

# BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

## Online False Advertising Risks

By Scott J. Slavick

*Recently issued Federal Trade Commission guidelines reveal a new risk: employer liability for false or misleading advertising stemming from employees' online postings.*

Employee blogs and social-networking websites create myriad thorny issues for employers. Recently issued Federal Trade Commission (FTC) guidelines regarding product endorsements reveal a new risk: employer liability for false or misleading advertising stemming from employees' online postings about their employer's products or services—even when the employer has not authorized or affirmed the postings.

A few startling statistics will put into perspective how essential blogging and social networking have become to today's successful businesses. According to a 2009 study by the Center for Marketing Research (CMR), 91 percent of the 500 fastest-growing U.S. companies used at least one social media tool in 2009. An estimated 200 million blogs are published worldwide, according to a study by social media consultant Erik Qualman. Qualman's study also reports that 55 percent of bloggers post content daily and 34 percent of that content contains opinions about various products and services. In addition, his research shows that 78 percent of consumers trust peer recommendations, while only 14 percent of consumers trust commercial advertisements.

Judging by these statistics, consumers trust blogs far more than they trust traditional advertisements. Perhaps because of consumers' overwhelming trust in blogs, the FTC has now decided to get involved in trying to ensure that blogs and social networking posts are accurate and truthful. The FTC's revised *Guides Concerning the Use of Endorsements and Testimonials in Advertising*, published in the Federal Register at 16 C.F.R. Part 255, address the application of Section 5 of the FTC Act to the use of endorsements and testimonials in online advertising. Section 5 prohibits unfair or deceptive acts or practices and unfair competition in or affecting commerce.

According to the CMR study, only 36 percent of those 500 fastest-growing companies maintained a formal social media policy for employees. However, the potential liability for employers under the FTC's new guidelines is far too high for the other two-thirds of the 500 fast-growing companies to ignore any longer.

### Understanding the New FTC Guidelines

The guidelines make it clear that employees endorsing their employer's products or services have a duty to disclose to their audience their relationship to an employer at the time they give the endorsement or testimonial, wherever the posting may appear. The following explanation of these key terms will provide a better under-

standing of what is and is not prohibited under the FTC's new guidelines.

**Net Impression.** According to the new guidelines, the FTC plans to utilize a "net impression" approach to evaluate whether companies using new media to advertise their products or services should be subject to liability for false or unsubstantiated statements made through endorsements, or for failing to disclose material connections between themselves and their endorsers, or for failing to properly explain atypical results. The FTC's net impression approach begins with an analysis of each advertisement or promotional commentary on a case-by-case basis.

The key to compliance appears to be to focus on the consumer's overall impression of the advertisement, rather than on its specific details. The first question is whether the endorser is making a personal recommendation in the post at issue. A second question is the kind of compensation, if any, the endorser received for posting the recommendation; obviously, an endorser who is a company employee is receiving a wage or salary from the company. Third, the company should try to determine what consumers' expectations were about the endorser's compensation in this particular context, if any. Taking this three-step approach may help employers better determine whether a particular post is problematic.

**New Media.** "New media" refers primarily to blogs and social-networking

sites, as opposed to traditional print media such as newspapers and magazines. Much ado has been made about whether the FTC's new guidelines hold new media to a higher standard than traditional print media, since some print media—even well-known media brands—have long followed the “quid pro quo” publishing model without explicit disclosures of this practice. More important than the medium is that employers should make sure their employees are transparent and truthful in their public communications, wherever those statements are published.

**Material Connections.** “Material connections” between companies and online endorsers, such as bloggers, should be disclosed. These “material connections” typically arise in the form of in-kind or cash payments from advertisers to bloggers to review a particular product, but also could arise in the form of an employee posting a comment on a third-party blog or participating in a non-company online forum without stating his or her company affiliation. Such relationships should be disclosed, even if the employee's statements are truthful. A good rule of thumb is that, if in doubt, disclose it.

**Endorsement.** “Endorsements” or “testimonials” subject to these guidelines are messages “that consumers are likely to believe reflect the opinions, beliefs, findings or experiences of a party other than the sponsoring advertiser, even if the views expressed by that party are identical to those of the sponsoring advertiser.” 16 C.F.R. Part 255.01(b).

**Duty to Disclose.** Employees endorsing their employer's products or services have a “duty to disclose” to their audience their relationship to the employer at the time they give the endorsement or testimonial. This duty would even apply when the employee's endorsement is posted on a site that is not maintained by the employer, such as a popular bulletin board or chat site.

**Atypical Results.** Advertisements that convey a consumer's experience with a product as “typical” when that is not the case should clearly disclose the results that a consumer should typically expect to receive from the product at issue. The

previously allowed “results not typical” disclaimer is now no longer sufficient. Instead, the new guidelines suggest that endorsements that reference specific positive results should either 1) discuss the typical results that a consumer also could expect; or 2) be accompanied by a disclosure of the typical results. The guidelines do not, however, require general testimonials such as “It smells terrific” or “This is my favorite cereal” to be accompanied by a typical results disclaimer.

### **New Interpretations, New Questions**

New guidelines inevitably create issues of first impression that companies will need to address. The following are some of the far-reaching issues in which businesses should be most interested.

One is the level and severity of potential FTC enforcement of its new guidelines. It appears that advertisers violating the FTC's new guidelines have a great deal to fear. Even though the guidelines technically are administrative interpretations of the law and are not binding law themselves, advertisers could face FTC enforcement actions if their advertisements are deemed false. Additionally, because postings on blogs and social networking pages can reach wide audiences, false advertisers may also be vulnerable to large-scale class-action lawsuits if consumers are injured, and could even face legal action taken by state prosecutors.

The bottom line is that any type of enforcement action is terrible public relations and also can be financially damaging for a company. If the FTC simply announces that a company is a particularly bad actor, the action can be devastating to a company's bottom line.

**The “Rogue” Employee.** If a company routinely has numerous employees blogging falsely about its products, it can reasonably expect an FTC enforcement action. But what about the company that is trying hard to honestly portray its products and control its online presence, but employs one “rogue” employee who strays off message and deceptively endorses the company's product? Would the FTC pursue an enforcement action against a company because of the actions

of one employee?

The FTC has suggested that it would be unlikely to take action against a company for the conduct of a single employee. However, the FTC has pursued enforcement actions against companies that failed to establish or maintain appropriate internal procedures and whose employee actions resulted in consumer injury. Ultimately, the FTC's decision to pursue enforcement against a company because of the postings of one employee may depend upon how much actual damage or injury was caused to consumers. If there was significant injury to consumers, the company with the one rogue employee may still face FTC enforcement, regardless of the company's social networking policy. Nonetheless, instituting strong social networking policies for employees could go a long way toward helping shield a company from liability based on the actions of one employee.

**At Work vs. At Home.** Another open issue is the employer's liability for online comments posted by an employee while at work versus those posted from the employee's own home. Clearly, businesses should assume that, if the misleading online posts occur while the employee is at the office, the FTC could more easily argue that the employer was or should have been on notice of the conduct. If those same posts were to occur while the employee was at home, the link to the company is more tenuous. Having a good social media policy addressing at-home comments could further strengthen the company's defense. In addition, monitoring references to the company's brand online could also help catch deceptive employee endorsements posted while off site.

**Disclaimers.** When to use or not use a disclaimer is another interesting issue. Whether an online endorsement or testimonial should carry a disclaimer depends on several factors, including 1) whether the speaker is compensated by the advertiser; 2) whether the product or service in question was provided gratis by the advertiser; 3) the terms of any agreement between the speaker and the advertiser; 4) the length of the relationship

between the speaker and the advertiser; 5) the previous receipt of products or services from the same advertiser to the speaker; 6) the likelihood of future receipt of such products or services from the same advertiser to the speaker; and 7) the value of the items or services received from the advertiser to the speaker. In the end, the more these factors support a strong advertiser-speaker connection, the more likely the FTC will expect an endorsement to contain a disclaimer.

### Staying on the Right Side of the New Guidelines

In comments published with the revised guidelines on endorsements, the FTC suggested that it would consider an employer's policies and procedures governing employee postings on blogs and social-networking sites in determining whether the employer should be held liable for misleading employee endorsements on such sites.

Therefore, to reduce the potential for liability for employee statements, companies should heed the FTC's advice and adopt strong social networking policies immediately. The social networking policy should be in writing, consistently implemented throughout the company and effectively monitored. It should also:

- Adopt standards of conduct for employees' online communications regarding intellectual property, defamation, and privacy issues.
- Notify employees that the company will take an interest in employees who blog about company products and services.
- Require all employee comments to be

reviewed by the company's marketing department or legal department before being posted online.

- Explicitly notify employees that the company will take action when an employee acts in violation of its policy. Doing so could enhance the company's credibility if the violation is later reviewed by the FTC.
- Explain that all endorsements should be limited to truthful and verifiable statements.
- Clarify that all endorsements should be accompanied by an employee's written disclosure of the employment relationship so that consumers can fairly weigh the testimonial. For example, a company could instruct its employees posting online to include the following explanation "I am an employee of Company A. These comments represent my own opinions and not those of Company A. I am not a Company A spokesperson."

If the company is not working directly with the blogger and instead is working through an intermediary, e.g., a blog advertising service, the company may want to perform an additional level of due diligence by verifying that the advertising service is providing guidance and training to its bloggers. If free products or services are being provided, the company should make sure bloggers are disclosing their commercial relationships.

When using expert endorsers, companies should make sure these experts review products they are endorsing to a degree that is at least equal to what most other experts in their field would deem adequate. Marketers can best avoid issues

in this area by selecting quality experts to review their products; requesting experts to conduct thorough examinations; guaranteeing that experts provide their unbiased opinions; and selecting experts that have expertise in areas relevant to the reviewed product.

### Conclusion

New federal guidelines created to protect consumers from deceptive endorsements and false advertising pose liability risks for companies whose employees utilize social media such as blogs and other social networking sites to promote their employer's products or services, even if the comments are not authorized by or sponsored by the company. If your company provides services or sells products and your employees are blogging about them or talking about them on their Facebook accounts, the presumption may be that they are doing so with the company's blessing and for the company's benefit.

Such online posts can reach thousands of consumers at a time, increasing an employer's exposure to liability under the FTC's new guidelines. If consumers later claim they were misled into purchasing falsely advertised products by the employee's comments, the company could be liable. To best avoid liability, a company should take the time upfront to train employees on proper online social media usage and draft a strong social media policy. Doing so may be the best protection a company can get from an FTC enforcement action or worse.

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## Third Circuit Denies Secured Lenders Right to Credit Bid in Plan Sale

By William P. Weintraub, Gregory W. Fox, and Kizzy L. Jarashow

*The Third Circuit in In re Philadelphia Newspapers, LLC, turns secured lenders expectations upside down—holding that secured lenders do not have a right to credit bid in the plan sale context.*

In *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010), the Court of Appeals for the Third Circuit held that a secured lender does not have an absolute right to credit bid its claim in a sale by the debtor of the lender's collateral as part of a plan of reorganization. Credit bidding has long been an important tool of a secured lender—allowing it to bid its debt rather than cash in connection with a sale of its collateral. This tool permits a secured creditor to credit up to the full amount of its debt against the price of its collateral before bidding cash, thus enabling a creditor to “purchase” its collateral at a sale when the creditor believes that the collateral is being undervalued by competing bidders or by the debtor. The court's ruling was contrary to the established rule—embedded in Bankruptcy Code section 363(k)—that a secured creditor has an absolute right in a bankruptcy case to credit bid its debt when the sale of its collateral is done outside of the context of a plan, and also contrary to the conventional wisdom that the secured creditor's right to credit bid is preserved under Bankruptcy Code section 1129(b)(2)(A)(ii) if the sale of its collateral is to occur pursuant to a plan of reorganization. This decision highlights fundamentally differ-

ent interpretations of section 1129(b)(2)(A) of the Bankruptcy Code which governs “cramdown” of a plan on secured creditors, and will undoubtedly impact the decision-making of lenders and debtors on a go-forward basis, especially as to how, and when, bankruptcy court sales will occur.

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### Background

Philadelphia Newspapers, LLC and certain of its affiliates (the Debtors) owned and operated two of Philadelphia's major newspapers. The newspapers were purchased in July 2006 for \$515 million using the proceeds of a \$295 million secured loan from a syndicate of lenders (collectively, the Secured Lenders) who held first priority liens on substantially all of the Debtors' real and personal property. Six months after filing voluntary Chap-

ter 11 petitions, the Debtors filed a joint Chapter 11 plan of reorganization (the Plan) that provided for the sale of substantially all of the Debtors' assets free and clear of existing liens, including those of the Secured Lenders. Concurrently with filing the Plan and in anticipation of the auction of the Debtors' assets, the Debtors entered into an asset purchase agreement with a joint venture comprised of insiders of the Debtors (the Stalking Horse). The Debtors advertised the auction with the slogan “Keep it Local”—referring to the largely Philadelphia-based Stalking Horse group—and, leading up to the auction, attempted to steer the sale toward the insider-controlled Stalking Horse group.

Notably, rather than pursuing a “section 363 sale” ahead of proposing a plan of reorganization, which is a common approach used in many cases, the Debtors instead used the Plan to structure a sale under section 1129(b)(2)(A)(iii) of the Bankruptcy Code. The strategy used by the Debtors in the Plan was an apparent effort to circumvent Bankruptcy Code section 363(k) in order to prevent the Secured Lenders from credit bidding at the auction. To implement their strategy, the Debtors proposed to “cramdown” the Secured Lenders. Pursuant to section 1129(b) of the Bankruptcy Code, a debtor is permitted to confirm a plan of reorganization over the objection of an impaired class of creditors who has voted against the plan (i.e., do a “cramdown”), provided that

the dissenting class is treated fairly and equitably. The Bankruptcy Code provides for three avenues to fair and equitable treatment of impaired creditor classes, as set forth in subsections (i)–(iii) of section 1129(b)(2)(A). Subsection (i) of section 1129(b)(2)(A) contemplates, among other things, that a secured creditor retain its liens and receive deferred cash payments; subsection (ii) expressly applies to “plan sales,” calls for a secured creditor’s lien to attach to sale proceeds and mandates the secured creditor’s right to credit bid; and subsection (iii) is a general catch-all, permitting cramdown if the impaired class receives the “indubitable equivalent” of their claims pursuant to a plan of reorganization. Even though subsection (ii) expressly applies to plan sales and includes the right to credit bid, the Debtors in *Philadelphia Newspapers* instead attempted to use subsection (iii), which does not on its face either apply to sales or require credit bidding. In other words, the Debtors skipped over section 1129(b)(2)(A)(ii), the provision that mandates credit bidding in a sale of a secured lender’s collateral, and jumped directly to the catch-all provision of section 1129(b)(2)(A)(iii).

Pursuant to the Plan, the Secured Lenders would receive on account of their \$318 million claim: (1) the cash generated at the auction (at least \$37 million—the cash portion of the Stalking Horse bid) and (2) the Debtors’ Philadelphia headquarters, valued at \$29.5 million, subject to a two-year rent-free lease. In essence, the lien of the Secured Lenders would be stripped from their collateral in exchange for payments or distributions valued at only \$66.5 million.

The Debtors’ proposed auction bidding procedures specifically prohibited the Secured Lenders from credit bidding their \$318 million secured claim at the auction. The Secured Lenders objected to the bid procedures, arguing that, as a matter of law, a debtor cannot strip a secured creditor’s lien without permitting it to credit bid, and that the Debtors should not be permitted to sell their asset to insiders “on the cheap” by circumventing the protections intended to be available to secured creditors under the Bankruptcy Code.

In response to objections from the

Secured Lenders, the Bankruptcy Court for the Eastern District of Pennsylvania held that, based on the statute, the Secured Lenders had an absolute right to credit bid their claims in any sale of their collateral, whether under Bankruptcy Code section 363 or in a plan sale context. The Bankruptcy Court ruled that subsection (ii) of Bankruptcy Code section 1129(b)(2)(A)—which explicitly provides for the right to credit bid—applies whenever a debtor is attempting a plan sale. On appeal, the District Court reversed the Bankruptcy Court, holding that the plain language of section 1129(b)(2) provides a debtor with an option to use either subsection (i), (ii), or (iii). According to the District Court, a debtor is not required to allow a secured creditor to credit bid in a plan sale; as long as such creditor receives the indubitable equivalent of its claim, a plan can be confirmed over the creditor’s objection.

### Third Circuit Decision

In a 2–1 decision, the Third Circuit affirmed the District Court and held that a secured creditor does not have a presumptive right to credit bid in the context of a sale pursuant to a plan. In so holding, the court reasoned that, when dealing with a sale of property subject to liens pursuant to a plan, the three subsections set forth in sections 1129(b)(2)(A)(i)–(iii) were alternative paths to satisfying the fair and equitable test, and the Debtors could, therefore, utilize subsection (iii) of section 1129(b)(2)(A)—the indubitable equivalent prong—to strip the Secured Lenders’ lien from their collateral without providing the Secured Lenders with the opportunity to credit bid their \$318 million secured claim. The majority was careful to explain that its decision was limited to whether the Debtors could propose to sell assets under the Plan using subsection (iii) of section 1129(b)(2)(A), and that it was leaving open for the Bankruptcy Court to decide at Plan confirmation whether, as a result of the auction and the distributions proposed to be made to Secured Lenders under the Plan, the Secured Lenders would in fact receive the indubitable equivalent of their claims.

The guiding rationale behind the major-

ity’s ruling was that the plain language and meaning of section 1129(b)(2)(A) was unambiguous and that, consequently, the court did not need to look outside the four corners of the statute for guidance. Specifically, the court held that, since subsections (i), (ii), and (iii) are phrased in the disjunctive (using “or” rather than “and”), a plan can be crammed down over a secured creditor’s objection so long as any one of the three subsections is satisfied. The court noted that when a statute is written in the disjunctive, the intent of the drafters is to permit the debtor to select any one, or more, of the options presented. Accordingly, the Debtors could utilize subsection (iii) to satisfy the fair and equitable requirement of section 1129(b)(2)(A) and deny the Secured Lenders the opportunity to credit bid at the auction.

Of particular import is the discussion, in both the majority and dissent, of the interplay between sections 1111(b) and 1129(b)(2)(A) of the Bankruptcy Code. Section 1129(b)(2)(A) is the basic cramdown provision that enables the debtor to confirm a plan of reorganization notwithstanding the “no” vote of the secured creditor, provided the treatment of the creditor’s secured claim is “fair and equitable.” Subsections (i)–(iii) of section 1129(b)(2)(A) define the minimum treatment that is fair and equitable. Section 1111(b), on the other hand, does two things: first, the section makes non-recourse secured claims recourse in Chapter 11 (which means that, notwithstanding the loan agreement or applicable state law, the undersecured non-recourse secured creditor will have an unsecured deficiency claim in the case); and, second, under certain circumstances, the undersecured secured creditor can elect to have its claim be treated as fully secured (which means the creditor can retain its lien on its collateral for the full amount of its debt even though the collateral is worth less than the debt). Thus, an undersecured creditor that is permitted to and makes the election to be fully secured must be treated differently under section 1129(b)(2)(A)(i) than an undersecured creditor that cannot or does not make the election. Congress added section 1111(b) to the Bankruptcy Code in response to the decision in *Great Nat’l Life*

*Ins. Co. v. Pine Gate Assocs., Ltd. (In re Pine Gate Assocs., Ltd.)*, 2 Bankr. Ct. Dec. 1478 (Bankr. N.D.Ga. 1976), where, pursuant to the plan of reorganization and over the objection of the secured creditor, the debtor was permitted to strip the lien of the secured creditor from real property and, in exchange, only pay the secured creditor the then-appraised and depressed value of the property. As a result of *Pine Gate*, debtors could strategically file for bankruptcy at a time when property values were depressed, strip the liens of secured creditors and benefit from any future appreciation of the property. The purpose of section 1111(b) was to prevent lien stripping. Section 1111(b) is not, however, limited to real estate loans. Although the fix to *Pine Gate* proposed by the Senate was only applicable to loans secured by real property interests, the House version, which was enacted as part of the Bankruptcy Reform Act of 1978, had no such limitation.

Pursuant to section 1111(b)(1)(B)(ii), a secured recourse creditor is not permitted to make a section 1111(b)(2) election if its collateral is being sold pursuant to section 363 of the Bankruptcy Code or under a plan. In theory, and as argued by the Secured Lenders, this is because such creditor (even a recourse lender like the Secured Lenders) can make a credit bid to purchase its collateral to avoid its lien being stripped. Likewise, a secured non-recourse creditor can make the 1111(b)(2) election unless the collateral is to be sold under section 363 or the plan. To protect itself, the non-recourse secured creditor can either credit bid its claim (if its collateral is to be sold by the debtor) and acquire its collateral, or make the 1111(b)(2) election (if its collateral is to be retained by the debtor) and preserve its full claim against its collateral.

In *Philadelphia Newspapers*, the Secured Lenders would not have been permitted to make an 1111(b)(2) election because of the exception set forth in section 1111(b)(1)(B)(ii), namely, the Secured Lenders were recourse secured creditors whose collateral was to be sold. The Debtors argued that because the sale was not under Bankruptcy Code section 363 or section 1129(b)(2)(A)(ii), the language of the statute did not

mandate the Secured Lenders be given the right to credit bid. The Secured Lenders argued that, in the absence of the right to make the 1111(b)(2) election, they must be permitted to credit bid at the auction to ensure that the Debtors did not collude with the insider-controlled Stalking Horse bidder to sell the assets for less than market value. The Third Circuit dismissed this argument, holding that the Bankruptcy Code does not provide secured lenders with an absolute right to preferred treatment in the form of guaranteed upside, but rather, limits a secured creditor's recovery to the value of its collateral. If the auction process failed to properly value the Secured Lenders' collateral, the court reasoned, the Secured Lenders could still object to Plan confirmation on the basis that they would not be receiving the indubitable equivalent of their claims.

#### Dissent

Judge Thomas L. Ambro, a former bankruptcy lawyer, wrote a spirited dissent in *Philadelphia Newspapers* in which he argued that the Bankruptcy Code does provide secured creditors with a presumptive right to credit bid when their collateral is being sold through a plan of reorganization. Judge Ambro echoed Bankruptcy Judge Raslavich's concerns that the Debtors' ulterior motive for denying the Secured Lenders the right to credit bid was to gain leverage to steer the sale to the insider group so that they could buy those assets "on the cheap" and free and clear of the Secured Lenders' liens. According to the dissent, the Debtors' attempts to "Keep it Local" by structuring the auction in a way that advantaged the insider-controlled Stalking Horse and disadvantaged the Secured Lenders was inconsistent with the goal of obtaining the "best and highest offer" at the auction.

The linchpin of Judge Ambro's dissent is that section 1129(b)(2)(A) is ambiguous and, under the principles of statutory interpretation, cannot be read in isolation. Instead, section 1129(b)(2)(A) must be read in the "context of the entire Bankruptcy Code" and the statute's legislative history. According to Judge Ambro, when the statute is read in proper context, it is

clear that a debtor seeking to sell assets pursuant to a plan must comply with the specific requirements of subsection (ii) of section 1129(b)(2)(A)—which specifically permits credit bidding in order to cramdown a plan sale and strip the liens of secured creditors.

According to Judge Ambro, the three subsections of section 1129(b)(2)(A) are "distinct routes" to meeting the fair and equitable test that "apply specific requirements depending on how a given plan proposed to treat the claims of secured creditors." Clause (i) applies when the plan provides that the secured lender retains the lien securing its claim, clause (ii) applies when the plan provides for the sale of any encumbered property free and clear of liens, and clause (iii) only applies whenever the plan provides for the secured creditor to realize the indubitable equivalent of its secured claim through the plan, for example, by offering secured lenders replacement liens on other collateral or abandonment of property to secured lenders. Under this reading, debtors can only proceed under clause (iii) in situations where the treatment of secured creditors under the plan is not addressed by clauses (i) or (ii).

Noting the canon of statutory construction that "a specific provision will prevail over a general one," Judge Ambro determined that Congress would not have drafted subsection (ii) of section 1129(b)(2)(A), dealing with plan sales of property free of liens, if a debtor were able to circumvent those procedures by using subsection (iii). Such a result would render subsection (ii) "superfluous, void or insignificant."

Judge Ambro also looked to other sections of the Bankruptcy Code related to sales of encumbered property and other secured creditor protections, such as sections 1123(a)(5)(D), 363(k), and 1111(b), to demonstrate that Congress intended for a secured creditor to have a presumptive right to credit bid when there is a sale of its collateral under a plan or otherwise. Judge Ambro asserted that sections 1129(b)(2)(A)(ii) and 1111(b) are "best understood as alternative protections for the secured creditor: one to apply when its collateral is sold free and clear of liens,

and the other to apply when its collateral is treated other than as a sale.” Sections 1129(b) and 1111(b), enacted in conjunction with each other, were intended to provide stronger creditor safeguards than what had existed under the prior Bankruptcy Act. If one accepts the proposition that the right to credit bid and the right to make the section 1111(b)(2) election are two sides of the same coin—designed to prevent lien stripping—the secured creditor should be protected in all permutations against a low-ball valuation by the debtor either by enabling the creditor to purchase its collateral through a credit bid or maintain its lien on its collateral for the full amount of its claim. In both cases the secured creditor is able to negate any efforts by the debtor to limit the creditor’s claim to the low-ball value and pay nothing (or next to nothing) to the creditor on its resulting deficiency claim.

### Events Since the Third Circuit Decision

Following the Third Circuit’s ruling, the Secured Lenders requested a stay of the sale and en banc review of the panel’s decision, both of which requests were denied. With no chance for certiorari prior to the auction, the Secured Lenders had two choices: (1) bid cash at the auction to drive up the price and/or take control of the company or (2) allow the auction to go forward without bidding, risk that the insider-controlled Stalking Horse group could acquire the assets for less than fair-market value, and object to confirmation of the Plan on the grounds that the Plan did not provide the Secured Lenders with the indubitable equivalent of their claims as required under Bankruptcy Code section 1129(b)(2)(A)(iii). Ultimately, the Secured Lenders chose the former, bidding cash at the auction on April 28, 2010, and winning the assets with a bid valued at approximately \$138.9 million (\$105 million of which was cash). In essence, the Secured Lenders paid themselves with their own cash. The Bankruptcy Court confirmed the Debtors’ Plan on June 28, 2010, which provided for the company to be sold to Philadelphia Media Network Inc., an entity owned by the Secured

Lenders. That sale did not close, however, as a result of a dispute between the Secured Lenders and one of the labor unions representing the Debtors’ employees. Accordingly, the Bankruptcy Court conducted another auction in September 2010. The Secured Lenders prevailed again at the second auction and subsequently reached labor agreements with each of the Debtors unions. The sale of the Debtors’ assets to the Secured Lenders closed in early October 2010.

### Implications for Secured Lenders

While the *Philadelphia Newspapers* decision did not prevent Secured Lenders from taking control over their collateral because they chose to bid cash at the auction, the decision still marks a dramatic shift in existing law regarding the right of secured creditors to credit bid their claims.

While the plain language of section 1129(b)(2)(A) of the Bankruptcy Code provides for multiple avenues for a debtor to prove it is treating its secured creditors “fairly and equitably” in a cramdown, the majority decision failed to adequately address the schism between a literal interpretation of section 1129(b)(2)(A) and legislative intent. The practical result of majority’s decision—that secured creditors can credit bid in 363 sales but cannot credit bid when their collateral is sold pursuant to a plan—is hard to reconcile with what seems to be a clear indication that the drafters of the Bankruptcy Code intended section 1111(b), 363(k), and 1129(b)(2)(A) to work together to prevent a debtor from stripping a secured creditor’s lien without providing the secured creditor with a right to credit bid. It is simply unlikely that Congress intended this distinction.

The decision may have a serious impact on the relationship between secured creditors and borrowers. As Judge Ambro noted in his dissent, this decision effectively denies secured creditors the “benefit of their bargain” and “uproots settled expectations of secured lending.” Going forward, lenders may insist on including provisions in loan documents that guarantee them the ability to credit bid in the plan sale context. In addition, distressed

companies contemplating a Chapter 11 filing may also feel pressure by their lenders to file outside of the Third Circuit—where the law on this issue has not yet been settled and could possibly fall in the secured creditor’s favor. Future debtors in possession in the Third Circuit and elsewhere may jump at the opportunity to use *Philadelphia Newspapers* as precedent and strip the liens of their undersecured creditors while an insider buys the business on the cheap. Especially troubling is the prospect that *Philadelphia Newspapers* could be used as a roadmap for mischief by a Chapter 11 debtor seeking to circumvent subsection (ii) and its credit bidding requirement by structuring a hybrid sale that also provides for abandonment (or quasi-abandonment—as the Debtors attempted through a proposed abandonment their headquarters subject to a two-year, rent-free lease by the Debtors) of some portion of the collateral. In addition, whether a debtor can provide a secured creditor with the indubitable equivalent of a secured claim if the secured creditor has not been given the opportunity to credit bid remains unclear. There may be instances where a secured lender chooses not to, or cannot, make a cash bid when faced with a plan sale of its collateral that does not allow credit bidding. Not every creditor group will be able (or willing) to raise cash from its multiple and possibly disparate members. In such circumstances, it is unclear whether a court would find that the auction process adequately valued the collateral absent credit bidding by the secured lenders. As such, the lasting impact of the *Philadelphia Newspapers* decision cannot yet be fully known.

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## Avoiding “Benefit of the Bargain” Damages in Letters of Intent

By Rocco E. Testani and Kurt E. Lentz

Prior to entering into a final contract, parties frequently memorialize certain key deal points in preliminary agreements. These preliminary agreements are known by many names: letters of intent, term sheets, letters of interest, expressions of interest, or memoranda of understanding. Preliminary agreements often contain both non-binding provisions and binding provisions, such as an exclusivity provision or an agreement to negotiate in good faith. When a party breaches a binding provision in an otherwise expressly non-binding preliminary agreement, the question inevitably arises: what is the proper measure of damages?

Although courts addressing this issue have generally held that the proper measure of damages is limited to out-of-pocket or reliance damages, dicta in an influential opinion by Judge Richard Posner leaves open the door for an award of “benefit of the bargain” or expectation damages such as lost profits. *Venture Associates Corp. v. Zenith Data Systems Corp.*, 96 F.3d 275 (7<sup>th</sup> Cir. 1996). Judge Posner’s opinion, which has been favorably cited by a number of commentators, injects enough uncertainty into the damages analysis to expose unsuspecting parties to hundreds of thousands or even millions of dollars in damages, or, at the very least, subject them to litigation that is not easily or inexpensively resolved based on a preliminary agreement that a party thought to be non-binding.

In *Venture*, Judge Posner recognized the prickly issues surrounding preliminary agreements:

One of the most difficult areas of contract law concerns the enforceability of letters of intent and other preliminary agreements, and in particular the subset of such agreements to negotiate toward a final contract. When if ever are such agreements enforceable as contracts? If they are enforceable, how is a breach to be determined? Is “breach” even the right word? Or is the proper rubric “bad faith”? Could the duty of good faith negotiation that a letter of intent creates be a tort duty rather than a contract duty, even though created by contract? *And can the victim of bad faith ever get more than his reliance damages?*

Whatever difficulties may inhere in the area of contract law surrounding so-called “preliminary agreements,” determining the proper measure of damages for the breach of a binding provision contained in an otherwise expressly non-binding preliminary agreement should not be one of them. Bedrock principles of contract law, such as the requirement that damages be capable of proof to a reasonable degree of certainty and reasonably foreseeable as a consequence of the breach at the time the contract was made, should limit the non-breaching party’s recovery to

reliance damages. Nevertheless, because only a handful of courts have addressed the precise issue of the proper measure of damages for the breach of a deemed-to-be binding provision contained in an otherwise non-binding preliminary agreement, the possibility remains that a court faced with this issue for the first time may adopt the approach taken by Judge Posner in *Venture*.

### The *Venture* “Rule”

A closer look at the facts in *Venture* is instructive. *Venture* involved the proposed acquisition by Venture Associates Corporation of certain assets of Zenith Data Systems Corporation. The purchaser, *Venture*, sent a letter to Zenith, the seller, proposing terms for the acquisition. The letter stated that it was not a binding obligation on either party, but was rather “merely a letter of intent” subject to execution of a definitive purchase agreement, *except* for a paragraph in the letter stating that the parties agreed to negotiate in good faith to enter into a definitive purchase agreement, and that pending execution of a definitive purchase agreement, the seller would not negotiate with other companies. The seller responded to the letter, agreeing to negotiate for the sale of the company and agreeing in principle to the purchaser’s proposed terms. The Seventh Circuit found that the exchange of letters “established a binding agreement to negotiate in good faith toward the formation of a

contract of sale.”

When the deal outlined in the purchaser’s letter fizzled, the jilted purchaser sued, claiming that the seller breached the agreement to negotiate in good faith toward a definitive purchase agreement and seeking expectation damages for the breach. In considering the proper measure of damages, Judge Posner penned the following passage, which parties are sure to see if they ever find themselves embroiled in litigation over the proper measure of damages for the breach of a binding provision in an expressly non-binding preliminary agreement:

Damages for breach of an agreement to negotiate may be, although they are unlikely to be, the same as the damages for breach of the final contract that the parties would have signed had it not been for the defendant’s bad faith. If, quite apart from any bad faith, the negotiations would have broken down, the party led on by the other party’s bad faith to persist in futile negotiations can recover only his reliance damages—the expenses he incurred by being misled, in violation of the parties’ agreement to negotiate in good faith, into continuing to negotiate futilely. *But if the plaintiff can prove that had it not been for the defendant’s bad faith the parties would have made a final contract, then the loss of the benefit of the contract is a consequence of the defendant’s bad faith, and, provided that it is a foreseeable consequence, the defendant is liable for that loss—liable, that is, for the plaintiff’s consequential damages.*

Judge Posner did point out the difficulties of proof plaintiffs would face: “The difficulty, which may well be insuperable, is that since by hypothesis the parties had not agreed to *any* of the terms of their contract, it may be impossible to determine what those terms would have been and hence what profit the victim of bad faith would have had.” But, according to Judge Posner, this difficulty “goes to the practicality of the remedy, not the principle of it.”

What Judge Posner’s opinion in *Venture* does, perhaps unwittingly, is create an expedient means for plaintiffs to survive summary judgment in lawsuits seeking expectation damages based on the breach of a binding provision of an otherwise expressly non-binding preliminary agreement. If a non-breaching party can convince a court that a binding provision “found” in an otherwise non-binding preliminary agreement carries with it an obligation to negotiate in good faith toward a final deal, then the non-breaching party can argue under *Venture* that it is entitled to expectation damages because “but for” the breaching party’s bad faith, a final deal would have been reached.

The problem with applying the *Venture* “rule” to binding provisions contained in expressly non-binding letters of intent is manifest: it holds the parties to the terms of a contract to which they expressly disavowed any intent to be bound. This fundamental problem is magnified by the fact that *Venture*’s analysis makes it difficult to obtain summary judgment or other pre-trial resolution in such cases because the “but for” causation standard it adopts typically involves factual disputes to be resolved by a jury. This, in turn, creates several perverse incentives for the disappointed party to such a preliminary agreement. Specifically, the disappointed party has an incentive to bring a case since it knows that defense costs may force a settlement in excess of its out-of-pocket or reliance damages, even if the merits of its case are lacking. More troubling, though, is the incentive it creates for the disappointed party to “roll the dice” with a jury and actually obtain an award of its expectation damages. Obviously, these perverse incentives are not desirable consequences for any legal standard.

### **The Scope of the *Venture* “Rule” is Limited**

While the *Venture* case creates uncertainty, breaching parties do have recourse to a body of case law that rejects the notion that “benefit of the bargain” or expectation damages are available for the breach of binding provisions of expressly non-binding preliminary agreements.

First, the rule of *Hadley v. Baxendale* requires that contract damages be the “natural and necessary consequence” of the breach and must have been in the contemplation of the parties at the time the contract was made. When parties expressly disavow any intent to be bound by the substantive terms outlined in a preliminary agreement, it runs counter to *Hadley* and defies logic to suggest that the non-breaching party’s “benefit of the bargain” damages were within the contemplation of the parties at the time the agreement was made, since those are the same damages that would be available for a breach of the completed contract. In effect, the parties’ intent not to be bound by the terms in the preliminary agreement should shield them from the liability that would attach for a breach of the final agreement.

In *Logan v. D.W. Sivers Co.*, 169 P.3d 1255 (Or. 2007), the Oregon Supreme Court, echoed the rule in *Hadley* and found just such a shield to exist and held that consequential damages were not available for the breach of a binding non-solicitation provision contained in an otherwise non-binding letter of intent that detailed the plaintiff’s proposed purchase of a shopping mall owned by the defendant. Given the parties’ disclaimer of any intent to be bound by the overall terms of the preliminary agreement, the court found it to be irrelevant that “a reasonable person in the same position as defendant might have foreseen that plaintiff would suffer tax losses down the road” if the defendant breached the non-solicitation provision. The court also found it to be irrelevant that the defendant might have sold the property to the plaintiff “but for” the defendant’s breach of the non-solicitation provision because the “parties expressly declined . . . to assume the risks of injury in a completed contract of purchase and sale,” and the “defendant cannot now be saddled with those very same liabilities on the theory that, because defendant likely would have sold the property to plaintiff except for its breach of the lesser promise not to sell the property to someone else for 60 days, those liabilities are the natural and foreseeable consequences of defendant’s breach.”

In an analogous context, the New York Court of Appeals has aptly described the trouble with awarding expectation damages based on the breach of a binding provision found in an otherwise non-binding letter of intent. In *Goodstein Construction Corp. v. City of New York*, 604 N.E.2d 1356 (N.Y. 1992), the court reasoned that the “loss of profits based on fulfillment of the terms of the contract being negotiated could not have been reasonably contemplated as damages for a breach of the agreement to negotiate those very contractual terms.”

Simply put, parties have a right to rely on the language they choose to include in their preliminary agreement. If the parties choose to include language expressly making the preliminary agreement non-binding, they are entitled to rely on that language. If they do include such language, it is not foreseeable that the same measure of damages that would be available for breach of a completed contract would be available for the breach of a lesser-included binding provision of a preliminary agreement. A contrary rule would have the anomalous effect of holding the breaching party as guarantor for the profits the non-breaching party expected to earn from a final contract that may never have been executed.

Second, only damages that can be proved with reasonable certainty are recoverable. Damages cannot be based on speculation and conjecture. Two layers of speculation inhere in every claim for damages based on the breach of a binding provision contained in a non-binding letter of intent: first, because the parties never agreed to be bound, it cannot be determined without resort to speculation and conjecture that a final deal would have been reached absent the breach; and, second, because the letter of intent, by its very nature, did not set terms, it cannot be determined without resort to speculation and conjecture what the final terms of the deal would have been.

In *Logan*, for example, the court emphasized that “the parties were at pains in their letter of intent to identify what they were *not* agreeing to do: Defendant was not agreeing to sell, or even to negotiate in good faith toward selling, and plain-

tiff was not agreeing to buy, or even to negotiate in good faith toward buying, the property in question.” The court also correctly noted that “each party remained free to sit on its hands and do nothing,” and that “each party also might hope that the other would not behave in that way, but such a party had nothing beyond that—hope on which to risk its financial circumstances.” In view of the “narrow and specific bargain struck by the parties,” the court concluded that the plaintiff could only recover its reliance damages, “[b]ut because defendant never agreed to sell or even to negotiate in good faith toward the sale of the property to plaintiff (and, in fact, explicitly disclaimed any such agreement when it signed the letter of intent), plaintiff cannot . . . charge defendant with losses that flowed from her inability to finally purchase it.”

Similarly, in *Vestar Development II, LLC v. General Dynamics Corp.*, 249 F.3d 958 (9th Cir. 2001), the Ninth Circuit considered a binding exclusivity provision contained in an expressly non-binding letter of intent and held that the plaintiff could recover its reliance damages, but not its expectation damages, for a breach of the exclusivity provision. The court found that the plaintiff’s claim for expectation damages could not satisfy the requirement under California law “that damages not be speculative or, conversely, that they be proved to a reasonable certainty.” The court explained that “satisfactory proof” of the plaintiff’s expectation damages was impossible because, since the preliminary agreement was expressly non-binding, “[t] here [was] no way to know what the terms of the eventual sale would have been—or even if a deal would have been reached.”

The reasons for denying recovery of expectation damages for breaches of binding provisions contained in the expressly non-binding preliminary agreement in *Logan* and *Vestar* are present in every case involving the breach of a binding provision in a non-binding preliminary agreement. Specifically, the plaintiffs in such cases will be put to the task of establishing that the parties’ express intent not to be bound by the terms set forth in the letter of intent should be set aside in favor of a

finding that the breach of the limited binding provision precluded a final deal from being reached. This “proof” necessarily involves speculation that a deal would have been done absent the breach.

Even if it could be assumed that a final deal would have been reached without a breach, plaintiffs face the further challenge of proving what the terms of the deal would have been. No doubt, they will point to the terms outlined in the preliminary agreement as a guidepost for what the terms of a final deal would have been, but since those terms are expressly non-binding, the court must once again necessarily resort to speculation: either that the preliminary terms would have been the final terms, despite the parties’ expressed intent not to be bound by those terms, or that some other set of terms would ultimately have been agreed to by the parties.

### Steps to Avoid Application of the Venture “Rule”

Of course, as with most things, an ounce of prevention is worth a pound of cure: parties can take certain proactive steps to avoid ending up in litigation regarding the proper measure of damages recoverable for the breach of a binding provision of an expressly non-binding preliminary agreement.

To avoid an argument that there is a binding obligation to negotiate in good faith, thus bringing the provision within the purview of *Venture*, parties should expressly state that there is no such duty. In addition, proper care should be taken to avoid “contract-like” language in letters of intent. Words matter. For example, the non-binding provisions should refer to the “potential transaction” or the “possible deal,” or other terms or conditions that “would” be applicable. Within any non-binding provision, care should be taken to avoid the use of words such as “shall,” “will,” or “must.” In contrast, any provisions intended by the parties to be binding, to the extent they are to be included, should use these types of words to indicate contractual formality. Being precise in choosing what language to include in a letter of intent provides an additional layer

of protection from a court imposing a duty to negotiate in good faith. The cumulative effect of such precision is to draft a preliminary agreement that expressly states it is not an agreement to negotiate in good faith, and that does not contain any language capable of being interpreted as creating a binding obligation to negotiate in good faith, rendering the rationale from *Venture* inapplicable.

Parties should also include language that expressly limits recovery for the breach of the binding provision to the non-breaching party's reliance damages, or, alternatively, provide for a specific break-up fee. In light of such a limitation, a plaintiff would be hard-pressed to argue that an award of expectation damages was within the contemplation of the parties at the time the letter of intent was executed. Such language may

be included in conjunction with a provision expressly stating that no liability will attach for the breach of any of a letter of intent's expressly non-binding provisions.

### Conclusion

In today's complex business world, negotiating parties routinely enter into preliminary agreements, which often contain binding and non-binding provisions, prior to executing a final contract. When entering into such preliminary agreements, parties should be wary of the *Venture* "rule" that leaves open the door to the possibility of expectation damages being awarded for the breach of a non-binding preliminary agreement. Parties should also be aware, however, of the case law that holds that expectation damages are not recoverable for

the breach of a binding provision of a non-binding preliminary agreement and the practical steps they can take to avoid finding themselves embroiled in messy, expensive litigation. If parties structure their preliminary agreements consistent with the case law discussed above and take the proper precautions in drafting their preliminary agreements, they may significantly reduce the risk of having to pay expectation damages for the breach of a preliminary agreement to which they never intended to be bound.

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# BUSINESS LAW TODAY

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## Keeping Current: Securities

### Top-Up Options—Recent Delaware Decisions

By George R. Bason, Jr., Justine Lee, and Scott Luftglass

As the percentage of tender offers in friendly transactions has risen in recent years, so too has use of so-called “top-up options.” Yet, despite their prevalence, the validity of top-up options has not been addressed squarely by the Delaware courts and continues to be challenged by the plaintiffs’ bar. However, two separate rulings from the Delaware Court of Chancery this week suggest that the use of top-up options is likely to present little litigation risk.

A top-up option gives the acquiror the right, upon successful completion of a tender offer at or above the minimum condition level (usually 50 percent), to purchase newly issued shares of the target so as to increase its ownership in the target to greater than 90 percent. Under Delaware law, once an acquiror crosses the 90 percent ownership threshold, it may complete the back-end squeeze out through a simple short-form merger. The purpose of the top-up option is to expedite the closing of the merger (and thus the receipt of the consideration by the target’s stockholders) once a majority (but less than 90 percent) of the target’s stockholders have endorsed the transaction by tendering their shares.

In *In re Cogent, Inc. S’holders Litig.* (Consol. C.A. No. 5780-VCP), Vice Chancellor Parsons denied a motion to preliminarily enjoin the proposed friendly two-step acquisition of Cogent by 3M. Certain Cogent stockholders challenged, among other things, the companies’ inclusion of a top-up option in the 3M/Cogent

merger agreement. In denying the motion for preliminary injunction, Vice Chancellor Parsons found that the plaintiffs did not establish a likelihood of success on their challenge to the top-up option:

- **Theoretical Disenfranchisement of Minority Stockholders Too Speculative**

Plaintiffs argued that because 3M, with the consent of the Cogent, could waive the minimum tender condition, 3M was theoretically able to exercise the option even if a majority of shares were not tendered. Vice Chancellor Parsons concluded that although “it technically might be possible for 3M to acquire the Company through the Top-Up Option without acquiring a majority of the shares in the tender offer, this argument depends on the occurrence of more than one highly unlikely event [i.e., that 3M would waive the minimum tender] and is far too speculative to warrant injunctive relief.”

- **Top-Up Option is Not a “Sham” Transaction or Illusory Promise**

Vice Chancellor Parsons likewise found that plaintiffs were not likely to succeed in their contention that, because the top-up option allowed 3M to pay for the top-up shares with a promissory note payable in a year (by which time it presumably would own Cogent), it was an illusory promise to pay itself. Noting that DGCL section 157 leaves the judgment as to the sufficiency of consideration received

for stock to the conclusive judgment of the directors absent fraud, Vice Chancellor Parsons reasoned that the Board had received due consideration for entering into the merger agreement and that the promissory note, at the time issued, would be a legally enforceable obligation owed by 3M to Cogent.

- **Excluding Top-Up Option from Consideration in Fair Value Appraisal**

Plaintiffs argued that the value of existing Cogent shares would be reduced as a result of (1) the dilutive effect of a substantial increase in shares outstanding if the top-up option were exercised and (2) the “questionable value” of the promissory note given as consideration for them. They contended that the fair value of the appraisal shares in a subsequent appraisal proceeding following the execution of the top-up option would also be decreased. Cogent and 3M, anticipating this issue, had followed the increasingly common practice of providing in the merger agreement that “the fair value of the Appraisal Shares shall be determined in accordance with DGCL § 262 without regard to the Top-Up Option, the Top-Up Option Shares or any promissory note delivered by the Merger Sub.” Noting that there is a strong argument in favor of permitting merger parties “to stipulate to certain conditions under which an appraisal will be conducted—certainly to the extent that it would benefit dissenting shareholders

and not be inconsistent with the purpose of the statute,” Vice Chancellor Parsons concluded that, in this case, the merger agreement provision was sufficient to overcome plaintiffs’ professed concerns about the potential dilutive effects of the top-up option.

Similarly, in *In re Protection One, Inc. S’holders Litig.* (Consol. C.A. No. 5468-VCS), Vice Chancellor Strine entered an order approving a settlement of stockholder litigation which included, among other things, a stipulation by the parties that any

top-up shares would not be included for purposes of adjudicating fair value in an appraisal action. Indeed, Vice Chancellor Strine seemed skeptical of any of the professed concerns about top-up options, declaring that he hadn’t “caught the top-up wave.” Emphasizing that the top-up option is “part and parcel of the transaction that gave rise to appraisal in the first instance,” he questioned why there was even an issue as to whether top-up shares would be included as part of the going concern value of the company.

These recent rulings provide certain

comfort to parties that seek to benefit from the flexibility of the top-up option feature. Despite the court’s recent and justifiable skepticism as to the theoretical necessity of the provision excluding the top-up option from appraisal value consideration, we continue to believe in the advisability of such a provision to further reduce litigation risk relating to its purported dilutive effect.

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