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Case No. 6192-VCP

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

SOUSAN BADII, DECEASED, BY AND THROUGH RAMIN BADII AS EXECUTOR OF THE ESTATE OF SOUSAN BADII, Plaintiff, v. METROPOLITAN HOSPICE, INC., Defendant.	)	C.A. No. 6192- VCP

MEMORANDUM OPINION

Submitted: November 2, 2011
Decided: March 12, 2012

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PARSONS, Vice Chancellor.

This is an action under 8 *Del. C.* § 291 for the appointment of a receiver for an insolvent, closely held corporation, Metropolitan Hospice, Inc. ("MHI" or the "Company"). Among other liabilities, MHI owes approximately $1.9 million to the IRS for back taxes, penalties, and interest. The Company's board of directors and the holders of its common stock having voting rights have agreed on a creative plan, to which the IRS is receptive, that could resolve this federal tax liability for a relatively small amount of money. In general terms, MHI intends to transfer all of its assets and liabilities to a newly formed corporation, "NewCo," in exchange for 100% of NewCo's stock. Then, NewCo will pay off the federal tax liability for the appraised value of MHI's tangible assets, approximately $54,000, and MHI will dissolve, distributing its sole asset—*i.e.*, the NewCo stock—to its shareholders pro rata. Under the proposed transaction, neither NewCo's business nor its capital structure will be any different than MHI's, except for the discharge of a $1.9 million liability.

The board and a major holder of nonvoting stock disagree, however, on how to implement this reorganization. Pursuant to a shareholders agreement, the voting rights attached to a shareholder's common stock terminate upon the shareholder's death. The Company's largest shareholder and its cofounder, Sousan Badii, died in 2010. Her estate (the "Estate") now holds 52% of the Company's common stock, but that stock is nonvoting by operation of the shareholders agreement. As a result, MHI's second largest shareholder, who owns 30% of the Company, controls over 60% of its voting stock. Animating the parties' disagreement is what effect, if any, the reorganization should have

on the shareholders' respective voting rights. The Estate argues that either it should have voting rights in NewCo or MHI should auction its NewCo stock with the cash proceeds being distributed to MHI's creditors upon dissolution. The board and voting shareholders characterize the reorganization as merely a change in form, not in substance, and argue that in all other respects the reorganization properly maintains the status quo, including the relative voting rights of the Company's shareholders. Unable to dissuade the board and voting shareholders, the Estate filed this action seeking the appointment of a receiver empowered to auction MHI's assets.

This post-trial Memorandum Opinion constitutes my findings of fact and conclusions of law regarding the Estate's application for the appointment of a receiver. Under 8 *Del. C.* § 291, I have discretion to appoint a receiver if a corporation is insolvent and, due to exigent circumstances, such an appointment would serve a beneficial purpose. Here, there is no dispute that MHI is insolvent. Thus, the sole issue is whether exigent circumstances warrant the relief that the Estate seeks.

For the reasons stated herein, I conclude that there is exigency in this case: the risk of losing altogether a favorable settlement with the IRS, which would be value-destroying to the Company, because of the parties' impasse on otherwise unrelated matters. Accordingly, I will appoint a receiver to ensure that MHI maximizes the Company's value for its stakeholders by effecting the settlement with the IRS, if possible, and, then, making a recommendation as to the disposition, if any, of MHI's remaining assets.

I. BACKGROUND

A. The Parties

Plaintiff, the Estate, is MHI's largest shareholder, but has no voting interest in the Company. Ramin Badii, Sousan's brother, is the executor of the Estate.[1] Since Sousan's death in May 2010, Ramin also has been a director of MHI.

Defendant, MHI, is a Delaware corporation with its principal place of business in Atlanta, Georgia. The Company operates a hospice facility in Atlanta. As of February 2011, the directors of MHI are Ramin, Dr. Errol Duncan, Michael Easterly, and Pearl Harrison (collectively, the "Board").

B. Facts

This case was tried on July 21, 2011. The parties introduced approximately 80 joint trial exhibits ("JX"), lodged depositions of eight fact witnesses, and adduced live testimony from four fact witnesses. Having considered this evidence and evaluated the credibility of the witnesses, I make the following post-trial findings of fact.[2]

1. The founding of MHI

MHI was founded in 2001 by Sousan, Duncan, and two other individuals. In 2004, Brookwood Hill Group, Inc. ("Brookwood"), an entity wholly owned by Easterly, acquired a minority interest in MHI in exchange for $250,000. Geraldine Bascoe acquired a smaller minority interest sometime thereafter. By the time Sousan passed

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[1] I refer to the Badiis herein by first name for clarity and intend no disrespect.

[2] In general, only findings as to disputed facts recited in this Memorandum Opinion are accompanied by citations to the evidentiary record.

away in May 2010, the respective interests of each of these MHI shareholders were as follows: Sousan (52%); Duncan (30%); Brookwood (15%); and Bascoe (3%).

Sousan, Duncan, and Brookwood also are parties to a Second Amended and Restated Shareholders Agreement dated as of August 13, 2004 (the "Shareholders Agreement").[3] Two provisions of the Shareholders Agreement are pertinent to this dispute. First, Section 6.2 provides:

> Deadlock. In the event of a major decision . . . in which the Board cannot reach unanimous agreement, the question shall be submitted to the Shareholders and the Majority Interest Holders shall be entitled to make the decision. In addition, no affirmative action may be taken by the Board with respect to a major decision or otherwise without the approval of the Majority Interest Holders.

A "major decision" for purposes of this provision includes, among other things, whether "to sell all or substantially all of the Corporation's assets [or] to dissolve or liquidate the Corporation."[4] Furthermore, "Majority Interest Holders" is defined by Section 3.1 as "the holders of a majority interest in the Corporation."

The second provision of the Shareholders Agreement pertinent to this action is Section 5.1. It provides, in relevant part, as follows:

> Upon death, the voting rights with respect to the deceased Shareholder's shares shall terminate and, from that point forward, the Shareholder's estate shall possess and have an economic interest only in the shares and have no voting rights whatsoever with respect to same.

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[3] JX 3 ("Shareholders Agreement").

[4] Shareholders Agreement § 6.1(v)-(w).

Jay Myers, the Company's outside general counsel and drafter of the Shareholders Agreement, testified that he inserted this language at Sousan's behest. He recalled that Sousan was concerned that Duncan might predecease her, and she did not want Duncan's wife, with whom Sousan did not have a good relationship, to become a voting shareholder of the Company.[5]

The relationship between Sections 5.1 and 6.2 is not delineated further in the Shareholders Agreement. This results in a potential ambiguity. That is, while Section 5.1 provides that a deceased shareholder's estate may possess "an economic interest only . . . [with] no voting rights whatsoever," the Shareholders Agreement does not state whether that economic interest may be considered in determining the identity of the Majority Interest Holders empowered to resolve deadlocks regarding major decisions under Section 6.2.

2. MHI under Sousan's management

From the Company's founding in 2001 until her death in 2010, Sousan was a director of MHI and its CEO charged with running the Company's day-to-day operations.[6] For the first four and a half years of the Company's existence, Duncan was MHI's medical director responsible for the care of all of MHI's patients. At least

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[5] July 21, 2011 Trial Tr. ("Tr.") 142-43 (Myers). In citations to the trial transcript, where the identity of the witness is not clear from the text, the witness's name is indicated parenthetically.

[6] Shareholders Agreement at 19 (signed on behalf of MHI by Sousan in her capacity as CEO); JX 32 ¶ 8 (affidavit of Duncan, swearing "Ms. Badii effectively ran MHI").

initially, he also considered himself and Sousan "the main thinkers behind how the company was going to be run and managed."[7] By early 2005, however, their working relationship had soured. Duncan testified at trial that he felt Sousan was micromanaging not only the Company's operations but also his practice of medicine, and he asked Myers to intervene on several occasions.[8] In June 2005, Sousan replaced Duncan as MHI's medical director, but Duncan retained his 30% equity interest in the Company.

While managing MHI, Sousan also ran perhaps as many as nine other hospices in Alabama, Georgia, and South Carolina, each of which was a legally distinct entity.[9] Duncan was not a shareholder of any of these other entities, although he was invited to invest in at least one of them.[10] Sousan caused each of these other hospices to enter into an intercompany loan agreement permitting MHI and the other hospices, each denominated an "Affiliate" of the others, to obtain loans from one another on demand "for general operating needs" or other approved purposes.[11] MHI borrowed

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7 Tr. 77.

8 Tr. 77-78.

9 JX 75 at 6-9 (intercompany loan agreement executed by Sousan as CEO or President of all the other hospice entities).

10 Tr. 86 (Duncan).

11 JX 75 § 1(c).

approximately $350,000 under this intercompany loan agreement while Sousan managed MHI.[12]

Beginning around 2007 at the latest, MHI's financial condition deteriorated. In addition to the demand loans it incurred under the intercompany loan agreement, MHI had engaged Brookwood as a consultant to provide financial and other business-advisory services for a fee of $5,600 per month.[13] MHI regularly missed payments to Brookwood and other creditors.[14] The Company also had intermittent difficulties meeting its payroll obligations.[15] In addition, by the time of Sousan's death, the IRS had perfected a tax lien on MHI's assets to secure a federal tax liability of, at that point, over $1.7 million for delinquent tax payments, penalties, and interest. In this regard, the parties have stipulated that MHI has been insolvent since at least July 2010.

3. Sousan's death and new management

Sousan died on May 30, 2010, and Ramin was appointed the executor of her Estate. Ramin was not involved in the management of MHI before his sister's death.

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12 JX 62. The Estate, which now controls all of the other "Affiliate" entities, terminated the intercompany loan agreement sometime after September 2010. Tr. 86 (Duncan), 153 (Myers). Pursuant to Section 3 of the intercompany loan agreement, all outstanding obligations become due within 180 days of termination and do not terminate until paid in full. JX 75 § 3(b)-(c). Because there is no evidence that MHI has repaid all of the debt it incurred under the intercompany loan agreement, I infer that at least some of that debt remains outstanding. Therefore, the Estate is a creditor of MHI.

13 JX 2 §§ 1, 3.

14 Easterly Dep. 53.

15 *Id.* at 75.

The Estate continues to hold Sousan's 52% equity interest in MHI but, by operation of Section 5.1 of the Shareholders Agreement, the Estate's shares do not have voting rights. Consequently, Duncan became MHI's largest voting shareholder. Duncan's 30% equity interest in MHI now equates to a 62.5% voting interest after excluding the Estate's shares.

When Sousan died, MHI had only two directors: Sousan and Bascoe. On June 24, 2010, MHI held a special meeting of its shareholders and then-board of directors. At that meeting, the shareholders entitled to vote (*i.e.*, Duncan, Brookwood, and Bascoe) removed all prior directors (*i.e.*, after Sousan's death, only Bascoe) and elected Ramin, Duncan, and Easterly to serve as directors. In February 2011, the voting shareholders elected Harrison as a fourth director. Between June 2010 and February 2011, the Board also appointed Ian Ash to serve as CEO and Sterling Lalor to the position of CFO.[16]

In late 2010 and early 2011, the Board and new senior management took numerous steps to address the Company's financial difficulties. For example, MHI had been paying the telephone bills for all of the other entities Sousan managed, a monthly expense of $20,000. MHI also had been providing employee health insurance benefits on a group plan with the other entities. By extracting itself from these shared expenses, MHI reduced expenses by nearly $30,000 per year. The Company also decreased staff not responsible for patient care, primarily in the accounting department, and reduced

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[16] Lalor resigned as CFO in May 2011. He was replaced by Clifton Harrison. Tr. 97-98 (Duncan); JX 60 (email from Duncan informing Myers of Lalor's resignation).

other operating expenses.[17] None of these efforts, however, addressed the Company's federal tax liability or returned MHI to a state of solvency.

During this same period, Ramin attempted on several occasions to restore the Estate's voting rights. For example, at the June 24 special meeting, the Estate asserted that it had various claims against MHI, including approximately $800,000 for unpaid salary to Sousan,[18] but that it would relinquish those claims if the Estate's voting rights were restored.[19] Ramin also offered to contribute an additional $150,000 to the Company and provide Duncan some type of veto right in exchange for restoring the Estate's voting rights.[20] Because no agreement was reached on any of these proposals, the Estate still has no voting rights in MHI.

4. MHI's tax liability options

Before her death, Sousan hired Aislee Smith, a tax attorney, to explore the Company's options for resolving its growing federal tax liability. In November 2010, Smith presented the Board with a proposal to discharge the tax debt (the "Smith Plan"). In broad strokes, the Smith Plan involved the dissolution of MHI, the transfer of all of its assets to a new company owned by the current MHI shareholders, and the discharge of

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17 Tr. 98-100 (Duncan).

18 JX 12 (email from Jere Wood, Esq., the Estate's attorney, informing Ash of the Estate's claims).

19 JX 7 at 4 (minutes of the June 24, 2010 special meeting).

20 Tr. 16 (Ramin).

the federal tax liability with respect to the new company.[21] From November 2010 to July 2011, MHI regularly considered adopting a plan consistent with this general framework.[22]

Duncan did not support the Smith Plan. Among other things, it would have restored the Estate's voting rights in the new company. Moreover, Duncan believed that the Smith Plan was "a package deal that involved four other entities [controlled] by the Badiis."[23] He also was dubious that Smith could represent the best interests of MHI and the Badiis concurrently and, for that reason, terminated Smith's representation of the Company.[24]

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21 Tr. 150-51 (Myers). The record is not entirely clear as to how the new company would obtain the discharge of the federal tax lien. The Board's alternative to the Smith Plan, discussed in detail *infra*, requires the new company to pay the appraised value of only the tangible assets it receives in the transfer from MHI, approximately $54,000. Myers testified that this alternative plan achieves "the genius behind the original proposal" that "Aislee Smith came up with." Tr. 176. Most likely, therefore, the Smith Plan required a similar payment to the IRS to discharge the tax lien.

On a related note, the Estate raised a general objection to Myers's trial testimony because he had asserted attorney-client privilege regarding various matters during his deposition. The Court reserved decision on that objection, but indicated that Myers's trial testimony would be stricken to the extent it covered any matter over which he asserted privilege at his deposition. Tr. 146-47. Myers did not claim privilege at his deposition regarding the general framework of the Smith Plan. *See* Myers Dep. 21-22.

22 JX 24 at 1 (minutes of shareholder meeting held February 3, 2011); JX 67 at 1 (notice and agenda for Board meeting to be held July 14, 2011).

23 Tr. 88 (Duncan).

24 Tr. 89 (Duncan).

In February 2011, MHI retained Morgan Mance, an enrolled agent licensed by the IRS to represent taxpayers, to advise the Company on its federal tax liability. By this time, MHI's liability had grown from approximately $1.7 to $1.9 million. In late March 2011, Mance advised the Company of the full range of its options, including pursuing a reorganization substantially similar to the Smith Plan, attempting to negotiate an in-business compromise with the IRS, liquidating the Company's assets and applying the sales proceeds to the tax liability, or filing for bankruptcy. Mance recommended that the Company reorganize, and the Board accepted that recommendation. The details of the Board's reorganization plan (the "Duncan Plan"), however, vary in certain material respects from the Smith Plan.

The Duncan Plan involves five steps. First, MHI transfers all of its assets and liabilities, including the federal tax liability, to NewCo. Although NewCo will be an entirely new Delaware corporation, the Duncan Plan contemplates that NewCo's certificate of incorporation will contain the same binding covenants that exist in the MHI Shareholders Agreement. In particular, Section 5.2 of Item Seventh of NewCo's proposed charter states expressly that any

> Non-voting Stockholder shall possess and have an economic interest only in the shares and have no voting rights whatsoever with respect to same. For the purposes of this Section 5.1, a "Non-voting Stockholder" is a stockholder holding shares of [MHI] as to which the voting rights with respect to such shares have terminated pursuant to Section 5.1 of the [MHI] Shareholders Agreement . . . including, without limitation, the estate of Sousan Badii and any person who

> may receive shares of common stock of [MHI] from such estate.[25]

Second, as consideration for its receipt of MHI's assets and liabilities, NewCo transfers 100% of its stock to MHI. Also as part of this second step, NewCo pays approximately $54,000 (*i.e.*, the appraised value of MHI's tangible assets, primarily furniture, equipment, and several automobiles) to the IRS to remove the tax lien from the assets purchased from MHI.[26]

Third, upon receipt of the $54,000, the IRS issues a certificate of discharge to MHI, which would extinguish the entire $1.9 million federal tax liability. As of this time, the IRS is under no obligation to discharge MHI's federal tax liability in exchange for the proposed $54,000 payment, but it apparently has expressed some measure of preliminary approval or willingness to do so.[27] In fact, closing on the first- and second-step transactions will be conditioned upon receipt of final IRS approval, which is expected to take six to eight weeks.[28] Assuming the IRS does issue a certificate of discharge and the first- and second-step transactions close, MHI then purportedly would have no liabilities and only one asset, the stock of NewCo.[29]

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25 JX 71 Item Seventh § 5.2, at 8.

26 Tr. 128-29, 137-38 (Mance). How NewCo will be capitalized to make this $54,000 payment has not yet been determined. Tr. 182 (Myers).

27 Tr. 129 (Mance).

28 Tr. 168 (Myers).

29 Tr. 189 (Myers). At this juncture, I note that the *design* of the Duncan Plan involves these five steps, and it *contemplates* that creditors will be amenable to

Fourth, MHI dissolves and distributes its NewCo stock pro rata to its current shareholders. To receive this distribution, however, the MHI shareholders must sign a consent agreement, expressly agreeing to be bound by Item Seventh of NewCo's proposed certificate of incorporation (*i.e.*, the provision continuing the restrictive covenants from the MHI Shareholders Agreement).[30] According to Myers, this fourth step was necessary to assuage any doubt as to the enforceability of the restrictive covenants in NewCo's charter and provides a belt-and-suspenders assurance that the soon-to-be-NewCo shareholders will remain bound by the extant provisions of the MHI Shareholders Agreement.[31] If the Estate does not sign the consent agreement, however, then the NewCo shares to which it would have been entitled would remain unissued—*i.e.*, the Estate would receive nothing.[32]

Fifth and finally, MHI files a certificate of dissolution. Thus, the end result of the Duncan Plan is a new company operating MHI's current business with the same stockholders, and with those stockholders having the same relative rights and obligations

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NewCo's assumption of MHI's liabilities. The Board has not consulted its creditors (other than the IRS and the Estate, which objects to the Duncan Plan) or otherwise received assurances that, in fact, none of the creditors other than the Estate will attempt to enforce their rights against MHI. Tr. 187-88 (Myers). Therefore, I make no findings or conclusions in this Memorandum Opinion as to whether MHI *actually* will have no liabilities and only one asset at the conclusion of the Duncan Plan's third step.

30 Tr. 174 (Myers); JX 72 § 1.

31 Tr. 171.

32 Tr. 175 (Myers).

inter sese as they had with MHI.[33] Accordingly, assuming each step occurs as planned, the Estate will hold a 52% economic interest, but no voting interest, in NewCo.

The Duncan Plan takes the form of a multi-step asset purchase and dissolution, but its substance is effectively a negotiated settlement of a $1.9 million federal tax liability. Importantly, however, neither the fourth nor fifth step of the Duncan Plan is necessary to discharge the federal tax lien; reportedly, so long as the IRS receives the appraised value of the Company's tangible assets, it would have no objection if, for example, MHI auctioned its NewCo stock and distributed the cash proceeds to its shareholders in dissolution.[34] Furthermore, although a settlement with the IRS can improve the Company's financial condition, it cannot resolve all of MHI's financial difficulties. That is, NewCo will be born into insolvency. The Board's intent, however, is only to "stand[] up from a position of weakness,"[35] after which, MHI asserts, the Board and the Company's shareholders together can discuss whether to continue running the business or to auction it.[36]

5. "Deadlock"

The Board met on July 14, 2011—*i.e.*, one week before trial—to consider, among other things, whether to approve the Duncan Plan. At that meeting, Ramin proposed as

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33 *See also* Tr. 187 (Myers).

34 Tr. 133-34 (Mance), 188 (Myers); *see also* Post-Trial Hr'g Tr. 32-33 (Nov. 2, 2011).

35 Tr. 105-06 (Duncan).

36 Tr. 106 (Duncan), 175-76 (Myers), 187-88 (Myers).

an alternative an open auction of the Company, rather than the asset sale to NewCo specifically contemplated by the Duncan Plan. After considering the merits of both proposals, the Board voted to reject Ramin's open auction proposal and to approve the Duncan Plan. The vote, however, was not unanimous; Ramin voted against it. Therefore, by operation of Section 6.2 of the Shareholders Agreement, the Board has reached a "deadlock" on a major decision (*i.e.*, whether to sell all or substantially all of the Company's assets), and that question must be submitted to MHI's shareholders and decided by the Majority Interest Holders. The parties, however, dispute whether the Majority Interest Holder is Duncan or the Estate.[37]

Hence, although the Board approved the Duncan Plan on July 14, 2011, it has not submitted the Plan for shareholder approval or taken any other action to effect it. In addition, both parties agree "that the IRS has issued a Notice of Intent to Levy, can levy at any moment, and time is of the essence."[38]

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[37] The Company contends that the Estate waived its right to claim that it is the Majority Interest Holder because it raised that argument for the first time in its post-trial briefs. Furthermore, MHI claims that it has been prejudiced by the Estate's delay. It argues that had the Estate provided timely notice of its claim to be the Majority Interest Holder, MHI would have presented evidence at trial relevant to any alleged ambiguity in the Shareholders Agreement in that regard. Def.'s Post-Trial Ans. Br. 1, 16-17. The Estate responds that any delay is excusable because both the pretrial briefs and stipulation were submitted before the Board voted on July 14, 2011 (*i.e.*, before the deadlock occurred). Pl.'s Post-Trial Reply Br. 24-28. Because my ruling in this Memorandum Opinion does not require resolution of the identity of the Majority Interest Holder, I do not reach that issue or the related issue of waiver.

[38] Pretrial Stip. and Order ("Pretrial Stip."), Docket Item No. 52, ¶ II.11.

C. Procedural History

On February 14, 2011, the Estate filed a verified complaint (the "Complaint") and a motion for expedited proceedings. The Complaint contains one count seeking the appointment of a receiver under 8 *Del. C.* § 291. After briefing and argument, the Court granted the Estate's motion to expedite, and a trial on the merits was held on July 21, 2011. The parties submitted post-trial briefs in September and October, and the Court heard post-trial argument thereafter.

D. Parties' Contentions

Although the parties agree that MHI is insolvent, they dispute whether a receiver is necessary. The Estate contends that a receiver is necessary because consummation of the Duncan Plan would violate Delaware law. In particular, the Estate argues that (1) the Duncan Plan seeks to effect an unfair, self-interested transaction in breach of the Board's fiduciary duty of loyalty; (2) as the Majority Interest Holder, the Estate is entitled to approve the Duncan Plan, which it will not do; and (3) the final-step dissolution of MHI under the Duncan Plan would violate the trust fund doctrine, constitute a fraudulent transfer, and fail to comply with 8 *Del. C.* § 281(b).[39]

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[39] In certain circumstances, which may exist in this case, 8 *Del. C.* § 281(b) requires a dissolved corporation to

> adopt a plan of distribution pursuant to which the dissolved corporation . . . (i) shall pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured contractual claims known to the corporation or such successor entity, (ii) shall make such provision as will be reasonably likely to be sufficient to

In response, MHI asserts that there is no need to appoint a receiver where, as it claims is the case here, the Board is dealing evenhandedly with, and doing its best to maximize value for, all stakeholders. In that regard, the Company maintains that, except for the discharge of a $1.9 million liability that furthers everyone's interests, the Duncan Plan merely preserves the status quo. Additionally, MHI denies that the Estate is the Majority Interest Holder under the Shareholders Agreement and argues that, in any event, the Estate waived this theory by not raising it before trial. Similarly, MHI claims that waiver bars the Estate from advancing its trust fund doctrine, fraudulent transfer, or § 281(b) arguments. Thus, while it concedes that the Company is insolvent and will remain insolvent even if the Duncan Plan is effectuated, MHI contends that the facts of this case do not warrant the appointment of a receiver.

II. ANALYSIS

A. Standard for Appointment of a Receiver

Upon application by any shareholder or creditor, 8 *Del. C.* § 291 empowers the Court to appoint a receiver for an insolvent corporation "to take charge of its assets, estate, effects, business and affairs, and . . . to do all other acts which might be done by

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> provide compensation for any claim against the corporation which is the subject of a pending action, suit or proceeding to which the corporation is a party and (iii) shall make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the corporation or that have not arisen but that, based on facts known to the corporation . . . , are likely to arise or to become known to the corporation or successor entity within 10 years after the date of dissolution.

the corporation and which may be necessary or proper." Even though the parties have stipulated that MHI is insolvent, "the appointment of a receiver does not follow automatically."[40] Rather, "the appointment of a receiver lies within the sole discretion of the Court."[41] In that regard, this Court has held that "[t]he appointment of a receiver is appropriate only if the company is insolvent and there exist 'special circumstances' where 'some real beneficial purpose will be served.' Accordingly, the court will appoint a receiver only if the company is insolvent and exigent circumstances warrant such relief."[42] Stated differently, the plaintiff must demonstrate that appointment of a receiver is necessary to protect the insolvent corporation's creditors or shareholders by showing "some benefit that such an appointment would produce or some harm it could avoid."[43]

B. Do Exigent Circumstances Exist?

The exigency in this case derives from two stipulated facts: (1) MHI is insolvent and (2) time is of the essence. Faced with mounting financial difficulties, the Company has received a finite grace period from the IRS to reorganize the business and discharge a significant debt for a relatively small amount of money. These circumstances demand decisive and deliberate action from the Board. The Duncan Plan takes advantage of the

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40 *Keystone Fuel Oil, Inc. v. Del-Way Petroleum, Co.*, 1977 WL 2572, at *2 (Del. Ch. June 16, 1977).

41 *Banet v. Fonds de Regulation et de Controle Café Cacao*, 2009 WL 529207, at *3 (Del. Ch. Feb. 18, 2009).

42 *Pope Invs. LLC v. Benda Pharm., Inc.*, 2010 WL 5233015, at *6 (Del. Ch. Dec. 15, 2010) (footnotes omitted) (quoting *Banet*, 2009 WL 529207, at *3).

43 *Id.* at *8.

limited opportunity the IRS has provided and, in that sense, does represent a decisive response by the Board to the difficult circumstances facing the Company.

But whatever action the Board takes, it must do so consistent with its fiduciary duties to the corporation itself.[44] "When a corporation is *insolvent*, . . . creditors take the place of the shareholders as the residual beneficiaries of any increase in [firm] value."[45] Hence, in assessing whether a receiver is necessary, my principal concern is whether the Board has attempted to exploit the waning opportunity of an advantageous settlement with the IRS in a manner that deals evenhandedly with the Company's creditors and shareholders alike.[46]

I do not believe the Board has acted consistently with that objective. The Duncan Plan would effect a self-dealing transaction. Duncan, both a director and controlling

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[44] *See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("It is well settled that directors owe fiduciary duties to the corporation." (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939))).

[45] *Id.*; *accord Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004) (insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value").

[46] *Cf. Prod. Res. Gp.*, 863 A.2d at 786 ("If, for example, the record . . . convinces the court that the board of an insolvent company is dealing even-handedly and diligently with creditor claims and is doing its best to maximize the value of the corporate entity for all creditors, then the court would have little justification for appointing a receiver.").

shareholder of MHI,[47] described the general framework of the eponymous plan as follows:

> By forming the new company, the shareholders would still maintain their perspective as is right now—whatever the ownership breakdown is—and also, we would be able to address some of the outstanding debts that the old company has, and that there will be no change in terms of the shareholders agreement. . . . [W]hat exists now will also be transferred over to [NewCo], and that's the main essence of it.[48]

That is, the "essence" of the Duncan Plan is an asset sale from one entity controlled by Duncan to another entity controlled by Duncan.

The fact that Duncan is interested in the Board's attempt to redress MHI's federal tax liabilities does not mean that he has acted in bad faith or even that the Duncan Plan necessarily is unfair. At the same time, however, the mere fact that the Duncan Plan would accomplish the discharge of a significant debt is insufficient to convince me that the Board has acted evenhandedly.

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[47] "It is well established in the corporate jurisprudence of Delaware that control exists when a stockholder owns, directly or indirectly, more than half of a corporation's voting power." *Weinstein Enters., Inc. v. Orloff*, 870 A.2d 499, 507 (Del. 2005). Duncan owns approximately 30% of MHI's common stock, and the Estate's holdings (*i.e.*, 52% of MHI's common stock) have no voting rights. Accordingly, Duncan owns approximately 62.5% of the Company's voting power and, therefore, controls MHI.

[48] Tr. 105-06; *see also* Tr. 176 (Myers) ("[T]he end result that we hope to achieve . . . is the same shareholders with the same rights and the same percentages moving forward with the company free of a $2 million tax debt.").

To the contrary, the Board refused to pursue any deal that would not advance Duncan's personal interests in maintaining control. Myers testified that the Smith Plan "would *only* work if the new corporation kept the same rights and preferences" as MHI and that he did not believe the Smith Plan was viable "*unless* the equity interests and the ownership percentages and the preferences and rights would be identical in the new corporation."[49] Whatever the merits of the Smith Plan, it too would resolve the Company's federal tax liabilities in a cheap and expeditious manner, and it differs from the Duncan Plan only as to the process it would follow to maximize MHI's value *after* the IRS discharges the federal tax lien. That is, although no one disputes that a transfer of assets to a new entity would benefit all of MHI's creditors and shareholders, the Board simply would not consider such a transaction unless the Board could extract a personal benefit for Duncan that would not be shared by MHI's creditors, including the Estate, which also owns nonvoting shares in MHI.

Moreover, the Board committed to this policy over the objections of a significant creditor and shareholder, the Estate, which also proposed alternative transactions. The Estate offered to acquire MHI's assets outright in lieu of creating a new company. Presumably, the Estate also is willing to purchase MHI's interest in NewCo as an alternative to having NewCo stock distributed to MHI's shareholders in dissolution. Notwithstanding this apparent market for MHI's assets, the Board effectively has insisted on all five steps of the Duncan Plan. Essentially, Duncan wants to discharge the federal

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[49] Tr. 150-51 (emphasis added).

tax liability, which all parties agree is a laudable goal, *but then continue to run the Company without paying any consideration for that privilege*, which is more suspect. As this Court has remarked,

> maximization of the economic value of the firm might, in circumstances of insolvency, require the directors to undertake the course of action that best preserves value in a situation when the procession of the firm as a going concern would be value-destroying. In other words, the efficient liquidation of an insolvent firm might well be the method by which the firm's value is enhanced in order to meet the legitimate claims of its creditors.[50]

Frankly, the Court is not in a position to determine whether, once the IRS debt is extinguished, MHI's economic value would be maximized by efficient liquidation, continued operation, sale of the company as a going-concern, or any intermediate course of conduct. Moreover, it does not appear that the Board has undertaken the investigation necessary to be in a position to evaluate those options objectively. From a creditor's perspective, the Board has not reached out to creditors other than the IRS and the Estate to gauge their receptiveness to the Duncan Plan. Thus, the Board has no assurance that other creditors would consent to MHI's assignment of their claims to NewCo or that, in any event, creditors would not attempt to hold MHI and NewCo jointly liable for those claims. Consequently, I consider unrealistic MHI's assertion in this proceeding that it will have no liabilities after completion of the Duncan Plan's third step.

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[50] *Prod. Res. Gp.*, 863 A.2d at 791 n.60.

From a shareholder perspective, the fourth and penultimate step of the Duncan Plan—*i.e.*, dissolution of MHI and distribution of NewCo stock pro rata, subject to execution of the consent agreement—potentially imposes a disproportionate burden on the Estate's equity interest in the Company. Neither the IRS nor any agreement to which the MHI shareholders are parties requires that NewCo, a wholly distinct and newly formed entity, replicate MHI's shareholder profile. Rather, the Board has concluded that doing so would be fair in this case. Furthermore, other than its belief in the Duncan Plan's fairness, the Board has not advanced any persuasive reason why the Estate's undisputed entitlement to 52% of MHI's residual value upon dissolution and satisfaction of the claims of MHI's creditors compels it to accept nonvoting stock of NewCo while all other MHI shareholders receive voting stock. The Board has not appraised, or even discussed, the prospective value of NewCo stock.[51] In this context, the Estate has presented at least a colorable argument that the Duncan Plan's mechanism for preserving the status quo in terms of shareholders' rights and ownership percentages amounts to self-dealing on unfair terms.

Where a company is insolvent, as MHI is, and the board believes that pursuing a certain course of action will result in an increase in the value of the firm, the creditors are the residual beneficiaries of that increase.[52] Here, the Board must act to exploit a time-sensitive opportunity in the form of the IRS settlement. The Board has attempted to do

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[51] Tr. 186 (Myers).

[52] *Gheewalla*, 930 A.2d at 101.

so by adopting the Duncan Plan. The Court is not convinced, however, that that Plan *evenhandedly* addresses the interests of the creditors, such as the Estate, and all of the shareholders. In these circumstances—indisputable insolvency, a time-sensitive opportunity, and the Board's insistence on a dubious transaction—there is sufficient exigency to warrant appointment of a neutral receiver charged with ensuring that the Company fairly attempts to take advantage of the possibly short-lived IRS offer.

C. Would Appointment of a Receiver Serve a Beneficial Purpose?

"Even [where] exigent circumstances . . . exist, the appointment of a receiver is only justified if it would serve a 'beneficial purpose.'"[53] In that regard, the potential benefits must outweigh any potential harm that appointment of a receiver could cause.[54]

Appointment of a receiver could harm MHI in at least two respects. First, reevaluation of the Duncan Plan—and, if necessary, pursuing an alternative—would involve additional delay. Second, a receiver would be entitled to reasonable compensation and reimbursement of expenses, which would be paid out of the corporation's assets before any distribution to creditors or stockholders.[55] Such delay and expense could be harmful to MHI: the Company is underwater now, the IRS has filed a

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53 *Pope Invs. LLC v. Benda Pharm., Inc.*, 2010 WL 5233015, at *13 (Del. Ch. Dec. 15, 2010) (quoting *Banet v. Fonds de Regulation et de Controle Café Cacao*, 2009 WL 529207, at *3 (Del. Ch. Feb. 18, 2009)).

54 *Id.*; *see also Prod. Res. Gp., L.L.C.*, 863 A.2d at 786 ("[T]his court should not lightly undertake to substitute a statutory receiver for the board of directors of an insolvent company.").

55 *See* 8 *Del. C.* § 298.

Notice of Intent to Levy, and the parties agree that "time is of the essence."[56] Continued delay and expense—as well as the attendant instability—in the management of MHI's affairs raise the possibility that the IRS simply will run out of patience, which would not serve the interests of MHI, its creditors, or its shareholders. Indeed, the parties agree that the Duncan Plan's general structure (*i.e.*, an asset sale to a new entity that discharges the federal tax lien) is desirable; they dispute only how the Company should proceed *after* that lien is extinguished. Loss of this transitory opportunity altogether because of a second-order dispute over how to proceed thereafter would do more harm than good.

Appointment of an objective and independent receiver to exploit the opportunity presented by the IRS offer could address that dilemma and thereby provide a countervailing benefit. Section 291, by its own terms, displaces the board by empowering the receiver "to take charge of [the corporation's] . . . business and affairs" and to do "all other acts which might be done by the corporation and which may be necessary or proper." Hence, a receiver can act immediately to ensure that, at the very least, the Company attempts to accept the IRS's offer before the government walks away, but without needing to decide whether to adopt wholesale either the Duncan or Smith Plan. He or she can separate the pursuit of a common goal from the resolution of a seemingly intractable dispute. Proceeding in that manner permits expeditious resolution of the primary exigency in this case (*i.e.*, the risk of losing altogether a favorable settlement with the IRS) and, therefore, is in the best interests of the Company's creditors

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[56] Pretrial Stip. ¶ II.11.

and shareholders alike. Once the first three steps of the Duncan Plan are in place (*i.e.*, once MHI is essentially a holding company for NewCo stock and the federal tax liability is discharged), the receiver *then* can evaluate independently and disinterestedly whether the remaining two steps of the Duncan Plan or some other alternative represents the best available option for MHI and its continuing stakeholders.

Appointment of a receiver also avoids other delay and expense. As discussed above, if MHI attempted to effectuate the Duncan Plan *in toto* as currently devised with the approval only of the current directors (a majority of whom are interested in the contemplated transactions), the transaction would be susceptible to an entire fairness challenge by the Estate in its capacity as either a shareholder or a creditor suing derivatively.[57] Such a challenge would produce its own delays and litigation costs as well as the potential for injunctive and monetary relief. In contrast, action by an independent receiver would avoid this susceptibility; a neutral officer of the Court, not a board of self-interested directors, would be taking action on the corporation's behalf.[58] On balance, the incidental delay and expense accompanying appointment of a receiver

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[57] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); *Gheewalla*, 930 A.2d at 101 ("creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties" (emphasis omitted)).

[58] Additionally, although I do not reach whether the Estate is the Majority Interest Holder under the Shareholders Agreement, I note that appointment of a receiver likely will moot this issue. The Majority Interest Holder is entitled to decide major decisions only if the board cannot reach unanimous agreement. Shareholders Agreement § 6.2. Decisions by an individual receiver necessarily would be unanimous, thus avoiding operation of Section 6.2 in the first instance.

are less severe than the delay and expense of a subsequent plenary action if the Board were to proceed with the Duncan Plan. Avoiding such delay and expense and increasing the likelihood of a full and fair evaluation of the Company's options for taking advantage of the IRS offer provide a sufficiently beneficial purpose to justify appointment of a receiver under the circumstances of this case.

Because the benefits outweigh the harms of a receiver, appointment of a receiver is justified.

D. Duties of the Receiver Appointed

Having determined to appoint a receiver, the next issue is the assignment with which to charge him or her. Under 8 *Del. C.* § 291, "[t]he powers of the receivers shall be such and shall continue so long as the Court shall deem necessary." The receiver's initial task shall be to determine, and to execute promptly, whatever steps are necessary to effect the discharge of the federal tax liability. To do so, the receiver shall have all of the authority contemplated by 8 *Del. C.* § 291. Once the IRS has issued a certificate of discharge, the receiver shall attempt to resolve outstanding creditor and shareholder claims to all parties' mutual satisfaction or, if they cannot agree, to make a recommendation to the Court regarding how to proceed. In performing these tasks, the receiver may exercise independent business judgment to implement, in relation to the IRS offer, or recommend otherwise whatever steps he or she determines, in good faith, will maximize the value of the Company for its various stakeholders under the circumstances.

The receiver's authority shall continue until further order of the Court.

III. CONCLUSION

For the reasons stated in this Memorandum Opinion, a receiver will be appointed to attempt expeditiously to discharge MHI's federal tax liability and to negotiate or recommend how to proceed with the disposition, if at all, of MHI's assets thereafter Counsel shall confer and submit within ten days a form of order consistent with this Memorandum Opinion together with a recommendation of an agreed upon receiver or, if no agreement can be reached, a list of three proposed receivers from each party.