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RETRACING DELAWARE'S CORPORATE ROOTS THROUGH RECENT DECISIONS: CORPORATE FOUNDATIONS REMAIN STABLE WHILE JUDICIAL STANDARDS OF REVIEW CONTINUE TO EVOLVE

Bradley R. Aronstam and David E. Ross*

Delaware's renowned corporation law rests upon a director-centric premise, reflected in Section 141 of the Delaware General Corporation Law ("DGCL"), that the business and affairs of corporations are to be managed by boards of directors. In carrying out this mandate, directors owe fiduciary duties requiring that they act in an informed manner (*i.e.*, the duty of care) and only in the best interests of the corporation and all of its shareholders (*i.e.*, the duty of loyalty). Consistent with the legislative judgment placing directors at the helm of the corporate enterprise, and mindful of the necessary risk-taking inherent in that role, the Delaware courts afford unconflicted, informed, and properly motivated directors wide latitude in carrying out their duties. That deference is reflected in the venerable business judgment rule, under which courts will not second-guess the decisions of independent and disinterested directors acting in good faith and following an appropriate decision-making process.

This Article explores seven significant decisions of the Supreme Court of Delaware and the Delaware Court of Chancery over the last eighteen months addressing various director challenges and the appropriate standards of judicial review for assessing the propriety of the contested conduct. Part I of this Article addresses *In re Citigroup Shareholder Derivative Litigation*,¹ which involved director business risk oversight allegations and emphasized the continued viability of the business judgment rule in this setting. Part II of this Article discusses *Selectica, Inc. v. Versata, Inc.*,² including the Court's application of enhanced scrutiny to a modern shareholder rights plan with a 4.99% threshold and the deference afforded directors who are well informed and advised by sophisticated experts. Part III of this Article examines *Lyondell Chemical Co. v. Ryan*,³ which revisited the *Revlon* doctrine and raised the bar for plaintiffs seeking to establish that unconflicted directors failed to maximize shareholder value in the sale of corporate control context. Part IV of this Article evaluates *In re John Q. Hammons Hotels Inc. Shareholder Litigation*⁴ and the applicability of entire fairness review to transactions involving controlling shareholders not standing on both sides of the underlying transaction, as well as the effect that special committees and majority-of-the-minority conditions should have on the governing standards for assessing such transactions. Part V of this Article highlights a number of related issues addressed in *In re CNX Gas Corporation Shareholders Litigation*,⁵ which departed from the traditional deferential review accorded two-step "Siliconix" freeze-out transactions

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1. 964 A.2d 106 (Del. Ch. 2009).
2. 2010 WL 703062 (Del. Ch. Feb. 26, 2010).
3. 970 A.2d 235 (Del. 2009).
4. 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).
5. 2010 WL 2291842 (Del. Ch. May 25, 2010).

by a controlling shareholder in favor of a “uniform standard” similar to the one employed in *Hammons*. Part VI of this Article reviews *Berger v. Pubco Corporation*⁶ and the appropriate parameters of the quasi-appraisal remedy arising from a controlling shareholder’s breach of its disclosure obligations in connection with a short-form merger. Part VII of this Article recounts the emphasis of the Court in *Maric Capital Master Fund Ltd. v. PLATO Learning, Inc.*⁷ on the importance of full disclosure in conventional long-form mergers and the risk to corporate transactions absent such disclosure. This Article concludes in Part VIII that, together, these decisions reaffirm the tenets underlying Delaware’s director primacy model and the policy judgments upon which the business judgment rule rests.

I. *IN RE CITIGROUP INC. SHAREHOLDER DERIVATIVE LITIGATION*

Director oversight liability has been an established cause of action in Delaware’s corporate jurisprudence since the Court of Chancery’s holding, in *In re Caremark International Derivative Litigation*,⁸ that the directors’ duty to remain “reasonably informed” necessarily requires that they ensure that “information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board . . . to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”⁹ Unlike traditional *Caremark* oversight claims that the directors failed to properly monitor the corporation’s regulatory or compliance risk, *In re Citigroup Shareholder Derivative Litigation*¹⁰ presented the Court of Chancery with allegations that directors failed to monitor properly “business risk” resulting from a corporation’s heavy exposure to the subprime lending market. Mindful of the vital risk-taking function of directors and emphasizing the continued viability of the business judgment rule in the business risk oversight setting, the Court in *Citigroup* refused to interpret *Caremark* in a manner that would subject the directors to judicial second-guessing of the company’s investment decisions absent conflict or other extreme reasons for doing so.



The *Citigroup* case centered on massive subprime-related losses experienced by banking giant Citigroup Inc. (“Citigroup”) during the 2007 credit crisis. Plaintiffs, the owners of Citigroup stock, asserted *Caremark* claims against the Company’s directors, alleging they had breached their oversight duties by failing to monitor properly and manage Citigroup’s subprime risk. Because their oversight claims did not challenge a particular business decision, plaintiffs argued that demand should be excused as “futile” given the “substantial likelihood of personal liability” faced by the directors in having failed to monitor properly Citigroup’s subprime risk.¹¹ Noting that “demand will be excused based on a possibility

6. 976 A.2d 132 (Del. 2009).

7. 2010 WL 1931084 (Del. Ch. May 13, 2010).

8. 698 A.2d 959 (Del. Ch. 1996).

9. *Id.* at 970.

10. 964 A.2d 106 (Del. Ch. 2009).

11. *Id.* at 121; *see also* Rales v. Blasband, 634 A.2d 927, 933-34 (Del. 1993) (addressing the requisite demand futility analysis for derivative actions that do not involve challenges to an affirmative business decision of the board).

of personal director liability only in the rare case when a plaintiff is able to show director conduct that is 'so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists,'¹² the Court turned to *Caremark* and the specifics of plaintiffs' oversight allegations.

As summarized by the Supreme Court in *Stone v. Ritter*,¹³ director oversight liability under *Caremark* requires one of two showings: (i) that "the directors utterly failed to implement any reporting or information system or controls" or (ii) "having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."¹⁴ A showing of "bad faith" is thus a "necessary condition" to oversight liability as "a plaintiff must show that the directors *knew* 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."¹⁵

Unlike traditional *Caremark* allegations that the directors failed to monitor employee misconduct or violations of law (*i.e.*, regulatory risk or compliance oversight), the plaintiffs in *Citigroup* sought to hold the defendant directors liable for failing to monitor adequately Citigroup's "business risk." In particular, the Court distilled plaintiffs' theory to one that the directors should be held liable because they failed to appreciate the risk associated with Citigroup's subprime investments which, in hindsight, turned out poorly. But such claims fall within traditional process-based duty of care and business judgment rule analysis, which is not displaced (or diminished) in the *Caremark* oversight context:

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a "wrong" business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law.¹⁶

Indeed, the Court found that fundamental differences between business risk oversight and traditional *Caremark* cases required plaintiffs to overcome even higher hurdles¹⁷ in business risk oversight cases:

While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different To impose oversight liability on directors for failure to monitor "excessive" risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors.

12. *Citigroup*, 964 A.2d at 121 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)).

13. 911 A.2d 362 (Del. 2006).

14. *Citigroup*, 964 A.2d at 123 (quoting *Stone*, 911 A.2d at 370).

15. *Id.* (emphasis in original).

16. *Id.* at 126.

17. As explained by the Court, "the burden required for a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a difficult one, and the burden to show bad faith is even higher." *Id.* at 125. And as noted in the *Caremark* decision, "director liability based on the duty of oversight 'is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.'" *Id.* (quoting *Caremark*, 698 A.2d at 967).

Oversight duties under Delaware law are not designed to subject directors, even expert directors, to personal liability for failure to predict the future and to properly evaluate business risk.¹⁸

Plaintiffs' specific allegations fell short of this substantial burden. Because Citigroup's certificate of incorporation included an exculpatory provision adopted pursuant to Section 102(b)(7) of the DGCL and there was no argument that the directors were conflicted or otherwise acted disloyally in failing to monitor Citigroup's subprime risk, plaintiffs were required to allege "bad faith." Plaintiffs invoked various "warning signs" in the public domain indicating worsening conditions that allegedly should have alerted the directors to the impending risks associated with Citigroup's subprime investments. But nothing about the so-called "red flags" supported the conclusion that the directors should have been aware of the impending losses or, more particularly, that they had "consciously" disregarded any warnings. And having acknowledged the establishment by Citigroup of procedures and controls designed to monitor risk, including an Audit and Risk Management Committee (the "ARM Committee") populated by a majority of the director defendants and charged with monitoring Citigroup's risk (thus negating the first basis for *Caremark* liability),¹⁹ plaintiffs were unable to attack those controls as inadequate.²⁰

In short, the Court refused to accept plaintiffs' invitation "to conclude from the presence of these 'red flags' ... that the directors failed to see the extent of Citigroup's business risk and therefore made a 'wrong' business decision by allowing Citigroup to be exposed to the subprime mortgage market."²¹ In so doing, the Court contrasted the oversight claims before it with those at issue in *American International Group, Inc. Consolidated Derivative Litigation*,²² which involved factual allegations of "pervasive, diverse, and substantial financial fraud involving managers at the highest levels."²³ *AIG*, unlike *Citigroup*, concerned the alleged failure to oversee "pervasive fraudulent and criminal conduct," and "the complaint there supported the assertion that top AIG officials[, certain of whom also served as AIG directors,] were leading a 'criminal organization' and that '[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG [wa]s extraordinary."²⁴ Plaintiffs' oversight claims in *Citigroup* were accordingly dismissed as insufficient to excuse demand.²⁵

18. *Id.* at 131.

19. *See* text accompanying *supra* note 14.

20. The Court refused to hold the director members of the ARM Committee to a higher standard of care, explaining that "[d]irectors with special expertise are not held to a higher standard of care in the oversight context simply because of their status as an expert." *Citigroup*, 964 A.2d at 128; *but see id.* (reaffirming the holding of *Emerging Communications, Inc. Shareholders Litigation*, 2004 WL 1305745, at *39-40 (Del. Ch. May 3, 2004), that "[e]valuating director action under the bad faith standard is a contextual and fact specific inquiry and what a director knows and understands is, of course, relevant to such an inquiry").

21. *Id.* at 130.

22. 2009 WL 366613 (Del. Ch. Feb. 10, 2009).

23. *Citigroup*, 964 A.2d at 130 (quoting *AIG*, 2009 WL 366613, at *3).

24. *Id.* (quoting *AIG*, 2009 WL 366613, at *3). The Court also emphasized that the allegations in *AIG* were analyzed "under the plaintiff-friendly standard of Rule 12(b)(6), rather than the particularized pleading standard of Rule 23.1." *Id.* at 130 n.75.

25. Also noteworthy was *Citigroup's* holding that plaintiffs had adequately pled demand futility with respect to their claim that the directors had committed "corporate waste" in approving an agreement with Citigroup's CEO that entitled him to \$68 million and other benefits upon his retirement. *See id.* at 139. After acknowledging the "difficult" and "stringent requirements" to state a claim for corporate waste and adequately plead demand excusal for such claims, the Court explained that a "plaintiff must overcome the general presumption of good faith by showing that the board's decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation's best interests." *Id.* at 136 (quoting *White v. Panic*, 783 A.2d 543, 554 (Del. 2001)). While

II. *SELECTICA, INC. V. VERSATA, INC.*

Shareholder rights plans, or “poison pills” as they are commonly referred to, emerged as popular defensive measures in the hostile takeover era of the 1980s. *Selectica, Inc. v. Versata, Inc.*²⁶ addressed the next generation of rights plans in upholding the adoption and use of a plan aimed at preserving potentially valuable net operating losses (“NOLs”) – as distinct from seeking to deter an unfriendly suitor – perceived to be threatened by a shareholder’s open market purchases of the corporation’s stock. While *Selectica* was not the Court of Chancery’s first foray into the world of poison pills, it marked the first time the Court sustained the triggering of a modern pill. Like the above described deference accorded the directors of Citigroup with respect to their monitoring of the company’s business risk, *Selectica*’s upholding of a 4.99% threshold pill intended to protect an asset with admittedly “speculative” and “questionable” value underscores the great deference – and substantial flexibility – afforded independent and disinterested directors in this context, especially where such directors are well advised and informed.



Selectica involved three corporate players: Selectica, Inc. (“Selectica”), a Delaware corporation providing enterprise software solutions for contract management and sales configuration systems; Trilogy, Inc., a Delaware corporation also specializing in enterprise software solutions that was a competitor of Selectica; and Versata Enterprises, Inc. (“Versata”), a Delaware corporation providing technology powered business services to clients.²⁷ Versata was a subsidiary of Trilogy, Inc. and together, the two (referred to collectively in *Selectica* and herein as “Trilogy”) owned more than 6% of Selectica’s outstanding common stock before intentionally triggering the rights plan in question.

Selectica was a struggling microcap company whose value consisted primarily of its cash reserves, intellectual property portfolio, customer and revenue base, and an estimated \$160 million in NOLs. The NOLs were generated over the preceding several years due to substantial losses and the failure to turn an annual profit since going public in March 2000.²⁸ Following previously rebuffed expressions of interest by Trilogy concerning an acquisition of Selectica, Trilogy

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executive compensation decisions fall within the authority of directors, “the discretion of directors in setting executive compensation is not unlimited” and “the Delaware Supreme Court was clear when it stated that ‘there is an outer limit’ to the board’s discretion to set executive compensation, ‘at which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste.’” *Id.* at 138 (quoting *Saxe v. Brady*, 184 A.2d 602, 610 (Del. Ch. 1962)). Plaintiffs’ allegations raised a reasonable doubt as to whether the exit package exceeded that “outer limit” and the case continued on that limited basis. *Id.*

26. 2010 WL 703062 (Del. Ch. Feb. 26, 2010). The Supreme Court of Delaware issued an opinion affirming this decision on October 4, 2010. See *Versata Enters., Inc. v. Selectica, Inc.*, No. 193, 2010 (Del. Oct. 4, 2010) (not available on Westlaw or Lexis as of this Article’s publication). Other than clarifying the test for “preclusion” under Delaware law (see *infra* note 48), the Supreme Court opinion embraced all aspects of the Court of Chancery’s analysis.

27. The parties’ dispute was preceded by an acrimonious relationship resulting from, among other things, Trilogy’s (or affiliates of Trilogy) having sued Selectica for alleged patent infringement on two separate occasions. See *Selectica*, 2010 WL 703062, at *2.

28. “NOLs are tax losses realized and accumulated by a corporation that can be used to shelter future (or immediate past) income from taxation.” *Id.* at *1. But because their value depends upon the company’s future profitability before they expire in 20 years, NOLs are considered contingent assets whose value is impossible to determine. *Id.* Also important to understanding NOLs (and the dispute in *Selectica*) are the limitations imposed on NOLs by the IRS which seek to deter corporate taxpayers from benefiting from NOLs generated by other entities. Specifically, Internal Revenue Code section 382 limits the use of NOLs in periods following an “ownership change” that, while complicated to calculate, only involves shareholders holding 5% or more of a corporation’s outstanding shares. See *id.* at *3.

began acquiring Selectica shares on the open market in the fall of 2008 and informed Selectica in November of that year that it had amassed more than 5% of Selectica's outstanding stock.

Concerned that such acquisitions might threaten Selectica's NOLs, the Selectica board (the "Selectica Board") – which was comprised of four independent and disinterested directors during the relevant period – met "to gauge the impact of these acquisitions, if any, on Selectica's NOLs, and to determine whether anything needed to be done to mitigate their effects."²⁹ The Selectica Board, with the assistance of its investment banker, an outside tax advisor retained to evaluate Selectica's NOLs,³⁰ and Delaware counsel, considered – and ultimately decided to adopt – an amendment to Selectica's existing rights plan that would lower the threshold trigger from 15% to 4.99% (the "NOL Pill").³¹ The 4.99% trigger was driven largely by the 5% "ownership change" threshold established by the IRS.

Purportedly "to 'bring accountability' to the [Selectica] Board and 'expose' [its allegedly] 'illegal behavior' ... in adopting a pill with such a low trigger," Trilogy intentionally "bought through" the NOL Pill the following month, increasing its total ownership share in Selectica to 6.7% and becoming an "Acquiring Person" under the NOL Pill.³² The Selectica Board met seven times during the ten-day period provided for under the NOL Plan and received numerous presentations from its financial, accounting and legal advisors concerning the effect of Trilogy's stockholdings on Selectica's NOLs. During that period, Selectica also repeatedly (and unsuccessfully) attempted to secure a standstill from Trilogy concerning any additional purchases while the Selectica Board assessed whether Trilogy should be exempted from the NOL Pill.

An independent committee of the Selectica Board ultimately confirmed the findings of the directors and their experts that "the NOLs were a valuable corporate asset and that they remained at significant risk of being impaired."³³ The committee "concluded that Trilogy should not be deemed an 'Exempt Person,' that its purchase of additional shares should not be deemed an 'Exempt Transaction,' that an exchange of rights for common stock (the 'Exchange') should occur, and that a new rights dividend on substantially similar terms ought to be adopted."³⁴ Those decisions were based on the committee's conclusions that:

Trilogy's actions ... "were very harmful to the Company in a number of respects," and that "implementing the exchange was reasonable in relation to the threat imposed by Trilogy," in particular, because the NOLs were seen as "an important corporate asset that could significantly enhance stockholder value," and because Trilogy had intentionally triggered the NOL Pill, publicly suggested it might purchase

29. *Id.* at *6.

30. The outside tax advisor, which specialized in NOL calculations, had analyzed Selectica's NOLs for the Selectica Board since March 2007. *See id.* at *3.

31. The NOL Pill grandfathered in existing 5% shareholders such that they were permitted to acquire up to an additional 0.5% (subject to the original 15% cap) without triggering the plan. *See id.* at *7. The NOL Plan also provided that the underlying rights would flip in ten business days after any shareholder became an "Acquiring Person" unless the Selectica Board either granted an exemption or exchanged the rights for common stock. Importantly, the NOL Pill conditioned the Selectica Board's ability to exempt an Acquiring Person upon a determination that the shareholder's ownership "would not 'jeopardize or endanger the availability to the Company of the NOLs....'" *Id.* at *8.

32. *Id.*

33. *Id.* at *10.

34. *Id.* at *11.

additional stock, and had refused to negotiate a standstill agreement, despite the fact that an additional 10% acquisition by a 5% shareholder would likely trigger an ownership change under Section 382.³⁵

Framing the “principal question” as “the reasonableness of a board’s adoption of a low-threshold poison pill in order to protect assets of speculative and questionable value absent an explicit plan for how such value might be realized,”³⁶ the Court assessed Selectica’s adoption and use of the NOL Plan under enhanced *Unocal* scrutiny.³⁷

The Court initially evaluated whether the Selectica Board should be afforded “material[ly] enhance[d]” deference under *Unocal* for defensive measures implemented by a majority of outside directors.³⁸ While the Selectica Board did not meet the specific requirements for this protection, the Court held that “any concern that the [Selectica] Board’s actions stem[med] from a desire for entrenchment [wa]s seemingly groundless” and concluded “that there [wa]s sufficient evidence to find good faith and reasonable investigation by the [Selectica] Board here.”³⁹

Addressing the first prong of *Unocal*, the Court found that the Selectica Board had acted reasonably in concluding that the NOLs comprised a potentially valuable asset that was threatened by Trilogy’s purchases of Selectica shares. Notwithstanding the “speculative” and “questionable” value of the NOLs to Selectica, the Court was satisfied that the Selectica Board, relying on the advice of multiple outside experts, “was reasonable in concluding that Selectica’s NOLs were worth preserving and that Trilogy’s actions presented a serious threat to their impairment.”⁴⁰

The Court next turned to the second prong of *Unocal*, which “requires an evaluation of whether a board’s defensive response to the threat was preclusive or coercive and, if not, whether it was ‘reasonable in relation to the threat’ identified.”⁴¹ In assessing the preclusiveness of the NOL Plan’s 4.99% trigger,⁴² the Court explained that “[a] defensive

35. *Id.* at *9. The Exchange doubled the number of Selectica shares owned by all shareholders other than Trilogy and effectively diluted Trilogy’s holdings from 6.7% to 3.3%. *See id.*

36. *Id.* at *11.

37. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (holding that before a board’s defensive measures will be accorded the protections of the business judgment rule the directors must first satisfy a two-step reasonableness test). Referred to as “enhanced judicial scrutiny,” *Unocal* requires directors to demonstrate both that “they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and that the “defensive measure [undertaken in response thereto] was reasonable in relation to the threat posed.” *Id.* at 955; *see also Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995) (expanding the *Unocal* doctrine by holding that a board’s action need only fall within a “range of reasonableness” to be upheld so long as the defensive measure at issue is not “coercive or preclusive”).

38. Specifically, *Unocal* held that “where the defensive actions were taken by ‘a majority of outside directors,’ proof of the board’s good faith and reasonable investigation is ‘materially enhanced.’” *Selectica*, 2010 WL 703062, at *12 (quoting *Unocal*, 493 A.2d at 955). In contrast to the “subjective ‘actual person’ standard” [applied] in considering the question of director independence,” *id.* at *13 (citation omitted), Delaware courts define an “outside” director “as ‘a non-employee and non-management director’ that ‘receiv[es] no income other than usual directors’ fees....” *Id.* (quoting *Unitrin*, 651 A.2d at 1375; *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1074-75 (Del. 1995)). Two of Selectica’s four directors therefore could not be considered “outside” directors in light of their roles as Co-Chairs of Selectica during the events at issue (a position acknowledged by Selectica to be akin to that of a CEO) and the additional compensation they received in connection with those roles. *Id.* The Court nevertheless concluded that “although nominally not outside directors, the record suggest[ed] both were ... independent.” *Id.* at *14.

39. *Id.* at *15.

40. *Id.* at *19; *see also id.* (“In order to conclude that a serious threat existed, the [Selectica] Board needed only reasonably conclude that the NOLs were a legitimate asset worth protecting.”).

41. As explained by the Court, “[i]t is the specific nature of the threat that ‘sets the parameters for the range of permissible defensive tactics.’” *Id.* (quoting *Unocal*, 493 A.2d at 955).

42. The parties agreed that the challenged actions of the Selectica Board were not coercive. *See id.* at *20 n.169.

measure is preclusive where it ‘operate[s] to unreasonably preclude a takeover’ or ‘preclude[s] effective stockholder action’—specifically, where the measure ‘makes a bidder’s ability to wage a successful proxy contest and gain control either “mathematically impossible” or “realistically unattainable.”’⁴³ Indeed, “[p]reclusive measures are those that are ‘insurmountable or impossible to outflank.’”⁴⁴

While Trilogy’s expert had opined that a pill with a less than 5% trigger “has a substantial preclusive effect,” the Court credited numerous examples of less than 5.49% shareholders that had been successful in waging proxy contests for control of microcap companies like Selectica⁴⁵ and held that the actions of the Selectica Board were not draconian given that “[s]uch a high standard operates to exclude only the most egregious defensive responses.”⁴⁶ Indeed, the Court made clear that it is not enough that a defensive measure make a proxy contest “more difficult—even considerably more difficult.”⁴⁷ To be preclusive, a defensive “measure must render a successful proxy contest a near impossibility or else utterly moot.”⁴⁸

With respect to the reasonableness inquiry, the Court explained that “[u]ltimately, *Unocal* and its progeny require that the defensive response employed be a proportionate response, not the most narrowly or precisely tailored one.”⁴⁹ As

43. *Id.* at *20 (quotations omitted).

44. *Id.* (quoting *Gaylord Container Corp. S’holders Litig.*, 753 A.2d 462, 482 (Del. Ch. 2000)).

45. This conclusion applied with particular force to Selectica given the concentration of holdings of its stock, a majority of which was owned by Selectica’s seven largest investors. *See id.* at *21; *see also id.* at *2 (noting that fewer than twenty-five investors held nearly two-thirds of Selectica’s stock).

46. *Id.* at *21.

47. *Id.*

48. *Id.* A subsequent decision of the Court of Chancery issued shortly before the publication of this Article questioned this formulation in upholding the adoption and employment of a shareholder rights plan by the board of directors of Barnes & Noble in response to an anticipated proxy contest. *See Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 2010 WL 3170806 (Del. Ch. Aug. 12, 2010). Specifically, the Court held “that if a defensive measure does not leave a proxy insurgent with a fair chance for victory, the mere fact that the insurgent might have some slight possibility of victory does not render the measure immune from judicial proscription as preclusive.” *See Yucaipa*, 2010 WL 3170806, at *18 n.182. According to the *Yucaipa* Court:

if the terms of a rights plan, which already has the powerful effect of barring the direct door to an acquisition, in themselves have the effect of rendering a victory for an insurgent improbable, the proportionality prong of the *Unocal* test should require the board to make an extremely strong showing why the rights plan should be sustained.

Id.

While the Supreme Court in *Versata* did not address the *Yucaipa* Court’s relaxed preclusivity standard, it relied on *Unitrin* for the proposition that “[a] defensive measure is preclusive where it ‘makes a bidder’s ability to wage a successful proxy contest and gain control either “mathematically impossible” or “realistically unattainable.”’” *Versata* Op. at 36 (quoting *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998); *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1389 (Del. 1995)). Reasoning that “[a] successful proxy contest that is mathematically impossible is, *ipso facto*, realistically unattainable” and that “the ‘mathematically impossible’ formulation in *Unitrin* is subsumed within the category of preclusivity described as ‘realistically unattainable,’” the Supreme Court in *Versata* held that “there is, analytically speaking, only one test of preclusivity: ‘realistically unattainable.’” *Id.* The Supreme Court has apparently lowered the preclusivity standard for future pill challengers by departing from the Court of Chancery’s “near impossibility or else utterly moot” formulation. How the “realistically unattainable” formulation will be applied going forward and the extent to which any such application will meaningfully differ from the “near impossibility” one is difficult to predict. The “realistically unattainable” standard does, however, seemingly exceed the “fair chance” and “improbable” threshold articulated by the Court of Chancery in *Yucaipa*.

49. *Selectica*, 2010 WL 703062, at *24.

such, the issue is not whether the response was “perfect,” only whether it was “reasonable.”⁵⁰ If the directors select one of several reasonable responses, that choice will not be second guessed by the courts.⁵¹ The actions of the Selectica Board were found to be reasonable, in part due to the fact that “the [4.99%] threshold, low as it is, was measured by reference to an external [tax] standard”⁵²

As the foregoing makes clear, a robust process and the deference accorded the unconflicted directors here was key: “the [Selectica] Board reasonably believed, based on the guidance of appropriate experts, that the NOLs had value, a value worth protecting.”⁵³ While the Selectica Board may have been incorrect “[i]n its view of the actual value of the NOLs,” it was not appropriate for the Court “to substitute its judgment for the reasonable conclusions of the Board protected as they are by 8 Del. C. § 141(e).”⁵⁴

III. LYONDELL CHEMICAL CO. V. RYAN

The Supreme Court refined *Unocal* in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁵⁵ where the Court required directors of target companies selling corporate control to seek the highest price reasonably attainable for the shareholders.⁵⁶ Colloquially referred to as “*Revlon* duties,”⁵⁷ the Delaware courts have recognized that there is no single blueprint that directors must follow to fulfill their responsibilities in this setting; rather, boards must engage in a reasonable – not perfect – process designed to achieve the highest price for stockholders. The Supreme Court of Delaware revisited *Revlon* in *LyondeLL Chemical Co. v. Ryan*⁵⁸ and clarified a number of important aspects of this doctrine, including when *Revlon* duties arise, the absence of any specific steps that directors must take when determining to embark on a sale of control transaction, and the heavy deference afforded independent and disinterested directors in this setting. As explored below, the Supreme Court’s adoption of a standard requiring challengers to demonstrate that the directors “utterly failed to obtain the best price” significantly raises the bar for plaintiffs seeking to establish that independent and disinterested directors failed to comport with their *Revlon* duties.

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50. *Id.* (quoting *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994)).

51. *See id.*

52. *Id.*; *see also supra* note 28.

53. *Selectica*, 2010 WL 703062, at *24.

54. *Id.*

55. 506 A.2d 173 (Del. 1986).

56. *See id.* at 182; *see also* *In re Topps Co. S'holders Litig.*, 926 A.2d 58, 64 (Del. Ch. 2007) (“When directors propose to sell a company for cash or engage in a change of control transaction, they must take reasonable measures to ensure that the stockholders receive the highest value reasonably attainable.”).

57. While referred to as “*Revlon* duties,” there are “no special and distinct ‘*Revlon* duties’” other than “to get the highest value reasonably attainable for the shareholders.” *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989); *see also* *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (“[T]he basic teaching . . . is simply that the directors must act in accordance with their fundamental duties of care and loyalty.”).

58. 970 A.2d 235 (Del. 2009).

Lyondell involved a stockholder challenge to the cash merger between Lyondell Chemical Company (“Lyondell”), a Delaware corporation and the then third largest publically traded chemical company in North America, and Basell AF (“Basell”), a privately-held Luxembourg company in the polyolefin business that was indirectly owned by Leonard Blavatnik (“Blavatnik”) through his control of Access Industries (“Access”). Lyondell had an eleven member board (the “Lyondell Board”) comprised of ten independent – and experienced – directors and Dan Smith (“Smith”), Lyondell’s Chairman and CEO.

Blavatnik informed Smith in April 2006 of Basell’s interest in acquiring Lyondell and sent a letter to the Lyondell Board a few months later offering \$26.50 - \$28.50 per share. The Lyondell Board determined that Lyondell was not for sale and rejected Basell’s proposal as inadequate. In May 2007, an affiliate of Access filed a Schedule 13D with the SEC disclosing its interest in a possible transaction with Lyondell and intention to acquire an 8.3% block of Lyondell stock owned by Lyondell’s second largest shareholder. Lyondell’s stock jumped more than 10% the day the 13D was made public.

The Lyondell Board concluded the following day that the 13D signaled to the market that Lyondell was “in play.” It nevertheless decided to take a “wait and see” approach and did not respond to or otherwise prepare for a possible proposal. Smith was subsequently approached – and rejected an expression of interest – by Apollo Management, L.P. concerning a management-led LBO a few days later. No other expressions of interest from potential bidders materialized. Basell temporarily turned its attention to a transaction with specialty chemical company Huntsman Corporation (“Huntsman”), but refocused on Lyondell after Hexion Specialty Chemicals, Inc. (“Hexion”) made a topping bid for Huntsman.⁵⁹

Blavatnik met with Smith on July 9, 2007 to discuss an all-cash acquisition by Basell of Lyondell for \$40 per share. Blavatnik raised his offer price to \$44 - \$45 after Smith dismissed the \$40 offer as too low. While Smith agreed to take the \$44 - \$45 proposal to the Lyondell Board, he cautioned that the proposal would be rejected by Lyondell’s directors and invited Blavatnik to make his best offer. The two agreed to speak later that day at which point Blavatnik proposed a transaction with a \$48 per share price, no financing contingency, and a \$400 million break-up fee in favor of Basell. Basell also conditioned its proposal on a merger agreement being signed by July 16, 2007.

The Lyondell Board held a special meeting for approximately 50 minutes the following day to address Blavatnik’s proposal. The directors reviewed valuation material that had been prepared by management for a regularly scheduled board meeting and discussed the Basell offer, the status of the Huntsman merger, and the likelihood that another acquiror might be interested in Lyondell. Smith was instructed to obtain a written offer from Basell with more details about its financing.

Blavatnik agreed to do so but requested that the Lyondell Board provide a firm indication of interest given the existence of a July 11 deadline for Basell to make a higher bid for Huntsman. The Lyondell Board considered that request and the Basell offer at its regularly scheduled meeting on July 11, which lasted approximately 45 minutes. Deciding that it was interested in pursuing a transaction with Basell, the Lyondell Board authorized the retention of Deutsche Bank as Lyondell’s financial advisor and instructed Smith to negotiate with Blavatnik.⁶⁰

59. While outside the scope of this Article, Hexion’s attempt to terminate its eventual \$10.6 billion merger agreement with Huntsman spawned a leading “material adverse affect” (“MAE”) decision in Delaware. *See Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008). In that case, Hexion could not carry its “heavy burden” of demonstrating that Huntsman had suffered a MAE as that term was defined in the governing merger agreement. A “short-term hiccup” is not enough, as a MAE requires unknown events that substantially threaten the long-term earnings of the company. *Id.* at *15 (quoting *In re IBP, Inc. S’holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001)). A party claiming a MAE therefore must demonstrate that there has been “an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than in months.” *Hexion*, 2008 WL 4457544, at *15.

60. Basell announced as a result that it would not raise its offer for Huntsman and Huntsman terminated the parties’ merger agreement. *See Lyondell*, 970 A.2d at 238.

The parties negotiated a merger agreement between July 12 to July 15, during which time Basell conducted due diligence and Deutsche Bank prepared a fairness opinion. The Lyondell Board discussed the Basell proposal again on July 12 and instructed Smith to test the waters on the prospect of better terms, including a higher price, a go-shop provision, and a reduced break-up fee. Having offered his best price and resolute in his insistence that the deal be signed up by July 16, Blavatnik rejected Smith's proposals (although as a sign of good faith agreed to reduce the break-up fee from \$400 million to \$385 million).

The Lyondell Board met to consider the negotiated merger agreement on July 16 and received presentations from management and its financial and legal advisors on the merits of the deal. In opining that the \$48 per share deal price was fair, Deutsche Bank noted that the price – which reflected a 45% premium – was so favorable that it fell outside a number of its valuation ranges and its managing director characterized the price as “an absolute home run.”⁶¹ Deutsche Bank also expressed its conclusion that Basell's offer would not be topped by another acquiror. The Lyondell Board subsequently approved and recommended the merger to Lyondell's shareholders, who approved the transaction at a special stockholder meeting with the holders of 65.8% of the total outstanding common stock voting in favor of the merger.

A Lyondell shareholder filed a class action suit against Lyondell's directors alleging they had breached their fiduciary duties given that the \$48 merger price was “grossly insufficient” and they had approved the merger “for their own self-interest,” employed a “flawed” merger negotiation process, agreed to “unreasonable” deal protection measures, and issued an incomplete and misleading proxy statement. Notably, and uncharacteristically for these types of claims, the plaintiff-shareholder did not seek to enjoin the merger and the case came before the Court of Chancery on defendants' motion for summary judgment.

The Court of Chancery granted defendants' motion in all respects except for plaintiffs' process and deal protection claims, which the Supreme Court characterized as “but two aspects of a single claim, under *Revlon* ... that the directors failed to obtain the best available price in selling the company.”⁶² Given the inclusion of a section 102(b)(7) provision in Lyondell's certificate of incorporation exculpating pure duty of care claims and the absence of any allegations that the directors lacked independence or disinterestedness, the sole issue on the motion for summary judgment was whether Lyondell's directors had breached their fiduciary duties of loyalty by failing to act in good faith.

Given the procedural posture of defendants' summary judgment motion, where all reasonable inferences had to be drawn in plaintiffs' favor, the Court of Chancery found that defendants' “two months of slothful indifference despite *knowing* that the Company was in play” following Basell's Schedule 13D raised factual issues as to whether the directors had conducted the sales process in “bad faith.”⁶³ Indeed, the Court of Chancery's opinion repeatedly emphasized that its ruling was driven by the governing summary judgment analysis.⁶⁴

61. *Id.* at 239.

62. *Id.*

63. *Id.* at 241 (quoting the opinion of the Court of Chancery below).

64. See J. Travis Laster & Steven M. Haas, *Reactions and Overreactions to Ryan v. Lyondell Chemical Co.*, 22 Insights: Director Liability 9, 12 (Sept. 2008) (“Practitioners must recognize, however, that the *Lyondell* opinion was driven by its procedural posture, which was a decision on summary judgment. The summary judgment standard requires the court to draw ‘all reasonable inferences ... in favor of the non-moving party’ and allows dismissal only when there is ‘no genuine issue of fact.’ Vice Chancellor Noble mentioned this repeatedly, starting on the first page of the opinion and again and again when he declined to adopt arguments made by the defendants. In this regard, *Lyondell* stands in sharp contrast to the majority of Delaware M&A opinions that are decided on motions for preliminary injunction [where] the court must determine whether the plaintiff has a reasonable probability of success on the merits (in addition to evaluating irreparable harm and the balance of hardships.”)).

Having taken the rare action of granting defendants' interlocutory appeal from a decision denying summary judgment, the Supreme Court took the even rarer action of not only reversing the Court of Chancery but also entering summary judgment in favor of the defendant directors. In so doing, the Supreme Court decided precisely when *Revlon* duties arose. Specifically, the Court held that *Revlon* duties arise not when a company is put in play (such as in the case of *Lyondell* upon Basell's filing of its Schedule 13D), but "when a company embarks on a transaction – on its own initiative or in response to an unsolicited offer – that will result in a change of control."⁶⁵ Here, the Supreme Court held that *Revlon* duties did not arise until Lyondell's directors actually began negotiating the sale of Lyondell. As a result, the adoption of a "wait and see" strategy to unsolicited bids was subject to the deferential business judgment rule, and the fact that the Lyondell Board failed to seek competing offers or other bidders during the two months following Basell's Schedule 13D filing was immaterial to the good faith calculus. *Revlon* duties instead arose on "July 10, 2007, when the directors began negotiating a sale of Lyondell" making the relevant timeframe "the one week during which they considered Basell's offer."⁶⁶

The Supreme Court also focused upon the affirmative actions of the directors (*i.e.*, what they did), not what they *did not* do. While the Court of Chancery repeatedly emphasized the procedural posture before it and, specifically, that the failure of the Lyondell Board to respond in any way following the Basell 13D raised an issue of fact as to whether the directors had done everything to get the best price, the Supreme Court defined the issue as a legal one of good faith as opposed to due care "where the analysis is very different."⁶⁷ Recounting its discussion of bad faith in *Disney*, the Court explained that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties."⁶⁸ Because "there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties," the failure to take particular actions during a sale could not demonstrate conscious disregard.⁶⁹ Insofar as "[d]irectors' decisions must be reasonable, not perfect," "extreme" facts are "required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."⁷⁰ In sum, "[o]nly if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty."⁷¹

Ultimately, the Supreme Court held that "[t]he trial court approached the record from the wrong perspective."⁷² The issue was not whether the directors "did everything that they (arguably) should have done to obtain the best sale

65. *Lyondell*, 970 A.2d at 242.

66. *Id.*

67. Indeed, the Court specifically noted that it "would not question the trial court's decision to seek additional evidence if the issue were whether the directors had exercised due care." *Id.* at 243.

68. *Id.* (quoting *In re The Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006)); see also Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffery M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010) (exploring the contours of good faith in the corporate context).

69. *Lyondell*, 970 A.2d at 243. Given this formulation, it is now arguably impossible for a plaintiff to show a bad faith breach because as a matter of logic there is no "known duty to act" that could be "consciously disregarded."

70. *Id.* at 243-44 (quoting *Lear Corp. S'holder Litig.*, 2008 WL 4053221, at *11 (Del. Ch. Sept. 2, 2008)).

71. *Id.*

72. *Id.* at 244.

price,” but whether they “utterly failed to attempt to obtain the best sale price.”⁷³ The Supreme Court’s granting of summary judgment on behalf of the defendants results from several key factors, including that: the consideration paid to Lyondell stockholders represented a 45% premium over the closing stock price of Lyondell immediately before disclosure of Basell’s interest in Lyondell via the Schedule 13D; the transaction was approved by an independent and disinterested board advised by financial and legal advisors; and the merger was approved by the holders of over 65% of the company’s outstanding common stock. The transaction thus represented a substantial premium, lacked any of the hallmark conflicted director or shareholder players that typically permeate these types of challenged deals, and garnered the resounding endorsement of the Lyondell shareholders. This confluence of factors was enough given the deferential analysis set forth by the Supreme Court.⁷⁴

IV. *IN RE JOHN Q. HAMMONS HOTELS, INC.*

In contrast to the deference accorded independent and disinterested directors in change of control transactions under *Lyondell*, self-dealing mergers involving controlling shareholders are subjected to heightened entire fairness review to minimize the risk that minority shareholders will be inequitably exploited in such transactions.⁷⁵ Indeed, in *Kahn v. Lynch Communication Systems, Inc.*,⁷⁶ the Supreme Court declared entire fairness the “exclusive standard” for assessing mergers in which a controlling shareholder “stands on both sides” of the transaction.⁷⁷ Unanswered by *Lynch*, however,

73. *Id.* “Utterly failed” is a linguistically extreme formulation, and the Supreme Court did not indicate what might constitute “utter failure.” Imagine a field goal kicker who misses wide right. He failed, but did he “utterly fail”? Certainly not: he tried and missed. But at what point does the failure become “utter”? If his foot missed the ball? He still would have attempted the kick, and thus would not have “knowingly and completely failed to undertake [his] responsibilities.” What if he picks up the ball, tries to run and fumbles, or tries to pass and throws an interception? In both instances he has failed to attempt a kick, his core responsibility, but he did try to do something. If an attempt is all that matters, as the “utter failure” test suggests, then one can well wonder how a board ever could “utterly fail” in the change of control setting.

74. Two post-*Lyondell* decisions make clear that it will be significantly more difficult for a stockholder plaintiff under the heightened standard adopted by *Lyondell* to establish that an independent and disinterested board “utterly failed to obtain the best price.” See *In re NYMEX S’holder Litig.*, 2009 WL 3206051, at *7 (Del. Ch. Sept. 30, 2009) (dismissing *Revlon* claims against a board populated by twelve of fourteen “unquestionably independent” directors because plaintiffs failed to allege “that the Board ‘utterly failed to obtain the best sale price’”); *Wayne County Employees’ Ret. Sys. v. Corti*, 2009 WL 2219260, at *14 (Del. Ch. July 24, 2009) (framing “the relevant question [proclaimed by *Lyondell*] as whether the Director Defendants ‘utterly failed to attempt to obtain the best sale price’” and dismissing *Revlon* claims against a board comprised of a majority of independent and disinterested directors) (emphasis in original).

75. The Court of Chancery in *Pure Resources* illustratively likened controlling shareholders in this setting – given the power wielded by such shareholders and the resultant “inherent coercion” vis-à-vis the minority – to that of an “800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors who might well have been hand-picked by the gorilla (and who was at the very least owed their seats on the board to his support).” *In re Pure Res. S’holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002); see also David C. McBride & Michael W. McDermott, *The Rights and Duties of Controlling Shareholders: Learning to Dance with the 800 Pound Gorilla* (Feb. 23, 2005) (unpublished manuscript, on file with authors) (analyzing the rights and duties of controlling shareholders and the treatment by courts of controlling shareholder transactions in different transactional settings).

76. 638 A.2d 1110 (Del. 1994).

77. *Id.* at 1117; see also *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) (extending *Lynch* to any transaction in which a controlling shareholder stands on both sides of the transaction). *Lynch* similarly clarified that while “[t]he initial burden of establishing entire fairness rests upon the party who stands on both sides of [such a] transaction,” “approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the

was the extent to which entire fairness applied to mergers involving a controlling shareholder on only one side of the deal. Subsequent cases have also questioned the effect that properly employed procedural safeguards (*i.e.*, special committees and majority-of-the-minority shareholder approval conditions) should have on the standard of review for controlling shareholder transactions.⁷⁸ Many of these doctrinal issues were at the forefront in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,⁷⁹ which held that, absent both a properly empowered and functioning special committee *and* a majority-of-the-minority condition, entire fairness applies to a merger involving a controlling shareholder that does not stand on both sides of the underlying transaction but competes with the minority shareholders for a fixed amount of consideration and will have a continuing interest in the post-merger entity.

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Hammons involved the merger of John Q. Hammons Hotels, Inc. (“JQH”) with an acquisition vehicle (“Acquisition”) controlled by Jonathan Eilian (“Eilian”) (the “JQH Merger”), a third party with no prior relationship to either

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controlling or dominating shareholder to the challenging shareholder-plaintiff ... [as] an entire fairness analysis is the only proper standard of judicial review” in this setting. *Lynch*, 638 A.2d at 1117 (emphasis added). In so doing, *Lynch* resolved a split in the Court of Chancery concerning whether a controlling shareholder’s use of either of these procedural safeguards, by itself, displaced entire fairness in favor of business judgment review for controlling shareholder transactions. *Compare* *In re Trans World Airlines, Inc. S’holders Litig.*, 1988 WL 111271 (Del. Ch. Oct. 21, 1988) (holding that special committee approval was sufficient to invoke business judgment review), *with* *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990) (holding that neither special committee approval nor the informed vote of a majority-of-the-minority shareholders negated entire fairness review). As observed by the Court of Chancery in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005), “[f]rom a close reading of the *Citron* decision, one discerns that Vice Chancellor Jacobs felt the *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) and *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985) [decisions] had already decided the key question and that he was bound to that determination.” *Id.* at 616 n.24.

78. See *Cox Communications*, 879 A.2d at 644-45 (exploring *Lynch*’s failure to provide controlling shareholders with additional incentives to condition going-private mergers on minority shareholder approval and advocating a “modest alteration of *Lynch*” that would afford business judgment rule protection if the underlying transaction was “subject from inception to negotiation and approval ... by an independent special committee *and* a Minority Approval Condition”); *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531, 549-50 & n.23 (Del. Ch. 2003) (suggesting “that the *Lynch* doctrine, if it is to be perpetuated, could be usefully simplified” and noting the suggestion in other cases “that the business judgment rule standard of review ought to, at the very least, apply if a merger or other transaction with a controlling stockholder has been approved by a majority independent board *and* conditioned on a majority of the minority (*i.e.*, disinterested) vote”); *Pure Resources*, 808 A.2d at 444 n.43 (“A slight easing of the *Lynch* rule would help level the litigation risk posed by the different acquisitions methods [in the controlling shareholder going-private transaction setting], and thereby provide an incentive to use the negotiated merger route. At the very least, this tailoring could include providing business judgment protection to mergers negotiated by a special committee and subject to majority of the minority protection.”); see also William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1306-09 (2001) (opining that *Lynch* “unintentionally created a disincentive to seek an approving ‘majority of the minority’ shareholder vote, because the acquired company’s board can obtain the same protection by using the ‘special committee’ device as a ‘cleansing’ mechanism” and “question[ing] whether there [wa]s enough utility to justify continuing the stricter scrutiny of interested mergers that are approved by one or both of these intra-corporate ‘cleansing procedures’”). Indeed, *Pure Resources* recognized that *Lynch* did not involve a self-dealing transaction in which the controlling shareholder had employed both a special committee and majority-of-the-minority condition and thus “it is arguable that the Supreme Court has never been asked to address the precise question that would be posed if a controller, from the inception of a transaction, made clear that its merger proposal was conditioned upon the use of both of these procedural protections ...” *Pure Resources*, 808 A.2d at 435.

79. 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

JQH or John Q. Hammons (“Hammons”) who was JQH’s controlling shareholder. JQH, a Delaware corporation which owned and managed hotels, had two classes of stock: Class A common stock which was publicly traded and entitled to one vote per share (of which Hammons owned approximately 5%) and Class B common stock which was not publicly traded and entitled to fifty votes per share (of which Hammons owned 72%). In addition to controlling over 75% of JQH’s total voting power, Hammons also served as JQH’s CEO and the Chairman of JQH’s eight member board of directors (the “JQH Board”).

In early 2004, Hammons informed the JQH Board that he had begun discussions with third parties regarding a potential sale of his interest in JQH and the JQH Board formed a special committee “to evaluate and negotiate a proposed transaction on behalf of the unaffiliated stockholders and make a recommendation to the [JQH] Board.”⁸⁰ The special committee, which plaintiffs conceded was independent and disinterested, retained both legal and financial advisors.⁸¹

After negotiations between the special committee and a prior suitor broke down, Eilian offered to acquire all of JQH’s outstanding Class A common stock for \$24 per share.⁸² Eilian was granted exclusivity and representatives of Eilian, Hammons and the special committee spent several months negotiating a deal. In June 2005, Hammons and Eilian informed the special committee that they had reached an agreement. Eilian also reaffirmed its offer to purchase the Class A common stock for \$24 per share.

The special committee met with its legal and financial advisors to consider the proposed transaction and, following presentations regarding the process preceding the transaction and the underlying merger consideration, approved the merger agreement and certain related agreements between Hammons and Eilian (with the Merger Agreement, the “Transaction Agreements”). The JQH Board met immediately thereafter and similarly approved the Merger Agreement.

The Merger Agreement entitled the holders of Class A common stock to \$24 per share in cash, a significant premium to the \$4 to \$7 range at which the stock was trading at before rumors of a possible transaction surfaced. Hammons and Eilian (through Acquisition) additionally “entered into a series of other agreements [*i.e.*, the Transaction Agreements], which provided for a complex, multi-step transaction designed to provide Hammons financing to continue his hotel development activities [following the Merger] without triggering the tax liability associated with an equity or asset sale.”⁸³ The Merger was conditioned on the approval of a majority of the unaffiliated Class A common stockholders voting on the transaction, although that approval was subject to waiver by the special committee.⁸⁴ Waiver was never an issue, however, as 72% of the outstanding shares of JQH’s Class A common stock voted to approve the Merger.

80. *Id.* at *4.

81. Although the Court did not address the ultimate independence of the special committee’s advisors, it noted the legal advisor’s representation of an entity providing Eilian’s financing in connection with the Merger and the financial advisor’s unsuccessful attempt to participate in Eilian’s refinancing of JQH’s debt. *See id.* The Court also noted JQH’s failure to disclose either of these conflicts in the proxy, implicitly questioning the advisors’ independence. *See id.* at *8.

82. Eilian had met with the special committee regarding his interest in a possible transaction with JQH in November 2004 and submitted an acquisition proposal the following month, although Hammons was negotiating with a different party at that time and initially expressed an unwillingness to do a deal with Eilian “under any circumstances.” *Id.* at *5.

83. Specifically, Hammons agreed to exchange his Class B common stock and controlling interest in a limited partnership through which JQH conducted its operations for (i) a 2% interest in the cash flow distributions and preferred equity of the surviving LP (with a company controlled by Eilian becoming the general partner of the LP and receiving the remaining 98% thereof), (ii) a preferred capital interest in the surviving LP with a total liquidation preference of \$335 million, (iii) a \$25 million short-term line of credit, (iv) a \$275 million long-term line of credit, and (v) various other rights and contractual obligations, including an agreement whereby Hammons’ “management entity would continue to manage the hotels in exchange for payments of actual operating costs and expenses incurred (estimated to be approximately \$6.5 million based on the budget for 2005) and a \$200,000 annual salary to Hammons, plus benefits.” *Id.*

84. The Merger Agreement also included a termination fee capped at \$20 million and a “no shop” provision that limited JQH’s ability to solicit offers from other parties. *See id.* at *7.

Owners of JQH's Class A common stock filed suit on behalf of the non-Hammons Class A common stockholders challenging the Merger on the basis that Hammons breached his fiduciary duties in negotiating benefits for himself that were not shared with the minority shareholders. They also alleged, among other things, that JQH's directors breached their duties in permitting a "flawed" negotiation process and approving the "unfair" Merger.

The "threshold issue" for the Court on the parties' dueling motions for summary judgment was the applicability of the entire fairness standard of review.⁸⁵ Plaintiffs argued that because Hammons was not selling his interest, but instead "restructur[ing it] in a way that accomplished his tax and financial goals while maintaining a significant interest in the surviving company, in addition to other rights," entire fairness applied because he "stood on both sides" of the Merger.⁸⁶ The Court disagreed and in so doing refused to extend *Lynch* to the facts of this case.

The Court distinguished *Lynch* on the grounds that the minority shareholders in *Hammons* were entering into a transaction with "an unrelated third party," not the controlling shareholder.⁸⁷ To that end, the acquiror negotiated with the controlling shareholder separately from its negotiations with the independent special committee on behalf of the minority. It was thus irrelevant that Hammons retained an interest in the surviving company, as he did not "stand[] on both sides" of the transaction for purposes of mandatory application of entire fairness review under *Lynch*.⁸⁸

The Court nevertheless held that entire fairness review would still apply unless the transaction was both "(1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders."⁸⁹ As explained by the Court:

Although I have determined that Hammons did not stand "on both sides" of this transaction, it is nonetheless true that Hammons and the minority stockholders were in a sense "competing" for portions of the consideration Eilian was willing to pay to acquire JQH and that Hammons, as a result of his controlling position, could effectively veto any transaction. In such a case it is paramount—indeed, necessary in order to invoke business judgment review—that there be robust procedural protections in place to ensure that the minority stockholders have sufficient bargaining power and the ability to make an informed choice of whether to accept the third-party's offer for their shares.⁹⁰

85. "According to the now familiar words of [*Weinberger v. UOP, Inc.*], entire fairness has two aspects: fair dealing and fair price. This test, however, is not a 'bifurcated one between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.'" *Gesoff v. IIC Indus. Inc.*, 902 A.2d 1130, 1144 (Del. Ch. 2006) (quoting *Weinberger v. UOP, Inc.*, 457 A.2d 701, 708 (Del. 1983)).

86. *Hammons*, 2009 WL 3165613, at *10.

87. *Id.*

88. See *Lynch*, 638 A.2d at 1117; see also *supra* note 77 (quoting and discussing same).

89. *Hammons*, 2009 WL 3165613, at *12. The Court's use and emphasis of "and" in formulating this construct provides an interesting and noteworthy contrast to *Lynch*'s use of the disjunctive in articulating the burden shifting consequences of *either* procedural safeguard in a self-dealing controlling shareholder transaction. See *supra* note 77. This formulation also arguably differs from the Court of Chancery's employment of traditional business judgment review in *Orman v. Cullman*, 794 A.2d 5 (Del. Ch. 2002), in assessing a controlling shareholder transaction in which the controller did not stand on both sides of the challenged transaction. See *id.* at 22 ("[A]though the Cullman Group was the controlling shareholder of the target company both before and after the merger, the Cullman Group did not stand on both sides of the challenged merger. Instead it was approached by, and began initial negotiations with, an unaffiliated third party, Swedish Match. A Special Committee of independent directors then completed those negotiations. Therefore, the burden remains on Orman to allege other facts sufficient to overcome the business judgment presumption.").

90. *Hammons*, 2009 WL 3165613, at *12.

Defendants' failure to satisfy this test precluded business judgment review. To provide sufficient protection, a majority-of-the-minority vote must be both nonwaivable and conditioned upon a majority of all minority shareholders—not just those voting.⁹¹ But in this case, the majority-of-the-minority condition (i) was waivable by the special committee and (ii) only required approval by a majority of the minority shares voted (as opposed to a majority of all outstanding minority stockholders). Moreover, such protections must be “preconditions” to the transaction, not conditions that may be satisfied after the fact.⁹²

While the majority-of-the-minority provisions were insufficient to entitle the defendants to the protection afforded by the business judgment rule, the Court suggested that they may have been sufficient to shift the burden of proof to the plaintiffs.⁹³ That determination – and the “modest procedural benefit” resulting from shifting the burden of proof⁹⁴ – could not be made at this stage of the action, however, given that certain of plaintiffs' disclosure allegations survived summary judgment.

V. *IN RE CNX GAS CORPORATION SHAREHOLDERS LITIGATION*

The preceding discussion of *Hammons* illustrates how the Delaware courts have wrestled with the effect that procedural safeguards employed by controlling shareholders should have on the underlying standards of judicial review for such transactions. While *Hammons* held that the proper use of both a special committee *and* majority-of-minority condition was necessary to secure business judgment review for the non-*Lynch* controlling shareholder transaction at issue, it also recognized the “recent suggestions of ways to ‘harmonize’ the standards applied to transactions that differ in form but have the effect of cashing out minority shareholders.”⁹⁵ The doctrinal march toward the marginalization of *Lynch* continued in *In re CNX Gas Corporation Shareholders Litigation*,⁹⁶ which involved a two-step “*Siliconix*” transaction by a controlling shareholder seeking to acquire its subsidiary's outstanding shares via a first step tender offer to be followed by a short-form merger of the non-tendering shareholders. *CNX Gas* departed from the traditional deferential review accorded non-coercive and fully disclosed controlling shareholder tender offers in favor of a “uniform standard,” similar to the one employed in *Hammons*, requiring both special committee negotiation and recommendation and a majority-of-the-minority shareholder approval condition. In so doing, *CNX Gas* goes further than *Hammons* in suggesting that a similar standard should apply to controlling shareholder squeeze-out mergers.



91. *Id.* (citing *In re PNB Holdings Co. S'holders Litig.*, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006)).

92. The Court did not specifically address the propriety of the special committee, although it expressly rejected plaintiff's argument that the committee “was ineffective merely based on the fact that *Hammons* was able to veto any transaction.” *Id.* at *14. That said, and as noted above, the Court apparently had questions concerning the independence of the special committee's advisors. *See supra* note 81.

93. *Hammons*, 2009 WL 3165613, at *14.

94. *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 617 (Del. Ch. 2005).

95. *Hammons*, 2009 WL 3165613, at *12 n.37 (citing *Cox Communications*, 879 A.2d at 606-07, 642-48; *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 549 n.23 (Del. Ch. 2003); *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 443-46 (Del. Ch. 2002)); *see also supra* note 78 (addressing same).

96. 2010 WL 2291842 (Del. Ch. May 25, 2010).

CNX Gas involved a motion to enjoin preliminarily the nearly \$1 billion tender offer by CONSOL Energy Inc. (“CONSOL”) for the approximately 16.5% of the CNX Gas Corporation (“CNX”) it did not already own. CONSOL, a leading producer of high-Btu bituminous coal and coalbed methane gas, controlled approximately 83.5% of CNX, a company created by CONSOL in 2005 to conduct its natural gas operations. CNX’s remaining shares were held by institutional investors, the top 25 of which owned more than 14% of the company. In particular, T. Rowe Price Associates, Inc. (“T. Rowe Price”) was the largest minority stockholder of CNX, owning 6.3% of CNX’s outstanding common stock or roughly 37% of CNX’s public float, as well as approximately 6.5% of CONSOL’s outstanding stock and CONSOL debt.⁹⁷

CONSOL’s CEO (J. Bret Harvey), who became CNX’s CEO and Chairman following a prior proposal by CONSOL to acquire the public shares of CNX that was received unfavorably by T. Rowe Price and other institutional investors, approached T. Rowe Price in September 2009 about its interest in exchanging its CNX shares for CONSOL stock. No further discussion progressed until T. Rowe Price met with executives of CONSOL and CNX on March 9, 2010, while attending an investor conference. T. Rowe Price’s representatives floated a price in the mid-\$40s at that meeting, and CONSOL indicated that a price of up to \$40 could be acceptable.

On March 15, 2010, CONSOL announced its agreement to acquire the gas assets of Dominion Resources, Inc. (“Dominion”) for approximately \$3.475 billion (the “Dominion Transaction”). The announcement also identified the possibility of a CONSOL/CNX consolidation given that Dominion was a competitor of CNX. T. Rowe Price requested a meeting with CONSOL management the day after this announcement, and representatives of both companies met on March 19, 2010.

David Giroux, the head of the Capital Appreciation Fund, represented T. Rowe Price at that meeting. During the negotiation session, Mr. Giroux proposed a range of \$42 to \$50 per share for T. Rowe Price’s CNX stock and rejected CONSOL’s counteroffer of \$35 per share as “not realistic.”⁹⁸ Mr. Giroux also rebuffed CONSOL’s higher offer of \$37 per share, communicating that T. Rowe Price needed \$40 per share. That price was rejected by Mr. Harvey, who “regarded the negotiations as over.”⁹⁹

Mr. Giroux then left the meeting but returned with his “final offer” of \$38.25 per share in cash after the others concluded a discussion of the Dominion Transaction.¹⁰⁰ Mr. Harvey agreed to the \$38.25 per share price subject to CONSOL board approval, which occurred less than a week later. CONSOL and T. Rowe Price thereafter executed an agreement that obligated T. Rowe Price to tender (and not withdraw) its CNX stock upon CONSOL’s tender offer at a price of no less than \$38.25 per share in cash.

CONSOL commenced a tender offer on April 28, 2010 for the public shares of CNX at a price of \$38.25 per share in cash.¹⁰¹ The tender offer was subject to a non-waivable “majority-of-the-minority” condition excluding the CNX shares owned by directors or officers of CONSOL and CNX but including those held by T. Rowe Price. CONSOL also

97. While T. Rowe Price’s CNX holdings were held roughly evenly by its Capital Appreciation Fund (managed by David Giroux) and its Mid-Cap Growth Fund (managed by John Wakeman and Brian Berghuis), the Capital Appreciation Fund did not own any CONSOL stock or debt. *See id.* at *2.

98. *Id.* at *4.

99. *Id.*

100. The Court viewed the record as suggesting that Mr. Giroux had called Mr. Berghuis in the interim but acknowledged that the issue was undeveloped. *See id.* at *5.

101. The \$38.25 tender offer price represented a premium of more than 45% over the closing price of CNX stock the day before the announcement of the Dominion Transaction and more than 24% over the closing price of CNX stock before the announcement of T. Rowe Price’s tender agreement with CONSOL. *See id.*

committed to effect a prompt second-step short-form merger pursuant to Section 253 of the DGCL following successful completion of the transaction at the same \$38.25 per share price.

CNX subsequently created a special committee comprised of CNX's sole independent director (John R. Pipski), which was vested with the power to review and evaluate – but not negotiate the terms of or consider alternatives to – the tender offer, prepare a schedule 14D-9 and retain legal and financial advisors.¹⁰² The tender offer was not conditioned on an affirmative recommendation of the special committee and requests by Mr. Pipski to expand the committee by an additional director and broaden its authority were not granted.

While not authorized to negotiate, and notwithstanding Lazard's conclusion that the \$38.25 per share price was "fair from a financial point of view" to CNX's minority shareholders, the special committee concluded that the \$38.25 price may not have reflected the highest price CONSOL was willing to pay and sought a higher price. Although the special committee was later given retroactive authority to negotiate, CONSOL ultimately declined to increase the tender consideration and the committee "remain[ed] neutral" with respect to the tender offer in its Schedule 14D-9.¹⁰³

The Court began its assessment of the motion by contrasting the differing standards of judicial review traditionally applied to controlling shareholder squeeze-out transactions based on the deal structure. While *Kahn v. Lynch Communications Systems, Inc.* mandated heightened "entire fairness" review for long-form mergers between a controlling shareholder and its subsidiary,¹⁰⁴ *In re Siliconix Inc. Shareholders Litigation*¹⁰⁵ and several subsequent Court of Chancery decisions¹⁰⁶ accorded deferential business judgment protection to non-coercive and fully disclosed controlling shareholder tender offers followed by a back-end short-form merger.¹⁰⁷

Indeed, it was generally recognized after *Siliconix* that a controlling shareholder had no duty to offer the minority a particular – much less fair – price in connection with a non-coercive and fully disclosed tender offer.¹⁰⁸ Questioning

102. The special committee retained Skadden and Lazard as its respective legal and financial advisors. *See id.*

103. *See id.* (excerpting the special committee's Schedule 14D-9 disclosures).

104. *Lynch*, 638 A.2d at 1117; *see also supra* note 77 (addressing same).

105. 2001 WL 716787 (Del. Ch. June 19, 2001).

106. *See In re Cox Radio, Inc. S'holders Litig.*, 2010 WL 1806616 (Del. Ch. May 6, 2010); *In re Pure Res. S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002); *In re Aquila Inc. S'holders Litig.*, 805 A.2d 184 (Del. Ch. 2002).

107. To be clear, and as recognized by the Court in *CNX Gas*, "the effectiveness of the *Siliconix* structure as a means of avoiding entire fairness review under *Lynch* depended on the absence of fairness review for the back-end short-form merger," which the Supreme Court decided one month after *Siliconix*, in *Glassman v. Unocal Exploration Corporation*, 777 A.2d 242 (Del. 2001). *CNX Gas*, 2010 WL 2291842, at *7 n.2; *see also Glassman*, 777 A.2d at 248 (holding that appraisal under section 262 of the DGCL is the exclusive remedy for minority shareholders challenging a short-form merger absent fraud or illegality and provided full disclosure). Together, *Siliconix* and *Glassman* provided controlling shareholders with a transactional blueprint for evading entire fairness review for going-private transactions notwithstanding that two-step *Siliconix/Glassman* transactions achieve the same ultimate outcome – and present at least the same risk of abuse – as one-step controlling shareholder squeeze-out mergers.

108. *See Siliconix*, 2001 WL 716787, at *6 (quoting *In re Ocean Drilling & Exploration Co. S'holders Litig.*, 1991 WL 70028, at *3 (Del. Ch. Apr. 30, 1991)); *see also In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 623 (Del. Ch. 2005) ("For years, there has existed a strand of Delaware law that stated that a controlling shareholder who made a tender offer – as opposed to a merger proposal – to acquire the rest of the controlled company's shares had no duty to offer a fair price."). The Delaware Supreme Court, quoting *Solomon v. Pathe Commc'ns Corp.*, 672 A.2d 35 (Del. 1996), recently recognized this principle as well. *See Pfeffer v. Redstone*, 965 A.2d 676, 684 (Del. 2009) ("In the case of totally voluntary tender offers ... courts do not impose any right of the shareholders to receive a particular price" and "in the absence of coercion or disclosure violations, the adequacy of the price in a voluntary tender offer cannot be an issue."). *Pfeffer* also quoted *Aquila* for the proposition that "Delaware law does not impose a

the “twin cornerstones” upon which those cases rested,¹⁰⁹ the Court in *CNX Gas* disagreed and in doing so framed the probative question as “[w]hat transactional structures result in the controlling shareholder not standing on both sides of a two-step freeze-out.”¹¹⁰

The Court next turned to *Pure Resources*’ enhanced requirements for rendering controlling shareholder tender offers “non-coercive” as a “move towards harmonizing the *Siliconix* and *Lynch* line of authority.”¹¹¹ Specifically, *Pure Resources* held that such tender offers would only be deemed “non-coercive” – and thus free from fairness review – if (i) “subject to a non-waivable majority of the minority tender condition,” (ii) accompanied by a promise by “the controlling stockholder ... to consummate a prompt § 253 merger at the same price if it obtains more than 90% of the shares,” and (iii) “the controlling stockholder has made no retributive threats.”¹¹²

Pure Resources nevertheless still questioned the wisdom of treating going-private transactions disparately based upon how they were structured, although the Court in that case advocated relaxing the *Lynch* element of the equation rather than rejecting the *Solomon/Siliconix* approach.¹¹³ Those concerns were echoed in *Cox Communications*,¹¹⁴ a decision resolving an attorneys’ fee dispute, which *CNX Gas* characterized as “render[ing] the *Lynch* and *Siliconix* standards coherent by explaining that the business judgment rule should apply to any freeze-out transaction structured to mirror *both* elements

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duty of entire fairness on controlling shareholders making a non-coercive tender or exchange offer to acquire shares directly from the minority holders” and stated that “Delaware law [does not] require entire fairness scrutiny where a corporation engage[s] in a voluntary, noncoercive [tender] offer.” *Id.* (quoting *In re Aquila Inc. S’holders Litig.*, 805 A.2d 184, 190 (Del. Ch. 2002)). Acknowledging *Pfeffer*’s “no right to a particular price” point, the Court in *CNX Gas* observed that *Pfeffer* did not involve a controlling stockholder squeeze-out transaction. *See CNX Gas*, 2010 WL 2291842, at *11 n.6. The Court also sought to distinguish the underlying *Solomon* decision, which similarly did not involve a squeeze-out, on its facts. *See infra* note 109.

109. Specifically, *CNX Gas* questioned both (i) the “statutory distinction between mergers and tender offers and the lack of any explicit role in the [DGCL] for a target board of directors responding to a tender offer” and (ii) the oft-cited statement by the Supreme Court of Delaware in *Solomon* “that a tender offeror has no duty to provide a fair price.” *CNX Gas*, 2010 WL 2291842, at *8. With respect to the former, the Court relied on prior precedent and scholarly criticism in concluding that it failed to justify the differing standards of review. The Court also attempted to distinguish *Solomon*, wherein the Supreme Court stated “that ‘[i]n the case of a totally voluntary tender offer, as here, courts do not impose any right of the shareholders to receive a particular price.’” on the grounds that the tender offer in that case was part of an agreement negotiated by the controlling shareholder (“CLBN”) “primarily in its role as a third-party lender” and thus involved “the case-specific reality that CLBN was not standing on both sides of the transaction.” *Id.* at *11. In short, “[n]othing about CLBN’s actions resembled those of a controller in a squeeze-out scenario” and the Court in *CNX Gas* concluded that *Solomon* “therefore does not hold that controllers never owe fiduciary duties when making tender offers.” *Id.* at *9, *11.

110. *Id.* at *11.

111. *Id.*

112. Sensitive to “[t]he informational and timing advantages possessed by controlling shareholders,” *Pure Resources* also held that “the majority shareholder target owes a duty to permit the independent directors on the target board both free rein and adequate time to react to the tender offer, by (at the very least) hiring their own advisors, providing the minority with a recommendation as to the advisability of the offer, and disclosing adequate information for the minority to make an informed judgment.” *Pure Resources*, 808 A.2d at 445; *see also CNX Gas*, 2010 WL 2291842, at *12 (discussing same).

113. *See Pure Resources*, 808 A.2d at 444 (“To the extent that my decision to adhere to *Solomon* causes some discordance between the treatment of similar transactions to persist, that lack of harmony is better addressed in the *Lynch* line, by affording greater liability-immunizing effect to protective devices such as majority of minority approval conditions and special committee negotiation and approval.”).

114. *See Cox Commc’ns*, 879 A.2d at 646 (“It was thought preferable in *Pure Resources* to keep the standards separate until there is an alteration in *Lynch* ...”).

of an arms' length merger, *viz.* approval by disinterested directors *and* approval by disinterested stockholders."¹¹⁵ Citing *Hammons*, the Court in *CNX Gas* further observed that "[d]octrinally, the use of both structural protections results in the controller standing only on one side of the transaction – as the buyer – and renders entire fairness inapplicable."¹¹⁶

CNX Gas consequently adopted the "unified approach" espoused in *Cox Communications*. Specifically, the Court held that because controlling shareholders do not enjoy "an inalienable right to usurp or restrict the authority of the subsidiary board of directors," business judgment review should only apply to two-step controlling shareholder going-private transactions if the tender offer was "both (i) negotiated and recommended by a special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares."¹¹⁷ The special committee must moreover enjoy the requisite "authority comparable to what a board would possess in a third-party transaction."¹¹⁸

Applying this unified test, which it acknowledged diverged from *Siliconix* as modified by *Pure Resources*,¹¹⁹ the Court held that plaintiffs had demonstrated a reasonable likelihood of success on the merits of their challenge to the tender offer. The special committee did not recommend the transaction – it remained neutral. Nor had the committee been authorized to negotiate or consider alternatives or deploy a rights plan against CONSOL.

The Court also noted "questions about the role of T. Rowe Price [which] undercut the effectiveness of the majority-of-the-minority tender condition."¹²⁰ In particular, T. Rowe Price's ownership of equity and debt in CONSOL raised questions as to whether it had "materially different incentives than a holder of CNX Gas common stock."¹²¹ While

115. *CNX Gas*, 2010 WL 2291842, at *12.

116. *See id.* *Hammons* acknowledged the "different standard [that] applies to transactions that effectively cash out minority shareholders through a tender offer followed by a short-form merger." *Hammons*, 2009 WL 3165613, at *10 n.21 (citing *Pure Resources*, 808 A.2d 421; *In re Siliconix Inc. S'holders Litig.*, 2001 WL 716787 (Del. Ch. June 19, 2001); *In re Aquila Inc. S'holders Litig.*, 805 A.2d 184 (Del. Ch. 2002)).

117. *CNX Gas*, 2010 WL 2291842, at *15. The Court noted its "depart[ure] from the language of *Cox Communications*" in expressly requiring an affirmative recommendation by the special committee in order for entire fairness not to apply. *See id.* at *13.

118. *Id.* at *14.

119. *See id.* It similarly recognized that its adoption of the unified approach was incompatible with the recent decision by the Court of Chancery in *In re Cox Radio, Inc. Shareholders Litigation*, 2010 WL 1806616 (Del. Ch. May 6, 2010), which embraced *Pure Resources* as "provid[ing] the standard applicable ... to tender offers made by controlling shareholders." *Id.* at *11. The *Cox Radio* decision, which involved the Court of Chancery's approval of a class settlement of alleged breaches of fiduciary duty in connection with a similar two-step freeze-out transaction by Cox Enterprises, Inc. for the remaining shares of its controlled subsidiary Cox Radio, Inc., was subsequently appealed to the Supreme Court of Delaware. Argument on that appeal is scheduled for November 17, 2010 as of the time of this Article.

120. *CNX Gas*, 2010 WL 2291842, at *16.

121. *Id.* The argument that T. Rowe Price should be treated like CNX's other minority shareholders given that its negotiator with CONSOL (Mr. Giroux) managed the Capital Appreciation Fund (which again held no CONSOL stock or debt) and viewed his duties as requiring him to obtain the highest price for T. Rowe Price's shares was found to be undercut by CONSOL's decisions to both enter into an agreement with T. Rowe Price for *all* of the CNX shares owned by T. Rowe Price and treat T. Rowe Price as a whole by including *all* of those shares in the majority-of-the-minority condition denominator. The Court also rejected the argument that an inquiry into the holdings of institutional holders would present an unworkable precedent given that CONSOL had chosen to enter into the tender agreement with T. Rowe Price and, thus, "T. Rowe Price's incentives [we]re at issue because of decisions that CONSOL and T. Rowe Price chose to make." *Id.* at *17.

the Court expressed an inclination to enjoin preliminarily the tender offer under *Pure Resources*, its evaluation of the transaction under the unified standard obviated its need to definitively rule on the effectiveness of the majority-of-minority condition.¹²²

After dispatching plaintiffs' disclosure claims as "meritless,"¹²³ the Court turned to the irreparable harm and balancing of the equities factors which it concluded would weigh in favor of injunctive relief under *Pure Resources*. The application of the unified standard "simplif[e] matters," however, since money damages could be awarded if defendants "fail to establish that the tender price [wa]s fair."¹²⁴ The Court thereafter conducted a traditional analysis and concluded that the availability of monetary relief post-trial militated against enjoining the all-cash premium transaction.¹²⁵

VI. BERGER V. PUBCO CORPORATION

As noted in the preceding discussion of *CNX Gas*, the Supreme Court in *Glassman v. Unocal Exploration*¹²⁶ held that appraisal is the exclusive remedy for minority shareholders challenging a short-form merger absent fraud or illegality or inadequate disclosure.¹²⁷ With respect to the disclosure requirement in a short-form merger, *Glassman* mandated the disclosure of all facts material to the minority's decision whether to accept the merger price or seek appraisal.¹²⁸ What remained unclear, however, was the appropriate remedy for a controlling shareholder's breach of this disclosure obligation. The Supreme Court answered that question in *Berger v. Pubco Corporation*,¹²⁹ which acknowledged the quasi-appraisal remedy for the first time and held as a matter of law based on the facts before it that the contours of that remedy should apply to all minority shareholders automatically and that such shareholders are not required to escrow any portion of the merger proceeds paid to them.

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122. The Court made clear in a subsequent argument concerning plaintiffs' emergency motion for an injunction pending appeal that while it did not need to reach the issue in its opinion, it did not "think that [plaintiffs had] at this stage made the record necessary to get an injunction on the majority-of-the-minority condition because of ... holes in the record." Transcript of Telephonic Oral Argument at 26, *In re CNX Gas Corp. S'holders Litig.* (Del. Ch. May 26, 2010).

123. See *CNX Gas*, 2010 WL 2291842, at *19.

124. *Id.* at *21.

125. The Court of Chancery subsequently granted an application by the CONSOL defendants to certify the *CNX Gas* opinion and order for interlocutory appeal to the Supreme Court of Delaware in a separate opinion that canvassed "[t]he current doctrinal bramble" resulting from the conflicting treatment of unilateral two-step going private transactions by controlling shareholders. See *In re CNX Gas Corp. S'holders Litig.*, 2010 WL 2705147, at *3 (July 5, 2010); see also *id.* at *11 (emphasizing the prior lack of opportunity by the Supreme Court to address the *Siliconix*, *Pure Resources*, and *Cox Communications* decisions and the "real-world consequences" attendant to certainty concerning the underlying standard of review for such transactions). The Supreme Court nevertheless declined to grant an interlocutory appeal and ordered that the "issues raised in th[e] certification application should be addressed after the entry of a final order." *In re CNX Gas Corp. S'holders Litig.*, 2010 WL 2690402, at *1 (Del. July 8, 2010).

126. 777 A.2d 242 (Del. 2001).

127. See *id.* at 248; see also *CNX Gas*, 2010 WL 2291842, at *7 n.2; *supra* note 107 (addressing same).

128. See *Glassman*, 777 A.2d at 248 ("Although fiduciaries are not required to establish entire fairness in a short-form merger, the duty of full disclosure remains.... Where the only choice for the minority shareholders is whether to accept merger consideration or seek appraisal, they must be given all the factual information that is material to that decision.").

129. 976 A.2d 132 (Del. 2009).

Pubco Corporation (“Pubco”) was a privately-held Delaware corporation controlled by Robert H. Kanner, who owned over 90% of Pubco’s shares and served as its president and sole director. Deciding to take Pubco private, Mr. Kanner transferred his Pubco shares to an acquisition vehicle¹³⁰ and effected a short-form merger that cashed out Pubco’s minority shareholders, including plaintiff Barbara Berger, for \$20 per share.

As noted by the Supreme Court, a parent’s board of directors seeking to effect a short-form merger need only adopt a resolution approving the transaction and furnish the minority stockholders with a notice informing them of the merger’s occurrence and their entitlement to seek a statutory appraisal.¹³¹ “Section 253 requires that the notice include a copy of the appraisal statute, and Delaware case law requires the parent company to disclose in the notice of merger all information material to shareholders deciding whether or not to seek appraisal.”¹³²

Pubco disseminated the required notice of merger to its minority shareholders in November 2007 (the “Notice”) informing them of the short-form merger and that they had been cashed out for \$20 per share. The Notice further advised the minority shareholders of their right to seek an appraisal, attached an outdated version of the appraisal statute, provided general corporate information, and attached Pubco’s unaudited, consolidated financial statements (which addressed all of Pubco’s operations together). But the Notice contained no disclosure concerning how the \$20 per share merger price had been determined.

Plaintiff brought a class action on behalf of all Pubco minority shareholders challenging the adequacy of the \$20 per share merger consideration and the sufficiency of the disclosure. Plaintiff argued that the alleged disclosure violations entitled all minority shareholder class members to any increase over the \$20 per share merger consideration regardless of whether the member had properly and timely demanded appraisal.

The Court of Chancery found that Mr. Kanner breached his duty of disclosure as Pubco’s controlling shareholder in two respects. First, the Notice attached the wrong version of the appraisal statute in breach of the explicit requirements of section 253 of the DGCL. Next, the Notice failed to disclose the methodology by which the controlling shareholder unilaterally arrived at the \$20 per share merger consideration. The Court found that this methodology was material to the minority’s decision whether to accept the merger consideration or seek appraisal, particularly in the case of a private company like Pubco which “made no public filings and whose Notice was relatively terse and short on details.”¹³³

Turning to the appropriate remedy, the Court of Chancery determined that the minority shareholders were entitled to a “quasi-appraisal” remedy with four features. First, the minority was entitled to supplemental disclosure of the material information not included in the Notice, including information concerning the methodology used to determine the merger consideration. Second, the minority should then be given the opportunity to participate in an action to determine the “fair

130. As noted in *Pubco*, a short-form merger under section 253 of the DGCL is only available to corporate controlling shareholders, not individuals. *See id.* at 134 (quoting Delaware’s appraisal statute and observing that “[t]he short form merger authorized by 8 Del. C. § 253 is available only where ‘... at least 90% of the outstanding shares of each class of the stock of a corporation ... is owned by another corporation’”).

131. *Id.* Specifically, section 262(b)(3) of Delaware’s appraisal statute provides that “[i]n the event all of the stock of a subsidiary Delaware corporation party to a merger effected under § 253 ... is not owned by the parent corporation immediately prior to the merger, appraisal rights shall be available for the shares of the subsidiary Delaware corporation.” Del. Code. Ann. tit. 8, § 262(b)(3) (2010). The Court of Chancery’s statutory duty in an appraisal proceeding is to determine the “fair value” of the company’s shares, “exclusive of any element of value arising from the accomplishment or expectation of the merger.” *Id.* § 262(h).

132. *Pubco*, 976 A.2d at 134.

133. *Id.* at 136.

value” of their shares regardless of whether they previously demanded appraisal. Third, minority shareholders choosing to participate in a fair value proceeding would be required to “opt-in” to the underlying action. Finally, minority shareholders opting-in would be required to place a portion of their short-form merger consideration in escrow.

Berger appealed, claiming that “all minority shareholders should have been treated as members of a class entitled to seek the quasi-appraisal recovery, without being burdened by any precondition or requirement that they opt-in or escrow any portion of the merger proceeds paid to them.”¹³⁴ The Supreme Court agreed.

The Supreme Court first contrasted the “opt-in” requirement with that of an “opt-out” one that automatically treated the minority shareholders as members of the plaintiff class.¹³⁵ Whereas the forfeiture risk attendant to an “opt-in” remedy was burdensome to the minority, an opt-out structure eliminated any such risk. “To the corporation, however, neither alternative is more burdensome than the other” and “[u]nder either alternative the company will know at a relatively early stage which shareholders are (and are not) members of the class.”¹³⁶ An opt-out structure was thus preferable.

The Supreme Court next addressed the propriety of an escrow requirement during the pendency of a quasi-appraisal proceeding. While acknowledging that minority shareholders would enjoy a “dual benefit” if permitted to retain the underlying short-form merger proceeds while simultaneously litigating to recover a higher amount, the Supreme Court did not view this as problematic or inequitable. Whereas the appraisal statute does not entitle minority shareholders to the merger consideration they would have otherwise received had they not sought an appraisal, shareholders in class actions challenging long-form mergers on fiduciary duty grounds may retain the merger proceedings while pursuing the class action remedy. The Supreme Court further grounded its rejection of an escrow requirement upon its conclusion that “[t]he appraisal statute should be construed even-handedly” as a matter of fairness:

Minority shareholders who fail to observe the appraisal statute’s technical requirements risk forfeiting their statutory entitlement to recover the fair value of their shares. In fairness, majority stockholders that deprive their minority shareholders of material information should forfeit their statutory right to retain the merger proceeds payable to shareholders who, if fully informed, would have elected appraisal.¹³⁷

Because “the majority stockholder’s duty of disclosure provides important protection for minority stockholders being cashed out in a short-form merger,” the Supreme Court concluded that “the quasi-appraisal remedy for a violation of that ... obligation ... should not be restricted by opt-in or escrow requirements.”¹³⁸ Importantly, however, the Supreme Court suggested that less expansive quasi-appraisal relief may be appropriate for technical disclosure violations, such as where stockholders receive an incomplete copy of the appraisal statute with their notice of merger.¹³⁹ The extent and contours of any such limitations remain to be developed.

134. *Id.* at 138. Berger did not challenge the supplemental disclosure or standing requirements on appeal (*i.e.*, the first and second features above). *See id.*

135. In other words, the minority shareholders “would continue as members of the class, unless and until individual members opt-out after receiving the remedial disclosure and the Rule 23 notice of class action informing them of their opt-out right.” *Id.* at 143.

136. *Id.*

137. *Id.* at 144.

138. *Id.* at 145.

139. *Id.*

VII. *MARIC CAPITAL MASTER FUND LTD. V. PLATO LEARNING, INC.*

The importance of full disclosure is not limited to short-form mergers. The Court of Chancery's decision in *Maric Capital Master Fund Ltd. v. PLATO Learning, Inc.*¹⁴⁰ revisits and highlights both the need for full disclosure in long-form mergers and the risk to corporate transactions absent such disclosure. While the standard for assessing the adequacy of disclosure remains unchanged, *Maric* provides valuable insights respecting the analysis of disclosure claims – not only for the particular areas of disclosure at issue, but also in other contexts in which disclosure deficiency claims commonly arise – and the potential risks presented by inadequate disclosure.

• • •

Following the announcement by private equity firm Thomas Bravo, LLC (“Thomas Bravo”) of its proposed acquisition of PLATO Learning, Inc. (“PLATO”) for \$5.60 per share, plaintiff Maric Capital Master Fund, Ltd. (“Maric”), a shareholder of Thomas Bravo, sought to enjoin preliminarily the transaction on two grounds: (1) the failure of PLATO’s directors to secure the highest price attainable for shareholders under *Revlon*, and (2) the inadequacy of various disclosures in PLATO’s proxy statement.¹⁴¹

At the conclusion of a hearing on plaintiff’s preliminary injunction motion, the Court found that the plaintiff failed to establish a reasonable likelihood of success on its *Revlon* claim, but reserved judgment on the disclosure claims. In a written opinion issued later that day, the Court enjoined the transaction pending corrective disclosures with respect to three issues.¹⁴²

Preparation of Fairness Opinion: The Court found the proxy statement materially misleading regarding the means by which PLATO’s investment banker, Craig-Hallum Capital Group (“Craig-Hallum”), established the discount rate for the discounted cash flow (“DCF”) analysis underlying its fairness opinion. The proxy statement suggested that the 23% to 27% range used by Craig-Hallum in its DCF analysis resulted from “an analysis of PLATO Learning’s weighted average cost of capital.”¹⁴³

While “it [wa]s the literal case” that Craig-Hallum used a range of 23% to 27% in the DCF analysis presented to the special committee, that range did not result from the weighted average cost of capital analysis presented to the special committee.¹⁴⁴ Craig-Hallum presented two calculations of the weighted average cost of capital to the special committee

140. 2010 WL 1931084 (Del. Ch. May 13, 2010).

141. *Id.* at *1. Although once viewed as a standalone duty, the duty of disclosure – otherwise known as the duty of candor – is now treated as subsumed within the hallmark duties of care and loyalty. *See, e.g., In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 357 (Del. Ch. 2008).

142. *Maric*, 2010 WL 1931084, at *1. Under well-settled precedent, the failure to make adequate disclosure in connection with a challenged transaction is sufficient to establish a threat of irreparably injury. *See id.* at n.2 (citing *Transkaryotic*, 954 A.2d at 346; *In re Pure Res., Inc. S’holder Litig.*, 808 A.2d 421 (Del. Ch. 2002)); *see also Wayne County Employees’ Ret. Sys. v. Corti*, 954 A.2d 319, 329 (Del. Ch. 2008) (recognizing that “[a] preliminary injunction motion is ... the appropriate mechanism by which to challenge alleged disclosure violations” because the right to make informed decisions “if infringed, can only be truly remedied by a specific, injunctive order mandating the appropriate disclosure before the shareholders are required to vote”).

143. *Maric*, 2010 WL 1931084, at *2.

144. *Id.* at *1.

(one based upon a capital asset pricing model and one based upon a comparable companies analysis), which resulted in discount rates of 22.6% and 22.5%, respectively.¹⁴⁵ While both discount rates presented to the special committee were “hefty,” they were less than the lowest rate reflected in the proxy statement.¹⁴⁶

During discovery, defendants provided several justifications for Craig-Hallum’s use of this range. But these after-the-fact justifications were never suggested to the special committee.¹⁴⁷ Indeed, the only “*actual analysis*” generated by Craig-Hallum suggested a range of 22.5% to 22.6%, making the disclosure in the proxy statement materially misleading.¹⁴⁸ Nor was this a mere technical defect, as increasing the discount rate made the merger price “far more attractive” than it would have been under the discount rates suggested by Craig-Hallum’s analysis.

Omission of Management’s Free Cash Flow Estimates: The Court also found deficient defendants’ “selective[]” and “inexplicable” omission of the free cash flow estimates provided to Craig-Hallum by PLATO’s management.¹⁴⁹ To be sure, assuming compliance with federal securities laws, companies enjoy significant discretion regarding what to include in proxy statements. And the inclusion of too much information can itself be problematic.¹⁵⁰ The Court nevertheless concluded that the target “management’s best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information.”¹⁵¹

This is because shareholders voting on a merger must weigh the proposed merger consideration against the future benefits to be derived from the company if it does not merge. In this particular case, that required shareholders to determine whether it was worth “forsak[ing] the value that might obtain if the corporation remains independent” in exchange for “\$5.60 for sure.”¹⁵² Because traditional corporate finance theory suggests that “the value of stock should be premised on the expected future cash flows of the corporation,” future expected cash flows are a critical consideration. For this reason, the proxy statement “omit[ed] material information by, for reasons not adequately explained, selectively removing the free cash flow estimates from the projections.”¹⁵³

145. *Id.*

146. *Id.*

147. To get from the rates reflected in the proxy statement, Craig-Hallum “heaped” “dubious,” “eyebrow-raising premiums” “on top of” the rates suggested by the DCF analysis (including a “technology ‘industry risk premium’” of 1.4% and a “small cap premium” of 9.5%). *Id.*

148. *Id.* The Court suggested that defendants may not have had to disclose how they determined the appropriate discount rates. But “[b]ecause the proxy statement spoke on this subject, [the directors had] a duty to do so in a non-misleading fashion.” *Id.* at *2.

149. *Id.* at *1.

150. *Id.* (citing *In re General Motors (Hughes) S’holder Litig.*, 2005 WL 1089021, at *13 (Del. Ch. May 4, 2005) (“Delaware law does not require ‘directors to bury the shareholders in an avalanche of trivial information. Otherwise, shareholder solicitations would become so detailed and voluminous that they will no longer serve their purpose.’”) (citation omitted)).

151. *Id.*

152. *Id.* (citing *In re Netsmart Techs., Inc. S’holder Litig.*, 924 A.2d 171, 203 (Del. Ch. 2007) (“When stockholders must vote on a transaction in which they would receive cash for their shares, information regarding the financial attractiveness of the deal is of particular importance. This is because the stockholders must measure the relative attractiveness of retaining their shares versus receiving a cash payment, a calculus heavily dependent on the stockholders’ assessment of the company’s future cash flows.”)).

153. *Id.*

Post-Merger Employment Negotiations: The proxy statement also disclosed that one factor in the decision of the special committee and the board of directors to approve the merger was “the fact that Thomas Bravo did not negotiate terms of employment . . . with [PLATO’s] management for the period after the merger closes.”¹⁵⁴ But whether formal “negotiations” or not, the “reality” was that PLATO’s CEO engaged in “extended discussions” with Thomas Bravo concerning “the typical equity incentive package given by Thomas Bravo to management” in other deals, which “typically consist[ed] of 10% of the common stock, with 4% going to the CEO.”¹⁵⁵ Moreover, in these “extended discussions,” PLATO’s CEO asked if Thomas Bravo preferred to retain management, was assured that it typically did, and was led to believe that “top management would likely be retained” if the transaction was consummated.¹⁵⁶

As it did in its discussion regarding the DCF analysis, the Court emphasized the importance of full disclosure once a company elects to speak on a topic. Although the Court had little doubt that management would have “rationally believed” that a private equity buyer like Thomas Bravo would provide such incentives to incumbent management, the disclosure concerning the CEO’s negotiations concerning post-transaction employment “create[d] the materially misleading impression that management was given no expectation regarding the treatment they could receive from Thomas Bravo.”¹⁵⁷ The Court therefore ordered corrective disclosures to “clarify the extent of actual discussions” between Thomas Bravo and the incumbent CEO.¹⁵⁸

VIII. CONCLUSION

The decisions summarized above reaffirm Delaware’s commitment to the director-primacy model. *Hammons* and *CNX* stress the important role played by boards of directors as a bastion against interference by controlling shareholders. The substantial deference afforded to unconflicted boards in *Selectica* and *Citigroup*, as well as *Lyondell’s* holding that independent and disinterested directors essentially enjoy free rein in the *Revlon* context, underscore this tenet. The limited disclosure remedies granted in *Berger* and *Maric* are consistent with this board-centric paradigm as well.

To the extent that the Delaware courts have scrutinized the actions undertaken (or, in the case of *Citigroup*, forgone) by directors, their decisions reveal the judiciary’s sensitivity to circumstances that call into question the foundations of the business judgment rule. In this sense, the decisions embody the highly contextual approach undertaken by the Delaware courts. While boards of directors and their counsel must therefore continue to pay careful attention to all attendant facts, they may take comfort in the continuing stability of Delaware’s preeminent corporate law.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

REPOSE VS. FREEDOM — DELAWARE'S PROHIBITION ON EXTENDING THE STATUTE OF LIMITATIONS BY CONTRACT: WHAT PRACTITIONERS SHOULD KNOW

Melissa DiVincenzo*

I. OVERVIEW

Many complex commercial and corporate agreements contain provisions that purport to allow the parties to make claims arising from breach of the contract well into the future. A typical provision might provide that claims relating to certain types of the representations and warranties, sometimes referred to as "Core Representations," can be brought indefinitely or for a certain number of days following the applicable statutory limitations period. Notwithstanding the prevalence of such provisions, under many circumstances, to the extent such a provision is deemed to constitute an attempt to lengthen the applicable statute of limitations, it will be unenforceable.

This article will examine the cases which have held that, under Delaware law, the parties to a contract may agree to modify the otherwise applicable statute of limitations by cutting short the period of time in which claims must be filed, but may not agree to a longer period for filing claims than is permitted by the applicable statute of limitations. Although there is limited Delaware authority on point, the cases that have addressed the issue are clear that a contractual provision that attempts to lengthen the period of time during which claims may be filed is unenforceable as a violation of public policy. This prohibition on extending the statute of limitations by contract has important implications for negotiating and drafting contracts. In particular, this aspect of Delaware law would invalidate contractual provisions that purport to allow parties to bring claims beyond the applicable statute of limitations, e.g., a provision providing that a claim for breach of representations and warranties can be brought for ten years from the date of closing.

This article examines the Delaware rule prohibiting contractual lengthening of the statute of limitations and whether that rule should be reconsidered in light of the value that Delaware law places on freedom of contract. Under the current state of the law, the prohibition on lengthening the statute of limitations by contract places greater value on the policy goals served by the statute of limitations than the policy of freedom of contract. This preference for the public policy goals served by the statute of limitations over freedom of contract may be misplaced, particularly in commercial contracts among sophisticated parties. Furthermore, the prohibition on extending the statute of limitations by contract is inconsistent with Delaware's goal of promoting efficient corporate and commercial laws, because, by limiting the parties' ability to contract for a remedy beyond the applicable statute of limitations, the prohibition may prevent parties from allocating risk as they deem appropriate.

Nevertheless, practitioners seeking to lengthen the applicable statute of limitations by contract could pursue alternative approaches to get to the same result. The most effective alternative approach is a contract under seal, which is subject to a twenty year statute of limitations. This approach and other alternatives are addressed in the final section of this Article.

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II. BACKGROUND

A. Statutes of Limitations Generally

Delaware has a number of different statutes of limitations, which generally provide that claims must be brought within a specified period of time. Absent specific circumstances justifying tolling, claims that are not brought within that period are time-barred. In the commercial or corporate context, the statute of limitations that is often most relevant is the three-year statute of limitations set forth in Section 8106 of Title 10. Section 8106 applies to claims “based on a promise” and claims arising from “injury unaccompanied by force,” which include breach of contract, tort and fiduciary duty claims. Specifically, Section 8106 provides:

No action to recover damages for trespass, no action to regain possession of personal chattels, no action to recover damages for the detention of personal chattels, no action to recover a debt not evidenced by a record or by an instrument under seal, no action based on a detailed statement of the mutual demands in the nature of debit and credit between parties arising out of contractual or fiduciary relations, no action based on a promise, no action based on a statute, and no action to recover damages caused by an injury unaccompanied with force or resulting indirectly from the act of the defendant shall be brought after the expiration of 3 years from the accruing of the cause of such action; subject, however, to the provisions of §§ 8108-8110, 8119 and 8127 of this title.¹

In addition to Section 8106, Delaware has a number of different statutes of limitations that could apply depending on the nature of the injury or wrong alleged to have occurred, including four years for sales contracts,² one year for benefits arising from work or personal service,³ two years for personal injury,⁴ and two years for wrongful death.⁵

Under Delaware law, a statute of limitations has been described as a “statute of repose,” intended to discourage stale disputes where the passage of time may have made determination of the facts more difficult.⁶ Statutes of limitations represent the legislature’s attempt to balance a plaintiff’s right to seek a remedy in circumstances where he or she may not be immediately aware of such rights with a defendant’s right to avoid having to defend against stale claims.⁷ The courts have explained that, as a general matter, “the purpose underlying statutes of limitations is one of fairness to the defendant; that the defendant may be secure in his expectation that he will not be called upon to defend against stale claims.”⁸

1. DEL. CODE ANN. tit. 10, § 8106.

2. DEL. CODE ANN. tit. 6, § 2-725(1) (Delaware UCC). Under Section 2-725(1) the parties to a sales contract may shorten the statute of limitations to a period not less than one year, but may not extend it. *Id.*

3. DEL. CODE ANN. tit. 10, § 8111.

4. DEL. CODE ANN. tit. 10, § 8119.

5. DEL. CODE ANN. tit. 10, § 8107.

6. *Keller v. President, Dirs. and Co. of Farmers Bank of Del.*, 24 A.2d 539, 541 (Del. Super. Ct. 1942) (quoting *Boston v. Brady’s Ex’r.*, 4 Del. (4 Harr.) 524 (1847)).

7. *See Rudginski v. Pullella*, 378 A.2d 646, 649 (Del. Super. Ct. 1977) (“Yet, in the application of the statute in a given set of circumstances, it should not be made to produce a result which the legislature as men and women of reason could never have intended. Thus, the question becomes one of balancing the difficulty of proof which may increase with the passing of time against the hardship to a plaintiff who neither knows nor has reason to have known of the existence of his right to sue.”) (citation omitted).

8. *Pack & Process, Inc. v. Celotex Corp.*, 503 A.2d 646, 650 (Del. Super. Ct. 1985).

A statute of limitations also protects the court from having to adjudicate stale claims where a plaintiff has delayed exercising his or her rights. In all of these respects, a statute of limitations serves an important public interest:

[S]tatutes of limitation are founded in wisdom and sound policy. They have been termed statutes of repose, and are regarded as highly beneficial. They proceed on the principle, that it is to the interest of the public to discourage the litigation of old or stale demands; and are designed not merely to raise a presumption of payment, but to afford a security against the prosecution of claims where, from lapse of time, the circumstances showing the true nature or state of the transaction, may have been forgotten; or may be incapable of explanation by reason of the uncertainty of human testimony, the death or removal of witnesses, or the loss of receipts, vouchers, or other papers.⁹

Courts applying Delaware law have described the purpose of a statute of limitations similarly: “[s]tatutes of limitations protect defendants from having to confront controversies in which the search for truth may be thwarted by the loss of evidence, the fading of memories, or the disappearance of witnesses.”¹⁰ “They also protect the courts by relieving them of ‘the burden of trying stale claims when a plaintiff has slept on his rights.’”¹¹

Although the Delaware cases are in agreement with respect to the purpose served by statutes of limitations, the Delaware cases are not clear with respect to the exact nature of a statute of limitations. On the one hand, the courts have stated that such statutes “arbitrarily establish judicial prerequisite” for filing suit and have characterized the attempt to file suit after the applicable statute of limitations has run as a “jurisdictional defect ... that cannot be excused.”¹² For example, in *Scharf v. Edgcomb Corp.*, the Delaware Supreme Court discussed statutes of limitations generally in a decision involving a former CEO’s pursuit of indemnification for legal fees.¹³ The Delaware Supreme Court reversed the Court of Chancery’s determination that the CEO’s claims for indemnification were time-barred by the applicable statute of limitations.¹⁴ Whether or not the claims were time-barred turned on when the statute of limitations began to run.¹⁵ The court explained that determining when the statute begins to run is important because, if a complaint is not timely filed, the court does not have jurisdiction to decide the claim:

“[A]ll statutes of limitation[s] and all statutory appeal requirements are, by their very nature, ‘harsh’ in that they arbitrarily establish jurisdictional prerequisites for initiating or maintaining a suit.” When a

9. *Keller*, 24 A.2d at 541 (quoting *Boston v. Bradley’s Ex’r.*, 4 Del. (4 Harr.) 524 (1847)).

10. *Nat’l Iranian Oil Co. v. Mapco Int’l, Inc.*, 983 F.2d 485, 494 (3d Cir. 1992).

11. *Id.*

12. *Scharf v. Edgcomb Corp.*, 864 A.2d 909, 920 (Del. 2004) (citation omitted); *see also Hines v. New Castle County*, 640 A.2d 1026, 1028 (Del. 1994) (distinguishing “notice of claim ordinances” from statutes of limitations and explaining that “the latter are true statutes of repose intended to bar causes of action by reason of the passage of time”). Generally, a statute of limitations appears to be treated as a jurisdictional prerequisite in the case of a statutory appeal requirement. *See, e.g., Riggs v. Riggs*, 539 A.2d 163, 163-64 (Del. 1988); *Mary A.O. v. John J.O.*, 471 A.2d 993, 995 (Del. 1983).

13. *Scharf*, 864 A.2d at 916.

14. *Id.* at 921.

15. *Id.* at 916.

plaintiff fails to file a timely complaint, a jurisdictional defect is created that cannot be excused. Therefore, it is imperative to identify a date certain when any statute of limitations begins to run.¹⁶

On the other hand, the Delaware courts have also described a statute of limitations as a defense that is personal to the defendant. Characterized this way, a statute of limitations is a procedural device rather than a jurisdictional prerequisite.¹⁷

B. Waiver of the Statute of Limitations

The characterization of the statute of limitations as a defense that is personal to the defendant (rather than as a jurisdictional prerequisite) bears directly on the question of whether the statute of limitations may be waived. Accordingly, the Delaware courts that have characterized the statute of limitations as a procedural mechanism have also held it can be waived by the defendant.¹⁸ The cases that have permitted waiver have done so under circumstances where the claim had already accrued. The cases have not specifically addressed whether the statute could be waived before the claim accrued, but, for the reasons discussed in Section III, it appears that it could not. For example, in *Department of Labor v. Red Rose Roofing*, the Delaware Superior Court held that the statute of limitations is a defense that is personal to a particular defendant and can, therefore, be waived.¹⁹ In *Red Rose Roofing*, the Delaware Superior Court refused to grant a defendant's motion to dismiss former employees' claims despite the fact that the action was brought after the applicable statute of limitations had expired.²⁰ The court found that the statute of limitations had been waived and that such a waiver did not violate public policy. Specifically, the defendant had waived the statute of limitations through a letter from its counsel stating that it was "willing to further extend the statute of limitations . . . as necessary to provide [the plaintiffs] with sufficient time to review and reconcile the benefit calculations and thus avoid the unnecessary filing of a lawsuit."²¹ The defendant's counsel wrote the letter providing the waiver as the Department of Labor was investigating the allegations and after the claim had accrued.²² The court upheld the waiver but provided limited reasoning, and did not address whether such a waiver would be permitted before the claims had accrued.

In *Studiengesellschaft Kohle, mbH v. Hercules, Inc.*, the District Court for the District of Delaware also held that a statute of limitations defense may be waived by a defendant after a claim accrues.²³ There, the plaintiff had agreed not to bring suit if the defendant would waive the statute of limitations.²⁴ The waiver agreement stated that, if the plaintiff

16. *Id.* at 920 (quoting *Mary A.O. v. John J.O.*, 471 A.2d 993, 995 n.4 (Del. 1983)) (citing *Mary A.O.*, 471 A.2d at 995; *Riggs v. Riggs*, 539 A.2d 163 (Del. 1988)).

17. *See, e.g.*, *Dep't of Labor v. Red Rose Roofing, Inc.*, C.A. Nos. 98C-02-019-SCD, 98C-02-020-JOH, 2000 WL 970678 (Del. Super. Ct. Mar. 13, 2000).

18. *See, e.g.*, *Studiengesellschaft Kohle, mbH v. Hercules, Inc.*, 748 F. Supp. 247, 249, 251 (D. Del. 1990); *Red Rose Roofing, Inc.*, 2000 WL 970678, at *1.

19. *Red Rose Roofing, Inc.*, 2000 WL 970678, at *1.

20. *Id.*

21. *Id.* (emphasis in original).

22. *Id.*

23. 748 F. Supp. 247 (D. Del. 1990).

24. *Id.* at 251.

would refrain from bringing suit for past-due royalties for a specified period of time, the defendant would “waive the defense of statute of limitations to such claim, except to the extent of any statute of limitations bar that already has fallen into place” on the date of the waiver agreement.²⁵ The defendant argued that it had only waived the defense for a period of a few months, but the court rejected that argument because the defendant had failed to so specify in the agreement.²⁶ The court found that the defendant had not waived the statute of limitations defense as to any claim that was already barred prior to the date the parties entered the waiver agreement, but had waived the defense as to claims on which the statute of limitations had not yet run.²⁷

C. Laches/Equity

The statute of limitations does not apply in a court of equity. In equitable proceedings, the policy goals achieved by the statute of limitations are, instead, achieved by application of the doctrine of laches. The doctrine of laches serves a similar purpose and, where applicable, will act like a statute of limitations to cause actions in equity to be time-barred. “Laches is an equitable principle that operates to prevent the enforcement of a claim in equity where a plaintiff has delayed unreasonably in bringing suit to the detriment of the defendant or third parties.”²⁸ To determine whether the doctrine of laches applies, a court of equity will often look to the analogous statute of limitations, if any. A court applying laches may shorten or lengthen the period of time contemplated by the analogous statute of limitations based on the equities; however, a plaintiff’s failure to seek relief within the statutory limitations period is often conclusive evidence that the doctrine of laches applies.

The Delaware Supreme Court recently discussed the doctrine of laches and its relationship to the statute of limitations.²⁹ The court explained that while “laches does not prescribe a specific time period as unreasonable,” a court in equity will apply the applicable statute of limitations by analogy.³⁰ The plaintiff’s failure to file suit within the analogous statute of limitations period will typically be given “great weight” in determining whether laches bars the claims.³¹ Laches also permits a court to apply a shorter limitations period than the analogous statutory period if the plaintiff should have sought relief and its failure to do so prejudiced the other party.³² Elsewhere, the Delaware courts have explained that when the equitable action does not correspond to a statute of limitations, a court of equity will apply a traditional equity analysis to determine whether laches applies.³³

25. *Id.* at 250.

26. *Id.* at 251.

27. *Id.* at 252.

28. 1 DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE & COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY § 11.05 (2000 & Supp. 2009).

29. *Whittington v. Dragon Group, L.L.C.*, 991 A.2d 1 (Del. 2009).

30. *Id.* at 7.

31. *Id.* at 9.

32. *Id.* at 8.

33. *Kirby v. Kirby*, C.A. No. 8604, 1989 WL 111213, at *5 (Del. Ch. Sept. 26, 1989).

D. Accrual

Under Delaware law, the statute of limitations begins to run when the cause of action accrues, which is generally the time of the wrongful act.³⁴ In general, an action accrues when it “come[s] into existence as an enforceable claim or right,” i.e., when it “arise[s].”³⁵ Section 8106 provides that “no action . . . shall be brought after the expiration of 3 years from the accruing of the cause of such action.”³⁶

The key to accrual, as it relates to the statute of limitations, is that it can be analyzed in a number of different ways depending on the nature of the underlying claim.³⁷ It is clear, for example, that a cause of action for a breach of contract will accrue when the breach, i.e., the wrongful act, occurs.³⁸ Such a breach could occur at signing, closing or later.³⁹ In the case of representations and warranties, which often speak to the state of facts at closing, a breach of such representations and warranties occurs at closing, such that the cause of action would accrue on the closing date and the statute of limitations would begin to run. Other causes of action for breach of contract might accrue post-closing. For example, covenants contained in a contract might require performance at a later date. In that case, a claim for breach of a covenant will accrue on the date that the party fails to perform its obligations.⁴⁰

The complexity of the law with respect to the accrual of claims in the breach of contract context is demonstrated by the analysis of the Delaware courts in two unrelated decisions involving Celotex Corporation.

In a 1985 decision, *Pack & Process, Inc. v. Celotex Corp.*, the Delaware Superior Court examined the issue of accrual of claims relating to a breach of contract for purposes of determining whether the statute of limitations required dismissal of the claim — and dilated on when different types of warranties will affect accrual.⁴¹ In *Celotex*, the plaintiff

34. *Coleman v. PricewaterhouseCoopers, LLC*, 854 A.2d 838, 842 (Del. 2004); *Krahmer v. Christie’s Inc. (Krahmer II)*, 911 A.2d 399, 407 (Del. Ch. 2006) (stating that “a statute of limitations is calculated from the time of the wrongful act”).

35. BLACK’S LAW DICTIONARY 22 (8th ed. 2004).

36. DEL. CODE ANN. tit. 10, § 8106.

37. *Certainteed Corp. v. Celotex Corp.*, C.A. No. 471, 2005 WL 217032, at *7 (Del. Ch. Jan. 24, 2005).

38. Similarly, for tort claims, the cause of action accrues at the time the tort was committed. *WaveDivision Holdings, LLC v. Highland Capital Mgmt. L.P.*, C.A. No. 08C-11-132-JOH, 2010 WL 1267126, at *4-5 (Del. Super. Ct. Mar. 31, 2010) (explaining the operation of accrual in the context of a tortious interference with contract claim).

39. *Certainteed Corp.*, 2005 WL 217032, at *7.

40. Note that while a contract claim typically accrues as of the date of breach, “a statute of limitations will not generally bar a continuing cause of action until the contract’s termination.” *Smith v. Mattia*, C.A. 4498-VCN, 2010 WL 412030, at *4 (Del. Ch. Feb. 1, 2010) (citing *Guerriei v. Cajun Cove Condo. Council*, 2007 WL 1520039, at *6 (Del. Super. Ct. Apr. 25, 2007)). A contract may be continuous or severable, with a continuous contract being one in which “the obligations under the contracts are all done for the ‘same general purpose.’” *Id.* In the case of a continuous contract, “the statute begins to run only when full damages can be ascertained and recovered.” *Id.* (internal quotation marks and footnote omitted). In *Smith*, the court explained that deciding whether a contract was continuous or severable was a fact specific determination that cannot be made on a motion to dismiss. *Id.* *Smith* concerned plaintiff’s claim that defendants had breached a contract to build a house for plaintiff by July 1, 2005, and had failed to do so. If the obligation to build the house by July 1, 2005 was severable from defendants’ overriding obligation to build the house within a reasonable time, then the action would have accrued on July 1. If the obligation to complete construction by July 1, 2005 was simply part of a continuing obligation to perform, then the cause of action would not have accrued until April 10, 2006, when defendants completely abandoned the contract.

41. *Pack & Process, Inc. v. Celotex Corp.*, 503 A.2d 646 (Del. Super. Ct. 1985).

brought breach of express and implied warranty claims against the defendants in connection with the installation and manufacture of a warehouse roof.⁴² The plaintiff had purchased the warehouse from a third party and had paid a twenty-year bond for repairs for ordinary wear and tear and ongoing inspection of the roof.⁴³ The court noted that the action was governed by Section 2-725 of Title 6 of the Delaware Code (Delaware’s version of Article 2 of the Uniform Commercial Code), which required that a cause of action for a breach of any sale contract be brought within four years of the “tender of delivery” except where “a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance.”⁴⁴

The *Celotex* court explained that, where the warranty “extends to future performance,” the cause of action does not accrue until the party should have discovered the breach.⁴⁵ The court discussed the differences between warranties extending to future performance and present warranties.⁴⁶ The court noted that the distinction in Section 2-725 between present warranties “which are representations as to the quality or condition of goods at the time of sale, and prospective warranties, those which refer to the future condition or performance of goods, is not an innovation in the law of warranty.”⁴⁷ With respect to the distinction between the accrual of prospective and present warranties, the court noted that courts have attempted to balance a seller’s interest “in repose” and a buyer’s interest in a remedy available for “defects that cannot be discovered until several years after the sale or delivery of defective goods.”⁴⁸ The court concluded that genuine issues of material fact existed with respect to whether warranties were prospective or present warranties and declined to grant summary judgment with respect to that issue.⁴⁹

In a 2005 decision, *Certainteed v. Celotex Corp.*, the Court of Chancery distinguished between different types of claims to determine when the applicable statute of limitations or contractual limitations period began to run in connection with an asset purchase agreement.⁵⁰ The court determined that there were three categories of claims under the asset purchase agreement. The first category, the “facilities claims,” arose from the seller’s breach of representations and warranties relating to environmental conditions, required permits, and compliance with regulations.⁵¹ The seller had agreed to “indemnify” the purchaser for losses for such breaches of representations and warranties. The second category, “the product liability claims,” arose from the purchaser’s losses to third parties for settling claims for defective products.⁵²

42. *Id.* at 648.

43. *Id.*

44. *Id.* at 652.

45. *Id.*

46. *Id.* at 652-55.

47. *Id.* at 652-53.

48. *Id.* at 653 (citation omitted).

49. *Id.* at 656.

50. *Certainteed Corp. v. Celotex Corp.*, C.A. No. 471-VCS, 2005 WL 217032 (Del. Ch. Jan. 24, 2005).

51. *Id.* at *7-8.

52. *Id.* at *13.

The seller had also agreed to “indemnify” the purchaser for these losses. The third category of claims, the “remediation claims,” arose from the seller’s failure to perform certain testing and remediation activities required by the agreement.⁵³ These claims were breach of covenant claims.

The *Certainfeed* court compared the “indemnification” obligations relating to both the “facilities claims” and the “product liability claims.” The court explained that what the contract referred to as “indemnification” with respect to the breach of the representations and warranties was not common law indemnification, but was instead a contractual remedy for losses caused by the plaintiff’s breach of representations and warranties. Common law indemnity, by contrast, provides “a general right of reimbursement for debts owed to third parties” by one who is a “secondarily-liable party.”⁵⁴ The distinction between claims for contractual indemnification, i.e., the facilities claims, and common law indemnification, i.e., the product liability claims, was important because the court held that such claims would accrue at different times. Claims relating to breaches of representations and warranties began to accrue at closing, while common law claims for third party indemnification would not begin to accrue until the claim was resolved with certainty, i.e., once the purchaser had made payment to a third party.⁵⁵ The court also held that the remediation claims would accrue at the time when the party failed to perform its obligation.

The Delaware court’s decisions involving Celotex Corporation demonstrate the subtleties under Delaware law with respect to the accrual of claims, and, in particular, breach of contract claims. Whether the claim relates to a present or a prospective warranty, a representation, a covenant, or a third-party claim, may impact when the statute of limitations begins to run.

E. Tolling

A plaintiff need not be aware that the cause of action has accrued for the statute of limitations to begin to run. However, there are circumstances where the statute of limitations will not begin to run at the time of the wrongful act. This concept is referred to as “tolling.” The term “tolling” “refers to suspending or stopping the running of a statute of limitations; it is analogous to a clock stopping, then restarting.”⁵⁶

Under Delaware law, there are two generally recognized doctrines that define the circumstances where the tolling concept will apply (as an exception to the general rule that the statute of limitations begins to run when the wrongful act occurs): the doctrine of fraudulent concealment and the doctrine of inherently unknowable injury.⁵⁷ “Each of these doctrines permits tolling of the limitations period where the facts underlying a claim were so hidden that a reasonable plaintiff could not timely discover them.”⁵⁸ Under Delaware law, “ignorance of the cause of action will not toll the statute,

53. *Id.* at *12.

54. *Id.* at *3.

55. *Id.* at *3, *5.

56. 51 AM. JUR. 2D *Limitations of Actions* § 169 (2000 & Supp. 2008).

57. See *Krahmer v. Christie’s Inc. (Krahmer I)*, 903 A.2d 773, 778 (Del. Ch. 2006); *Whittington v. Dragon Group L.L.C. (Whittington I)*, C.A. No. 2291-VCP, 2008 WL 4419075, at *6 (Del. Ch. Sept. 30, 2008), *rev’d on other grounds*, 991 A.2d 1 (Del. 2009).

58. *Krahmer I*, 903 A.2d at 778 (quoting *In re Dean Witter P’ship Litig.*, C.A. No. 14816, 1998 WL 442456, at *5 (Del. Ch. July 17, 1998)).

absent concealment or fraud, or unless the injury is inherently unknowable and the claimant is blamelessly ignorant of the wrongful act and the injury complained of.”⁵⁹

With respect to the doctrine of fraudulent concealment, a claim has been fraudulently concealed for purposes of Delaware law when the defendant:

[k]nowingly acted to prevent [the] plaintiff from learning facts or otherwise made misrepresentations intended to “put the plaintiff off the trail of inquiry.” Mere silence is insufficient to establish fraudulent concealment. Rather, the evidence must show that the defendant engaged in some sort of “actual artifice” to toll the running of the limitations period.⁶⁰

Stated differently, a claim has been fraudulently concealed when the defendant has actively “concealed facts necessary to put a plaintiff on notice of the truth.”⁶¹ The doctrine essentially requires an intentional act of concealment or a misrepresentation by the defendant.⁶²

With respect to the doctrine of inherently unknowable injury, a claim is inherently unknowable and the plaintiff blamelessly ignorant when discovery of the existence of a cause of action would be a “practical impossibility.”⁶³ The plaintiff must demonstrate that through no fault of her own she had no knowledge of the act and the injury.⁶⁴

In either case, the statute of limitations only begins to run upon the discovery of facts “constituting the basis of the cause of action or the existence of facts sufficient to put a person of ordinary intelligence and prudence on inquiry which, if pursued, would lead to the discovery” of such facts.⁶⁵ That is, the “statute is suspended only until [the plaintiff’s] rights are discovered or until they could have been discovered by the exercise of reasonable diligence.”⁶⁶ Although the cases have dealt extensively with the concept of tolling, the circumstances in which the courts will toll the statute of limitations are very fact specific. Accordingly, a party entering into a contract should not, at the outset, rely on the concept of tolling to protect its ability to recover for a breach that is not detected within the statutory limitations period.

59. *Coleman v. PricewaterhouseCoopers, LLC*, 854 A.2d 838, 842 (Del. 2004).

60. *Krahmer II*, 911 A.2d at 407.

61. *Whittington I*, 2008 WL 4419075, at *6.

62. *Id.*

63. *Id.*

64. *Id.*

65. *Krahmer I*, 903 A.2d at 779; *see also Sunrise Ventures, LLC v. Rehoboth Canal Ventures, LLC*, C.A. No. 4119-VCS, 2010 WL 363845, at *6 (Del. Ch. Jan. 27, 2010) (“The doctrine of equitable tolling applies when a plaintiff ‘reasonably relies on the competence and good faith of a fiduciary,’ and tolls the relevant statute of limitations until the plaintiff is ‘objectively aware of the facts giving rise to the wrong, *i.e.*, on inquiry notice.’ Similarly, the doctrine of fraudulent concealment tolls the statute of limitations until a plaintiff is put on inquiry notice where an affirmative act of concealment or a misrepresentation was used to put the plaintiff ‘off the trail of inquiry.’”) (footnotes omitted).

66. *Whittington I*, 2008 WL 4419075, at *6 n.50 (citation omitted); *see also Wal-Mart Stores, Inc. v. AIG Life Ins. Co.*, 860 A.2d 312, 319-20 (Del. 2004) (reversing the Court of Chancery’s finding that claims were time-barred because plaintiff was on inquiry notice and concluding that claims had been tolled because facts created a reasonable inference that plaintiff was blamelessly ignorant of the wrongful acts).

In addition to equitable tolling concepts, the statute of limitations may also be tolled by agreement of the parties. Such tolling agreements may prevent a party from relying on a statute of limitations or laches defense.⁶⁷ A tolling agreement will not be implied from the conduct of the parties. Instead, the parties must reach an express agreement with respect to tolling. For example, the fact that the parties are in the process of negotiating with respect to bringing claims and potential litigation will not, standing alone, cause the statute of limitations to be tolled.⁶⁸ Furthermore, it appears that tolling agreements must be entered into *after* the claims have accrued. Tolling agreements entered into prior to accrual may not be enforceable under Delaware law.⁶⁹

III. ANALYSIS

A. Shortening The Statute Of Limitations By Contract

Under Delaware law, the parties to a contract may agree to shorten the length of time in which claims can be brought as long as the length of time is reasonable.⁷⁰ In fact, there are a number of Delaware cases that have upheld contractual limitations periods that shorten the time for filing claims or recognized that such contractual limitations provi-

67. *Universal Studios Inc. v. Viacom Inc.*, 705 A.2d 579, 599 (Del. Ch. 1997). In *Universal Studios*, the Court of Chancery found that a tolling agreement between the parties to a merger prevented the defendant from relying on a laches defense. *Id.* The merger had created potential breach of contract issues. *Id.* at 584-85. Following the merger and after discussion of these issues, the parties entered into a tolling agreement. *Id.* at 585.

68. *VLIW Tech., LLC v. Hewlett-Packard Co.*, C.A. No. 20069, 2005 WL 1089027 (Del. Ch. May 4, 2005). In *VLIW Technology*, the Delaware Court of Chancery found that certain of the plaintiff's claims were time-barred because of the statute of limitations. The court instructed that negotiations between the parties regarding potential litigation cannot be a basis for tolling statute of limitations:

In almost all disputes that end up in court, the parties attempt some sort of negotiation to avoid litigation. Tolling the statute of limitations during such negotiations, without agreement of the parties, would encourage potential plaintiffs to engage in bad faith negotiations to lengthen the time they would have to bring a suit. It would also discourage potential defendants from engaging in negotiations to avoid giving plaintiffs more time to bring their suits. This is to be avoided.

Id. at *13 n.54.

69. *Studiengesellschaft Kohle, mbH v. Hercules, Inc.*, 748 F. Supp. 247 (D. Del. 1990); *Dep't of Labor v. Red Rose Roofing, Inc.*, C.A. Nos. 98C-02-019-SCD, 98C-02-020-JOH, 2000 WL 970678 (Del. Super. Ct. Mar. 13, 2000).

70. *Compare Pettinaro Constr. Co. v. All Seasons Contractors, Inc.*, C.A. No. 4726, 1976 WL 163270, at *2 (Del. Ch. Sept. 10, 1976). In *Pettinaro*, the court held that a contractual provision requiring that notice of damages be provided to the other party within a certain number of days as a condition to the damaged party's right to bring suit will not be construed as a contractual limitations period and, thus, will not be subject to a reasonableness test. At issue was a contract provision between a general contractor and a subcontractor which required the subcontractor to notify the general contractor of any damages within ten days and to deliver a full accounting of the damages within ten days after the extent of such damages had been ascertained. The contract provided that a failure to provide such notice would cause the damages to be considered void. The court found that such a provision was enforceable and required the subcontractor to notify the general contractor of damages within the time frame required. *Id.* at *2. In so holding, however, the court rejected the plaintiff's argument that the provision was a contractual statute of limitations. *Id.* The court reasoned that the provision did not purport to modify the statute of limitations but simply required that notice of damages be given to the general contractor to be enforceable. *Id.* The court found that this did not restrict the time for filing an action in court as long as the proper notice had been given. *Id.*

sions are valid.⁷¹ The courts reason that a provision shortening the statute of limitations by contract is consistent with the policy of a statute of limitations. The courts have explained that:

statutes of limitation proceed on the principle that it is to the interest of the public to discourage the litigation of old or stale demands.... Therefore, an express provision in a contract which abbreviates the time for filing a claim, so long as it remains a reasonable time, hastens the enforcement and complements the policy behind the statute of limitations...⁷²

This policy in favor of shortening the length of time during which claims may be brought is further reflected in Section 8121 of Title 10, the Delaware “borrowing” statute, which provides that where a cause of action accrues outside of the state of Delaware, the Delaware court must apply whichever is shorter, the statute of limitations of Delaware or the foreign jurisdiction.⁷³

The reasonableness test for shortening the statute of limitations by contract is not a difficult one to satisfy.⁷⁴ The courts have upheld a number of one-year contractual limitations periods.⁷⁵ The courts have even upheld limitations periods of less than one year. In *Johnson v. DaimlerChrysler Corp.*, for example, the District Court of Delaware dismissed racial discrimination claims against an employer based on language in an employment agreement that reduced the time for filing an action to six months after the date that the wrongful act occurred. In upholding the contract provision and dismissing the plaintiff’s claims as untimely, the District Court relied on “well-settled” Delaware law that permits parties to contractually limit the time period for filing a cause of action.⁷⁶ In so holding, the court considered the plaintiff’s argument that the contractual limitations period was unreasonable and against public policy. In particular, the plaintiff

71. See, e.g., *Closser v. Penn Mut. Fire Ins. Co.*, 457 A.2d 1081, 1083 (Del. 1983) (“It is settled Delaware law ... that a one year limitation on suit on an insurance contract is reasonable and binding on an insured.”); *Betty Brooks, Inc. v. Ins. Placement Facility of Del.*, 456 A.2d 1226, 1228 (Del. 1983) (holding that a “one-year period of limitations contained within an insurance contract is reasonable and binding on the insured” but noting that “an insurer can be deemed to have waived the limitation or be estopped from asserting it”) (citing *Ottendorfer v. Aetna Ins. Co.*, 231 A.2d 263, 265 (Del. 1967); *Rumsey Elec. Co. v. Univ. of Del.*, 358 A.2d 712 (Del. 1976)); *Rumsey Elec.*, 358 A.2d at 714 (stating that a statute of limitations does not prevent shorter contractual limitations period); *Wesselman v. Travelers Indemnity Co.*, 345 A.2d 423, 424 (Del. 1975) (“It is generally held that, in the absence of express statutory provision to the contrary, a statute of limitations does not proscribe the imposition of a shorter limitations period by contract.”); *Ottendorfer*, 231 A.2d at 264 (“There is no doubt that a one-year period of limitation of suit contained in an insurance policy is reasonable and binding upon the insured.”); *Smith v. Mattia*, C.A. 4498-VCN, 2010 WL 412030, at *3 (Del. Ch. Feb. 1, 2010) (noting the “apparent validity” of a one-year contractual limitations period, but holding that defendants were not protected by the period because they were not parties to or intended third party-beneficiaries of the contract); *Rob-Win, Inc. v. Lydia Sec. Monitoring, Inc.*, C.A. No. 04C-11-276-CLS, 2007 WL 3360036 (Del. Super. Ct. Apr. 30, 2007) (holding that one-year contractual limitations period was reasonable); *Fort Howard Cup Corp. v. Quality Kitchen Corp.*, C.A. No. 89C-DE-34, 1992 WL 207276 (Del. Super. Ct. Aug. 17, 1992) (recognizing that the contract at issue shortened the applicable statute of limitations to one year); *Goodyear v. Fleece*, 1988 WL 130470, at *1 (Del. Super. Ct. Nov. 16, 1988) (holding that a two-year contractual limitations period in insurance contract is reasonable); *Nardo v. New Castle Mut. Ins. Co.*, C.A. No. 80C-FE-107, 1981 WL 377669 (Del. Super. Ct. July 30, 1981) (enforcing one year limitation period contained in insurance contract to bar plaintiff’s claims).

72. *Shaw v. Aetna Life Ins. Co.*, 395 A.2d 384, 386 (Del. Super. Ct. 1978).

73. DEL. CODE ANN. tit. 10, § 8121.

74. See *Johnson v. DaimlerChrysler Corp.*, C.A. No. 02-69-GMS, 2003 WL 1089394 (D. Del. Mar. 6, 2003).

75. See *supra* note 71.

76. *Johnson*, 2003 WL 1089394, at *3 (citing *Shaw*, 395 A.2d at 386).

argued that because she was required by law to receive a notice of the right to sue from the Equal Opportunity Commission before proceeding with an action, the six-month limitations period was unreasonable. The court rejected this argument and noted:

six months is ample time to investigate one's legal rights and obligations and to file an action. The time is not so short as to work a practical abrogation of [the plaintiff's] right of action, nor did it bar the plaintiff's right to sue before she was able to ascertain that a loss or damage had occurred.⁷⁷

The courts have recognized that upholding the reasonableness of shortened limitations periods is consistent with Delaware law and the law of other jurisdictions. The courts have noted that “the very great weight of authority in the country is to the effect that provisions in insurance policies requiring actions for loss to be instituted within a time less than the period of limitations prescribed by statute are valid if the period provided for in the policy is reasonable.”⁷⁸ The Delaware courts have upheld shortened contractual limitations periods even in certain consumer contracts, such as a contract for the purchase of a home.⁷⁹

B. Lengthening The Statute Of Limitations By Contract

In contrast to the treatment of contractual provisions shortening the statute of limitations, under Delaware law, a contractual extension of the otherwise applicable statute of limitations is against public policy. The decision most often cited for this Delaware rule is *Shaw v. Aetna Life Insurance Co.*, a 1978 decision of the Delaware Superior Court.⁸⁰ In *Shaw*, the plaintiff had been injured in an employment-related accident and sought coverage under the employer's accident insurance policy. The insurance policy provided for a three-year contractual statute of limitations running from the date that notice of loss was required — a period longer than the otherwise applicable statute of limitations.⁸¹ The defendant insurance company argued that the statute of limitations applied and that the three-year period provided for by contract was invalid. The court noted that, under Delaware law, a statute of limitations may be shortened by contract as long as the contractual limitations period is reasonable.⁸² The court indicated that the shortening of the statute of limitations is

77. *Id.*

78. *Murray v. Lititz Mut. Ins. Co.*, 61 A.2d 409 (Del. Super. Ct. 1948) (holding that a one-year contractual limitation on the time period for bringing suit was reasonable); *Johnson*, 2003 WL 1089394, at *3 (citing *Shaw*, 395 A.2d at 386).

79. *Masso v. Pulte Home Corp.*, C.A. No. 1998-10-314, 2000 WL 33653462 (Del. Com. Pl. Apr. 7, 2000). In *Masso*, the plaintiffs brought breach of contract claims against the builder of their home. The defendant corporation argued that the action was barred by a one-year contractual limitations provision. The court explained that it is “clear that where there are no conflicts with statutory authority, the parties may contract for a shorter limitation period.” *Id.* at *2 (citing *Ramsey Elec. Co. v. Univ. of Del.*, 358 A.2d 712 (Del. 1976)). However, because only some of plaintiff's claims would be barred by contract, the court determined that, at the motion to dismiss stage, it could not determine which claims were time-barred based on the record. *Id.*

80. *Shaw v. Aetna Life Ins. Co.*, 395 A.2d 384, 386-87 (Del. Super. Ct. 1978).

81. *Id.* at 386.

82. *Id.*

consistent with the public policy reasons for the statute. As the court explained, however, a contractual provision extending the otherwise applicable limitations period is not consistent with the policy:

[A] contractual period of limitations which attempts to lengthen or extend the period otherwise contained in a statute violates the aforesaid public policy interests set out [in *Keller*]. Two parties contracting between themselves cannot agree to circumvent the law as mandated by the legislature in its attempt to protect the public interests.⁸³

The court noted that the legislature recognized this policy in Section 2-725 of Title 6, which expressly permits parties to a sales contract to shorten the limitations period but not to extend it.⁸⁴ The *Shaw* court found that the rationale behind the prohibition in § 2-275 was equally applicable to the contract at issue and, therefore, held that the contract provision was invalid.⁸⁵ As a result, the plaintiff's claims were time-barred.⁸⁶

In decisions following *Shaw*, the courts have acknowledged that Delaware law does not permit a contractual lengthening of the statute of limitations.⁸⁷ In *Menefee v. State Farm Mutual Insurance Co.*, for example, the court rejected the plaintiff's argument that the ruling should be delayed until it could be determined whether the insurance policy provided

83. *Id.* at 386-87.

84. *Id.* at 387. Section 2-725 provides as follows:

- (1) An action for breach of any contract for sale must be commenced within 4 years after the cause of action has accrued. By the original agreement the parties may reduce the period of limitations to not less than one year but may not extend it.
- (2) A cause of action accrues when the breach occurs, regardless of the aggrieved party's lack of knowledge of the breach. A breach of warranty occurs when tender of delivery is made, except that where a warranty explicitly extends to future performance of the goods and discovery of the breach must await the time of such performance the cause of action accrues when the breach is or should have been discovered.
- (3) Where an action commenced within the time limited by subsection (1) is so terminated as to leave available a remedy by another action for the same breach such other action may be commenced after the expiration of the time limited and within 6 months after the termination of the first action unless the termination resulted from voluntary discontinuance or from dismissal for failure or neglect to prosecute.
- (4) This section does not alter the law on tolling of the statute of limitations nor does it apply to causes of action which have accrued before this subtitle becomes effective.

DEL. CODE ANN. tit. 6, § 2-725.

85. *Shaw*, 395 A.2d at 387 (citing 1A CORBIN ON CONTRACTS § 218).

86. *Id.*

87. *Hennegan v. Cardiology Consultants, P.A.*, C.A. No. 07C-02-015, 2008 WL 2943397 (Del. Super. Ct. July 15, 2008). In *Hennegan*, the court explained the rule with respect to lengthening the statute of limitations by contract in the context of determining the effect of a release in a wrongful death action:

When a statute is in conflict with a contract provision, the statute will override the contract. Further, while parties can contract to limit rights, they cannot contract with each other to provide more rights than are offered by the statute. For example, the courts will enforce contract provisions which shorten a statute of limitations period. However, provisions attempting to lengthen statutes of limitations will not be enforced.

Id. at *4 (citing *Shaw*, 395 A.2d at 387; *Thayer v. Tandy Corp.*, 533 A.2d 1254 (Del. 1987)). The court explained that a contractual attempt to circumvent the law is "invalid and unenforceable." *Id.*

for a longer limitations period than the statutory limitations period.⁸⁸ The court explained that “a contract provision for a longer period of limitation than provided by the applicable statute would be void as against public policy.”⁸⁹ Despite subsequent statements by the Delaware courts acknowledging the prohibition, the courts have not rendered additional decisions applying the prohibition or provided any additional guidance with respect to the ongoing viability of the prohibition. Furthermore, the Delaware Supreme Court has not specifically addressed the issue.

C. The Mechanics Of Altering The Statute Of Limitations By Contract

Although Delaware law is clear that the statute of limitations may be shortened by contract, and may not be lengthened by contract, the words of the contract may not always be clear as to whether the parties intended to shorten the statutory period, conform to the statutory period, or lengthen the statutory period. One of the ways that this issue could arise in the commercial or corporate context is in the operation of provisions describing the “survival” of claims, rights, or representations and warranties for a certain period of time. The interpretation of contractual provisions that use the “survival” terminology is not entirely clear under Delaware law. Certain Delaware courts have construed clauses relating to the survival of rights or claims as creating a contractual statute of limitations and have permitted such clauses to cut short the period for filing claims, while other Delaware courts have held that clauses relating to the survival of representations and warranties create a period during which notice of claims must be given, but when such notice is timely given, do not necessarily shorten the applicable statute of limitations. Because it is not uncommon for contracts to provide that certain claims, rights or representations and warranties “survive” for some period of time in excess of the applicable statute of limitations, parties should be aware that such provisions may run afoul of Delaware’s prohibition on lengthening the statute of limitations by contract. Furthermore, as the cases demonstrate, the term survival is imprecise and should be avoided where clear language demonstrating the parties’ intent can be used.

For example, in *Hovde Acquisition, LLC v. Thomas*, the defendants alleged that the plaintiff’s claims for breach of representation and warranty under a purchase agreement were time-barred.⁹⁰ To determine the applicable time period for filing claims, the Court of Chancery began its analysis with a review of the purchase agreement entered into on December 31, 1998. The purchase agreement at issue contained a “survival clause,” which provided that the parties had the right to seek indemnification for breach of contract for two years from the date of closing.⁹¹ Specifically, the agreement stated that “the right of the parties to seek indemnification . . . [for breach of any representation or warranty made in the purchase agreement] shall survive for two (2) years from the date of the Closing.”⁹² The court construed this clause as creating a contractual statute of limitations: “[o]bviously, to have been timely, any contractual claim for indemnification for breach of a representation or warranty needed to have been filed by December 31, 2000 [i.e., two years from the date of closing].”⁹³ Notwithstanding the limitation in that provision, the court found that a different section of the purchase

88. 1986 WL 253 (Del. Super. Ct. July 11, 1986).

89. *Id.* (citing *Shaw v. Aetna Life Ins. Co.*, 395 A.2d 384 (Del. 1978)).

90. *See Hovde Acquisition, LLC v. Thomas*, C.A. No. 19032, 2002 WL 1271681 (Del. Ch. June 5, 2002) (Mem. Op.).

91. *Id.* at *5.

92. *Id.*

93. *Id.*

agreement granted the plaintiffs additional rights and remedies.⁹⁴ This provision provided that “[n]otwithstanding the foregoing right of indemnification, in the event of any default” the plaintiff “may avail itself of any and all rights or remedies available to it either at law or equity”⁹⁵ The court found that, because an action for the breach of representations and warranties is also permitted by common law, not simply pursuant to the indemnification provision, the applicable statute of limitations was three years under Section 8106 of Title 10.⁹⁶

Similarly, the *Certainteed* court noted that the asset purchase agreement at issue contained a clause stating that claims could not be brought after the second anniversary of the closing date, subject to certain exceptions.⁹⁷ One of the exceptions provided that certain claims would “survive indefinitely” subject to any applicable statute of limitations. The court found that the contract was governed by Delaware law and that, as a result, a three-year statute of limitations applied (by analogy) to claims covered by the exception. The court did not address whether the statute of limitations could be extended by contract (based on the survival clause) because the survival clause was expressly subject to the applicable statute of limitations. Nevertheless, the court appeared to construe the survival clause as creating a contractual limitations period.

In a more recent Superior Court decision, *Sterling Network Exchange, LLC v. Digital Phoenix Van Buren, LLC*, the court took a different approach to the interpretation of a survival clause.⁹⁸ The *Sterling* court, like the *Hovde* and *Certainteed* courts, characterized the survival period as a contractual statute of limitations, but ultimately construed the survival clause as creating a time period within which notice of a claim had to be brought (not as a period of time in which the claim had to be filed).⁹⁹ In *Sterling*, the parties entered into a number of contracts in connection with an acquisition. The first agreement, for the purchase of property (the “Property Agreement”), contained a clause limiting the survival of representations and warranties to six months from the date of closing. The second agreement, for the sale of a 350,000 square foot data center and the related entity which provided space and power to third party customers at the data center (the “SNS Agreement”), contained a clause that limited the survival of representations and warranties to one year from the date closing and another clause that required the defendant to dispute errors relating to the purchase price within sixty days of closing.¹⁰⁰ The parties also entered into an escrow agreement (the “Escrow Agreement”) providing for \$7 million to satisfy certain authorized claims for breach of the transaction agreements upon written demand. The demand had to be made within one year and had to contain a good faith estimate of the amount to be reserved for the claim and a reasonable description of the basis of such claim. The Escrow Agreement also gave the parties the opportunity to dispute the claim.

On the day prior to the one-year anniversary of the closing of the transactions, the defendants sent notice to the plaintiff and made a demand on the funds that the parties had placed in escrow based, in part, on breach of contract

94. *Id.* at *5.

95. *Id.*

96. *Id.*

97. *Certainteed Corp. v. Celotex Corp.*, C.A. No. 471-VCS, 2005 WL 217032 (Del. Ch. Jan. 24, 2005).

98. C.A. No. 07-08-050-WLW, 2008 WL 2582920 (Del. Super. Ct. Mar. 28, 2008).

99. *Id.*

100. *Id.* at *1, *4.

claims.¹⁰¹ The court held that the defendants' claims under the Property Agreement and the portion of the SNS Agreement relating to the purchase price face "contractual time limitations restricting the time in which [the defendant] may bring claims. The limitations on both claims expired by the time [the defendant] provided written notice of their claim."¹⁰² The court characterized such claims under the agreements as "expired" and described the survival clauses as contractual statutes of limitations: "because of the 60-day purchase price statute of limitation and the 6-month Property Agreement statute of limitation, [the defendants'] claims are barred."¹⁰³ The court found that the defendants, sophisticated parties, were bound by the time limitations and method of notice that they contractually agreed to.¹⁰⁴ However, with respect to the defendant's other claims under the SNS Agreement, the court noted that such other claims did not relate to the purchase price and, therefore, were not subject to the sixty-day limitation.¹⁰⁵ The court held that these claims were not barred by the survival clause because the defendant provided written notice to the plaintiff within the one-year survival period.¹⁰⁶ That is, despite the court's characterization of the survival clauses as creating a "statute of limitations," the court ultimately construed the survival clauses as notice periods under the contracts.

Accordingly, under the existing Delaware law, it is not clear whether a survival clause acts as a contractual statute of limitations to cut off claims that are not filed within that period, or whether such a clause creates a period of time during which notice of a claim must be given to the other party. The Delaware courts' interpretation of survival clauses suggests that parties seeking to shorten the period for filing claims should do so through clear contractual language, rather than through the use of a "survival clause." Similarly, where parties provide by contract that certain representations and warranties or claims "survive" for a period of time that extends beyond the otherwise applicable statute of limitations, the parties should be aware that such provisions may be unenforceable under either construction of a survival clause.¹⁰⁷

IV. THE CASE FOR RECONSIDERATION

The Delaware courts (or the legislature) should reconsider the prohibition on extension of the statute of limitations by contract. Delaware law strongly values freedom of contract, particularly in contracts between sophisticated parties.¹⁰⁸ The Delaware courts have noted that:

101. *Id.*

102. *Id.* at *5.

103. *Id.* at *5, *6.

104. *Id.*

105. *Id.*

106. *Id.*

107. As noted above, because it is not uncommon for contracts to provide that certain types of representations and warranties "survive" indefinitely (or for some period of time in excess of the statute of limitations) and because such provisions could be interpreted as creating a period of time during which notice must be given (or, alternatively, as a period of time during which claims for breach of representations or warranties must be brought), Delaware's prohibition of lengthening the statute of limitations by contract could invalidate such provisions.

108. See *Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1061-62 (Del. Ch. 2006).

the common law ought to be especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts. There remains much harshness in the world, and such entities are unlikely candidates to place at the head of the line for judicial protection, especially when the legislature is free to consider providing such relief.¹⁰⁹

Accordingly, the courts have instructed,

[w]hen parties have ordered their affairs voluntarily through a binding contract, Delaware law is strongly inclined to respect their agreement, and will only interfere upon a strong showing that dishonoring the contract is required to vindicate a public policy interest even stronger than freedom of contract. Such public policy interests are not to be lightly found, as the wealth-creating and peace-inducing effects of civil contracts are undercut if citizens cannot rely on the law to enforce their voluntarily-undertaken mutual obligations.¹¹⁰

Despite this clear Delaware policy in favor of freedom of contract, the Delaware courts, by prohibiting the extension of the statute of limitations by contract, have essentially determined that the policy goals of the statute of limitations are more important than freedom of contract principles.¹¹¹ This preference for the public policy goals served by the statute of limitations over freedom of contract seems misplaced in the case of commercial contracts among sophisticated parties. With respect to commercial contracts among sophisticated parties, Delaware law ought to recognize the efficiency of permitting parties to contract for the ability to bring claims for breach of contractual representations and warranties beyond three years from the date of closing. In cases where the parties have negotiated for that ability, the parties are on notice of the longer limitations period and can preserve evidence, as many parties routinely do, as necessary to protect their interests. As noted above, the courts should be hesitant to “relieve sophisticated business entities of the burden of freely negotiated contracts.”¹¹² Such judicial interference with freely negotiated contracts ought to be reserved for cases of fraud or other, stronger public policy concerns.

Furthermore, notwithstanding the statements in some of the cases to the contrary, the policy underlying the statute of limitations does not appear to be a particularly strong one, i.e., protecting parties from defending against stale claims and protecting courts from adjudicating disputes involving such claims. Delaware law permits parties to a contract to waive compliance with the statute of limitations and to enter into tolling agreements after the claim has accrued. Dela-

109. *Id.*

110. *Libeau v Fox*, 880 A.2d 1049, 1056-57 (Del. Ch. 2005) (citation omitted), *aff'd in pertinent part*, 892 A.2d 1068 (Del. 2006). *See also State v. Tabasso Homes, Inc.*, 28 A.2d 248, 252 (Del. Ct. Gen. Sess. 1942) (“Of course we appreciate the fact that the right to contract is one of the great, inalienable rights accorded to every free citizen. . . . [T]his freedom of contract shall not lightly be interfered with.”); *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 891 A.2d 150, 172 (Del. Ch. 2005) (citing the “fundamental principle that parties should have the freedom to contract and that their contracts should not easily be invalidated”); *Texas Instruments Inc. v. Tandy Corp.*, C.A. No. 12166, 1992 WL 200604, at *5 (Del. Ch. Aug. 13, 1992) (acknowledging a “powerful presumption in favor of freedom of contract”); *Fleming v. U.S. Postal Service AMF O’Hare*, 27 F.3d 259, 261 (7th Cir. 1994) (Posner, J.) (“[A] premise of a free-market system is that both sides of the market, buyers as well as sellers, tend to gain from freedom of contract.”).

111. An argument can be made that the Delaware courts are without the power to permit parties to extend the statute of limitations by contract since the law has fixed the period of time for filing claims. However, in light of Delaware’s blessing of waivers of the statute of limitation, the courts do not appear to be limited in this regard.

112. *Abry Partners*, 891 A.2d at 1061-62.

ware law, as discussed below, also permits parties to employ certain formalities to enter into a contract under seal, thereby creating a twenty-year limitations period. The fact that Delaware law permits parties to extend the limitations period for twenty years by following simple formalities — even where the parties may create such a limitations period unintentionally¹¹³ — but will not allow parties who specifically desire an extended limitations period to do so by clear contractual language, demonstrates the weakness of the policy goals served by the statute of limitations. In either case, the defendant may be forced to defend against stale claims and the court may be required to adjudicate them.

There is another important policy reason that weighs in favor of eliminating the prohibition on extending the statute of limitations by contract. Delaware, through its legislature and its courts, seeks to promote efficient corporate and commercial laws.¹¹⁴ Consistent with Delaware's goals in this regard, the courts seek to demonstrate a sophisticated understanding of business transactions in their decisions. A prohibition on the extension of the statute of limitations by contract is inconsistent with the promotion of efficient and sophisticated corporate laws because it prevents parties from allocating risk as they deem appropriate and, where the prohibition is recognized by the parties at the outset, could add significant transaction costs. For example, when parties enter into an agreement for the purchase of a business, the parties perform due diligence. In many cases, the parties do not have the resources to undertake unlimited due diligence and may rely on the representations and warranties of the other side to allocate risk in light of these practical limitations. Where parties cannot contractually seek a remedy for breach of those representations and warranties after the statutory limitations period, the parties may engage in greater due diligence and add unnecessary costs to the transaction that could be avoided if parties had the freedom to allocate risk as they determined, or the parties might avoid certain transactions altogether because of their inability to allocate risk beyond the statutory period.

Finally, it should be noted that no Delaware decision has analyzed the interplay between these competing policy goals (or Delaware's interest in promoting efficient corporate and commercial laws). The Delaware Supreme Court has not had the opportunity to decide the issue. Accordingly, although the statements in the cases suggest that the law in this area is "well-settled," there may be room for a Delaware court to reconsider Delaware's prohibition on contractual extension of the statutory limitations period.

V. PRACTICAL GUIDANCE

Where it is important to have a remedy for breach of contract for a period beyond the applicable statute of limitations, there are a number of different options that should be considered. One such option is to create a contract under seal, which, under the common law, has a twenty-year statute of limitations. The other options, which have not been well-tested in the Delaware case law, require the parties to structure the contract around the technical issue.

A. Contracts Under Seal

1. An Overview Of The Law

One possible method for extending the applicable statute of limitations is to execute a contract under seal — which if done properly, can extend the statute of limitations to twenty years. The act of creating a "sealed" instrument traces

113. That is, for a contract to be enforceable, the parties must intentionally enter into the contract under seal, but the parties need not be aware that a twenty year limitations period will apply to such a contract.

114. See, e.g., *Aspen Advisors LLC v. United Artists Theatre Co.*, 843 A.2d 697, 712 (Del. Ch. 2004) (observing "Delaware law's goal of promoting reliable and efficient corporate and commercial laws"), *aff'd*, 861 A.2d 1251 (Del. 2004).

back to English common law and has carried over into the common law of many states. As early as 1851, the Delaware Superior Court observed that “[i]t is well understood that when a seal is used, it imparts deliberation and solemnity in the transaction; that it imparts an importance and finality to it, which do not belong to instruments not under seal.”¹¹⁵ Today, Delaware remains one of the few states that have retained the concept, enabling it through both statutory¹¹⁶ and common law mechanisms.¹¹⁷ Over time, Delaware has developed a unique common law doctrine that defines the required elements and the resulting effect of executing a contract under seal.¹¹⁸

The only consistent requirement in the case law with respect to sealed contracts is that some form of symbolic “seal,” whether printed or typed, be affixed near the signature line. Even clear language evidencing intent to affix a seal is insufficient absent the formulaic use of a “seal” in executing the document.¹¹⁹ The traditional use of wax seals, however, has given way to printed recitals denoting a “seal.”¹²⁰ Beyond the basic proposition that a seal is required for all sealed contracts, whether a sealed contract is otherwise properly executed is a mixed question of law and fact,¹²¹ and depends on the nature of the contract at issue and the types of parties involved.

With respect to the nature of the contract at issue, the law has treated certain debt instruments — i.e., mortgages and promissory notes — differently from other contracts. For such debt instruments, both early and modern cases have been consistent in requiring only minimal evidence of the parties’ intent to create a sealed instrument (also called a “specialty”). In fact, the case law has generally recognized that little, if anything, is required beyond a recital affixing the

115. *Armstrong v. Pearce*, 5 Del. (5 Harr.) 351 (Del. Super. Ct. 1851).

116. The Delaware Code codifies the rules for debt instruments discussed above, expressly exempting “debt instruments” under seal, i.e., mortgages and promissory notes, from the three-year statute of limitations for contracts. DEL. CODE ANN. tit. 10, § 8106 (providing that “no action to recover a debt not evidenced by a record or by an instrument under seal . . . shall be brought after the expiration of 3 years from the accruing of the cause of such action”). This statutory recognition in the debt context, however, has no effect on the broader significance given to all contracts under seal under the common law rule. Notably, in *Newark v. NVF Co.*, C.A. No. 5176, 1980 WL 6367, at *4 (Del. Ch.) the Court of Chancery refused to assign a negative implication to the reference to sealed debt instruments in the statute, finding that a government services contract under seal was not subject to the statute of limitations.

117. *See Monroe Park v. Metro. Life Ins. Co.*, 457 A.2d 734, 737 (Del. 1983) (noting that Delaware recognizes the “unique effect of sealed contracts, mortgages, and other instruments” under both common law and in certain statutes and that “the existence of a seal . . . exempts the contract from the applicable statute of limitations”).

118. *See, e.g., Transbel Inv. Co. v. Venetos*, 18 N.E.2d 129 (N.Y. 1938) (discussing New York law); *In re Pirie*, 91 N.E. 587 (N.Y. 1910) (same).

119. Some of the earliest references to instruments under seal in the case law, mostly involving promissory notes and mortgages, have noted this basic requirement. *See also Connie v. Junction & Breakwater R. Co.*, 8 Del. (3 Houst.) 288 (Del. 1866) (holding that there was no need for a reference to a seal in a testimonium clause, but that there must be some “seal” affixed); *Armstrong v. Pearce*, 5 Del. (5 Harr.) 351 (Del. Super. Ct. 1851) (finding that a testimonium clause was not sufficient and requiring an actual “seal,” even if merely hand printed.). More recently, the Supreme Court identified this essential element. *Monroe Park v. Metro. Life Ins. Co.*, 457 A.2d 734, 737 n.5 (Del. 1983) (dismissing plaintiff’s claim that language referencing a seal in the body of the agreement was sufficient absent some evidence of a “seal” in the document).

120. *See Armstrong v. Pearce*, 5 Del. (5 Harr.) 351 (Del. Super. Ct. 1851) (“A seal upon wax is not necessary; but something designed to answer the purpose of a seal is necessary. . . . It may seem absurd to give consequence to a mere scroll seal made by the flourish of a pen; but such a seal is as good at this day as the wax seal was formerly.”).

121. *See Consol. Rail Corp. v. Liberty Mut. Ins. Co.*, C.A. No. 97C-10-001-CHT, 2002 WL 32080503, at *4 (Del. Super. Ct. Sept. 6, 2002); *Kirkwood Kin Corp. v. Dunkin’ Donuts, Inc.*, C.A. No. 94C-03-189, 1995 WL 411319, at *5 (Del. Super. Ct. June 30, 1995); *Smith v. Thau-Hsiung*, C.A. No. 2004-09-128, 2005 Del. C.P. LEXIS 36 (Del. Com. Pl. Sept. 15, 2005).

seal.¹²² In *American Telephone & Telegraph Co. v. Harris Corp.*, then Vice Chancellor Jacobs, sitting by designation on the Superior Court, first articulated that mortgages were special in this regard.¹²³ He observed that mortgages are “a special form of instrument that historically and customarily was made under seal” and, therefore, “[g]iven the peculiar nature of mortgages, it is not surprising that the Court has required less strict proof of intent to create a sealed instrument where a mortgage was involved than in the case of other instruments.”¹²⁴ This distinction has subsequently carried through the case law.¹²⁵ Accordingly, in another Superior Court decision, *Dunn v. Avanti Corp.*, the court found that it was sufficient for a mortgage contract to have the word “seal” printed next to the signature line and a corresponding reference in a testimony clause.¹²⁶ No additional evidence of the parties’ intent was required, and, in fact, the court discounted testimonial evidence presented by one party that suggested they did not intend to create a sealed instrument.¹²⁷

With respect to the types of parties involved, the rule for sealed contracts entered into by *individuals*, rather than entities, essentially replicates the rules for debt instruments. The Delaware Supreme Court made clear in the recent *Whittington v. Dragon Group, L.L.C.* decision that, for an individual, all that is necessary to create a sealed instrument is the presence of the word “seal” next to the individual’s signature. The Supreme Court rejected the Court of Chancery’s requirement that the parties show a clear intent to enter into a contract under seal. The Supreme Court explained that, at least in the case of individuals, it preferred a bright line rule that would be “easily applied” by the courts, and that the mere presence of the word “seal” next to an individual’s name created a sealed instrument.¹²⁸ Accordingly, in the case of

122. See, e.g., *River Bank Am. v. Tally-Ho Assocs., L.P.*, C.A. No. 90L-JN-21, 1991 WL 35719 (Del. Super. Ct. Feb. 22, 1991) (holding that mortgage with a recital affixing a “seal” next to the signature line created a sealed instrument); *In re Beyea’s Estate*, 15 A.2d 177, 180 (Del. Orphan’s Ct. 1940) (finding that recital affixing “seal” was sufficient for a promissory note to be under seal “irrespective of whether there is any indication in the body of the obligation itself.”).

123. 1993 WL 401864 (Del. Super. Ct. Sept. 9, 1993).

124. *Id.* at *7 n.6; see also *Kirkwood Kin Corp. v. Dunkin’ Donuts, Inc.*, C.A. No. 94C-03-189, 1995 WL 411319, at *5 (Del. Super. Ct. June 30, 1995) (“Mortgages are conveyances that typically involve an unequivocal debt secured by specific reality in a recorded instrument. Moreover, mortgages usually are operative for decades. Thus, claims arising out of mortgages are readily susceptible to proof even decades after their execution.”) (citations omitted).

125. See, e.g., *Whittington v. Dragon Group L.L.C. (Whittington I)*, C.A. No. 2291-VCP, 2008 WL 4419075 (Del. Ch. Sept. 30, 2008), *rev’d on other grounds*, 991 A.2d 1 (Del. 2009); *Ryland Group, Inc. v. Santos Carpentry Co.*, C.A. No. 00C-09-056-SCD, 2004 Del. Super. LEXIS 87, at *6-9 (Del. Super. Ct. Mar. 26 2004); *Consol. Rail Corp. v. Liberty Mut. Ins.*, C.A. No. 97C-10-001-CHT, 2002 WL 32080503 (Del. Super. Ct. Sept. 6, 2002). The treatment of promissory notes under seal has been less consistent. More recent cases clearly conflate promissory notes and mortgages as “debt instruments” that are subject to a lesser standard of proof. *Ryland Group*, 2004 Del. Super. LEXIS 87, at *6-7 (“It is clear from the cases construing § 8106 that documents of debt, such as mortgages or promissory notes, escape the three year limitation if they contain the most minimal reference to a seal.”) (emphasis added); *Whittington I*, 2008 WL 4419075 (same). Earlier cases, however, are less clear on this point. Compare *In re Beyea’s Estate*, 15 A.2d 177, 180 (Del. Orphan’s Ct. 1940) (finding that recital affixing “seal” was sufficient for a promissory note to be under seal “irrespective of whether there is any indication in the body of the obligation itself”) with *First Trust Corp. v. Byers*, C.A. No. 95-05-356, 1997 WL 1737103 (Del. Ct. Com. Pl. Feb. 25, 1997) (recognizing a lesser standard of proof for mortgage instruments under seal but finding that promissory note had to meet higher standard applying to other types of contracts).

126. C.A. No. 78C-AU-125, 1983 Del. Super. LEXIS 940, at *1-2 (Del. Super. Ct. Feb. 18, 1983).

127. *Id.* at *2.

128. *Whittington v. Dragon Group L.L.C. (Whittington II)*, 991 A.2d 1, 14 (Del. 2009) (“[W]e hold that in Delaware, in the case of an individual, in contrast to a corporation, the presence of the word ‘seal’ next to an individual’s signature is all that is necessary to create a sealed instrument, ‘irrespective of whether there is any indication in the body of the obligation itself that it was intended to be a sealed instrument.’”).

individuals, evidence of intent is not relevant where the contract contains the word “seal” in the signature line. Furthermore, the parties need not understand the consequence of creating a contract under seal.

On the other hand, agreements (other than mortgages and promissory notes) entered into by *entities*, rather than individuals, require a more exacting standard of proof. For such a contract entered into by an entity to be considered “under seal,” it must contain: (1) a recital affixing the “seal”; (2) language evidencing a seal in the body of the agreement; and (3) additional extrinsic evidence of the parties’ intent to create a sealed instrument.¹²⁹ The third element, requiring some additional extrinsic evidence of the parties’ intent, forms the basis of the more exacting standard. The case law provides some guidance on this point.

In *Kirkwood Kin Corp. v. Dunkin’ Donuts, Inc.*, the Superior Court stressed that “the simple use of formalities and boilerplate unaccompanied by substantive evidence of the parties’ intent to seal it is not enough to turn an ordinary contract into a specialty.”¹³⁰ There, the court considered whether a set of franchise and lease agreements were “sealed” and therefore exempt from the three-year statute of limitations. The court initially noted that the “only support” for a finding that the agreements were under seal was the presence of a corporate seal after the parties’ signatures and language in the respective testimonium clauses in both agreements.¹³¹ The court observed, however, that nothing in the body of

129. Although the case law in this area is somewhat conflicted, there has been a noticeable shift within the past twenty years towards more restrictive requirements. Early cases outside of the mortgage/promissory note context applied a more lenient standard. *See, e.g., Peninsula Methodist Homes and Hospitals, Inc. v. Architect’s Studio, Inc.*, C.A. No. 83C-AU-118, 1985 WL 634831 (Del. Super. Ct. Aug. 28, 1985) (finding that a recital affixing seal and language referencing a “seal” in a testimonium clause in a construction contract were sufficient to create a sealed instrument). Then, in *AT&T v. Harris Corp.*, 1993 WL 401864 (Del. Super. Ct. Sept. 9, 1993), then Vice Chancellor Jacobs relied on a Third Circuit Court of Appeals decision, *Aronow Roofing Co. v. Gilbane Building Co.*, 902 F.2d 1127 (3d Cir. 1990), in restating the relevant standard under Delaware law. The Vice Chancellor stated that:

[F]or an instrument other than a mortgage to be under seal, “it must contain language in the body of the contract, a recital affixing the seal, and extrinsic evidence showing the parties’ intent to conclude a sealed contract. . . . The mere existence of the corporate seal and the use of the word ‘seal’ in a contract do not make the document a specialty. . . .”

AT&T, 1993 WL 401864, at *7 (quoting *Aronow*, 902 F.2d at 1129).

Subsequent cases, however, have consistently applied the formulation provided in *AT&T* and *Aronow* to require some additional evidence of the parties’ intent beyond the formalities used in the contract at least as to a signature by an individual. *Compare Whittington II*, 991 A.2d at 14 (holding that recitals affixing the “seal” next to the parties’ signatures were sufficient to create a sealed instrument when the parties were individuals rather than corporations); *Sunrise Ventures, LLC v. Rehoboth Canal Ventures, LLC*, C.A. No. 4119-VCS, 2010 WL 975581, at *2 (Del. Ch. Mar. 3, 2010) (finding that a testimonium clause alone was insufficient to create a sealed instrument); *Ryland Group*, 2004 Del. Super. LEXIS 87, at *8 (finding that a subcontractor agreement and accompanying addendum failed to show the “requisite intent to create a contract under seal” where the only references to a seal were in the testimonium clause in the subcontractor agreement and the word “seal” located to the right of the signature lines in an addendum); *Kirkwood Kin Corp. v. Dunkin’ Donuts, Inc.*, C.A. No. 94C-03-189, 1995 WL 411319 (Del. Super. Ct. June 30, 1995) (finding that the use of a corporate seal and language in the testimonium clauses in franchise and lease agreements was insufficient to create a sealed instrument).

In fact, in the *Consolidated Rail Corp. v. Liberty Mutual Insurance Co.*, C.A. No. 97C-10-001-CHT, 2002 WL 32080503 (Del. Super. Ct. Sept. 6, 2002), decision discussed more fully above, the Superior Court, in recognizing the inconsistencies in the case law and also declining to follow *Peninsula*, observed that “[i]n today’s world, no purpose would be served by according the same archaic presumptions applicable to mortgages as sealed instruments to documents other than mortgages absent clear evidence of the parties intent to do so.” *Id.* at *7. *But see Whittington II*, 991 A.2d at 14 (adopting the rule that all an individual need to do to create a sealed instrument is affix the word “seal” next to his signature, based on the court’s preference for a bright line rule).

130. 1995 WL 411319, at *6.

131. *Id.* at *5.

the documents showed any “substantive intent” to create a sealed document.¹³² Indeed, the court found that the available extrinsic evidence suggested otherwise, pointing to language in an accompanying guaranty suggesting that the parties intended to seal that document as evidence that the underlying commercial contracts at issue were not intended to be sealed.¹³³ Therefore, the court preliminarily found that the common law rule extending the statute of limitations for sealed contracts did not apply, and permitted discovery into whether there was extrinsic evidence to support the plaintiff’s claim that the franchise and lease agreements were under seal.¹³⁴

In the most detailed treatment in the Delaware case law of what is meant by “extrinsic evidence,” in *Consolidated Rail Corp. v. Liberty Mutual Insurance Co.*, the Superior Court found that the plaintiffs failed to make the requisite showing that a construction contract was under seal.¹³⁵ The court initially stressed that “[t]here must . . . be substantive evidence of the intent of the parties to create a sealed document [and] [t]he absence of such evidence will deny sealed status to an ordinary contract.”¹³⁶ While the agreement in question contained references to being under seal with phrases such as “signed, sealed and delivered” and “seal attest” printed next to the signature lines, the body of the agreement contained “no reference” to an intent to seal the document.¹³⁷ Nor was there any mention of an intent to create a seal in the related correspondence and other transaction documents. Moreover, the court went on to observe that there was no “evidence from any source” that suggested the parties intended to seal the contract, noting that extensive discovery conducted in related tort litigation as well as in the present suit failed to provide evidence on this point.¹³⁸ The court also considered the nature of the contractual obligations at issue. For example, the court pointed to the “limited duration” of the work, i.e., road construction work which was to be completed within 150 working days and to be followed by a release of any liability once the work was completed, as being distinct from the more familiar mortgage context.¹³⁹ The court also observed that “[t]here is no evidence, extrinsic or otherwise, which indicates, as is the case with mortgages, that such documents were customarily sealed.”¹⁴⁰

Recently, the Court of Chancery rejected a plaintiff’s argument that, under the Supreme Court’s decision in *Whittington*, a testimonium clause alone is sufficient to create a sealed document in a contract between two entities.¹⁴¹ The word “SEAL” did not appear next to the parties’ signatures, but the agreement contained a clause stating “IN WITNESS

132. *Id.*

133. *Id.* at *5 n.8.

134. *Id.* at *6.

135. C.A. No. 97C-10-001-CHT, 2002 WL 32080503 (Del. Super. Ct. Sept. 2, 2002).

136. *Id.* at *5.

137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Sunrise Ventures, LLC v. Rehoboth Canal Ventures, LLC*, C.A. No. 4119-VCS, 2010 WL 975581 (Del. Ch. Mar. 3, 2010).

WHEREOF, the parties have set their Hand and Seal as of the day of the year first above written.”¹⁴² The Court of Chancery declined to construe *Whittington* as holding that a testimonium clause was by itself sufficient to create a sealed document.

Practitioners looking to seal an agreement between entities, rather than individuals, in order to extend the statute of limitations, should recognize that an inquiry into the “extrinsic evidence” of the parties’ intent will be determinative. Therefore, parties should create a record of their intent to enter into an agreement under seal. Whichever set of rules may apply, the effect of a properly sealed instrument is clear, sealed documents will be subject to a twenty-year limitations period.¹⁴³

2. Creating A Contract Under Seal

For parties to a commercial contract seeking to create a contract under seal, the agreement should contain: (1) a recital affixing the “seal”; (2) language evidencing a seal in the body of the agreement; and (3) additional extrinsic evidence of the parties’ intent to create a sealed instrument. A contract properly under seal will be subject to a twenty-year limitations period. Nevertheless, parties may wish to specify a shorter period. The ability of parties to create a contract under seal that provides for a limitations period less than twenty years has not been addressed in the case law. However, because Delaware law permits parties to cut short the statute of limitations by contract, Delaware law should also permit parties to create contracts under seal that extend the otherwise applicable statute of limitations for less than the full twenty years.

B. Contracting Around The Prohibition

Although Delaware law prohibits a contractual extension of the statute of limitations, the law does not appear to limit the parties’ ability to contract around accrual, i.e., to fix accrual at a certain time or upon the occurrence of certain events. Although no Delaware case has addressed the issue, the Fourth Circuit Court of Appeals, in a decision applying Maryland and Nebraska law, held that the parties to a contract can agree when claims will accrue, and therefore, when the statute of limitations would begin to run.¹⁴⁴ The court held that such a contractual provision was not against public policy even though Nebraska law did not allow contractual alteration of the statute of limitations. Accordingly, parties

142. *Id.* at *1.

143. *See, e.g.*, *State v. Regency Group, Inc.*, 598 A.2d 1123, 1129 (Del. Super. Ct. 1991) (recognizing a “common law limitation of twenty years” for contracts under seal) (citing *Garber v. Whittaker*, 2 A.2d 85 (Del. Ch. 1938)); *DiBiase v. A & D, Inc.*, 351 A.2d 865, 867 (Del. Super. Ct. 1976) (“The common law rule provides that [a sealed] contract is actionable for twenty years.”) (citing *Garber v. Whittaker*, 2 A.2d 85 (Del. Ch. 1938)); *Garber v. Whittaker*, 2 A.2d 85, 88 (Del. Ch. 1938) (noting that the common law “prescribes no absolute bar due to the lapse of time, but only a presumption of satisfaction after twenty years”); *see also* *Aronow Roofing Co. v. Gilbane Bldg. Co.*, 902 F.2d 1127, 1129 (3d Cir. 1990) (applying Delaware law and noting that “[s]ealed contracts are subject to a twenty year statute of limitations period”). Delaware practitioners also should note that several Court of Chancery decisions have relied on the common law doctrine to bar claims based on laches. *See Whittington v. Dragon Group L.L.C.*, C.A. No. 2291-VCP, 2010 WL 692584, at *4-*9 (Del. Ch. Feb. 15, 2010) (holding that the common law doctrine on sealed instruments barred a claim under the analogous statute of limitations in deciding on laches claim); *Lleiter v. Carpenter*, 22 A.2d 393, 397 (Del. Ch. 1941) (same); *Garber v. Whittaker*, 2 A.2d 85, 88 (Del. Ch. 1938) (noting that “[a]n obligation that arises out of a sealed instrument appears to be left by our statutory law, so far as limitations of action are concerned, to the common law” and therefore refusing to apply the doctrine of laches within that period absent a showing of extraordinary circumstances for doing so).

144. *Harbor Court Assocs. v. Leo A. Daly Co.*, 179 F.3d 147 (4th Cir. 1999).

to a contract could, for example, agree that claims will not accrue until the wrongful act has been discovered or should have been discovered. The risk of such an approach under Delaware law is that a court would construe such a provision as against public policy.

Another possible approach to contracting around Delaware's prohibition on extension of the statute of limitations is to structure the agreement to cause the breach of contract to occur post-closing. The use of prospective warranties, where feasible, could achieve this result. For example, in *Krahmer v. Christie's Inc.*, the Court of Chancery explained that a six-year express warranty of a painting's authenticity "created a reasonable inference that [the auction house] put the [buyers] on inquiry notice that claims involving the authenticity of the painting could only be brought within six years from the date of purchase."¹⁴⁵ The court declined to toll the statute of limitations and explained that, given the "notice" the buyers had as a result of the express warranty, the court could not allow the buyers to bring a claim "after the expiration of both the applicable statute of limitations and the [auction house's] express warranty."¹⁴⁶ In addition, the court noted that the "six-year warranty provided protection to the [buyers] beyond the applicable three-year Delaware statute of limitations and the four-year UCC statute of limitations."¹⁴⁷ Such an approach may not be practical in certain situations where the subject matter of the contract does not lend itself to future warranties.

Another alternative, which draws on the concept of the future performance of covenants — so as to enable a party to seek a remedy beyond three years from the date of closing, is to draft the contract to avoid tying the reimbursement/indemnification obligations to a breach of representations and warranties. For example, a contract could provide that the seller will reimburse a purchaser for any losses caused by environmental conditions arising on the purchased property that were caused by the seller for 10 years from the date of closing. Such an obligation could be characterized as a covenant that contemplates future performance and, accordingly, the claim with respect to that obligation should not accrue, and the statute of limitations should not begin to run, until the purchaser discovers the loss. While in the absence of authority construing such a provision, there is inevitably some uncertainty with respect to the enforceability of this approach, it should avoid the issue raised by the Court of Chancery in the *Certainfeed v. Celotex Corp.*,¹⁴⁸ where the court distinguished between reimbursement for claims for breach of representations and warranties and indemnification for third party claims, and held that claims for losses incurred as a result of a breach of representations and warranties accrue at closing.

VI. CONCLUSION

Practitioners entering into commercial and corporate contracts should be cognizant of the enforceability issues that arise in connection with provisions that attempt to lengthen the applicable statute of limitations by contract, and should note that such provisions may be drafted using "survival" or other vague terminology but without specific reference to the statute of limitations. In situations where the availability of a remedy beyond the statutory limitations period is important to a client, practitioners should consider the use of alternative approaches, such as a contract under seal and restructuring

145. *Krahmer I*, 903 A.2d at 783.

146. *Id.*

147. *Id.* at 783 n.58.

148. See Section II.D, *supra*.

closing representations as either forward looking warranties or covenants, while keeping in mind, and advising the client of, any limitation or uncertainty associated with these approaches.

Finally, while practitioners may have the ability to create an enforceable contract that is aligned with the parties' commercial desires and expectations through creative lawyering, practitioners and their clients would be better served by a legal framework that permitted sophisticated parties to commercial and corporate agreements to contract for remedies and allocate risk as they deem appropriate and in connection therewith to extend by contract otherwise applicable statute of limitations periods. The availability in Delaware of such a legal framework would be attractive to parties negotiating corporate and commercial contracts and would bolster Delaware's well-earned reputation as a sophisticated jurisdiction with the flexibility and predictability that is critical to business transactions.

IT'S ALL ABOUT TIMING: WILL *KARNS* IMPACT THE IRS BATTLES OVER ADVANCE RECEIPTS?

Nicholas A. Mirkay*

I. INTRODUCTION

The accounting for advance receipts or payments continues to vex those who administer, and advise on, federal income tax law.¹ An “advance receipt” can be defined expansively to comprise any payment received in exchange for providing future services or product, or for the promise to repay the amount transferred.² Thus, an advance receipt can encompass loans and deposits as well as prepayments for services or product to be delivered in the following year.³ Under current income tax law, a taxpayer or tax advisor must generally make an initial threshold determination when addressing the tax treatment of an advance receipt: (i) is the amount received a loan or deposit, neither of which is generally required to be included in income; or (ii) is the receipt not a loan or deposit and, thus, includable in income as an “accession to wealth,” such as salary or wage income.⁴ If the latter is determined, the next step is to determine the proper year in which it should be recognized or reported as income.⁵

At the core of this next step is an issue with which the Internal Revenue Service (“IRS”) consistently deals — timing. The term “timing” is basically self-defined: in what taxable year should a receipt be reported as income or an expenditure reported as a deduction for federal income tax purposes. Determining the proper taxable year for the inclusion of income or the deduction of an expense can definitively impact a taxpayer’s ultimate tax liability.⁶ The timing issue is not just about determining whether inclusion or deduction occurs in year one or year two. Rather, it reflects (i) the substantive changes in the tax law, tax rates, and status of the taxpayer; (ii) the applicability of statutes of limitation; and (iii) the time value of money principles.⁷

The U.S. Supreme Court has addressed the proper federal income tax treatment of various forms of advance receipts in numerous decisions over the last four decades, the most recent of which occurred in its 1990 decision in *Com-*

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1. David Hasen, *The Tax Treatment of Advance Receipts*, 61 TAX L. REV. 395, 396 (2008).
2. *Id.* at 399.
3. *Id.* at 399-400.
4. *See infra* notes 16-17 and accompanying text.
5. *See, e.g.*, I.R.S. Tech. Adv. Mem. 200849015 (Dec. 5, 2008).
6. JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME TAXATION 588 (15th ed. 2009).
7. *Id.*

*missioner v. Indianapolis Power & Light Co.*⁸ In *Indianapolis Power*, the Court held that a public utility's receipt of a deposit was not includable in income at the time of receipt, finding there was a significant difference between a deposit and an otherwise "advance payment" for federal income tax purposes.⁹ Although practitioners and legal scholars hoped *Indianapolis Power* would provide some final clarity, it has nevertheless been criticized as lacking the necessary economic foundation and analysis on which income taxation should rely.¹⁰

Several federal circuit courts of appeal have applied *Indianapolis Power* subsequently with varying degrees of consistency. In *Johnson v. Commissioner*,¹¹ the Eighth Circuit ruled that amounts received by car dealerships for vehicle service contracts were properly includable in gross income in the year of the car sale. In *Westpac Pacific Food v. Commissioner*,¹² the Ninth Circuit determined that advance trade discounts received by the taxpayer in consideration for committing to future volume purchases were akin to security deposits or loans and, thus, not includable in gross income in the year of receipt. Finally, on virtually identical facts to those in *Westpac*, the Third Circuit, in *Karns Prime & Fancy Food, Ltd. v. Commissioner*,¹³ openly disagreed with *Westpac* and the Ninth Circuit's application of *Indianapolis Power*, concluding that funds provided to the taxpayer by its food supplier in exchange for a promissory note and a supply agreement constituted taxable income to the taxpayer in the year of receipt.

This article analyzes the most recent decision in this continually vexing area, *Karns*, and its impact on future applications of law in this area. Part II of this article discusses the evolution of federal income tax law governing advance receipts, highlighting the distinction and corresponding disparate tax treatment of loans and deposits versus "advance payments." Part III focuses on the federal circuit courts' conflicting application of *Indianapolis Power* in *Westpac* and *Karns*. In conclusion, Part IV of this article analyzes the propriety of the above-referenced distinction and disparate tax treatment of various advance receipts, emphasizing how the *Karns* decision impacts, if at all, this complex area of income tax law.

II. THE EVOLUTION OF FEDERAL INCOME TAX LAW WITH RESPECT TO ADVANCE RECEIPTS

A. Contrasting Tax Treatment Of Deposits With Other Forms Of Advance Receipts

1. Basic Income Principles Under Current Tax Law

Section 61 of the Internal Revenue Code¹⁴ broadly defines gross income as "all income from whatever source derived."¹⁵ In the seminal case of *Commissioner v. Glenshaw Glass Company*,¹⁶ the Supreme Court defined gross income as

8. 493 U.S. 203 (1990).

9. Unless otherwise indicated or defined herein, such as in the context of particular Treasury regulations or revenue procedures discussed in the text accompanying *infra* notes 91 and 97, the term "advance payment" typically denotes an "advance receipt" other than a loan or deposit.

10. Hasen, *supra* note 1, at 402 (citing William A. Klein, *Tailor to the Emperor With No Clothes: The Supreme Court's Tax Rules for Deposits and Advance Payments*, 41 UCLA L. REV. 1685, 1718-23 (1994), and Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17, 20 (1998)).

11. 184 F.3d 786 (8th Cir. 1999).

12. 451 F.3d 970 (9th Cir. 2006), *rev'g* 82 T.C.M. (CCH) 175 (2001).

13. 494 F.3d 404 (3rd Cir. 2007).

14. Unless otherwise indicated, all "section" references herein are to the Internal Revenue Code of 1986, as amended.

15. I.R.C. § 61(a) (2010).

16. 348 U.S. 426 (1955).

“undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”¹⁷ As to determining “complete dominion,” the Supreme Court explained in *Indianapolis Power* that “[t]he key is whether the taxpayer has some guarantee that he will be allowed to keep the money.”¹⁸ The Supreme Court has further described income as “[w]hen a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition.”¹⁹

Section 446 requires taxpayers to compute their taxable income for a taxable year under any reasonable method of accounting, provided the method “clearly reflects” their income.²⁰ A taxable year is defined as a twelve-month period ending on the last day of a month;²¹ typically ending on December 31, unless the taxpayer elects a fiscal taxable year that ends on the last day of another month.²² The most common permissible methods of accounting are the cash receipts and disbursements method, and the accrual method.²³ Individual taxpayers most often use the cash receipts and disbursements method of accounting, which includes an item in income or permits a deduction of an expense on the receipt or payment of cash or an equivalent (e.g., property or services).²⁴ The accrual method, typically used (or required to be used) by business entities, employs an “all events” test with respect to income and deductions. Under the accrual method, an item is included in income when all events have occurred that fix the right to receive the income, and the amount of the income can be determined with reasonable accuracy.²⁵ A deduction for expenses is generally taken in the taxable year in which all the events have occurred that establish: (i) the fact of the liability; (ii) the amount, determined with reasonable accuracy; and (iii) economic performance has occurred with respect to the liability.²⁶

2. Tax Treatment Of Loans And Deposits

It is well established that a debtor does not include loan proceeds in his income because he has an obligation to repay the amount loaned at some designated point in the future.²⁷ In essence, the existence of the repayment obligation

17. *Id.* at 431.

18. *Indianapolis Power*, 493 U.S. at 310.

19. *James v. U.S.*, 366 U.S. 213, 219 (1961) (quoting *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932)).

20. I.R.C. § 446(a)-(b) (2010).

21. I.R.C. § 441 (2010).

22. I.R.C. § 441(a), (g) (2010); FREELAND, *supra* note 6, at 588.

23. *See generally*, I.R.C. § 446(c) (2010). The cash receipts and disbursements and accrual methods are the most common, but not the exclusive, methods of accounting. The Internal Revenue Code permits other methods, such as the installment sales method under section 453, the long-term contract method under section 460, and the special treatment of certain types of income and expense. Treas. Reg. § 1.446-1(c)(1)(iii) (amended 2006).

24. FREELAND, *supra* note 6, at 589; Treas. Reg. § 1.446-1(c)(1)(i) (amended 2006).

25. *Id.*; Treas. Reg. § 1.446-1(c)(1)(ii) (amended 2006).

26. Treas. Reg. § 1.446-1(c)(1)(ii) (amended 2006).

27. *Comm'r v. Tufts*, 461 U.S. 300, 307 (1983).

disqualifies the loan proceeds from constituting an “accession to wealth” and, accordingly, income.²⁸ As a result, a fundamental question arises at the time a taxpayer receives any advance receipt — is the taxpayer unconditionally obligated to repay the advance?²⁹ In discerning whether a given transaction constitutes a loan, the substance, as opposed to the form, of the transaction controls.³⁰

Overall, the rules applicable to various forms of advance receipts are simultaneously settled and perplexing. As stated above, loan proceeds are not income due to the repayment obligation. Deposits, like loans, must be examined on a case-by-case basis to determine their federal income tax treatment. Depending on the terms of the deposit, the recipient may retain the money to be applied against future fixed or contingent liabilities, thus typically creating income, or may retain for potential refund to the deposit payor, thus garnering loan-like tax treatment, as in *Indianapolis Power*.³¹ In contrast to deposits and loans, other advance receipts are generally included in the recipient’s income upon receipt. For example, prepayments of rent are generally included in the landlord’s income in the year received.³² In addition, advance payments received by accrual method taxpayers (namely, business entities, as discussed above) in consideration for future services or product are generally includable in income upon receipt, with some narrow exceptions that permit deferral of recognition.³³

In slugging through this morass of complexity, this article first addresses the federal income tax treatment of deposits and the *Indianapolis Power* decision that ultimately led to the conflicting federal circuit decisions in *Westpac* and *Karns*. This article then compares and contrasts the usual exclusion of deposits from a recipient’s income to the income inclusion of other forms of advance receipts described above.

a. *Commissioner v. Indianapolis Power & Light Co.*

Indianapolis Power & Light Company (“IPL”) was a regulated utility in Indiana and an accrual method taxpayer. Like most utilities, it required certain of its customers with questionable credit (approximately five percent during the years of 1974 to 1977) to submit deposits to ensure payment of future utility bills.³⁴ The deposit typically amounted to twice the customer’s estimated monthly bill, and IPL paid 3 percent interest on deposits held for greater than six months.³⁵ After March 1976, IPL raised the interest rate to 6 percent payable on deposits held for greater than twelve months and instituted a more perfunctory rule for refunding the deposit. Prior to termination of utility service, IPL provided these

28. *Id.*; see also *James*, 366 U.S. at 219 (accepted definition of gross income “excludes loans”); *Comm’r v. Wilcox*, 327 U.S. 404, 408 (1946).

29. *Karns*, 494 F.3d at 408.

30. *Knetsch v. U.S.*, 364 U.S. 361, 365-66 (1960).

31. *Hasen*, *supra* note 1, at 400.

32. *Id.*; *Treas. Reg. § 1.61-8(b)* (amended 2004). The general income tax treatment of prepaid rent may be modified by section 467. *Hasen*, *supra* note 1, at 400 n.27.

33. *Hasen*, *supra* note 1, at 400-01. See also *Artnell Co. v. Comm’r*, 400 F.2d 981 (7th Cir. 1968); *Rev. Proc. 2004-34*, 2004-22 I.R.B. 991 (granting up to one year deferral for certain advance payments in certain instances).

34. *Indianapolis Power*, 493 U.S. at 203-04.

35. *Id.* at 204.

customers, upon satisfying a credit test, the option of either a refund of their deposits or application of the deposits against future utility bills. IPL did not recognize these deposits as income at the time of their receipt, but rather recorded them on its books as current liabilities in accordance with applicable state regulations. No dispute existed with respect to whether “IPL’s treatment of the deposits was consistent with accepted accounting practice and applicable state regulations.”³⁶ Upon audit, the IRS asserted that the deposits were advance payments for future utility services and, therefore, taxable to IPL in the year of receipt.³⁷

Upon appeal of the IRS’s deficiency notice, the United States Tax Court (“Tax Court”) in a full-court review (with one judge not participating) unanimously ruled in IPL’s favor following the “facts and circumstances” approach it adopted in *City Gas Co. of Florida v. Commissioner*.³⁸ Utilizing this approach, several factors persuaded the court that IPL’s exclusion of the deposits from its income was proper: (i) only five percent of its customers were required to submit a deposit; (ii) the customer rather than IPL possessed “the right to control the ultimate disposition of the deposit;” and (iii) IPL’s accounting for the deposits as current liabilities and payment of interest.³⁹ The Seventh Circuit affirmed on basically the same grounds, placing greater reliance on IPL’s payment of interest, which resulted in the deposit beginning “to serve purposes that comport more squarely with a security deposit.”⁴⁰

The Supreme Court unanimously upheld the lower courts’ rulings in favor of IPL. It began its opinion with the “common ground” that deposits are includable in income upon receipt if they constitute “*advance payments* for electricity to be supplied.”⁴¹ In a footnote, the Court cited to a string of prior cases in which it addressed advance payments and determined them to be “indisputably” income in the year of receipt because they represented payments for future services.⁴² In those cases, the Court explained, “the issue was *when* that income was taxable. Here, in contrast, the issue is whether these deposits, as such, are income at all.”⁴³ It further noted the IRS’s concession that customer deposits that secure the performance of non-income-producing covenants, such as the customer’s responsibility to ensure no damage to meters, are not taxable, comparing such deposits to the nontaxable receipt of loan proceeds.⁴⁴ The Court characterized the economic

36. *Id.* at 205.

37. *Id.* at 206.

38. 74 T.C. 386 (1980), rev’d, 689 F.2d 943 (11th Cir. 1982). In *City Gas*, similar to IPL’s facts, the Tax Court adopted a “facts and circumstances” test compiled from its prior decisions, ultimately determining that the amounts at issue were nontaxable security deposits. On appeal, the Seventh Circuit reversed the Tax Court, remanding for application of a “primary purpose test,” which looked to “whether the sums were intended to be applied to discharge payment for income items (*e.g.*, the final month’s bill for gas, or for turn-on and turn-off charges or other charges for services), or on the other hand were intended to secure performance of nonincome-producing covenants (*e.g.*, damage to meters).” *Id.* at 946. On remand, the Tax Court determined that the deposits were “better characterized as prepayments of income” than nontaxable security deposits. 47 T.C.M. (CCH) 971. The Supreme Court in *Indianapolis Power*, which addressed the then existing conflict between the Seventh Circuit’s decision in *Indianapolis Power* and the Eleventh Circuit’s decision in *City Gas*, effectively rejected the use of the Eleventh Circuit’s primary purpose test.

39. *Indianapolis Power*, 493 U.S. at 206.

40. *Id.* at 207 (quoting *Indianapolis Power & Light Co. v. Comm’r*, 857 F.2d 1162, 1169 (7th Cir. 1988)).

41. *Id.* at 207.

42. *Id.* at 207 (citing *Schlude v. Comm’r*, 372 U.S. 128 (1963)); *Am. Auto. Ass’n v. U.S.*, 367 U.S. 687 (1961); *Auto. Club of Mich. v. Comm’r*, 353 U.S. 180 (1957).

43. *Indianapolis Power*, 493 U.S. at 207. *See infra* notes 71-81 and accompanying text for a discussion of the cited cases.

44. *Indianapolis Power*, 493 U.S. at 207-08.

distinction between a loan and an advance payment as “one of degree rather than of kind.”⁴⁵ With a loan, the borrower can earn income on the use of the money prior to the time for repayment, but with an advance payment, the recipient achieves both “immediate use of the money ... *and* the opportunity to make a profit by providing goods or services at a cost lower than the amount of the payment.”⁴⁶ Accordingly, although the Court agreed with the IRS’s assertion that IPL derived some economic benefit from the receipt of the deposits, it nevertheless decided, based on the above distinction, that the taxability turns more on the “nature of the rights and obligations” of both parties.⁴⁷

In the end, the Court turned to a less economic-based and a more “earmarks” approach; namely, whether the depositor is entitled in the future to demand repayment of the deposit.⁴⁸ In essence, for the Court, the depositor’s ultimate control over the deposit and its repayment is dispositive and distinguishes it from the income treatment accorded to other forms of advance payments. The IRS has subsequently adopted the *Indianapolis Power* distinction between deposits and advance payments as “one of degree rather than kind.” It recently explained that “[w]hile both bestow economic benefits to the recipient, economic benefits qualify as income only if the taxpayer [recipient] has complete dominion,” which is governed by whether the recipient has some guarantee that it will be allowed to retain the money.⁴⁹ As will be discussed in Part IV of this article, some legal scholars have dismissed the Supreme Court’s distinction between a deposit and other advance payments as illogical based on economics and tax theory.⁵⁰

b. *Indianapolis Power* Progeny

Not surprisingly, *Indianapolis Power* sparked a number of cases that adopted its “complete dominion” test as a basis for excluding deposits from recipients’ income, with varying outcomes. In *Oak Industries, Inc. v. Commissioner*,⁵¹ the issue concerned the tax treatment of deposits paid by subscribers to a subscription television operator. The television company was obligated to refund the entire deposit if no amounts were due from the subscriber upon termination of service by either party. A majority of subscribers chose to apply at least a portion of the deposit to pay monthly service charges on their final bill. In holding that the deposits were not taxable income to the television company at the time of the receipt, the Tax Court reasoned that the subscribers *controlled* whether the deposit would be refunded or applied against amounts due for services.⁵² Because the subscriber made no commitment to purchase a specified amount of services, if any, from the television company, no guarantee existed that the television company would be able to keep any portion of the deposit.⁵³

45. *Id.* at 208.

46. *Id.*

47. *Id.* at 208-09.

48. Klein, *supra* note 10, at 1718.

49. I.R.S. Tech. Adv. Mem. 200849015 (Dec. 5, 2008) (Payments received by accrual-basis taxpayer for sale of gift cards were includable in income upon receipt and not eligible for deferral as “advance payments” under Treas. Reg. § 1.451-5 (amended 2001) or Rev. Proc. 2004-34, 2004-22 I.R.B. 991).

50. *See infra* notes 162-166 and accompanying text.

51. 96 T.C. 559 (1991).

52. *Id.* at 571.

53. *Id.* at 572.

In *Buchner v. Commissioner*,⁵⁴ a direct mail advertising agency required its clients to make deposits into “postage impound accounts” to cover estimated postage expenses. In the event that a client failed to reimburse the agency for postage, money would be withdrawn from the client’s account. When a client terminated its relationship, any account balance was refunded. The Tax Court held that the deposits were not income to the agency under the *Indianapolis Power* “complete dominion” test because, provided clients paid their monthly bills, no portion of the deposits would be retained by the agency and applied to payments for services.⁵⁵

In *Johnson v. Commissioner*,⁵⁶ the Tax Court and, on appeal, the Eighth Circuit addressed the appropriate accounting method with respect to income received on sales of vehicle service contracts (“VSCs”) by related automobile dealerships. Upon sale of a car, a VSC, which is akin to a warranty agreement, is also offered for sale. Under the VSC, the dealership grants the VSC buyer (the “holder”) the right to have parts or components covered by the VSC repaired or replaced upon the occurrence of a mechanical breakdown.⁵⁷ Pursuant to the VSC’s terms, the dealership agreed either to repair or replace covered parts itself or to reimburse the holder for repairs done by other qualified facilities. In either event, the repair had to be preapproved by a VSC administrator either employed by, or contracted with, the dealership. The holder could cancel the VSC at any time and thereby receive a refund of a portion of the VSC contract price based either on the amount of the time elapsed since the purchase of the VSC or the miles travelled. Upon receipt of the VSC contract price, the dealership would retain a portion and include that amount in income, placing the remaining portion in escrow or a reserve fund intended to secure the performance of the dealership’s obligations under the VSC. The reserve fund would either reimburse the dealership or another authorized facility for the work done under the VSC.⁵⁸ Any investment income accrued on the reserve fund would be deposited therein. Customarily, any amounts remaining in the reserve fund at the termination of the VSC reverted to the dealership. The dealerships also procured insurance policies to cover losses exceeding the aggregate amount of reserve funds on all VSCs.⁵⁹

The primary issue in *Johnson* involved whether the amounts the dealerships placed in the reserve fund upon the sale of a VSC was income in the year of the car sale or when services were performed (and amounts withdrawn from the reserve fund). The Eighth Circuit affirmed the Tax Court’s conclusion that the money received by the dealerships upon the sale of the VSCs and immediately paid into the reserve funds was includable in income in the year of receipt.⁶⁰ In reaching its decision, the Tax Court expressly rejected the dealerships’ contention the amounts placed in the reserve fund amounted to nontaxable deposits governed by *Indianapolis Power*.⁶¹ The dealerships argued that because they retained the amounts allocated to the reserve fund subject to an obligation to refund them at the VSC holder’s option, the dealerships did not have “some guarantee that ... [they would] be allowed to keep the money” as long as they complied with the

54. 60 T.C.M. (CCH) 429 (1990).

55. *Id.*

56. 108 T.C. 448 (1997), *aff’d & rev’d in part*, 184 F.3d 786 (8th Cir. 1999).

57. *Johnson*, 184 F.3d at 787.

58. *Id.*

59. *Id.* at 787-88.

60. *Id.* at 788.

61. *Johnson*, 108 T.C. at 467.

terms of the VSC. Therefore, the reserves, according to the dealerships, were not income to them until applied to future purchases of repairs or released to them without restriction upon expiration of the VSC.⁶² The Tax Court responded that the dealerships' reliance on *Indianapolis Power* was "misplaced" in that "[n]ot all refundable payments can be excluded from income," citing to an extensive amount of case law to the contrary.⁶³ In addition, the Tax Court made the following important observation:

Indianapolis Power & Light did not purport to overrule these authorities and establish refundability as the exclusive criterion for distinguishing taxable sales income from nontaxable deposits in all cases.... [citations omitted] What distinguished the nontaxable deposits in the *Indianapolis Power & Light* line of cases from taxable income was not their refundability *per se*; ultimately the classification of these amounts as nontaxable deposits turned on the fact that the taxpayer's right to retain them was contingent upon the customer's future decisions to purchase services and have the deposits applied to the bill.... [citations omitted] The payments at issue in the cases at hand do not share this characteristic.⁶⁴

Ultimately, the courts in *Johnson*, like the Supreme Court in *Indianapolis Power*, considered the customer's continued control over the deposit — either claiming a refund or applying it against future services — as the single most important factor in determining the exclusion of a deposit from income.

3. Tax Treatment Of Advance Receipts Other Than Deposits

a. Historical Overview — No Deferral Of Income

As previously discussed, a taxpayer adopting the accrual method of accounting, which typically comprises most businesses, includes a payment or receipt in income when all events have occurred that fix the right to receive the income and the amount is determinable with reasonable accuracy, with any adjustments to be made in the year of actual receipt.⁶⁵ Typically, the all events test is satisfied as to income inclusion upon the earliest of the following to occur: (i) obligatory performance, (ii) payment is due, or (iii) payment is made.⁶⁶ Accordingly, a taxpayer generally includes any payments received in income upon receipt even though goods or services are to be rendered in a future taxable year.⁶⁷ However, the application of the all events test has proven to be more challenging in the context of advance receipts such as prepayments for products or services where accrual method taxpayers have long argued that the immediate taxation of such payments violates the "matching principle" of generally accepted accounting principles ("GAAP"). The matching principle requires that income recognition be deferred for financial accounting purposes until the period in which associated goods or services are rendered.⁶⁸

62. *Id.*

63. *Id.* at 470 (citations omitted).

64. *Id.* at 471 (citing *Indianapolis Power*, 493 U.S. at 210-12; *Oak Industries*, 96 T.C. at 571-72, 574-75; *Buchner*, 60 T.C.M. (CCH) 429).

65. Treas. Reg. § 1.451-1(a) (amended 1999).

66. *Id.*; *Schlude v. Comm'r*, 372 U.S. 128 (1963); Rev. Rul. 84-31, 1984-1 C.B. 127.

67. Treas. Reg. § 1.451-1(a) (amended 1999).

68. Hasen, *supra* note 1, at 404 (citing Geier, *supra* note 10, at 128-29).

Beginning in the late 1950s, the Supreme Court decided a trifecta of cases addressing the proper tax treatment of prepayments for future services or goods. From the cases emerged a general rule — upon receipt, accrual-basis taxpayers must include in income prepayments for future services. In each case, the taxpayer received an amount in year one for which it was required to provide services in year two, with some ambiguity as to the amount of services the taxpayer would actually provide.⁶⁹ These cases appear to collectively reject the financial accounting matching principle as fundamental in the tax accounting sphere.⁷⁰

In *Automobile Club of Michigan v. Commissioner* (hereinafter *Auto Club*), the Court addressed the proper income tax treatment of prepaid membership dues.⁷¹ The club conceded that it collected dues in advance for one-year memberships under the “claim of right” doctrine (basically, the right to receive dues without restriction as to their disposition), but contended that the dues could be recognized ratably over the membership term under clear reflection of income principles.⁷² The Court disagreed, explaining that “[t]he pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner [the club] may in fact be called upon to render for the member.”⁷³

In *American Automobile Association v. United States* (hereinafter *AAA*), the taxpayer included in its income only the portion of the prepaid annual membership dues actually collected in a taxable year that “ratably corresponded with the number of membership months covered by those dues” and occurring within that taxable year.⁷⁴ Any amount of dues not ratably corresponding in that year was deferred for recognition in the following taxable year. Operating expenses with respect to such memberships were similarly deducted ratably over the identical periods of time as those over which the dues were recognized as income. This method of accounting for income and expenses was in accordance with GAAP and regularly employed in the association’s industry. Similar to *Auto Club*, the IRS labeled the association’s accounting method as “purely artificial,” contending that it should have included the entire amount of membership dues actually received in its taxable income without regard to any expected future services with respect to those memberships in the following year.⁷⁵ The Court ultimately rejected AAA’s assertion that its accounting method was reliable, in part because of the association’s inability to predict when services, if ever, would be required on a particular membership.⁷⁶ Accordingly, the ultimate issue emerged as one of timing — in what year should the prepaid membership dues be included in income? The

69. Hasen, *supra* note 1, at 404.

70. *Id.*

71. 353 U.S. 180 (1957).

72. With respect to the proper tax treatment of prepayments, some courts initially analyzed under the “claim of right” doctrine, but later court decisions dismissed the doctrine as dispositive. *See, e.g.,* *Moritz v. Comm’r*, 21 T.C. 622 (1954) (pursuant to claim of right analysis, photographer taxed on deposits despite policy of permitting full refund if customer not satisfied); *Bressner Radio v. Comm’r*, 267 F.2d 520, 525 (2d Cir. 1959) (differentiated claim of right cases as involving income that taxpayers conceded was “earned”); *Beacon Publ’g v. Comm’r*, 218 F.2d 697, 699-700 (10th Cir. 1955) (distinguished “receipt” issue from “accounting” issue of timing of income recognition).

73. *Auto Club*, 353 U.S. at 189.

74. 367 U.S. 687, 688 (1961).

75. *Id.* at 690-91.

76. *Id.* at 691-92.

Court answered: the calendar year in which the dues are actually received, explicitly rejecting any method that employs statistical computation or estimation of income.⁷⁷

The third case in the trifecta was *Schlude v. Commissioner*, which involved tax accounting for contracts of an Arthur Murray franchise dance studio.⁷⁸ Two basic contract types governed dance lessons. The cash plan required a cash down payment at contract execution with installment payments of the balance. The deferred payment contract required only a portion of the down payment be in cash, with the remainder paid in installments and a negotiable note signed at contract execution with respect to the balance of the contract price. Although the contracts provided a designated term during which the lessons had to be taken, no detailed schedule was specified. Under both plans, the contract was “noncancelable,” resulting in the forfeiture of any unused balance if the client failed to take all of the designated lessons within the contract term.⁷⁹ Under the studio’s accrual-based accounting, upon execution of a contract, a “deferred income account” was credited with the total contract price. At the end of each fiscal year, a client’s record was analyzed and the total number of instruction hours utilized was multiplied by a designated hourly rate, with the result being deducted from the deferred income account and recognized as income on the studio’s financial statements and income tax returns. If no activity as to a client contract occurred for over a year, the remaining balance of the contract was cancelled, removing the unused contract price from the deferred income account and including it in the studio’s income.⁸⁰

The Court concurred with the IRS’s rejection of the studio’s accounting method as lacking clear reflection of income, noting both (i) that the dance lessons were not to take place on specific dates, but rather were left to the discretion of the client and the instructor; and (ii) taking into consideration the contract forfeiture provision, no certainty existed that remaining lessons under the contract would ever be demanded. Stating that the issue was “squarely controlled” by *AAA*, the Court held that all prepayments in cash, negotiable notes, and contract installments due and owing under the contract were immediately includable in the studio’s income for tax purposes.⁸¹

As previously discussed, *Schlude*, like its predecessors, appears to dispel the financial accounting notion of matching recognition of income in the same period in which the associated expenses are incurred.⁸² As one legal commentator noted, the Supreme Court “acknowledged that the matching of income and expense is a tax value, but declined to permit deferral on that basis in the absence of a sufficiently determinate showing of the future expenses.”⁸³ Essentially, if the timing or amount of the associated expenses was unclear, the matching principle was trumped by the IRS’s determination that any deferral of income does not clearly reflect income under section 446.⁸⁴ As a result, the Tax Court, among other

77. *Id.* at 693.

78. *Schlude*, 378 U.S. at 130.

79. *Id.*

80. *Id.* at 131-32.

81. *Id.* at 134-36. Only those amounts “neither due as a matter of contract, nor matured by performance of the related services” could be deferred from income recognition. *Id.* at 133 n.6.

82. Hasen, *supra* note 1, at 404.

83. *Id.* at 405 (citing Geier, *supra* note 10, at 120).

84. *Id.* (citing Geier, *supra* note 10, at 118).

courts, subsequently interpreted and applied *Schlude* as espousing a per se rule prohibiting the deferral of any advance payment.⁸⁵

However, some courts, as in *Artnell v. Commissioner*, viewed the Supreme Court trifecta as leaving the door open for possible deferral “where the time and extent of performance of future services” related to the prepayment for services are sufficiently definite.⁸⁶ In *Artnell*, the main issue was whether prepayments for future services — advance ticket sales proceeds for future baseball games — should be immediately included in income by the petitioner, the owner of the Chicago White Sox, or deferred until the baseball games were played and other services provided. The petitioner, an accrual basis taxpayer, booked as “deferred unearned income” amounts it received for season tickets, advanced ticket sales and other revenues allocable to games to be played in the next season. As the games were played, the petitioner recognized the allocable amount of previously deferred income.⁸⁷ In response to the IRS’s application of its nondeferral rule to these advance payments, the petitioner argued that its deferral under the accrual method of accounting clearly reflected its income. The petitioner further argued that the Supreme Court trifecta of cases all involved facts where the “extent and performance of future services were uncertain,” which was not present in this case because the “deferred income was allocable to games played on a fixed schedule.”⁸⁸ The Seventh Circuit agreed, finding that the prepayments for future fixed baseball games “approaches much closer to certainty” than the facts present in the Supreme Court trifecta of cases. Accordingly, it determined that the petitioner’s deferral of the prepayments did clearly reflect income and the IRS abused its discretion under section 446 in requiring income inclusion upon receipt.⁸⁹

b. Deferral Of Income On Certain Advance Payments

Although *Artnell* represents a departure from the general rule of inclusion of advance payments upon receipt, the decision has been narrowly construed and applied.⁹⁰ However, subsequent to the *Artnell* decision, the particular problems faced by accrual method taxpayers with respect to advance payments began to be heard by the IRS, which crafted limited deferral rules.

The first deferral rule exists under the section 451 regulations, which defers recognition of income on certain “advance payments.” An advance payment is defined under the regulations as an amount received by an accrual method taxpayer,

pursuant to, and to be applied against, an agreement: (i) [f]or the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his

85. See, e.g., *Decision, Inc. v. Comm’r*, 47 T.C. 58, 62 (1966) (citing to the “no-deferral rule” of *Schlude*); *Bell Elec. Co. v. Comm’r*, 45 T.C. 158, 166 (1965) (without a specific statutory exclusion, deferral is not allowed); *Huebner v. Comm’r*, 25 T.C.M. 406, 409-410 (1966) (“the [*Schlude*] court adopted the position that any relief from the current taxation of prepaid income must be provided by Congress”).

86. Hasen, *supra* note 1, at 405 (quoting *Artnell Co. v. Comm’r*, 400 F.2d 981, 983-84 (7th Cir. 1968), *rev’g and remanding* 348 T.C. 411 (1967)).

87. *Artnell*, 400 F.2d at 982-83.

88. *Id.* at 983-84.

89. *Id.* at 985.

90. Hasen, *supra* note 1, at 405-06.

trade or business, or (ii) [f]or the building, installing, constructing or manufacturing by the taxpayer of items where the agreement is not completed within such taxable year.⁹¹

Pursuant to the regulations, an accrual method taxpayer can defer the income recognition of advance payments for goods until the taxable year in which they are properly accrued under the taxpayer's accounting method. This deferral is permissible provided that the taxpayer's accounting method results in the advance payments being recognized as income no later than when they are recognized in revenues pursuant to the taxpayer's accounting method for financial reporting purposes.⁹² If that financial reporting method requires income recognition sooner than for tax purposes, the regulations require the taxpayer to include the advance payments in income in that earlier year.⁹³ Furthermore, if the taxpayer's obligation to provide goods under the sales agreement ends, or the taxpayer fails to survive (death, dissolution, or other reason), income inclusion of the deferred amount is immediately triggered.⁹⁴

Another possibility for deferral of advance payments is granted to accrual method taxpayers by Revenue Procedure 2004-34.⁹⁵ Deferral is granted if the taxpayer (i) employs, or is changing to, an accrual method of accounting; and (ii) receives an "advance payment."⁹⁶ The revenue procedure defines an advance payment as a payment that the taxpayer (a) includes in gross income in the taxable year of receipt pursuant to a permissible method of accounting; and (b) recognizes, in whole or in part, in its financial statements as revenue for a subsequent taxable year (or earned in a subsequent taxable year if taxpayer has no financial statements). In addition, the advance payment must be made for: (i) services; (ii) sale of goods (other than for a sale for which the taxpayer defers income pursuant to the section 451 regulations); (iii) use of intellectual property by license or lease; and (iv) other uses and sales of property.⁹⁷ Under the revenue procedure, an advance payment excludes, with some exceptions, rent, insurance premiums, payments with respect to financial instruments (including prepayment of interest), service warranty contract payments, and other specific prepayments.⁹⁸

Revenue Procedure 2004-34 provides two permissible methods of accounting for advance payments as defined above. Pursuant to the "full inclusion method," a taxpayer includes the entire amount of an advance payment in income in the taxable year of receipt, regardless of whether the full amount of an advance payment is recognized in revenues for financial reporting purposes or is earned by the taxpayer in that taxable year.⁹⁹ The second method, the "deferral method," postpones the inclusion of an advance payment, in whole or in part, in income to the extent that the taxpayer defers recognition of the payment, in whole or in part, in its revenues for financial reporting purposes. However, the taxpayer includes

91. Treas. Reg. § 1.451-5(a)(1) (amended 2001).

92. Treas. Reg. § 1.451-5(b)(1)(ii)(a) (amended 2001).

93. Treas. Reg. § 1.451-5(b)(1)(ii)(b) (amended 2001).

94. Treas. Reg. § 1.451-5(f) (amended 2001).

95. Rev. Proc. 2004-34, 2004-22 I.R.B. 991, *modifying and superseding* Rev. Proc. 71-21, 1971-2 C.B. 549.

96. George L. White, 570-2nd BNA T.M. *Accounting Methods – General Principles*, at A-107 (2008).

97. Rev. Proc. 2004-34, 2004-22 I.R.B. 991 § 4.01.

98. *Id.* § 4.02.

99. *Id.* § 5.01.

the deferred portion of the advance payment in income in the next succeeding taxable year.¹⁰⁰ Similar to the section 451 regulations, the inclusion of an advance payment in income may be accelerated due to the taxpayer's death or dissolution.¹⁰¹ In contrast to the deferral permitted under the section 451 regulations, which defers recognition of advance payment until it is included in the taxpayer's revenues for financing reporting purposes, the revenue procedure generally permits deferral only to the taxable year after the taxable year of receipt.¹⁰² Although the deferral method under the section 451 regulations may provide a longer deferral period, the regulations and the revenue procedure are not mutually exclusive, with an advance payment partially eligible for deferral under the regulation and partially under the revenue procedure.¹⁰³ The result is a complex interplay between financial accounting rules and the above described tax deferral rules.

The above overview of the complex deferral rules for certain advance payments illuminates presumably the reason that taxpayers may strenuously argue that prepayments for goods or services are similar to deposits deserving nonrecognition treatment. Accordingly, the following discussion of *Westpac* and *Karns* tests the veracity of that asserted deposit analogy. The two federal circuits deciding those cases reached diverging conclusions on the application of *Indianapolis Power* to a particular type of advance receipt — an advance trade discount.

III. CIRCUIT CONFLICT: *WESTPAC* AND *KARNS*

In the retail industry, it is common for suppliers to incentivize distributors and retailers to make future purchases by providing cash payments, also known as “advance trade discounts.”¹⁰⁴ As with any advance receipt, the threshold determination a recipient must make is whether the cash payment is income upon receipt or can be excluded from income as a deposit or loan, or a purchase price reduction.¹⁰⁵ The proper tax treatment of such supplier to retailer payments resurfaced in the Ninth Circuit's opinion in *Westpac* and the Third Circuit's opinion in *Karns*, each of which are discussed below. Although these cases can be distinguished on their facts, they nevertheless illustrate the complexity of income tax law that taxpayers face when addressing advance receipts.

A. The Ninth Circuit's Decision In *Westpac*

In *Westpac*, the court had to decide whether cash paid in advance by manufacturers of products to *Westpac*, a food wholesaler, in exchange for volume purchase commitments (also known as advance trade discounts) constituted gross income to the wholesaler.¹⁰⁶ Under each purchase agreement, the wholesaler agreed that the manufacturer would be the primary or exclusive supplier of the particular product and, in some of the agreements, agreed to maintain a specific

100. *Id.* § 5.02(1).

101. *Id.* § 5.02(5).

102. White, *supra* note 96, at A-107.

103. *Id.* at A-108.

104. W. Eugene Seago, *Do Advance Trade Discounts Represent a Liability or Income?* 105 J. TAX'N 144 (2006).

105. *Id.*

106. *Westpac*, 451 F.3d at 971-72.

amount of shelf space for the manufacturer's product.¹⁰⁷ Upon termination of these agreements, Westpac agreed to reimburse the manufacturers on a prorated basis for any portion of the cash advance not earned due to the wholesaler's failure to purchase the agreed upon amount of product. The accrual-basis wholesaler booked the cash advances or discounts as liabilities akin to loans in favor of the manufacturers.¹⁰⁸ As merchandise was purchased under the agreement, Westpac applied the discounts pro rata to the full purchase price under each agreement, the net effect of which decreased its cost of goods sold and increased its net profit and, therefore, its taxable income.¹⁰⁹ The IRS conceded, and the Tax Court concurred, that Westpac's method of accounting was consistent with GAAP. Notwithstanding, the Tax Court dismissed the wholesaler's argument that the cash advances were trade discounts that reduced the cost of the goods purchased under Treasury Regulation § 1.471-3(b), finding the discount referenced under that regulation requires that the discount arise "contemporaneously" with the purchase of the goods.¹¹⁰ Accordingly, the Tax Court determined that the cash advances were income at the time of receipt and not eligible for deferral.¹¹¹

On appeal, the Ninth Circuit addressed the issue as simply "whether advance trade discounts constitute gross income when received;" ultimately concluding they did not and reversing the Tax Court.¹¹² The Ninth Circuit found that prior Supreme Court decisions compelled its answer: "Cash advances in exchange for volume purchase commitments, subject to *pro rata* repayment if the volume commitments are not met, are not income when received."¹¹³ In citing the Supreme Court decisions in *Indianapolis Power, Auto Club*, and *Schlude*, the Ninth Circuit concluded that *Indianapolis Power* governed the facts before it, analogizing advance trade discounts to security deposits due to their repayment feature. Unlike the membership dues in *Auto Club*, Westpac could not keep the cash advance "regardless of what happens after the receipt."¹¹⁴ It could only retain the entire advance if it met the volume purchase requirements and, therefore, like the security deposit, the cash advance, in whole or in part, was subject to repayment. In fact, under one of the contracts, the volume requirement was not met ultimately and Westpac reimbursed the manufacturer a pro rata amount of the cash advance. In addition, because of the repayment possibility, the cash advance did not constitute an "accession to wealth," reasoned the court, but rather was more like a loan or liability than income upon receipt.¹¹⁵ Accordingly, Westpac's receipt of the cash advances

107. The Ninth Circuit, like the Tax Court, did not divide the cash advances into a portion attributable to the shelf space, product exclusivity, and advances against future purchases. The Ninth Circuit agreed with Westpac's argument that due to the fact that the obligation was to be satisfied primarily through future purchases, the entire amount constituted advance trade discounts. See *Westpac*, 82 T.C.M. (CCH) 175 (2001); Seago, *supra* note 104, at 149.

108. *Westpac*, 82 T.C.M. (CCH) 175 (2001).

109. *Westpac*, 451 F.3d at 972. The wholesaler based its case on the trade discount provisions in Treas. Reg. § 1.471-3(b), which provides that trade discounts may be used to reduce the cost of goods purchased. *Westpac*, 82 T.C.M. (CCH) 175 (2001).

110. Seago, *supra* note 104, at 147-48. Seago noted that the IRS's holding in I.R.S. Tech. Adv. Mem. 200605010 (Feb. 3, 2006) seems to contradict the Tax Court's conclusion. In that TAM, the IRS held that rebates received by the retailer after the purchase of the goods constituted trade discounts that should reduce the cost of the goods purchased.

111. *Westpac*, 82 T.C.M. (CCH) 175 (2001).

112. *Westpac*, 451 F.3d at 974.

113. *Id.* at 975.

114. *Id.* at 976.

115. *Id.* at 974.

increased its cash assets, not its income, offset by a corresponding liability in the amount of the advance. When Westpac purchased product under the agreement at list price, not a discounted price, it realized income for tax purposes.¹¹⁶

B. The Third Circuit's Decision In *Karns*

Over four years after the Tax Court issued its decision in *Westpac*, it confronted virtually identical facts in *Karns Prime & Fancy Food, Ltd. v. Commissioner*.¹¹⁷ Whereas in *Westpac* the issue was expressed as whether an advance trade discount constitutes income, the Tax Court in *Karns* stated that the only issue was whether the cash advance received from *Karns*' principal supplier constituted a loan when received and, thus, not included in income.¹¹⁸ The Tax Court concluded that the supplier's payment could not be characterized as a loan, which the Third Circuit subsequently affirmed. As in *Westpac*, both courts adopted the analysis utilized in *Indianapolis Power*. Nevertheless, the courts reached a result contrary to that reached by the Ninth Circuit in *Westpac*.

Karns operated a grocery store chain in Harrisburg, Pennsylvania. In order to obtain additional funds for capital improvements in its stores, *Karns* entered into two agreements with its principal supplier, Super Rite Foods, Inc. Under a supply agreement, *Karns* agreed to purchase annually \$16 million worth of product from Super Rite, granting Super Rite a security interest in its assets.¹¹⁹ The supply agreement held *Karns* to specific product pricing or markups, with provisions regarding payment dates, and billing and payment terms. *Karns* also executed a promissory note payable to Super Rite in exchange for \$1.5 million in immediate funds from Super Rite. Commencing on April 16, 2000, the note obligated *Karns* to six annual repayments of \$250,000 with stated interest on the unpaid balance, unless *Karns* met the volume purchase requirements for the previous calendar year under the supply agreement. In that instance, Super Rite agreed to forgive the \$250,000 due and owing for that year. Upon receipt of the \$1.5 million on May 4, 1999, *Karns* booked the amount as a long-term note payable.¹²⁰

Karns satisfied the supply agreement for the periods ending April 16, 2000 and 2001, resulting in the forgiveness of the required annual payments due under the note. For the taxable years ending January 30, 2001 and 2002, *Karns* reported forgiveness of debt income (also known as cancellation of indebtedness or COI income) in the amount of \$250,000 on its income tax returns. On March 9, 2001, *Karns* executed a second promissory note to SuperValu, Inc. (the successor to Super Rite resulting from an August 1999 purchase of Super Rite's parent company) in the amount of \$300,000 with stated interest. In exchange for the funds, *Karns* also executed a second amendment to the supply agreement, increasing the annual product purchase requirement from \$16 to \$21 million. Pursuant to the second note, *Karns* agreed to annual repayments to be made on March 9 beginning in 2002 and ending in 2005.¹²¹ *Karns* fulfilled the product purchase requirement for the period ending March 9, 2002, resulting in that \$250,000 repayment being forgiven. However, *Karns*

116. *Id.* at 977.

117. 90 T.C.M. (CCH) 357 (2005).

118. *Westpac*, 82 T.C.M. (CCH) 175 (2001); *Karns*, 90 T.C.M. (CCH) 357 (2005); *see also* Seago, *supra* note 104, at 148.

119. *Karns*, 494 F.3d at 405-06.

120. *Id.* at 406.

121. *Id.* at 407.

failed to meet the \$21 million product purchase requirement for the following period by \$1.2 million, obligating it to pay a pro rata payment of \$4,929.19 to SuperValu.¹²²

Pursuant to a notice of deficiency, the IRS determined that Karns should have included the entire \$1.5 million payment from Super Rite in its income for tax year ending January 30, 2000 (the taxable year of receipt). On appeal, the Tax Court held that the payment did not constitute a loan and thus was includable in income upon receipt.¹²³ According to the Third Circuit, in addressing whether a transaction constitutes a loan, the essential element is the recipient's unconditional obligation to repay the amount advanced.¹²⁴ Citing *Indianapolis Power* as the "leading decision" on the proper tax treatment of advance payments, the Third Circuit acknowledged the difficulty in analogizing the facts therein with the facts present in *Karns* because of the differences between the transactions and the parties' relative positions.¹²⁵ Notwithstanding, the court stated that the "key element" with respect to any advance payment, as announced in *Indianapolis Power*, is whether the recipient is able to keep the money advanced.¹²⁶ The Third Circuit explicitly agreed with the Tax Court's differentiation that the customers in *Indianapolis Power*, rather than the utility company, controlled whether the utility would retain the deposits; whereas, in *Karns*, Karns controlled whether it would retain the annual payment due under the note.¹²⁷ Karns alone, according to the court, had "complete dominion" over the money advanced by meeting the volume purchase requirements under the supply agreement. Therefore, the court determined that the \$1.5 million in advanced funds were "in substance a projected rebate for products to be supplied, analogous to an advance payment, and as such were taxable income."¹²⁸

In addressing *Westpac*, the Third Circuit took issue with the Ninth Circuit's handling of Supreme Court precedents *Auto Club* and *Schlude*, both of which concluded that advance payment of membership dues and fees for dance lessons, respectively, were income when received.¹²⁹ "The *Westpac* court ignored the discussion in *Indianapolis Power*," explained the Third Circuit, "that 'so long as the recipient fulfills the terms of the bargain, the money is its to keep.'"¹³⁰ The majority opinion in *Karns* dismissed the dissent's arguments that the supply agreement and note payable were not "one unitary advance rebate," and that Super Rite had greater ability to cancel the supply agreement thereby dissipating *Karns*' control over the advanced funds. With respect to the dissent's latter argument, the majority opinion responded that Karns was still obligated to make a certain amount of purchases under the supply agreement, with Super Rite obligated to forgive the annual repayments of the advance if Karns did so. Again, "so long as [Karns] fulfilled the terms of the bargain, the money [was] its to keep."¹³¹

122. *Id.* at 407-08.

123. *Id.* at 408.

124. *Id.*

125. *Id.* at 409.

126. *Id.* at 410 (citing *Indianapolis Power*, 493 U.S. at 212).

127. *Id.* at 410.

128. *Id.*

129. See *supra* notes 73 and 81 and accompanying text.

130. *Karns*, 494 F.3d at 411 (citing *Indianapolis Power*, 493 U.S. at 212). The Ninth Circuit addressed *Auto Club* and *Schlude* in a statement that its case "is like *Indianapolis Power*, not *Automobile Club of Michigan* or *Schlude*." *Westpac*, 451 F.3d at 976.

131. *Karns*, 494 F.3d at 412 (quoting *Indianapolis Power*, 493 U.S. at 213).

1. Judge Ambro's Concurrence In *Karns*

Judge Ambro, who joined in the majority opinion, wrote a separate concurring opinion based on a tax accounting perspective to support the court's holding. He began his concurrence with the preliminary statement that the case was really about "timing." He explained that "[b]oth loans and advance payments confer an economic benefit on recipients because they allow the recipient 'both immediate use of the money (with the chance to realize earnings thereon) and the opportunity to make a profit by providing goods or services at a cost lower than the amount of the payment.'"¹³² However, under current income tax law, these two transfers are treated differently — loans are not income upon receipt whereas advance payments generally are.

Judge Ambro then proceeded to dissect and refute the basis for the Ninth Circuit's *Westpac* decision. As he explained, the Ninth Circuit asserted that its decision was based on (1) the lack of an absolute repayment obligation by *Westpac*, and (2) the lack of accession to wealth upon *Westpac*'s receipt of the cash advance.¹³³ The majority opinion addressed the first basis in that *Karns*, not *Super Rite*, "controlled whether the obligation to repay would occur."¹³⁴ Employing four hypothetical scenarios, Judge Ambro illustrated how deferral of income recognition can lead to tax savings in the initial years, thereby refuting the second basis for the *Westpac* conclusion. In the scenarios, he employed a basic set of facts: Hal Homemaker opens a grocery distribution center out of his garage, purchasing food valued at \$2,000 and reselling it for \$4,000.¹³⁵

In the first three scenarios, Judge Ambro distinguished between (i) an upfront twenty percent reduction or discount in the purchase price of goods equal to \$400, which reduces Hal's business deductions and increases his net profit and taxable income; (ii) a \$400 cash advance with an unconditional repayment obligation (owed regardless of whether Hal met minimum purchase requirements), which Hal treats as a bona fide loan without income tax consequences; and (iii) a \$400 cash advance accompanied by a six-year minimum purchase requirement with the supplier forgiving the cash advance at the end of the six years if the purchase requirement is met (a conditional repayment obligation under Hal's control). In that third scenario, Hal treats the cash advance as a reduction in his cost of the goods purchased in the first year, thereby decreasing his business deductions and increasing both his net profit and taxable income. In each of these first three scenarios, Judge Ambro concludes that Hal has computed his tax liability without controversy.¹³⁶

But, in the fourth scenario, Judge Ambro changed Hal's income tax reporting in the third scenario fact pattern. Instead of Hal deducting \$1,600 in the first year as a business expense, reflecting the \$400 advance payment as a reduction in the cost of goods purchased, Hal instead deducts \$2,000 as his business expense to offset his \$4,000 income, leaving the \$400 cash advance to be claimed as income in the sixth year as COI income. By deducting \$2,000 rather than \$1,600 as the cost of the goods purchased, Hal is able to realize a \$136 tax savings (\$816 in taxes under the third scenario less \$680 in taxes under the fourth scenario), which is multiplied, under time value of money principles, for the six years in which those savings can be invested. Judge Ambro's conclusion is straightforward: when a taxpayer is able to defer taxes on cash advances received in the first year and goods purchased in the first year are resold for profit, the taxpayer can definitely

132. *Id.* at 413 (quoting *Indianapolis Power*, 493 U.S. at 207).

133. *Id.* at 413 (citing *Westpac*, 451 F.3d at 975, 977).

134. *Id.* at 413.

135. *Id.*

136. *Id.* at 414-15.

earn more money, illustrating the very essence of the timing effect in taxation. When applied to the facts in *Karns*, deferring the recognition of the cash advance received by Karns yielded an approximate tax savings of \$500,000 by the end of the note term, roughly equal to the amount of the tax deficiency asserted by the IRS.¹³⁷

Judge Ambro concluded his concurrence by reiterating the timing problem inherent in the *Westpac* decision — “[f]unds received with no unconditional repayment obligation result in one set of profit margins and tax liabilities, and deferred tax payment on those same funds results in another set.”¹³⁸ The current income tax laws do not permit deferral of income recognition and taxation when a conditional repayment obligation exists.

2. The Effect Of *Erickson Post* On *Karns*

In the Tax Court’s decision in *Karns*, it distinguished the facts before it from those in *Erickson Post Acquisition, Inc. v. Commissioner*, on which Karns attempted to rely.¹³⁹ Similarly, the Third Circuit’s majority opinion, in a footnote, dismissed the memorandum opinion as nonbinding precedent.¹⁴⁰ Because both courts rendering decisions in *Karns* mentioned this case, it is constructive for this article to discuss the *Erickson Post* facts and decision.

In *Erickson Post*, the petitioner corporation is the owner and operator of two gasoline stations containing convenience stores. All of the petitioner’s issued and outstanding common stock was owned in equal shares by Richard Zimmerman and his wife, who served as president and vice president, respectively. The petitioner entered into an exclusive dealer supply agreement with Amoco for a five-year period commencing on July 1, 1996. The supply agreement was accompanied by a number of other agreements, including Amoco’s agreement to provide the petitioner with certain equipment and improvements as well as a cash advance of \$175,000, which the parties characterized as a loan.¹⁴¹ In exchange for the cash advance, Mr. Zimmerman, on behalf of the petitioner, executed a promissory note obligating the petitioner to repay the \$175,000 over ten years in annual payments of \$17,500 plus a six percent annual rate of interest. Pursuant to the note’s terms, the annual payment was deemed paid or forgiven by Amoco provided the supply agreement remained in effect on the payment due date. In addition to the note, Mr. Zimmerman, on behalf of the petitioner, executed a mortgage security agreement and assignment of rents securing petitioner’s repayment obligation. Because the supply agreement remained in effect throughout the note’s term, Amoco forgave all ten annual repayments plus any interest due and owing.¹⁴²

The petitioner booked the Amoco cash advance as “Amoco/Deferred Income,” and not explicitly as a loan or note payable. The petitioner reduced the Amoco/Deferred Income account monthly by \$1,458.33, a pro rata reduction of the \$175,000 over 120 months, with a corresponding recognition of income in the same amount. The petitioner did not book nor deduct any annual interest expense on the cash advance. In a notice of deficiency, the IRS determined that the entire Amoco cash advance was income to the petitioner in 1996, the year of receipt, characterizing it as a nondeferrable advance payment. Contrary to the petitioner’s assertion that the advance constituted a nontaxable loan, the IRS

137. *Id.* at 415-416.

138. *Id.* at 416.

139. *Karns*, 90 T.C.M. (CCH) 357 (2005) (citing *Erickson Post Acq., Inc. v. Comm’r*, 86 T.C.M. (CCH) 111 (2003)).

140. *Karns*, 494 F.3d at 412 n.2.

141. *Erickson Post*, 86 T.C.M. (CCH) 111 (2003).

142. *Id.*

concluded that the money represented an inducement received in exchange for the petitioner's purchase and distribution of Amoco products.¹⁴³

The Tax Court stated that a receipt will be characterized as a loan for federal income tax purposes if there was "an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure the payment."¹⁴⁴ Furthermore, the parties' intent to treat the advance as a loan must exist at the time it is made — the recipient's intent to repay and the transferor's intent to demand repayment.¹⁴⁵ The existence of a debtor-creditor relationship is a factual question determined by all surrounding circumstances. Based on the factual record, the Tax Court found that the \$175,000 cash advance constituted a loan and, therefore, was not income to the petitioner upon receipt. The court cited as persuasive the annual payments of principal and interest required under the note's terms and the mortgage securing the debt.¹⁴⁶

The IRS argued that the petitioner's obligation to repay the advance was conditional, in that repayment was triggered only if the supply agreement failed to remain in effect, citing the Tax Court's decisions in *Westpac* and *Colombo v. Commissioner*.¹⁴⁷ The facts in *Colombo* are somewhat similar to those in *Erickson Post*, involving a service station owner's receipt of a \$50,000 payment from a major oil company. In exchange for the payment, the station owner agreed to maintain and sell the oil company's products for a ten-year period. The station owner's repayment obligation was triggered only upon a contract breach. The Tax Court dismissed the owner's argument that the payment constituted a loan, reasoning that the owner owed nothing if it fulfilled its purchase and other obligations under the contract.¹⁴⁸ In essence, the Tax Court concluded, as it subsequently did in *Karns*, that a contract breach was a condition precedent to a liability creation, as further explained below.¹⁴⁹

The Tax Court explained that the crucial issue is whether a liability was created at the transaction's inception. "If existence of a liability depends on satisfaction of a condition precedent, the liability is not unconditionally fixed.... A liability subject to a condition subsequent, however, is definitely fixed, subject only to a condition which may cut off liability in the future."¹⁵⁰ As a result, the Tax Court quickly dispensed with the IRS's argument, explaining that in *Westpac* and *Colombo*, the taxpayers' repayment obligations did not arise "unless and until" a contract breach occurred (failure to purchase an agreed amount of product) — a condition precedent — with the repayment in proportion to the amount of nonpurchased product. Accordingly, in both cases, the repayment obligations possessed no loan characteristics; rather, they bore a closer resemblance to "forfeiture penalties" for contract breach.¹⁵¹ By comparison, the petitioner in *Erickson Post* maintained an unconditional obligation to repay the cash advance from its inception, secured that obligation with a

143. *Id.*

144. *Id.* (quoting *Haag v. Comm'r*, 88 T.C. 604, 616 (1987), *aff'd without published opinion* 855 F.2d 855 (8th Cir. 1988)).

145. *Id.* (quoting *Haag*, 88 T.C. at 615).

146. *Id.*

147. *Id.* (citing *Westpac*, 82 T.C.M. (CCH) 175 (2001); and *Colombo v. Comm'r*, 34 T.C.M. (CCH) 733 (1975)).

148. *Id.*

149. *Seago*, *supra* note 104, at 145.

150. *Erickson Post*, 86 T.C.M. (CCH) 111 (2003).

151. *Id.*

mortgage on its property, and had a potential for debt forgiveness in the future, all of which resulted in a fixed liability subject to a condition subsequent.

Finally, the Tax Court dismissed the IRS's assertion that under an *Indianapolis Power* analysis, the petitioner possessed "completed dominion" over the cash advance and, therefore, had income upon receipt. Examining both parties' rights and obligations at the time of the cash payment, the Tax Court concluded that the petitioner's control over the Amoco cash advance was "far less complete than is ordinarily the case in an advance payment situation."¹⁵² Upon receipt of the advance, the petitioner lacked any assurance it would be permitted to keep any portion of the payment.¹⁵³

At least one tax scholar has commented that the Tax Court "indirectly achieved" the correct result in *Erickson Post* when it applied the tax accounting principles of conditions precedent and subsequent to conclude that an advance trade discount or payment constituted a liability, thereby precluding any "accession to wealth" necessary for income recognition.¹⁵⁴ The IRS subsequently issued an Action on Decision, nonacquiescing in the Tax Court decision and vowing to continue its litigation on the issue.¹⁵⁵ The IRS also stated that the Tax Court's decision in *Karns* represented the "better analysis" by focusing on the substance when addressing a loan versus advance payment issue.¹⁵⁶

The Tax Court in *Karns* distinguished *Erickson Post* on the substance of the transaction at issue, determining that *Erickson Post* was "materially distinguishable" from the facts before it.¹⁵⁷ Specifically, the court found that, unlike the petitioner's obligation in *Erickson Post*, Karns' repayment obligation under the note payable did not arise until it materially breached the supply agreement with Super Rite and its successor.¹⁵⁸ In other words, Karns' repayment obligation was not unconditional because it was subject to a condition precedent (breach of the supply agreement) and, therefore, no liability existed from inception.¹⁵⁹ Accordingly, the Tax Court in *Karns* essentially ruled in a manner similar to *Erickson Post*. It seems that the Third Circuit, instead of dismissing *Erickson Post* as nonprecedential, might have cited *Erickson Post* as persuasive support of both the Tax Court's and its ultimate conclusion that Karns' arrangement with Super Rite (and its successor) did not constitute a loan for federal income tax purposes and, therefore, was includable in income upon receipt.

152. *Id.*

153. *Id.* (citing *Indianapolis Power*, 493 U.S. at 210-11; and *Highland Farms, Inc. v. Comm'r*, 106 T.C. 237, 250-52 (1996)).

154. Seago, *supra* note 104, at 150.

155. I.R.S. Action on Dec. 2006-01 (Oct. 10, 2006).

156. *Id.*

157. *Karns*, 90 T.C.M. (CCH) 357 (2005).

158. *Id.*

159. The Tax Court in *Karns* did refer to a "condition precedent" early on in its legal analysis when defining a loan:

In order for a transfer of funds to constitute a loan, at the time the funds are transferred there must be an unconditional obligation (i.e., *an obligation that is not subject to a condition precedent*) on the part of the transferee to repay, and an unconditional intention on the part of the transferor to secure repayment of, such funds.

Id. (emphasis added).

IV. THE IMPACT OF *KARNS* ON THE LAW GOVERNING ADVANCE RECEIPTS

The clear import of *Karns*, by utilizing *Indianapolis Power* and distinguishing *Westpac*, is that the more two parties to a transaction treat an advance payment (or an advance trade discount) as a loan from its inception, the more likely the recipient will prevail against the IRS in excluding that advance from income upon receipt. From the cases discussed herein, that liability treatment should: (i) include loan documentation such as a note payable, (ii) avoid contractual language tying the receipt of the advance to any future services, and (iii) provide for forgiveness of the loan amount upon satisfaction of a condition subsequent (for example, achieving a fixed level of purchases or providing a fixed amount of services).¹⁶⁰ In applying this distinction between loan-like deposits and other advance payments as well as the complete dominion test of *Indianapolis Power*, the Third Circuit in *Karns* seems to have gotten it right. As discussed above, no facts were present in *Karns* that supported the existence of an unconditional repayment obligation akin to a loan, as established by *Indianapolis Power* and reasserted more recently in *Erickson Post*. Nevertheless, as discussed below, the *Indianapolis Power* decision is fraught with criticism over its lack of economic-based analysis as well as facts that seem to belie the Court's choice of analysis and, thus, its ultimate conclusion.

In contrast to *Karns*, the Ninth Circuit misapplied the *Indianapolis Power* "complete dominion" test in *Westpac*. Unlike IPL (the taxpayer in *Indianapolis Power*) whom the Supreme Court found lacked complete dominion over the utility deposits received from customers, *Westpac* appeared to control and have complete dominion over the cash advances received from product manufacturers. Specifically, *Westpac*, rather than those manufacturers, controlled whether it retained or repaid the cash advances, in whole or in part, by fulfilling fixed volume purchase requirements under its agreements with those manufacturers. The Ninth Circuit in *Westpac* completely failed to acknowledge and distinguish this disparate fact.¹⁶¹

Although *Karns* arguably prevails over *Westpac* in properly applying the loan versus other advance payment distinction, the more significant question involves the validity of the distinction in the first place. This question of validity has not escaped several legal commentators who have noted the "incoherence" of the distinction as a matter of economics or tax theory.¹⁶² The Supreme Court's asserted distinction between loans and, by extension, certain deposits and prepayments for services is nonexistent. In critiquing the Seventh Circuit's decision in *Indianapolis Power*, one commentator, William Klein, noted:

The court seems to suggest that the prospect of repayment of a loan somehow constrains the use of the loan funds while, in the case of an advance payment, the prospect of delivering some quid pro quo does not. Stated so baldly, this proposition makes no sense. Stated any less baldly, it has no apparent meaning.¹⁶³

Whether an advance receipt is characterized as a loan, deposit, or an advance payment under current income tax rules, in all cases, asserts Klein, the recipient receives the right to use the amount received for a period of time prior to any obligation to repay or provide services.¹⁶⁴ Essentially, Klein argues that all advance receipts should be given like treatment, postulating

160. Seago, *supra* note 104, at 150.

161. *Id.* at 148.

162. Hasen, *supra* note 1, at 403 (citing Klein, *supra* note 10, at 1713-23).

163. Klein, *supra* note 10, at 1716.

164. *Id.* at 1721.

three possible solutions: (i) all advance receipts should not be includable in income upon receipt; (ii) all deposits should be includable in income upon receipt, thereby eliminating the tax disparity between them and other advance payments; or (iii) continued inclusion of advance payments in income with accrual of the related expenses. Klein acknowledges that there are pros and cons to each of these approaches with an overshadowing reality that neither Congress nor the IRS will likely tackle a full-scale overhaul of this complex area.¹⁶⁵ Other legal commentators agree fundamentally with Klein's preliminary conclusion that there is no fundamental basis for treating various types of advance receipts differently, but propose alternative solutions, which are beyond the scope of this article.¹⁶⁶

In addition to perpetuating the loan versus other advance payment distinction, *Indianapolis Power* can also be criticized on the basis that the Supreme Court may have misapplied its own-stated distinction by inaccurately viewing the deposits received by IPL as loans rather than advance payments for future utility services. The Tax Court's record in *Indianapolis Power* reveals that over the four-year period at issue, approximately 62 percent of the time, on average, IPL's customers applied their deposits as credits against future utility bills.¹⁶⁷ This fact alone seems to belie IPL's assertion, and the Supreme Court's conclusion, that IPL lacked sufficient control over when, if ever, the deposit would be "its to keep."¹⁶⁸ If approximately 62 percent of the time customers applied their deposits as credits against their bill rather than requesting a refund, a good argument can be made that these deposits were not akin to loans, but rather constituted "advance payments for electricity to be supplied."¹⁶⁹ If that assertion is viable, the Supreme Court should have focused more of its determination on when the advance payments were income in accordance with its trifecta of decisions in *Auto Club*, *AAA*, and *Schlude*, rather than on whether IPL retained sufficient dominion or control over the deposits so as to treat them as nontaxable loans upon receipt. In that trifecta, the Court declined to permit deferral of the advance payments under the matching principle due to an indeterminate showing of future expenses.¹⁷⁰ However, based on the 62 percent average of crediting the deposits against future utility bills, IPL might have countervailed the trifecta by arguing that there was a sufficiently definite showing of associated future expenses that would permit it to defer recognition of such advance payments until the occurrence of a credit or refund, citing to *Artnell* as persuasive authority. Under either characterization (loan or advance payment), the result to IPL is virtually identical — no income recognition until a customer credit or refund — but the analysis in reaching that conclusion would have been entirely different. Once again, this illustrates that the legal distinction and corresponding tax treatment imposed on deposits versus other advance receipts, such as prepayments for services, is both confusing and overly fact sensitive likely resulting in disparate tax treatment to similarly situated taxpayers.

Because *Indianapolis Power* was decided on the deposit side of the distinction, the *Karns* court was clearly bound by its precedent. But, because the Third Circuit limited its decision and discussion as to whether the cash advance received by *Karns* constituted a loan, it missed an opportunity to further clarify the disparate tax treatment of other advance payments.

165. *Id.* at 1731-33.

166. See Hasen, *supra* note 1, at 403 (citing and discussing Geier, *supra* note 10, at 133; and Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should Be Eliminated*, 26 VA. TAX REV. 245, 256-65 (2007)).

167. *Indianapolis Power & Light Co. v. Comm'r*, 88 T.C. 964, 970 (1987).

168. *Indianapolis Power*, 493 U.S. at 212.

169. See *supra* note 41 and accompanying text.

170. See *supra* note 83 and accompanying text.

In particular, it might have seized the opportunity to expand the deferral potential created by the Seventh Circuit in *Artnell*. Could the future purchases requirement under Karns' supply agreement constitute a sufficiently definite showing of associated future expenses so as to permit deferral in whole or in part under *Artnell*? In other words, could Karns have deferred recognition of a portion of the cash advance on a pro rata basis as future purchases were made under the supply agreement? As in *Artnell*, an argument could be made that such treatment clearly reflects income under the deferral and matching principles inherent in the accrual method.

In the end, *Karns*' legacy may be simple, yet pertinent — it ended a line of cases like *Westpac* and *Erickson Post* that successfully challenged the IRS's long-held position that advance payments and advance trade discounts are includable in income upon receipt.¹⁷¹ Even though it perpetuated the complex distinction between loan-like deposits and other advance payments, *Karns* nevertheless applied legal precedent appropriately and, through Judge Ambro's concurrence, reaffirmed the importance of timing considerations in income tax accounting. Although challenging the Supreme Court's trifecta on facts arguably similar to *Artnell* may constitute a viable academic exercise, the ultimate responsibility to clarify or reduce the complexity of the income tax treatment with respect to advance receipts lies practically with Congress and the IRS, not the judicial system.

171. Seago, *supra* note 104, at 144.

**CLAIMS TRADING AND THE AUTOMATIC STAY:
REVISITING *IN RE PRUDENTIAL LINES*
AND THE IMPLICATIONS FOR CURRENT PRACTICE**

Max Barker*

INTRODUCTION

The growing trend of debtors seeking first day orders pursuant to sections 105(a) and 362(a)(3) restricting trading in claims has added yet another motion to present to the bankruptcy judge on the first day of a new case. In support of these motions, debtors argue that claims trading among creditors during bankruptcy violates the automatic stay and threatens their ability to preserve net operating loss (“NOL”) tax attributes. In response, creditors acknowledge that claims trading puts the NOLs at risk, but argue that the automatic stay provision of the Bankruptcy Code¹ cannot be interpreted to restrict their ability to freely trade their claims against the debtor. Appellate courts have yet to step fully into the fray, but when they have considered the bankruptcy court’s power to limit claims trading, the disagreement among judges has been sharp. The issue remains a point of vigorous disagreement in chapter 11 reorganizations.²

Because the ability of a bankruptcy court to restrict claims trading remains an unsettled question that arises routinely, this paper examines the intersection of tax and bankruptcy law that creates the conflict. Part I provides an overview of the relevant bankruptcy and tax code provisions. Part II considers several questions animating the debate over whether the automatic stay should be interpreted to prevent claims trading by creditors by analyzing different possible frameworks for deciding what actions constitute exercising control over property of the estate. Part III discusses the implications of judicial decisions restricting claims trading and compares the operation of the automatic stay as a mechanism for restricting claims trading to injunctive relief as a separate source for the same relief.

I. BACKGROUND LAW

Two statutory schemes are implicated by a debtor’s request to restrict trading in claims against the estate in order to preserve the value of the debtor’s NOL carryforwards: the Internal Revenue Code and the Bankruptcy Code.

A. Internal Revenue Code Provisions Relating To NOLs

The Internal Revenue Code (“IRC”)³ generally allows taxpayers to use operating losses to offset prior or future taxable income, which reduces the taxpayer’s bill. A corporation with a net loss during a taxable year may carry back the

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1. 11 U.S.C. §§ 101 *et seq.*

2. The Bond Market Association and Loan Syndications and Trading Association have attempted to reshape the debate by promulgating a Model NOL Order that seeks to achieve balance between debtor and creditor interests. The order is available at <<http://www.abiworld.org/pdfs/lsta.swf>> (last visited May 11, 2009). A critique of the BMA-LSTA’s Model NOL Order is beyond the scope of this article. It is enough to say that the order creates an environment of uncertainty that only a lawyer could appreciate.

3. 26 U.S.C. §§ 1 *et seq.*

NOL to each of the two prior taxable years, entitling the corporation to a current refund.⁴ If the corporation still has unused NOLs after offsetting all taxable income during the prior two taxable years, or if the corporation elects, it may carry the NOL forward to offset taxable income during the next twenty years. The use of the NOL in this situation is referred to as an NOL carryforward or carryover.⁵ A corporation's ability to use prior losses to offset future taxable income can be impaired when the corporation undergoes a sizeable change in equity ownership, although the IRC provides some special rules for corporations that issue equity in exchange for canceling debt obligations in a court approved bankruptcy reorganization.

1. IRC Section 382

IRC section 382 limits the use of net operating losses to offset taxable income after a change in corporate ownership.⁶ A change in corporate ownership occurs when a shareholder or coordinated group of shareholders increase their stake in the corporation by more than fifty percentage points.⁷ After the ownership change occurs, the corporation can only deduct a portion of its NOL carryforwards annually.⁸ Thus, although section 382 does not prohibit a corporation from utilizing its NOLs after an ownership change, it may significantly limit the use of NOLs to offset future income.

Section 382 is intended to prevent companies from trafficking in tax attributes. Absent section 382, operating losses could be claimed on an acquirer's tax return, a transaction that, in essence, would permit the acquirer to purchase a reduction of its tax bill from the owners of the acquired corporation.

2. The (L)(5) Exception

In a plain-vanilla bankruptcy reorganization, the equity and debt of the old corporation is canceled and the debt holders receive equity interests. Such reorganizations would seem to trigger section 382's ownership change provision, but Congress provided a bankruptcy exception—found in section 382(l)(5) (the “(L)(5) Exception”)—allowing a corporate debtor to use its NOLs without being subject to the annual limitation as long as the reorganization meets several requirements.

4. The use of the NOL in this situation is referred to as an NOL carryback. *See* 26 U.S.C. § 172.

5. This article examines chapter 11 debtors' uses of NOL carryforwards, and refers to “NOLs” and “NOL carryforwards” interchangeably.

6. 26 U.S.C. § 382(a)-(b).

7. 26 U.S.C. § 382(g). For example, an ownership change for §382 purposes would occur if a shareholder who owns 7.5% of the outstanding shares of a corporation were to purchase additional shares increasing the shareholder's ownership stake to 57.6%.

8. 26 U.S.C. § 382(b). The amount of NOL carryforwards available to offset a corporation's taxable income is equal to the value of the corporation prior to the ownership change multiplied by a “long-term tax-exempt rate” determined monthly by the IRS. In April 2009, the long-term tax exempt rate was 4.61%. Rev. Rul. 2009-12 Table 3, available at <<http://www.irs.gov/pub/irs-drop/rr-09-12.pdf>> (last visited May 7, 2009). The value of the corporation is the value of the equity of the corporation immediately prior to the ownership change. 26 U.S.C. § 382(e). Thus, if an ownership change occurred in a corporation on April 15, 2010, and the equity of the corporation had a value of \$100 million immediately prior to the ownership change, then the corporation would be able to offset up to \$4.61 million in income on its 2009 tax return.

The first requirement is that the debtor actually file for bankruptcy. Informal workouts do not qualify for the exception, even if the debtor was insolvent. The reorganization must occur in a chapter 11 (or similar) proceeding and must have resulted in a confirmed plan of reorganization.⁹ Second, at least fifty percent of the equity of the reorganized firm must be owned by the debtor's former shareholders and creditors, as long as those creditors held "qualified indebtedness" of the debtor.¹⁰ Qualified indebtedness is limited to (i) debt that has been continuously held by the same beneficial owner for the 18 months prior to the bankruptcy reorganization or (ii) debts that arose in the ordinary course of the debtor's business and have been held by the same beneficial owner. Treasury regulations allow a reorganized debtor to treat any creditor who receives less than five percent of the reorganized firm's equity as having held qualified indebtedness for the (L)(5) test.¹¹ Third, the debtor must reduce its NOL carryforwards by the amount of deductible interest paid or accrued on debt converted to equity through the reorganization during the three taxable years prior to the reorganization as well as any interest paid or accrued during the taxable year in which the reorganization takes place.¹² This is commonly referred to as the "bankruptcy toll charge." Finally, there must be no section 382 ownership change within two years after the reorganization.¹³ If such a change occurs, the NOLs will be forfeited.

3. The (L)(6) Special Valuation Rule

If the reorganized firm fails to qualify for the (L)(5) Exception, the firm's ability to use its NOLs will be limited, but not destroyed. Section 382(l)(6) allows the firm to use a special valuation rule (the "(L)(6) Special Valuation Rule") to determine the amount of NOLs the firm may use annually. Under normal circumstances, the annual NOL offset a firm may use after an ownership change occurs is determined by the value of the firm's equity immediately *prior* to the ownership change multiplied by the long-term tax-exempt rate. By comparison, the (L)(6) Special Valuation Rule computes the annual NOL offset available to the reorganized firm by multiplying the value of the firm's equity *after* the reorganization by the applicable long-term tax-exempt rate. This generally yields a higher amount, because the equity value of a firm after reorganization is greater than the equity value of a firm in financial distress. This rule also benefits the debtor because it does not apply the (L)(5) "toll charge" to reduce the debtor's NOLs.

4. Section 382(g)(4)(D) Worthless Stock Deduction Rule

When a debtor's majority stockholder treats its stock as worthless, for example, by taking a section 165(g) deduction for worthless securities, section 382(g)(4)(D) treats the majority stockholder as "having acquired such stock on the 1st day of his 1st succeeding taxable year", and as "not . . . having owned such stock during any prior period."¹⁴ This construc-

9. 26 U.S.C. § 382(l)(5)(A)(i).

10. 26 U.S.C. § 382(l)(5)(A)(ii).

11. Orders restricting claims trading generally aim to take advantage of this regulation by prohibiting creditors and other investors from acquiring claims that would lead to the receipt by the creditor or investor of 5% or more of the reorganized firm's equity.

12. 26 U.S.C. § 382(l)(5)(B).

13. 26 U.S.C. § 382(l)(5)(D).

14. 26 U.S.C. § 382(g)(4)(D).

tive ownership change triggers the section 382 limitation.¹⁵ Further, because the shares of the debtor firm are considered worthless, the section 382 limitation could completely bar the debtor from using its NOLs to offset future income.¹⁶

B. Bankruptcy Code Provisions Relating To NOLs

Two issues arising in the context of claims trading restrictions in bankruptcy are (i) whether NOLs should be considered property of the estate and (ii) whether the automatic stay applies to claims trading. This section will briefly review the statutory provisions relevant to these issues.

1. Section 541 Property Of The Estate

The filing of a bankruptcy petition creates an estate that is comprised of “all legal or equitable interests of the debtor in property as of the commencement of the case.”¹⁷ This provision is broadly construed and includes interests that are contingent or of uncertain value as of the commencement of the bankruptcy case¹⁸ as well as intangible interests.

The Supreme Court of the United States held in *Segal v. Rochelle* that an individual debtor’s NOL carryback resulting in a tax refund to the debtor was property of the individual debtor’s estate.¹⁹ The Court expressed concern that including an NOL carryforward in the property of individual debtor’s estate would be inapposite to the Bankruptcy Code’s fresh start policy, but it did not decide the issue.²⁰

2. Section 362 Automatic Stay

When individual creditors race to foreclose on a debtor’s limited assets, they threaten to destroy any going concern value created by the firm. To prevent this destructive race, the Bankruptcy Code imposes an automatic stay on certain actions against parties that have petitioned for bankruptcy relief.²¹ The automatic stay prevents creditors from foreclosing on the debtor’s assets, stops other parties from commencing or continuing lawsuits against the debtor, and prohibits other actions that could be detrimental to the debtor’s value as a going concern. The automatic stay also applies

15. Curiously, § 382(g)(4)(D) only applies when the majority stockholder who treated the stock as worthless still holds the stock as of the close of the majority stockholder’s taxable year. This section is intended to prevent taxpayers from taking a “double deduction” for the same economic loss. The double deduction would occur because the majority stockholder would be entitled to a worthless securities deduction under 26 U.S.C. § 165(g) and the debtor firm would be entitled to offset its income by its NOLs.

16. The IRS will likely argue that the shares are worthless given the majority shareholder’s treatment of the stock as such. The § 382(b) limitation is calculated by multiplying the equity of the debtor corporation—in cases of worthless stock, the equity value is 0—by the long-term tax-exempt rate, preventing the debtor from using any amount of its NOLs.

17. 11 U.S.C. § 541(a)(1).

18. A good example is a chose in action. The debtor’s ability to bring a lawsuit is property of the estate despite the uncertain value of the interest. The debtor’s interest is not contingent (it can bring the lawsuit now if it desires), but the value of the interest is contingent upon the debtor’s success in court and upon the damages awarded.

19. 382 U.S. 375, 380 (1966).

20. *Id.* at 381.

21. 11 U.S.C. § 362.

to “any act to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate.”²²

Accordingly, if NOLs are considered property of the estate under section 541, then the automatic stay prevents any party from engaging in “any act to obtain possession” of these NOLs or any act “to exercise control over” the NOLs, providing a justification for orders preventing claims trading.

C. Case Law Treatment of NOLs in Bankruptcy

Appellate court decisions examining the treatment and status of NOLs in chapter 11 reorganizations are scarce. Two cases, a 1990’s era case from the United States Court of Appeals for Second Circuit and a case of relatively recent vintage from the United States Court of Appeals for the Seventh Circuit, have become the seminal cases for parties litigating restrictions on claims trading—which is occurring more and more often in bankruptcy courts—and provide opposing views of the issue.

1. Prudential Lines

The Second Circuit’s seminal case treating NOLs as property of the estate subject to the automatic stay is *In re Prudential Lines, Inc.*²³ Prudential Lines, Inc. (“PLI”) was the wholly-owned subsidiary of PSS Steamship Company, Inc. (“PSS”). The two companies filed a consolidated tax return and were jointly managed by the Skouras family. PLI became the subject of an involuntary petition for reorganization, and the Skourases, as managers of PLI, presented a plan to creditors allowing the Skouras family to retain control of PLI and leaving the reorganized company a \$74 million NOL carryforward available to offset future income.²⁴ The plan did not garner creditor support. The creditor’s committee formulated its own plan to cancel the Skouras family’s PLI stock and remove the Skouras family from PLI management, yet to retain the availability of PLI’s NOL to offset future income.²⁵ PLI’s parent company, PSS, also controlled by the Skouras family, rejected the creditor’s plan and announced its intention to take a worthless stock deduction on its PLI stock. At the same time, PLI management (again the Skouras family) met with PLI’s largest unsecured creditor and urged it to support PLI’s plan, telling the creditor that the NOL carryforward would be preserved under PLI’s plan but would be uncertain under the creditor’s committee’s plan.²⁶ The Skourases and creditors attempted to negotiate an acceptable resolution to the battle of the plans. After negotiations failed, the creditor’s committee asked the bankruptcy court to enjoin PSS from taking a worthless stock deduction on its PLI stock.²⁷ The bankruptcy court granted the injunction, holding (i) that the NOL constituted property of PLI’s estate and (ii) that PSS’s worthless stock deduction would violate the automatic stay as an attempt to exercise control over PLI’s property.²⁸ The district court affirmed the bankruptcy court’s decision.²⁹

22. 11 U.S.C. § 362(a)(3).

23. 928 F.2d 565 (2d Cir. 1991).

24. *Id.* at 567.

25. *Id.*

26. *Id.*

27. *Id.*

28. *In re Prudential Lines, Inc.*, 114 B.R. 27 (Bankr. S.D.N.Y. 1989).

29. *In re Prudential Lines, Inc.*, 119 B.R. 430 (S.D.N.Y. 1990).

The court of appeals agreed with the lower courts' decisions and ruled unanimously that PLI's NOLs constituted property of the estate under section 541, noting Congress's intent that the term be interpreted broadly.³⁰ The court then determined that the injunction was proper, reasoning that PSS's worthless stock deduction would effectively eliminate PLI's NOL carryforwards, that "PSS's interest in its worthless stock deduction [was] intertwined with PLI's NOL," and that taking the worthless stock deduction would be an attempt to exercise control over property of the estate in violation of the automatic stay.³¹ In other words, "where a non-debtor's action with respect to an interest that is intertwined with that of a bankrupt debtor would have the legal effect of diminishing or eliminating property of the bankrupt estate, such action is barred by the automatic stay."³²

2. *United Airlines*

When United Airlines ("United") declared bankruptcy in December 2002, more than half of its stock was held by its Employee Stock Ownership Program (ESOP).³³ United feared that the ESOP would sell its stock, triggering a section 382 ownership change that would limit its ability to use its NOLs to offset future income. Accordingly, United sought and obtained a first day order prohibiting the ESOP from selling its stock. A final injunction was issued two months later. The bankruptcy court did not require United to post a bond to protect the ESOP against loss or direct United otherwise to provide "adequate protection" of the ESOP's interests under section 362(d)(1).³⁴ The ESOP's trustee appealed the injunction, but it did not ask the district court to require a bond or adequate protection.³⁵ While the appeal was pending, United terminated the ESOP, which distributed the shares to United's employees. The decision to terminate was made after the Internal Revenue Service ("IRS") issued a regulation permitting ESOPs to distribute shares to employees without triggering an ownership change that would jeopardize the corporation's ability to use its NOLs. Thus, United asked the district court to dismiss the appeal as moot.³⁶ The district court, however, continued with the appeal and affirmed the bankruptcy court's ruling on the merits. The trustee filed an appeal in the Seventh Circuit.

In the court of appeals, Judge Easterbrook vacated the district court's judgment and remanded the case to the bankruptcy court, with instructions to dismiss the appeal as moot to the extent that it blocked a sale of shares by the defunct ESOP or any of the investors who obtained stock via the ESOP.³⁷

In dicta, the court chastised the bankruptcy judge for not having required adequate protection or an injunction bond, noting that United workers were left bearing illiquid securities and uncompensated risk because the injunction

30. 928 F.2d at 569-73.

31. *Id.* at 574.

32. *Id.*

33. *In re UAL Corp.*, 412 F.3d 775, 777 (7th Cir. 2005).

34. *Id.*

35. *Id.*

36. United's stock price decreased from \$1.06 on the day of the bankruptcy court's order to \$0.76 at the time the ESOP was dissolved. *See* 412 F.3d at 777.

37. *Id.* at 780.

required their holdings to be undiversified.³⁸ The court conceded that a stock sale could have affected United's interest in its NOL carryforwards, but added that "this would not occur because of anything the ESOP possessed or controlled."³⁹ The court distinguished *Prudential Lines* on this basis, noting that in the *Prudential Lines* case, the corporate parent's tax benefit "would have come in lieu of the corporate family's accumulated operating losses," and "taking the deduction would have exercised control over the debtor's operating losses."⁴⁰ In other words, apportioning the benefit was a zero-sum game. The deduction could have benefitted the debtor or its parent, but the parent controlled the choice and was entitled to capture the tax benefit for its own use by taking a worthless stock deduction.

The court remarked that in United's case "there [was] no equivalent example of control (or consumption) of a loss carry-forward in an investor's simple sale of stock."⁴¹ Judge Easterbrook concluded that section 105(a) and section 362(a)(3) did not justify an injunction absent a bond or other adequate protection.⁴²

II. DISCUSSION

Orders restricting claims trading in bankruptcy, like the orders at issue in *Prudential Lines* and *United Airlines*, raise a number of questions at the intersection of tax and bankruptcy law. This section will explore those fundamental questions before considering the implications.

A. Are NOL Carryforwards Property Of The Estate?

Although the question of whether NOL carryforwards are property of the estate was once the subject of vigorous debate,⁴³ creditors now generally accept the proposition without controversy.⁴⁴ NOL carryforwards are current, intangible interests. The right to use an NOL carryforward is not contingent upon the occurrence of any event, although the debtor's right may be limited in the event of an ownership change or worthless stock deduction. The tax savings available because of the NOL carryforward is contingent upon the debtor's ability to generate future income. The future tax savings are uncertain, and they depend upon the amount of future taxable income generated, the tax character of that income, and the tax rates applicable to that income.

These qualities make a debtor's NOL carryforwards similar to a debtor's chose in action, which is property of the estate. The chose in action is a current right possessed by the debtor, notwithstanding that its value is contingent upon the debtor's success in court and is uncertain, because the debtor does not know in advance the amount of the judgment that may be awarded. A modern bankruptcy judge comfortable with uncertain valuations of current property interests should have little problem finding a debtor's NOL carryforward to constitute property of the estate, especially if creditors do not contest the issue.

38. 412 F.3d at 777-78.

39. *Id.* at 778.

40. *Id.* at 779.

41. *Id.*

42. *Id.*

43. See, e.g., *In re Prudential Lines*, 928 F.2d at 569-73.

44. See, e.g., Objection of Wells Fargo Foothill, LLC, dated Mar. 31, 2009, ¶ 16, *In re Foothills Texas, Inc.*, No. 09-10452 (Bankr. D. Del. 2009).

But what does it mean to say that the NOL is estate property pursuant to section 541? Nothing in the canon of non-bankruptcy law prevents parties from taking actions that could destroy NOL value, and neither shareholders nor creditors have fiduciary duties to preserve a corporation's NOL value. Accordingly, we must ask what code provision or policy justifies expanding the debtor's interest in its NOL carryforwards within bankruptcy.⁴⁵ Many people argue that one purpose of bankruptcy is to ease a debtor's burden, but it is difficult to see the relevance of this argument. Restrictions on claims trading operate on the assumption that after the reorganization, the creditors will own at least fifty percent of the reorganized firm's equity. Given that creditors will own the firm upon reorganization in any event, restricting creditors' ability to trade claims on the front end in order to benefit them on the back end is an odd manner in which to preserve the creditors' interests. Nevertheless, this is par for the course in bankruptcy. One purpose of the automatic stay is to provide breathing room to the debtor to prevent a "tragedy of the commons" situation. Arguing that debtors' rights are not necessarily expanded based upon the filing of a bankruptcy petition might beg the question: If claims trading constitutes exercising control over property of the estate, then it violates the automatic stay, which authorizes departure from the non-bankruptcy baseline.⁴⁶ The key issue is whether claims trading constitutes "exercising control" as prohibited by section 362(a)(3).

But this is not the only way to think about the extent of a debtor's right to use NOLs to offset future income. We could differentiate between property rights that contain inherent limitations and property rights that continue until a superior right is asserted. For instance, if a debtor acquires equipment that it later pledges to secure a loan, the debtor's property right can be extinguished by the creditor's right to foreclose on the equipment in the event of a default. The security interest acts as a limitation on the debtor's interest in the equipment, but only because the creditor's adverse interest is superior to the debtor's interest. If the debtor were to file for chapter 11 relief, the automatic stay would prevent the creditor from foreclosing on the collateral. The creditor would have to petition the bankruptcy court to lift the stay and allow the creditor to seize the equipment.

Contrast the debtor's interest in the equipment with the debtor's interest in a leased warehouse. In the latter case, the right that the debtor acquires is limited. The debtor's interest in the leased warehouse ends upon expiration of the lease, and the automatic stay provides no holdover rights if the debtor refuses to vacate the premises at the end of the lease. Similarly, a debtor's insurer could not cancel an insurance policy upon the debtor's bankruptcy filing, but the automatic stay does not give the debtor the ability to force the insurer to renew the policy after it expires. These interests have inherent limitations that define the extent of the property interest conveyed to the debtor.

Is the debtor's interest in NOL carryforwards more similar to its interest in equipment subject to a security interest or its interest in a leased warehouse or an insurance contract? Because the IRC permits the unrestricted use of NOL carryforwards to offset future income until an ownership change occurs, we could view the NOL interest as having a natural expiration date akin to the leased warehouse and insurance contract, namely, the date of an ownership change. As with the lease and insurance contract, the debtor knows that the day an ownership change occurs is its day of reckoning – the day when its ability to realize fully its NOL benefits will be impaired in accordance with the terms set forth in the IRC.

Accepting this view requires accepting that the actions of other parties will determine the debtor's NOL rights. In other words, the debtor's ability to use its NOL carryforwards can be impaired by the actions of other parties, as is

45. *Butner v. U.S.*, 440 U.S. 48 (1979).

46. However, determining that § 382 cannot restrict a debtor's ability to use its NOL carryforwards would violate the *Butner* principle that, unless otherwise expressly provided in the Bankruptcy Code, property rights in bankruptcy are defined by non-bankruptcy law. *See id.* at 55.

the case where a secured creditor seizes pledged equipment. We might respond, however, that the debtor's NOL interest is impaired not because a creditor asserts a priming interest in the NOL, but because of the natural limitation built into the NOL right. But section 362(a)(3) reaches "any act . . . to exercise control over property of the estate," and the natural limitation of NOL rights could be triggered by creditor actions.

B. What Does It Mean To Exercise Control Over An NOL?

If the debtor's NOLs are not property of the estate, then the automatic stay does not apply to claims trading in bankruptcy. But this debate is over; NOL carryforwards are likely (and appropriately) to be viewed as property of the estate. Thus, we must next consider what actions would constitute an attempt to obtain possession or exercise control over the NOL.

1. Differing Views Of Control

We can imagine two different views of "control" over a debtor's property rights: (i) any action affecting the value of a property right constitutes control, or (ii) only actions that affect the existence of the right itself constitute control.

Debtors seeking restrictions on claims trading may advocate that actions affecting the value of the property right constitute control. This argument proves too much. If this were accepted as the governing principle, the automatic stay would reach actions by a party that reduce the value of the debtor's estate. Consider again the chose in action. If the debtor were to bring a lawsuit against the counterparty, the counterparty could respond by asserting a legal defense. The value of the debtor's claim is uncertain and depends upon the likelihood that the debtor will succeed in court. But it would be absurd to argue that the counterparty violates the automatic stay by defending itself against the claim, although its defense arguably decreases the debtor's likelihood of success and, therefore, decreases the value of the chose in action. Surely asserting a legal defense would not be considered an action to exercise control over the property of the estate.⁴⁷

The alternative view, limiting the definition of control to acts that effectively eliminate the existence of the right itself, may be more consistent with the *Prudential Lines* decision. There, the managers of the debtor and the debtor's corporate parent threatened to take an action that would have completely eliminated the value of the debtor's NOL carryforwards.⁴⁸ This view of control is more consistent with the traditional understanding of the word, especially given that section 362(a)(3) contemplates actions "to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."

"Obtain possession" indicates taking the whole of the property. If we were to interpret the term "exercise control" in light of the term "obtain possession," then we might define "control" as an instance where another party prevents the

47. An opponent of this example may object that defending against a lawsuit brought by the debtor merely reduces the *expected* value of the chose in action. But when dealing with property of uncertain value, expected value is the best one can do without reliable methods for peering into the future (which itself could turn the operation of a bankruptcy proceeding on its head). In fact, the value of the debtor's NOL carryforward is itself an expected value, which must account for the likelihood of future profit, the distribution of future profit and loss, and the possibility that an ownership change will occur in the future.

48. Of course, this result only follows if the parent corporation still holds stock at the end of the parent's taxable year under a literal reading of 11 U.S.C. § 382(g)(4)(D). It appears that the parent corporation's equity interest would have been eliminated in the creditor's plan, and if the plan were confirmed before the end of the parent's taxable year, the parent would not have held any stock in PLL, potentially rendering § 382(g)(4)(D) inapplicable. As interesting as this line of thinking is, it is a difficult tax question best left for another author.

debtor from benefiting from a property interest at all. The drafters of section 362(a)(3) could easily have used the phrase “impair the value of property of the estate,” but they chose to limit the stay to actions to “obtain possession” or “exercise control.” Of the two views of control, this interpretation is superior because it avoids the absurdity created by an automatic stay that prevents any party from doing anything that might impair the value of the debtor’s property.

2. Considering Individual And Aggregate Claims

In defining what it means to “exercise control” over property, we could make a distinction between trades or traders that could threaten the NOL benefit by themselves and those that could not. In other words, “control” could become a proxy for “autonomy”, which, in turn, would preclude claims trading only where it involves large claimholders that could independently threaten the debtor’s NOLs.⁴⁹

But if the automatic stay applies to claims trading, should it not apply to all parties, regardless of the size of their interests?⁵⁰ Not necessarily, as the relevant provision refers to actions “to exercise control over property of the estate.” Accordingly, by limiting the concept of control, we limit the applicability of the automatic stay to parties capable of exercising such control. One problem here is that the automatic stay would not be “automatic”—the bankruptcy court would have to define who is a “large” claimholder and what constitutes a “large” claim sufficient to satisfy the meaning of control. Admittedly, this might be a simple process, but requiring a first day order to define the scope of the automatic stay may make some judges and practitioners uncomfortable. Declining to define control in terms of large trades or large claimholders avoids these issues, for better or worse.

3. Is It Impossible For Claims Trading To Violate The Automatic Stay?

Technically, trading in equity sufficient to constitute an ownership change triggers a section 382 NOL limitation, but trading debt does not. It is the subsequent exchange of debt for equity pursuant to a plan of reorganization that triggers the section 382 limitation, and claims trading merely eliminates the possibility of qualifying for the (L)(5) Exemption. It may be more accurate to think of claims trading as limiting the reorganization options available for the managers of the debtor rather than as impairing the value of the debtor’s NOLs.⁵¹

This understanding would imply that claims trading does not violate the automatic stay unless actions limiting the debtor’s ability to propose a plan of reorganization constitutes an act of control over property of the estate. Here, the only way to justify the stay would be to conclude that the debtor’s exclusive ability to propose a plan of reorganization

49. This author uses the term “controlling shareholders” to refer to shareholders who hold enough stock to independently dictate the management of a company. The relationship between the parent and the wholly-owned subsidiary in *Prudential Lines* fits this model of control. One normally does not consider minority shareholders to exercise control when they vote their shares independently. Although minority shareholders can influence the outcome of a shareholder election if enough of them vote similarly, absent coordination, the law does not consider such shareholders to “control” the corporation.

50. In fact, it is difficult to classify many orders restricting claims trading as orders enforcing the automatic stay. To the extent that the orders allow for some trades to be completed, the orders may be thought of as partially lifting the automatic stay. The BMA-LSTA Model NOL Order adopts a “sell down” approach, requiring claims traders to unwind certain trades if and when the debtor proposes a plan of reorganization relying upon the bankruptcy exception to the NOL limitation rule. This approach tentatively and partially lifts the automatic stay to allow trades that would otherwise have been prohibited by the stay.

51. That is, the debtor is unable to propose a plan that contemplates the unrestricted ability of the reorganized debtor to use NOL carryforwards to offset future income.

pursuant to section 1121(b) is itself a property right of the debtor and that claims trading would deprive the debtor of this right. Thus, we must examine whether the section 1121(b) right constitutes “property of the estate” as defined by section 541.⁵²

By its nature, the section 1121(b) right is one conferred by statute and held by the debtor upon the filing of a chapter 11 case. Thus, it may be appropriate to consider the section 1121(b) right as property of the estate. But even assuming that the right constitutes property of the estate, the relevant question is whether an act that limits the debtor’s options when proposing a plan would constitute exercising control over the section 1121(b) right for purposes of section 362(a)(3). Federal Rule of Bankruptcy Procedure 3001 suggests that it would not.

Given that Rule 3001(e) contemplates a limited role for judicial involvement in claims transfers, it would be odd if the drafters of the Rule considered claims trading to be a violation of the automatic stay. Rule 3001(e) was last amended on April 30, 1991, just over one month after *Prudential Lines* was decided. It is thus very likely that the drafters of the amended Rule failed to consider the reasoning in that case. It would be premature to reject restrictions on claims trading by arguing that such restrictions are incompatible with Rule 3001(e). Such an argument on its own would be insufficient to support that conclusion. But the existence of Rule 3001(e), and the fact that it has not been amended to allow for greater judicial involvement in claims trading, does lend some support to the argument that claims trading should not be considered a violation of the automatic stay.

Although the preceding analysis does not present any clear answer, it would appear that, on the whole, claims trading should not be considered an activity that rises to the level of exercising control over the debtor’s NOL carryforwards, and the automatic stay should not inhibit creditors’ ability to trade claims in bankruptcy.

C. Is It Possible To Reconcile *Prudential Lines* With The View That The Automatic Stay Does Not Apply To Claims Trading?

Creditors and judges who are satisfied that claims trading does not violate the automatic stay should consider whether that conclusion is reconcilable with the Second Circuit’s *Prudential Lines* decision, which governs all cases in the Second Circuit, including those in the Southern District of New York, one of the nation’s busiest bankruptcy venues.

1. Limiting *Prudential Lines* To Its Facts

Prudential Lines does rest on a unique set of facts giving rise to a unique problem. The subsidiary was wholly-owned by the parent. Both the parent and subsidiary were managed and controlled by one family. The parent threatened to take a worthless stock deduction in the context of competing battle plans between management and the creditor’s committee, with the relevant IRC provision, section 382(g)(4)(D), used as a weapon in that battle. The tax benefit was a binary option that would either allow the parent to use the worthless stock deduction to decrease its tax bill or allow the debtor subsidiary to use the NOL to offset future income. Thus, *Prudential Lines* could be limited to its facts. But analyzing the case with an eye upon the interplay among insiders, creditors, and leverage in the reorganization process may reveal a better reason for limiting the reach of *Prudential Lines*.

52. The Supreme Court has stated that the § 1121(b) exclusivity rule is not property for purposes of § 1129(b)(2)(B)(ii). *See Bank of Am. Nat’l Trust and Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 454 (1999).

2. Creditor Protection Against Insiders

Prudential Lines can be viewed as a case where the court was driven by concerns about creditor protection in the face of insider-shareholders seeking to retain control after the reorganization. In *Prudential Lines*, the insider-shareholders' threat to take the worthless stock deduction appeared to be an attempt to pressure creditors into accepting management's plan, which would have allowed the controlling family to retain control of the debtor corporation. Allowing the corporate parent to take the worthless stock deduction would have increased management's negotiating leverage and helped management retain control of the corporation after driving it into bankruptcy. Modern cases authorizing restrictions on claims trading do not operate for the protection of the creditors, but, rather, permit management to retain control of the reorganization process. Specifically, claims trading prevents outside investors and large claimholders from increasing their leverage in the reorganization process vis-à-vis management by "voting with their feet" or by meaningfully increasing their participation within a class of claims by increasing their holdings. This outcome is in direct conflict with the result in *Prudential Lines*, where the court prevented management from using the NOL as a trading chip in reorganization negotiations.

If we read the underlying theme in *Prudential Lines* as one of viewing insiders' actions with skepticism and suspicion, the case becomes consistent with other aspects of bankruptcy law. For example, the policy debate and case law developments that ultimately led courts to adopt the absolute priority rule over relative priority was driven by the mistrust of managers who drove their firms into bankruptcy.⁵³ In addition, the Bankruptcy Code itself treats insiders with suspicion, providing lesser protections for employee bonuses and transfers to insiders.⁵⁴ Regardless of whether the automatic stay was the best tool for the Second Circuit to use to protect creditors, courts could certainly read *Prudential Lines* as an equity-based decision, designed to prevent insiders from using coercive tactics in the reorganization process and not as justification for restricting claims trading.

III. IMPLICATIONS

The decision whether to restrict claims trading or to allow for the free transfer of claims against debtors has broad implications for the entire field of corporate reorganizations and distressed debt investors.

A. Preserving Asset Value

We might ask whether claims trading is the kind of destructive race to the debtor's assets that the automatic stay seeks to prevent. The threat to NOL value posed by the collective action problem is at least similar to such a race. Prohibiting claims trading may preserve the size of the pie available to creditors to distribute in the reorganization plan, but it is certainly different from foreclosing on collateral. Collateral provides immediately ascertainable value to the estate, whereas NOLs carry value that is both uncertain and contingent. Additionally, we may presume that collateral has synergy value in the hands of the debtor. Although NOLs do not have synergistic value in the traditional sense—that is, NOL value is not dependent upon the debtor firm possessing a unique collection of assets and skills—NOL carryforwards do have going concern value in that they have no value once removed from the debtor corporation.⁵⁵

53. For an excellent discussion of the issue see Douglas G. Baird and Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393 (1999).

54. 11 U.S.C. §§ 547(b)(4)(B), 548(a)(1)(B)(IV).

55. The NOL tax attribute is unique to the taxpayer and is non-transferable.

Liquidity is also an important consideration. When one creditor trades its claim, that trade does not impair the value of the other creditors' claims. Rather, claims trading by one creditor probably increases the value of the other creditors' claims, because claims trading implies that claims are liquid assets. Investors are willing to pay more for liquid assets. Thus, claims trading by one creditor may make it easier for other creditors to also trade their claims. This is not the case where an unsecured creditor levies on certain assets of the debtor corporation; once one creditor has foreclosed on collateral, other creditors are unable to collect against that collateral. In the foreclosure realm, one creditor cannot do what it wants to do without making it harder for other creditors to take the same action. Accordingly, a decision to restrict claims trading represents a decision to put the long-term prospective value of the estate ahead of the ability of the creditors to realize short term gains.

But why force creditors to wait for a recovery that may or may not be increased by the NOL when their recovery can be maximized now? The automatic stay is part of a larger system designed to determine whether the greatest value may be realized by reorganizing or liquidating the debtor firm. One reason this is important is because it maximizes the value available to repay the debtor's many creditors. Restricting claims trading and forcing creditors to participate in the entire bankruptcy seems to be at odds with the purpose of preserving going concern value for the benefit of creditors. In the absence of trading restrictions, creditors can realize the value of their claims immediately by selling the claim to another party or can wait to receive consideration in a court approved reorganization. Restricting claims trading maximizes creditor value at the reorganization stage at the expense of creditor value in the early stages of the bankruptcy process.

B. Injunctive Relief As An Alternative

Even if the automatic stay does not prevent claims trading, however, creditors may face another obstacle. A bankruptcy court could issue an injunction restricting or prohibiting claims trading during the reorganization process.⁵⁶

1. Full Consideration Of The Debtors' Options

There are several factors that a bankruptcy court should consider when assessing a motion to enjoin claims trading. The first is the value of the NOL. Bankruptcy courts should determine whether the debtor has fully considered and properly valued all of the debtors' options. Although debtors' motions and briefs speak of NOL tax benefits as though they were an all or nothing affair, this simply is not the case. And, if the court is going to require debtors to participate in the entire bankruptcy, it should require them to show that they have fully considered the effects and applicability of sections 382(l)(5) and (l)(6) of the IRC. Specifically, if the debtor fails to qualify for the (L)(5) Exception, how much of the NOL tax benefit would it lose under the section 382 limitation computed with the (L)(6) Special Valuation Rule?

In arriving at a valuation of the NOL tax benefits under the (L)(5) Exception and the (L)(6) Special Valuation Rule, debtors should consider the "bankruptcy toll charge",⁵⁷ the present value of future tax benefits, the likelihood and

56. Aside from the procedural differences between the automatic stay and injunctive relief, one difference resulting from requiring injunctive relief may be that the debtor's management may not bother petitioning for injunctive relief restricting claims trading if preliminary relief is not granted early in the bankruptcy proceeding. The debtor will presumably have to expend some non-negligible amount of time and effort in order to properly prepare the necessary showing of harm, and the debtor may rationally decide that the costs outweigh the benefits. Sufficient trading may have occurred by the time the parties have prepared for a hearing to make the issue moot. The numerous issues facing a court considering whether to grant an injunction against claims trading illustrates the substantive and procedural difficulties of the task.

57. Recall that § 382(l)(5)(B) requires the debtor using the (L)(5) Exception to reduce its NOL carryforwards by the amount of deductible interest paid or accrued on debt converted to equity through the reorganization during the three taxable years prior to the reorganization, as well as any interest paid or accrued during the taxable year in which the reorganization takes place. See *supra* note 12 and accompanying text.

timing of future profitability, and the likelihood that an ownership change will occur during the two years subsequent to the reorganization. If the interest toll charge is high, the debtor may be better off not making an (L)(5) election and instead relying on the (L)(6) Special Valuation Rule, which does not reduce the debtor's NOL carryforward.⁵⁸ The debtor's ability to use NOL carryforwards in a given taxable year is limited by section 382 or the amount of taxable income of the reorganized corporation. It may not matter that the debtor fails to qualify for the (L)(5) Exception if future annual profits are not expected to be greater than the amount of the section 382 limitation under the (L)(6) Special Valuation Rule.⁵⁹ Additionally, if there is an ownership change during the two years after a reorganization that qualifies for the (L)(5) Exception, the reorganized debtor will forfeit its ability to carryforward its pre-reorganization NOLs. However, the same ownership change occurring after a reorganization that fails to qualify for the (L)(5) Exception but that uses the (L)(6) Special Valuation Rule will not cause the debtor to lose its ability to use pre-reorganization NOL carryforwards to offset future income.⁶⁰

Although this analysis relies on financial forecasts and the expected outcome of the reorganization, at the very least, it provides a check on the increasingly routine impulse to restrict claims trading, and the analysis may reveal that the effect is not always as drastic as the debtor claims.

2. Balancing Harms

Once the court is aware of how much money is at stake if the debtor fails to qualify for the (L)(5) Exception, the court will be better able to balance the harms that may result from issuing or declining to issue an injunction restricting claims trading.⁶¹ We might ask whether the gains from preserving the (L)(5) Exception outweigh the losses from illiquidity suffered by the claims holders. If the benefit of restricting claims trading to permit the debtor to qualify for the (L)(5) Exception outweighs the creditors' losses due to illiquidity, then the court might ask the debtor to "put its money where its mouth is" and post an injunction bond to compensate the creditors for the devaluation of their claims.⁶² If the injunc-

58. Assume the debtor has an unexpired \$100 million NOL carryforward, but if § 382(l)(6) applies (because the (L)(5) exception is unavailable), the debtor would only be able to use the NOL to offset \$20 million in income per year for the next five years. If the debtor paid \$25 million in interest per year for each of the past three years to creditors who become equity holders in the reorganization, the debtor's NOL would be reduced to \$25 million. If the debtor qualifies for the (L)(5) Exception, it could use all \$25 million to offset income in its first year. This benefit may be less valuable than the ability to deduct up to \$20 million per year for the next five years under § 382(l)(6).

59. Assume that a reorganized debtor will have a \$50 million NOL if it qualifies for the (L)(5) Exception, but would be limited to \$10 million per year for the next 10 years if it fails to qualify for the (L)(5) Exception. If the expected taxable income of the debtor is between \$8 million and \$10 million for each of the next five years, then the (L)(5) Exception reduces the value of the debtor's NOL tax benefit.

60. However, a change in ownership would still trigger the usual § 382 limitation.

61. Whether the harm to the debtor would be irreparable is an interesting question. Any harm would be monetary (the loss of a tax benefit), but courts would run into real trouble apportioning blame among creditors. Any exercise in attempting to do so may be futile, because the reorganized firm, owned by the former creditors and investors who purchased claims, would be collecting any judgment from the former creditors. Furthermore, would the reorganized debtor, owned by the former creditors, bring a cause of action suing for lost NOL tax benefits? Does a corporation even have standing to sue creditors for a lost NOL tax benefit? And, if the corporation does not have that right, why should a court issue an injunction in the first instance?

62. The Model NOL Order and other recent orders generally do not impose a flat prohibition on all claims trading. The orders often contemplate a "sell down" mechanism or advance notice procedure that technically permits claims trading to continue, although with a much later and riskier close. If there is a market for claims against the debtor, the court could compare the price of the claims before the injunction to the post-injunction price as a very rough proxy for a liquidity premium.

tion is Kaldor-Hicks efficient, then a bond would be an effective mechanism for the winners to compensate the losers in a transaction that would approximate what we would expect outside of bankruptcy.⁶³

C. Creating Robust Markets For Claims Trading

A robust market for claims trading can efficiently move claims from creditors to parties who place higher values on the claim. Such markets give creditors the ability to opt out of the uncertainty and expense of a bankruptcy proceeding and receive cash more quickly. Claims trading allows creditors to shift the risk associated with holding distressed debt to firms and investors who are better able to manage the risk. Liquid claims markets not only benefit creditors and distressed debt investors, but should also benefit debtors. Sophisticated creditors who realize that their claims will be illiquid in bankruptcy will charge higher interest rates on loans.

Prohibitions on claims trading obviously decrease the robustness of distressed debt markets, but prohibitions are not the only judicial actions that could impair liquidity. Restrictions short of prohibition, such as orders that contemplate requiring “sell-downs” in the event that the debtor proposes a plan relying on the (L)(5) Exception or requiring lengthy notice, can also introduce a great deal of uncertainty into the market for a debtor’s claims. It is possible that such restrictions could operate as *de facto* prohibitions that freeze claims trading markets. Sophisticated parties will generally be able to order their affairs if given clear rules in advance, but courts should be aware of how the rules they set will reorder the behavior of market participants.

IV. CONCLUSION

Bankruptcy judges are likely to see a growing number of debtor motions seeking to restrict claims trading to preserve NOL value during the next large wave of chapter 11 filings. Although a debtor’s interest in NOL carryforwards should be considered property of the estate under section 541’s expansive definition, the concept of exercising control under section 362(a)(3) should not be extended to apply to claims trading. A broad reading that applies section 362(a)(3) to any action that could affect the expected value of property of the bankruptcy estate would expand non-bankruptcy rights in a manner inconsistent with the Bankruptcy Code. Courts should reject this interpretation and deny debtor motions to restrict claims trading in order to preserve NOL value. Courts should limit the scope of the *Prudential Lines* decision to situations where insider-shareholders threaten NOL value in order to improve negotiating leverage vis-à-vis creditors in a bankruptcy proceeding.

Declining to extend the operation of the automatic stay has several benefits. It serves to protect a robust market for claims trading, which allows creditors to effectively opt out of the bankruptcy process and shift the risk of holding claims against a debtor in a chapter 11 proceeding to parties that are better able to bear the risk. Because claims trading does not create the same collective action problem brought about by the traditional creditors’ race to the debtor’s assets, the automatic stay is not needed to preserve the debtor’s synergy value. Where restricting claims trading is desirable,

63. *In re UAL*, 412 F.3d at 778. An action may be described as “Kaldor-Hicks efficient” if “the winners from a possible policy change could [(hypothetically; actual compensation is not required)] compensate the losers from the change enough so that the losers would be indifferent between the status quo, on one hand, and the world of the new policy plus the compensation, on the other, while leaving the winners enough benefits left over that they still prefer their new (winning) status.” David A. Hoffman & Michael P. O’Shea, *Can Law and Economics Be Both Practical and Principled?*, 53 ALA. L. REV. 335, 358 (citing Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. CHI. L. REV. 63, 64-67 (1990) and Matthew D. Adler & Eric A. Posner, *Rethinking Cost-Benefit Analysis*, 109 YALE L.J. 165, 190-91 (1999)).

injunctive relief provides a better mechanism for implementing restrictions because it requires and allows for a fuller examination of the value of the debtor's various options, including the special valuation rule of section 382(l)(6) of the Internal Revenue Code.