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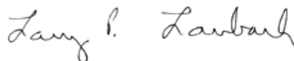
# MESSAGE FROM THE CHAIR

*To the friends of Cozen O'Connor:*

This Spring edition highlights many pertinent issues confronting a business owner in the 21st century. In the wake of unprecedented economic trouble, our lead article discusses how to protect your business from preference exposure when a customer goes bankrupt. As a result of the continued growth of China as a world economic power, we offer two timely articles: the first on the protection of intellectual property when outsourcing to China and the second discussing how you may be deemed to be an exporter of technology even if you don't sell overseas. If you regularly engage independent contractors, you'll be interested in our discussion on how the IRS is focusing enforcement efforts on misclassification of workers. Our remaining articles illustrate the breadth of our practice specialties, discussing legal issues pertaining to aircraft fractional ownership programs and the fiduciary obligations of a board of directors. We urge you to read the contents of this issue closely, and invite your inquiries concerning any of the topics in our Observer, or any concerns you may have relating to operating your business.

Best Regards,



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# INSULT TO INJURY: *Dealing with Preference Exposure When a Customer Goes Bankrupt*

Especially in our current economic climate, the financial woes of a customer can have painful repercussions for your business. The following scenario is one you may have experienced. One of your largest customers files for bankruptcy, leaving you with $75,000 in unpaid invoices. Your lawyer advises that, other than filing a proof of claim and hoping your eventual recovery in the bankruptcy case amounts to more than mere pennies on the dollar, there is nothing you can do (unless the debtor has received your goods within 20 days of its bankruptcy filing, in which case you may have a priority claim known as a "503(b)(9)" claim, so named for the section of the Bankruptcy Code covering such claims). So you absorb the hit to your bottom line and move on as best as you can.

The real kicker, however, comes a year or two down the road. You receive a letter from lawyers for the debtor or a bankruptcy trustee, or even more daunting, a summons and complaint that has been filed in the Bankruptcy Court, demanding the return of the payments you received from the debtor within 90 days prior to its bankruptcy. You are warned that these payments were "preferences" under section 547 of the Bankruptcy Code, and that they must be returned. What does that mean, and what can be done in response?

## WHAT ARE PREFERENCES?

The United States Bankruptcy Code permits a bankruptcy trustee or debtor-in-possession to avoid and compel repayment of certain transfers made by a debtor to a creditor in the 90 days prior to the filing of a bankruptcy petition (the "preference period"). These transfers are referred to as "preferences."

Section 547 sets forth the elements that a debtor-in-possession or trustee must satisfy to avoid a preference. Specifically, the trustee must prove that the payment was a transfer of an interest of the debtor in property (i) to or for the benefit of a creditor; (ii) for or on account of an antecedent debt owed by the debtor before such transfer was made; (iii) made while the debtor was insolvent; (iv) made on or within 90 days before the date of the filing of the bankruptcy petition (or within one year of filing if the creditor is an insider); and (v) that enabled the creditor to receive more than such creditor would otherwise receive in a Chapter 7 liquidation. The trustee bears the burden of proving each of these elements.

The notion of preference liability – in particular, the fact that a trustee may recover payments received on a completely legitimate debt – strikes most creditors as being grossly unfair or unreasonable, especially when the debtor may *still* owe money to the creditor. While there is no sugarcoating the fact that, on the individual creditor level, it is unfair, from a broader policy perspective the rationale for the preference law is to level the playing field among creditors – some of whom may have received nothing from the debtor during the preference period while other creditors received some or all of what they were owed. The ability of a debtor-in-possession or trustee to recover preferential transfers ensures that like-situated creditors receive an equitable share of the debtor's assets in proportion to their respective claims. Moreover, as discussed more fully below, a creditor is not defenseless in a preference action as the creditor may assert defenses set forth in the Bankruptcy Code.

*"...a creditor is not defenseless in a preference action as the creditor may assert defenses set forth in the Bankruptcy Code."*

## WHAT ARE THE STATUTORY DEFENSES TO PREFERENCE ACTIONS?

The Bankruptcy Code affords creditors a number of defenses to preference liability. These statutory defenses are aimed at encouraging creditors to continue doing business with a financially distressed entity. The three most common statutory defenses are: (i) contemporaneous exchange for new value; (ii) subsequent new value; and (iii) ordinary course of business.

### *Contemporaneous Exchange for New Value Defense*

The contemporaneous exchange for new value defense protects transfers that are both: (1) intended by the debtor and the creditor to be a contemporaneous exchange for

new value given to the debtor; and (2) in fact, a substantially contemporaneous exchange. *See* 11 U.S.C. § 547(c)(1). The rationale behind the contemporaneous exchange for new value defense is simple: if the creditor provides the debtor with "new value" (*i.e.,* goods or services) in exchange for payment, the debtor's bankruptcy estate has not been diminished as a result of the payment.

**Example:** During the preference period, creditor ships $10,000 in goods or merchandise to a customer. At the time of shipment or very shortly thereafter, the customer pays $10,000. Provided that both the creditor and the customer in bankruptcy intend that the exchange of goods for payment be a contemporaneous exchange, the $10,000 payment would be protected and not subject to avoidance by the trustee as a preference in the event of customer's bankruptcy.

### *Subsequent New Value Defense*

The subsequent new value defense prevents a trustee from avoiding a transfer where the creditor *subsequently* provides new value to the debtor, which new value was not secured by an otherwise unavoidable security interest and on account of which the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor. *See* 11 U.S.C. § 547(c)(4). Subsequent new value provided to the debtor may be offset against the potential preference liability that the creditor faces.

**Example:** During the preference period, customer pays creditor $20,000 on an outstanding invoice. Following creditor's receipt of this $20,000 payment, creditor ships the customer $15,000 in additional goods. The customer subsequently files for bankruptcy without paying creditor for the $15,000 in additional goods. Applying the new value defense, creditor may apply this $15,000 in subsequent new value to reduce its preference exposure to $5,000.

### *Ordinary Course of Business Defense*

The third common defense is the ordinary course of business defense, which protects transfers made in the ordinary course of business between the debtor and creditor. *See* 11 U.S.C. § 547(c)(2). To avail itself of this defense, a creditor must prove that the transfer was made either in the ordinary course of business or financial affairs of the parties (the "subjective test") or according to ordinary business terms in the industry in which the parties are engaged (the "objective test").

An analysis of the ordinary course of business focuses primarily upon the amount of time that passes between invoicing and payment, industry standard invoice terms, typical efforts taken by vendors in the industry to collect accounts receivable, whether accounts receivable in the industry are typically factored, and similar considerations regarding the timing and manner of payment between the parties. A deviation from the standard course of conduct will tend to support a finding that payments are out of the ordinary course of business and thus should be avoided as preferences.

The defense is predicated on consistency. Thus, with respect to the subjective test, to prove that the parties' business relationship remained consistent both before and during the preference period, it is essential that the creditor maintain meticulous and detailed records for transactions made both during the preference period as well as prior, recording the date invoices were issued, payment terms, and the dates on which payments were received. While it may be tempting, a creditor should avoid changes in payment terms in the weeks and months leading up to the filing of the bankruptcy petition, as a bankruptcy court may construe payments made according to those new terms as outside the parties' ordinary business relationship. An exception to this rule is if the change in payment terms is to payment in advance or COD, because such terms will remove the payment from the reach of the preference provision entirely – payment in advance or COD is not "on account of an antecedent debt" and therefore, by definition, not a preference.

With respect to the objective test, a creditor must prove that the parties' relationship was consistent with that found among similarly-situated entities in the applicable industry. This is usually accomplished through the use of expert witnesses who can opine as to the industry standard for course of dealing between parties in the vendor's industry. The typical expert is a credit professional having experience in the pertinent industry.

**Example:** Creditor's contractual arrangement with customer is that customer pays on 45-day net terms. Over the course of the prior year, however, customer frequently paid within

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55 to 65 days. In the 90 days prior to its bankruptcy, customer makes payments to vendor which are within 60 to 65 days net. Although the agreed upon terms were 45-days net, because customer and creditor established a course of payment which was often 55 to 65 days net, if this occurred frequently enough, most courts would likely find that none of the payments received during the preference period within 55 to 65 days net were a preference.

### CAN STEPS BE TAKEN IN ADVANCE OF BANKRUPTCY TO REDUCE PREFERENCE EXPOSURE?

In addition to asserting these statutory defenses once a demand for return of a preference has been made, creditors may also proactively adopt credit strategies to implement in their dealings with a financially distressed entity *prior* to the filing of a bankruptcy petition. Such strategies may include requiring payment in advance or payment COD and improving recordkeeping practices, among other things. For example, if a trade creditor doing business with a financially troubled debtor wishes to preserve the contemporaneous exchange defense, it is prudent to create a new account ledger for the debtor and apply payments received to this account contemporaneously with any shipment being made to the debtor. Trade creditors will lose this defense by applying payments received to aging invoices.

### CONCLUSION

Preference actions pose a real threat to any creditor doing business with financially distressed entities. An informed and proactive creditor can reduce its potential preference exposure by implementing credit strategies that, in the event of a future preference demand, permit it to avail itself of the statutory defenses to preference actions.

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*Cozen O'Connor's bankruptcy attorneys have significant experience in defending against preference actions and counseling clients in formulating credit strategies aimed at reducing potential preference exposure. For more information, please contact Eric L. Scherling (Philadelphia, 215.665.2042, escherling@cozen.com) or Lauren J. Grous (Philadelphia, 215.665.4658, lgrous@cozen.com).*

## PROTECTING YOUR INTELLECTUAL PROPERTY WHEN OUTSOURCING TO CHINA

The increased quality of Chinese manufacturing and the attractive cost savings realized in moving U.S. operations to China make outsourcing to China an option that many U.S. companies have undertaken or are considering. Such outsourcing relationships often require the sharing of valuable intellectual property rights with Chinese counterparts creating a potentially risky situation if the U.S. company does not carefully consider the peculiarities of doing business in China and the Chinese legal system. This article provides a brief overview of the considerations that U.S. companies establishing outsourcing relationships in China should bear in mind with regard to protecting their intellectual property rights.

While risks to the integrity of a company's intellectual property rights exist in any outsourcing arrangement, taking steps to understand the intellectual property system in China, carefully selecting local suppliers, clearly documenting the expectations of each party, and actively monitoring the use of one's intellectual property can assist in mitigating the risks to a company's intellectual property when outsourcing to China.

### INITIAL STEPS: REGISTER

Prior to beginning discussions with potential Chinese partners, U.S. companies should identify the intellectual property rights that are potentially involved in its China plans and consider registering this intellectual property both in the U.S. (if not registered already) and in China. While China's legal mechanism for protecting intellectual property rights is in place, it is still developing. However, without intellectual property registration protection in China, traditional legal remedies are not available if there is future infringement. As a primarily "first to register system," it is also imperative that intellectual property be registered in China as soon as possible to protect a company's rights and to have access to legal avenues of recourse. Concerns

about the cost and time involved in registering intellectual property in China or concerns about confidentiality should be carefully weighed against the potential value of accessing the Chinese judicial system if necessary to address infringement.

In addition to registration of a U.S. company's intellectual property rights, it is important that any license agreement to use a company's intellectual property rights be recorded in China. Such recordation creates a clear public record of a company's ownership in the licensed intellectual property, and with regard to trademark rights in particular, such recordation confirms that the goodwill associated with the trademarks flows to and benefits the U.S. company as the owner of the marks (and not the licensee).

## DUE DILIGENCE

After initiating efforts to register its intellectual property rights in China (or after careful consideration of such registration) but prior to negotiating a contract, a company should carefully evaluate several potential partners.

The extent of such due diligence will clearly depend on the type of product being manufactured, the type of intellectual property involved and the length of the proposed relationship. However, key considerations in carrying out due diligence with a potential Chinese partner include: (i) a review of the potential partner's financial information and business license; (ii) information about other outsourcing relationships that the Chinese company has established and references from such partners (preferably including a description of the Chinese company's handling and protection of the intellectual property of others), (iii) what processes and systems are in place to protect intellectual property rights; and (iv) location of the factory, including whether it is located in an area known for protecting intellectual property (China is highly regionalized and consideration should be given to the local reputation and attitudes toward the protection of intellectual property when choosing a partner).

Many consultants exist in China that can help companies find and evaluate potential Chinese partners. After an appropriate partner is chosen, then the contracting period is the time to begin defining and building the outsourcing relationship.

## CONTRACT NEGOTIATION

It is important that the parameters of one's relationship in China be carefully detailed in a written contract. Chinese companies will generally abide by written contracts but the contract language should be as specific as possible and avoid terms of art that might be ambiguous or open to interpretation. If a contract is considered punitive or does not make economic sense from the perspective of the Chinese partner, it is less likely to be enforceable. As a result, contracting parties should

> *"...it is also imperative that intellectual property be registered in China as soon as possible to protect a company's rights and to have access to legal avenues of recourse."*

strive to be fair. In addition, if a clause in a signed contract goes against Chinese laws or regulations, such clause will be considered void and will have no effect making more imperative the need to also have appropriate counsel review the contract. U.S. companies should make every attempt to document all aspects of the relationship from the onset of the contract. It should also be noted that a contract is often thought of by Chinese parties as subject to change as the relationship between the contracting parties develops.

With regard to intellectual property, any agreement should include all standard intellectual property protection clauses, i.e., ownership, use, protection and confidential information. Provisions should be included to require consent for all subcontracting arrangements, use of excess inventory, waste or substandard product (a particularly important issue since infringing products may quite literally be coming from the back door of the factory) and promotional use of business products or brands. In addition, audit rights should be included so that companies can monitor production and take steps to confirm compliance with the contract. In addition, key employees should execute separate contracts covering the protection of intellectual property.

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## ONGOING CONCERNS

After the contract is signed, U.S. companies should maintain and develop the relationship with their Chinese partners, establish industry appropriate ways to protect intellectual property (such as by taking anti-counterfeiting measures including limiting the supply of certain key components), and perform regular audits. If the relationship ends, the U.S. company should be careful that intellectual property is protected and that steps are taken to insure key information or products are destroyed, including monitoring of the market and visiting the Chinese factory, if possible.

*Cozen O'Connor's intellectual property and other business attorneys work regularly with local counsel in China to guide clients through the registration process, to explain the regulatory environment (and how it affects the ability to contract with regard to intellectual property rights) and to assist with ongoing audit and compliance monitoring so that those U.S. companies outsourcing to China can achieve the strongest protection possible with regard to their intellectual property. For more information, please contact Camille M. Miller (Philadelphia) at 215.665.7273 or cmiller@cozen.com or David M. Albert (Philadelphia) at 215.665.7277 or dalbert@cozen.com.*

## EXPORTING WITHOUT LEAVING THE UNITED STATES

The Wonder Widget Company (WW) is the largest exporter in the United States. As part of its sales promotion, WW often invites its foreign customers to visit its facility in York, Pa, to view its production process. It also likes to invite foreign university faculty and post-graduate engineering students to work at its facility temporarily, to assist in the creation of new product lines. While WW considers itself to be a responsible exporter that follows all export laws and regulations, it is not aware of the "deemed export" rule, which states that an export of technology is "deemed" to take place when it is released to a foreign national within the United States (§734.2 (b)(2)(ii) of the Export Administration Regulations (EAR)). This covers all technology produced by WW that requires an export license under the EAR and "technology" is broadly defined for these purposes. For example, certain materials, chemicals, electronics, computers, telecommunications and information security equipment, among other categories, require export licenses under the EAR.

Technology is "released" for export when it is available to foreign nationals for virtual inspection, when technology is exchanged orally, or when it is made available by practice or application under the guidance of persons with knowledge of the technology (§734.2(b)(3) of the EAR). WW may be required to obtain an export license before WW's foreign customers or foreign university faculty or research students read technical specifications, plans or blueprints, discuss the widget research or watch a demonstration of the production process. This is because technology required for the development, production or use of a controlled product remains controlled. Under the "deemed export" rule, WW has to apply for an export license if (1) it intends to transfer controlled technology to foreign nationals in the United States; or (2) there will be a transfer of the same technology to the foreign national's home country.

All foreign nationals are subject to the "deemed export" rule except a foreign national who (1) is granted permanent residence, as demonstrated by the issuance of a permanent resident visa (also known as a Green Card); or (2) is granted U.S. citizenship; or (3) is granted status as a "protected person" under 8 USC 1324b(a)(3) (which applies to political refugees and political asylum holders). Thus, if the person is a naturalized citizen or permanent resident of the United States, the "deemed export" rules do not apply. For individuals that are citizens of more than one foreign country, or have citizenship in one foreign country and permanent residence in another, as a general policy, the last permanent resident status or citizenship governs.

For example, if a Chinese national becomes a citizen of the United Kingdom, but also retains his Chinese citizenship, having dual-citizenship, the person's most recent citizenship in the U.K. governs and the release of technology would be

viewed as a release to the U.K. If WW is not sure about the status of a foreign national, it can ask the Bureau of Export Administration (BXA), to determine where the stronger ties exist based on the facts of the specific case. BXA may also look at the foreign national's family, professional, financial and employment ties in making a decision.

WW may also be subject to the "deemed re-export" rule, which is a term used to indicate the transfer of controlled U.S. technology to a foreign national overseas. For example, if WW transfers its controlled proprietary technology to ABC Widgets (ABC) in the U.K., and ABC, in turn, employs a Chinese national who is not a permanent resident of the U.K., nor of the United States, and who will need the controlled proprietary technology to perform his duties, WW is responsible for obtaining any required deemed export license as if it were transferring the technology to China (§734.2(b)(4) of the EAR).

Generally, the types of technology subject to the EAR are those that are in the United States or of U.S. origin, in whole or in part. Most are proprietary. Technologies that tend to require licensing for transfer to foreign nationals are also dual-use (civil and military applications). Foreign technology that is commingled with even a de minimus amount of U.S.-origin technology is subject to the EAR. While the Bureau of Industry and Security is responsible for implementing and enforcing the EAR, regulating the export and reexport of most commercial items, other government agencies regulate more specialized exports. Defense articles are under the jurisdiction of the State Department, pursuant to the International Traffic in Arms Regulations, and technology related to the production of nuclear material is under the jurisdiction of the Energy Department. *See* Supplement No. 3 to Part 730 of the EAR.

*"The deemed export rule highlights the fact that sending technology... out of the United States can be done in ways that most of us would not consider an 'export.'"*

The deemed export rule highlights the fact that sending technology, even a single item, out of the United States can be done in ways that most of us would not consider an "export." For example, in addition to a foreign person viewing technology, as described above, one can export technology by mail, e-mail or facsimile, carrying on an airplane, uploading or downloading on an Internet site, or even via a phone conversation. The technology does not have to be sold; it can be a gift, and it only needs to leave the U.S. temporarily.

Enforcement has increased in the past few years, and today it is not unusual for a single civil violation to result in a $250,000 civil fine or twice the amount of the transaction upon which the penalty is imposed. Criminal violations can result in a penalty up to $1,000,000 per violation and/or up to 20 years of imprisonment. If the person making the illegal transfer is not a U.S. citizen, she or he can face removal proceedings. For example, in 2008, a manufacturing company in California paid a $31,500 fine for allowing an employee, a national of Iran, to access technology related to aircraft parts. Later that year, a retired professor from the University of Tennessee was convicted of export control violations for allowing two foreign graduate students to access information about a military defense project. In 2009, he was sentenced to four years in prison.

To protect themselves, all U.S. exporters should have an export compliance plan. The plan should be detailed, setting forth internal export procedures and designating responsible individual(s) for carrying out the procedures. While the plan will not protect a company from civil or criminal liability under the EAR, it is normally useful for obtaining mitigation of any penalty.

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*Cozen O'Connor's international trade attorneys work regularly with clients in drafting export compliance plans and assisting them in determining whether their products are subject to Export Administration Regulations. For more information, please contact Marcela B. Stras (Washington, D.C., 202.912.4875, mstras@cozen.com).*

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# WORKER CLASSIFICATION HEATING UP AT THE FEDERAL AND STATE LEVELS

## CLASSIFICATION OVERVIEW

Worker misclassification issues are now drawing more attention from the Internal Revenue Service (IRS) and various states. This is in part due to the widening tax gap and the need for additional revenues to close budget deficits at the Federal and state levels. Additionally, states continue to be dissatisfied with the actions at the Federal level and are taking action on their own. This activity has increased substantially over the last year.

Under the common law, an employer/employee relationship exists if the person contracting for the services has a right to *control and direct both the results of the services and the means by which those results are achieved.* It is not necessary that the employer actually direct or control the manner in which the services are performed, it is sufficient that the employer merely have the right to do so. Conversely, if a worker is subject to the control or direction of another person only as to the result to be accomplished by the worker and not as to the means and the methods, he or she is an independent contractor.

The IRS and Social Security Administration have developed a 20-factor test to assess the degree of control held by the person contracting for the services. These factors were compiled and published in Rev. Rul. 87-41, and were distilled from cases and rulings that considered the issue of worker classification. Another guideline interpreting the twenty factors is found in IRS Publication 937, which lists the twenty factors and their respective relevance to the classification of a worker. In fact, these factors are merely guidelines or analytical tools and the relative importance of each factor varies with the occupation at issue and the surrounding factual context. Finally, the IRS issued a detailed training manual in order to aid auditors in the classification of independent contractors. The manual breaks down the control analysis into three component parts: behavioral control, financial control, and relationship of the parties.

Behavioral control is shown by facts that illustrate whether there is a right to control how the worker performs the specific task for which he or she is hired. Financial control is shown by facts that illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted. Finally, the relationship of the parties is shown by facts that illustrate how the parties perceive their relationship.

## FEDERAL INITIATIVE

The IRS will be utilizing a new National Research Project (NRP) audit program to cover employment taxes. It will encompass 6,000 U.S. companies over a three-year period. Commencing in February 2010, 2,000 companies will be audited each year and if selected they will be notified via an IRS Letter 3850-B. The initial audits will be based on Federal Form 941s and then be analyzed into other areas. The companies will be chosen at random and will include both small and large companies, for-profit and non-profit companies, and public and private companies. Any employment tax issue that presents itself during the course of these NRP audits will be examined.

The IRS has indicated that its goal in performing this NRP audit program is to collect data that will be used to form a basis of new audit selection formulas and over the long-term improve results of employment audits. The compilation of trending data will primarily focus on four categories: worker classification, fringe benefits, non-filers, and executive compensation. In addition to the NRP audits, the IRS will be conducting regular employment tax audits of about 60,000 employers annually.

*"...the IRS will be conducting regular employment tax audits of about 60,000 employers annually."*

## STATE INITIATIVES

**New Jersey:** Senate Bill 2773 was signed into law on January 14, 2010. This legislation is broad based covering all types of employers and provides that the New Jersey Department of Labor and Work Force Development can

audit any employer that fails to maintain or report for one or more employees every wage, benefit and tax record required under state law, or fails to pay wages, benefits, taxes or other required assessments. In addition to fines imposed for misclassification, the new law provides that if the Commissioner of Labor and Work Force Development determines that an employer knowingly violated the law, the Commissioner is allowed to suspend any business licenses held by the employer. The length of this suspension will depend on a number of factors including the number of employees for which the employer failed to maintain the required records or pay the required wages; the total amount of wages, benefits and taxes involved; and whether the employer made a good faith effort to comply with any applicable requirements. If upon a second audit conducted within 12 months of the first, the violations have not been corrected, the legislation affords the Commissioner the ability to permanently suspend or revoke the employer's business licenses.

**Maryland:** Effective October 1, 2009, Maryland enacted the Workplace Fraud Act of 2009, Senate Bill 909, covering all employers in the construction and landscaping industries. This legislation granted specific authority to the State Commissioner of Labor and Industry to investigate misclassification of workers. Moreover, the legislation makes distinctions between employers that "improperly" classify workers from those that "knowingly" misclassify such workers. In the event an employer has improperly classified workers as independent contractors, that employer will be given a 45-day period to pay restitution to the affected workers and come into compliance with all applicable labor requirements in Maryland. Failing to fully comply and make the corrections may result in a civil penalty of up to $1,000 for each employee improperly classified.

**Delaware:** Effective October 29, 2009, Delaware also enacted legislation entitled the Workplace Fraud Act, House Bill 230, covering construction service employers. Under this legislation, each construction company must keep records of all employees for 3 years and this legislation provides penalties up to $5,000 per misclassification of a worker. In addition, employers who fail to produce requested records can be issued a stop-work order by the Delaware Department of Labor and fined up to $500 per day for each day the records are not produced. This legislation provides that an employer-employee relationship is presumed to exist when work is performed for remuneration, and places the burden on the employer to demonstrate to the Department of Labor that the individual is an independent contractor. Finally, any employer who violates the act twice in a two-year period will be assessed a $20,000 penalty for each employee misclassified and may be debarred for a five-year period from obtaining any public construction contract.

**Pennsylvania:** House Bill 400 (Construction Workplace Fraud Act) has passed the Pennsylvania House and is being considered by the Pennsylvania Senate. As with Maryland and Delaware, this proposed legislation specifically attacks worker misclassification in the construction industry. The bill provides a specific set of criteria to be met by a worker in order to be classified as an independent contractor. Additionally, the bill provides a rebuttable presumption as an independent contractor if certain criteria are met. Although criminal penalties were eliminated from the latest version of the bill, there are still substantial civil penalties as well as debarment for a period of up to three years.

Based upon this expanded and seemingly extensive effort by the IRS and various states, every company that engages independent contractors should be reviewing these relationships and taking proactive measures to minimize potential exposure that may arise.

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*Cozen O'Connor's tax attorneys work regularly with clients in reviewing their relationships with independent contractors and assessing worker classification issues. For more information, please contact Dan A. Schulder (Harrisburg, 717.703.5905, dschulder@cozen.com).*

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# DOW CHEMICAL DECISION – *Delaware Chancery Court Reaffirms Business Judgment Rule is Alive and Well in Delaware*

A few recent Delaware cases had cast doubt on the protections afforded to directors of a Delaware corporation. More recent decisions, however, seem to indicate that protections for directors of a Delaware corporation are alive and well.

These decisions focus on the fiduciary duties owed by a director of a Delaware corporation and the protections afforded to directors by the business judgment rule.[1]

## FIDUCIARY DUTY GENERALLY

Every director of a Delaware corporation must discharge his or her duties in good faith, and in a manner the director reasonably believes to be in the best interests of the corporation. These concepts have been translated into two basic duties: duty of care and duty of loyalty. In addition, Delaware corporate law permits a Delaware corporation to have a provision in its charter that eliminates the personal liability of a director to the corporation or its stockholders for monetary damages for a breach of fiduciary duty as a director, except for:

- any breach of the director's duty of loyalty to the corporation or its stockholders;
- acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; or
- any transaction from which the director derived an improper personal benefit.

This exculpatory provision, which most Delaware corporations have adopted, eliminates the personal liability of directors for monetary damages for breach of duty of care, but not for breach of duty of loyalty. As a result, much of Delaware fiduciary litigation is focused on claims of a breach of the duty of loyalty or lack of good faith, a component of such duty, not a breach of the duty of care.

1. The business judgment rule is a principle that defers to the decision-making process of the directors themselves. Absent evidence of self-dealing, conflict of interest, bad faith or fraud, directors of a corporation are presumed to have exercised their business judgment in the best interests of the corporation. A court will not second-guess board decisions with 20-20 hindsight or substitute its judgment for that of the board.

However, in the context of injunctive relief, both fiduciary duties may be implicated.

## TYPES OF FIDUCIARY CASES

Delaware director fiduciary litigation has principally involved two types of cases.

- Transactional cases – involving the board taking action, typically in the context of a takeover.
- Oversight cases – involving inaction by the board in which directors are alleged to have breached their fiduciary duty by failing to properly oversee the operations of a company.

## DOW CHEMICAL

Although *Dow Chemical* (Del. Ch. Civ. No. 4349-CC (Jan. 11, 2010)) did not make new law, it did reaffirm the protections afforded to directors of a Delaware corporation in both the transactional and oversight contexts. The case involved shareholder litigation surrounding the acquisition by Dow Chemical Company of Rohm & Haas Company (R&H).

In July 2008, after a vigorous auction process by R&H, the Dow board approved a merger agreement to purchase R&H for almost $19 billion. Because of the intense bidding and competition for the deal, the Dow board approved the acquisition without traditional "outs" for Dow, most notably a financing contingency. The merger agreement did contain, however, a number of protections for R&H to make sure the transaction closed. As a result of the turmoil in the financial markets between the time the agreement was signed and its expected closing date, Dow was unable to obtain the necessary financing. Accordingly, Dow refused to close and R&H filed suit for specific performance. On the eve of trial, the lawsuit settled and Dow acquired R&H on April 1, 2009, on substantially altered (and less rich to R&H) financial terms.

### *Transactional Fiduciary Duty Claims*

The Dow shareholders' principal complaint was that the directors breached their fiduciary duty by entering into the merger agreement without traditional "outs," particularly a financing contingency. The court analyzed the breach of fiduciary claims on the approval of the merger under the standard set forth in *Aronson v. Lewis,* which provides that plaintiffs must plead particularized facts that raise reasonable doubt that either (a) a majority of the directors who approved

the transaction were disinterested and independent or (b) the transaction was the product of the board's good faith, informed business judgment.

The court then analyzed the two prongs. For the first prong, plaintiffs would have to show that a least half the Dow board was not disinterested and independent. Disinterested "means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit that devolves upon the corporation or all stockholders generally." "Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." The court rejected arguments that any of the directors were interested. As a result, the court held that independence need not be considered.

The court then considered the second prong of *Aronson* – that there was reason to deny defendants the protection of the business judgment rule. To do so, plaintiffs had to plead particularized facts sufficient to raise reasonable doubt that (a) the action was taken honestly and in good faith or (b) the board was adequately informed in making the decision. The court stated that there was no real evidence that the board was not adequately informed. In fact, the court noted that the plaintiffs' real issues were with the substance of the board's decisions, not the process the board followed. The court stated that substantive second-guessing of the merits of a business decision is precisely the kind of inquiry that the business judgment rule prohibits.

The court similarly rejected arguments that the directors did not act in good faith. "To show that a disinterested and independent board acted outside the bounds of business judgment, plaintiffs must show that directors acted in bad faith." The court then cited the recent Delaware Supreme Court decision in *Lyondell Chemical* for the proposition that "[i]n the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."

In *Lyondell,* the Delaware Supreme Court reviewed its jurisprudence on what constitutes bad faith. At one end of the spectrum is "subjective bad faith" – conduct motivated by actual intent to do harm – which clearly constitutes bad faith. At the opposite end of spectrum is lack of due care – *i.e.,* gross negligence without any malevolent intent. Gross negligence, without more, does not constitute bad faith. A third (intermediate) category is intentional dereliction of duty or conscious disregard for one's responsibilities. In some cases, this type of misconduct may be treated as violation of the fiduciary duty to act in good faith. To prevail on such a charge, however, plaintiffs would have to show that the directors completely and utterly failed to attempt to meet their duties. Finding that this extreme standard was not met, the *Dow* court dismissed the claim that the defendant directors breached their fiduciary duties by approving the R&H merger.

### *Oversight Fiduciary Duty Claims*

Plaintiffs in Dow also brought breach of fiduciary duty oversight claims, alleging that the board failed to detect a variety of alleged wrongs, including bribery. Because Dow had adopted a charter provision eliminating directors' liability for monetary damages for a breach of the duty of care, plaintiffs had to plead particularized facts showing bad faith (*i.e.,* breach of the duty of loyalty) in order to establish a substantial likelihood of personal liability.

*In re Caremark Int'l* provided that directors could be liable for a failure to monitor only if there is a sustained or systematic failure of the board to exercise oversight, such as an utter failure to attempt to assure a reasonable information and reporting system exists. Another case, *Stone v. Ritter,* made clear that director oversight liability is based on the concept of good faith imbedded in the duty of loyalty. Bad faith is a necessary condition to director oversight liability. Imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations or that the directors demonstrated a conscious disregard for their responsibilities, such as by failing to act in the face of a known duty to act.

The court then analyzed the facts in *Dow* and found that even if there may have been wrongdoing at the company, there were no facts that would lead to the conclusion that the board should have had cause for suspicion to the level required to sustain a failure to supervise claim. Accordingly, the court also dismissed those charges.

## PRACTICE POINTS

Delaware case law consistently demonstrates that board process and recordkeeping, as well as director

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independence, are crucial in combating breach of fiduciary claims. Accordingly, boards should be conscious of the following points:

- Process is very important.
- Board should keep good records of its deliberations and matters considered.
- Board should engage legal and financial advisors and, as appropriate, other advisors.
  - Advisors should be independent.
- Board should be actively involved in the process.
  - Board should get regular updates from individuals involved in negotiations, as well as from its advisors.
- Board needs to be independent and disinterested.
  - If not, Board should create special committee of disinterested directors.
  - Committee should be authorized to retain its own independent financial and legal advisors.

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*Cozen O'Connor's corporate and other business attorneys work regularly with clients in assessing director liability and fiduciary duty issues. For more information, please contact Richard J. Busis (Philadelphia, 215.665.2756, rbusis@cozen.com).*

## A SECOND LOOK AT AIRCRAFT FRACTIONAL PROGRAMS

Not long ago, aircraft fractional ownership was promoted as an attractive alternative for individuals and businesses seeking the benefits of private aircraft travel, but whose annual flight time requirements did not justify the substantial capital and operating costs of owning a full airplane or undertaking the burden of maintaining a flight department. While charter and jet card programs do not require long term commitments or initial capital investment, the lure of fractional programs was in providing the owner with access to a managed fleet of aircraft, and the ability to depreciate his or her capital investment while maintaining and, perhaps, increasing the value of the investment in a market in which private aircraft travel was in demand.

In the current economic climate, however, luxury and business travel has significantly declined, and pre-owned aircraft values have dramatically fallen due to a glut of private aircraft on the market with few buyers. Many fractional owners are making an early exit from their programs to eliminate monthly fixed costs and fees, even if it means taking a loss on their capital investment and paying brokerage or remarketing fees to the fractional operators. At the same time, however, fractional operators are offering incentives and discounts to attract new customers and maintain existing customers. Given this environment, there are significant buying opportunities for those who still favor fractional programs over full aircraft ownership, as well as opportunities for current fractional owners to renegotiate their deals if they are willing to retain their capital investment in a declining market, rather than exercise repurchase rights when aircraft values are at their lowest in years.

A fractional interest in an aircraft is an undivided capital interest in a private aircraft. Fractional owners agree not only to share their own aircraft with others having a shared interest in the same aircraft, but also to "lease" their aircraft to other owners in the fractional program (an "interchange"). All of the owner participants use a common management company to provide a turnkey operation of the aircraft, including for crews, scheduling and maintenance.

There are multiple benefits of fractional ownership. Participants avoid the hassle of repeated airport searches and the need to arrive at the airport two hours before take-off. Business jets can land at more than 5,500 US airports compared to 500 airports for commercial service, reducing overall travel time and expense. Unlike commercial air travel, fractional owners are assured of privacy during their flights, so flight time can be productively utilized for business meetings and the like. In most programs, there is guaranteed on demand availability: with a minimum of only six hours of advance notice, a jet will be made available to the owner. Unlike many charter arrangements, the fractional owner is not charged for "deadhead" or ferrying time before the start time of the flight or after the owner has reached his or her destination.

Upon joining a fractional program, the customer purchases the undivided interest in a specific aircraft. The capital cost is proportionate to the size of the interest purchased, and most programs offer a one-sixteenth share or greater. The larger the share, the greater the number of hours allocated annually to the owner during the program's term. In addition to the up front capital cost, the owner pays an hourly fee for each hour of flight time used (an "occupied hour"), a monthly management fee (which will also be proportionate to the size of the purchased share), and other selected fees depending upon the program, including, for example, a fuel surcharge to account for fluctuations in fuel prices and "ferry" fees for traveling outside of the program's standard geographic service area. Generally, there is no economy of scale in purchasing a larger percentage interest, although some programs are offering incentives along with larger shares, such as guaranteed availability for upgrades to a larger cabin aircraft, simultaneous use of more than one aircraft without a premium charge, and limited flights outside of designated geographic service areas without a surcharge.

The cost of the fractional interest is tied to the cost of the aircraft's purchase by the fractional operator, but it is typically not equal to that cost. For example, larger fractional operators can often purchase aircraft from manufacturers at discounts without passing along the total savings to the fractional customer. Operators that offer fractional pre-owned aircraft often add hard to verify costs for refurbishment and other charges associated with purchasing the aircraft. The true value of the aircraft relative to the purchase price paid by the owner for a fractional share is particularly relevant when it comes time to resell the interest back to the operator at the end of or during the term of the program. Since the repurchase price for the aircraft is generally based upon its fair market value as of the date of sale, any premium paid at inception over the true cost of the aircraft will not be recovered on resale, and the residual value of the fractional interest will likely be less than the owner anticipated, even taking into account normal depreciation and market fluctuation. This becomes an even more critical issue if the purchase price was financed and the proceeds on resale of the aircraft are less than the outstanding balance of the loan. Moreover, establishing fair market value is a challenge in the current market since there are so few sales for comparable aircraft to establish a real market price.

In this current environment, purchasers of fractional interests will find plenty of negotiating room for the price of their interest. Some owners of newer aircraft have been forced by financial considerations to sell their aircraft at current market value, notwithstanding the depressed market, meaning that fractional owners who resell shares in an aircraft are selling them at prices which are substantially less than they were able to command for the very same aircraft just months ago. In fact, pre-owned aircraft prices represent the biggest decline in the industry, with discounts as high as 25% to 30% in some cases, making fractional programs more attractive than ever.

Similarly, to maintain market share in a declining market, fractional operators are more than ever inclined to negotiate the other terms, fees and charges associated with fractional programs. These incentives include reducing monthly management fees, or waiving the annual increase in those fees, and in occupied hourly rates; guaranteeing upgrades to larger cabin aircraft for smaller cabin fractional owners that might only occasionally need larger aircraft; increasing or waiving the minimum flight time (short-leg) requirements; waiving fuel surcharge requirements; and waiving ferry surcharges on a set number flights outside the program's standard coverage area. Depending upon the usage patterns of an owner, these concessions can represent real value and may help to offset the cost of holding on to the fractional interest in a declining market.

While savings abound in the fractional market, fractional programs are not for everyone. Depending upon the specific needs and objectives of the user, card programs, charters, and in some cases, full aircraft ownership may make more sense, and in this market, there are savings to be had in each. Due diligence, careful planning and proper guidance from consultants, counsel, and accountants with aircraft experience will help to ensure that the owner's objectives are met and that the savings are well worth the commitment to private aircraft travel.

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*Cozen O'Connor's business attorneys regularly counsel clients in legal issues relating to private aircraft purchase and ownership, and aircraft fractional programs. For more information, please contact Steven N. Haas (West Conshohocken, 610.832.7441, shaas@cozen.com).*

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