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Subsidiary Restructurings

MELISSA G. SALLEE AND BIANCA STOLL

In this article, the authors provide guidance on how to accomplish a subsidiary restructuring.

It is good corporate practice for a company to occasionally evaluate its organizational structure to determine if its structure is efficient and cost effective. A company may determine that a subsidiary restructuring would be beneficial to its company. A subsidiary restructuring may be accomplished through many different means such as (i) merging subsidiaries into other existing subsidiaries of the company, (ii) converting corporations into other forms of organization, such as limited liability companies, or vice versa, and (iii) forming new subsidiaries of the company and/or its subsidiaries.

BENEFITS OF SUBSIDIARY RESTRUCTURING/CONSOLIDATION

There are several potential benefits of subsidiary restructurings and consolidation, including the following:

- Reduction of management costs;
- Reduction of costs related to organization and handling of economic activity including the combination of complementary businesses;

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- Reduction of costs related to organization and handling of a subsidiary's activity;
- Simplification of the company's organizational structure;
- Simplification of the management structure resulting in more efficient decision making; and
- Reduction in tax expenses.

OVERVIEW OF SUBSIDIARY RESTRUCTURING/CONSOLIDATION

Initial Determinations and Diligence

Initially, a company will need to assess its current organizational structure and determine whether there are opportunities to combine subsidiaries for efficiency and ease of operations. If so, the company will need to develop a detailed step plan for the actions to be taken and the resulting structure. This process should be well thought out and not rushed. Before undertaking a subsidiary restructuring, the company will want to evaluate the timing for the restructuring and its practical implications. It should involve not only senior level management but also operational management that can provide input as to how a restructuring will affect the day-to-day operations and reporting of the company and its resulting subsidiaries. In addition, the company will also want to involve its accountants and legal counsel. If a company has international operations or entities, experts from foreign jurisdictions will likely need to be involved too. A subsidiary restructuring can have significant tax implications for the ongoing business and, while the tax implications of a subsidiary restructuring are beyond the scope of this article, the company should consider in advance the tax implications of all scenarios of the subsidiary restructuring. Involving legal counsel at an early stage of the subsidiary restructuring can assist the company in addressing time consuming issues early in the process and in developing alternatives in the event of local and state law limitations or quirks.

Once the structure of the reorganization is determined, the company will need to undertake diligence and research of company organizational and other documents and state law. First, the company should review the

state law governing each of the subsidiaries involved in the restructuring to determine whether the subsidiary restructuring is permitted under state law and the various filing and reporting requirements.

Next, the company should review the corporate governance documents (i.e., articles of incorporation, articles of organization, bylaws, operating agreements, partnership agreements, etc.) of each of the subsidiaries involved in the restructuring, including each subsidiary's parent company, to determine what approvals are required for the restructuring (e.g., whether board and stockholder approval is required and, if approval is required, what percentage is required to approve the specific restructuring transaction(s)).

The company should then review the various contracts and agreements of each of the entities involved in the restructuring and their parent entities to determine if there are any prohibitions or notices required in connection with the subsidiary restructuring. Depending on the plan, the company should look for provisions in contracts that require consent or notice in connection with a transfer of assets, transaction with affiliates, merger or change of control situation.

Also, any other registrations, licenses, permits, tax numbers and other items that are registered in the name of any of the entities involved in the subsidiary restructuring should be reviewed and the company should determine if any actions need to be taken as a result of the subsidiary restructuring.

It may be helpful to have counsel prepare a step plan memo and checklist that explains in detail the subsidiary restructuring. This detailed memo can summarize the diligence review and the consents and notices that are required in connection with the subsidiary restructuring. Additionally, the memo can contain a detailed checklist of all the documents that are required to be drafted and filed. With some restructurings, it may be important to intricately map out the sequence of the transactions and steps and have the timing of the filings identified down to the minute they are occurring.

Drafting and Filing Documents

The documents that are part of a subsidiary restructuring will vary depending on the structure of the restructuring. Generally, legal counsel

will be primarily responsible for drafting the restructuring documents. However, management will play a key role with populating schedules and exhibits and advising on the operations of the subsidiaries involved in the restructuring. While it would be impossible to list every conceivable document, the following is a summary of documents that are commonly involved in a subsidiary restructuring:

- *Step Plan Memo* — As noted above, a step plan memo can be a key organizational document and guide to the subsidiary restructuring. The memo will set forth each of the steps in the subsidiary restructuring, the legal documents for each step, the responsible party and specific timing and sequence for each step. The step plan memo helps to ensure that each member on the subsidiary restructuring team is aware of each step and his/her responsibilities.
- *Authorizing Resolutions* — A subsidiary restructuring can involve a number of steps and it is critical that each of the entities involved in a subsidiary restructuring has the requisite authorization to undertake the action(s). The requisite authorization will vary depending upon state law and the subsidiary's organizational documents (i.e., articles of incorporation, bylaws, articles of organization, operating agreement, partnership agreement, etc.). Depending upon the action being taken, both shareholder and board consent may be required for a corporation, member and manager consent for a limited liability company and general partner and limited partner consent for a partnership. Although subsidiaries may be wholly owned, it is important that the company obtain the requisite vote required to approve an action, which can vary based upon state law and the company's organizational documents.
- *Contribution Agreement* — Often in a subsidiary restructuring, a subsidiary may need to distribute assets down the organizational structure. Such assets may include operational assets or equity interests in other subsidiaries. The contribution agreement should specify what assets are being transferred, the party transferring and the party receiving the assets and what consideration will be given for the assets.

This necessarily means determining the fair value of the asset being transferred (which may also be relevant for tax purposes). Both the party transferring and the party receiving the assets should authorize the transfer as well as the contribution agreement.

- *Distribution Agreement* — In the event assets need to be distributed up the organizational structure, this can be affected as a distribution from a subsidiary to its parent and memorialized in a distribution agreement. Assets that may be distributed include operational assets or equity interests in other subsidiaries. The distribution agreement should specify the assets being transferred and the party transferring and the party receiving the assets. Here too, it may be necessary to specify what consideration/value will be attributed to the assets. Both the party transferring and the party receiving the assets should authorize the transfer as well as the distribution agreement.
- *Asset Purchase Agreement* — As an alternative to contributing or distributing certain assets in a subsidiary restructuring, the company can cause its subsidiaries to sell/convey specific assets (and assign specific liabilities). The effect of a transfer of assets is that only the specified assets and liabilities listed in the asset purchase agreement will be transferred. The asset purchase agreement (or similarly titled agreement) should specify the assets and liabilities being transferred and that the parties are thereby transferring the assets and liabilities, the party transferring and the party receiving the assets and liabilities and the consideration attributable to the assets. A transfer of assets through an asset purchase agreement may require the subsidiary to provide notice to third parties if the underlying contractual agreements require notice or consent upon transfer. Additional documents typically required in an asset purchase transaction include an assignment and assumption agreement, intellectual property assignment and assumption agreement or intellectual property license, bill of sale, deeds and lease assignments. There can be tax implications with respect to an asset purchase (including the basis recognizable in the acquired assets) and these should be weighed in light of the other legal alternatives to transferring assets.

- *Stock Purchase Agreement* — As an alternative to contributing or distributing certain assets in a subsidiary restructuring or a transfer of specific assets, the company can cause its subsidiaries to sell all of the outstanding stock of a subsidiary through a stock purchase agreement. Contrary to an asset purchase agreement, the effect of a stock purchase is that the acquiring subsidiary acquires all the assets and liabilities of the acquired subsidiary whether known or unknown. The stock purchase agreement should specify the stock being transferred and that the parties are thereby transferring such stock, the party transferring and the party receiving the stock and the consideration attributable to the transfer. A transfer of the outstanding stock may require notice to or consent from third parties if the underlying contractual agreements require notice or consent upon a change in control, stock transfer or the like. Additional documents required in a transfer of stock include a stock power and newly issued stock certificate in the name of the acquiring subsidiary. There can be tax implications with respect to a stock purchase and these should be weighed in light of the other legal alternatives to transferring assets. In the event that a membership interest is being transferred rather than stock, similar concepts would apply with respect to a membership interest purchase agreement.
- *Agreement and Plan of Merger* — If two or more subsidiaries will merge or consolidate in a subsidiary restructuring, this will typically be completed through an agreement and plan of merger and the filing of a certificate of merger (or similar form) with the appropriate state filing office (e.g., Arizona Corporation Commission, Delaware Secretary of State's Office, etc.). Depending upon applicable state law requirements, the agreement and plan of merger set forth the overall plan for the merger, including the effect of the merger and which subsidiary shall survive the merger, any amendments to the organizational documents of the surviving subsidiary, the effective date and time of the merger, how to terminate the merger prior to filing the certificate of merger, as well as other items. The agreement and plan of merger does not necessarily have to be filed with the state filing office, in some states it may be maintained in the corporate records if it is made

available to interested parties upon request. Both the merging and surviving subsidiary will need to approve the merger, agreement and plan of merger and the certificate of merger.

- *Certificate of Merger* — The certificate of merger is a more abbreviated document than the plan of merger and is filed with the appropriate state filing office (e.g., Arizona Corporation Commission, Delaware Secretary of State's Office, etc.). Depending upon applicable state law requirements, the certificate of merger may set forth the name of the surviving subsidiary and merging subsidiary, effective date and time of the merger (if not effective upon filing), whether there will be a name change for the surviving subsidiary and a copy of the agreement and plan of merger, or that it is on file with the surviving subsidiary and that a copy can be provided upon request. State filing offices can vary in how long it will take to process a certificate of merger and the company will want to take this into consideration.
- *Plan of Conversion* — If a subsidiary will be converted to a different organizational form, such as converting a corporation to a limited liability company (or vice versa), the plan of conversion will set forth the terms of such conversion. Depending upon applicable state law requirements, the plan of conversion may set forth the name of the entity converting, including its post-conversion name, the effective date of the conversion, the conversion terms, articles of incorporation or articles of organization of the resulting subsidiary, how the equity interests of the converting subsidiary will be converted to the resulting subsidiary and the management of the resulting subsidiary. Certain states may not have provisions within their code allowing for conversions. In such instances, the subsidiary restructuring may need to contain additional steps such as having the subsidiary re-domesticate to a different jurisdiction to effect the conversion and re-domesticate back to the original jurisdiction. Alternatively, a subsidiary could use the merger process to merge into an entity with the desired organizational form. Tax implications of a conversion should be carefully considered prior to effecting the conversion. Typically, the plan of conversion is not filed with the state filing

office, rather it is maintained in the corporate records and the certificate of conversion is filed and is required to be made available upon request. The converting subsidiary will need to approve the conversion, plan of conversion and the certificate of conversion.

- *Certificate of Conversion* — Similar to the process for a merger, the plan of conversion is not typically filed with the state filing office but the company will file the certificate of conversion. Depending upon applicable state law requirements, the certificate of conversion may set forth the jurisdiction and name of the converting subsidiary as well as where the converting subsidiary is organized prior to and following the conversion. State filing offices can vary in how long it will take to process a certificate of conversion and the company will want to take this into consideration.
- *Organizational Documents* — In addition to consolidating subsidiaries, the subsidiary restructuring may require the formation of new subsidiaries. Depending upon the desired form and applicable state law, organization of new subsidiaries may include articles of incorporation, bylaws, articles of organization, operating agreement, partnership agreements, etc. The company will also want to consider whether any new subsidiaries should register to do business as a foreign organization in any states and whether they will need any permits or tax identification numbers or certificates.
- *Notices and Consents* — As part of the diligence process, the contracts and agreements for the subsidiaries involved in the subsidiary restructuring should be reviewed to determine whether any contracts require consent or notice in connection with the actions. A notice will notify a third party of the subsidiary restructuring. A consent will also notify a third party of the subsidiary restructuring and, in addition, will request the third party to countersign and agree to the action. Consideration should also be given to the impact of contracts and arrangements that would be breached or terminated if such consent cannot or will not be obtained.

- *Other Ancillary Documents* — In addition to the above, a subsidiary restructuring may require a number of other ancillary documents. Such documents may include, for example, issuance of new stock or membership interests, real property transfer documents, including deeds of trust or mortgages, assignment and assumption agreements, intellectual property assignments, bills of sale, transition services agreements, etc. Also, if the stock or membership interests of any of the entities involved have been pledged, the company will need to coordinate with the secured party that is holding the stock or membership interest certificates to exchange any cancelled certificates for the new certificates. It is common that such pledges will arise if the company is party to a credit agreement and the lender will receive a pledge of certain subsidiary stock or membership interests. The company or subsidiary may also be required to file or record, as applicable, documents reflecting a release of all or certain liens (including UCC-3 termination statements), if it has taken the necessary steps to remove such liens.
- *State and Federal Filing Issues* — A subsidiary restructuring may also trigger filing requirements under federal, state and local law. Additional filings may include, for example, foreign registrations, termination of foreign registrations, applications for new licenses and permits or transfer of existing licenses and permits, applications for new tax identification numbers, federal, city and state tax filings, notice to the Internal Revenue Service regarding the subsidiary restructuring, payment of real property transfer taxes, intellectual property assignment filings with the United States Patent and Trademark Office, etc. To the extent the subsidiary restructuring involves or affects international subsidiaries, the company will want to check with local counsel regarding additional authorization requirements, local filings and notices and local taxes, fees or assessments.

POST-CLOSING CLEAN UP

After the documents are drafted and filed to effectuate the subsidiary restructuring, there are likely some additional steps that need to be taken in

connection with the subsidiary restructuring. First, if any of the subsidiaries that were merged or converted were registered to do business in a state other than the state of organization, the company will need to amend those foreign qualification filings to reflect the subsidiary restructuring. In addition, if any of the subsidiaries involved in the restructuring own real property, such real property filings (e.g., deeds) may need to be revised to reflect the restructuring (depending on the state in which the property is located).