint ventures, private companies, private equity and investment funds, and tax-exempt organizations and charitable giving.

For more information, please contact Dave Swerdloff at daswerdloff@daypitney.com (203) 977 7334; or Eli Salcedo at esalcedo@daypitney.com, (203) 977 7339.

Eight Significant Points in Technology Outsourcing and Remote Hosting Contracts

By Michael J. Dunne, *Day Pitney LLP*

Outsourcing is a buzz word that now covers a multitude of transactions. In general, outsourcing consists of a vendor's providing services to a customer over an extended period at agreed costs and levels of performance. Remote hosting is one type of outsourcing in which a vendor maintains and services on its computer resources certain aspects of the information technology (IT) resources of a customer.

Remote hosting is offered by vendors whose software applications require significant investments in hardware and other resources. They offer customers a choice. Customers may follow the classic license model with the software installed on customer's systems, or they may elect vendor's outsourcing services referred to as remote hosting. If a customer chooses the remote hosting option, it is in essence outsourcing a portion of its IT resources. Such customers face many of the complex business and legal issues associated with classic outsourcing whereby a customer transfers to a vendor resources previously owned and managed internally.

This article discusses a few significant points that customers should consider when acquiring new, business critical IT resources that will be remotely hosted by a vendor.

1. It Is a Relationship!

This is the single most important point. When you buy a widget, you have purchased a widget; but when you enter into an outsourcing or remote hosting arrangement, you enter into a partnership for the long haul, and both customer and vendor should strive for a positive, win-win, we-are-in-this-together-for-our-mutual-success relationship. If this point is not understood, the parties are likely doomed to failure at some level. The concept that the parties are entering into a long-term relationship under which both must feel like winners, cannot simply be embedded into one neat, well-stated provision or even a series of well-drafted provisions. It is a condition, a thought process, and an approach that must be understood, must be taken to heart, and must govern the behavior of both parties throughout the process, including during the contract negotiations. Ultimately, it must be embodied throughout the contract provisions and be reflective of each party's behavior and intent.

A prime example involves a customer's focus on price. If the customer focuses intensely on price, squeezing vendor at every turn during the negotiations, the customer's negotiating team may walk away extremely proud that they got the best possible price, but at what cost? Will the vendor then be in a position that at every turn during the relationship it will need to cut corners in an attempt to squeeze a profit or break even? Will the vendor be placed in a position that it ultimately determines to breach the agreement rather than continue to run at a loss? What motivation will the vendor have to place its top people on the engagement? Will the vendor approach the long-term relationship with a very negative attitude: Yes it won the deal over its competitors, but will it have buyer's remorse and wish it had lost?

A second example involves the request for proposal (RFP). Often customers send out an RFP developed without vendor involvement. The RFP sets forth a requirements list. Each vendor focuses on the list and its ability to meet the requirements. Then the customer grades each vendor on how many "yes" answers it provides. Such a process often leads to vendors missing the forest (the true solution needed by the customer) for the trees (the individual requirements listed). Rather than independently developing an RFP, the customer would be better served by first meeting with the potential vendors and reviewing in general terms the customer's view of its problems, obstacles, and/or principal goals and conducting a gap analysis and beginning to develop a cooperative working relationship with the various vendors. Such a cooperative process begins developing the relationship that will be so important in the long term and helps the customer develop an RFP focused in a meaningful way on its goals and solutions.

2. SLAs or Managing Expectations

Service level agreements (SLAs) are key to a successful outsourcing or remote-hosting arrangement. When addressed properly, SLAs serve a number of important functions and help ensure the success of the relationship. The process of developing and establishing SLAs should start close to the beginning of the overall acquisition process. If SLAs are left to the end, a good deal of their value is lost, they become contentious and counterproductive to the relationship, and will likely be unsatisfactory to one or both parties.



Applying the partnership concept in crafting SLAs should result in effective SLAs that enhance the likelihood of a successful outsourcing.

SLAs are not a means of extracting a penalty from a vendor that has failed to perform at an agreed level. They are more a means of confirming that the vendor's service is aimed at and can meet the customer's key goals and establishing an appropriate method of monitoring and managing the level of performance desired by the customer. Consistent with the first point, the parties must view the remote-hosting relationship as a team or partnership, each member seeking its own personal success but knowing that its success depends on the success of the other member of the relationship. If the customer sees the SLAs simply as a big stick or means to extract monetary remedies that inflict economic pain on the vendor, the long-term result is likely to be the opposite of what the customer truly wants and needs.

Applying the partnership concept in crafting SLAs should result in effective SLAs that enhance the likelihood of a successful outsourcing. When the vendor and the customer work together as a team to establish meaningful SLAs with appropriate remedies and rewards, they will focus on the reasons that the customer is seeking an outsourcing relationship and on what the customer expects to gain from that relationship. Equally, they should focus on what the vendor can actually and realistically provide and whether that will meet the customer's goals. In essence, they are managing each other's expectations on what each party will obtain from the relationship and what each party will need to contribute. Additionally, the customer will obtain a better idea of the vendor's abilities and approach to the relationship.

Effective SLAs usually consist of:

1. Metrics focused on key performance indicators;
2. Reasonable remedies for failure to achieve targeted performance levels;
3. The ability of the vendor to gain back any monetary remedies through enhanced performance;
4. A method to determine and remedy the cause of the failure; and
5. A process for periodic review and adjustment of the SLAs.

SLAs should also include a metric, such as excess repetitive failures to meet certain SLAs, by which the customer may declare the vendor's performance unacceptable and a corresponding process for the termination of the arrangement.

In crafting SLAs, the devil can be in the details. SLAs measure key aspects of the vendor's performance, such as system availability. System availability compares the number of hours that the system is available against the number of hours that it was scheduled to be available over a set period. Such equations are rife with opportunities to skew them to the point that they become meaningless or unreasonably burdensome. The definitions can be key. For example, vendors seek to reduce the scheduled hours by the number of hours devoted to emergency repairs. The time period over which the metric is measured may also be used to skew the equation. If the SLA is a percentage, the longer the period over which the measurement is made, the more favorable it is for the vendor, as it will allow poor performance to be lost in the average spread out over a longer period.

3. Acceptance

Acceptance is a hot button in the acquisition of computer resources and becomes even more of an issue when the same vendor is also remotely hosting the application. In the case of remote hosting of newly acquired IT resources, two items are being accepted, the software application and the hosting service. With respect to the software, the vendor may seek to trigger acceptance on such standards as the software performs "in all material respects" or "substantially in accordance with the Documentation." With respect to both the software and the hosting services, vendors often seek to trigger acceptance on "first productive use," or "first live use." Customers, however, prefer something more akin to the perfect tender rule under the UCC. For purposes of acceptance, a customer should, at a minimum, insist that the application perform in accordance with the documentation but only after determining the documentation adequately describes the desired features, functionalities, and performance capabilities of the software and hosting service.

Vendors argue that, if customer places the application into productive use in a manner that causes it to reap the financial benefits of the application, then the application should be deemed accepted. From the vendor's view, the customer should not take advantage of the benefits of the application and service to run its business without formally accepting and paying the

vendor. Anyone who has ever sat in front of a computer screen, however, knows that, until you actually use new computer resources or services in a real life situation, you cannot know how it will function when rolled out to the customer's staff or the customers. From a customer's view, the customer has not had a reasonable opportunity to inspect the product and service until it has sat behind the wheel and driven awhile, usually over a period that enables the customer to run the application through a full relevant cycle.

An evaluation should be made as to whether any of the new identity theft prevention and privacy statutes are applicable and then document compliance obligations as appropriate.

The agreement should also provide for acceptance of the remote-hosting service. The acceptance criteria can mirror some of the SLAs. A principal metric for both acceptance and general SLAs may involve response times. This metric raises the question of how to address the network connection between the vendor's server and the customer's server. Initial SLAs from a vendor in a remote-hosting transaction often measure only the time within the vendor's system, from the moment that the request is received at the vendor's gateway until the moment that the response is available for the customer at the vendor's gateway. The customer, however, is concerned with the overall time it takes to get from query to answer. An appropriate metric therefore should include the connection between the customer's and vendor's systems and factor in the parties' control or lack of control over such connection.

The acceptance process should include an opportunity for the vendor to correct errors that arise during the acceptance testing and for the customer to retest. It should also include a deadline by which the vendor must have demonstrated that the application and service perform as promised. The deadline should be a specified, reasonable, fixed date. If acceptance has not occurred by the date specified, then the customer may reserve its rights and allow the vendor additional time to achieve final acceptance or terminate the contract and obtain any agreed upon remedies such as a refund of fees paid to date.

The request for a refund often draws the loudest "cannot do" replies from vendors. Often vendors point to the accounting revenue recognition rules and argue that a right to reject and require a refund will prevent them from recognizing any revenue until too far in the future. Although revenue

recognition rules can cause issues for vendors, knowledgeable counsel working with the business teams and knowledgeable financial personnel for a vendor can achieve appropriate protections for both the customer and vendor in the area of acceptance. One approach is a blend of the SLAs and reasonable initial warranty provisions that do not contain an exclusive remedy of repair or replace.

4. Privacy and Security

Privacy and security are now the concerns of almost all businesses. The customers and vendors in the financial services and healthcare industries must focus on and ensure that they comply with the regulatory requirements under Gramm-Leach-Bliley Act and Health Insurance Portability and Accounting Act, as applicable. In response to numerous security breaches involving personal information and the rise in identity theft, many states have enacted laws to fight identity theft. Those laws need to be reviewed to determine their applicability. Many, like New Jersey's Identity Theft Prevention Act[1], apply to all businesses and impose certain obligations on both the businesses that own the personal information and the vendors that serve those businesses. For example, under the New Jersey Act, "personal information" means an individual's first name or initial with the last name linked to one of three categories of information, one of which is the individual's Social Security Number (SSN). The New York law regarding identity theft[2] has a similar definition, which also includes the SSN as one element. Consequently, an evaluation should be made as to whether any of the new identity theft prevention and privacy statutes are applicable and then document compliance obligations as appropriate.

In addition to standard covenants regarding the confidentiality and non-use of the protected information other than as part of the services provided, the parties should address how they will respond if a breach of security occurs and such privacy information is or might have been obtained by an unauthorized person. The provisions should require not simply that the vendor promptly report any unauthorized disclosure to the customer. The vendor should be obligated to provide the customer all information and assistance required or reasonably requested for the customer to comply with all applicable laws, including properly notifying the individuals whose information may have been obtained and applicable law enforcement agencies. Additionally, the agreement should provide for the return and/or appropriate destruction of such information.

5. Assignment

Often considered a boilerplate provision, prohibitions on assignment by either party may seem typical and appropriate at first glance. One may argue that the services are akin to a personal services contract and that the vendor should not be able to assign. Similarly, a vendor may argue that the customer may not assign without the vendor's consent because any assignment could greatly change the burdens on the vendor. Those approaches miss the reality. Each day subsidiaries, divisions, business units, and entire businesses are sold. Often such sales are in the nature of asset sales. The parties should consider and address in the outsourcing agreement a means for allowing such sales and related assignments to occur.

Similarly, the parties should address provisions that restrict use of the IT resources by the customer. Such provisions are often boilerplate. If the IT resources are used enterprise-wide, however, the parties need to address what rights the customer's subsidiaries and affiliates will have to use the IT resources. Equally important, the parties should address what rights the customer will have in connection with the sale of any business unit that uses the outsourced IT resources. The buyer in any such sale may need to use the IT resources for some transitional period after the sale closes. In such event, the customer will need the right to offer such use without violating any license, confidentiality, or other provision of its agreements with the vendor.

6. Transition Assistance

At the expiration or termination of the relationship, the customer may need the vendor's assistance to efficiently transition the services to the customer's own internal resources or to a replacement vendor. The customer will be wise to address the end of term transition issues before entering into the outsourcing contract. If the customer waits until the transition services are needed before addressing such need, the vendor will have little or no motivation to agree to provide transition assistance or to do so at a reasonable cost. Vendors have been known to refuse to provide critical services needed to properly transition to a new vendor or to offer such services only at cost prohibitive fees. The result has often been that the customer finds itself with no practical solution except to extend its relationship with the current vendor, in some instances for another multiple year term. In general, a transition services provision should address:

- 1) the transition services that will be provided (that is, the download of all data in a standard machine form);
- 2) the maximum required duration of the transition services; and
- 3) the cost to the customer for such services. When addressing the costs for the transition services; one point to cover is whether the customer should pay for such transition services if the customer terminates the relationship early because the vendor materially breaches the outsourcing agreement.

7. Technology Refresh

The parties need to agree up front on a method for updating and upgrading the underlying technology. In some situations, for purposes of competitive advantage, the customer will want the ability to require upgrades of the outsourced IT resources. In other instances, technological advances will be less important. In either case, the parties should address the relevant issues, such as:

- Who can require an upgrade;
- What updates and upgrades are included in the regular fees paid by customer;
- What obligation does the customer have to adopt new technology because, for example, the customer's remotely hosted IT resources are resident on a common platform with the vendor's other customers; and
- What assurances does the vendor provide that neither it nor any third party whose software or hardware is incorporated in the remotely hosted solution, will require an upgrade in the short term (the first three years), which will add unexpected expenses to the customer's costs.

8. Dispute Resolution

When disputes arise, they need to be resolved promptly and amicably for the relationship to survive. The parties need to provide a method to address disputes without resorting to litigation or the suspension of services or payments, neither of which can, in most situations, be an option. If the parties can raise, in a non-threatening way, problems as they occur and resolve those problems through practical business approaches, all while continuing to perform under the agreement, the



relationship has the best chance to survive and to deliver the desired benefits for the customer and vendor.

These eight points are only a sample of the complex issues that confront counsel and client when a customer seeks to establish an outsourcing or remote-hosting relationship with a vendor. In addition, counsel and client may need to address such points as the transfer and non-solicitation of employees, intellectual property rights, price certainty, warranties, changes in the services essentially mandated by changes in law (this is especially important in highly regulated industries), limitations of liabilities, international questions, rights to and upon termination, and insurance requirements. A customer considering an outsourcing transaction would be best served by working early in the process with counsel experienced in dealing with the numerous complex points that arise in such transactions.

NOTES

[1] N.J.S. 56:8-161, *et. seq.*

[2] N.Y.L. 2005 CH 442.



Michael J. Dunne practices in the areas of general corporate, intellectual property, and finance in the New Jersey office of Day Pitney LLP. Mr. Dunne is the Emerging Companies and Venture Finance practice group leader. Mr. Dunne represents clients in the computer technology, manufacturing, health care, and financial services industries with respect to general intellectual property and information technology issues, corporate matters, mergers, acquisitions and strategic alliances, and financial transactions. He represents both users and owners of technology and intellectual property assets. His experience includes acquisitions by and of technology companies, enterprise-wide licensing arrangements for key management of operations information systems, technology, joint ventures, and structuring and advising organizations to protect intellectual property assets.

For further information on specific matters in this summary, please contact Michael Dunne at mdunne@daypitney.com, (973) 966 8138.

Timely and Accurate Financial Statements

How Can They Help Your Company?

By Edward F. Burke, *Partner, B2BCFO Partners, L.L.C.*

The preparation of timely and accurate financial statements is critical to the success or failure of a business. The Chief Executive Officer, owner, partner or a member of the senior management team of a business must review the financial statements and have a good understanding of them. Visualize a funnel, with all the daily activities and costs of a business - sales, production, distribution, advertising, promotion, warehousing, engineering, research, accounting and administration - dropped into the top of this funnel, with timely and accurate financial statements coming out the bottom of it. Each and every internal and external stakeholder in the business - owners, shareholders, partners, management, employees, suppliers, landlords, bankers, legal counsel, consultants, leasing companies, federal and state tax agencies, credit agencies, potential buyers and/or sellers of the company - all depend upon and have a vested interest in the issuance of timely and accurate financial statements, the review of the financial statements and an understanding of the financial statements.

The preparation of timely and accurate financial statements creates confidence, credibility, reliability and business awareness of the owner and senior management in the eyes of bankers and other financial institutions and investors who provide cash and working capital to the business. Bankers and other financial institutions are more apt to provide the necessary cash and working capital when they have confidence the owners and senior management know what's happening in the business. The greater the level of confidence bankers and other financial institutions have in timely and accurate financial statements, the easier and faster it is to obtain the necessary cash and working capital at attractive interest rates, with satisfactory covenants, terms and conditions and the easier it is to increase cash and working capital as the business grows. This is especially valid when the business experiences ups and downs during the various economic cycles of the domestic and worldwide economy.

The internal review of financial statements and especially management's understanding of the financial statements are critical elements in making proper strategic and operating decisions regarding the business. Timely and accurate financial statements provide key financial ratios and trends, in comparison with previous months and years and in comparison with industry

peers. The understanding and analysis of these factors provide owners and management with the ability to anticipate cash and working capital needs before events occur in the business. There is nothing worse to owners and management than to find themselves with inadequate cash and working capital to grow the business when an opportunity is presented to it. Understanding financial statements, financial ratios, and inter-relationships among the various business functions - sales, production, warehousing and inventory control, engineering and accounting - is the key to a successful business. It enables the business to better budget the future and not find itself in the difficult and sometimes insurmountable situation of having neither cash nor working capital to fulfill its objectives and insufficient or no time to explore options to obtain cash and working capital.

Timely and accurate financial statements, understood by owners and management, enable them to look at "what if" scenarios. What is the impact on cash, working capital and profits if the business grows 15%, 20%, 25%, 50%? What is the impact on cash, working capital, expenses and profits if greater promotional programs are offered to customers? What is the impact if the business expands distribution domestically and internationally? What is the impact if the business introduces new products?

The preparation of timely and accurate financial statements and the analysis and understanding of financial statements empower the owner and management to significantly control the business's direction and destiny on its own terms and conditions and achieve its long-term goals.



*Submitted by, Edward Burke, CMA.
Edward is a partner in the national firm
B2BCFO Partners, L.L.C., a national firm
providing Chief Financial Officer Services to
emerging and mid-sized companies on a part
time basis.*

Edward can be reached at eburke@b2bcfo.com. His web site is www.b2bcfo.com.

Landlord Security and Recovery Rights in a Tenant Bankruptcy

By Gabriel J. Vidoni

Edited by James J. Tancredi, *Partner, Day Pitney LLP*

The recent economic downturn and accompanying challenges faced by businesses across the United States have resulted in an upsurge of bankruptcy filings by non-residential tenants. As many lessors have discovered, a tenant's entrance into bankruptcy often produces a host of troubling legal, financial, and practical problems. With unpaid rent, lease rejection damages, and uncertain prospects of recovery routinely foisted upon them, landlords may find some measure of relief in their rights against an often substantial security deposit or letter of credit.

Security deposits, whether small or large, become part of the bankruptcy estate the moment a tenant-debtor files its bankruptcy petition. See 11 U.S.C. § 541(a). Given the Bankruptcy Code's underlying objective of distributing unsecured assets of the estate equally among unsecured creditors, the fact that security deposits immediately become property of the estate might suggest that they, too, are subject to division and distribution to a commercial debtor's numerous creditors. Fortunately for landlords in possession of such lease security, this is not the case.

Section 553 of the Bankruptcy Code provides a limited advantage to creditors who share both debts and claims with a debtor in bankruptcy. Where debts are mutual and applicable state law permits, a creditor may offset the amount of its claim against the property of the estate. 11 U.S.C. § 553. Many jurisdictions equate possession of a security deposit or letter of credit with possession of a debt sufficient for purposes of offset under § 553. See *Hickey v. Fireside Inn Motel (In re Scionti)*, 40 B.R. 947, 948 (Bankr. D. Mass. 1984). Some courts have gone further, holding that a security deposit, as a matter of law, is akin to a perfected security interest in a landlord's favor. *ITXS, Inc. v. F & S Hayward (In re ITXS)*, 318 B.R. 85, 89–90 (Bankr. W.D. Pa. 2004).

Thus, where a landlord has a claim for unpaid pre-petition rent and damages stemming from rejection of a lease, after filing a motion and obtaining relief from the automatic stay under § 362, they may use the security deposit to offset or satisfy these claims up to the allowed amount. *Aspen Data Graphics, Inc. v. Boulton (In re Aspen)*, 109 B.R. 677, 683 (Bankr. E.D.

Pa. 1990); *In re Johnson*, 215 B.R. 381, 385 (Bankr. N.D. Ill. 1997); *In re Scionti*, 40 B.R. at 948; see also *Brown v. Atteritano (In re Spinelli)*, 36 B.R. 819, 821–22 (Bankr. E.D.N.Y. 1984). This is an especially attractive outcome as claims for pre-petition rent and rejection damages fit into the category of general unsecured claims which typically result in only partial satisfaction, often just cents on a dollar. Utilizing the security deposit for offset or satisfaction of pre-petition rent and lease rejection claims may enable a landlord to legitimately recover a substantially higher percentage of its claims than would occur otherwise.

Landlords must nonetheless be mindful of several legal constraints when seeking to use a security deposit for satisfaction of claims against the bankruptcy estate. First, because the security deposit is technically property of the estate under § 541(a), a landlord must obtain relief from the automatic stay prior to taking any action with respect to those funds. As a practical matter, this requirement may considerably delay the landlord's ability to draw upon the security deposit, as obtaining relief can be a slow process. Second, where state law mandates segregation of a tenant's security deposit from the rest of a lessor's funds, commingling may deprive the landlord of the ability to offset. *IndyMac Bank v. Nat'l Settlement Agency, Inc.*, No. 07 Civ. 6865, 2008 U.S. Dist. LEXIS 61786, at *12 (S.D.N.Y. Aug. 14, 2008). Fortunately, where commingling has occurred, landlords can cure the problem by immediately separating the security deposit from other funds, thereby restoring the right to offset. *In re Spinelli*, 36 B.R. at 821–22. Finally, landlords should be aware that security deposits obtained within 90 days prior to the tenant's bankruptcy filing will likely be disallowed from use for offset as a preference. 11 U.S.C. § 553.

A letter of credit provided to secure a tenant's lease obligations may also be drawn upon to cure defaults and satisfy rejection damages. See *Enron Power Mktg. v. Calif. Power Exchange Corp. (In re Enron Corp.)*, No. 04 Civ. 8177 (CM), 2007 U.S. Dist. LEXIS 73638, at *12–13 (S.D.N.Y. Sept. 21, 2007); *In re ITXS, Inc.*, 318 B.R. at 87. Because a letter of credit represents an obligation of a third party, it is not considered property of the estate, and therefore is not subject to the



automatic stay.[1] *Elegant Merch. v. Republic Nat'l Bank (In re Elegant Merch.)*, 41 B.R. 398, 399 (Bankr. S.D.N.Y. 1984). As a result, where letters of credit have been properly drafted, landlords do not have to obtain permission from the bankruptcy court before drawing upon this source of funds, greatly speeding up the process of recovery as compared to use of a security deposit. Additionally, because letters of credit and their proceeds are not part of the bankruptcy estate, funds drawn from them generally do not risk avoidance as preferential transfers under § 547(b) of the Bankruptcy Code. *In re ITXS, Inc.*, 318 B.R. at 87.

Where a security deposit or letter of credit is applied to bankruptcy claims, and use of those funds is not dictated by the terms of the lease or letter of credit, landlords should satisfy claims in the following order. Landlord should proceed against prepetition defaults first, rejection damages second, and lastly against any administrative expenses for unpaid rent.

While security deposits and letters of credit allow landlords to maximize their collection of general unsecured claims, this benefit does not come without costs. Application of these funds to claims will certainly, in the case of security deposits, and likely, in the case of letters of credit, reduce the total amount of possible recovery for lease rejection damages. *Solow v. PPI Enters. (U.S.) (In re PPI Enters.(U.S.))*, 324 F.3d 197, 208 (3d Cir. 2003). Section 502(b)(6) of the Bankruptcy Code caps a landlord's claims in bankruptcy for losses suffered as a result of lease termination. 11 U.S.C. § 502(b)(6). Such claims are limited to "[t]he rent reserved by [the] lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of [the] lease," and "[a]ny unpaid rent due under such lease, without acceleration..." *Id.* Courts have routinely held that use of a security deposit counts toward this statutory cap, and in a number of instances ruled that draws upon a letter of credit count toward the same. *See, e.g., Solow*, 324 F.3d at 208; *EOP-Colonnade of Dallas Ltd. P'ship v. Faulkner (In re Stonebridge Techs., Inc.)*, 430 F.3d 260 (5th Cir. 2005); *Musika v. Arbutus Shopping Ctr., L.P. (In re Farm*

Fresh Supermarkets of Md., Inc.), 257 B.R. 770, 772 (Bankr. D. Md. 2001). Because case law regarding the use of letters of credit and the statutory cap in § 502(b)(6) varies between jurisdictions, landlords are advised to seek legal advice on rulings in the specific jurisdiction where the case is filed.

In conclusion, security deposits and letters of credit offer landlords a rare advantage over other unsecured creditors in bankruptcy. The protection these forms of lease security provide should prove especially invaluable in this period of increasing commercial bankruptcies and lease rejections. Though, as discussed, landlords must be equally mindful of the procedural requirements and countervailing impacts when deciding to draw upon these sources of funds. Proper counsel can assure that recovery is maximized while also preventing creditors from running afoul of the law or inviting undue scrutiny.

NOTES

[1] This general proposition may be impaired where a precondition of a draw on the letter of credit is declaring a default or notice to the debtor, and such is not accomplished before the bankruptcy petition is filed.



Gabriel J. Vidoni is a third-year law student at the University of Connecticut School of Law, where he is Business Manager of the *Connecticut Law Review* and President of the Student Bar Association. Prior to law school, Gabriel worked for Tudor Investment Corporation, where he researched securities regulations and designed and implemented internal procedures to ensure compliance.

For further information on specific matters in this summary, please contact James J. Tancredi at jjtancredi@daypitney.com, (860) 275 0331.

What You Need to Know About Your D&O Policy and Bankruptcy

By Carl Stenger, *Vice President, WillisHRH Insurance*

THE ISSUE AT HAND

The concern for corporate solvency is at an all-time high. Executives, especially directors of corporations, are trying to weigh their fiduciary obligations to the companies on whose boards they serve against care for their own financial protection. Directors & Officers Liability Insurance (D&O) is more important than ever to ensure the protection of management and the board, so that corporations can retain qualified individuals to help guide them through these turbulent times.

IMPACT

The anxiety over how D&O policies will respond in bankruptcy is real and growing, because the potential of there being no corporate indemnity available to protect individuals increases the reliance on D&O policies, which ultimately may be a company's only protection. The key inquiries in those circumstances include:

- Will your D&O policy automatically shift to run-off?
- Do you have built-in protections to ensure that policy proceeds are there for individuals?
- What steps have been taken to “bankruptcy-proof” your D&O program?
- What if one of your insurers is financially unable to provide protection?

The best time to properly address all these issues is at renewal and before the company needs to enforce specific provisions, since this is when one has leverage with insurers in the negotiation process. Critical provisions may be negotiated or separately underwritten in riders. The management and the board of a distressed enterprise don't need distractions over coverage concerns when they are working to save the company.

ACTION

To help you select the best course of action and the most appropriate D&O coverage should your company face a real risk of insolvency, consider the following points:

1. If the D&O policies automatically shift into run-off upon entering bankruptcy or insolvency, will it only cover acts or omissions that allegedly occurred prior to bankruptcy? If the answer is yes, correct this; policies should go into run-off upon emergence from bankruptcy.
2. As respects the policy's retention and coverage for indemnifiable claims against the individuals, the company's financial condition should affirmatively shift treatment of an otherwise indemnifiable claim to non-indemnifiable.
3. It is advisable that D&O policies contain an order-of-payments provision stipulating that the policy should first cover non-indemnifiable claims against individuals before indemnifiable claims, and only when these have been satisfied should it respond to any corporate entity liability.
4. You should also ensure that there are dedicated Side-A DIC (difference-in-conditions) limits solely for the protection of the personal assets of the directors and officers that will “drop down” to first dollar for non-indemnifiable claims should the underlying insurance not respond – due to insolvency of underlying insurers, corporate refusal to indemnify or disputes over indemnity.

In assessing your protections, reflect on how the policy's proceeds may be utilized in bankruptcy in light of the fact that, in addition to individual executives, the company itself may be covered, directly or indirectly. An examination of limits coverages for individuals, single or combined acts, or other limitations, can reveal serious gaps in coverages.

Providing as much certainty as possible to management and the board is integral to attracting and retaining directors and officers, particularly during this period of rising challenges and concerns. A discerning annual examination of D&O coverage is integral to sophisticated business planning and long-term sustainability.

ABOUT WILLISHRH & CARL STENGER

By way of background, Willis HRH is the North American subsidiary of Willis Group Holdings, a leading global insurance broker, that develops and delivers professional insurance, reinsurance, risk management, financial and human resource consulting and actuarial services. Willis has more than 400 offices (210 in North America) in nearly 120 countries, with a global team of approximately 20,000 Associates serving clients in some 190 countries. The M&A Group, of which Carl is a member, has over 100 due diligence and marketing professionals with an average of 15 years experience serving private equity firms and their portfolio companies. This group has worked on over 3,000 leveraged buyout transactions throughout their respective careers and today works with over 250 different fund groups across North America. Carl is a proud member of the Turn Around Management Association.



Carl W. Stenger III is a TMA member and a Vice President of WillisHRH Insurance, located at 101 Merritt 7 Corporate Park, Norwalk, CT 06851.

For more specific information on this summary, Carl can be reached at the following locations:

OFFICE	203-523-0512
CELL	203-645-8542
FAX	203-523-0506
EMAIL	Carl.Stenger@willis.com
URL	www.willis.com

TUNE INTO CTTMA'S FALL SEASON

As the fall season for CTTMA arrives, we have already been soberly advised by Fairfield University Professor Edward Deak that the current recession will leave the Connecticut economy weakened and that we'll all likely suffer a sustained period of job losses, lack of liquidity and slow prospective growth. Notwithstanding that news, there is an implicit invitation to Connecticut business leaders and governmental officials to collaborate in reforging the economic fundamentals that will fuel the new economy.

The economic cycle of deleveraging also continues as hedge funds close, reposition or meltdown. At the October 5, 2009 CTTMA monthly meeting at the Stamford Marriott, we will hear more on an insiders' view of the current financial services climate and how hedge funds are moving through these tidal changes. Much like our banks, the movement and strategies in these institutions will be leading indicators of how we recover and move forward in a new competitive world.

The stock market hovering around 10,000 has provided some faint hopes that our investment or pension portfolios might be headed in a positive direction. Professor Deak would undoubtedly confirm that the market is fragile and that signs of true fundamental growth will be hard to discern near term. Our November 2, 2009 meeting in Fairfield County features Dave Kansas, a Wall Street Journal writer and the author

of The Wall Street Journal Guide to the End of Wall Street As We Know It: What You Need to Know About the Greatest Financial Crisis of Our Time and How To Survive It.

A seasoned financial writer, Dave "makes sense of the madness, revealing how the crisis is affecting our financial lives." His publishers promise that his book delivers:

- An inside look at the financial wizardry, easy money and overconfidence that drove the subprime crisis, credit crunch and market meltdown
- An analysis of the New World Order-the bankruptcy behemoths, the government's role-and how it will affect Main Street
- A look at what's safe: a rundown of which investments are protected and which aren't and how fund protection has changed
- Individual investor strategies: stocks, bonds, retirement and real estate (and whether you should think seriously about "the mattress")

These are singular opportunities for CTTMA members and colleagues to share in truly discerning insider views on the state of the world and to network with the diverse members of the Connecticut turnaround industry.

Please be sure to join us in our exciting array of fall programs.



Jim Tancredi has extensive experience in distressed acquisitions, workouts, restructurings, bankruptcies, commercial disputes, real estate, and partnership litigation matters. He has represented financial institutions, creditors' committees, bondholders, investors, acquirers, trustees, receivers, and debtors in reorganization,

bankruptcy and insolvency proceedings of regional and national significance. He has extensive mediation and arbitration experience in all related practice areas. Jim is cochair of the Bankruptcy and Creditors' Rights and Distressed Assets Practice Groups.

For further information, please contact Jim Tancredi at jjtancredi@daypitney.com, (860) 275 0331.

Disclaimer and Important Information

These Memoranda should not be construed as definitive legal advice or a legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only, and you are urged to consult a lawyer or financial advisor concerning your own situation and any specific questions you may have.