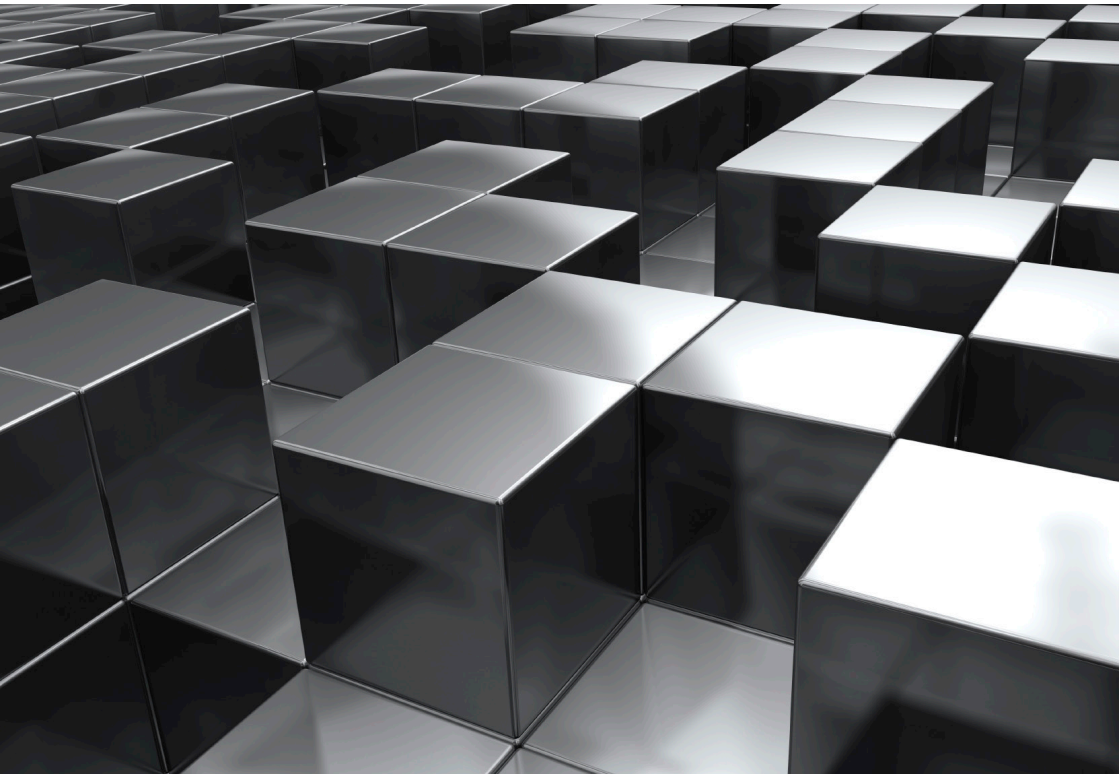


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2011 Bankruptcy Law: The Year in Review

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2011 saw many significant developments in insolvency law. The highest profile bankruptcy opinion in the United States was *Stern v. Marshall*, in which the Supreme Court ruled that bankruptcy courts lack the power to enter final judgments on certain counterclaims. The lower federal courts still are working through the impact of the decision, which could create litigation for many years. Secured creditors got two big breaks in 2011. Disagreeing with other circuits, the Seventh Circuit held in *River Road* that secured creditors must have the right to credit bid when their collateral is sold in a cramdown plan; the Supreme Court will now address the question. An appellate court nullified the much criticized 2009 bankruptcy court decision in *TOUSA* that had increased fraudulent transfer risks for secured creditors. 2011 also saw regulators adopt final rules for the wind-down plans — known as “Living Wills” — of the largest U.S. financial institutions.

Other important decisions have greater impact on creditors further down in the capital structure. Parties to derivative contracts can take solace in courts’ broad reading of the Bankruptcy Code’s safe harbor from avoidance actions. Claims traders must be wary of buying and selling when they possess confidential information in plan negotiations or settlement discussions. 2011 was a good year for employees of bankrupt companies, who saw courts sustain a broad reading of employers’ WARN Act liability and grant administrative expense priority to certain claims for pension plan withdrawal and pre-bankruptcy severance. Courts also opined on procedural and substantive rights in ancillary proceedings under chapter 15.

Other important events transpired outside the United States. The highest court in the U.K. upheld the validity of “flip clauses” in CDOs, creating a direct conflict with decisions in the U.S. Additionally, a U.K. appellate decision ranking floating charge holders and unsecured creditors behind certain pension debt has led to concerns about the decision’s impact on restructurings in the U.K. New laws in Germany should increase the number of court-supervised restructurings. French courts made significant rulings on the primacy of the law governing an indenture over the law where an insolvency proceeding is pending and on the rights of collateral agents. Italy reformed its reorganization laws, especially as to financing distressed companies.

Limitations on Bankruptcy Court Jurisdiction

Supreme Court Narrows Bankruptcy Court Jurisdiction in *Stern v. Marshall*

The Supreme Court, in a 5-4 vote in Stern v. Marshall,¹ held that a bankruptcy court cannot enter a final judgment on a state law counterclaim asserted by a debtor that is not resolved in the process of adjudicating the underlying claim. In affirming the decision of the Ninth Circuit, the Supreme Court ruled that although the bankruptcy court could render final decisions on such counterclaims under 28 U.S.C. § 157, it lacked authority to do so under Article III of the Constitution. The decision distinguished “core” from “non-core” counterclaims, and made clear that bankruptcy courts could adjudicate with finality only “core” counterclaims.

The dispute before the Supreme Court was the culmination of an epic set of lawsuits between Vickie Lynn Marshall (“Vickie”) and E. Pierce Marshall (“Pierce”). Vickie (known to the public as Anna Nicole Smith) was Pierce’s father’s third wife. Although Pierce’s father gave Vickie many gifts during their courtship and marriage, he did not include her in his will. Shortly before Pierce’s father’s death, Vickie filed suit in Texas state probate court against Pierce, asserting that he fraudulently induced his father to sign a living trust that did not include her. After Pierce’s father’s death, Vickie filed for bankruptcy protection in the United States Bankruptcy Court for the Central District of California. Pierce filed a complaint (and an accompanying

proof of claim) in Vickie’s bankruptcy proceeding for defamation. Vickie responded to the action by, among other things, filing a counterclaim for tortious interference (the same cause of action as in the Texas state probate court suit).

Lower Court Decisions

The bankruptcy court concluded that Vickie’s counterclaim was a “core proceeding” under 28 U.S.C. § 157(b)(2)(C), and therefore, it had the “power to enter judgment” on it.² It ruled in favor of Vickie on all counts, granting her summary judgment on Pierce’s defamation claim and awarding her over \$400 million in compensatory damages and \$25 million in punitive damages on her counterclaim.

The District Court for the Central District of California disagreed with the bankruptcy court’s conclusion that the counterclaim was a “core proceeding.”³ It recognized that the counterclaim falls within the literal language of what constitutes a core proceeding under 28 U.S.C. § 157(b)(2)(C), but interpreted Supreme Court precedent to hold that not all counterclaims are core proceedings. The district court treated the bankruptcy court’s judgment as proposed

1. 131 S. Ct. 2594 (2011).

2. *Marshall v. Marshall* (*In re Marshall*), 257 B.R. 35, 40 (Bankr. C.D. Cal. 2000).

3. *Marshall v. Marshall* (*In re Marshall*), 264 B.R. 609 (C.D. Cal. 2001).

rather than final, and after its own independent review of the record, declined to give the Texas state probate court's judgment in favor of Pierce preclusive effect. The district court instead ruled that Pierce tortiously interfered with Vickie's expectancy of a gift from Pierce's father.

After being reversed once previously by the Supreme Court on other grounds,⁴ the Ninth Circuit held that in order to constitute a "core proceeding" under section 157, the counterclaim must be so closely related to the creditor's proof of claim that the resolution of the counterclaim is necessary to resolve the allowance or disallowance of the claim itself.⁵ It further held that Vickie's claim did not meet this test and that the Texas state probate court's judgment should be afforded preclusive effect.

The Supreme Court granted certiorari to determine (a) whether the bankruptcy court had statutory authority under 28 U.S.C. § 157(b) to issue a final judgment on Vickie's counterclaim and (b) if so, whether conferring that authority on the bankruptcy court was constitutional.

Statutory Authority

Under 28 U.S.C. § 157(b), in addition to having final jurisdiction over the bankruptcy case itself, bankruptcy judges may enter final judgments "in all core proceedings arising under title 11, or arising in a case under title 11."⁶ Section 157(b)(2)(C) enumerates a non-exclusive list of 16 different types of matters that are considered core proceedings, including "counterclaims by [a debtor's] estate against persons filing claims against the estate."⁷ When a bankruptcy judge determines that a proceeding is not a core proceeding but "is otherwise related to

a case under title 11," the judge may only "submit proposed findings of fact and conclusions of law to the district court."⁸ The district court then conducts its own independent review before entering a final judgment.

The distinction between the authority of the bankruptcy court and the district court turns on the manner of appointment of bankruptcy judges under the United States Constitution. Article III, section 1 of the Constitution mandates that "[t]he judicial Power of the United States shall be vested in one supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish."⁹ The same section provides that the judges of those constitutional courts "shall hold their Offices during good Behaviour" and "receive for their Service[] a Compensation[] [that] shall not be diminished" during their tenure.¹⁰ Because bankruptcy judges are appointed for a term (not for life) and do not have the salary guarantees of Article III judges, they are considered to be appointed under Article I solely to implement the uniform bankruptcy laws of the United States.

The core/non-core distinction was implemented as part of the 1984 amendments to the Bankruptcy Code that were enacted after the Supreme Court's

4. The Ninth Circuit Court of Appeals initially ruled that the bankruptcy court lacked jurisdiction because the tortious interference was, in substance, nothing more than a thinly-veiled wills contest that came within the exclusive jurisdiction of the Texas probate court. 392 F.3d 1118 (9th Cir. 2003). That decision was reversed and remanded by the Supreme Court. *Marshall v. Marshall* (In re *Marshall*), 547 U.S. 293 (2006).

5. *Marshall v. Stern*, 600 F.3d 1037 (9th Cir. 2010).

6. 28 U.S.C. § 157(b)(1).

7. 28 U.S.C. § 157(b)(2)(C).

8. 28 U.S.C. § 157(c)(1).

9. U.S. Const. art. III, § 1.

10. *Id.*

decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*¹¹ In *Northern Pipeline*, the Supreme Court held that because bankruptcy judges were not appointed under or with the protections of Article III, they were not constitutionally vested with the jurisdiction to decide state-law contract claims against an entity that was not otherwise part of the bankruptcy proceedings.

Constitutional Authority

In the majority opinion, written by Chief Judge Roberts, the Supreme Court held that although the bankruptcy court had statutory authority under section 157(b)(2)(C) to enter a final judgment on Vickie's counterclaim, the designation of all counterclaims as core proceedings violated Article III of the Constitution. Specifically, the Supreme Court held that the bankruptcy court lacked constitutional authority to enter a final judgment on a state law counterclaim because, in doing so, the bankruptcy court was exercising the "judicial Power of the United States" in respect of a state law claim.

Vickie's counsel argued that the bankruptcy court's final judgment on Vickie's state common law counterclaim fell into the "public rights" exception to Article III, under which non-Article III courts can adjudicate matters involving public rights over which the judicial branch retains the power to administer.¹² The majority rejected that argument because the counterclaim was a state common law claim between two private parties the adjudication of which did not depend on Congress. Vickie's requested relief also did not flow from a federal statutory scheme and was not completely dependent upon adjudication of a claim created by federal law.

Vickie's counsel also argued that by filing a proof of claim against Vickie's estate, Pierce had submitted himself to the jurisdiction of the bankruptcy court for all purposes.¹³ The Court rejected that argument because the adjudication of Pierce's claim did not impact Vickie's counterclaim, and therefore, could not create bankruptcy court jurisdiction over it.

Lastly, Vickie asserted that, as a practical matter, restrictions on the bankruptcy courts' ability to hear and resolve compulsory counterclaims would create significant delays and impose additional costs on the bankruptcy process. The majority disagreed, finding that the issue presented was "narrow" and did not "meaningfully change" the division of labor between bankruptcy courts and Article III courts.¹⁴ The majority was not convinced that the practical consequences of limiting the bankruptcy courts' authority to enter final judgments were as significant. The 1984 amendments and section 157(c)(1) contemplate that certain state law matters would not be resolved with finality by the bankruptcy courts, and the majority stated that exclusion of certain counterclaims from core bankruptcy jurisdiction would not meaningfully change the division of labor or the burden on the courts.

Concurring and Dissenting Opinions

Justice Scalia wrote a separate concurring opinion suggesting that the "public rights" exception should be viewed more narrowly, and that unless there is a firmly established historical practice to the contrary, an Article III judge is required in *all* federal adjudications.

11. 458 U.S. 50 (1982).

12. *Stern v. Marshall*, 131 S. Ct. at 2611.

13. In fact, Pierce went further by affirmatively consenting on the record — he advised the bankruptcy court that "he was happy to litigate his claim there." *Stern v. Marshall*, 131 S. Ct. at 2597.

14. *Id.* at 2620.

Justice Breyer, joined by Justice Ginsburg, Justice Sotomayor and Justice Kagan, dissented. Justice Breyer agreed with the majority that section 157(b)(2)(C) authorizes a bankruptcy court to adjudicate Vickie's counterclaims, but disagreed with the majority about the statute's constitutionality. The dissent contended that the statute is constitutional because, among other reasons: (a) the resolution of counterclaims often turns on facts identical to, or at least related to, those at issue in a creditor's claim that is undisputedly proper for the bankruptcy court to decide; (b) bankruptcy judges are appointed by federal courts of appeal, and they can functionally be compared to magistrate judges, law clerks and the Judiciary's administrative officials; (c) Article III judges retain control and supervision over the bankruptcy court's determinations so there are sufficient checks on the bankruptcy court's judgments; and (d) the parties in this case consented to the jurisdiction of the bankruptcy court. Regarding Vickie's argument of the practical consequences, the dissent agreed that limiting bankruptcy courts' authority would lead to inefficiency, increased cost, delay and needless additional suffering among those faced with bankruptcy. ■

Reaction to *Stern v. Marshall*

Since *Stern v. Marshall*,¹ more than 370 cases have cited the Supreme Court's decision and hundreds of litigants have argued that, in light of the decision, their case should be decided by a non-bankruptcy court. This widespread invocation of *Stern v. Marshall* has clouded whether bankruptcy courts have jurisdiction to issue final orders in a variety of matters. Because of this uncertainty, many judges have hedged their bets, even where purporting to issue a final order, by

noting that their ruling should be treated as proposed findings of fact or conclusions of law for review by the relevant district court if the bankruptcy court is found, on appeal, to have lacked jurisdiction to enter the order.

As of April 1, 2012, approximately 370 reported decisions (and likely multiples of that number in unreported decisions) have cited *Stern v. Marshall*. In most circumstances, litigants have cited the decision as a basis upon which to move their case to a different court prior to trial.² Some litigants have waited until after the bankruptcy court rendered a final judgment against them to argue that the court lacked jurisdiction to enter its judgment.³ Regardless of the motive of the litigants, *Stern v. Marshall* is quickly becoming one of the most frequently cited bankruptcy jurisdiction cases.

Bankruptcy courts have reacted to these jurisdictional challenges in a variety of ways. Some have stated that they have the authority to issue final orders on matters traditionally thought of as "core." These bankruptcy courts may have distinguished the facts of their case from those of *Stern v. Marshall*⁴ or may have focused on the "narrow" nature of the Supreme Court's

1. 131 S. Ct. 2594 (2011).

2. See, e.g., *In re Ambac Fin. Group, Inc.*, 457 B.R. 299, 308 (Bankr. S.D.N.Y. 2011) (noting that "[u]nfortunately, *Stern v. Marshall* has become the mantra of every litigant who, for strategic or tactical reasons, would rather litigate somewhere other than the bankruptcy court"), *aff'd*, 2011 U.S. Dist. LEXIS 149610 (S.D.N.Y., Dec. 28, 2011).

3. See, e.g., *In re Bearingpoint, Inc.*, 453 B.R. 486, 497 (Bankr. S.D.N.Y. 2011) (noting that "... it's fair to assume that it will now be argued that consent, no matter how uncoerced and unequivocal, will never again be sufficient for bankruptcy judges ever to issue final judgments on non-core matters. That huge uncertainty presages litigation over that issue with the potential to tie up this case, and countless others, in knots. It also would at least seemingly invite litigants to consent, see how they like the outcome, and then, if they lose, say their consents were invalid").

4. See, e.g., *In re Salander O'Reilly Galleries*, 453 B.R. 106, 117-18 (Bankr. S.D.N.Y. 2011) (distinguishing *Stern* from the *Salander* facts by noting that *Stern* only addresses the constitutionality of a bankruptcy court's final ruling on a state-law counterclaim that would not be finally resolved in the process of allowing or disallowing a proof of claim and noting that in the case before it, the counterclaim would be resolved in the process of allowing or disallowing the proof of claim).

holding.⁵ Other bankruptcy courts have submitted proposed findings of fact and conclusions of law to the district court (either on appeal or *de novo*) when their own authority to issue a final order was unclear.⁶ Other courts have found that where a bankruptcy court does not have the authority to issue a final order, the reference should be withdrawn, or discretionary abstention should be granted and the case voluntarily referred to the district court.⁷

As the number of cases citing *Stern v. Marshall* increases, some trends have emerged. Most courts have found that bankruptcy courts may issue final decisions on the dischargeability of claims.⁸ Some courts have found that bankruptcy courts may approve settlement agreements related to property of the estate.⁹ Other types of claims, though, have divided courts over the scope of bankruptcy court

jurisdiction. Most prominently, courts disagree over whether fraudulent transfer claims fall under bankruptcy court jurisdiction,¹⁰ particularly when the fraudulent transfer cause of action is based upon state law.¹¹

5. See, e.g., *Burtch v. Huston (In re USDigital, Inc.)*, 461 B.R. 276, 291 (Bankr. D. Del. 2011) (noting that “*Stern* can be read to have broad implications as to the judicial power of bankruptcy courts. To do so, however, is contrary to the letter and the spirit of the Supreme Court’s holding. Chief Justice Roberts made as much clear in his summation: ‘We conclude today that Congress, in one isolated respect, exceeded’ the Constitutional limitation on the exercise of judicial power to Article III judges by empowering the bankruptcy court ‘to enter a final judgment on a state law counterclaim that is not resolved in the process of ruling on a creditor’s proof of claim.’ It is clear from the Court’s own words in its conclusion that it considered its holding to be narrow.”); *McClelland v. Grubb & Ellis Valuation & Advisory Group (In re McClelland)*, 460 B.R. 397, 405 (Bankr. S.D.N.Y. 2011) (finding that “*Stern* has a narrow application”); *Liberty Mut. Ins. Co. v. Citron (In re Citron)*, No. 08-71442-AST, 2011 Bankr. LEXIS 3934, at *4 n.1 (Bankr. E.D.N.Y. Oct. 6, 2011) (taking the Supreme Court “at its word” and reading the *Stern* decision narrowly).
6. See, e.g., *O’Cheskey v. Horton (In re Am. Housing Found.)*, No. 09-20232 -RLJ-11, 2011 Bankr. LEXIS 3837, at *54 (Bankr. N.D. Tex. Sept. 30, 2011) (finding that the causes of actions are “core,” but in the event that a superior court finds that they are not “core,” the bankruptcy court’s findings and conclusions are “submitted as proposed findings and conclusions.”); *White v. Pugh (In re Butler Innovative Solutions)*, No. 08-00065, 2011 Bankr. LEXIS 3866, at *1 (Bankr. D.D.C. Oct. 3, 2011) (finding that the proceeding is a “core proceeding,” but, if the proceeding were contested, then the order would be restricted to proposed findings of fact and conclusions of law for consideration by the district court).

7. See, e.g., *Picard v. Flinn Invs., LLC*, No. 11-CV-5223-JSR, 2011 U.S. Dist. LEXIS 136627 (S.D.N.Y. Nov. 28, 2011) (district court withdraws the reference to the bankruptcy court in part); *PFM, LLC v. Provident Royalties, LLC (In re Provident Royalties, LLC)*, No. 3:11-CV-2238F, 2011 U.S. Dist. LEXIS 126195 (Bankr. N.D. Tex. Oct. 17, 2011) (bankruptcy court recommends withdrawal of reference).
8. See, e.g., *Sigillito v. Hollander (In re Hollander)*, No. 04-14550, 2011 Bankr. LEXIS 5099 (Bankr. E.D. La. Dec. 28, 2011) (finding that the determination of a claim’s dischargeability is a core proceeding and therefore the court has jurisdiction); *Bluestone Trading Co. v. Storey (In re Storey)*, No. 10-20926, 2011 Bankr. LEXIS 3405 (Bankr. N.D. Ohio Sept. 7, 2011) (finding that dischargeability is a core proceeding and therefore the court had authority to enter a final order).
9. See, e.g., *Police & Fire Ret. Sys. of the City v. Ambac Fin. Group, Inc. (In re Ambac Fin. Group, Inc.)*, No. 11-CV-7520-NRB, 2011 U.S. Dist. LEXIS 149610 (S.D.N.Y. Dec. 28, 2011) (holding that *Stern* does not affect the approval of settlements relating to property of the debtor’s estate, under Rule 9019); *In re Washington Mut., Inc.*, No. 08-12229-MFW, 2011 Bankr. LEXIS 3361 (Bankr. D. Del. Sept. 13, 2011) (holding that *Stern* does not apply because a bankruptcy court does not need jurisdiction to rule on the merits of the underlying claims to approve a settlement of them).
10. Although the Court did not rule directly on this issue in *Stern v. Marshall*, when *Granfinanciera* and *Langenkamp*, both cases cited by the Supreme Court in that case, are read together with *Stern v. Marshall*, fraudulent conveyance and preference actions brought against noncreditors and creditors could be interpreted to be outside of the “public rights” exception and thus outside of the jurisdiction of bankruptcy courts such that they have to be adjudicated by district courts. However, since *Stern v. Marshall*, bankruptcy courts, in practice, have issued conflicting decisions on whether they can adjudicate fraudulent conveyance claims. Compare *Dev. Specialists, Inc. v. Orrick, Herrington & Sutcliffe, LLP*, No. 11-CV-6337-CM, 2011 U.S. Dist. LEXIS 148720 (S.D.N.Y. Dec. 23, 2011) (finding that a fraudulent conveyance action invokes private rights as opposed to public rights and therefore cannot be adjudicated by a bankruptcy court), with *Kirschner v. Agoglia (In re Refco Inc.)*, No. 05-60006-RDD, 2011 Bankr. LEXIS 4496, at *12 (Bankr. S.D.N.Y. Nov. 30, 2011) (finding that bankruptcy court had jurisdiction to decide matter because fraudulent transfer claims flowed from federal statutory scheme and were “completely dependent upon adjudication of a claim created by federal law”) (citations omitted), and *Liberty Mut. Ins. Co. v. Citron (In re Citron)*, No. 08-71442-AST, 2011 Bankr. LEXIS 3934 (Bankr. E.D.N.Y. Oct. 6, 2011) (finding that bankruptcy court had jurisdiction to adjudicate Bankruptcy Code and state-law fraudulent conveyance claims because defendant’s counterclaim required a finding of defendant’s liability pursuant to plaintiff’s claims.)
11. See, e.g., *Springel v. Prosser (In re Innovative Commc’ns Corp.)*, No. 07-30012, 2011 Bankr. LEXIS 3040 (Bankr. D.V.I. Aug. 5, 2011) (finding that the bankruptcy court has jurisdiction over fraudulent conveyance actions brought under sections 548 and 549 of the Bankruptcy Code, but does not have jurisdiction over fraudulent conveyance actions brought under section 544(b) and applicable state law).

As courts continue to face jurisdictional challenges in a post-*Stern v. Marshall* context, it is clear that guidance is needed. Although most circuit courts of appeal have yet to write meaningfully on the *Stern v. Marshall* decision, the Second Circuit, Seventh Circuit and District Court for the Southern District of New York have provided some direction.¹²

In 2011, two circuit courts substantively addressed the issues raised in *Stern v. Marshall*, providing guidance to lower courts with respect to the scope of bankruptcy court jurisdiction. In *Ace American Insurance Company v. DPH Holdings Corp.*¹³ and *Ortiz v. Aurora Health Care, Inc.*, the Second Circuit and the Seventh Circuit, respectively, considered whether the bankruptcy court had jurisdiction to enter a final order. In *Ace*, the Second Circuit found that the bankruptcy court had jurisdiction because the adversary proceeding involved prepetition and post-petition contracts that affected the administration of the bankruptcy estate and, therefore, the proceeding was “core.” In *Ortiz*, the Seventh Circuit dismissed an appeal, finding that it did not have a statutory basis for appellate jurisdiction because the bankruptcy court lacked Article III authority to enter a final judgment in a class action lawsuit regarding disclosure of health care records. These two cases provide the only insight from appellate courts as to how *Stern v. Marshall* will be applied.

In early 2012, the District Court for the Southern District of New York also provided some guidance for bankruptcy courts in that district, in the form of a standing order providing that “[i]f a bankruptcy judge or district judge determines that entry of

a final order or judgment by a bankruptcy judge would not be consistent with Article III of the United States Constitution in a particular proceeding referred under this order and determined to be a core matter, the bankruptcy judge shall, unless otherwise directed by the district court, hear the proceeding and submit proposed findings of fact and conclusions of law to the district court.”¹⁴ The standing order also clarifies that “[t]he district court may treat any order of the bankruptcy court as proposed findings of fact and conclusions of law in the event the district court concludes that the bankruptcy judge could not have entered a final order or judgment consistent with Article III of the United States Constitution.”¹⁵ This order, therefore, covers bankruptcy court decisions no matter where the matter is procedurally, and will have the effect of minimizing the number of litigants who invoke *Stern v. Marshall* simply to forum shop, at least in the Southern District of New York. If this effect is achieved, other courts may choose to issue their own standing orders to restore the labor balance between the bankruptcy court and the district court to pre-*Stern v. Marshall* levels.

We will further review the *Stern v. Marshall* progeny and elaborate on notable trends and developments in a publication titled “One Year After *Stern v. Marshall*,” which we expect to publish in the summer of 2012. ■

12. See, e.g., *Ace Am. Ins. Co. v. DPH Holdings Corp.* (In re *DPH Holdings Corp.*), No. 10-4170-BK, 2011 U.S. App. LEXIS 23749 (2d Cir. Nov. 29, 2011); *Ortiz v. Aurora Health Care, Inc.*, Nos. 10-3465 and 10-3466, 2011 U.S. App. LEXIS 26009 (7th Cir. Dec. 30, 2011).

13. 2011 U.S. App. LEXIS 23749.

14. In re *Standing Order of Reference Re: Title 11*, No. 12-MISC-00032 (S.D.N.Y., Jan. 31, 2012), available at <http://nysd.uscourts.gov/courtrules.php>.

15. *Id.*

Post-Confirmation Jurisdiction in the Delaware Bankruptcy Court

The Bankruptcy Court for the District of Delaware recently issued several opinions that address the scope of a bankruptcy court's jurisdiction after the confirmation of a plan of reorganization. These opinions maintain the narrow post-confirmation jurisdiction applicable under prior decisions of the Third Circuit Court of Appeals and demonstrate the bankruptcy courts' reluctance to hear matters that do not affect the interpretation or administration of a confirmed plan of reorganization. These decisions remind plan proponents to specify those matters over which the bankruptcy court would retain jurisdiction after confirmation, although even a specific reference will not assure that the bankruptcy court will exercise jurisdiction.

The long-standing precedent in the Third Circuit, *Pacor, Inc. v. Higgins*,¹ established that a civil proceeding is “related to” the bankruptcy case if its outcome could conceivably have any effect on the estate being administered in bankruptcy. *Pacor* left open whether a bankruptcy court retained any subject matter jurisdiction over post-confirmation civil proceedings outside of bankruptcy (when the estate, by definition, ceases to exist). The Third Circuit dealt with that issue in *In re Resorts Int'l, Inc.*,² holding that when a “close nexus” exists between the issues in an adversary proceeding and the bankruptcy plan, a bankruptcy court, in limited circumstances, retains “related to” jurisdiction post-confirmation.

Four recent Delaware bankruptcy court decisions have addressed the scope of the *Resorts* “close nexus” test. In *BWI Liquidating Corp. v. City of Rialto* (*In re BWI Liquidating Corp., et al.*),³ Judge Walrath granted the defendants’ motion to dismiss an adversary proceeding brought

post-confirmation by the liquidating trust established under the debtors’ plan of reorganization for damages stemming from the alleged breach of a prepetition contract, on the ground that the dispute did not have a sufficiently close nexus with the bankruptcy proceeding to establish post-confirmation “related to” jurisdiction. Last summer, Judge Sontchi followed the *BWI* opinion by holding, in *The Fairchild Liquidating Trust v. State of New York (In re The Fairchild Corp.)*,⁴ that a broad and general retention of jurisdiction in a plan that fails to mention the specific claims subject to the court’s jurisdiction is insufficient for the court to retain “related to” jurisdiction. In *BWI* and *Fairchild*, the principal issue was whether post-confirmation “related to” jurisdiction existed where (a) claims asserted in a post-confirmation adversary proceeding arose prior to the confirmation of the plan, (b) the plan purported to provide the court with jurisdiction over post-confirmation matters related to the debtors and (c) any proceeds realized from successful litigation would benefit the debtor’s estate. In each decision, the courts dismissed the respective adversary proceeding and ruled that the respective plans did not describe the contract claims being pursued in the litigation in sufficient detail to provide the courts with post-confirmation jurisdiction.

In *In re ACandS, Inc.*,⁵ Judge Fitzgerald was confronted with a discovery dispute involving a trust that was set up to provide

1. 743 F.2d 984, 994 (3d Cir. 1984).

2. 372 F.3d 154, 168-70 (3d Cir. 2004).

3. 437 B.R. 160 (Bankr. D. Del. 2010).

4. 452 B.R. 525 (Bankr. D. Del. 2011).

5. The following two opinions were issued in *In re ACandS, Inc.*: (i) *ACandS, Inc. v. Hartford Accident Indemnity Co. (In re ACand S, Inc.)*, No. 02-12687-JKF, 2011 Bankr. LEXIS 609 (Bankr. D. Del. Feb. 22, 2011) (hereinafter, “*ACandS I*”), and (ii) *ACandS, Inc. v. Hartford Accident Indemnity Co. (In re ACandS, Inc.)*, No. 02-12687-JKF, 2011 Bankr. LEXIS 2962 (Bankr. D. Del. Aug. 8, 2011). The two cases discussed similar jurisdictional issues and will be referred to collectively as “*ACandS, Inc.*”

for distributions to asbestos claimants in connection with the confirmation of the company's plan of reorganization. Trust distribution procedures adopted in connection with the plan restricted the disclosure of asbestos claimants' information submissions to the trust, except under certain circumstances, and any requests for discovery had to be brought before the bankruptcy court. When several insurance companies sought discovery from the asbestos trust in connection with a state court litigation, the asbestos trust sought to enjoin the insurance companies from obtaining the discovery. The bankruptcy court, however, ruled that it did not have subject matter jurisdiction to preside over the discovery dispute between the parties. First, the court held that it did not have "arising in" jurisdiction since the nature of the dispute was a discovery dispute, which was not a dispute that by its nature could arise only in the context of a bankruptcy case. Second, the court held that it did not have "related to" jurisdiction since the dispute between the trust and the insurance companies had no effect on the reorganized debtor or the trust, and thus the "close nexus" required for the bankruptcy court to have post-confirmation jurisdiction was not present.⁶

In contrast, in *In re SemCrude, L.P.*,⁷ Judge Shannon was faced with a jurisdictional dispute where plaintiffs sought damages in Oklahoma state court from the debtor's former CEO and pre-bankruptcy auditor. The defendants sought to enjoin the Oklahoma state court action on the

basis that the claims asserted by the plaintiffs belonged to a litigation trust created to pursue claims under the plan of reorganization. The plaintiffs argued that the bankruptcy court did not have jurisdiction over their claims. The bankruptcy court disagreed, ruling that it had "related to" jurisdiction because the motion affected "the interpretation and administration of the Plan because it require[d] the Court to determine if the Plan meant to, and did, transfer the claims asserted in the Oklahoma [l]itigation to the [l]itigation [t]rust."⁸ The court further found that granting the motion to enjoin would prevent the state court from entering orders that could be inconsistent with the plan and confirmation order. Thus, the court found the motion to enjoin the Oklahoma state court action affected "integral aspect[s] of the bankruptcy process" that justified the bankruptcy court's involvement in the dispute between the parties and established a sufficient nexus for continued jurisdiction.⁹

Conclusion

Bankruptcy courts generally have broad jurisdiction during a pending bankruptcy case, but that jurisdiction narrows after the confirmation of a plan of reorganization. The past year has seen Delaware bankruptcy judges take a strict view of that narrowing in their application of the "close nexus" test for post-confirmation "related to" jurisdiction. Parties seeking to invoke a bankruptcy court's jurisdiction should be mindful that bankruptcy judges, at least in Delaware, will be less available post-confirmation to adjudicate disputes that are not closely tied to the pre-confirmation bankruptcy case, and, in order to maximize the likelihood of establishing post-confirmation jurisdiction, such parties should identify claims or actions with specificity when drafting plans of reorganization. ■

6. *ACandS I*, 2011 Bankr. LEXIS 609, at *23-24. The court noted that the possibility that the action might increase the assets of the trust available to former creditors of the estate is not by itself sufficient to create a close nexus. *Id.* at *22-23 (citing *In re Resorts Int'l*, 372 F.3d 154, 169 (3d Cir. 2004)).

7. No. 08-11525-BLS, 2011 Bankr. LEXIS 3801 (Bankr. D. Del. Oct. 7, 2011).

8. *Id.* at *11-12.

9. *Id.* at *12 (citations omitted).

Developments in Secured Creditors' Rights

River Road Recognizes Right of Secured Creditors to Credit Bid in Cramdown Context

In In re River Road Hotel Partners, LLC,¹ the Seventh Circuit held that secured creditors cannot be deprived of their right to credit bid in a sale of their collateral under a cramdown plan of reorganization. Previously, the Third Circuit in *Philadelphia Newspapers*² and the Fifth Circuit in *Pacific Lumber*³ held that a plan of reorganization containing a sale of a secured creditor's collateral could satisfy the "fair and equitable" standard under section 1129(b)(2)(A) of the Bankruptcy Code if the secured creditor realized the "indubitable equivalent" of its claim, even if the plan did not allow the secured creditor to credit bid its debt in the sale. In *River Road*, the Seventh Circuit declined to follow the Third and Fifth Circuits and instead closely tracked the reasoning of Judge Ambro's dissent in *Philadelphia Newspapers*. The Seventh Circuit held that if a plan contemplates the free and clear sale of property securing a debt, then the secured creditors must be afforded the opportunity to credit bid the value of the secured debt. The *River Road* decision sets the stage for the Supreme Court to resolve the issue.

Statutory Background

The Bankruptcy Code affords an impaired class the right to vote to accept or reject a

proposed plan of reorganization. Section 1129(b) provides that a plan may be confirmed and "crammed down" on an impaired class that does not accept the plan if the plan, among other things, is "fair and equitable" to the rejecting class. If the impaired class consists of secured claims, then section 1129(b)(2)(A) provides that the plan is fair and equitable if:

- (i) holders of secured claims retain the liens securing their allowed claims and receive deferred cash payments having a present value at least equal to the value of their collateral;
- (ii) holders of secured claims retain a lien on the proceeds of any "free and clear" sale of their collateral; or
- (iii) the proposed plan provides for the secured creditors to receive the "indubitable equivalent" (an undefined term) of their secured claims.

Prior to *Philadelphia Newspapers* and *Pacific Lumber*, clause (ii) was commonly understood to allow secured creditors to credit bid up to the value of their debt in any asset sale pursuant to a reorganization plan.

1. 651 F.3d 642 (7th Cir. 2011), cert. granted, 132 S. Ct. 845 (2011).

2. *In re Phila. Newspapers*, 599 F.3d 298 (3d Cir. 2010).

3. *In re Pacific Lumber, Co.*, 584 F.3d 229 (5th Cir. 2009).

In *Philadelphia Newspapers*, the debtor submitted a plan of reorganization in its chapter 11 case that provided for the sale of substantially all of the debtor's assets but did not allow the secured creditors to credit bid. The bankruptcy court sustained the secured creditors' objection on the ground that under clause (ii) of section 1129(b)(2)(A), such a plan must permit credit bidding. The district court reversed, and the case was appealed to the Third Circuit. *Pacific Lumber* similarly involved a sale of assets under a plan which the debtor sought to confirm under clause (iii) (i.e., the "indubitable equivalent" prong) of section 1129(b)(2)(A) that did not allow secured creditors to credit bid. The bankruptcy court confirmed the plan over the secured creditors' objection, and the confirmation order was appealed directly to the Fifth Circuit.

The Third Circuit Court of Appeals in *Philadelphia Newspapers* and the Fifth Circuit Court of Appeals in *Pacific Lumber* both focused on the use of the disjunctive "or" between clauses (ii) and (iii) of section 1129(b)(2)(A). Both courts reasoned that the inclusion by Congress of the term "or" supported an interpretation of this section giving a debtor two options in a cramdown scenario involving the free and clear sale of assets: either comply with the provisions of clause (ii) and allow credit bidding by the secured creditors, or proceed under clause (iii) and disallow credit bidding, as long as the secured creditors would receive the "indubitable equivalent" of their claims.

In his dissent in *Philadelphia Newspapers*, Judge Ambro reasoned that section 1129(b)(2)(A) was susceptible to multiple interpretations and therefore ambiguous. In addition to the construction given to the section by the majority, Judge Ambro advanced another interpretation which he

viewed as more plausible: clause (iii) is not an independent option under which a debtor may proceed, but a catchall for plans that are not covered by clauses (i) and (ii). Under Judge Ambro's reasoning, section 1129(b)(2)(A) provides three independent scenarios — (a) a plan predicated upon clause (i) in which the secured creditors retain the liens on the assets, (b) a plan predicated on clause (ii) in which assets are sold free and clear and the secured creditors retain a lien on the proceeds, with the protection of credit bidding to ensure that the assets are not undervalued in the auction process, and (c) a plan not predicated upon clause (i) or (ii), which may be confirmed if it provides the secured creditor with the indubitable equivalent of its claim. Judge Ambro submitted that this interpretation more closely tracked Congressional intent because not only would it preserve the protection of credit bidding provided for in the Bankruptcy Code for sales outside of a plan, but also because the majority's interpretation would render clauses (i) and (ii) superfluous.

River Road

River Road involved two separate but jointly administered bankruptcy proceedings in which substantially all of the debtors' property collateralized obligations to lenders. The debtors proposed bidding procedures that contemplated a sale of the collateral under the plans at prices below the amount of secured debt and did not permit the lenders to credit bid. The bankruptcy court sustained the secured creditors' objection, citing Judge Ambro's dissent in *Philadelphia Newspapers*, and held that the bidding

procedures must afford the opportunity to credit bid. The decision was appealed directly to the Seventh Circuit.⁴

In upholding the bankruptcy court's decision, the Seventh Circuit also relied heavily on the analysis in Judge Ambro's dissent in *Philadelphia Newspapers*. The Seventh Circuit first examined the text of section 1129(b)(2)(A) and concluded that nothing in that section "directly indicates whether subsection (iii) can be used to confirm any type of plan or if it can only be used to confirm plans that propose of disposing of assets in ways that can be distinguished from those covered by subsections (i) and (ii)."⁵ Because the statute was open to these two interpretations, the court held it was ambiguous and set about determining which interpretation was correct. In doing so, the court first noted that canons of statutory construction disfavor interpretations that render parts of the statute superfluous. The court held that the interpretation endorsed by the Third and Fifth Circuits was unacceptable because it would render the other subsections of the statute superfluous. The court stated that it could not "conceive of any reason why

Congress would state that a plan must meet certain requirements if it provides for the sale of assets in particular ways and then immediately abandon these requirements in a subsequent [s]ubsection."⁶ The court also was persuaded by the fact that credit bidding is an important protection afforded to secured lenders in other areas of the Bankruptcy Code, and was especially important in the cramdown context because assets are susceptible to undervaluation in a bankruptcy auction.

Conclusion

The ruling in *River Road* is a victory for secured creditors who, at least in the Seventh Circuit, can rely on the protection of credit bidding. The decision creates a split in the circuits, which will be resolved by the Supreme Court, as the Supreme Court has granted *certiorari* to hear the debtors' appeal of the *River Road* decision. ■

4. *In re River Road Hotel Partners, LLC*, No. 09-B-30029, 2010 WL 6634603, at *1 (Bankr. N.D. Ill. Oct. 5, 2010).

5. *In re River Road Hotel Partners*, 651 F.3d at 649.

6. *Id.* at 652.

The High Bar of the Indubitable Equivalent Standard

In *re SUD Properties, Inc.*¹ from the Eastern District of North Carolina illustrates the high burden in establishing that a secured creditor will receive the “indubitable equivalent” of its claim in a cramdown context. The court held that the plan proponent must prove the receipt of the “indubitable equivalent” by “clear and convincing” evidence. Under that stringent standard, attempting to satisfy a secured creditor’s claim with less than all of its pledged collateral would face an uphill battle — especially where the value of the collateral being offered to the secured creditor is uncertain or difficult to determine.

In order to confirm a plan over the rejection by a class of secured creditors, the plan must, among other things, be “fair and equitable” to the creditor over whose dissent confirmation is sought.² A plan is fair and equitable to a class of secured creditors, in certain circumstances, if it provides them with the “indubitable equivalent” of their secured claim.³ The term “indubitable equivalent” is not defined by the Bankruptcy Code, and there remains relatively little case law interpreting this phrase in chapter 11 cases involving complex collateral packages. Most reported cases involve “dirt for debt”⁴ plans, or other relatively simple forms of collateral.⁵

In *SUD Properties*, the debtor developed residential properties and had defaulted on a first and second deed of trust secured by 70 lots in a development known as Springstone. This real estate was the only asset of the debtor, and the secured lender filed a secured claim for approximately \$1.4 million. The debtor’s plan contemplated conveying 32 of the 70 lots to the bank in full satisfaction of its secured claim. The bank objected, arguing that the arrangement did not provide it with the indubitable equivalent of its claim. Both parties presented extensive evidence on the value of the collateral, which showed a wide range of potential valuations.

The court noted that “indubitable” is defined in the dictionary as “too evident to be doubted: unquestionable.”⁶ After reviewing precedent, the court determined that, although the standard for proving valuation of the collateral proposed to be transferred to the secured creditor was “preponderance of the evidence,” the standard for proving that the property so valued constituted the indubitable equivalent of the creditor’s claim was “clear and convincing” — a more demanding standard of proof.⁷

In so holding, the court discussed at length the meaning of indubitable equivalent. The court noted that there “is inherent difficulty in satisfying the indubitable equivalent standard. If any doubt exists, the plan should not be confirmed.”⁸ After reviewing case law, the court stated the indubitable equivalent is the “unquestionable value of a lender’s secured interest in the collateral,” and “if there is any doubt regarding whether the creditor will realize the full

1. No. 11-03833-8-RDD, 2011 WL 5909648 (Bankr. E.D.N.C. Aug. 23, 2011).

2. 11 U.S.C. § 1129(b)(1).

3. 11 U.S.C. § 1129(b)(2)(A)(iii).

4. A “dirt for debt” plan is one in which the debtor claims the creditor holding a lien on real property is oversecured and therefore attempts to convey to the secured creditor less than 100% of the real property in full satisfaction of the debt.

5. See, e.g., *In re Arnold & Baker Farms*, 85 F.3d 1415 (9th Cir. 1996) (discussing the indubitable equivalent standard in another dirt-for-debt case); *In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346 (5th Cir. 1989) (discussing the indubitable equivalent standard regarding residential real estate as collateral); *In re Freymiller Trucking, Inc.*, 190 B.R. 913 (Bankr. W.D. Okla. 1996) (discussing commercial real estate); *In re Atlanta S. Business Park, Ltd.*, 173 B.R. 444 (Bankr. N.D. Ga. 1994) (discussing commercial real estate).

6. *In re SUD Props., Inc.*, 2011 WL 5909648, at *5 (quoting Merriam-Webster Online Dictionary).

7. *Id.*

8. *Id.* at *6 (internal quotation marks and citation omitted).

value of its claim, then the requirements of [the Bankruptcy Code] are not met.”⁹ The court further observed that, in order to ensure that secured creditors are actually receiving the indubitable equivalent, “[m]any courts have required substantial equity cushions to satisfy the ‘indubitable equivalent’ standard.”¹⁰

Ultimately, the court held that the proposed plan did not provide the secured creditor with the indubitable equivalent of its claim. In so ruling, the court pointed out that even under the most optimistic valuation put forth by the debtor, the plan did not provide for an equity cushion to ensure the secured creditor realized the full value of its secured claim. Moreover, the optimistic valuation was significantly higher than the valuation presented by the lender, and the court found the uncertainty over the value significant enough to cast doubt on the value of the collateral proposed to be transferred to the lender.¹¹ The court went on to determine that no number of lots less than 70 — the original collateral pledged to the lender to secure its debt — could be the indubitable equivalent of the secured creditor’s claim in this case.

Conclusion

SUD Properties serves as a reminder of the difficulty debtors face when attempting to satisfy the indubitable equivalent standard. Volatility in the markets, which leads to uncertainty in the valuation of assets, makes the task of demonstrating that the indubitable equivalence standard has been met that much more difficult. According to *SUD Properties*, the clear and convincing standard of proof associated with establishing the indubitable equivalent requires a near certainty that a secured creditor will be made whole if it is to be provided with less than the totality of the collateral for which it bargained. ■

9. *Id.* at *10.

10. *Id.* at *11 (citation omitted).

11. The court employed a “three-step valuation process” derived from *In re Bannerman Holdings, LLC*, No. 10-01053, 2010 WL 4260003 (Bankr. E.D.N.C. Oct. 20, 2010): (i) determine fair market value of the property; (ii) reduce the fair market value by 10% to reflect cost incurred liquidating the property; and (iii) apply a discount rate to the net value of each property to reflect costs associated with the secured creditor’s loss of the use of its money during the time the property remains unsold. *In re SUD Props., Inc.*, 2011 WL 5909648, at *6.

Subrogation Clauses Can Transfer Plan Voting Rights Between Lenders

The district court, in In re Avondale Gateway Center Entitlement, LLC,¹ held that a subrogation clause contained in an intercreditor agreement can convey plan voting rights to a senior lender because under applicable (Arizona) state law, a subrogee “steps into the shoes” of the original creditor for all purposes, including for voting on a plan of reorganization.

In *Avondale*, the holder of the first lien on the debtor’s property, National Bank of Arizona (“NBA”), and the second lienholder, MMA Realty Capital, LLC (“MMA”), entered into an intercreditor agreement that contained a clause subrogating MMA’s claims, rights, liens and security interests in favor of NBA under certain circumstances. When *Avondale* solicited votes in connection with its plan of reorganization, MMA submitted a ballot accepting the plan, while NBA submitted two ballots — one on its own behalf, and one on behalf of MMA’s claim — both rejecting the plan. The debtor objected to the ballot filed by NBA on account of the MMA claim. The bankruptcy court held that the subrogation clause in the intercreditor agreement authorized NBA to vote on behalf of MMA and disregarded the vote of MMA.

On appeal, the district court upheld the bankruptcy court’s ruling. The district court first observed that the subrogation clause did not expressly transfer voting rights. In doing so, the district found that under Arizona law, subrogation is “the wholesale substitution of one party . . . in place of another . . . [c]onsequently, the subrogee succeeds to all of the subrogor’s rights under the claim.”² In contrast, the court noted that an assignment may be limited to an individual right of performance

related to a matter. As a result, the court concluded, regardless of the fact that voting was not one of the enumerated benefits set forth in the subrogation, “NBA steps into the shoes of MMA with respect to the claim,” including the right to vote the claim in the bankruptcy proceeding.³

Avondale argued that the subrogation clause was not enforceable in bankruptcy with respect to plan voting rights. In support, *Avondale* cited two cases, *In re Hart Ski*⁴ and *LaSalle*,⁵ both of which are frequently cited for the general proposition that a party cannot contract away its voting rights to another party. In contrasting those cases, the court observed that both cases dealt with the allocation of voting rights under *subordination* agreements, which were inapplicable to a case involving subrogation because the concept of subordination merely “affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights.”⁶ The two concepts also differ because the subordinated lender is still the “holder” of a claim (and Bankruptcy Rule 3018(c) allows only the “holder” of the claim to sign the ballot), whereas a subrogee is the actual holder of the claim. The court additionally cited the policy

1. No. 10-1772, 2011 WL 1376997 (D. Ariz. April 12, 2011).

2. *Id.* at *3 (citations omitted). The court noted that, under Arizona law, subrogation agreements are unenforceable as to non-assignable rights; however, bankruptcy law permits the assignment of bankruptcy voting rights.

3. *Id.*

4. *In re Hart Ski Mfg. Co.*, 5 B.R. 734 (Bankr. D. Minn. 1980). *Hart Ski* concerned a subordination clause that did not contain an express transfer of voting rights. The subordinated lender moved for adequate protection and the senior lender objected. The court sided with the junior lenders, concluding that certain rights cannot be affected by contract of the parties prior to the bankruptcy on the basis that such rights did not exist prior to the bankruptcy filing, including the right to vote a claim and the right to seek adequate protection.

5. *In re 203 N. LaSalle St. P’ship*, 246 B.R. 325 (Bankr. N.D. Ill. 2000). *In LaSalle*, the relevant intercreditor agreement contained a subordination clause with a provision expressly transferring voting rights from the junior lender to the senior lender. The rationale of the *LaSalle* court was the same as the *Hart Ski* case — certain rights under the Bankruptcy Code cannot be waived, including voting rights.

6. *In re Avondale*, 2011 WL 1376997, at *4 (citation omitted).

considerations related to the transfer of voting rights that are different between subordination agreements and subrogation agreements. In the case of subordination, a creditor “may very well have a substantial interest in the manner in which its claim is treated”; therefore, a case can be made that the junior creditor has not given up its right to vote its claim.⁷ There are no such policy considerations at stake in the case of subrogation where one creditor entirely steps into the shoes of the other. Accordingly, a senior lender may properly vote the claim.

Conclusion

The *Avondale* case reinforces the expanded bundle of rights that are obtained by senior lenders in subrogation agreements, as distinguished from subordination agreements. The court construed subrogation of rights to include plan voting rights, even absent language providing for the junior creditor to transfer such rights. ■

7. *In re 203 N. LaSalle St. P'ship*, 246 B.R. at 332.

Mortgagee's Security Interest in Rents Prevails over Later-Arising IRS Lien

In Bloomfield State Bank v. U.S.,¹ the Seventh Circuit addressed whether a bank's security interest in rents from leased real estate that was subject to a mortgage takes priority over a later-arising federal tax lien. In reversing the district court, the Circuit Court of Appeals held that the property interest in the rental income was inseparable from the interest in the land, and, as a result, the bank's security interest in the rents was senior to the federal tax lien.

Bloomfield State Bank held a mortgage that created a security interest in real property and all rents derived from the real estate or improvements to it. The bank sued for declaratory relief that its mortgage took priority over a federal tax lien filed after the mortgage was created but before the property was rented.

The Statutory Context

Section 6323(h)(1) of the Internal Revenue Code (“IRC”) provides that if any person fails to pay taxes, the amount due shall be a lien in favor of the United States upon that person's property and rights to property. Generally, a federal tax lien arises at the time of assessment and continues until the liability for the amount assessed is satisfied, but the lien imposed by section 6321 of the IRC is not valid against the holder of a security interest in the property until proper notice has been filed. Section 6323(h)(1) makes clear when a security interest arises:

[a] security interest exists at any time
(A) if, at such time, the property is *in existence* and the interest has become

1. 644 F.3d 521 (7th Cir. 2011).

protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.²

A federal tax lien will be subordinate to a security interest (a) on “property [that] is in existence” before the IRS lien and (b) that is properly perfected under applicable law.

The District Court Holding

The district court granted summary judgment in favor of the IRS. The district court analogized rental income to accounts receivable and relied on precedents establishing that a federal tax lien takes priority over accounts receivable that arise after the tax lien attaches to the assets generating the receivables.

The Seventh Circuit Holding

The Seventh Circuit reversed the district court and held that the bank's security interest in future rents was in “existence” before, and thus had priority over, the federal tax lien. The court concluded that rental income is not after-acquired property because, like sales income, rent payments are a form of proceeds from land. For perfection purposes, rental income

is an inseparable part of the land that exists on the date that a lien is granted or obtained, regardless of whether the land then was generating rents.

According to Judge Posner, “[b]y virtue of the rental-income provision in the mortgage, the bank had a separate lien on the rents, but that is not the lien on which it is relying to trump the tax lien. The lien on which it is relying is the lien on the real estate.”³ The court acknowledged that the outcome would have been different had the bank only perfected an interest in the future rents and not the underlying real property. In such a case, the future rents clause would have been an after-acquired property clause and a federal tax lien would have taken priority.

Conclusion

Whether *Bloomfield* will be adopted by the courts of other circuits remains to be seen. However, the case makes clear that, at least in the Seventh Circuit, a tax lien filed after a perfected mortgage will be subordinate to the mortgagor's rights not only to sale proceeds, but also to rental proceeds derived from the property. ■

2. I.R.C. § 6323(h)(1).

3. *Bloomfield State Bank*, 644 F.3d at 526.

Avoidance Actions

District Court Quashes Controversial TOUSA Fraudulent Conveyance Decision

In late 2009, the Bankruptcy Court for the Southern District of Florida issued a controversial opinion in the bankruptcy of TOUSA, Inc.¹ that upset the secured lending world. Early in 2011, the District Court for the Southern District of Florida quashed a significant portion of the bankruptcy court's decision on appeal, a move widely viewed as a significant restoration of secured lenders' rights and protections.

TOUSA, Inc. (the "Parent") and its subsidiaries were home builders whose principal debt consisted of unsecured bonds and a revolving credit facility secured by substantially all of the assets of the subsidiaries. Most of the Parent's subsidiaries guaranteed the bond and bank debt. Separately, the Parent financed a joint venture, known as the "Transeastern JV," which defaulted on its debt. If Transeastern JV's lenders (the "Transeastern Lenders") were to obtain a judgment against the Transeastern JV, it would have triggered cross-defaults under the bonds and the revolver. To avoid that result, the Parent settled the litigation and obtained the money for the settlement by entering into new first and second lien credit facilities (the "New Loans") with certain lenders (the "New Lenders"). The New Lenders required that certain subsidiaries that had guaranteed the Parent's bonds and revolver, but had not been obligated

under any of Transeastern JV's debt (the "Conveying Subsidiaries"), become "subsidiary borrowers" and grant liens on their assets as security for the New Loans. The documents for the New Loans contained "savings clauses" that limited the liability of each subsidiary borrower to "the maximum extent that would not cause such . . . liability . . . to be unenforceable under applicable law."²

The settlement enabled the Parent to continue operations, make periodic payments on the bonds, and temporarily avoid bankruptcy. Ultimately, however, most of the TOUSA entities commenced chapter 11 cases in the Southern District of Florida. The creditors' committee initiated an adversary proceeding seeking to avoid the transfers relating to the New Loans, including the repayments to Transeastern Lenders. The primary rationale behind the creditors' committee's action was that the Conveying Subsidiaries were harmed to the benefit of the Transeastern Lenders because the Conveying Subsidiaries had not been obligated under the Transeastern JV debt, but became obligated and conveyed security interests under the New Loans as a means to generate the proceeds used to settle the Transeastern JV debt litigation.

1. *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc.* (In re TOUSA, Inc.), 444 B.R. 613 (S.D. Fla. 2011).

2. *Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp N. Am.* (In re TOUSA, Inc.), 422 B.R. 783, 863 n. 49. (Bankr. S.D. Fla. 2009).

The bankruptcy court issued an opinion in favor of the creditors' committee that, among other things: (a) avoided the obligations incurred and the liens granted by the Conveying Subsidiaries to the New Lenders; (b) held that the Transeastern Lenders were entities "for whose benefit" those improper transfers were made; (c) avoided the transfer of settlement payments to the Transeastern Lenders, and ordered the repayment of the payments plus interest; and (d) found that savings clauses, which are commonly used to avoid having courts set aside upstream guarantees as fraudulent conveyances, are unenforceable under Florida law. It also found that the Transeastern Lenders acted in bad faith and were grossly negligent in receiving the settlement payment because they knew or should have known that the Parent was financially distressed at the times that the New Loans were entered into and they were repaid.

Following the bankruptcy court's decision, the Transeastern Lenders and the New Lenders each filed separate appeals to the district court. In its February 2011 opinion on the Transeastern Lenders' appeal, the district court issued a strongly worded rebuke of the bankruptcy court's decision and took the unusual step of quashing it and issuing its own order without remand.³

The district court ruled that the bankruptcy court erred in its finding that the New Loan proceeds were a fraudulent conveyance by the Conveying Subsidiaries directly to the Transeastern Lenders. Under Eleventh Circuit precedent, a transferor for fraudulent conveyance purposes must exercise "actual control" over property received by the transferee. The district court concluded that the Conveying Subsidiaries made no transfers because, despite their status as subsidiary borrowers under the loan documents, only the Parent, as "administrative borrower," had the

ability to designate the party receiving the loan proceeds and the power to actually disburse those funds.

The district court also found that any transfers the Conveying Subsidiaries made in connection with the New Loans were in exchange for "reasonably equivalent value"⁴ and thus were not avoidable under section 548 of the Bankruptcy Code. The bankruptcy court had construed "value" narrowly, finding that it did not include the ability of the Parent (and ultimately the Conveying Subsidiaries) to stave off bankruptcy. The district court took a more expansive view of "value," finding that "the weight of authority supports the view that indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it proved to be short lived, may be considered in determining reasonable equivalent value."⁵ The district court concluded that settling the Transeastern JV litigation did constitute value received in exchange for the obligations incurred and the security interests granted.

The district court also ruled that the value the Conveying Subsidiaries received in funding the settlement payment was reasonably equivalent to their secured guarantees. The relevant inquiry was "*but for the transfer*, was there a realistic risk that the Conveying Subsidiaries and the enterprise would not financially continue to survive?"⁶ The district court's analysis demonstrated that entry of a judgment against the TOUSA entities

3. The bankruptcy court and district court decisions remain subject to multiple appeals pending before the Eleventh Circuit Court of Appeals.

4. One element of avoiding a transaction under section 548 of the Bankruptcy Code, absent a showing of fraud or other intentional misconduct, is a determination that the impugned transaction was made without receiving reasonably equivalent value in exchange.

5. *In re TOUSA, Inc.*, 444 B.R. at 660.

6. *Id.* at 662.

in the Transeastern JV litigation — a virtual certainty without the settlement — would have triggered cross-defaults under the bonds and the revolver. Cross-defaults would have caused the lenders under those facilities to enforce the Conveying Subsidiaries' guarantees. According to the district court, "eliminating the threat of these claims against the Conveying Subsidiaries' parent, and indirectly against each of them, constituted an enormous economic benefit"⁷ The indirect benefits of avoiding default and bankruptcy were not required by the district court to be quantified in order to constitute reasonably equivalent value. The district court also noted that the TOUSA entities' eventual chapter 11 filings were not determinative because, for fraudulent conveyance purposes, the court was required to look at the facts in light of the situation at the time that the transfers were made. TOUSA's subsequent failure did not undermine the value of the breathing spell that the settlement of the litigation and the New Loans provided.

The district court also overturned one of the bankruptcy court's most controversial holdings — the apparent imposition of additional duties on creditors receiving repayments of antecedent debts. Under section 550 of the Bankruptcy Code, liability for avoided transfers may extend to (a) initial transferees of avoided transfers or to entities for whose benefit the initial transfer was made and (b) subsequent transferees. A defense exists for a subsequent transferee (but not for an initial transferee or an entity for whose benefit the initial transfer was made) who takes the transfer for value (including the satisfaction of an antecedent debt) and in good faith.⁸ The bankruptcy court had held that the liens the Conveying Subsidiaries granted to the New Lenders were for the benefit of the Transeastern Lenders and allowed them to receive the proceeds of

the New Loans. The district court held that the bankruptcy court improperly collapsed multiple transactions and that the Transeastern Lenders' exchange involved value — the satisfaction of an antecedent debt in the form of the Transeastern JV settlement payment — in a transaction that was separate and distinct from the transaction by which the Conveying Subsidiaries became obligated under, and granted liens in connection with, the New Loans.

The bankruptcy court compounded its error by holding that the Transeastern Lenders acted in bad faith and were grossly negligent. The district court rejected the bankruptcy court's apparent supposition that "it is 'bad faith' for a creditor of someone other than the debtor to accept payment of a valid, tendered debt repayment outside of any preference period, through settlement or otherwise, if the creditor does not first investigate the debtor's internal financing structure and ensure that the debtor's subsidiaries had received fair value as part of the repayment."⁹ Finding this standard to be "patently unreasonable and unworkable," the district court held that section 550 did not create any additional duties for creditors.¹⁰

Conclusion

The district court's decision protects secured lenders that obtain subsidiary guarantees and grants of collateral from distressed companies. Under the district court's reasoning, a company that incurs debt or grants liens to prevent, even

7. *Id.* at 663.

8. 11 U.S.C. § 550(b)(1).

9. *In re TOUSA, Inc.*, 444 B.R. at 675.

10. *Id.*

temporarily, the enterprise's bankruptcy may receive reasonably equivalent value. The decision also questions the imposition of a duty of inquiry on lenders in connection with the prepetition repayment of debts by subsidiaries of the corporate borrower. In the absence of fraud or other misconduct, repayments received outside of the preference period appear once again to be safe from avoidance. The district court's decision, which is now on appeal to the Eleventh Circuit, is a major victory for secured lenders and reaffirms lender rights and protections that had been called into doubt by the bankruptcy court's decision. Notably, the district court's decision did not address the bankruptcy court's ruling that savings clauses are unenforceable. Thus, the savings clause issue has not been conclusively resolved, and remains an issue in the appeal brought by the New Lenders, which is stayed pending the outcome of the Eleventh Circuit appeal. ■

Delaware Bankruptcy Court in *Friedman's* Provides Clarity on Subsequent New Value Preference Defense

The Bankruptcy Court for the District of Delaware clarified the “subsequent new value” defense to preference actions in Friedman’s Inc. v. Roth Staffing Companies, L.P. (In re Friedman’s Inc.).¹ Judge Sontchi made clear that, for purposes of evaluating a new value defense to a preference action, the extent of new value is fixed as of the petition date — post-petition events cannot be considered. Receipt of a post-petition critical vendor payment does not defeat a new value defense.

A pre-bankruptcy transfer of the debtor's property is avoidable as a preference if it was made to or for the benefit of a creditor on account of an antecedent debt, within certain prescribed time periods (90 days for most creditors), and allows the creditor to recover more than it would have in a chapter 7 liquidation had the transfer not been made. Section 547(c) of the Bankruptcy Code contains several affirmative defenses available to the transferee. Section 547(c)(4) provides that a transfer is not avoidable “to the extent that, after such transfer, such creditor gave new value to or for the benefit of *the debtor* . . . on account of which . . . *the debtor* did not make an otherwise unavoidable transfer to or for the benefit of the creditor.”² Section 547(a)(2) makes clear that “new value” includes “money or money's worth in new goods, services, or new credit.”³ In other words, if a creditor receives what otherwise would have been a preferential transfer, and subsequently provides money, credit or services to the debtor without receiving any further consideration, the

1. No. 09-10161-CSS, 2011 WL 5975283 (Bankr. D. Del. Nov. 30, 2011).

2. 11 U.S.C. § 547(c)(4) (emphasis added).

3. 11 U.S.C. § 547(a)(2).

creditor has a defense to the preference claim to the extent of the subsequent new value.

Friedman's addressed whether the subsequent new value defense is available where a creditor receives a preferential payment and provides new value prior to the petition date, but the debtor subsequently pays for that new value *after* the petition date. *Friedman's* made a payment of approximately \$82,000 to Roth that contained all of the elements of a preferential transfer. After that payment, but prior to *Friedman's* bankruptcy filing, Roth supplied staffing services worth approximately \$100,000 to *Friedman's*. On the first day of its bankruptcy case, *Friedman's* obtained court authorization to pay Roth over \$72,000 on account of prepetition claims so that Roth would continue to provide staffing services. More than a year later, *Friedman's* brought an action against Roth to recover the \$82,000 prepetition payment as a preferential transfer. Roth asserted a subsequent new value defense under section 547(c)(4).

The debtor argued that its post-petition payment to Roth of \$72,000 for prepetition invoices related back to the prepetition preference period and reduced Roth's subsequent new value defense from \$100,000 to approximately \$28,000. In cross-moving for summary judgment, both sides put forth conflicting arguments involving the use of the term "debtor" in section 547(a), both of which turned on the pre- and post-petition debtors being viewed as two distinct entities. In rejecting both arguments, the court likened the filing of a chapter 11 petition to the election of a baseball player to the Hall of Fame, stating:

Consider the following statement, "Willie Mays is a person that has been elected into the Hall of Fame." Did Willie Mays come into existence the moment he was elected to the Hall of Fame (*i.e.*, *Friedman's* position that the debtor doesn't exist before the bankruptcy filing)? Of course not. Did Willie Mays cease to exist upon election to the Hall of Fame (Roth's position that debtor ceases to exist on the petition date)? Of course not. Under the rules of English grammar and syntax, the phrase "that has been elected" in this example is not a temporal restriction. Rather, it is an adjective that sets forth what it is that makes the particular person or thing of interest to the reader. If one is interested in great baseball players it is significant to know that Willie Mays is in the Hall of Fame. If one is interested with bankruptcy it is significant to know whether the company actually has filed for bankruptcy.⁴

The court instead found a bright line in case law that did not turn on the nuance of whether the prepetition entity and the debtor should be considered one entity or two. The court found that under applicable Third Circuit law, in order to establish a subsequent new value defense, a creditor must show that the debtor received the new value "as of the date that it filed its bankruptcy petition."⁵ Accordingly, in *Friedman's*, the court found that the "provision or payment of new value [after the petition date] does not affect the preference analysis even if the debtor completely compensates the creditor for its prepetition claim."⁶

4. *Friedman's Inc.*, 2011 WL 5975283, at *4.

5. *Id.* (citing *New York City Shoes, Inc. v. Bentley Int'l Inc.*, 880 F.2d 679, 680 (3d Cir. 1989)).

6. *Friedman's Inc.*, 2011 WL 5975283, at *4.

Conclusion

The court's holding in *Friedman's* will protect critical vendors that may have a subsequent new value defense to a preference action and who are also included among creditors that receive payment on account of their prepetition claims through the debtor's first day orders. A creditor's receipt of post-petition payments on account of prepetition claims, in light of *Friedman's*, does not affect any subsequent new value defense that it may have to potential preference claims. ■

Safe Harbors and “Flip Clauses”

“Settlement Payment” Under Section 546(e) Safe Harbor Interpreted Broadly in *Enron*

The Second Circuit affirmed the district court’s decision in Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.¹ to interpret “settlement payment” broadly under section 546(e) of the Bankruptcy Code to include purchases by the debtor of its own outstanding commercial paper. The Second Circuit reasoned that because nothing in the statute or case law exempts redemptions of debt from the definition, a transaction in securities is sufficient to constitute a settlement payment for purposes of the section 546(e) safe harbor.

Section 546(e) of the Bankruptcy Code² provides a safe harbor for “settlement payments” that otherwise qualify as a preferential transfer or fraudulent conveyance. Section 741(8) of the Bankruptcy Code defines “settlement payment” in a somewhat circular manner as: “A preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade.”³ Prior to Enron’s chapter 11 filing, it paid more than \$1.1 billion to retire certain of its unsecured and uncertified commercial paper prior to its maturity. Because the commercial paper could not be redeemed or repaid prior to maturity, Enron instead “purchased” the commercial paper from holders through

transactions referenced as “trades” that contained “settlement” dates. The commercial paper was purchased at par value, which was considerably higher than the paper’s market value.

After the chapter 11 filing, the reorganized entity brought an adversary proceeding against approximately two hundred financial institutions, alleging that the payments to commercial paper holders were recoverable as (a) preferential transfers under section 547 of the Bankruptcy Code because they were made on account of antecedent debt within 90 days prior to the chapter 11 filing; and (b) a constructive fraudulent transfer under section 548 of the Bankruptcy Code because the redemption price exceeded the fair market value. The defendant financial institutions filed a motion to dismiss on the basis that the redemption payments were “settlement payments” within section 546(e) and, therefore, not subject to avoidance. The Bankruptcy Court for the Southern District of New York disagreed and denied the motion. It held that the phrase “commonly used in securities trade” modified all of the terms in the section, thereby limiting “settlement payments” to those that are common in the industry. Following discovery, the defendants again

1. 651 F.3d 329 (2d Cir. 2011).

2. The text of section 546(e) is reproduced in the article in this Year in Review entitled *Section 546(e) Safe Harbor Held Not to Apply to LBO*.

3. 11 U.S.C. § 741(8).

made a motion for summary judgment that was similarly denied by the bankruptcy court, which held that transfer of ownership was necessary in the securities settlement process such that “settlement payments” must include payments made to buy or sell securities, not just payments to retire debt. The defendants filed an interlocutory appeal to the District Court for the Southern District of New York.

The district court reversed the bankruptcy court’s decision and directed entry of summary judgment in favor of the defendants. It held that settlement payments are not limited to those payments that are “commonly used” in the industry and that the circumstances of a particular payment are not determinative of whether the payment is a settlement payment. The district court held that a settlement payment is any transfer that concludes or consummates a securities transaction and that Enron’s redemption constituted a securities transaction regardless of whether Enron acquired title to the commercial paper. Enron appealed to the Second Circuit Court of Appeals.

The Second Circuit affirmed the district court’s decision. The court found that nothing in the Bankruptcy Code or the relevant case law supported Enron’s position that the definition of settlement payment in section 741(8) should be construed narrowly. The court disagreed with the position originally taken by the bankruptcy court that “commonly used in the securities trade” modifies the entire definition. The grammatical structure suggests that it only modifies the term “any other similar payment” immediately preceding the phrase, and restricting the

definition to mean payments commonly used in securities trade would require a factual determination in every case regardless of how common the given transaction may be. In addition, the court held that a transaction in securities is sufficient to satisfy the meaning of settlement payments, because nothing in the Bankruptcy Code or relevant case law excludes redemption of debt securities from the definition of settlement payments. The court also agreed that a settlement payment refers to the completion of a securities transaction, but a securities transaction does not need to involve a purchase or sale of a security. Finally, the court concluded that the absence of a financial intermediary does not preclude the application of section 546(e).

Judge Koeltl dissented from the majority opinion and agreed with the bankruptcy court’s decision. He found that the definition of a settlement payment should include a requirement that there be a purchase or sale of a security and, because the redemption of commercial paper does not include a purchase or sale, Enron’s redemption was not a settlement payment.

Conclusion

The issue of whether a commercial paper repurchase is considered a settlement payment for purposes of section 546(e) was an issue of first impression. The Second Circuit’s *Enron* decision will likely be influential in bankruptcy cases going forward where debtors and trustees seek to avoid prepetition payments that do not involve traditional purchases or sales of securities. ■

Section 546(e) Safe Harbor Held Not to Apply to LBO

The Bankruptcy Court for the Southern District of New York, in In re MacMenamin's Grill,¹ ruled that the safe harbor under section 546(e) of the Bankruptcy Code does not apply to transfers made or obligations incurred in the context of a leveraged buyout of a privately held company. The court also held that the safe harbor applies only to a "transfer" and that debt incurred in connection with an LBO was not a "transfer" for purposes of the safe harbor.

MacMenamin's Grill Ltd. filed for chapter 11 protection in 2008 in the Southern District of New York. Prior to its filing, MacMenamin's Grill conducted a small LBO transaction in August 2007, in which three of its shareholders agreed to sell their ownership interests back to MacMenamin's Grill. To finance the transactions, MacMenamin's Grill obtained a loan secured by all of its assets, the proceeds of which were wired to the three shareholders in exchange for their ownership interests.

A trustee was appointed in the chapter 11 case. The trustee filed a complaint seeking to avoid the transfers made and obligations incurred in connection with the LBO as constructively fraudulent conveyances pursuant to sections 544 and 548 of the Bankruptcy Code and to recover the value of the proceeds paid out to the shareholders under section 550. The shareholders did not dispute the trustee's allegations, but instead moved for summary judgment on the basis that they were shielded from the claims under the section 546(e) safe harbor. They argued that the payment of the loan proceeds to them constituted a "settlement payment" within the meaning of section 546(e) and that, in the alternative, such payment constituted

a "transfer . . . made by . . . a financial institution . . . in connection with a securities contract."²

Section 546(e) of the Bankruptcy Code provides, in relevant part:

Notwithstanding sections 544, 545, 547, 548(a)(1)(B) and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment . . . or settlement payment . . . made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, . . . a commodity contract, . . . or forward contract, that is made before the commencement of the case.³

The primary issue for the court was whether the safe harbor applied to private stock transactions. Precedent was split on the issue. Some courts applied the safe harbor based on the plain meaning of the statute; others declined to extend the safe harbor because the statute is ambiguous, and its legislative history and purpose do not support an expansive reading. The bankruptcy court denied the shareholders' motions for summary judgment and followed the line of cases that have declined to extend the safe harbor.

The court acknowledged that Congress did not expressly place any limitations on

1. Memorandum of Decision on Defendants' Motion for Summary Judgment, *Geltzer v. Mooney, Hantho, Clark and TD Bank, N.A. (In re MacMenamin's Grill, Ltd.)*, Adv. Pro. No. 09-8266-RDD, Dkt. No. 41 (Bankr. S.D.N.Y. Apr. 21, 2011).

2. *In re MacMenamin's Grill* at 6.

3. 11 U.S.C. § 546(e).

the application of the statute based upon whether the transactions in question were public or private. But the shareholders did not provide any evidence that the avoidance at issue involved any entity “in its capacity as a participant in any securities market” or that the avoidance of the transaction at issue “poses any danger to the functioning of any securities market.”⁴ As a result, the court found that the shareholders were not safe harbored from the trustee’s avoidance action.

The court also ruled that the safe harbor only applies to “transfers.” According to the court, the plain meaning of the statute as well as legislative history support the view that section 546(e) does not apply to any incurrence of loan obligations in connection with an LBO.

Conclusion

MacMenamin’s Grill should serve as a warning to participants in private LBOs that they may be susceptible to fraudulent transfer avoidance actions, particularly in the Southern District of New York, because the safe harbor defense under section 546(e) is unavailable. ■

4. *In re MacMenamin’s Grill* at 19-20.

Southern District of New York Limits Trustee’s Avoidance Power in Madoff SIPA Proceeding

The District Court for the Southern District of New York ruled that, as a result of the section 546(e) safe harbor, the Madoff trustee could bring avoidance actions against investors under section 548 of the Bankruptcy Code only for actual fraud.¹ The court also ruled that, with respect to the actual fraud claims, the trustee must show that the investors acted in bad faith based upon actual knowledge of, or with willful blindness to, the fraud.

The trustee appointed to oversee the liquidation of the Bernard L. Madoff Investment Securities (“Madoff Securities”) brokerage firm under the Securities Investor Protection Act (“SIPA”) brought an action in the United States Bankruptcy Court for the Southern District of New York against the owners of the New York Mets and other defendants for, among other things: (a) actual and constructive fraudulent transfer under sections 548, 550 and 551 of the Bankruptcy Code; (b) constructive fraudulent transfer under New York Debtor and Creditor Law; (c) preferential transfer under section 547 of the Bankruptcy Code; (d) equitable subordination; and (e) other violations of the New York Debtor and Creditor Law and the Bankruptcy Code. The reference of the action was withdrawn by the District Court for the Southern District of New York on the ground that the issues required interpretation of SIPA, a federal statute.

The defendants moved to dismiss the complaint or, in the alternative, for summary judgment, arguing, among other things, that there was no showing of bad faith because they were not aware

1. Opinion and Order, *Picard v. Katz*, No. 11-CIV-3605, Dkt. No. 40 (S.D.N.Y. Sept. 27, 2011).

of the Ponzi scheme. Specifically, the defendants argued that the transfers were safe harbored as “transfers made in connection with securities contracts” under section 546(e) of the Bankruptcy Code to which the theory of constructive fraud (*i.e.*, a fraudulent conveyance without an actual intent to hinder, delay or defraud other creditors) does not apply.²

The district court generally agreed with the defendants and dismissed the preference, constructive fraud and equitable subordination claims. The court cited to *In re Enron Creditors Recovery Corp.*³ for the principle that the safe harbors under section 546(e) apply to broker-dealer insolvencies. The court then found that the case before it fell squarely within the definition of section 546 for two reasons. First, the contracts Madoff Securities had with its customers were within the definition of “securities contracts” as they were for the purchase, sale or loan of a security. Second, because of its broad definition, payments made by Madoff Securities to its investors were “settlement payments.” The court found that “[b]y its literal language . . . the Bankruptcy Code precludes the Trustee from bringing any action to recover from any of Madoff’s customers any of the monies paid by Madoff Securities to those customers except in the case of actual fraud.”⁴ Accordingly, the court dismissed all claims except those for actual fraud under section 548 of the Bankruptcy Code.

With respect to the actual fraud claims, the court held that the trustee could only recover defendants’ net profits for actual fraud from the two years prior to the bankruptcy by showing that the defendants failed to provide value for those transfers. The court noted that because Madoff’s Ponzi scheme began more than two years

before the petition date, it was clear that all of Madoff’s transfers during the two-year period were made with intent to defraud present and future creditors. Therefore, the court found that the principal invested by any of the Madoff customers gave value to the debtor and could not be recovered by the trustee absent bad faith. Bad faith could be shown if the defendants had actual knowledge of the Ponzi scheme or willfully blinded themselves to the fact that Madoff was involved in some kind of fraud.

Finally, the court dismissed the equitable subordination claim on the basis that SIPA trumps section 510(c) of the Bankruptcy Code. Although the Bankruptcy Code permits the equitable subordination of claims in appropriate cases, section 78fff-2 of SIPA provides that securities customers who have received avoidable transfers may still seek to pursue those transfers as creditors of the estate.

Conclusion

Although the litigation was subsequently settled, the safe harbor defense recognized by the court in *Picard v. Katz* substantially limits the trustee’s ability to bring avoidance actions against investors for the purpose of clawing back funds for the benefit of the estate. By allowing investors in a Ponzi scheme to invoke the safe harbor protections of the Bankruptcy Code, the court effectively limited the trustee’s claims to only those involving where the investor either has actual knowledge of the Ponzi scheme or has willfully blinded itself to the existence of the fraud. ■

2. The text of section 546(e) is reproduced in the article in this Year in Review entitled *Section 546(e) Safe Harbor Held Not to Apply to LBO*.

3. *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011) (discussed in the article in this Year in Review entitled “Settlement Payment” Under Section 546(e) Safe Harbor Interpreted Broadly in *Enron*).

4. Opinion and Order, *Picard v. Katz*, No. 11-CIV-3605, Dkt. No. 40, at 6.

District Court in *Lehman* Holds that Mutuality Requirement for Setoff is Not Overridden by Derivatives Safe Harbor

The district court, in In re Lehman Bros. Holdings Inc.,¹ affirmed the bankruptcy court's holding that the mutuality requirement for setoffs under section 553 of the Bankruptcy Code is not overridden by the section 560 derivative safe harbors. Thus, a creditor seeking to set off claims it has against a debtor must establish mutuality.

Section 553 of the Bankruptcy Code preserves “any right of a creditor to offset a mutual debt owing by such creditor to the debtor” against that creditor’s claim against the debtor.² In order to offset a debt owed to the debtor against a claim owed by the debtor, both the claim and the debt must have arisen before the bankruptcy filing, and mutuality must exist between the creditor and the debtor.

In 2010, the Bankruptcy Court for the Southern District of New York, in the Lehman bankruptcy, addressed mutuality in the context of the Bankruptcy Code’s safe harbor for derivative contracts.³ Swedbank AG became a creditor of Lehman Brothers Holdings Inc. (“LBHI”) as a result of the early termination of certain derivative transactions under an ISDA Master Agreement. LBHI had a deposit account with Swedbank when it filed for chapter 11. Shortly after LBHI’s bankruptcy filing, Swedbank froze the account, but allowed other parties to deposit funds into the account. A year afterwards, Swedbank sought to set off the amounts, all of which had been deposited after the petition date, in the account against its derivative claim against LBHI.

LBHI filed a motion to prohibit the Swedbank setoff and sought the release of the funds in the frozen account on the basis that the funds consisted of post-petition deposits that lacked mutuality with LBHI’s indebtedness under the terminated swap transactions. Swedbank acknowledged that temporal mutuality did not exist between the prepetition indebtedness of LBHI and the funds deposited in the account post-petition. Swedbank, however, countered that section 560 of the Bankruptcy Code, relating to contractual rights to liquidate, terminate or accelerate swap agreements, permits a derivative counterparty to exercise any “contractual right” to setoff, notwithstanding any other provisions of the Bankruptcy Code, including the mutuality requirements of section 553.

The bankruptcy court sided with LBHI, holding that the mutuality requirement of section 553 is not overridden by the section 560 derivative safe harbors and that Swedbank violated the automatic stay by placing an administrative freeze on LBHI’s account.⁴ The court found that the safe harbor provisions were silent as to whether mutuality requirements of section 553 were inapplicable to derivative contracts and therefore refused to “read in” such an exception.⁵ Swedbank appealed the bankruptcy court’s decision, and the United States District Court for the Southern District of New York affirmed in all respects.

The district court found that section 553 of the Bankruptcy Code prohibited Swedbank’s proposed setoff because of lack of mutuality, and that, as a result, its actions violated the automatic stay.

1. 445 B.R. 130 (S.D.N.Y. 2011).

2. 11 U.S.C. § 553.

3. See *In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), *aff’d*, 445 B.R. 130 (S.D.N.Y. 2011).

4. *In re Lehman Bros. Holdings Inc.*, 433 B.R. at 112.

5. *Id.* at 105.

According to the district court, the Bankruptcy Code safe harbors did not permit derivative counterparties any exceptions to the other provisions of the Bankruptcy Code, such as the mutuality requirements of section 553. In reaching that conclusion, the district court wholly adopted the bankruptcy court's reasoning with respect to the mutuality requirements of section 553 and the violation of the automatic stay, and separately opined only on the issue of safe harbors. The district court reviewed the express language and legislative history of the safe harbors in sections 560 and 561 and found that, contrary to Swedbank's position, those sections contained no indication that they were intended to eliminate or provide an exception to section 553's mutuality requirement. The district court also found that the safe harbors do not extend to the general commercial obligations of swap counterparties. The safe harbors allowed Swedbank to terminate its swap agreements and determine a single net termination value. They did not, however, allow Swedbank to contract out of the Bankruptcy Code's mutuality and priority requirements. Reading the safe harbors in such a manner would result in a swap counterparty being granted superpriority status with respect to all of its commercial transactions with the debtor, which Congress did not intend.

Conclusion

The district court's decision affirms the trend toward strict judicial enforcement of the mutuality requirement of section 553 of the Bankruptcy Code. As a result, all creditors seeking to offset claims under the derivatives safe harbors will have to establish mutuality. Although Swedbank involved a question of mutuality of prepetition derivatives claims and post-petition deposits, the decision could apply with equal weight to other types of mutuality. For example, many derivatives contracts provide for "triangular" setoffs — allowing a creditor to offset amounts the debtor owes against amounts the creditor owes to the debtor *or its affiliates*. Courts have held that such clauses are invalid because (a) mutuality cannot be created by contract where the third-party affiliate has no material obligations under the agreement other than potentially permitting setoff by one of the primary obligors, and (b) the plain meaning of section 553 requires mutuality, and it is impossible to contractually create an exception to this requirement.⁶ ■

6. See, e.g., *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010).

Third Circuit in *American Home Mortgage* Broadly Interprets “Reasonable Determinants of Value” for Purposes of Calculating Swap Claims

The Third Circuit, in In re Am. Home Mortgage Holdings, Inc.,¹ upheld the district court’s decision regarding the interpretation of “reasonable determinants of value” for purposes of section 562 of the Bankruptcy Code. Reasonable determinants of value are not limited to the market or sale value of an asset. Other methodologies, such as discounted cash flow, may be applicable where the relevant market was dysfunctional.

The safe harbors available under sections 559 and 560 of the Bankruptcy Code allow, among other things, swap and repurchase agreement counterparties to “liquidate, terminate or accelerate” swap and repurchase agreements based on what otherwise would constitute unenforceable *ipso facto* clauses, such as bankruptcy event of default provisions. If a swap or repurchase agreement counterparty elects to exercise its rights under the safe harbors, section 562 governs its damages calculation. Under section 562(a), damages generally are calculated as of the earlier of (1) the date of contract rejection or (2) the date or dates of such liquidation, termination or acceleration.

An important exception to that rule is contained in section 562(b), which provides that: “[i]f there are not any commercially reasonable determinants of value as of any date referred to in paragraph (1) or (2) of subsection (a), damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.”² The legislative history provides additional guidance on the availability (or unavailability) of “commercially reasonable determinants of value”:

... in certain unusual circumstances, such as dysfunctional markets or liquidation of very large portfolios, there may be no commercially reasonable determinants of value for liquidating any such agreements or contracts or for liquidating all such agreements and contracts in a large portfolio on a single day.³

The statute, in other words, contemplates that, in unusual circumstances involving dysfunctional markets or liquidation of very large portfolios, damages will be measured as of the earliest date on which commercially reasonable determinants of value appear.

The transaction at issue in *American Home Mortgage* was a repo of mortgage loans between Calyon New York Branch and certain debtors. Calyon, pursuant to section 559 of the Bankruptcy Code, exercised its right to terminate and accelerate the agreement as a result of America Home Mortgage’s chapter 11 filing and served a notice of default shortly after the petition date. Calyon sought to recover damages of approximately \$500 million — an amount that represented the difference between the total repurchase price of the loans and the market value of the loans as of August 15, 2008 (approximately one year after the chapter 11 filing date). Calyon maintained that regardless of whether it intended to hold the loans involved in the repos, the only way to value its damages was to determine the market value of the repos based upon indicative sale prices, and because the repo market was so dysfunctional at the time of the termination, the market value only could be determined one year later, when the markets returned to normal.

1. 637 F.3d 246 (3d Cir. 2011).

2. 11 U.S.C. § 562(b).

3. H.R.Rep. No. 109-31, at 134-35 (2005).

The Bankruptcy Court for the District of Delaware rejected Calyon's argument.⁴ It held that section 562 does not limit "commercially reasonable determinants of value" to the market or sale value of an asset. Other methodologies could be used to determine the value of assets, such as a discounted cash flow analysis where the relevant market was otherwise dysfunctional. Because these other methodologies were available and would, in the court's view, reasonably estimate the value of the repurchase agreement at the time of termination, these methodologies should have been used instead of waiting until the relevant market stabilized.

On direct appeal, the Third Circuit Court of Appeals affirmed the bankruptcy court's decision and agreed that market price is not the only commercially reasonable determinant of value under section 562. Specifically, the court found that market price should be used when the market is functioning properly, but that when the market is dysfunctional, other determinants of value must be used.

Further, the court found persuasive the fact that Calyon did not sell and had no intention of selling the loans. Calyon's choice was a "logical flaw" in its position that market value should be the only determinant of value.⁵ Discounted cash flow analysis is appropriate where the owner holds the mortgage loans and is receiving the cash flows.

Conclusion

The Third Circuit's decision makes clear that under section 562 of the Bankruptcy Code, more than one commercially reasonable determinant of value methodology may be applied to calculate a party's termination damages. However, the parties agreed that the markets were dysfunctional, so the issue of whether a discounted cash flow methodology could be found to apply during normal market conditions was not before the court. ■

4. *In re Am. Home Mortgage Holdings Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd*, 637 F.3d 246 (3d Cir. 2011).

5. *In re Am. Home Mortgage Holdings Inc.*, 637 F.3d at 257.

Validity of “Flip Clauses”: Conflict Between U.S. and U.K. Courts in *Lehman*

The Supreme Court of the United Kingdom, affirming lower courts’ decisions, ruled that “flip clauses” — provisions that alter the priority of distributions upon a counterparty’s bankruptcy filing — are valid and enforceable as a matter of English law. This ruling creates a direct conflict with the U.S. bankruptcy court’s ruling in Lehman that flip clauses are invalid ipso facto clauses.

A “flip clause” is a common provision of a synthetic collateralized debt obligation (“CDO”). The flip clause reorders the payment priorities in the CDO’s waterfall so that noteholders are paid in full before a swap counterparty receives any termination amounts from the CDO. Flip clauses are intended to prevent a defaulting swap counterparty from benefiting as a result of its own default at the expense of its noteholders.

In *Lehman*, the synthetic CDO transactions containing flip clauses were governed by English law trust deeds (the equivalent of a U.S. trust indenture). Pursuant to these CDO transactions, Lehman Brothers Special Financing Inc. (“LBSF”) entered into swap agreements with special purpose vehicles that issued notes. Lehman Brothers Holdings Inc. (“LBHI”) guaranteed LBSF’s obligations under the swaps. The commencement of LBHI’s chapter 11 case triggered events of default under the swap agreements.

Two noteholders under the Lehman CDO transactions, Belmont Park Investment Party Limited (“Belmont”) and Perpetual Company Limited (“Perpetual”), commenced an action in the U.K. against the relevant note trustee, which had

refused to comply with the noteholders’ direction to (a) give effect to the flip clause, making the noteholders first in priority, (b) liquidate the collateral securing the notes and the swap agreement, and (c) distribute the proceeds in accordance with the altered priority of payments. LBSF intervened and argued that the flip clause is invalid under U.S. bankruptcy law. The High Court of Justice, Chancery Division, held that the flip clause was valid, effective and enforceable under English law.¹ Under the “anti-deprivation rule” of English common law, contracts cannot provide that someone’s property is taken away from them upon bankruptcy so as to not be available for their creditors. LBSF appealed the High Court’s decision to the English Court of Appeal, which similarly ruled in favor of the noteholders and found that, as a matter of English law, LBSF had only a limited recourse right of payment from the trustee in an order of priority of payments that could change over time.² In doing so, the English Court of Appeal noted that any deprivation had taken place before LBSF had commenced its bankruptcy case. LBSF again appealed, and the Supreme Court of the United Kingdom granted permission to appeal the Court of Appeal’s decision.³

In addition to intervening in the U.K. action, LBSF filed a separate action against the note trustee and Perpetual in the U.S. bankruptcy court. The U.S. bankruptcy court entered a memorandum decision in favor of LBSF, ruling that: (a) the flip clause was an unenforceable *ipso facto* clause and enforcement of such provision was a violation of the automatic stay; (b) the

1. *Perpetual Tr. Co. Ltd. v. BNY Corp. Tr. Servs. Ltd.*, [2009] EWHC (Ch) 1912.

2. *Perpetual Tr. Co. Ltd. v. BNY Corp. Tr. Servs. Ltd.*, [2009] EWCA (Civ) 1160.

3. *Lehman Bros. Sp. Fin., Inc. v. BNY Corp. Tr. Servs. Ltd.*, No. 09-01242-JMP, Dkt. No. 92, Ex. J (Letter from the High Court of Justice confirming permission to appeal).

trust deed containing the flip clause did not benefit from the “safe harbor” provisions of section 560 of the Bankruptcy Code;⁴ and (c) the flip clause was not a subordination agreement that must be given effect in bankruptcy.⁵ The note trustee sought permission to appeal the bankruptcy court’s decision, and the District Court for the Southern District of New York granted leave to appeal. In doing so, it noted that there is “substantial ground for difference of opinion” on the question of whether the *ipso facto* analysis is applicable to disputes of this nature and took judicial notice of legal and other commentaries questioning the correctness of the bankruptcy court’s decision.⁶ Appellate briefs were filed, but prior to the entry of a decision by the district court, LBSF settled with the note trustee and Perpetual, thus mooted the appeal.

As part of the settlement, the Perpetual U.K. action was withdrawn, but the U.K. action with respect to Belmont remained. The Supreme Court of the United Kingdom affirmed the decisions of the High Court of Justice and the English Court of Appeal and unanimously ruled in favor of Belmont.

The Supreme Court of the United Kingdom emphasized that the flip clause did not violate the English common law anti-deprivation rule because “this was a complex commercial transaction entered into in good faith” and the provisions were not intended to “evade insolvency law.”⁷ In determining that the provision was valid, Lord Walker also

noted that the noteholders were “the only party who contributed real assets,” and LBSF “contributed only promises, and then proved unable to perform them.”⁸ According to the transaction documents, LBSF did not have a contractual priority until the occurrence of certain events and, because these events did not occur prior to the event of default, LBSF was not deprived of any property right — it was merely deprived of its priority of payment. The provision did not operate to divest LBSF of its monies, property or debt or to revest them in Belmont; it was merely designed to change the order of priorities in which the rights were to be exercised in relation to the proceeds of the sale of the collateral upon the occurrence of an event of default. With respect to when the flip clause was triggered, the Supreme Court of the United Kingdom found that the chapter 11 filing of LBHI constituted an event of default under the swap agreements and, because there is “nothing in the documents to require a notice of termination for this purpose,” LBHI’s chapter 11 filing, and not LBSF’s chapter 11 filing, triggered the change in priority.⁹ Finally, the Supreme Court of the United Kingdom noted that “[t]hese transactions were designed, arranged and marketed by the Lehman group [and] [t]here was evidence that the fact that the Noteholders would have priority over the Collateral in the event of LBSF’s insolvency was a very material factor in obtaining Triple A credit ratings which enabled Lehman to market the Notes.”¹⁰

5. *Lehman Brothers Special Financing, Inc. v. BNY Corp. Trustee Services Ltd.*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

6. *Decision and Order Granting BNY Corporate Services Limited’s Motion for Leave to Appeal*, No. M47 (CM) (S.D.N.Y. Sept 22, 2010) at 11.

7. *Belmont Park Invs. PTY. Ltd. v. BNY Corp. Tr. Servs. Ltd. and Lehman Bros. Sp. Fin., Ltd.*, [2011] UKSC 38, Justice of the Supreme Court ¶¶ 108-09 (Lord Collins).

8. *Id.* at ¶ 132 (Lord Walker).

9. *Id.* at ¶¶ 117-18 (Lord Collins).

10. *Id.* at ¶ 113 (Lord Collins).

4. One of the exceptions to the application of section 365(e)(1) of the Bankruptcy Code is the safe harbor protection under section 560. Under that section, swap counterparties are permitted to “liquidate, terminate or accelerate” swap agreements based on what otherwise would constitute unenforceable *ipso facto* clauses, such as bankruptcy event of default provisions.

Conclusion

The decisions by the U.S. and English courts with regard to the validity of the flip clause and the priority of payment are in direct conflict. There are other proceedings pending before the bankruptcy court in the U.S. that involve similar issues, and it is likely that the issue of the validity of the flip clause will be appealed. Depending on how the issue is resolved on appeal, there may be an irreconcilable difference between the two jurisdictions. ■

Distressed Sales

Dodgers Decision Calls into Question Enforceability of No-Shop Clauses

In In re Los Angeles Dodgers,¹ the Bankruptcy Court for the District of Delaware held that a provision arguably akin to a no-shop clause was unenforceable against a debtor because it did not allow the debtor to exercise its fiduciary duty to maximize the value of the estate. The precedential value of the ruling, however, is unclear. The district court granted a stay pending appeal of the order, and its opinion indicates that it may not have agreed with the bankruptcy court's decision.

No-shop clauses, which prevent a seller from soliciting and negotiating other offers or providing due diligence materials to other parties, are common outside the bankruptcy context in a purchase or merger agreement. In the *Dodgers* case, an agreement between the debtor baseball team and Fox Sports Net West 2 LLC ("Fox") governed the broadcast rights of the Dodgers games. The agreement contained a so-called "back-end" rights clause that provided for a 45-day exclusive negotiating period at a specified time to reach an agreement extending the telecast rights for the five years following the end of the 2013 major league baseball season.

On the basis that it would maximize the value of the estate, the debtors sought to sell the team along with Fox's telecast rights by accelerating the exclusive

negotiating period to shortly after the petition date (effectively shortening it by ten-and-a-half months). Fox objected, contending that it had bargained for this provision and it would be difficult for it to negotiate with cable providers if they did not have the telecast rights to the Dodgers games. Fox also argued that the significant damages it would incur outweighed the benefit the debtors would receive by altering the agreement in the proposed manner.

The debtors presented testimony that without the telecast rights included as part of the estate, it was unclear whether the sale would generate proceeds sufficient to pay all creditors in full; thus, in order to maximize the value of the estate, they submitted that the telecast rights must be sold and the agreement with Fox modified as proposed. The debtors pointed out, and the court noted on multiple occasions, that the agreement with Fox did not contain a clause stating that time is of the essence in the negotiations.

Ultimately, the bankruptcy court agreed with the debtors, and even went further by concluding that where a no-shop clause would prevent the exercise of the fiduciary duty of the debtors to maximize the value of their estates, the clause is unenforceable. The court's findings of fact supporting its ruling included that (a) any damages to

1. No. 11-12010, 2011 WL 6257336 (Bankr. D. Del. Dec. 5, 2011).

Fox were “highly speculative and therefore unsubstantiated,” (b) Fox’s expert had testified that he did not know if the relevant agreement was profitable for Fox, and (c) the lack of a clause stating that time is of the essence indicated that the time for performance was not material.² The court also noted that a sale of the Dodgers’ assets that did not include the telecast rights might not provide enough capital to pay all creditors in full. As a consequence, Fox’s damage claim was unpersuasive to the court, and the court stated that altering the timing of the exclusive negotiating period should be of no concern to Fox because of the lack of a “time of the essence clause.” The absence of such a clause indicated that there was no material difference between the debtor’s proposed procedures, accelerating the exclusive negotiating period by ten-and-a-half months, and the original language in the contract.

Fox appealed the ruling to the district court, and requested a stay of the bankruptcy court’s decision. The district court entered an order granting the stay, finding Fox had a “strong likelihood of success on the merits.”³ In a follow-up written opinion, the district court discussed the reasons for granting the stay.⁴ The district court noted that the bankruptcy court had relied on a single non-binding case, *In re Big Rivers Electric Corp.*,⁵ for the proposition that no-shop clauses are unenforceable against a debtor, and distinguished *Big Rivers Electric* because it concerned a no-shop clause invalid as a matter of public policy, not a *per se* rule against the enforceability of a no-shop clause against a debtor.⁶ The district court was not convinced that the clause at issue in the *Dodgers* case could

even be considered a no-shop clause because “under Delaware law . . . it was not executed as part of [d]ebtors’ efforts to merge with another entity, nor does it concern the sale of all of [d]ebtors’ assets.”⁷

The district court’s opinion, however, did not decide the matter on appeal; it merely granted a stay of enforcement of the bankruptcy court’s decision. Notwithstanding the preliminary indications of the district court, there will be no further decision to clarify the treatment in bankruptcy of contractual rights and an exclusivity period of negotiations with a debtor because Fox and the Dodgers reached a settlement and the appeal was withdrawn.

Conclusion

The bankruptcy court’s opinion was issued in a high profile case in an influential bankruptcy court, but until other courts rule on the issue, it is unclear what weight should be accorded the *Dodgers* decision. If it is followed, the bankruptcy court’s opinion would allow a debtor to disregard or modify no-shop provisions, or at least “back-end” exclusive negotiating rights provisions, when compliance with those provisions would not allow the debtor to maximize the value of the estate. Taken to the extreme, such an outcome would allow debtors to rewrite unfavorable contract provisions if to do so would yield a greater return to creditors. This judicially-created

2. *Id.* at *8.

3. *In re Los Angeles Dodgers*, No. 11-01235, 2011 WL 6749081, at *1 (D. Del. Dec. 23, 2011).

4. *In re Los Angeles Dodgers*, No. 11-01235, 2011 WL 6778564 (D. Del. Dec. 27, 2011).

5. 233 B.R. 739 (W.D.Ky. 1998).

6. The debtors in *Big Rivers Electric Corp.*, a public utility, entered into a prepetition agreement with an energy broker for the lease of the debtors’ electric plants. The agreement contained a no-shop clause preventing the debtors from entertaining competing offers for their assets after the bankruptcy filing and also required the approval of the bankruptcy court. The district court agreed with Fox’s interpretation of *Big Rivers Elec.* stating that it “merely reflects the Revlon-like principle that ‘no-shop’ provisions are invalid only if at the time they were adopted they were in violation of a board’s fiduciary duty.” *In re Los Angeles Dodgers*, 2011 WL 6778564, at *9 (citation omitted).

7. *Id.* at *10.

absolute value of maximizing creditors' returns undermines the otherwise valid rights of contract counterparties. The order and opinion of the district court granting the stay, however, gives reason to doubt the applicability of the bankruptcy court's ruling. ■

Confirmation and Plan Provisions

Motors Liquidation Disallows Involuntary Exculpation by Third Parties

The Bankruptcy Court for the Southern District of New York held, in In re Motors Liquidation Co.,¹ that involuntary third-party exculpation provisions in General Motors' plan of reorganization were impermissible. The court noted that third-party releases are permissible "only in rare cases, with appropriate consent or under circumstances . . . regarded as unique." Despite denying the third-party release, Judge Gerber nevertheless recognized the importance of protecting the parties in question from frivolous suits. To address that problem, he adopted an innovative solution whereby he would serve as a "gatekeeper" to weed out claims belonging to the debtors' estate (which were voluntarily being released under the plan) from claims belonging to creditors and equity security holders (which were not being released under his ruling).

As is common in plans of reorganization, in *Motors Liquidation*, the debtors' plan provided for the *bankruptcy estate* (subject to certain specified exceptions) to release claims for actions or omissions in connection with the chapter 11 case against present and former directors and officers of the debtors, the debtors' chapter 11 professionals, the debtor in possession lenders, the official creditors' committee, various chapter 11 fiduciaries and other identified parties. In addition, the plan provided for such protected

persons to receive the benefit of *third-party* exculpation from the debtors' creditors and equity security holders for actions or omissions in connection with the chapter 11 case.

The Bankruptcy Court Decision

Judge Gerber observed that "[r]eleases by estates, on the one hand, and by third parties, on the other, are very different, and are governed by different principles of law."² He held that the releases by the *estate* were valid, but that the third-party release provisions had to be removed from the plan in order for the court to confirm it. He found that releases by the estate ordinarily are permissible in a chapter 11 plan as long as the court is satisfied that such releases are an appropriate exercise of the debtor's business judgment. In this regard, he noted that nothing in the Bankruptcy Code prohibits releases by the estate, and in fact many releases are authorized by section 1123 of the Bankruptcy Code, which permits a plan to include settlements of claims belonging to the estate.

In adjudicating the permissibility of the third-party releases, Judge Gerber referred to his own earlier consideration of this

1. 447 B.R. 198 (Bankr. S.D.N.Y. 2011).

2. *Id.* at 220.

issue in *Adelphia*.³ He noted that, although the discharge of a debtor's liabilities to its creditors does not also result in a discharge of the liabilities of non-debtors on those obligations to such creditors, the Bankruptcy Code does not state that provisions in plans providing for such releases are impermissible. Moreover, section 1123(b)(6) of the Bankruptcy Code states that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of this title."⁴ Third-party releases are not "inconsistent with the applicable provisions of this title," since the Bankruptcy Code makes no mention of them.⁵ Nevertheless, under Second Circuit law they are permissible "only in rare cases, with appropriate consent or under circumstances that can be regarded as unique."⁶ Where those circumstances have not been shown, however, the court cannot find third-party releases to be "appropriate."⁷

Based upon the facts of the case, Judge Gerber determined that the third-party releases were impermissible under both applicable Second Circuit law and his prior rulings in other chapter 11 cases.⁸ Nevertheless, recognizing the importance of protecting the parties in question from frivolous suits by disgruntled creditors and equity holders, he adopted an innovative solution under which he himself would serve as "gatekeeper." In other words, in order for a creditor or equity holder to be able to sue one of the parties in question, they had to first present their claim to

Judge Gerber so that he could weed out claims that belonged to the debtors' estate (which were being released under the plan) from claims that actually belonged to creditors and equity security holders (which were not being released).

Conclusion

The *Motors Liquidation* decision represents a "mixed bag" for chapter 11 fiduciaries and other parties who are accustomed to receiving the benefit of exculpation for most types of non-egregious actions and omissions in connection with a chapter 11 case. Without the protection afforded by third-party releases, it is possible that certain types of parties (particularly certain creditors and indenture trustees) may be less willing to become actively involved in the plan negotiation process. On the other hand, the decision has been viewed by some as developing a creative means of avoiding having chapter 11 fiduciaries and other parties become needlessly enmeshed in frivolous litigation. ■

3. *In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 263-70 (Bankr. S.D.N.Y. 2007).

4. 11 U.S.C. 1123(b)(6).

5. *In re Motors Liquidation Co.*, 447 B.R. at 215 (citation omitted).

6. *Id.* at 220 (citation omitted).

7. *Id.*

8. See, e.g., *In re Chemtura Corp.*, 439 B.R. 561, 609-14 (Bankr. S.D.N.Y. 2010); *In re DBSD North Am.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd* No. 90-13061, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd, in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010) & 634 F.3d 79 (2d Cir. 2011); *In re Adelphia Commc'ns Corp.*, 368 B.R. at 263.

Seventh Circuit Muddies Waters with Respect to Treatment of Executory Contracts Under Plan

The Seventh Circuit's decision in the United Airlines bankruptcy case raises serious concerns regarding a debtor's ability to prolong its right to assume or reject executory contracts for an indefinite period after confirmation of a plan. The court declined to specifically address whether the post-confirmation assumption or rejection of an executory contract by a debtor violates the terms of the Bankruptcy Code.

In order to be confirmed, a plan of reorganization must, among other things, be submitted in good faith and not violate any laws (including the Bankruptcy Code).¹ Section 365(d)(2) of the Bankruptcy Code requires a debtor to decide to assume or reject executory contracts “at any time before confirmation of a plan.”² Moreover, as a condition to assumption of any executory contract that is in default, section 365(b) requires either (i) payment of amounts necessary to cure all monetary defaults or (ii) adequate assurance that such cure amounts will be promptly paid.

In *ReGen Capital I, Inc. v. UAL Corp. (In re UAL Corp.)*,³ which arose in the United Airlines chapter 11 cases, the debtors filed a plan of reorganization providing for the assumption of certain specified executory contracts and that confirmation would “constitute[] the Bankruptcy Court’s approval of the proposed treatment of executory contracts and determination that the Debtors have exercised reasonable business judgment in determining whether to assume or reject each of their executory contracts.”⁴ An exhibit to the plan listed executory contracts and unexpired leases that were to be assumed, including the contracts giving rise to the claim of ReGen Capital I (“ReGen”), but did not include any proposed cure amounts for those contracts.

In accordance with the procedures set forth in the plan, ReGen timely filed a cure claim for payment in full of past due amounts under the contracts.

Importantly, the plan also contained a reservation of rights provision that purported to allow the debtors to reject any executory contracts until after either the debtors and the contract counterparty agreed to a cure amount or the bankruptcy court entered an order establishing the cure amount. Although another creditor objected to this provision as violating the plain language of the Bankruptcy Code⁵ — and reached a settlement with the debtors carving its claim out of this provision — ReGen did not object and instead voted in favor of the plan.

More than two years after the plan confirmation date, the cure amount for the contracts giving rise to ReGen’s claim still had not been determined, and the debtors moved to reject the contracts pursuant to the terms of the plan. In response to ReGen’s objection, the bankruptcy court found that the debtors were entitled to reject the contracts. The district court affirmed the bankruptcy court’s ruling, and ReGen appealed to the Seventh Circuit. The Seventh Circuit agreed that the debtors effectively rejected the contracts even though (a) they had been listed in an exhibit to the plan as contracts to be assumed (subject to the reservation of

1. 11 U.S.C. § 1123(a)(3).

2. 11 U.S.C. § 365(d)(2).

3. 635 F.3d 312 (7th Cir. 2011). The executory contracts issue discussed in this article is in addition to the *ReGen Capital* court’s ruling on claims trading discussed in the article in this Year in Review entitled *Seventh Circuit Addresses Issues of Concern to Claims Traders with Respect to Claims Arising Out of Executory Contracts*.

4. *Id.* at 315 (internal quotation marks and citation omitted).

5. See 11 U.S.C. § 365(d)(2) (“the trustee may assume or reject an executory contract . . . of the debtor at any time before the confirmation of a plan.”).

rights provision), and (b) more than two years had elapsed since the confirmation date.

The Seventh Circuit found that the debtors could reject the contracts notwithstanding the inclusion of the contracts on the assumption list because “where there remained an outstanding default, confirmation of the plan did not, and could not, constitute the act of assumption itself” since the contracts had not yet been cured, a prerequisite to assumption under the Bankruptcy Code.⁶ Instead, the court noted that the debtors’ contract assumption procedures could be justified by the judicially created “ride through” doctrine, which holds that if a plan does not provide for treatment of an executory contract, the contract may ride through confirmation unaffected without being either assumed or rejected.⁷ The court further noted that contracts that ride through plan confirmation may be subject to post-confirmation assumption or rejection.

The Seventh Circuit explicitly noted that it was not deciding whether the debtors’ post-confirmation assumption or rejection of executory contracts was legal under the Bankruptcy Code. Rather, the court relied on the fact that the plan had long ago been

confirmed by the bankruptcy court with the support of ReGen. Therefore, ReGen had lost its opportunity to challenge the legality of the plan or seek an exemption from its provisions.

Conclusion

Although the Seventh Circuit’s decision can be justified based upon the specific facts of that case, it may serve as an invitation to chapter 11 debtors to propose similar executory contract resolution schemes in their own reorganization plans. The incentives for a debtor to maximize optionality on post-confirmation assumption or rejection of executory contracts are strong. By proposing a plan that includes such a feature, a debtor may exit bankruptcy without resolving and adjudicating cure amounts under some or all of its executory contracts. Non-debtor contract counterparties should beware of any proposed plan that reserves the right to assume or reject executory contracts on a post-confirmation basis or otherwise shifts away from the debtor the burden of having cure amounts determined. ■

6. *In re UAL Corp.*, 635 F.3d at 320.

7. *Id.* (citing *Stumpf v. McGee (In re O'Connor)*, 258 F.3d 392, 404-05 (5th Cir. 2001)).

General Growth Properties Enforces *Ipsso Facto* Loan Provisions for Purposes of Determining Creditors' Entitlement to Default Interest Under Plan

The Bankruptcy Court for the Southern District of New York, in two separate decisions in the General Growth Properties chapter 11 cases, upheld the validity of default interest provisions that took effect upon the chapter 11 filing of the debtors. The court found that so-called “ipso facto clauses” — clauses that cause certain rights to be triggered or modified upon the commencement of a chapter 11 filing — are not per se invalid.

Under section 365(e)(1) of the Bankruptcy Code, a contract provision that provides for the termination or modification of an executory contract of the debtor upon the debtor's chapter 11 filing (an “*ipso facto*” clause) is unenforceable, subject to certain limited exceptions. The Bankruptcy Court for the Southern District of New York, in *General Growth Properties*, ruled twice that loan provisions which triggered certain rights automatically upon the commencement of a bankruptcy case were valid and enforceable.

The first decision involved a default interest rate provision of a promissory note (the “CRF decision”).¹ The Common Retirement Fund (“CRF”) entered into a promissory note with General Growth Properties (“GGP”) which provided that the voluntary commencement of a chapter 11 proceeding by GGP automatically (without the issuance of a default notice) constituted an event of default. Further, upon such an occurrence, CRF would become entitled to receive interest at the higher contractual default rate of interest. Shortly after GGP's chapter 11 filing, CRF filed a proof of secured claim for the principal outstanding amount, interest at the non-default rate for all unpaid interest up to the petition

date, interest at the default rate for interest accruing after the petition date, and fees and expenses. GGP did not object to CRF's proof of claim.

Pursuant to its chapter 11 plan, GGP proposed to cure the default on the promissory note by reinstating the principal amount and paying all outstanding interest at the non-default rate. CRF objected to this proposed treatment on the basis that it was entitled to post-petition interest at the contractual default rate. The bankruptcy court agreed and awarded CRF post-petition interest at the default rate.

Although the bankruptcy court recognized that post-petition interest ordinarily is disallowed under section 502(b)(2) of the Bankruptcy Code, the court noted that there are two exceptions to this rule — one statutory and one court-created. The statutory exception is pursuant to section 506(b) of the Bankruptcy Code, which provides that an oversecured creditor is entitled to post-petition interest. The court-created exception is based on *Ruskin v. Griffiths*,² in which the Second Circuit Court of Appeals held that before there is a return to equity in a reorganization case, creditors should receive interest as compensation for the delay of the bankruptcy process.

The bankruptcy court recognized that CRF's right to receive post-petition interest derived from GGP's reinstatement of the loan under section 1124 of the Bankruptcy Code. Section 1124 allows a debtor to reinstate debt in connection with plan confirmation by curing any existing defaults and reinstating the maturity of the debt, without altering any legal, equitable or contractual rights of the debt holder.³

1. *In re General Growth Properties, Inc.*, 451 B.R. 323 (Bankr. S.D.N.Y. 2011).

2. *Ruskin v. Griffiths*, 269 F.2d 827 (2d Cir. 1959).

3. 11 U.S.C. § 1124.

The court noted that section 1124 is silent as to the applicable interest rate and further noted that case law discussing section 1124 is equally unclear and conflicting. The court did not resolve this conflict, but instead focused on the fact that GGP was a solvent debtor. Accordingly, the court determined that the case fell squarely within the *Ruskin v. Griffiths* exception and that CRF was entitled to receive default interest as compensation for the delay of the bankruptcy process. The court found no reason why CRF should not be entitled to such interest because the default rate was not a penalty and GGP did not allege any misconduct by CRF. Moreover, payment of default interest would neither inflict harm on unsecured creditors nor impair GGP's fresh start because GGP was exceedingly solvent when it emerged from bankruptcy. Additionally, the bankruptcy court noted that while *ipso facto* clauses are generally unenforceable, such clauses are "not *per se* invalid in the Second Circuit except where contained in an executory contract or unexpired lease."⁴

The second decision, a month later, also involved a default interest rate provision.⁵ A group of lenders made a series of secured loans to GGP. After its chapter 11 filing, GGP stopped making certain interest payments as required by the credit agreement. The administrative agent for the lender group delivered interest rate modification notices to GGP, asserting that as a result of GGP's failure to make payment, the operative interest rate under the credit agreement was increased to the contractual default rate. The administrative agent, however, did not call an event of default or accelerate the loan.

Pursuant to its chapter 11 plan, GGP proposed to pay the lenders all outstanding principal, accrued pre and post-petition interest at the non-default rate and other related fees. The administrative agent, on behalf of the lender group, objected to the plan, arguing that the lenders were entitled to receive post-petition interest at the default rate. GGP argued that the lenders were not entitled to the default rate because the facility was never properly accelerated as a result of the automatic stay imposed by the bankruptcy filing.

The bankruptcy court, relying heavily on its prior CRF decision, sided with the lenders. The court found that the lenders were oversecured, the interest rate was reasonable and not a penalty, and most importantly, GGP was solvent. With respect to GGP's argument, the court noted that *ipso facto* clauses are not *per se* invalid and that so long as they do not impair a debtor's fresh start, they can be enforceable.

Conclusion

The bankruptcy court's two decisions illustrate that *ipso facto* clauses are not *per se* invalid except in the context of an executory contract. Thus, as a general matter, such clauses may be enforced in other situations (such as the enforcement of a default interest provision of a prepetition loan agreement where the lender is oversecured or where the debtor's equity holders are receiving a distribution) as long as they do not frustrate the debtor's fresh start. ■

4. *In re Gen. Growth Props., Inc.*, 451 B.R. at 330.

5. *In re Gen. Growth Props., Inc.*, No. 09-11977-ALG, 2011 Bankr. LEXIS 2857 (Bankr. S.D.N.Y. July 20, 2011).

Claims and Claims Trading

Washington Mutual Illustrates Risk of Possessing Confidential Information in Context of Claims Trading

A decision by the Bankruptcy Court for the District of Delaware, in In re Washington Mutual, Inc.,¹ highlights the risks of possessing confidential information obtained through the plan negotiation process. The court determined that it had the rarely-used power to equitably disallow the claims of traders who traded while in the possession of confidential information that had not been publicly “cleansed.” The decision also suggested that a creditor who has a blocking position in a creditor class may be considered an insider of the debtor that has a fiduciary duty to act for the benefit of other creditors within that class, even if the creditor does not sit on an official creditors’ committee. Consequently, claims traders who have access to confidential information gained through chapter 11 negotiations need to be very careful about how and when they trade based upon that information.

During the 2008 financial crisis, JPMorgan Chase Bank, N.A. (“JPMCB”) acquired substantially all of the assets of Washington Mutual Bank (“WMB”). Following the acquisition, WMB’s former parent, Washington Mutual, Inc. (“WMI”), and its affiliates commenced chapter 11 proceedings in Delaware. After the commencement of the chapter 11 cases, many of the claims were purchased by professional distressed debt investors.

WMI asserted various claims against JPMC arising from the acquisition, including its alleged entitlement to \$4 billion in cash held by JPMC. The two parties engaged in protracted settlement discussions as part of the plan negotiation process. These negotiations included the exchange of various term sheets between the debtors and JPMC. Counsel for certain noteholders (the “Settlement Noteholders”) participated in many of these negotiations, but were contractually precluded from sharing information with their clients unless and until those clients were bound by confidentiality agreements.

The Settlement Noteholders themselves also participated directly in the negotiations and were subject to confidentiality agreements during two specific periods. During the first confidentiality period, one of the Settlement Noteholders established an ethical wall, whereas the others restricted their trading. At that time, there were settlement discussions among the debtors, JPMC, and the Settlement Noteholders, and various term sheets were exchanged. Those negotiations did not result in a settlement. The Settlement Noteholders’ understanding was that after the restricted period, the debtors would disclose all material information publicly, thereby “cleansing” the information

1. 461 B.R. 200 (Bankr. D. Del. 2011).

and removing any restrictions on the Settlement Noteholders' use of the information. Based upon this belief, the Settlement Noteholders shared all confidential information they had received from the debtors with their traders and resumed their trading in the debtors' debt. With the discussions having been inconclusive, however, the debtors had elected not to disclose the fact that settlement negotiations had occurred on the theory that the failure of the negotiations made the existence of the talks not material.

After the conclusion of the first confidentiality period, two of the Settlement Noteholders independently resumed negotiations with JPMC, and term sheets were exchanged. One of those two Settlement Noteholders restricted its trading during these negotiations, while the other restricted trading only upon receipt of a formal counter-proposal from JPMC.

During the second confidentiality period, settlement negotiations resumed with JPMC and each of the Settlement Noteholders restricted trading. Term sheets were exchanged again, and the Settlement Noteholders received information with respect to the progress of those settlement talks and with respect to a large tax refund that the debtors were expecting to receive. During these talks, JPMC indicated a willingness to turn over the \$4 billion that had been in dispute. This was not publicly disclosed.

Ultimately, it became clear that a deal with JPMC was not imminent and near the end of the second confidentiality period, one of the Settlement Noteholders asked the debtors to terminate the confidentiality period one day early so it could begin trading. The debtors agreed. But because the JPMC settlement negotiations were

again inconclusive, the debtors did not disclose to the public the fact that the JPMC settlement talks had occurred or any details of those negotiations. They did disclose information regarding the anticipated tax refund. After the second confidentiality period ended, the Settlement Noteholders immediately resumed their claims trading activities.

Certain WMI shareholders contended that the Settlement Noteholders' counsel, which was involved in the relevant negotiations, improperly tipped off its clients about the undisclosed JPMC agreement in violation of the terms of its confidentiality agreement. Specifically, they alleged that counsel shared summaries of the April 2009 settlement negotiations with two Settlement Noteholders, who were not subject to confidentiality restrictions at that time. Although one of those Settlement Noteholders voluntarily restricted its trading activities, the other continued to trade.

The Bankruptcy Court's Decision

The bankruptcy court did not reach a final determination concerning the insider trading allegations against the Settlement Noteholders. Rather, Judge Walrath's analysis was limited to whether those allegations gave rise to "colorable" claims sufficient to confer standing on the equity committee to pursue claims for equitable disallowance against the Settlement Noteholders based on their allegedly improper trading. In finding that they did, Judge Walrath made a number of notable determinations.

First, Judge Walrath rejected the equity committee's motion to equitably subordinate the claims of the Settlement Noteholders to the interests of the equity holders because "under the plain language

of the statute [section 510(c) of the Bankruptcy Code] equitable subordination only permits a creditor's claim to be subordinated to another claim and not to equity."² She then determined, however, that if the necessary facts were established, the rarely-used remedy of "equitable disallowance" could be invoked to disallow the claims of the Settlement Noteholders on equitable grounds. Drawing on case law authority from the Supreme Court's decision in *Pepper v. Litton*,³ and the bankruptcy court's and district court's decisions in the *Adelphia* chapter 11 cases, Judge Walrath concluded that she did "have the authority to disallow a claim on equitable grounds 'in those extreme instances — perhaps very rare — where it is necessary as a remedy.'"⁴

Second, in analyzing the equitable disallowance claim, Judge Walrath rejected the Settlement Noteholders' argument that the information exchanged about the settlement discussions with JPMC did not become "material" for securities law violation purposes until an agreement in principle on the settlement was reached with JPMC. Judge Walrath noted that the Supreme Court, in *Basic, Inc. v. Levinson*,⁵ had "rejected the 'agreement-in-principle' standard for evaluating materiality" in the context of merger discussions and found that the same rationale applied in *Washington Mutual*.⁶

Third, Judge Walrath found that the equity committee stated a colorable claim that the Settlement Noteholders received material non-public information, and concluded that discovery "would help shed light on how the Settlement Noteholders internally treated the settlement discussions and if they considered them material to their trading decisions."⁷

Fourth, Judge Walrath found that the equity committee stated colorable

claims for securities law violations under both the "classical theory" and the "misappropriation theory" of liability of section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Under the classical theory, the securities laws are violated when a corporate insider trades the corporation's securities on the basis of material non-public information and in violation of the insider's fiduciary duty owed to shareholders. In contrast, under the misappropriation theory, a corporate "outsider" violates securities laws when he or she misappropriates confidential information in breach of a fiduciary duty owed to the source of the information.

The court was persuaded that a colorable claim was stated under the classical theory because (a) the Settlement Noteholders became "temporary insiders" when the debtors gave them confidential information and allowed them to participate in settlement negotiations with JPMC, and (b) there was sufficient evidence to raise a serious question as to whether the Settlement Noteholders acted recklessly in their use of material non-public information. The court was also persuaded that a colorable claim was stated against the Settlement Noteholders under the misappropriation theory based upon evidence that one of the Settlement Noteholders continued to trade after its counsel improperly shared confidential information about the JPMC settlement discussions with certain of the Settlement Noteholders. In reaching that conclusion, Judge Walrath found that the Settlement

2. *Id.* at 256.

3. 308 U.S. 295 (1939).

4. *In re Washington Mut., Inc.*, 461 B.R. at 257 (quoting *Adelphia Commc'ns Corp. v. Bank of Am., N.A.* (In re *Adelphia Commc'ns Corp.*), 365 B.R. 24, 73 (Bankr. S.D.N.Y. 2007)).

5. 485 U.S. 224 (1988).

6. *In re Washington Mut., Inc.*, 461 B.R. at 261.

7. *Id.* at 263.

Noteholders might be considered insiders of the debtors because collectively they held a sufficient amount of claims to have a blocking position in two classes under any plan, and therefore, might have “owed a duty to the other members of those classes to act for their benefit.”⁸

Finally, Judge Walrath found that it was not a valid defense to argue, as the Settlement Noteholders did, that they assumed the debtors had complied with their obligation under the confidentiality agreements to disclose material non-public information at the end of each restricted period. She adopted the equity committee’s argument that the Settlement Noteholders “knowingly traded with knowledge that the [d]ebtors were engaged in global settlement negotiations with JPMC of which the trading public was unaware.”⁹ Judge Walrath also rejected as a defense the fact that certain of the Settlement Noteholders made contrary trades which allegedly showed that the Settlement Noteholders were not trading on the basis of the confidential information they had received.

Conclusion

Although *Washington Mutual* contains an extensive analysis of the law of insider trading, the court did not reach any final conclusion with respect to the merits of the specific allegations at issue. The court’s ultimate finding was simply that the allegations met the low bar of being “colorable” claims, which justified a grant of standing to the equity committee to pursue the claims. Nevertheless, the ruling by Judge Walrath that a creditor who has a blocking position with respect to a plan of reorganization may become an insider and thereby take on a fiduciary duty to other creditors within its class is a significant departure from the usual rule that a creditor owes no fiduciary duty to

its fellow creditors and may act in its own self-interest. Notably, this is not the first time that Judge Walrath has suggested that a creditor can take on a fiduciary duty to other creditors within its class even though it is not purporting to represent them. She made a similar suggestion *in dicta* in a prior *Washington Mutual* decision involving a Bankruptcy Rule 9019 dispute, stating that “collective action by creditors in a class implies some obligation to other members of that class.”¹⁰

For a variety of reasons, it would be problematic if this rationale were ever formally adopted. Creditors who acquire blocking positions usually do so specifically to be able to influence plan negotiations in a way that is best suited to their own individual needs. To impose a fiduciary obligation on such a creditor would greatly alter the dynamics of the chapter 11 process and limit key parties in a chapter 11 case in ways that presumably were never envisioned. Additionally, not allowing a creditor to act in its own self-interest would likely create a great deal of uncertainty with respect to that creditor’s rights and obligations because such creditor would not always be in a position to know what the official position of the class would be or what degree of deviation from that position might be permissible under the facts of a particular case. The extent to which Judge Walrath’s rationale will be followed and extended in other cases is unclear, but creditors holding, or considering acquiring, a blocking position or who are purporting to take action on a collective basis that affects the larger creditor class should take account of these risks.

In rejecting the contention of the Settlement Noteholders that equitable

8. *Id.* at 264.

9. *Id.* at 265.

10. *In re Washington Mut., Inc.*, 419 B.R. 271, 278-79 (Bankr. D. Del. 2009).

disallowance of their claims would have a chilling effect on investors' willingness to participate in settlement discussions in bankruptcy cases of public companies, Judge Walrath concluded that "creditors who want to participate in settlement discussions in which they receive material non-public information about the debtor must either restrict their trading or establish an ethical wall between traders and participants in the bankruptcy case."¹¹ Clearly, this finding may discourage some creditors from actively participating in key settlement discussions in chapter 11 cases. If this were to occur, it could ultimately harm debtors whose aim is to emerge from chapter 11 by obtaining consensus among their various creditor groups.

The *Washington Mutual* decision should serve as a warning that creditors cannot merely rely on a debtor's contractual commitment to publicly disclose confidential information at the end of a confidentiality period but rather need to make sure that such information is actually disclosed. In the absence of full public disclosure, the creditors who are in possession of the non-public information have not been "cleansed" and, therefore, may not be free to trade claims. ■

11. *In re Washington Mut., Inc.*, 461 B.R. at 266.

Claims in Third Circuit Post-*Grossman's*: *Owens Corning* and *W.R. Grace* Clarify When a Claim Arises

For over two decades, the Third Circuit did not disturb its much criticized Frenville¹ decision, which held that a claim for bankruptcy purposes arises when the underlying cause of action accrues under applicable non-bankruptcy law. Frenville limited the breadth of the discharge available to a debtor in asbestos and other mass tort bankruptcy cases because injury claims did not arise until there was manifestation of an injury. Where manifestation did not occur until after the bankruptcy was filed, claims against a debtor based on that injury could not be discharged.

The Third Circuit overturned Frenville in 2010 in In re Grossman's Inc.,² which, like other courts, held that a claim generally arises when the conduct giving rise to the claim occurred. In 2011, courts within the Third Circuit provided insight into how they will apply Grossman's. In Wright v. Owens Corning,³ the district court held that the new rule applied to any type of claim existing prior to confirmation of a reorganization plan, not solely to asbestos claims. In In re W.R. Grace & Co.,⁴ the bankruptcy court clarified that a potential, future claim is a contingent "claim" and, as a result, a plan of reorganization may provide for treatment of such claim.

Owens Corning

In *Owens Corning*, two plaintiffs, Wright and West, sued Owens Corning for defective roofing shingles. Wright purchased the shingles from Owens Corning in 1998 (prepetition), and West

1. *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984).

2. *JELD-WEN v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010).

3. 450 B.R. 541 (W.D. Penn. 2011).

4. 446 B.R. 96 (Bankr. D. Del. 2011).

purchased them in 2005 (post-petition, but before confirmation of Owens Corning's chapter 11 plan). The company filed its chapter 11 case in October 2000, and a plan of reorganization was confirmed in September 2006. Under the plan, all claims arising prior to confirmation were discharged. Wright and West each discovered that the shingles were defective after the confirmation date and promptly sought payment from Owens Corning under the product's warranty. After Owens Corning's refusal to pay, Wright initiated an action, on behalf of a putative class, against Owens Corning and later filed an amended complaint to include West as an additional named plaintiff. The company promptly filed a summary judgment motion, arguing that the plaintiffs' claims were discharged under the plan.

The District Court for the Western District of Pennsylvania considered whether *Grossman's* applied only to asbestos-related claims. The court recognized that *Grossman's* emphasized Congress's intention that the word "claim," as used in the Bankruptcy Code, be construed very broadly. It also looked to the Third Circuit's decision in *In re Rodriguez*,⁵ which held that a mortgagee's right to collect escrow payments existed prepetition and thereby constituted a "claim" under the Bankruptcy Code. After determining that *Grossman's* was not limited to asbestos claims, the *Owens Corning* court, relying on the Eleventh Circuit's *Piper Aircraft*⁶ opinion, ruled that a creditor has a claim against a debtor-manufacturer if "(i) events occurring before confirmation create a relationship, such as contact, exposure, impact or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product."⁷ The district court determined that Wright and West had been exposed

to the shingles before confirmation and, therefore, had claims that were discharged under Owens Corning's plan.

W.R. Grace

W.R. Grace & Co. filed for chapter 11 relief in Delaware in 2001. W.R. Grace operated numerous mines where employees and their relatives were exposed to asbestos, and its bankruptcy filing was a direct result of a substantial increase in asbestos injury claims. In 2010, W.R. Grace filed a plan of reorganization to deal with all claims, including asbestos-related claims. The State of Montana objected to the plan on the grounds that it might have a claim that would arise in the future and therefore be nondischargeable. Montana asserted that it faced lawsuits for failure to warn of the dangers of asbestos and that, if it was found liable, it would have contribution or indemnity claims against W.R. Grace. Montana argued that because it did not presently have a claim against W.R. Grace, the discharge did not apply. Relying on *Grossman's*, the bankruptcy court held that Montana had a contingent claim because the conduct giving rise to the claim — which was determined to be the asbestos exposure — already had occurred.

In a similar manner, another party with potential contribution or indemnity claims objected to the plan on the basis that it did not provide for a future claims representative for those individuals holding future "demands" for contribution or indemnification claims. That claimant argued that it is likely that it would be sued in the future for asbestos-related personal injury claims, and at that time,

5. 629 F.3d 136 (3d Cir. 2010).

6. *Epstein v. Official Comm. of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573, 1577 (11th Cir. 1995).

7. *Id.*

it would have contribution or indemnity claims against W.R. Grace, but that currently it did not have any “demands” as that term is used under section 524(g) of the Bankruptcy Code. In overruling the objection, the bankruptcy court, applying *Grossman’s*, found that there was an existing contingent claim against W.R. Grace that could be asserted prior to confirmation.

Conclusion

The *Owens Corning* and *W.R. Grace* decisions demonstrate that the courts in the Third Circuit will apply *Grossman’s* in ways that broadly define what constitutes a claim for bankruptcy purposes, and thereby maximize the scope of the debtor’s discharge. *W.R. Grace* also provides that contingent claims (where the injury may manifest in the future) are, in fact, claims and may be dealt with under a plan of reorganization. ■

Seventh Circuit Addresses Issues of Concern to Claims Traders with Respect to Claims Arising Out of Executory Contracts

The Seventh Circuit ruled in the United Airlines bankruptcy case¹ that, in certain circumstances, a debtor may reject executory contracts years after the effective date of its plan of reorganization. This ruling could have a detrimental impact on claims traders who expect to recover the full amount of their claims based on the assumption (and associated cure payment) of the contracts giving rise to their claims.

AT&T Corporation (“AT&T”) sold its unsecured claim against United Airlines to ReGen Capital I (“ReGen”). United filed a plan of reorganization that provided for the assumption of certain specified executory contracts, subject to determination and payment of the amount required to cure contractual defaults. AT&T filed cure claims, although the amounts were never established. After the plan was confirmed, ReGen received its *pro rata* share of the distribution to general unsecured creditors, but not the cure payments arising under the AT&T contracts. Meanwhile, the reorganized airline entered into new contracts with AT&T to continue to receive services and objected to AT&T’s (now ReGen’s) cure claim.

More than two years after the plan confirmation date, United filed a notice of intent to reject the AT&T contracts underlying ReGen’s claims and also filed papers arguing that, as an assignee of AT&T’s prepetition claim, ReGen had only the right to file a general unsecured claim, not a cure claim. The bankruptcy court

1. *ReGen Capital I Inc. v. UAL Corp.* (In re UAL Corp.), 635 F.3d 312 (7th Cir. 2011). *ReGen Capital* is also discussed in the article in this Year in Review entitled *Seventh Circuit Muddies Waters with Respect to Treatment of Executory Contracts Under Plan* with respect to issues relating to executory contracts.

agreed that ReGen did not have the right to assert a cure claim and found that United Airlines had properly rejected the AT&T contracts. The district court affirmed the bankruptcy court ruling on both grounds, and ReGen appealed to the Seventh Circuit.

The Court of Appeals first turned to the lower courts' rulings that the right to cure costs does not run with a claim. The Seventh Circuit disagreed, finding that both the assignment agreement between AT&T and ReGen and the Bankruptcy Code defined the term "claim" broadly enough to include the right to collect any cure amounts arising from the AT&T contracts. The court found that the underlying general unsecured claim and the cure claim arose from the same transaction and gave rise to "a single right to payment."² The only difference between the claims is the priority they are afforded as a result of the assumption or rejection of the contract to which they relate. Based on this reasoning, the Seventh Circuit found that ReGen properly asserted the cure claim against the debtors.³ However, for the reasons discussed elsewhere in this Year in Review,⁴ it also found that the debtors had properly rejected the contracts even though more than two years had passed since the effective date of their plan, and thus ReGen was not entitled to any cure payment.

Conclusion

The *ReGen* case serves as a lesson to bankruptcy claims traders, because acquiring a claim that arises out of an executory contract can create misaligned incentives. If the original party to the contract wishes to continue its commercial relationship with the debtor, it can simply enter into a new contract with the reorganized entity. If the service provider has sold its prepetition claim, it no longer has any incentive to seek assumption of its old contract because it has no economic stake in the cure claim. Therefore, claims traders purchasing an executory contract claim should ensure, when possible, that their claims purchase agreements contain provisions that align incentives between the claims trader and its counterparty by obligating the counterparty to take reasonable steps in pursuit of assumption of its prepetition contracts. ■

2. *Id.* at 317.

3. The court noted that its holding was in accordance with decisions of the Second Circuit Court of Appeals — which also found that there is no difference between a general unsecured claim and a related cure claim in a very similar case — and the United States Supreme Court. *Id.* (citing *ReGen Capital I, Inc. v. Halperin (In re U.S. Wireless Data)*, 547 F.3d 484 (2d Cir. 2008); see also *Shropshire, Woodliff & Co. v. Bush*, 204 U.S. 186, 189 (1987) (holding that a claim is "attached to the debt and not to the person of the creditor; to the claim and not to the claimant").

4. See *supra* note 1.

Claims Trader in *Mesa Air Group* That Failed to Comply with Applicable Bankruptcy Rule and Court Order Forfeited Rights

The Bankruptcy Court for the Southern District of New York, in In re Mesa Air Group, Inc.,¹ ruled that a claims trader lacked standing to object to the proposed treatment of its claims under a plan of reorganization because it failed to strictly comply with the Bankruptcy Rules and a claims trading order. The decision serves as a reminder to claims traders to identify and comply with rules and orders that may affect the acquisition of claims in a particular case.

Bankruptcy Rule 3001(e)(2) provides that if a claim has been transferred after a proof of claim has been filed, the transferee must file evidence of the transfer. In *Mesa Air Group's* chapter 11 case, the bankruptcy court issued an order expanding on this requirement by directing that “a proposed claims acquirer file a Notice of Intent to Purchase, Acquire or Otherwise Accumulate a Claim” and, absent a waiver by the debtors, “at least thirty (30) calendar days notice must be given before a transaction is effectuated”² The order also provided that any trade that did not comply would be “void *ab initio* as an act in violation of the automatic stay.”³

Kitty Hawk Onshore Fund LP and certain of its affiliates (collectively “Kitty Hawk”) filed eight claims acquisition notices,

and the debtors waived the 30-day notice period. Kitty Hawk then transferred its claims to another affiliate (“Holdings”) without filing a second claims acquisition notice. Holdings later objected, as an unsecured creditor, to confirmation of the debtors’ plan of reorganization. In overruling Holdings’ objection, the bankruptcy court held that even a trade between affiliates had to comply with the trading order and Bankruptcy Rule 3001. Because the transfer from Kitty Hawk to Holdings did not comply with the trading order, Holdings lacked standing to prosecute the objection.

Conclusion

As a result of *Mesa Air Group*, claims traders are on notice that they need to carefully examine and abide by relevant claims trading rules and orders in bankruptcy cases when they acquire claims. Furthermore, under *Mesa Air Group*, Bankruptcy Rule 3001 applies to transfers between affiliates. Even technical failures to comply with applicable requirements can result in the loss of rights ordinarily associated with claim ownership, such as the right to object to confirmation of a proposed plan. ■

1. No. 10-10018, 2011 WL 320466 (Bankr. S.D.N.Y. Jan. 20, 2011).

2. *Id.* at *4 (internal quotation marks and citations omitted).

3. *Id.*

New Analytical Approach Taken by Fifth Circuit Expands Potential Bases for Recharacterization of Debt Claims

In determining whether claims should be recharacterized as equity interests, the Fifth Circuit, in Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.),¹ departed from the equitable test adopted by other circuits and instead looked to the claim allowance provisions of section 502 of the Bankruptcy Code. Through this somewhat novel approach, the Fifth Circuit created an alternative avenue to argue that certain debt claims should be recharacterized as equity and thereby relegated to an inferior status in the chapter 11 distribution waterfall.

Debt recharacterization is a remedy that allows courts to treat a creditor's purported claim against a debtor as an equity interest, which pushes the claim down in the capital structure and reduces or eliminates the prospects for recovery. Most circuits have recognized the equitable power of bankruptcy courts to recharacterize debt claims as equity interests under appropriate circumstances.² Courts that rely upon their general equitable powers under section 105(a) of the Bankruptcy Code to recharacterize a particular claim generally use a multi-factor test. In *In re Friedman's Inc.*,³ for example, the bankruptcy court recognized that recharacterization depends upon (i) the names given to the instruments, if any, evidencing the indebtedness, (ii) the presence or absence of a fixed maturity date and schedule of payments, (iii) the presence or absence of a fixed rate of interest and interest payments, (iv) whether repayment is dependent on success, (v) the adequacy of capitalization, (vi) the identity of interests between creditor and stockholder, (vii) security, if any, for the advances, (viii) the ability to obtain financing from outside lending

institutions, (ix) the extent to which the advances were subordinated to the claims of outside creditors, (x) the extent to which the advances were used to acquire capital assets, (xi) the presence or absence of a sinking fund to provide repayments, and (xii) the presence or absence of voting rights.

In *Grossman v. Lothian Oil*, however, the Fifth Circuit took a different approach by relying on section 502 of the Bankruptcy Code (which governs allowance of claims and interests) and applicable state law. The Fifth Circuit considered applying section 105(a), but found it "unnecessary" to do so because section 502 was applicable. In *Lothian Oil*, Grossman, a non-insider, executed two "loan agreements" under which he lent approximately \$350,000 to Lothian Oil. Pursuant to the agreements, no interest was charged, principal was to be repaid from the proceeds of certain equity issuances, and Grossman was to receive royalty payments on the gross production of oil and gas from certain properties. Two years after entering into the second agreement, Lothian Oil filed for bankruptcy. Grossman filed two claims in the bankruptcy case, each for \$250,000. The bankruptcy court rejected both claims and held that they should be recharacterized as equity interests. Grossman appealed, and the district court reversed, holding that debt recharacterization could not be applied to a non-insider creditor in the Fifth Circuit. Lothian Oil then appealed to the Fifth Circuit Court of Appeals.

1. 650 F.3d 539 (5th Cir. 2011), cert. denied, 80 B.N.A. U.S.L.W. 3400 (Feb. 21, 2012).

2. To date, the Third, Fourth, Fifth, Sixth, Tenth and Eleventh Circuits have permitted some form of debt recharacterization. The Ninth Circuit, however, has rejected debt recharacterization, holding that bankruptcy courts do not have the authority to recharacterize debt into equity under the Bankruptcy Code. See *In re Pac. Express, Inc.*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986).

3. 452 B.R. 512, 520-24 (Bankr. D. Del. 2011).

The Fifth Circuit held that bankruptcy courts have the ability to recharacterize claims because they have been granted such authority under section 502 of the Bankruptcy Code, which provides that “the court, after notice and a hearing, shall determine the amount of such claim . . . and shall allow such claim in such amount, except to the extent that . . . such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law.”⁴ In applying this section, the Fifth Circuit noted that it was required to determine whether the claim would be enforceable or unenforceable under the “applicable law” which it found to be Texas tax law. In considering Texas tax law, the Fifth Circuit focused primarily on the fact that there was a royalty payment, instead of a prescribed interest rate owed to Grossman, and the amount of the royalty payment ultimately depended upon the success of Lothian Oil’s business. As such, the Fifth Circuit concluded that Texas tax law would not have recognized Grossman’s claims as debt claims and held that the bankruptcy court was correct in holding that these two claims were in fact equity interests.

Conclusion

The *Lothian Oil* decision made clear that recharacterization of non-insider claims was permissible, under appropriate facts, in the Fifth Circuit. The court also made clear that, although other courts have relied upon section 105(a) when conducting a recharacterization analysis, it disagreed with that approach. The Fifth Circuit’s reliance on the claim allowance provisions of section 502 of the Bankruptcy Code creates an alternative avenue for debtors or trustees to argue that certain debt claims should be recharacterized as equity. ■

Second Circuit Rules on Calculation of Net Equity Claims in Madoff SIPA Proceeding

In its decision in In re Bernard L. Madoff Investment Sec., LLC,¹ the Second Circuit allowed the SIPA trustee to utilize the “net investment method,” instead of the “last statement method,” to calculate investors’ net equity claims against the Madoff estate. The impact of that distinction is that under the net investment method, only those creditors who deposited more into their investment accounts than they withdrew would have customer claims against the Madoff estate.

Under the Securities Investor Protection Act (“SIPA”), the SIPA trustee must calculate the net equity claim of each creditor that is determined to be a customer. SIPA provides that the starting point for determining the net equity amount of a claim is “calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer (other than customer name securities reclaimed by such customer)”² In a non-Ponzi scheme SIPA case, the trustee is able to rely on the books and records (including customer statements) to determine what was owed to each customer. In a Ponzi scheme context, however, the records that formed the basis of what the customer thought it was owed are inherently false.

In the Madoff SIPA proceeding, rather than looking to the statements of alleged holdings customers received, the trustee sought court approval to use the “net investment method” to determine the

1. 654 F.3d 229 (2d Cir. 2011).

2. Securities Investor Protection Act of 1970, 15 U.S.C. § 78III(11)(A).

4. 11 U.S.C. § 502.

amount owing to each customer. Only customers with positive “net equity” can recover from customer property under the net investment method. The method credits a customer with the amount of cash deposited into its account less any amounts withdrawn from it. This limits the class of customers with allowable claims against the customer property fund to those who deposited more cash than they withdrew. Some customers argued that the trustee should instead use the “last statement method,” which would allow customers to recover the “market value” of the securities reflected in their last customer statement.

The Bankruptcy Court for the Southern District of New York sanctioned the trustee’s use of the net investment method on the basis that last customer statements could not be relied on since they were fictitious and do not reflect actual securities positions held.³ The court found that the trustee’s suggested method fairly and accurately reflected customer property.

On direct appeal to the Court of Appeals for the Second Circuit, the appellate court agreed with the bankruptcy court and approved the trustee’s use of the net investment method. In doing so, the

court cautioned that it was only approving this method based on the unusual facts and circumstances of the Madoff SIPA proceeding and that this method might not be applicable in other cases. The court found that SIPA is silent on the actual means of calculating “net equity” and that the method should be the fairest given the facts and circumstances of each case. The court held that since the trades reflected in the customer statements never took place, it would be a “legal error” for the trustee to determine “net equity claims” based on these statements.⁴

Conclusion

The Second Circuit’s decision has a significant impact on the Madoff estates, as only those claimants who deposited more than they withdrew are entitled to customer status and thus entitled to their *pro rata* share of customer property. This results in a smaller number of claimants being entitled to customer status, and a higher percentage recovery for those who have that status. ■

3. *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (In re Bernard L. Madoff Inv. Securities)*, 424 B.R. 122 (Bankr. S.D.N.Y. 2010).

4. *In re Madoff*, 654 F.3d at 241.

Treatment of Claims under TBA Contracts in *Lehman* SIPA Proceeding

In the Lehman SIPA case,¹ the Bankruptcy Court for the Southern District of New York held that so-called TBA contracts (forward contracts for the future purchase of “to be announced” debt obligations) are not “securities,” and TBA contract claimants are not “customers” within the definition of the Securities Investor Protection Act of 1970.²

“TBA contracts” are forward contracts for the future purchase of “to be announced” debt obligations of the three U.S. government-sponsored agencies that issue or guarantee mortgage-backed securities. The mortgaged-backed securities to be bought or sold are not specified when the parties enter into the agreement, but the parties do agree on six general parameters of the debt obligations to be transferred: date, issuing agency, interest rate, maturity date, total face amount of the obligation and price. Then, immediately prior to the time of performance, the seller will specify how many and which securities will be used to satisfy the contract. Typically, there is an interval of several weeks between the date the contract is entered into (the “trade date”) and the date performance under the contract is required (the “settlement date”). On the settlement date, there will be a simultaneous “delivery-versus-payment” exchange of cash and securities.

Lehman Brothers Inc. (“LBI”) had a series of TBA contracts with various counterparties. Shortly after the commencement of LBI’s proceedings under the Securities Investor Protection Act of 1970 (“SIPA”), the Securities Industry and Financial Markets Association issued protocols for market participants to terminate and close out TBA contracts with LBI and notify the trustee for the LBI estate (the “SIPA Trustee”) of the close out cost. In accordance with these protocols, TBA claimants submitted termination notices setting forth the damages and replacement costs. In addition, TBA claimants asserted “customer claims” under SIPA; customer status is significant because only customers, and not general unsecured creditors, are entitled to receive a *pro rata* share of “customer property” (which generally means the failed broker-dealer’s pool of non-proprietary cash, securities and futures positions) and to receive up to a certain amount of any shortfall from insurance provided by the Securities Investor Protection Corporation (“SIPC”).

The SIPA Trustee issued determination notices denying TBA contract claims customer status and classifying them as general creditor claims in an unspecified amount. The SIPA Trustee argued that SIPA’s definition of “customer” should be construed narrowly and the TBA claimants did not fall within the definition because they did not entrust any securities to LBI. According to the SIPA Trustee, the TBA claimants had not transferred any property to LBI in connection with any open TBA contracts and, in fact, elected not to entrust property to LBI by establishing non-custodial delivery-versus-payment accounts. Further, the SIPA Trustee maintained that the TBA claims sought damages for breach of contract and not the return of cash or securities. The SIPA Trustee also argued that the TBA claimants did not qualify as customers because the

1. *In re Lehman Bros. Inc.*, 462 B.R. 53 (Bankr. S.D.N.Y. 2011).

2. At the time of LBI’s filing, the term “customer” was defined under SIPA as any person “who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or a dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral, security or for purposes of effecting transfer.” Subsequent to LBI’s filing, the definition of customer was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The amendment adds to the definition of customer, “any person who has a claim against the debtor for cash, securities, futures contracts, or options on futures contracts received, acquired, or held in a portfolio margining account carried as a securities account pursuant to a portfolio margining program approved by the [Securities and Exchange] Commission.” Because the amendment took place after LBI’s filing, it was not applicable to the LBI proceeding.

TBA claimants did not have a fiduciary relationship with LBI.

Various investment firms objected to the SIPA Trustee's motion, arguing that TBA claimants were customers under SIPA. They asserted that "customer" includes all investors who interacted with and lost money or securities because of the insolvency of a broker-dealer. The objectors also argued that TBA contracts satisfy each of the customer requirements because they are vehicles for the purchase and sale of securities, and LBI was obligated to obtain the securities and deliver them to the claimant's custodian. Finally, the objectors maintained that the TBA contracts did not fall within any express exclusions to the customer definition.

The bankruptcy court issued a memorandum decision agreeing with the SIPA Trustee that the TBA contract claims did not fit the definition of customer claims under SIPA and properly were classified as general unsecured claims. The decision was based on the fact that the claimants did not entrust customer property to LBI. The claimants' accounts with LBI did not contain cash or securities, which distinguished the TBA claims from claims that other courts found were customer claims. The bankruptcy court also cited cases which held that an investor is entitled

to compensation from the SIPC "only if he ha[d] entrusted cash or securities to a broker-dealer who becomes insolvent; if an investor has not so entrusted cash or securities, he is not a customer and therefore not entitled to recover from the SIPC trust fund."³ The bankruptcy court concluded that the TBA claims were not claims for recovery of property held for the customer, but for breach of the TBA contracts. The TBA claims, therefore, were not customer claims. The bankruptcy court also noted that TBA contracts are not one of the enumerated examples of a security and do not fall within the definition of the term "security" under SIPA.

Conclusion

The treatment of TBA claims under SIPA was an issue of first impression. Deeming TBA claims to be general unsecured claims rather than customer claims will result in a larger pool of assets for those LBI creditors who are deemed customers under SIPA. As a result of the decision, future investors may alter the way they purchase and sell TBA contracts in order to manage counterparty risk. ■

3. *In re Lehman Bros. Inc.*, 462 B.R. at 61 (citing *In re Brentwood Secs., Inc.*, 925 F.2d 325 (9th Cir. 1991) (citation omitted); *In re Stalvey & Assocs., Inc.*, 750 F.2d 464 (5th Cir. 1985)).

Bankruptcy Litigation Matters

Third Circuit Declines Opportunity to Limit “Deepening Insolvency” Theory of Liability in *Lemington Home*

The Third Circuit, in Official Comm. of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged),¹ declined to reject or limit the highly-criticized theory under which claims for “deepening insolvency” are deemed cognizable. At least for now, deepening insolvency remains a viable cause of action under Pennsylvania law in cases involving alleged fraud.

Pennsylvania has been a haven for deepening insolvency claims, due largely to the Third Circuit’s 2001 decision in *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*² Although the courts of Pennsylvania have not formally recognized the theory, the Third Circuit, relying on “decisions interpreting the law of other jurisdictions and on the policy underlying Pennsylvania tort law,” found that “the Pennsylvania Supreme Court would determine that ‘deepening insolvency’ may give rise to a cognizable injury.”³ In *In re CitX Corp.*, the Third Circuit defined deepening insolvency as “an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.”⁴ Under this rationale, a deepening insolvency claim must be based on fraud, not negligence, and requires the plaintiff to demonstrate that the defendant’s actions caused the degree of insolvency to increase.

The theory of deepening insolvency has faced significant criticism from commentators and courts. The Delaware Chancery Court, for example, has opined that deepening insolvency has had some success as a cause of action only “because the term has the kind of stenorious [*sic*] academic ring that tends to dull the mind to the concept’s ultimate emptiness.”⁵ Likewise, a New York bankruptcy court rejected the viability of deepening insolvency in its entirety.⁶ Given the heavy criticism of deepening insolvency as an independent theory of liability, some restructuring professionals believed that the Third Circuit might overturn or narrow the scope of *Lafferty* in the recent *Lemington Home* case. Instead, the Third Circuit overturned the district court’s grant of summary judgment against a deepening insolvency claim and remanded the case for further evidentiary hearings, allowing the deepening insolvency litigation to continue.

Lemington Home involved a financially troubled and mismanaged elder care home located in Pittsburgh (the “Home”).

1. 659 F.3d 282 (3d Cir. 2011).

2. 267 F.3d 340 (3d Cir. 2001).

3. *Id.* at 349.

4. 448 F.3d 672, 677 (3d Cir. 2006).

5. *Trenwick Am. Lit. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 204 (Del. Ch. 2006) *aff’d*, *Trenwick Am. Lit. Trust v. Billett*, 931 A.2d 438 (Del. 2007)).

6. *In re Global Serv. Grp. LLC*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004).

Commencing in about 2002, the Home was insolvent and had going concern warnings issued with its audited financial statements. The Home's new Chief Financial Officer never maintained a general ledger or any accounting system. The Home's board became aware that the chief administrator was working part-time, offsite, even though state law required the Home to maintain a full time administrator, but took no action to replace the administrator. Beginning in 2003, regulators began to cite the Home for significant deficiencies, primarily related to a failure to properly document services rendered. The Home also left vacant the positions of finance committee chair and treasurer, resulting in there being no substantive oversight of its financial operations.

The board decided in January 2005 that the Home would immediately stop all new admissions, but did not vote to approve the filing of a bankruptcy petition until three months later. In the interim, the board considered transferring the Home's principal asset, a charitable fund, to another entity controlled by many of the same board members. In furtherance of this goal, the board approved a transition plan and a request for financial support from a charitable foundation to fund the transfer. Before the transfer could be consummated, the board determined that the Home should file for bankruptcy protection in April 2005. Evidence showed that no Medicare billings had been submitted for several months prior to the filing, which had further harmed the Home's cash position. After the petition date, the Home failed to file its required May and June monthly operating reports until September 2005. When they were filed, the reports showed that

the Home had incurred \$1.4 million in assessment taxes.

The official committee of unsecured creditors in the Home's bankruptcy case filed a complaint on behalf of the debtor, alleging various causes of action, including deepening insolvency, against the Home's directors and officers. The district court granted a motion for summary judgment filed by the Home's officers and directors, finding that when considering the evidence in a light most favorable to the plaintiff, it would be impossible to prove the fraud element of the deepening insolvency claim. The committee appealed that ruling to the Third Circuit.

The Third Circuit began by noting that fraud is a necessary element of any successful deepening insolvency claim arising under Pennsylvania law. The Third Circuit found that there was a question of fact as to whether the officers and directors fraudulently contributed to the Home's deepening insolvency prior to approving the bankruptcy filing. Therefore, the court remanded the case to the district court to take evidence on the issue. In rendering its decision, the Third Circuit acknowledged that "courts and commentators have increasingly called into question the viability of "deepening insolvency" as an independent cause of action."⁷ Nonetheless, the court noted that it can only overturn its own precedent in an *en banc* hearing (i.e., involving all the members of the court), and, because the *Lemington Home* case was not decided *en banc*, it was bound by the *Lafferty* decision, which recognized deepening insolvency as an independent cause of action in Pennsylvania.

7. *Official Comm. of Unsecured Creditors v. Baldwin*, 659 F.3d at 294 fn. 6.

Conclusion

Following the decision in *Lemington Home*, deepening insolvency, at least for now, remains a viable cause of action under Pennsylvania law in cases involving alleged fraud. As a result, the board members, officers, advisors and lenders of financially troubled companies in Pennsylvania should be aware of — and plan appropriately to build a defensible record against — potential deepening insolvency claims. The application of *Lemington Home*, however, may be limited because it is unclear whether deepening insolvency will be recognized under the laws of jurisdictions other than Pennsylvania or in cases not involving alleged fraud. ■

Parameters of Common Interest Privilege Explored in *Tribune*

In In re Tribune Co.,¹ the Bankruptcy Court for the District of Delaware concluded that a complete alignment of interests amongst the parties exchanging documents or communications in relation to a plan of reorganization is not necessary for the existence of a “common interest privilege.” The court addressed a number of related issues, including the scope of the privilege and the time at which it arises.

Prior to filing for bankruptcy, The Tribune Company had been the subject of a leveraged buyout (“LBO”), which gave rise to certain potential causes of action. After a mediated negotiation among various parties with respect to a plan of reorganization and these causes of action, four competing plans were filed, including one by certain noteholders. Those noteholders filed a motion to compel production of documents from the other three plan proponents regarding their respective plan’s proposed settlement of the LBO causes of action to “test the arm’s-length nature and good faith of the settlement negotiations.”²

The common interest privilege, also known as the “community of interest privilege,” provides an exception to the general rule that a client waives the attorney-client privilege by communicating previously privileged information to a third party. In a dispute over the production of documents, the noteholders argued that the privilege could not apply to parties with divergent economic interests.

1. No. 08-13141-KJC, 2011 WL 386827 (Bankr. D. Del. Feb. 3, 2011).

2. *Id.* at *3.

The court rejected the noteholders' argument. To invoke the common interest privilege, the party seeking its protection must prove that: (a) the communication in question was made by separate parties in the course of a matter of common interest; (b) the communication was designed to further that effort; and (c) the privilege was not otherwise waived. Judge Carey found that the parties' joint interest in resolving the disputes amongst them by "obtaining approval of their settlement and confirmation of [their] plan" was sufficient to enforce the common interest privilege.³ He relied on *In re Leslie Control, Inc.*,⁴ where a shared interest in maximizing the debtor's assets, despite competing interests regarding their distribution, gave rise to a common interest privilege.

The parties disagreed about the specific time at which the common interest privilege arises. The court found that once the plan proponents had agreed upon the material terms of a settlement, it was reasonable to conclude that the parties might share privileged information in furtherance of their common interest in obtaining approval of the settlement through confirmation of the plan, and thus the privilege arose at that time.

The noteholders next argued that the privilege applies only to communications made or written by lawyers. The court rejected the approach as too restrictive, finding that "the appropriate inquiry is whether the subject matter of the communications would be protected by the attorney-client or work product privilege but for its disclosure to a party

with the common interest."⁵ After addressing which communications were privileged under the facts of the case, the court warned that because of the fact-specific nature of the common interest privilege analysis, the privilege should not be viewed as being applicable to every situation involving a joint plan or mediation settlement. Moreover, no inference should be drawn that there is any bright line requiring a formal joint plan or mediation settlement.

Conclusion

Tribune lends support for the view that a complete alignment of interests amongst the parties exchanging documents or communications is not necessary for the common interest privilege to apply. Rather, it should generally apply where the parties have agreed upon the material terms of a settlement that is to be embodied in the proposed plan of reorganization for which they are co-proponents. However, as the court cautioned, the fact that parties are co-proponents of a plan or are parties to a settlement achieved through mediation does not guarantee that the privilege applies. On the other hand, as the court also cautioned, application of the privilege is not limited to circumstances in which a joint plan is proposed or a settlement results from mediation. Rather, each case will need to be judged on its own facts. ■

3. *Id.* at *5.

4. 437 B.R. 493 (Bankr. D. Del. 2010).

5. *In re Tribune Co.*, 2011 WL 386827, at *6.

In Pari Delicto Defense Defeats Trustee's Fraudulent Transfer Claim

The in pari delicto defense prevents a plaintiff from asserting a claim if the plaintiff's fault for the claim is equal to or greater than that of the defendant. With the collapse of various Ponzi schemes in recent years, there has been an increase in the use of this defense and the number of courts considering when the defense is available. In USACM Liquidating Trust and USA Capital Diversified Trust Deed Fund LLC v. Deloitte & Touche LLP,¹ the District Court for the District of Nevada held that a debtor's former external auditor could raise the defense to prevail against a trustee's fraudulent transfer claim. The decision is presently on appeal in the Ninth Circuit Court of Appeals.

The *in pari delicto* defense prevents a plaintiff from asserting a claim if the plaintiff bears equal or greater fault for the claim than the defendant. The rationale for the defense is that courts should not resolve disputes between wrongdoers. In the bankruptcy context, *in pari delicto* is sometimes used as an equitable defense against claims made by a debtor or trustee where the debtor or its principals have engaged in fraudulent conduct.

Background

USACM was a mortgage loan originator and loan servicer. Between 1998 and 2001, Deloitte performed audits containing unqualified opinions and certifications that the company's financial statements were fairly stated. Nevertheless, Nevada regulatory authorities issued fines against USACM, and it ultimately filed for bankruptcy in April 2006.

A land acquisition holding company, two investment funds and two individuals ran USACM. Until USACM's demise,

the two individuals never owned less than 83 percent of USACM's stock. They regularly transferred large sums of money from USACM to their other entities without any legitimate business reason or benefit to USACM. During USACM's bankruptcy it was discovered that the individuals were operating a Ponzi scheme.

Arguments of the Parties

The trustee of a liquidation trust created by the debtor's reorganization plan asserted claims against Deloitte for aiding and abetting a breach of fiduciary duty, professional malpractice and breach of contract. Deloitte moved for summary judgment, arguing that, as the successor in interest to USACM, the liquidating trust should not be able to bring suit against Deloitte because the criminal conduct and knowledge of the wrongdoing individual owners should be imputed to USACM for *in pari delicto* purposes. Deloitte argued that although bankruptcy law affords a trustee expansive powers on behalf of an estate, section 541(a) of the Bankruptcy Code specifically states that the estate is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case."² As such, the trustee (and its successor, the liquidating trust) stepped into the debtor's shoes and should not be able to assert claims that the debtor itself could not bring. Deloitte further argued that the acts and knowledge of the wrongdoing individuals must be imputed to USACM. This, according to Deloitte, barred USACM, and a successor standing in the wrongdoers' shoes, from bringing suit against Deloitte because the individuals' fraudulent acts were equally, if not more, responsible for the fraud.

1. 764 F. Supp. 2d 1210 (D. Nev. 2011).

2. 11 U.S.C. § 541(a) (emphasis added).

The trust attacked the second prong of Deloitte's argument by disputing that the criminal acts and knowledge of the corporation's agents were necessarily imputed to the corporation under Nevada law. Under the so-called "innocent-insider exception" to the *in pari delicto* defense, courts would not automatically impute to a principal its agent's actions in aiding and abetting a fraud where there was at least one decision-maker among the company's shareholders or managers who was uninvolved in the furtherance of the fraud and could have reasonably prevented it. In the alternative, the trust argued for the application of the long-standing "adverse-interest exception" under which a court will not impute the actions of an agent to the principal where the agent defrauded the principal exclusively for that agent's own benefit.³

After a long discussion of the applicability of the various exceptions to the *in pari delicto* defense, the court ultimately concluded that the defense was properly invoked and that the exceptions raised by the trust did not apply. The court concluded that Deloitte's *in pari delicto* defense was valid because no one had authority to override the decisions of the wrongdoing individuals, and the debtor, through the imputation of its agents' acts, was at greater fault than Deloitte.

Conclusion

As evidenced by *USACM*, courts will apply the rules of imputation of fraud broadly, where the principals of a debtor have engaged in fraudulent conduct, to dismiss claims by the bankruptcy estate against third parties who either are complicit in the fraud or have otherwise acted negligently in failing to spot the fraud. This makes it difficult for bankruptcy trustees to recover for the benefit of the innocent victims.

The *USACM* decision appears to have turned on its specific facts rather than by any broadening of the legal doctrine of *in pari delicto*. The decision does not alter the fact that, in order to use the defense successfully, a defendant must be able both to impute fraudulent acts to the debtor and to prove that the debtor was at least as responsible for those fraudulent acts as the defendant. Application of the *in pari delicto* defense, therefore, always necessitates a highly fact-specific inquiry. ■

3. The application of this exception is itself subject to two qualifications. First, under the "sole-actor exception," where the agent is "self-dealing," the knowledge of the fraud will be imputed to the principal notwithstanding the adverse interests if "the party that should have been informed was the agent itself albeit in its capacity as princip[al]." See *Breeden v. Kirkpatrick & Lockhart LLP*, 336 F.3d 94, 100 (2d Cir. 2003). Second, under the "ratification exception," the actions of the agent will be imputed to the principal if the principal has allowed the agent's actions to continue or has consented to the actions of the agent.

Standing

Unsuccessful Bidder that Failed to Comply with Auction Requirements in Connection with Section 363 Sale Lacks Standing to Sue

In In re Farmland Indus., Inc.,¹ the Eighth Circuit affirmed the bankruptcy court's holding that an unsuccessful bidder for the debtor's assets lacked standing to seek monetary damages in an action for fraud. The determinative factor was that the unsuccessful bidder was deemed not to be a "qualified bidder" due to its failure to provide a deposit as required under the bid procedures. Although the bidder did not challenge that determination at the sale hearing, it later argued that the determination was unjust. While the decision seemingly turned on its unique facts, it should serve as a reminder to an aggrieved bidder that the failure to be deemed a qualified bidder could be fatal to a subsequent attempt to raise issues relating to the sale.

In *Farmland Industries*, the plaintiff bid for the debtor's assets in a 363 sale. The bid was not "qualified" because it was not accompanied by the monetary deposit and supporting information required under the court-approved sale procedures. The plaintiff did not contest the debtor's determination that the bid was "non-qualified." The bankruptcy court approved the sale to a third party and made the customary good faith finding. The plaintiff did not at that time challenge or appeal the sale order.

Subsequently, the plaintiff filed a motion under Rule 60(b) of the Federal Rules of Civil Procedure to set aside the sale order on the ground of improper collusion. The bankruptcy court denied the motion, and the plaintiff did not appeal.² The plaintiff then commenced an adversary proceeding in bankruptcy court against various parties, including the successful bidder, alleging that the successful bidder had intentionally interfered with, and conspired to frustrate, the plaintiff's business expectancy of purchasing the assets in question. The plaintiff contended that the respondents' actions caused the plaintiff to lose the bid on the assets and thus the opportunity to profit from the transaction. Notably, it made this contention despite the fact that it only could have purchased the assets if it had qualified through the bidding process approved by the bankruptcy court, which it did not.

The Bankruptcy Court Proceedings

In considering the plaintiff's Rule 60(b) motion, the bankruptcy court found that the plaintiff's complaint did not state a claim for fraud on the court. The court also found that the plaintiff had not established an injury traceable to the respondents' actions and, therefore, lacked standing

1. 639 F.3d 402 (8th Cir. 2011).

2. The plaintiff also did not challenge a subsequent order of the bankruptcy court authorizing an amendment to the sale order.

to sue in federal court under Article III of the U.S. Constitution. In large part, the bankruptcy court based its decision on the fact that although the plaintiff was alleging in its Rule 60(b) motion that the determination that it was not a qualified bidder at the auction was unjust, it did not allege any facts to suggest that the respondents were responsible for the deficiencies in the bid, which were not contested at the sale hearing, including the failure of the plaintiff to submit the deposit required under the bid procedures.

The Eighth Circuit Court of Appeals Ruling

After a long procedural history involving a previous remand, the Eighth Circuit ultimately ruled that the plaintiff did not suffer an injury traceable to the winning bidder's actions, as required for standing by Article III of the Constitution. The Eighth Circuit based its conclusion, in part, on the finding by the bankruptcy court that the plaintiff's bid did not satisfy the auction and sale bidding procedure requirements. The Eighth Circuit found that although the plaintiff asserted that the disqualification of its bid was "unjustified," it did not allege any facts suggesting that the appellees were responsible for the deficiencies in its bid. Thus, the alleged injury was not traceable to the winning bidder's actions.

The court also rejected the plaintiff's alternative argument, that Rule 60(b) relief was appropriate because the auction

amounted to a fraud on the bankruptcy court. The Eighth Circuit noted that fraud on the court is an extraordinary means by which to obtain equitable relief and requires the plaintiff to prove that it had no adequate remedy at law. The court found that the plaintiff did not allege that it had no adequate remedy at law, and the remedy that it did seek — monetary damages — was at odds with a claim for fraud on the court. The appropriate remedy for such a claim, said the court, is to set aside the bankruptcy court judgment that was allegedly fraudulently obtained rather than collaterally attacking it on appeal.

Conclusion

In *Farmland*, the Eighth Circuit held that an unsuccessful bidder at a bankruptcy auction lacked standing to sue for damages where that bidder was not in compliance with the court-approved auction requirements and could not establish an injury traceable to the winning bidder. Although the decision may be limited to the specific facts of the case, it is a reminder to an aggrieved potential bidder at a section 363 sale to challenge its "non-qualified bidder" status, as well as any bankruptcy court rulings with respect to the bidding procedures, the *bona fides* of the auction process and the auction results, at the time they occur rather than attempting to raise these issues for the first time on appeal. ■

Madoff SIPA Trustee Lacks Standing to Assert Common Law Claims

The Bankruptcy Court for the Southern District of New York, in Picard v. HSBC Bank Plc,¹ ruled that the Madoff SIPA trustee does not have standing to assert common law claims on behalf of the Madoff estate's customers. The trustee does not have standing under SIPA and is not otherwise a bailee, subrogee or assignee of the customers' claims or property.

The trustee appointed under the Securities Investor Protection Act of 1970 ("SIPA") to oversee the liquidation of the Bernard L. Madoff Investment Securities brokerage firm commenced an adversary proceeding against various defendants. The causes of action included common law claims for conversion, unjust enrichment, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty (collectively, the "Common Law Claims"), as well as preference and fraudulent transfer actions. The trustee asserted standing to pursue these claims on behalf of Madoff customers as (a) a bailee of customer property, (b) a subrogee to customer claims and (c) an assignee of customer claims.² The District Court for the Southern District of New York granted defendants' motion to withdraw the reference to resolve whether the trustee had standing or was preempted by the Securities Litigation Uniform Standards Act.

The defendants thereafter moved to dismiss the Common Law Claims, arguing that the trustee had no standing to assert them, whether as successor to the Madoff estate, representative of the purported subrogation rights, bailee of customer property or assignee of unspecified customer claims. The defendants cited to Second Circuit precedent that trustees may only assert claims held by the bankrupt corporation and not those of the bankrupt

corporation's creditors. Further, according to the defendants, Second Circuit precedent also provides that if the debtor's former management participated in the alleged fraud, then the trustee is prevented from bringing claims against third parties in connection with these fraudulent actions.³ The defendants also claimed that the trustee's efforts to give credence to his standing by purporting to bring his action on behalf of thousands of investors ran afoul of the Securities Litigation Uniform Standard Act's preemption of class action-type suits brought under state law in connection with securities fraud. The plain meaning and legislative purpose of the Securities Litigation Uniform Standard Act, they argued, preempted these claims, and nothing in SIPA alters that result.

The district court agreed with the defendants. As a threshold matter, the court noted that mere status as a trustee did not provide standing in federal court to assert the Common Law Claims on behalf of Madoff's customers, absent a non-bankruptcy federal law basis. The court relied on the Supreme Court's decision in *Caplin v. Marine Midland Grace Trust Co. of New York*⁴ to find that a bankruptcy trustee only has standing on behalf of the estate and not the estate's creditors. The court also agreed that under the common law doctrine of *in pari delicto*, the trustee of an estate of a wrongdoer is generally precluded from bringing claims against other alleged wrongdoers.⁵

1. 454 B.R. 25 (S.D.N.Y. 2011).

2. Pursuant to SIPA, customers are treated differently than general unsecured creditors. Only customers are entitled to receive a *pro rata* share of "customer property" (which generally means the failed broker-dealer's pool of non-proprietary cash, securities and futures positions) and to receive up to a certain amount of any shortfall from insurance provided by the Securities Investor Protection Corporation ("SIPC").

3. This is known as the *in pari delicto* defense, which is discussed in the article in this Year in Review entitled *In Pari Delicto Defense Defeats Trustee's Fraudulent Transfer Claim*.

4. 406 U.S. 416 (1972).

5. *Picard v. HSBC Bank Plc*, 454 B.R. at 29.

The court rejected each of the trustee's asserted bases for standing. With respect to the bailee of customer property argument, the court dismissed the trustee's reliance on a provision of SIPA that authorizes the trustee to investigate and report because it did not provide authority to bring suits on behalf of defrauded creditors. The court also rejected the trustee's suggestion that the term "customer property" implies an authority to bring claims on behalf of customers, and found that the fact that any recovery might be treated as personal property does not provide the trustee with standing to bring such claims. The trustee could not have standing under common law bailment theory because the trustee was not seeking to return any recovered bailments to the individual bailors. Additionally, the court rejected the trustee's argument that, pursuant to SIPA, he had standing as subrogee to SIPC, which itself became subrogated to customers upon its payment of SIPC insurance to the customers.

The court found that SIPA makes clear that only SIPC is subrogated to customer claims against the estate and generally not to customer claims against third parties. Finally, the court rejected the trustee's argument that he had standing as assignee of the Common Law Claims, finding that at least four other courts had rejected this proposition.

Conclusion

This decision has significant implications in the Madoff SIPA proceeding as well as other broker-dealer SIPA proceedings going forward. To the extent this decision is followed, the power of trustees to claw back property on behalf of the estate is now limited as the trustees do not have standing to bring common law claims on behalf of the estate's customers. ■

Insurers Have Standing to Object to Chapter 11 Plan Despite Insurance Neutrality Provision

In In re Global Industrial Technologies,¹ the Third Circuit held that, despite a so-called “insurance-neutrality provision” contained in the debtors’ chapter 11 plan of reorganization, certain insurers had standing to object to confirmation of the plan. The Third Circuit’s rationale was that the insurers had a sufficient degree of interest in the plan because they were the “pockets” serving as a potential source of funding for plan distributions to certain personal injury creditors and their rights were otherwise affected by the increase in their potential liability under the plan.

Global Industrial Technologies (“GIT”) and its subsidiaries that filed chapter 11 petitions were in the business of manufacturing heat shielding and others products. As part of GIT’s plan of reorganization, the debtors proposed to establish a silica trust to address a significant number of personal injury claims involving exposure to silica, and a corresponding channeling injunction² to deal with the silica claims. The GIT plan obtained overwhelming approval from creditors.

The plan did not require the debtors’ insurers to contribute any funds to the silica trust, but it did propose to assign to the silica trust the debtors’ rights to coverage for silica claims under certain insurance policies. Moreover, the plan contained an explicit “insurance neutrality” provision, which was intended to make clear that the rights and obligations of the

insurers in question were not impaired or altered by virtue of the debtors’ plan of reorganization. Despite the inclusion of the insurance neutrality provision, certain of the debtors’ insurers objected to the plan on, among others, the following three grounds: (a) the plan violated the anti-assignment provisions of the insurance policies, (b) the silica trust and channeling injunction were neither necessary nor appropriate for the debtors’ successful reorganization, and (c) the bankruptcy process had inappropriately created the debtors’ silica-related liability by causing claims to be asserted that allegedly would have not been asserted in the absence of bankruptcy.

The Bankruptcy and District Court Proceedings

The debtors moved to strike the insurers’ objections on the ground that, because the insurance neutrality provision would ensure that the plan would have no effect on the insurers’ rights and defenses, the insurers lacked standing to object to the plan. The bankruptcy court granted the debtor’s motion to strike based upon its finding that the plan’s insurance-neutrality provisions fully preserved the insurers’ rights and defenses. On appeal, the district court affirmed the bankruptcy court’s ruling that the insurers lacked standing to participate in the plan confirmation proceedings. The insurers appealed to the Third Circuit.

The Third Circuit Ruling

The Third Circuit reversed the decisions of the bankruptcy and district courts, finding that the insurers did have standing to challenge confirmation. The Third Circuit first considered the relationship between constitutional standing under Article III and statutory standing under

1. 645 F.3d 201 (3d Cir. 2011).

2. A channeling injunction is an injunction that protects the debtor and certain other parties by channeling all liability for a particular kind of tort claim to a specially-created trust (subject to certain due process and other requirements).

section 1109(b) of the Bankruptcy Code,³ and found that statutory “party-in-interest” standing under the Bankruptcy Code was effectively co-extensive with constitutional “injury-in-fact” standing. It also observed that a narrow construction of section 1109(b) would be inconsistent with that section’s intended purpose of promoting greater participation in reorganization cases. Accordingly, to satisfy the standing requirement, the insurers needed only to demonstrate some specific identifiable minimal degree of injury that was fairly traceable to the plan.

Next, the Third Circuit confronted the question of whether the insurers had in fact suffered sufficient “injury” to merit standing as a “party-in-interest.” Relying on *In re Combustion Engineering, Inc.*,⁴ the debtors had argued that the plan did not change the insurers’ prepetition contractual rights or obligations and therefore was insurance neutral. In response, the Third Circuit determined that the insurers’ administrative costs and potential liability under the plan were identifiable “trifles of injury” fairly traceable to the plan. The plan’s establishment of the silica trust drastically increased the number of present silica-based claims, and thus correspondingly increased the quantum of the insurers’ potential liability as well as the costs of managing and responding to such potential liability.

The Third Circuit also rejected the debtors’ argument that any harm to the insurers was too speculative to serve as a basis for standing, finding that a contingent liability that results in a tangible disadvantage to the affected party can support Article III standing. That the plan resulted in a

marked increase in the number of silica claims, which in turn created a probability of greater liability for the insurers and higher administrative costs of responding to claims, constituted a cognizable injury for the purposes of Article III standing.

The material increase in the insurers’ potential liability provided sufficient reason to distinguish the present case from the Third Circuit’s earlier decision in *Combustion Engineering*, which had held that the insurance companies lacked standing because of the plan’s insurance-neutral language, which “broadly preserves insurers’ prepetition rights under the subject insurance policies and settlements.”⁵ An additional distinguishing factor was the insurers’ allegations of collusion among the debtors and tort claimants in *GIT* and the resulting threat that a failure to grant standing posed to the integrity of the bankruptcy process.

Conclusion

The precedential significance of *GIT* appears to be somewhat mixed. Although it establishes a very low threshold for the degree of injury that must be shown to support a finding that an insurer has standing for bankruptcy purposes, the ultimate holding by the Third Circuit was based upon the specific facts of the case, which involved alleged collusion and an increase in the potential liability of the insurers. ■

3. 11 U.S.C. § 1109(b) provides in pertinent part that “[a] party in interest ... may appear and be heard on any issue in a case under [chapter 11].”

4. 391 F.3d 190 (3d Cir. 1994).

5. *Id.* at 217.

Bankruptcy Remote Entities

Involuntary Chapter 11 Petition of CDO Issuer Survives Motion to Dismiss in *Zais*

In In re Zais Inv. Grade Ltd. VII,¹ junior noteholders moved to dismiss an involuntary chapter 11 case commenced against a Cayman Islands issuer of collateralized debt obligations (“CDOs”) on the ground that the issuer had no place of business in the United States and thus could not be a chapter 11 debtor. The Bankruptcy Court for the District of New Jersey denied the motion. As a result, the debtor’s senior noteholders were permitted (subject to the resolution of plan confirmation objections) to use involuntary chapter 11 as a means of circumventing express provisions in the indenture that otherwise required each tranche of senior noteholder debt to approve any liquidation of the issuer’s assets by a super-majority vote. Participants in the structured finance community should take heed of this ruling in evaluating their CDO exposure and in structuring finance vehicles in the future.

The debtor, Zais Investment Grade Ltd. VII (“Zais”), was a special-purpose entity formed under Cayman Islands law. It issued eight tranches of non-recourse senior notes pursuant to an indenture, using the proceeds to acquire securities consisting of a portfolio of CDOs, which included residential and commercial mortgage-backed securities and asset-backed securities. These CDO securities were pledged as collateral for its obligations

to the senior noteholders, creating a structure commonly referred to as a “CDO squared.”

As a result of a covenant default under the indenture, certain obligations were imposed on the indenture trustee in relation to the collateral. In order to gain access to the collateral, certain noteholders of the most senior notes (Class A-1 notes) commenced an involuntary chapter 11 petition against Zais. The debtor did not oppose the senior noteholders’ petition and the bankruptcy court entered an order for relief.

Following the commencement of the bankruptcy case, other investors acquired junior Class A-2 notes. These junior noteholders contested the filing of the bankruptcy case and opposed the chapter 11 plan proposed by the petitioning creditors on three basic grounds. First, they contended that Zais was not eligible to be a chapter 11 debtor because it had no place of business in the United States. Second, they argued that the petitioning noteholders were not qualified to be petitioning creditors because their ownership of non-recourse notes made them secured creditors. Finally, they argued that the bankruptcy court should abstain from exercising jurisdiction and dismiss the case

1. No 11-20243, 2011 WL 3795169 (Bankr. D.N.J. Aug. 26, 2011).

on the ground that the interests of creditors would be better served outside of chapter 11.

Zais's Eligibility to be a Chapter 11 Debtor

In response to the first argument, the court found that Zais met the requirements for eligibility under section 109 of the Bankruptcy Code because it had both a place of business and property in the United States. Although Zais maintained a registered office in the Cayman Islands, it conducted most of its business in the U.S. because its primary operations consisted of the services provided to Zais by its manager in the U.S. Significantly, however, the court noted that section 109(a) only requires that the debtor have “a” place of business in the U.S. rather than that the U.S. be its “principal” place of business. The finding in regard to property was based upon the fact that that virtually all of Zais’s property was located in the U.S. (*i.e.*, collateral securities either physically located or registered in New York and cash collateral accounts maintained in a U.S. bank).

Junior Noteholders' Qualification to Challenge the Petition

Section 303(b) of the Bankruptcy Code permits only unsecured or undersecured creditors to be petitioners in an involuntary bankruptcy case. The junior noteholders argued that the senior noteholders’ status as secured creditors prevented them from qualifying as petitioners. The court declined to make a determination on this point because it held that the junior noteholders were precluded from challenging the petitioners’ qualifications on the basis that only an alleged debtor is authorized under section 303(d) to do so (subject to one exception not relevant here), and the debtor here did not do so.

The Court Declined to Abstain from Exercising Jurisdiction

The junior noteholders argued, in the alternative, that the court should abstain from exercising jurisdiction over the debtor’s case because the senior noteholders were acting in bad faith by (a) improperly using bankruptcy to avoid the restrictions on collateral disposition contained in the indenture, and (b) proposing a plan that would not reorganize the debtor. The court found that, even if true, these concerns did not provide sufficient grounds for dismissal prior to a confirmation hearing. The court rejected these allegations, observing that classes of creditors and interest holders may be wiped out in bankruptcy provided that the debtor’s plan passes the “fair and equitable” test embodied in section 1129(b)(1) of the Bankruptcy Code and that liquidation under chapter 11 is permissible.

On the question of bad faith generally, the court was not persuaded that bankruptcy should not be used to circumvent the terms of an indenture. In reaching this conclusion, it noted that sections 365(a) and 1123(b)(2) of the Bankruptcy Code permit the rejection of an executory contract. In the court’s view, this showed that the burdensome contracts can be overridden in bankruptcy.

The court also rejected the junior noteholders’ contention that the indenture was a subordination agreement that must be enforced by virtue of section 510(a) of the Bankruptcy Code. The court predicated this determination on the fact that section 1129(b)(1) of the Bankruptcy Code permits confirmation of a plan “notwithstanding section 510(a)”² and that the non-petition clause in the indenture

2. 11 U.S.C. § 1129(b)(1).

was intended to be for the benefit of senior noteholders rather than a limit on their right to file a petition.

Conclusion

Although the issues in *Zais* ultimately were settled, the decision may be relied upon in other contexts. The facts of *Zais* are akin to many offshore CDO issuers and other special purpose entities designed to minimize the risk of a bankruptcy filing. Indeed, the essential managerial and administrative functions for such entities are commonly performed by U.S.-based institutions. According to *Zais*, this affords a basis for finding that such entities qualify as debtors under the Bankruptcy Code because they can be deemed to have a place of business in the U.S. It also is common for the pledged collateral of such entities to be held or registered in the U.S.,

thereby providing an additional basis for jurisdiction in the U.S. It is important for parties involved with structured finance vehicles, therefore, to keep in mind that being “bankruptcy-remote” should not be confused with being bankruptcy-proof.

Zais is likely to provide an impetus for senior noteholders of other CDO issuers and similar special purpose entities to attempt to use involuntary bankruptcy as a means of liquidating their collateral, where the liquidation would not have otherwise been achievable under the terms of the documents absent unanimous consent. Junior noteholders will be required to assess the economic impact of such a tactic in any given case and whether they should take steps to reduce those risks. It is possible that the risks faced by junior noteholders as a result of *Zais* can be avoided by more specific drafting in the indenture. ■

Employee Matters

Parent Liable Under WARN Act as a “Single Employer”

The Bankruptcy Court for the District of Delaware, in D’Amico v. Tweeter Opco LLC (In re Tweeter Opco, LLC),¹ held that a parent corporation that exercised de facto control over its indirect subsidiary was liable for the subsidiary’s WARN Act violations. The decision should serve as a reminder to parent companies to avoid becoming overly involved in the decisions leading to employee layoffs with less than the required notice under the WARN Act.

Under the WARN Act,² an employer must give 60 days’ notice prior to most types of layoffs involving 50 or more employees. A legal entity can be liable for a related entity’s WARN Act violations if they acted as a “single employer.”

In *D’Amico*, the bankruptcy court focused on whether an indirect parent of the debtor, Tweeter Opco, LLC, was a single employer with the debtor for purposes of the WARN Act. During its bankruptcy, the debtor shut down two different factories, each affecting more than 50 people. The terminated employees were not given WARN Act notice until the day of their termination. The former employees commenced a class action adversary proceeding against the debtor and an ultimate parent (five levels of ownership up) of the debtor.

The employees argued that the debtor and the parent constituted a “single employer” within the meaning of the WARN Act, and that the parent was therefore liable for its subsidiary’s violations. The court employed the Third Circuit’s five-factor test to determine whether a parent is liable as a single employer, including: (a) common ownership; (b) common directors and/or officers; (c) the *de facto* exercise of control; (d) unity of personnel policies emanating from a common source; and (e) the dependence of operations between the entities.³ These factors are not exclusive and a court may consider other evidence of the interrelationship between the entities.

Examining each of the factors, the court in *D’Amico* held that there was common ownership of the debtor and parent. The debtor had argued that a “grandparent” entity (or in this case a great-great-great grandparent entity) is not a common owner with its indirect subsidiary as a matter of law. The court disagreed with this *per se* rule and noted that there was “significant indirect ownership” necessitating further inquiry.⁴ The parent had made a significant loan to the debtor, thereby becoming

1. 453 B.R. 534 (Bankr. D. Del. 2011).

2. Worker Adjustment and Retraining Notification Act, 29 U.S.C. §§ 2101-2109.

3. *D’Amico*, 453 B.R. at 541 (citing *Pearson v. Component Tech. Corp.*, 247 F.3d 471, 495 (3d Cir. 2001)).

4. *Id.* at 542.

its senior lender. The parent's position as senior lender allowed it "to make critical decisions for the Debtor."⁵ This financial control, coupled with the indirect ownership, led the court to find common ownership between the debtor-subsidiary and its indirect parent.

After finding that there were directors and officers in common at both of the companies, the court examined whether the parent exercised *de facto* control over the debtor. A former director of the debtor testified that the individual who owned all of the equity in the parent told the then-CEO of the debtor that he wanted the CEO to fire half of the employees at a certain site. Emails introduced into evidence also demonstrated the parent's *de facto* control, including involvement in the termination of individual employees and large scale forced personnel reductions. Finally, the evidence showed that the parent had involved its inside counsel in the affairs of the debtor, including employment practices, and had sent another employee to assist the debtor in the terminations. After reviewing this evidence, the court found that the parent and its employees had exercised *de facto* control over the employment practices at the debtor.⁶

Conclusion

The parent of a troubled subsidiary, even if it is several generations removed in the corporate family, should avoid exercising such a degree of control over the subsidiary's personnel decisions that it risks WARN Act liability for layoffs without appropriate notice. ■

5. *Id.*

6. With respect to the fourth and fifth factors, the court found that there was no unity of personnel policies between the employers and no dependency between the two entities as it related to day-to-day operations. In reaching its decision to grant summary judgment in favor of the former employees, however, the court noted that the *de facto* exercise of control is given special weight among the factors.

Third Circuit's *Marcal* Decision Deems Multiemployer Pension Plan Withdrawal Liability an Administrative Priority Expense

The Court of Appeals for the Third Circuit, in In re Marcal Paper Mills, Inc.,¹ granted administrative expense priority to the portion of a claim for withdrawal liability under a multiemployer pension attributable to the post-petition services of the debtor's employees because participation in the plan conferred a benefit on the debtor's estate. As a result, a distressed entity must carefully consider whether to terminate its employees and withdraw from a multiemployer pension plan before a bankruptcy filing in order to avoid the risk of incurring administrative expense liability.

In a case of first impression, the Third Circuit held that if a debtor withdraws from a multiemployer pension plan after the commencement of the bankruptcy case, it will incur administrative expenses (which are required to be paid in full under a chapter 11 plan of reorganization) for that portion of the withdrawal liability attributable to employee work performed post-petition.² The withdrawal liability itself stems out of another federal statute, the Multiemployer Pension Plan Amendment Act of 1980 ("MPPAA").

In *Marcal*, several collective bargaining agreements ("CBAs") required the debtor to contribute to a multiemployer defined benefit pension fund (the "Pension Fund"). While in bankruptcy, the debtor continued to employ the union members until substantially all of the debtor's assets were sold. The Pension Fund determined

1. 650 F.3d 311 (3d Cir. 2011).

2. The Third Circuit noted in its opinion that the Second Circuit in *In re McFarlin's, Inc.* "has suggested that post-petition withdrawal liability can be considered an administrative expense", though that case dealt with work performed entirely prepetition and the court ruled that the withdrawal liability was not entitled administrative priority. *Id.* at 319 (citing *In re McFarlin's, Inc.*, 789 F.2d 98, 101-04 (2d Cir. 1986)).

that the termination of the union members' employment caused a complete withdrawal from the fund. The Pension Fund filed a claim for withdrawal liability as an administrative expense. After an objection by the debtor, the Pension Fund amended its claim to seek administrative priority only for that portion of its claim incurred as a result of the post-petition employment of the union members. The debtor again objected to this priority, arguing the entire claim should be a general unsecured claim because: (a) the debtor had made all required post-petition contributions to the Pension Plan pursuant to the CBA and (b) withdrawal liability was not direct compensation to the employee and could not qualify as an administrative expense, as there was no post-petition benefit to the estate. The bankruptcy court sustained the debtor's objection, but the district court reversed and the decision was appealed to the Third Circuit.

The Third Circuit first stated that to qualify as an administrative expense, a claim must be for "actual, necessary costs and expenses of preserving the estate,"³ and "must be beneficial to the debtor-in-possession in the operation of the business."⁴ The court then focused on the reasons for enactment of the MPPAA. The Employee Retirement Income Security Act ("ERISA") initially allowed employers to withdraw from a multiemployer plan without penalty. Withdrawals left many plans under-funded, leaving the employers who remained in the multiemployer plan to compensate. The MPPAA was enacted to "alleviate this problem."⁵ The Third Circuit concluded that the withdrawal liability incurred post-petition was entitled to administrative priority because: (a) the debtor benefited from the employment of the union

members post-petition and (b) the CBAs governing the union members' post-petition employment provided for pension plan benefits in exchange for work. These benefits were the actual and necessary costs of employing the union members post-petition, and, accordingly, the withdrawal liability should be an administrative expense. The court stated it was "simply not seemly . . . to disclaim responsibility for the vested benefits [the debtor] created by choosing to use covered employees to perform post-petition work."⁶ That decision was based in part upon the Third Circuit's conclusion that the MPPAA itself was enacted to "ensure that employers could not avoid their obligation to provide a promised benefit by withdrawing, thereby hurting their employees and the entire pension fund's health."⁷

Conclusion

The *Marcal* decision is important for any distressed company that is a member of a multiemployer defined benefit pension plan, as it must balance the need to continue to obtain services provided by covered employees after the bankruptcy filing against the risk of incurring an administrative priority claim for withdrawal liability if the debtor continues to employ covered employees under a pension plan that will not continue to be funded. ■

3. 11 U.S.C. § 503(b)(1)(A).

4. *In re Marcal Paper Mills, Inc.*, 650 F.3d at 315 (quoting *In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 532-33 (3d Cir. 1999)).

5. *Id.* at 316.

6. *Id.* at 317.

7. *Id.* at 316.

Fourth Circuit in *Matson v. Alarcon* Gives Priority to Severance Payments for Employees Terminated Prepetition

In a case of first impression for courts of appeal, in Matson v. Alarcon,¹ the Fourth Circuit held that severance payments are entitled to priority treatment under the Bankruptcy Code. This decision confirms that severance claims of employees terminated within six months of their employer's bankruptcy filing will be paid in full under a confirmed plan, up to the amount of the statutory cap. Financially distressed employers should be mindful of the need to focus on the timing of employee terminations in order to potentially avoid incurring priority expenses.

In *Matson v. Alarcon*, the Court of Appeals for the Fourth Circuit affirmed a ruling of the Bankruptcy Court for the Eastern District of Virginia that granted priority to the full amount of severance claims (up to the statutory maximum) of employees terminated within the 180 days prior to the employer's bankruptcy filing. The Fourth Circuit premised its conclusion on the plain and ordinary meaning of "earned" and "severance" in section 507(a)(4) of the Bankruptcy Code, finding that severance is earned when employment is terminated. Thus, an employee severed within the 180-day period prior to the employer's bankruptcy filing has a claim entitled to priority treatment for the full amount of the severance owed up to the statutory cap.²

According to the terms of the debtor's severance benefits plan, an employee became a participant in the plan when the employee "(i) was terminated without cause [and] (ii) signed a severance agreement"³ The amount of severance was based on the length of employment. During the 180 days prior to its bankruptcy filing, the debtor terminated 125 employees. At the time of the commencement of the

bankruptcy, the former employees had all become participants in the severance plan, but had not received any compensation under it.

The former employees filed proofs of claim against the bankruptcy estate, asserting that their severance claims were entitled to priority pursuant to section 507(a)(4) of the Bankruptcy Code. The bankruptcy trustee objected, arguing that the former employees "earned" their severance payments over the course of their employment and that each employee was entitled only to a ratable portion of their severance allocated to the 180-day period preceding the bankruptcy filing. The trustee's interpretation meant longer tenured employees would receive priority treatment for a smaller proportion of their severance claim.

The Court of Appeals, though, upheld the bankruptcy court's ruling that an employee earns severance when employment terminates. Section 507(a)(4) of the Bankruptcy Code grants priority status to compensation "earned" within 180 days prior to bankruptcy; the question of when severance is earned was one of first impression.⁴ The court observed that "earn" generally means "receive as equitable return for work done or services rendered," or "to come to be duly worthy of or entitled"⁵ and that the "purpose for severance compensation is to 'alleviate the consequent need for economic readjustment' and 'to recompense [the employee] for certain losses attributable

1. 651 F.3d 404 (4th Cir. 2011).

2. From and after April 1, 2010, 11 U.S.C. § 507(a)(4) allows for a maximum of \$11,725 to be given priority treatment with the remainder, if any, to be given general unsecured treatment.

3. *Matson v. Alarcon*, 651 F.3d at 406.

4. *Id.* at 408.

5. *Id.* (quoting *Webster's Third New International Dictionary* 714 (2002)).

to dismissal.”⁶ While an employee “earns” his wages, salary or commission in exchange for services that generally are under the control of the employee to perform, severance pay is within the employer’s control because the employer ultimately decides whether to provide severance and terminate employment. Thus, “employees do not ‘earn’ ‘severance pay’ in exchange for services rendered as they do when they earn wages, salaries, and commissions. Rather, employees receive ‘severance pay’ as compensation for the injury and losses resulting from the employer’s decision to terminate the employment relationship.”⁷ The court held that an employee “earns” severance pay on the day he or she becomes entitled to the pay, which is the date of termination.

The court further found that the trustee’s position would yield the nonsensical result that some employees would have earned severance compensation prior to the adoption of the severance plan. Furthermore, had the debtor terminated the severance plan, as it was entitled to do by its terms, employees would have theoretically earned severance pay but would never have received it. The court determined that both of these results conflicted with the purpose and the plain terms of the severance plan.

Importantly, the court concluded its opinion by distinguishing case law addressing the priority treatment of severance pay as an administrative expense under section 503(b)(1)(A) of the Bankruptcy Code.⁸ Certain courts have found that severance payments are entitled to administrative priority only to the extent

that services were rendered for the benefit of the bankruptcy estate after the filing of the bankruptcy petition.⁹ However, as the Fourth Circuit noted, unlike section 507, section 503 does not refer to amounts being “earned” and does not list “severance pay” as a form of wages, salary or commissions. Rather, when determining entitlement to an administrative expense, courts will allocate a value to the services rendered after the bankruptcy filing.

Conclusion

The *Matson* decision is the first court of appeals decision to address the applicability of section 507(a)(4) to severance payment obligations. It serves to put financially distressed companies on notice that severance obligations triggered within the six months prior to a debtor’s bankruptcy filing may be entitled to be paid in full, up to the statutory priority cap. ■

6. *Matson v. Alarcon*, 651 F.3d at 409 (quoting *Straus-Duparquet, Inc. v. Local Union No. 3, Int’l Bhd. of Elec. Workers*, 386 F.2d 649, 651 (2d Cir. 1967)).

7. *Matson v. Alarcon*, 651 F.3d at 409.

8. 11 U.S.C. § 503(b)(1)(A) states, in relevant part that “. . . there shall be allowed, administrative expenses . . . including — the actual, necessary costs and expenses of preserving the estate, including — wages, salaries, and commission for services rendered after the commencement of the case”

9. See *In re Roth Am., Inc.*, 975 F.2d 949, 957 (3d Cir. 1992) (holding that severance pay claims under 11 U.S.C. § 503(b)(1)(A) only have administrative priority “to the extent that they are based on services provided to the bankruptcy estate post-petition”); *In re Health Main. Found.*, 680 F.2d 619, 621 (9th Cir. 1982) (holding that “severance pay based on length of service is not entitled to priority status under [the Bankruptcy Act.]”); *In re Mammoth Mart, Inc.*, 536 F.2d 950, 953 (1st Cir. 1976) (holding that under the Bankruptcy Act, a precursor to the Bankruptcy Code, employees seeking severance pay were not entitled to priority where “no portion of [the employees’] claims can be apportioned to their employment” after the case was filed; but see *Straus-Duparquet*, 386 F.2d at 651 (holding that “since severance pay is compensation for termination of employment and since [the employees] were terminated as an incident of the administration of the bankrupt’s estate, severance pay was an expense of administration and is entitled to priority as such an expense.”).

Adequate Assurance to Utilities

Debtors Granted Breathing Room to Provide Adequate Assurance to Utilities

The Bankruptcy Court for the Southern District of New York, in Long Island Lighting Co. v. Great Atlantic & Pacific Tea Co., Inc. (In re Great Atlantic & Pacific Tea Co., Inc.),¹ clarified the provision of adequate assurance of payment to utility companies under Bankruptcy Code section 366.

Section 366 of the Bankruptcy Code governs the post-petition relationship between a debtor and its utility providers. Section 366(c)(2) provides, among other things, that a utility provider can discontinue service if, during the 30 days following a debtor's petition date, it "does not receive from the debtor . . . adequate assurance of payment . . . that is satisfactory to the utility."² Section 366(c)(3) provides that upon notice and a hearing, "the court may order modification of the amount of an assurance payment" under section 366(c)(2).³

Some courts have held that a debtor must provide assurance of payment in an amount and form demanded by its utility providers, and only then may it seek relief from the bankruptcy court to alter the amount of that assurance.⁴ Other courts have held that section 366 gives a debtor 30 days to either (a) reach an agreement with its utility providers

as to a reasonable amount of adequate assurance or (b) petition the court for an order determining the proper amount of adequate assurance.⁵

In *Great Atlantic*, the bankruptcy court agreed with the latter interpretation, finding that to hold otherwise would "potentially place a debtor in a position where it would lose the Section 366 protections . . . or it would hamstring the authority of the courts to set the amount of adequate assurance."⁶

Conclusion

The court's ruling recognizing that the debtor has a 30-day window to either reach agreement with its utility providers or petition the court for determination of the adequate assurance amounts is consistent with the "first day" relief typically obtained by debtors in jurisdictions such as the Southern District of New York and the District of Delaware, and provides clarity to debtors seeking to negotiate adequate assurance with their utility providers. ■

1. No. 11-1338-CS, 2011 WL 5546954 (Bankr. S.D.N.Y. Nov. 14, 2011).

2. 11 U.S.C. § 366(c)(2).

3. 11 U.S.C. § 366(c)(3).

4. *E.g., In re Lucre, Inc.*, 333 B.R. 141, 154 (Bankr. W.D. Mich. 2005).

5. *E.g., Bedford Town Condo. v. Wash. Suburban Sanitary Comm'n (In re Bedford Town Condo.)*, 427 B.R. 380, 383 (Bankr. D. Md. 2010).

6. *In re Great Atlantic & Pacific Tea Co., Inc.*, 2011 WL 5546954, at *4.

Disclosure Requirements Under Rule 2019

Changes to Disclosure Requirements Under Federal Bankruptcy Rule 2019

On December 1, 2011, a substantially amended Federal Rule of Bankruptcy Procedure 2019 went into effect, containing new disclosure requirements for certain representative entities and the creditors and equity security holders they represent. Amended Bankruptcy Rule 2019 generally clarifies the groups, committees and other entities that must make disclosures. It also broadens the types of economic interests that must be disclosed (to include, among other things, derivative instruments), but importantly scales back controversial disclosure requirements pertaining to claims pricing information.

Prior to its recent amendment, Rule 2019 obligated “every entity or committee representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee” to file a verified statement disclosing information about its claims. This statement required each such entity, committee and indenture trustee to disclose “the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.” If a verified statement did not include this information, on motion of any party-in-interest or on its own initiative, the court could, among other things, refuse to permit the entity, committee or indenture

trustee to be heard in the bankruptcy case and hold invalid any authority, acceptance, rejection or objection given, procured or received by it.

The requirements of Rule 2019 went undisputed for years until the rise of so-called *ad hoc* groups or committees of creditors formed to share costs and to increase influence in chapter 11 cases as a result of collective action. Historically, *ad hoc* groups sought to comply with Rule 2019 by disclosing only the names of committee members and the aggregate amount of the claims held by such members. That practice was challenged, however, as *ad hoc* committees began to play an increasingly active and important role in chapter 11 cases and debtors and other parties-in-interest sought to curtail their influence. The first decision addressing the scope of Rule 2019 was published in 2007, and bankruptcy courts ever since have issued conflicting rulings on how strictly the rule must be followed, who must disclose, and the type of information that must be provided.¹

In response to these inconsistent decisions, in August 2009, the Advisory Committee on Bankruptcy Rules proposed amendments to Rule 2019. The proposed amended rule was commented on by the public, revised in response to such comments, and passed through various committees for approval. Most of the debate surrounding the amendments

was focused on disclosure of the date when economic interests were acquired and the amount paid for such interests, with many commentators arguing that such information was generally irrelevant to any issue in a chapter 11 case and prone to strategic use. In addition, some commentators argued that, among other things, agents and indenture trustees should not be required to disclose individual lender and bondholder information. Following the comment and debate period, the amended Rule 2019 went into effect on December 1, 2011.

Amended Rule 2019

Amended Rule 2019 applies to “every group or committee that consists of or represents, and every entity that represents, multiple creditors or equity security holders that are (A) acting in concert to advance their common interests, and (B) not composed entirely of affiliates or insiders of one another.” The addition of “group” and “consists of” serves to resolve the split in the pre-amendment case law with respect to the applicability of Rule 2019 to *ad hoc* groups and parties operating informally in concert. Given

that the phrase “acting in concert” is not defined by the amended rule, it is likely that there will be future disputes as to its meaning.

The inclusion of “consists of” also creates a disparity in the way amended Rule 2019 treats a “group or committee” on the one hand and an “entity” on the other. Namely, amended Rule 2019 applies to a group or committee that “consists of or represents” but only to an entity that “represents” multiple creditors or equity security holders acting in concert to advance their interests and that is not composed entirely of affiliates or insiders. Amended Rule 2019 defines “represent” as to “take a position before the court or to solicit votes regarding the confirmation of a plan on behalf of another.” The net effect is that, unlike entities, groups or committees may have to make Rule 2019 disclosures regardless of whether they appear before the court or actively engage in the plan solicitation process.

As a result of modifications made following the comment period, amended Rule 2019 is now clear that indenture trustees, administrative agents under credit agreements, and groups of insiders or affiliates are exempt from its disclosure requirements. Additionally, in a significant change to the existing rule, groups, committees and entities subject to amended Rule 2019 will be required to disclose, among other things, credit default swaps and similar positions as a result of the expansion of the rule to cover all “disclosable economic interests.” The term “disclosable economic interests” is defined broadly to include not only claims or interests, but all economic rights and interests that could affect the legal and strategic positions that a party-in-interest takes in a case, including pledges, liens, options, participations, and derivative instruments, as well as “any other right

1. *In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007) (holding that an *ad hoc* committee of equity security holders (which was made up of hedge funds and other investment entities) was obligated to supplement their initial Rule 2019 disclosure and provide detailed information with respect to each member's claims); *In re Scotia Dev. LLC*, No. 07-20027, 2007 WL 1192137 (Bankr. S.D. Tex. April 20, 2007) (holding that Rule 2019 did not apply to an *ad hoc* group of noteholders and therefore they were not required to file a supplemental Rule 2019 statement describing each member's claims); *In re Washington Mut.*, 419 B.R. 271 (Bankr. D. Del. 2009) (holding that Rule 2019 applied to an informal group of noteholders and therefore extensive disclosure was required); *In re Premier Int'l Holdings, Inc. (Six Flags)*, 423 B.R. 58 (Bankr. D. Del. 2010) (holding that disclosure under Rule 2019 was not required for an informal bondholders' committee); *In re Accuride Corp.*, No. 09-13449-BLS, 2010 WL 42851004 (Bankr. D. Del. Jan. 22, 2010) (holding that an *ad hoc* noteholders committee was required to disclose information concerning their interests under Rule 2019); *In re Philadelphia Newspapers, LLC*, 422 B.R. 553 (Bankr. E.D. Penn. 2010) (holding that Rule 2019 did not apply to a lenders' steering committee and therefore, it was not required to supplement its initial disclosure with the date or price at which the debt was acquired); *In re Milacron, Inc.*, 436 B.R. 515 (Bankr. S.D. Ohio 2010) (holding that a noteholder group was acting as an “entity” and therefore full disclosure under Rule 2019 was warranted).

or derivative right that grants the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest.”

Although amended Rule 2019 generally increases disclosure requirements, it does limit the information that needs to be provided regarding a party’s acquisition of a “disclosable economic interest.” Under amended Rule 2019, a party is no longer required, except in limited circumstances, to provide the date on which an interest in the debtor was acquired, provided that where a group or committee purports to represent the interests of parties beyond its members the members are required to disclose the quarter and year in which their respective interests were acquired. Furthermore, amended Rule 2019 eliminates the prior pricing disclosure requirement; however, the Advisory Committee Notes to the amendment do state that “[a]lthough the rule no longer requires the disclosure of the precise date of acquisition or the amount paid for disclosable economic interests, nothing in this rule precludes the discovery of that information when it is relevant or its disclosure when ordered by the court pursuant to its authority outside this rule.”

Similar to the old rule, amended Rule 2019 contains an obligation to update the information contained in the verified statement if there are material changes. Likewise, if there is a failure to comply, amended Rule 2019 provides that the court can, among other things, refuse to permit the entity, group or committee to be heard further or intervene in the cases and hold

invalid any authority, acceptance, rejection or objection, given, procured or received by it.

Amended Rule 2019 applies in all proceedings in bankruptcy cases commenced on or after December 1, 2011. Amended Rule 2019 may also be applied in cases pending prior to that time unless a party demonstrates that application of such rule would be inappropriate under the circumstances.

Conclusion

The amendments to Rule 2019 provide greater clarity with respect to which persons or entities are obligated to provide disclosure and what types of information are required to be disclosed; however, the lack of definition around some concepts, such as what it means to be “acting in concert,” continues to create doubt as to the precise scope of the rule. Rule 2019 alters the types of entities required to disclose, by including *ad hoc* groups but excluding indenture trustees, administrative agents under credit agreements, and groups of insiders or affiliates. It also alters the amount of information that must be disclosed, by requiring disclosure of all “disclosable economic interests” (including derivatives), but generally eliminating any requirement for disclosing dates of acquisition of economic interests and claim pricing information. The rule, however, does not prevent the discovery of such information in appropriate cases, an area that also may be ripe for continued disputes in the courts. ■

Living Wills

Final “Living Wills” Requirements for Large Financial Institutions

A major step designed to end the need for future financial bailouts was taken by federal bank supervisors in 2011 with the adoption of final joint regulations requiring a resolution plan (or “Living Will”) for the largest financial institutions active in the United States. The requirement that major financial institutions engage in advance resolution planning irrespective of their financial health is intended to reduce the risk of financial destabilization in the event that a systemically important financial institution (or “SIFI”) were to fail. Preparation of these plans will constitute a major undertaking for the institutions, with ramifications that will continue to evolve over time.

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), certain financial institutions are required to create “Living Wills” or explicit plans for rapid and orderly resolution in the event of material financial distress or failure of the company. The Dodd-Frank Act, which was signed into law on July 21, 2010, required the Federal Deposit Insurance Corporation (the “FDIC”) and the Board of Governors of the Federal Reserve System (the “Federal Reserve”) to develop specific regulations to address the required content, timing and

considerations for these resolution plans. On September 13, 2011 and October 17, 2011, the FDIC and Federal Reserve, respectively, approved final resolution plan regulations for the largest financial groups operating in the United States. On September 13, 2011, the FDIC also approved a final interim regulation requiring plans from FDIC-insured institutions with \$50 billion or more in total assets, and on January 17, 2012, it approved the final version of such regulation.

The joint rule approved by the FDIC and the Federal Reserve implements the resolution plan requirements of section 165(d) of the Dodd-Frank Act.¹ This rule (the “DFA Rule”) requires the largest U.S. bank holding companies and non-U.S. headquartered institutions that conduct U.S. banking operations, and any financial companies designated as systemically important by the new U.S. systemic risk council (the Financial Stability Oversight Council (“FSOC”)), to prepare and periodically revise a plan that would facilitate its resolution in the event of material financial distress or failure. The DFA Rule sets out an extensive list

1. A copy is on the FDIC’s website at <http://www.fdic.gov/regulations/laws/federal/2011/11FINALNov1.pdf>. The joint rule will be Regulation QQ for the Federal Reserve (12 C.F.R. Part 243) and Part 381 for the FDIC (12 C.F.R. Part 381).

of minimum information requirements for a satisfactory resolution plan.

The final rule approved by the FDIC (the “IDI Rule”) requires a U.S.-insured depository institution (an “IDI”) with \$50 billion or more in total assets (a “Covered IDI”) to submit periodic contingency plans to the FDIC for resolution in the event of the institution’s failure.² The interim rule that preceded the IDI Rule became effective on January 1, 2012 and will remain in effect until superseded by the IDI Rule effective April 1, 2012.³

It currently is estimated that there are 124 banking firms (approximately 90 of which are headquartered outside of the United States) initially subject to the DFA Rule and 37 IDIs initially subject to the IDI Rule. As the FSOC has yet to identify systemically important non-bank financial institutions, it is unclear how many non-banks will also become subject to the DFA Rule. Financial groups with FDIC-insured commercial bank subsidiaries meeting the \$50 billion threshold will be required to prepare both a group resolution plan under the DFA Rule and a bank resolution plan under the IDI Rule.

Different Aims of the DFA Rule and IDI Rule

The DFA Rule and the IDI Rule (collectively, the “Rules”) form a core element of the U.S. regulatory reforms designed in the Dodd-Frank Act to identify and mitigate systemic risks and to contribute to the end of so-called “too big to fail” status. The requirements are intended both to assist the ability of the FDIC to conduct advanced resolution planning for covered institutions facing financial distress and also “to facilitate improved efficiencies and risk management practices amongst systemically important financial

institutions as they produce and evaluate these plans.”⁴

The two Rules, while complementary, have some fundamental differences. The DFA Rule requires a plan for a rapid and orderly resolution — liquidation or restructuring — under the Bankruptcy Code and other insolvency statutes applicable to particular types of regulated entities (such as securities broker-dealers), while the IDI Rule requires a plan for resolution under the Federal Deposit Insurance Act (“FDIA”) with the FDIC acting as receiver. Although the Bankruptcy Code and FDIA share some similarities, there are significant differences between the two statutes.

The DFA Rule and IDI Rule also have fundamentally different purposes. The DFA Rule focuses on minimizing systemic risk in the resolution of a failed institution in order to protect the stability of the U.S. financial system while maximizing recovery for creditors. Thus, the driving concept is that steps should be taken to prevent the discontinuance of critical operations of a systemically significant institution, or mitigate its fallout, through a restructuring, and the DFA Rule plan is intended to outline those steps, including any impediments to taking them and efforts needed to avoid them. The IDI Rule, on the other hand, focuses on ensuring that depositors receive prompt access to insured deposits upon the failure of a Covered IDI, minimizing costs to the FDIC and creditors, and maximizing recovery value for creditors.

In a nutshell, the DFA Rule enters uncharted territory by requiring Covered

2. A copy is on the FDIC’s website at http://www.fdic.gov/regulations/laws/federal/2012/2012-01-23_final-rule.pdf. The IDI Rule is added to Part 360 of the FDIC’s regulations at section 360.10.

3. A copy is on the FDIC’s website at <http://www.fdic.gov/regulations/laws/federal/2011/11finalSep21.pdf>.

4. Minutes of FDIC Board meeting, Sept. 13, 2011 (comments of Martin Gruenberg, Acting Chairman of the FDIC).

Companies to analyze what they would do in order to protect both their insured banking operations and U.S. financial stability generally if they (or a material subsidiary) were on the verge of insolvency, while the IDI Rule requires the preparation of a roadmap for the FDIC, as receiver of an insolvent IDI, to follow in the event that the Covered IDI is declared insolvent.

Institutions Required to File Resolution Plans

The following institutions are required to submit resolution plans under the DFA Rule:

- any non-bank financial company designated by the FSO for heightened supervision by the Federal Reserve pursuant to title I of the Dodd-Frank Act;
- any bank holding company with at least \$50 billion in total consolidated assets; and
- any foreign bank with a U.S. branch, agency or commercial lending company subsidiary, as well as any company that controls such a foreign bank, if the foreign bank or company has at least \$50 billion in total global consolidated assets (together with the entities described in (1) and (2) above, “Covered Companies”).⁵

If a Covered Company subsequently falls below the \$50 billion asset threshold, it will remain a Covered Company until it has less than \$45 billion in total consolidated assets, as determined in its most recent annual report or the average total consolidated assets as reported in the four most recent quarterly reports. Under the IDI Rule, IDIs with \$50 billion or more in total assets are required to submit resolution plans.

Key Substantive Elements of the Resolution Plan Requirements under the DFA Rule

The requirements for Covered Companies under the DFA Rule are broken down into seven major areas and approximately 40 individual components. The DFA Rule plans generally must contain a detailed analysis of how a Covered Company can be resolved in a bankruptcy proceeding, including a range of specific actions to be taken in a resolution, and a detailed description of the Covered Company’s organization, material entities, interconnections and interdependencies, management information systems, other key components of their business activities among other elements.

Distinctions are made based on asset size and complexity of the Covered Company. In particular, a smaller, less complex institution may provide a less detailed “tailored” resolution plan. Covered Companies qualifying for such a “tailored” plan are:

- U.S. Covered Companies with total non-bank assets of less than \$100 billion that are engaged primarily in insured depository institution activities (*i.e.*, total U.S. IDI assets comprise 85% or more of total consolidated assets).
- Non-U.S. Covered Companies with total U.S. non-bank assets of less than \$100 billion that, in the United States, are engaged primarily in banking activities (*i.e.*, the total U.S. IDI operations, branches, and/or agencies comprise 85% or more of total U.S. consolidated assets).

The status of a Covered Company subject to the DFA Rule is based on total *global* (*i.e.*, not only U.S.) assets; however, non-U.S. headquartered institutions with limited U.S. non-bank operations

5. In a multi tiered holding company structure, the “Covered Company” is only the top tier holding company.

may be permitted to provide a “tailored” resolution plan with fewer information requirements. In general, the DFA Rule plan for such a company only needs to cover U.S.-domiciled subsidiaries and operations, with some information on interconnections with non-U.S. operations, and identify how the DFA Rule plan is integrated into the institution’s global resolution plan. This provision arguably recognizes the importance of deferring to a non-U.S. institution’s home country supervisor and limitations on the territorial reach of the U.S. agencies as the “host country” supervisor.

The seven key components of, and a summary of the required information that must be included as part of, a Covered Company’s resolution plan are set forth below:

- *An Executive Summary:* An overview of the plan, including (a) key elements of the Covered Company’s strategic plan, (b) material changes to prior plans, and (c) any actions taken by the Covered Company (since filing of the previous resolution plan) to improve the effectiveness of a resolution plan.
- *A Strategic Analysis of the Resolution Plan’s Components:*
 - Description of (a) the plan for rapid and orderly resolution and key assumptions and supporting analysis underlying the resolution plan, and the range of specific actions to be taken to facilitate a rapid and orderly resolution of the Covered Company, its material entities and its critical operations and core business lines in the event of material financial distress or failure of the Covered Company, (b) information regarding funding, liquidity, support functions and other resources and needs, including capital resources and needs, mapped to the Covered Company’s material entities, core business lines and critical operations, (c) the Covered Company’s strategy for maintaining and funding the “critical operations” and “core business lines” in an environment of material financial distress and (d) the strategy for ensuring that any insured depository institution subsidiary will be adequately protected from risks arising from the activities of any non-bank subsidiaries.
- For each “material entity” (subsidiary) that is either (a) subject to the Bankruptcy Code or (b) subject to another specialized insolvency regime and has either \$50 billion in total assets or conducts a “critical operation”: description of strategy in the event of a failure or discontinuation of the subsidiary (or core business line/critical operation) and actions that will be taken to prevent or mitigate any adverse effects of such failure or discontinuation on the financial stability of the United States.
- Time period that would be needed to execute each material aspect of the plan.
- Identification of weaknesses/deficiencies in systems and processes to collect, maintain and report information and plans to remedy any such deficiencies.
- Description of processes for determining the value of core business lines/critical operations, and feasibility of the resolution plans.
- *A Description of the Covered Company’s Corporate Governance Structure for Resolution Planning:* Description of policies, procedures, and internal controls governing preparation and

approval of a resolution plan and relevant risk measures used to report credit risk exposures and other data underlying the plan to senior executives and the board of directors.

- *Information Regarding the Covered Company's Overall Organizational Structure and Related Information:* Information regarding material assets, liabilities, derivatives, licensees, hedges, capital and funding sources and major counterparties (in general, mapped to material entities along with location information), and an analysis of whether the bankruptcy of a major counterparty would likely have an adverse effect on, or result in the material financial distress or failure of, the Covered Company.
- *Information Regarding the Covered Company's Management Information Systems (MIS):* Information regarding MISs supporting the Covered Company's core business lines and critical operations, including information regarding the legal ownership of such systems as well as associated software, licenses or other associated intellectual property.
- *Description of Interconnections and Interdependencies among the Covered Company and its Material Entities:* Description of interconnections and interdependencies among the Covered Company and its material entities and affiliates, and among the critical operations and core business lines that, if disrupted, would materially affect the funding or operations of the Covered Company, its material entities or its critical operations or core business lines.
- *Supervisory and Regulatory Information:* Identification of regulatory authorities (whether U.S. or non-U.S.) that have supervisory or regulatory authority or

responsibility with respect to the Covered Company or that are responsible for resolving a non-U.S.-based material entity or critical operations or core business lines of the Covered Company.

Key Substantive Elements of the Resolution Plan Requirements under the IDI Rule

The requirements for Covered IDIs generally include items like those listed above for a Covered Company under the DFA Rule as well as other items relevant only for banks. Thus, an IDI Rule plan must include detailed descriptions of organizational structure, business practices, including core business lines, and operations.

In addition, several specific items reflect the types of activities conducted by most large IDIs:

- A detailed analysis of how a Covered IDI can be resolved in an orderly and timely manner by the FDIC in the event of receivership.
- Specific information on (a) major counterparties and the effect on the bank of the failure of each one, (b) off-balance-sheet exposures, (c) the process for determining to whom to pledge collateral, (d) practices for the booking of trading and derivative activities, including material hedges, (e) material entity financial statements and an unconsolidated balance sheet for the bank, (f) payment, clearing and settlement systems used by the bank, (g) funding sources for the bank and its material subsidiaries including short-term and long-term liabilities by type and term to maturity, and (h) material affiliate funding relationships, accounts and exposures.

- Systemically important functions that the Covered IDI and its subsidiaries and affiliates provide, including payments systems, custodial or clearing operations, large sweep programs and the like, along with estimated vulnerabilities and exposure.
- Cross-border elements, including branches and other components located outside the United States, the location and amount of foreign deposits and assets and the nature and extent of cross-border assets, operations, interrelationships and exposures.

Key Procedural Elements of the Resolution Plan Requirements

Timing

Both Rules have staggered deadlines for Covered Companies and Covered IDIs to submit their resolutions plans, based on an institution's total non-bank assets (for a non-U.S. bank, U.S. non-bank assets). The timing under the IDI Rule is based on the size of the Covered IDI's parent company's total non-bank assets so that the deadlines for the initial submission for resolution plans under both Rules are aligned, thereby lessening the burden on Covered Companies and Covered IDIs. The deadlines for filing subsequent annual resolutions plans are also aligned. This is helpful to institutions affected by both Rules, as Covered Companies with Covered IDIs will be subject to the same deadlines for both sets of plans.

The initial submission date is July 1, 2012 for the following:

- A DFA Rule plan, with respect to a Covered Company with \$250 billion or more in total non-bank assets (or,

in the case of a foreign-based Covered Company, such company's total U.S. non-bank assets); and

- An IDI Rule plan, with respect to a Covered IDI whose parent company has \$250 billion or more in total non-bank assets (or in the case of a foreign-based parent, such company's total U.S. non-bank assets).⁶

The date is July 1, 2013 for the following:

- A DFA Rule plan, with respect to a Covered Company with \$100 billion or more (but less than \$250 billion) in total non-bank assets (or, in the case of a foreign-based Covered Company, such company's total U.S. non-bank assets); and
- An IDI Rule plan, with respect to a Covered IDI whose parent company has \$100 billion or more (but less than \$250 billion) in total non-bank assets (or in the case of a foreign-based parent, such company's total U.S. non-bank assets).

For all others, the date is December 31, 2013.

Any IDI that becomes a Covered IDI after the effectiveness of the IDI Rule, or any company that becomes a Covered Company after the effectiveness of the DFA Rule, generally must submit its resolution plan no later than July of the following calendar year. After filing its initial resolution plan, each Covered IDI and Covered Company

6. "Non-bank assets" are not defined in the DFA Rule, but it appears that the usual meaning given for BHCA purposes would apply. Thus, they would generally be those assets held by legal entities that are not themselves U.S. banks or U.S. branches or agencies of non-U.S. banks. For example, a securities broker-dealer subsidiary, futures commission merchant, investment adviser, and consumer lending subsidiary would be a non-bank entity, and their assets would be non-bank assets. It is not clear how non-bank subsidiaries of an IDI would be classified.

must submit a resolution plan annually on or before each anniversary of its initial submission.⁷

The staggered deadlines benefit both the agencies and the companies that will file resolution plans. With the largest institutions filing first, regulatory resources will be focused initially on those companies that theoretically pose the largest systemic concern. Also, all of the staggered deadlines fall later than the deadlines in the proposed rules, giving Covered Companies and Covered IDIs more time to understand and process the plan requirements and develop adequately responsive resolution plans.

Notice Filings for Material Events

Both Rules also require further filings beyond the filing of resolution plans. Covered Companies must file with the Federal Reserve and FDIC, and Covered IDIs must file with the FDIC, a notice within 45 days of the occurrence of any event or change in circumstances that results in, or could reasonably be foreseen to have, a “material effect” on the resolution plan. The notice must describe the event, describe any material effects it may have on the resolution plan, and summarize the changes that may be required to the resolution plan. While the Rules are not explicit as to what constitutes a “material effect,” the releases accompanying the rules note that a “material effect” would be brought about by an event or change that would render the resolution plan “ineffective, in whole or in part.”

7. Both Rules authorize the FDIC and Federal Reserve to determine that a Covered IDI or Covered Company must submit its initial or annual resolution plan on a date other than those enumerated above.

Confidentiality

Unlike the original proposed Rules, there is now a requirement that a portion of the resolution plan be made public, and there is meaningful guidance on the confidentiality of sensitive information. Under both Rules, the resolution plan must be divided into a public section and a confidential section, and each Covered Company and Covered IDI must explicitly identify the confidential and public sections of its plan.

The public section consists of an executive summary of the resolution plan. The executive summary will contain information that is most likely otherwise publicly available, except that the executive summary must contain a “high level” description of the company’s resolution strategy, including a range of potential purchasers.

Both Rules state that the confidential section of resolution plans will be treated as confidential to the extent permitted by law. The Rules provide that confidential sections will be protected from Freedom of Information Act (“FOIA”) requests through applicable exemptions in that statute, and the accompanying releases note that regulators expect that information in the confidential sections will likely be protected through the “trade secret” and “confidential supervisory information” exemptions to public disclosure under FOIA, as discussed below.

Regulatory Review of Resolution Plans

The FDIC and the Federal Reserve must review a DFA Rule plan to determine that it is complete with respect to the minimum informational requirements, and the FDIC will conduct the same type of review of IDI Plans. Under the DFA Rule, such a

determination must be made within 60 days of submission; no such timeframe is provided in the IDI Rule. If a plan were deemed incomplete, the Covered Company or Covered IDI would then have time to revise and submit a complete resolution plan.

After a complete resolution plan is submitted, it will be reviewed pursuant to a standard of credibility. This standard is implicit in the DFA Rule and explicit in the IDI Rule. The DFA Rule provides that the Federal Reserve and FDIC jointly may determine that a submitted plan is not credible or would not facilitate the orderly resolution of the Covered Company, while the IDI Rule states unequivocally that “[e]ach resolution plan submitted shall be credible.” The IDI Rule says that a resolution plan is credible if its strategies for resolving the Covered IDI and the information provided pursuant to the IDI Rule are “well-founded and based on information and data related to the [Covered IDI] that are observable or otherwise verifiable and employ reasonable projections from current and historical conditions within broader financial markets.”⁸

Under the IDI Rule, the FDIC will review an IDI Plan in consultation with a Covered IDI’s primary regulator, but the FDIC alone will make a determination as to credibility.

If a plan under either Rule has been determined to be not credible or is deficient, the Covered Company or Covered IDI must submit a revised plan that addresses the deficiencies. The default rule

is that the revised plan must be submitted within 90 days of receipt of written notice of such a determination, although both agencies would have the power to lengthen or shorten the time period.

There are a few key implications of the review schemes set forth in the DFA and IDI Rules. As the process underlying the resolution plan requirements is an iterative one, the determination that a plan is credible will likely be informed by the back-and-forth conversation between a Covered Company or Covered IDI and the relevant agencies. This seems appropriate and beneficial as credibility will be a bespoke determination and there will be opportunity for a Covered Company or Covered IDI to provide its input as to credibility. Since the DFA Rule does not establish a clear standard of acceptability, there is room for the FDIC and Federal Reserve to develop their own standards over time with respect to the requirements to be met by DFA Plans.

Consequences of Failure to Cure a Deficient Plan

If a Covered Company fails to submit a revised DFA Rule plan in the required timeframe or if the Federal Reserve and FDIC determine that the revised plan does not adequately remedy the deficiencies identified in the deficiency notice, then the FDIC and Federal Reserve may jointly determine that the Covered Company be subject to more stringent capital, leverage, or liquidity requirements, or they may restrict the growth, activities, or operations of the Covered Company or its subsidiaries. In addition, if a Covered Company fails within two years to submit a revised plan that adequately remedies the deficiencies, the Covered Company may be directed to divest assets and operations.

8. Section 360.10(c)(4)(i). The word “credible” is used in the DFA Rule, but without a definition, at section __.5(b).

Given these consequences and the novelty of the resolution plan requirement, the FDIC and Federal Reserve note that they do not expect that the initial resolution plan submitted by a Covered Company would be found deficient, but rather that the initial plan would serve as a foundation for the development of more robust resolution plans to be filed subsequently on an annual basis. The IDI Rule does not set out specific sanctions the FDIC would impose on a Covered IDI that has failed to cure any deficiencies in its IDI Plan. In the absence of specific enforcement or punitive authority, the FDIC presumably would rely upon its supervisory and enforcement authority under the FDIA.

Orderly Liquidation Authority

DFA and IDI Rule Plans are two of three resolution planning schemes the FDIC has been developing. Under the “Orderly Liquidation Authority” (“OLA”) of title II of the Dodd-Frank Act, the FDIC has authority to manage, as receiver, the resolution of certain systemically important financial companies under a regime modeled after the FDIA. This would replace the mechanisms under the Bankruptcy Code that would otherwise be applicable to such institutions and is a response to the *ad hoc* approaches taken by U.S. authorities to the failures and near failures of financial institutions such as Lehman Brothers, Bear Stearns and AIG. The FDIC prepares OLA resolution plans for financial institutions that could be subject to that insolvency regime. The FDIC has indicated that it will use information provided by financial institutions in their DFA/IDI Rule plans to assist in its ongoing development of the OLA resolution plans.

Global Coordination of Resolution Planning

The United States is not alone in requiring resolutions plans as a measure to mitigate systemic risk and end the “too big to fail” problem. At the global level, resolution planning for large, complex financial institutions was urged by the Group of Twenty Finance Ministers and Central Bank Governors (“G20”) at its summit in Pittsburgh in 2009. The G20 called for the development of “internationally consistent firm-specific contingency and resolution plans.” The Financial Stability Board (“FSB”), formed by the G20, has been at the forefront of the development of international standards for contingency and resolution planning. In July 2011, the FSB released the *Consultative Document on Effective Resolution of Systemically Important Financial Institutions* (“FSB Consultative Document”).⁹

A degree of global coordination of resolution planning is evident. The FSB Consultative Document calls for resolution plans to be submitted by June 2012, consonant with the timing of resolution plan submission under the DFA and IDI Rules. However, FSB-style resolution plans would be developed by the lead supervisory authority based in part on information provided by the financial institution (rather than the financial institution itself fashioning the plan as under the DFA and IDI Rules). Other members of the G20 are not too far behind the United States on the issue of resolution planning, although the recent European sovereign debt crisis has delayed some further progress in the area. In August 2011, the United Kingdom’s Financial Services Authority issued its *Consultation Paper on Recovery and*

9. A copy of the FSB Consultative Document can be found at http://www.financialstabilityboard.org/publications/r_110719.pdf.

Resolution Plans, a proposal which has also set out an iterative resolution plan process in which initial plans would be due by June 2012. The European Union is behind the United Kingdom, with its resolution planning process — likely to generally reflect the FSB’s approach — in a pre-legislative stage. ■

Chapter 15 Developments

Awal Bank Clarifies Relationship Between Ancillary Proceedings under Chapter 15 and Plenary Cases under Chapter 7 or Chapter 11

The Bankruptcy Court for the Southern District of New York, in Charles Russell, LLP, London, as External Adm. of Awal Bank, BSC v. HSBC Bank USA, N.A. (In re Awal Bank, BSC),¹ ruled on issues relating to the relationship between ancillary proceedings under chapter 15 of the Bankruptcy Code and plenary cases under chapter 7 or chapter 11. The bankruptcy court held that a chapter 15 “foreign representative” who has filed a chapter 11 case may obtain relief from the disclosure requirements of section 521 of the Bankruptcy Code under certain circumstances. It also held that a chapter 15 foreign representative could seek to recover a setoff taken by a third party under section 553 of the Bankruptcy Code without filing a plenary case under chapter 7 or chapter 11. Finally, it held that the chapter 15 petition date is the appropriate date to use for determining whether a setoff occurred within the 90-day look-back period under section 553.

The issues in *Awal Bank* arose from an application to recover a setoff of a misdirected wire transfer taken by a bank in the U.S. The Royal Bank of Scotland sent a payment to Awal Bank, BSC, a bank in Bahrain, in connection with the

close out of a derivatives contract between the parties. Instead of transmitting the payment to Awal Bank as directed, RBS wired the payment to an Awal Bank deposit account at HSBC Bank USA, National Association. HSBC, which had recently served a notice of default and demanded payment under a credit agreement with Awal Bank, applied the \$13 million wire transfer to the \$75 million debt owed to it by Awal Bank.

A few weeks after the misdirected transfer, Awal Bank was placed into administration proceedings in Bahrain (the “Bahrain Administration”) and an external administrator was appointed. Approximately three months later, the Bankruptcy Court for the Southern District of New York granted the petition of the external administrator for recognition of the Bahrain Administration as a “foreign main proceeding” under chapter 15 of the Bankruptcy Code. A year later, the external administrator filed a petition for chapter 11 relief and commenced an adversary proceeding to recover the setoff taken by HSBC.

In granting the external administrator’s motion, the bankruptcy court held that the external administrator’s limited disclosure in the chapter 11 case, from which it had excluded scheduled amounts of each creditor’s claim from the debtor’s schedule of assets and liabilities as required by section 521 of the Bankruptcy

1. 455 B.R. 73 (Bankr. S.D.N.Y. 2011).

Code, was appropriate based on the principles of cooperation and comity. The court explained that those principles still apply in chapter 15 notwithstanding the commencement of a related chapter 11 case. The external administrator argued that listing the claim amounts on the debtor's schedules would conflict with a protocol established in the Bahrain Administration, pursuant to which creditors had provided claim information under an expectation of confidentiality. The bankruptcy court agreed that cooperation with the protocol in the Bahrain Administration was appropriate. In making that determination, the bankruptcy court considered HSBC's failure to identify any specific need in the chapter 11 case for individual claim information and the fact that HSBC had full access to that information through its significant involvement in the Bahrain Administration.

In its motion for dismissal of the chapter 11 case, HSBC asserted that the external administrator was acting in bad faith by failing to meet chapter 11 disclosure requirements regarding its creditors and having no intent or ability to file a chapter 11 plan. In rejecting HSBC's assertions, the bankruptcy court observed that "at [that] stage of the case, it would be inappropriate for the Court to make a finding of an 'absence of a reasonable likelihood of rehabilitation,'" because "the external administrator apparently had time remaining under Bahrain law to determine whether Awal Bank should be liquidated or reorganized."² In addition, the court noted that the viability of a plan turned in part on the success of the adversary proceeding against HSBC.

2. *Id.* at 84.

3. 11 U.S.C. § 1521(a)(7) states, in relevant part, "[u]pon recognition of a foreign proceeding . . . the court may . . . grant any appropriate relief, including — granting any additional relief that may be available to a trustee, except for relief available under sections 522, 544, 545, 547, 548, 550 and 724(a)."

The bankruptcy court also denied HSBC's motion to dismiss the adversary proceeding. HSBC relied primarily on the argument that its setoff did not occur within the 90 days prior to the chapter 11 petition date, which it contended was the appropriate period to consider under section 553 of the Bankruptcy Code. Section 553 provides that a trustee or debtor may recover certain setoffs applied within 90 days prior to the petition date of a case. HSBC argued that section 553's look-back period referred to the 90 days prior to the filing of the chapter 11 petition; the external administrator argued that the petition date of the chapter 15 case was the appropriate date from which to calculate that period.

The external administrator based his argument in part on section 1521 of the Bankruptcy Code, which sets forth the relief available to a foreign representative in a chapter 15 case and specifically excludes various avoidance actions from that relief.³ Because section 553 is not listed among the excluded provisions enumerated in section 1521, the external administrator maintained that he could seek to avoid the setoff under section 553 in the chapter 15 case without the need for a plenary chapter 11 case, but sought authority for the action as a chapter 11 debtor out of an abundance of caution. The bankruptcy court agreed with the external administrator in determining that relief under section 553 is available to a foreign representative in a chapter 15 case, notwithstanding the general exclusion of avoidance actions from the available relief under section 1521.

The court also dismissed the argument — which it described as putting "the powers of a foreign representative in a procedure straightjacket that is inconsistent with [chapter 15's] language and purpose" — that the chapter 11 petition date was the appropriate date to apply under

section 553.⁴ The court noted that section 1523 of the Bankruptcy Code grants a foreign representative standing to initiate avoidance actions (notwithstanding the exclusions of certain of those actions from the relief available to foreign representatives under section 1521), including under section 553. The court found that “[t]he standing of a foreign representative to use U.S. avoidance law, which is expressly dependent on recognition [in a chapter 15 case] and filing a plenary case [under chapter 7 or chapter 11] thereafter, would be impeded if the chapter 15 petition date were not the operative reference date because the process of obtaining chapter 15 recognition can take substantial time.”⁵ Because chapter 15 requires an order of recognition prior to the filing of a plenary case, the use of the subsequent chapter 7 or chapter 11 filing date would shorten or eliminate the look-back period as it may take longer than even the 90-day preference look-back period for a foreign representative to conduct discovery to determine whether a cause of action existed.

Conclusion

The bankruptcy court’s decision is significant in delineating the relationship between ancillary proceedings under chapter 15 and plenary cases under chapter 7 or 11, and in solidifying the accessibility to foreign representatives of avoidance actions relating to setoffs. ■

4. *In re Awal Bank*, 455 B.R. at 88.

5. *Id.* at 91.

Fairfield Sentry Limits Scope of Bankruptcy Court Jurisdiction under Chapter 15 with Regard to Certain Clawback Actions

The representatives of certain British Virgin Islands funds that had invested with Bernard Madoff commenced litigation in New York state court to recover “phantom profits” paid in connection with redemptions. In In re Fairfield Sentry Ltd.,¹ the liquidators overseeing the insolvency proceedings of the funds in the British Virgin Islands sought to use chapter 15 of the Bankruptcy Code to transfer those actions to the bankruptcy court. The district court reversed the bankruptcy court’s ruling that it had jurisdiction over such suits, holding that the bankruptcy court did not have core jurisdiction and remanding the case to determine whether mandatory abstention was warranted. The district court’s decision makes it more difficult for the representatives of an insolvent fund based outside the U.S. to invoke bankruptcy court jurisdiction under chapter 15 for the purpose of clawing back distributions, thereby depriving them of a potential tactical advantage.

Fairfield Sentry Ltd. and two affiliates (collectively, the “Funds”) were funds organized under the laws of the British Virgin Islands that sold shares to non-U.S.-based subscribers and invested the proceeds with Bernard L. Madoff Investment Securities LLC. After the collapse of Madoff’s Ponzi scheme, the Funds entered liquidation proceedings in the BVI. The BVI courts appointed liquidators and foreign representatives for the plaintiffs. The foreign representatives filed lawsuits in the New York state courts against certain banks that had purchased shares in the Funds and certain beneficial holders of the interests in the Funds, seeking return of the redemption payments. The lawsuits generally alleged

1. 458 B.R. 665 (S.D.N.Y. 2011).

that Madoff's fraud falsely inflated the price at which the Funds redeemed the shares.

The Funds' foreign representatives filed petitions in the Bankruptcy Court for the Southern District of New York, seeking recognition of the BVI insolvency proceedings as "foreign main proceedings" under chapter 15 of the Bankruptcy Code. The petition was granted, and the BVI insolvency proceedings were formally recognized by the bankruptcy court. Following recognition, the Funds' representatives began filing similar claims in the bankruptcy court rather than in state courts. All of the state court actions were removed by the foreign representatives to the District Court for the Southern District of New York, which then automatically referred them to the bankruptcy court.

Certain defendants moved to remand the actions to the state courts pursuant to 28 U.S.C. § 1452(b), or have the bankruptcy court abstain from exercising jurisdiction under 28 U.S.C. § 1334(c). Certain defendants also contended that removal of their actions was untimely. After the remand motions were filed, the representatives amended certain of the actions to include statutory claims under BVI law.

The bankruptcy court denied the remand motion, ruling that it had "core" jurisdiction under 28 U.S.C. § 1334(a) because the actions "directly affected" the bankruptcy court's "core bankruptcy functions under chapter 15."² The bankruptcy court ruled that it also had "related to" jurisdiction because the actions were related to the chapter 15 case. The court declined to abstain under either the mandatory or permissive standards and, *sua sponte*, extended the time to remove actions where removal had been challenged as untimely.

The District Court's Reversal and Remand

The United States District Court for the Southern District of New York reversed and remanded. The district court held that the claims removed from state court were not claims over which a bankruptcy court could exercise "arising under" core jurisdiction pursuant to 28 U.S.C. § 1334(b).³ The court reasoned that proceedings are within "arising under" jurisdiction of a bankruptcy court only where the cause of action or substantive right claimed is created by the Bankruptcy Code itself, which was not the case with respect to the state law and BVI law claims at issue.

The district court also determined that the removed actions did not fall within the bankruptcy court's core jurisdiction as "arising in" a title 11 case. The actions sought recovery of foreign assets by challenging transfers that occurred outside the U.S. and thus did not qualify as "assets within the territorial jurisdiction of the United States" as required by section 1521(a)(5) of the Bankruptcy Code. Likewise, the "catchall" provision of section 1521(a)(7) did not confer core jurisdiction, because "it is certainly not within the core jurisdiction of the bankruptcy court to aid the BVI courts in these cases because there are no assets sought in the United States."⁴ The district court also rejected the bankruptcy court's finding that core jurisdiction could be predicated upon one of the enumerated bases set forth in 28 U.S.C. § 157(b)(2), because, for example, the removed actions did not (a) qualify as "orders to turn over property of the estate", (b) concern

2. *In re Fairfield Sentry Ltd.*, 452 B.R. 64, 69, 74 (Bankr. S.D.N.Y. 2011). The limitations on a bankruptcy court's jurisdiction, as an Article I court under the Constitution, are discussed in the article in this Year in Review entitled *Supreme Court Narrows Bankruptcy Court Jurisdiction* in Stern v. Marshall, and will not be repeated herein.

3. 28 U.S.C. § 1334(b) provides in relevant part that "the district courts shall have original but not exclusive jurisdiction of all civil proceedings arising under title 11, or arising in or related to cases under title 11."

4. *In re Fairfield Sentry Ltd.*, 458 B.R. at 682.

the “administration of the estate,” or (c) constitute a “proceeding affecting the liquidation of the assets of the estate”. With respect to the latter two considerations, the court noted that both “require the existence of a bankruptcy estate, which is not created in a Chapter 15 proceeding.”⁵

Finding no statutory basis for jurisdiction, the district court looked at whether the “form and substance of the claims implicates the bankruptcy court’s core jurisdiction”⁶ — in other words whether the claims could not exist outside of bankruptcy or were a necessary component of estate administration. Although the bankruptcy court had focused on the addition of the BVI law claims as tipping the balance in favor of core jurisdiction, the district court found that they had no effect upon the analysis because “the BVI claims here are ‘quintessentially suits at common law that more resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors’ hierarchically ordered claims to a *pro rata* share of the bankruptcy res.’”⁷ Thus, the claims were not bankruptcy claims and were not subject to the bankruptcy court’s core powers.

Because there was no core proceeding, the bankruptcy court could not enter a final judgment on the claims without the consent of the parties. The district court, however, stopped short of determining whether the bankruptcy court had “related to” jurisdiction to hear the state court

actions on a non-final basis. Instead, the court remanded the dispute back to the bankruptcy court to determine whether the claims could be timely adjudicated in the state courts from which they were removed. If they could be, then the bankruptcy court had to abstain from hearing the state court actions under the mandatory abstention statute.

Finally, the district court found that the bankruptcy court’s *sua sponte* grant of an extension of time to remove certain of the actions that had been pending in state court after the dealing had already passed constituted reversible error. Although the removals may have promoted judicial efficiency, the district court found that the bankruptcy court could only extend the deadline after it had passed if the party seeking the extension had satisfied the “excusable neglect” standard under Bankruptcy Rule 9006(b)(1)(2), which it did not. Accordingly, these specific cases were required to be remanded because the removal motions were untimely.

Conclusion

The district court’s decision makes it more difficult for the representatives of an insolvent fund based outside the U.S. to use chapter 15 to obtain bankruptcy court jurisdiction over state-law and foreign-law actions for the purpose of clawing back distributions made in connection with redemptions. Thus, this could result in the loss of an important tactical advantage that such representatives might otherwise seek to have over the defendants. ■

5. *Id.* at 683.

6. *Id.*

7. *Id.* at 685 (quoting *Granfinanciera v. Nordberg*, 492 U.S. 33, 56 (1989)).

Qimonda Protects Intellectual Property Licensees in Cross-Border Insolvency

Where a debtor-licensor seeks to reject an intellectual property (“IP”) license agreement in a bankruptcy proceeding, licensees are granted certain protections under the Bankruptcy Code. Questions arise, however, over whether such protections exist in a chapter 15 case filed by a licensor based outside the U.S. A decision of the Bankruptcy Court for the Eastern District of Virginia, in In re Qimonda AG,¹ has alleviated some of the concern. In Qimonda, the bankruptcy court held that the protections afforded to IP licensees under section 365(n) of the Bankruptcy Code apply to U.S. patent licenses in a chapter 15 proceeding.

Section 365 of the Bankruptcy Code gives a debtor broad power to assume or reject executory contracts and unexpired leases. Rejection typically excuses the debtor from continued performance, but section 365(n) allows licensees of IP to continue to use the IP covered by the rejected license. Under section 365(n), the licensee may elect either to treat the contract as terminated and assert a claim for damages or retain its rights to use the IP for the remaining term of the license.

Background

The German company Qimonda had licensed numerous patents throughout the world, including in the U.S., and commenced an insolvency proceeding in Germany. The German administrator commenced a chapter 15 case in the Bankruptcy Court for the Eastern District of Virginia, which recognized the German

proceeding as a “foreign main proceeding.” This recognition allowed the bankruptcy court to exercise jurisdiction over Qimonda’s U.S. assets. Significantly, the court also entered an order specifying that section 365 of the Bankruptcy Code would apply in the chapter 15 case.

Following entry of this order, the debtor’s foreign representative sought to implement through the chapter 15 case the German law election of “nonperformance” of several of the debtor’s cross-licensing agreements. The prevailing view under German law was that the election of nonperformance would result in the licensee losing its rights to continue using the underlying IP. Certain of Qimonda’s licensees objected, arguing that section 365(n) provided them with the option to retain their rights under the licensing agreements.

Qimonda’s official representative filed a motion requesting the bankruptcy court to amend its order regarding the applicability of various Bankruptcy Code provisions to remove references to section 365. The court granted the motion and issued an amended order that restricted the applicability of section 365. On the U.S. patent licensees’ appeal of the amended order, the district court affirmed in part, but remanded the matter to the bankruptcy court for determination of whether: (a) limiting the applicability of section 365(n) adequately balanced the parties’ respective interests, as required by section 1522 of the Bankruptcy Code and (b) the relief granted violated fundamental U.S. public policy under section 1506 of the Bankruptcy Code.

The Bankruptcy Court’s Decision on Remand

In answering the first question, the bankruptcy court assumed that, under

1. 462 B.R. 165 (Bankr. E.D. Va. 2011).

German law, an insolvency administrator's election of nonperformance of a patent license agreement terminates a licensee's right to use the debtor's patents. On this basis, the court found that a failure to apply section 365(n) would put at risk substantial investments in research and manufacturing that the U.S. patent licensees had made in reliance on the "design freedom" derived from their licenses. In the court's view, this meant that the licensees' interests were not "sufficiently protected" within the meaning of section 1522(a) and that the foreign administrator's treatment of the U.S. patents should be subject to section 365(n).

In answering the second question, the court concluded that the inability of patent licensees to exercise license retention protections under section 365(n) would "undermine a fundamental U.S. public policy promoting technological innovation."² The court looked to the legislative history of section 365(n), in which Congress noted the "threat to American technology" that allowing licenses to be cancelled in bankruptcy

may produce, and to expert testimony that the "resulting uncertainty" that eliminating section 365(n) protection would produce was likely to "slow the pace of innovation to the detriment of the economy" in an industry that demanded heavy investment.³ The court concluded, therefore, that section 365(n) must apply to the administration of the U.S. patent licenses in the chapter 15 case.

Conclusion

The *Qimonda* decision provides protection for the rights of IP licensees whose counterparties become subject to cross-border insolvency proceedings. It is the only reported decision addressing the applicability of section 365(n) in the chapter 15 context and is also one of very few decisions determining whether relief under chapter 15 "sufficiently protects" creditors in the U.S. or is "manifestly contrary" to U.S. public policy. ■

2. *Id.* at 185.

3. *Id.*

Creditor Action Not Stayed in Chapter 15 Case After Foreign Proceeding Closed

The Bankruptcy Court for the Southern District of New York, in In re Daewoo Logistics Corp.,¹ held that, absent further relief from the court, the stay imposed in a chapter 15 case ends when the underlying foreign proceeding is closed.

Once the U.S. bankruptcy court recognizes an insolvency proceeding outside the U.S. as a “foreign main proceeding,”² various protections available under the Bankruptcy Code, including the stay under section 362, apply with respect to the debtor and its property within the United States. The recognition order entered by the Bankruptcy Court for the Southern District of New York in Daewoo’s chapter 15 case “sought to preclude actions against Daewoo’s assets in the U.S. in order to facilitate its orderly rehabilitation” in proceedings under Korean insolvency law (the “Korean Proceedings”).³

Shortly after the Korean Proceedings were closed, one of Daewoo’s creditors obtained a warrant from a court in Texas for the arrest of a vessel chartered by Daewoo. Daewoo filed a motion in the bankruptcy court for an order prohibiting the creditor from continuing the proceedings to arrest the vessel and holding the creditor in contempt of the stay under the bankruptcy court’s recognition order. The creditor maintained that, upon the closing of the Korean Proceedings, it was no longer obliged to comply with the stay under the Bankruptcy Code. The bankruptcy court agreed with the creditor and denied Daewoo’s motion.

The bankruptcy court held that, except under “exigent circumstances,” a debtor may not enforce the stay under an ancillary chapter 15 case when the analogous stay in the foreign main proceeding has terminated.⁴ The court based its holding on the principles of comity and cooperation, as contemplated by chapter 15, which principles the bankruptcy court opined should influence the extent to which a domestic court provides relief after the recognition of a foreign proceeding. If the foreign court has closed its proceedings and terminated the stay applicable to creditors, the purpose of maintaining the automatic stay is no longer served. Maintaining the automatic stay in the U.S. proceedings would burden creditors by preventing them from pursuing assets in the U.S., even though they would not be prohibited from pursuing assets in the foreign country.

Conclusion

Based on the holding in *Daewoo Logistics*, the official representative of a debtor whose foreign main proceeding is being concluded or terminated following its recognition by a U.S. bankruptcy court, if circumstances warrant, should seek injunctive relief from the bankruptcy court in the chapter 15 case prior to such conclusion or termination if continued protection in the U.S. is desired. Failure to do so may result in the opportunity for creditors to pursue recovery actions in the U.S. ■

1. 461 B.R. 175 (Bankr. S.D.N.Y. 2011).

2. 11 U.S.C. § 1502 (4) defines “foreign main proceeding” as “a foreign proceeding pending in the country where the debtor has the center of its main interests.”

3. *In re Daewoo Logistics Corp.*, 461 B.R. at 179.

4. *Id.* at 178.

Developments in the United Kingdom

A New Year in Old World Distressed Debt: Distressed Investment Opportunities in U.K./Europe for 2012¹

As a result of a unique confluence of events, there appears to be a tremendous amount of distressed investment opportunities in Europe on the horizon for hedge funds and other investors. Taking advantage of those opportunities will require an understanding of local law and practices.

For the past few years, a group composed primarily of U.S.-based hedge funds has focused with keen interest on potential distressed investment opportunities in the U.K. and the rest of Europe. A number of key players have dedicated greater resources to their U.K./European strategy, such as by increasing or reallocating staffing.

For a variety of capital and regulatory reasons, since the onset of the 2008 financial crisis, U.S. banks have been incentivized to sell off a chunk of their holdings to distressed hedge funds, even at a substantial discount to par, rather than hold the loans with reserves or other impairments to their capital. By contrast, banks in the U.K. and Europe do not appear to have faced the same sort of pressures or incentives, and in fact, still tend to attribute full value to loans that

by most reasonable accounts are severely distressed. With many underperforming loans remaining marked at par by European banks, the market thus far has witnessed a mismatch in expectations between U.K./European banks, on the one hand, and distressed investment funds, on the other. Because hedge funds typically only buy assets at a steeply discounted price so as to ensure an acceptable rate of return, the distressed investment activity in the U.K./Europe remained stagnant through much of 2011.

Many expect the tide to turn in 2012. For various reasons — including the implementation of Basel III (a global regulatory standard on bank capital adequacy, among other things), which will require banks to hold higher quality capital — analysts anticipate that U.K./European banks will need to downsize their balance sheets over the next 18 to 24 months by €1.5 to €2.5 trillion. It is widely expected that banks will comply by selling distressed loans and non-core assets. If a spate of loan sales were to materialize, distressed investment funds — estimated to have approximately \$150 billion (or approximately €200 billion) devoted to European “special situation” strategies — should have an abundant supply of distressed assets from which to choose.

In addition to this inventory of legacy distressed debt, it is expected that fresh supplies of underperforming loans and

1. This is an excerpt from an article written by Shearman & Sterling partner Solomon J. Noh originally published in *Legal Week* on January 27, 2012.

bonds will continue to surface in the U.K./Europe due to the vicious combination of stagnating growth, lack of high-yield financing, and a looming wall of debt maturities this year (totaling well in excess of €100 billion), all against the backdrop of the sovereign debt crisis. Indeed, some analysts predict that high-yield default rates will more than double from 2.6% at the end of 2011 to 5.6% in 2012.

Types of Distressed Investment Strategies

This unusual confluence of circumstances may lead to a wide array of investment opportunities in the U.K./Europe for distressed funds. A surge in distressed loan sales would provide fertile ground for distressed debt trading — for funds seeking to purchase at a discount with a view to holding the assets for the long-term (with the expectation that the underlying value will recover over time), or those who have no interest other than to buy at a favorable price and “flip” their investments for a quick profit.

Others may favor so-called “loan-to-own” strategies, whereby an investor acquires distressed debt with a view to ultimately owning all or a portion of the equity in the borrower/issuer through a debt-for-equity exchange. A debt-for-equity swap can occur through a court process — involving a formal bankruptcy/insolvency filing in which the presiding court would force the exchange upon dissenting creditors so long as certain voting thresholds are met — or a consensual out-of-court restructuring.

Another form of distressed investment which has become more prevalent recently is a “synthetic asset transfer.” In a synthetic transfer, the transacting parties use derivatives documentation (such as a total return swap) to transfer the value (as well as the risk) underlying the assets without

the actual title being transferred between them. Transactions of this type — which can be simple or immensely complicated, depending on the business deal and structure — may appeal to banks sensitive to appearing to have offloaded their assets to opportunistic hedge funds.

It is expected that as the involvement of U.S.-based hedge funds becomes more prevalent, restructurings increasingly will take on a U.S. style (meaning restructurings are likely to become more aggressive and fast-paced, among other things). Although that influence could dramatically change the conduct of restructurings throughout Europe, it is noteworthy that an increasing number of European jurisdictions are enacting insolvency laws molded in large part from the U.S. Bankruptcy Code.

Conclusion

Although the expected surge in distressed investment opportunities in the U.K./Europe may appear at first blush to be boundless, there is a caveat: in order to be successful, fund managers likely will need to be well-versed in local law, particularly local insolvency law. Insolvency law tends to be a trap for the unwary, as, depending on the jurisdiction, it could provide for the unwinding of contracts and transfers, render certain contract provisions unenforceable, and impose sometimes unforeseen risks and burdens (such as through a forced clawback of previously-transferred assets). Hedge funds making distressed investments will need to be cognizant of the relevant risks. This is true not only in situations involving a formal bankruptcy/insolvency process, but also where the borrower or issuer is insolvent (on a balance sheet basis or is otherwise unable to pay its debts as they come due) or is approaching insolvency, during

which time in some jurisdictions certain transactions with the borrower/issuer are subject to special *ex post* scrutiny. ■

The Long Arm of the U.K. Pensions Regulator

Since its establishment in 2005, the U.K. Pensions Regulator has had a wide range of powers that it may use to intervene in the running of work-based pension schemes and to take specific steps against trustees, employers and others, including foreign parent companies. A decision by the Court of Appeal, in Bloom v. Pensions Regulator,¹ giving priority to claims relating to pension-related financial support directions has raised concerns about how it might impact the restructuring culture in the U.K.

Many companies in the U.K. have “defined benefit” pension schemes, designed to pay retired employees a pension in retirement, often based on a percentage of their salary. While some companies have closed such schemes to new entrants, changes in actuarial projections and poor stock market performance have exposed other firms to substantial deficits in their pension schemes. Under the Pensions Act 2004, with the intent of protecting the pension scheme members and the U.K. Pension Protection Fund (which otherwise might have to pay for some of the liabilities of an under-funded scheme), the U.K. Pensions Regulator was given statutory “moral hazard” powers to issue financial support directions or contribution notices where a group of companies has been run in a way that leaves the employer company unable to fund its pension scheme properly. Under the Pensions Act, the Regulator can use these powers to direct other group companies to support the scheme. The power even applies to companies based outside the U.K.

A contribution notice requires persons to contribute to a pension scheme where they have been party to acts meeting a “material detrimental” test or with the main purposes of preventing recovery of money by that scheme.² To date, only one contribution notice, which related to a pre-packaged administration that included the sale of part of the business of the Bonas Group, has been issued.³ As a result, there is little judicial authority in this area. In January 2011, however, the Upper Tribunal in *Michel Van de Wiele NV v. The Pensions Regulator*⁴ dismissed a strike out application in relation to that contribution notice. The parties ultimately settled, but the judge opined that the amount specified in a contribution notice must be compensatory and not punitive; that is, it should reflect the amount of the “section 75 debt” (i.e., the amount of the pension trustees’ debt claim against the employer), which the employer has been prevented from paying into the scheme as a result of the detrimental act.

Financial support directions are directions requiring corporate entities to which they are addressed to put in place financial support. This support can be any arrangement which is approved by the Pensions Regulator, provided such arrangement submits to the jurisdiction of the English courts and is set out in a legally enforceable agreement between the parties. The first financial support direction was issued in 2007 when the Pensions Regulator targeted a Bermuda company, Sea Containers Limited, which was in chapter 11. In *In re Sea Containers*

1. [2011] EWCA (Civ) 1124.

2. Sections 38 & 38A Pensions Act 2004.

3. Bonas Group Pension Scheme TM1514, available at www.thepensionsregulator.gov.uk/docs/DN1923753.pdf.

4. *Re the Bonas Group Pension Scheme* [2011] U.K. UT B3 FS (17 January 2011).

Ltd., the U.S. bankruptcy court held that the financial support direction was a valid claim against the debtor.⁵

In *Nortel*,⁶ a recent high-profile case, financial support directions were made against multiple companies in the corporate group, including several Canadian and U.S. companies. In another high-profile case, the U.K. Pension Regulator's Determinations Panel determined to issue financial support directions against six companies in the Lehman group.⁷ More recently, the Panel has ordered that broadcaster ITV plc and four of its subsidiaries put in place financial support for the Box Clever Group Pension Scheme, despite those entities having never participated in the scheme.⁸

In October 2011, the Court of Appeal, in *Bloom*, decided a number of issues relating to the Nortel and Lehman financial support directions. The Court of Appeal confirmed the High Court's insolvency analysis in an earlier decision,⁹ that the liabilities arising from a financial support direction or contribution notice issued after a company had been placed in administration or liquidation would be treated as an administration expense with super-priority ranking ahead of floating charge holders and unsecured creditors.¹⁰ This is in contrast to the position where a financial support direction or contribution notice is issued against a company before administration (or liquidation) is commenced, in which case the liabilities would be treated as a provable debt and rank in the administration or liquidation as an unsecured debt without super-priority. Legislative change is likely to be required to correct this anomalous outcome.

Conclusion

The outcome in the *Nortel* case has resulted in concerns that, as floating charge holders and unsecured creditors will rank behind the pension debt created following the issuance of a financial support direction or contribution notice in an administration or liquidation, they may be less willing to cooperate with a restructuring or provide new money. Some have commented that the *Nortel* decision could prejudice a restructuring culture in the U.K. and that insolvency practitioners may be reluctant to take on cases involving companies with occupational pension schemes in deficit. However, it should be noted that the Pensions Regulator is required under the Pensions Act to act reasonably and to take into account the interest of creditors. ■

5. No. 06-11156-KJC, 2008 Bankr. LEXIS 2363, at *25-26 (Bankr. D. Del. Sept. 19, 2008).

6. Nortel Networks U.K. Pension Plan Determination Notice TM/6409 (July 8, 2010). The Determinations Panel determined to issue financial support directions against 25 companies in the Nortel group in Canada, the United States, Europe and Africa. The Determinations Panel considered that the financial affairs of the group companies were inextricably linked and that non-U.K. group companies benefited from the failure to remedy the scheme's deficit. An important aspect of the determination was evidence (uncontested before the panel because the Nortel companies did not appear) that from the early 1990s, the Nortel group was run as a single integrated global entity, with the Canadian parent companies (Nortel Networks Corporation and Nortel Networks Ltd) having effective control of the employer of the Nortel Networks U.K. pension plan (Nortel Networks U.K. Ltd). This case highlights the risk that the U.K. Pensions Regulator may look to a foreign parent company for financial support where a scheme is in deficit.

7. Lehman Brothers Pension Scheme Determination Notice TM5916 (September 2010), available at www.thepensionsregulator.gov.uk/docs/DN1772125.pdf

8. The Box Clever Group Pension Scheme Determination Notice TM8495 (December 2011), available at www.thepensionsregulator.gov.uk/docs/DN2072664.pdf

9. *Bloom v. Pensions Regulator*, [2010] EWHC (Ch) 3010.

10. As a result of the Court of Appeal decision on the order of priorities in insolvency, there is also a risk that an administrator might not get paid his expenses, since the debt represented by a Contribution Notice could take priority. Indeed, other liabilities also rank ahead of the administrator's claim for his fees and expenses (such as the claims of employees under adopted contracts for which an administrator is personally liable). However, as Mr. Justice Briggs made clear in his High Court judgment, under Rule 2.67(3) of the Insolvency Rules 1986 the administrator can apply to court to re-order the priority of expenses to allow the administrator to be paid.

Developments in Germany

Reform of In-Court Restructurings in Germany: New Options and Implications for Creditors, Debtors and Shareholders

As of March 1, 2012, German insolvency law has been reformed by a bill (the “Bill”) that facilitates in-court restructurings of distressed companies, provides new opportunities for creditors and debtors and affects the position of shareholders. The Bill applies to insolvency filings made on or after March 1, 2012.¹

The German insolvency regime had been widely criticized by restructuring professionals and various other stakeholders for being rescue-unfriendly and unpredictable. Complaints focused on the inadequate influence of creditors on important decisions such as the selection of the (preliminary) insolvency administrator, the obstacles faced when shareholders object to a restructuring, and the fairly insignificant role self-administration has played in German restructurings. The perceived weaknesses of the current legal regime appear to be among the decisive reasons why many German companies tend not to file for insolvency early, when the prospects for a successful restructuring are more promising. In some instances, German companies even migrated to a foreign jurisdiction to avail themselves of a more flexible and restructuring-friendly legal environment. Others, to the extent

possible, have resorted to restructuring procedures offered under foreign law, such as an English law scheme of arrangement.

Strengthening of Creditors' Influence

Under the new legal regime, creditors may participate in core questions of the restructuring process and exercise their influence earlier through a newly introduced so-called preliminary creditors' committee and the selection of the (preliminary) insolvency administrator:

- **Preliminary Creditors' Committee:** A preliminary creditors' committee will be established if the company meets at least two of the following three requirements: (i) total assets of at least €4.84 million (after deducting an equity shortfall if the company is over-indebted), (ii) revenues of at least €9.68 million during the twelve months prior to the last balance sheet date and (iii) an annual average of 50 employees. The court may refuse to appoint a preliminary creditors' committee if it appears to be inappropriate with respect to the estimated value of the insolvency estate or if the delay caused by the appointment would cause further deterioration of the company's financial situation. As described below, the preliminary creditors' committee influences the selection of the (preliminary) insolvency administrator, the decision

1. All other insolvency proceedings will continue to be governed by the existing legal regime.

of the insolvency court to order self-administration, and the appointment of a (preliminary) trustee (*Sachwalter*) supervising the debtor during self-administration. German law currently does not allow a single insolvency proceeding across a group of companies, so it may become necessary to form a committee for each individual insolvent company within the group.

- *Selection of Insolvency Administrator:* Under German law, the insolvency administrator has broad power to direct the restructuring process by, for example, preparing a sale of the company and making business decisions. Under the previous regime, however, creditors had no formal say in selecting the administrator. Under the Bill, a unanimous proposal for an administrator by the preliminary creditors' committee binds the court unless the court considers the proposed candidate not to be qualified. A candidate would become ineligible if the candidate had previously prepared the insolvency plan; however, prior advice given to the company in connection with a potential restructuring does not otherwise disqualify the candidate. When arranging a pre-packaged deal, it is important to ensure that the person who has prepared the insolvency plan is not identical with the person proposed as insolvency administrator. Even if the court considers the proposed person to be insufficiently qualified and ultimately appoints a different administrator, it must take into account the criteria for the administrator as set forth by the preliminary creditors' committee. The court does not need to solicit the committee's views if to do so would evidently cause a delay of the proceedings; therefore, it would be advisable to reach an agreement on the criteria and the proposal for an

individual as early as possible in the process.

Improved Restructuring Options for Distressed Companies and New Implications for Shareholders

The Bill significantly improves the restructuring options for distressed companies by limiting the discretion of the court to deny self-administration, by facilitating pre-packaged deals and insolvency plan proceedings and by providing the means to implement a debt-to-equity swap without consent of the shareholders.

Enhanced Prospects for Self-Administration and Pre-Packaged Deals

The procedure of self-administration available under German law is inspired by the U.S. debtor in possession regime. In the past, German companies had little incentive to make an early insolvency petition and apply for self-administration. Shareholders and management faced the risk that they would lose control over the company because a court might not permit self-administration and, in any event, a preliminary insolvency administrator was appointed. The preliminary administrator exercised a great deal of (if not entire) control over the company during initial insolvency proceedings until self-administration could ultimately take effect.

The Bill facilitates the institution of self-administration and makes self-administration more attractive for distressed companies in the following ways:

- A court must permit self-administration unless there are specific circumstances justifying the expectation that self-

administration would adversely affect creditors. If the preliminary creditors' committee unanimously supports self-administration, then the court cannot deny the motion on grounds that self-administration would adversely affect the position of creditors.

- If the company files an insolvency petition on grounds of imminent illiquidity and applies for self-administration, the court has to inform the company of its intention to refuse to issue a corresponding order permitting self-administration. The company may then withdraw a voluntary filing, thereby avoiding the appointment of a preliminary insolvency administrator who would assume control of the business. The expectation is that more companies will make use of the option to voluntarily initiate insolvency proceedings at an earlier stage once they no longer face the risk that they may afterwards lose control over the process.
- The Bill has introduced a new so-called rescue umbrella that is intended to enable an early restructuring of companies. If a company files for insolvency on grounds of imminent illiquidity (*drohende Zahlungsunfähigkeit*) or over-indebtedness (*Überschuldung*) and applies for self-administration, the insolvency court may determine a protection period not exceeding three months during which the company can work out an insolvency plan. During this period, the court, among other things, can issue protection orders preventing creditors from taking individual enforcement action against the company. The protection period is only available if a third party insolvency expert has certified that, at the time of the application, the company is still able to pay its debts as and when they come due (*zahlungsfähig*) and the reorganization of

the company is not obviously lacking any prospect of success.

The protection period may be suspended by court order in particular if the preliminary creditors' committee applies for a suspension or if the reorganization becomes futile. The court, however, may not order a suspension solely on grounds that the company has later become unable to pay its debts as and when they become due (*zahlungsunfähig*) unless at the same time a successful restructuring has become futile. Individual creditors, therefore, will not be able to interfere with a pre-insolvency restructuring initiated by the company simply by accelerating their claims. If the protection period has expired or has been suspended, regular insolvency proceedings will be instituted, which includes the appointment of an insolvency administrator.

- Finally, a company running its business in self-administration under the rescue umbrella (and not only the insolvency administrator as under the current legal regime), upon motion to the insolvency court, will be able to incur new obligations that will rank ahead of existing unsecured creditors (*Masseverbindlichkeiten*). An ability to incur such new senior indebtedness can be critical to a company's ability to continue running the business during the restructuring period.

Enhanced Prospects for Execution of Insolvency Plans

The Bill also addresses several problems that have arisen in practice and have prevented the successful implementation of insolvency plans:

- The Bill makes it more difficult for a dissenting creditor to challenge

the adoption of an insolvency plan. For a successful challenge, a creditor now would need to prove that it is in a significantly worse position if the plan were to be executed than it would be in without the plan and that such shortcoming could not be compensated for by funds reserved for that purpose in the insolvency plan. The court may reject the challenge if it determines that the advantages of executing the plan without delay outweigh the potential disadvantage to the challenging creditor. The challenging creditor, however, may be entitled to indemnification to be paid out of the insolvency estate.

- On several occasions prior to the effectiveness of the Bill, an adopted insolvency plan subsequently failed because claims of creditors that had not been registered until the final plan had been put to vote had not been accounted for in the plan, and the holders of those claims nevertheless were entitled to demand payment (albeit in a reduced amount if the plan provided that those claims were to be compromised). Under the Bill, such claims will need to be reflected in the financial model underlying the plan if they are known to the company, even if the respective creditors have not registered their claims. After the implementation of an insolvency plan, the court is entitled to lift or stay enforcement actions by such creditors against the company for a period of up to three years. The Bill also reduces the statute of limitation for such claims to one year.
- Under the previous legal regime, the insolvency administrator had to satisfy all undisputed claims, and to provide collateral for disputed claims, of preferred creditors (*Massegläubiger*) before an insolvency plan could be implemented, even if such claims had

not yet become due. The Bill limits this obligation to claims that are due and payable and allows for the submission of a robust liquidity forecast that shows that claims which are not yet due can be satisfied in the future when they become due. This will free up much-needed liquidity, in particular during the initial phase of an implemented plan.

Facilitating Debt-to-Equity Swaps and Other Reorganization Measures

Finally, the Bill facilitates debt-to-equity swaps and other reorganization measures if they are to be completed in the course of insolvency plan proceedings. The amendments also offer new opportunities for distressed debt investors as they make it much easier to convert debt into equity.

In the past, it has been virtually impossible to implement a debt-to-equity swap or to transfer shares in the debtor to third parties without the consent of the shareholders. Shareholders effectively had the power to block the restructuring process and obtain the benefit of considerable “nuisance value” even where the value of their equity interest in a distressed company is (close to) zero. Further, a creditor participating in a debt-to-equity swap is at risk of becoming liable under German capital maintenance rules vis-à-vis the company and, in cases where the debt is only partially exchanged for equity, at risk that its remaining claim could be equitably subordinated like an ordinary shareholder loan.

The Bill addresses most, but not all, of these issues:

- It is now possible to complete a debt-to-equity swap through an insolvency plan and to cram down dissenting shareholders under certain circumstances — in particular, if the

plan does not place them in a worse position than without the plan (taking into account any compensation awarded to them in the plan). This standard most likely will not be an obstacle to a debt-to-equity swap under a plan, as the equity interest in a distressed company will be commercially worthless in most insolvency scenarios.

- Importantly, however, under the Bill it is not possible to force a creditor into a debt-to-equity conversion.
- A debt-to-equity swap may trigger a change of control provision in one or more of the company's material agreements, which could have the potential to cause serious harm to the business. The Bill, therefore, provides that any termination or withdrawal rights resulting from a change of control shall be suspended.
- Further, once the insolvency plan has been approved by the court, the Bill expressly excludes liability claims against the creditors arising under German capital maintenance rules.
- Unfortunately, the Bill has not provided for a safe harbor for the portion of debt not swapped into equity. Creditors may thus only rely on the general restructuring privilege already contained in the German Insolvency Code. It remains unclear exactly when the restructuring exemption will be triggered and how long a creditor may benefit

from it. Only creditors acquiring an equity participation of less than 10% are sufficiently protected. Other creditors will therefore still face the risk that any remaining loans could be regarded as shareholder loans in a subsequent insolvency of the company.

- The Bill also does not eliminate the risk that, due to a debt-to-equity swap, the debtor may need to recognize a taxable restructuring profit and/or lose loss carry forwards. This, however, may be avoided or mitigated by creative custom-tailored structures.

In addition, the Bill permits all other restructuring measures permitted under corporate law to be implemented by way of an insolvency plan. This includes a transfer of shares in the company to third parties, a spin-off or a change of the corporate form. The insolvency plan may now also substitute the shareholder resolution required for a continuation of the business, which will further reduce the obstruction power of incumbent shareholders.

Conclusion

As a result of the adoption of the Bill, German insolvency law promises to become more predictable and rescue-friendly. Restructuring options for distressed companies will increase, as such companies will have a greater opportunity for self-administration, and creditors will have greater input into the process. ■

Developments in France

Recognition of the Trust and the “Parallel Debt” Mechanism by the French Highest Judicial Court

On September 13, 2011, the Cour de Cassation, the highest court in the French judiciary, recognized the concept of trust, holding that whether the trustee under a New York law notes indenture is a creditor is determined by the law governing the indenture rather than the law of the court in which the insolvency proceedings are pending. The court further held that the “parallel debt” mechanism under which the security agent has a claim for the full amount of the notes that is separate from the claim of the indenture trustee, subject to certain conditions, is not contrary to French international public order.

In 2006, Belvédère issued €375 million worth of FRN high-yield notes, which were guaranteed by several French and Polish subsidiaries. BNY Mellon acted as indenture trustee under the notes, and French and Polish banks Natixis and Raiffeisen acted as security agents with respect to the French and Polish security interests, respectively. The documentation included a traditional “parallel debt” mechanism, pursuant to which the security agent is deemed to be a creditor of the issuer and the guarantors in its own right, as principal and not as agent, for the full amount of the notes, and thus is directly granted a right in the collateral securing the notes.

In 2008, Belvédère sought the protection of a *sauvegarde* procedure, akin to chapter 11 in the U.S. BNY Mellon and the security agents jointly and severally filed a claim for the entire amount owed under the notes, which was contested by the debtors. The debtors lost on appeal (*Cour d’Appel* of Dijon, September 21, 2010) and brought the case to the *Cour de Cassation*, which confirmed the appeals court’s decision.

Recognition of the Trust

The *Cour de Cassation* confirmed two aspects of the Dijon appeals’ court decision pertaining to the trustee:

- While article 4.2 (h) of EU Regulation 1346/2000 provides that the law of the State of the opening of proceedings determines the rules governing the lodging, verification and admission of claims, whether a party is a creditor or not is determined under the law governing the claims themselves, in this case New York law.
- As under the indenture, the trustee is entitled to act in its name to recover any sum due under the indenture, file all corresponding claims and receive any proceeds in its name before redistributing them to the noteholders, the trustee can be considered, under New York law, as a creditor for the entire amount of the notes.

Conditions of Recognition of the “Parallel Debt” Mechanism

The *Cour de Cassation* approved the view that “the provisions of New York law applicable to syndicated loans, in that they recognize the principle of a “parallel debt” owed to the security agents, are not contrary to French international public order”, but described, as the court of appeals did, the mechanism and therefore set the conditions under which it could be recognized:

(i) security agents, equivalent to the one they owe to the noteholders or the trustee, entered into to facilitate the grant, perfection, monitoring and realization of the security interests directly in the name of the security agents,

(ii) the contractual documentation must provide that any sum paid to one of the agents or to any other preferred creditor will reduce pro tanto the amounts owed by the debtors and that the security agents will hold such sums as fiduciaries, so that the debtors are released from paying any such sum and are thus not exposed to the risk of having to pay twice, and

(iii) the trustee and the security agents must file their claim jointly and severally so as to avoid the creation of any “artificial debt.”

In addition, the *Cour de Cassation* stated that the French law construct of *cause* did not necessarily pertain in all its aspects to French international public order and that the fact that not all security interests were granted to both security agents did not necessarily prevent them, in the context of a global financing governed by a foreign law admitting the existence of a parallel debt owed to both agents, from being admitted as creditors of all the subsidiaries that had guaranteed the entire financing.

Conclusion

The decision of the *Cour de Cassation* in the insolvency proceedings of Belvédère makes clear that whether the security agent under a notes indenture is a creditor is determined not by the law governing the insolvency proceeding (in this case French law), but rather by the law governing the indenture (in this case New York law). The court further held that the “parallel debt” mechanism under which the security agent has a claim for the full amount of the notes that is separate from the claim of the indenture trustee, subject to certain conditions, is not contrary to French international public order. ■

Creation of the French Accelerated Financial Safeguard

A new Accelerated Financial Safeguard procedure was put in place in France to “fast-track” purely financial difficulties of large companies.

As a result of a new regulation that took effect on March 1, 2011,¹ a debtor in the course of *conciliation* proceedings in France may request commencement of Accelerated Financial Safeguard proceedings. This procedure has been designed to “fast-track” purely financial difficulties of large companies (with more than 150 employees or turnover greater than €20 million) and relates only to debts owed to financial institutions and bondholders (*i.e.*, debts owing to credit institutions that are eligible to serve on creditors’ committees and debts owing to bondholders that are eligible to participate in a bondholders’ general assembly), which

1. Law No. 2010-1249 of October 22, 2010 on banking and financial regulations, art. 57-58.

are subject to an automatic stay and dealt with under the Safeguard plan. While in an Accelerated Financial Safeguard proceeding, to reduce the impact of the Safeguard proceeding on an operating company, the debtor would continue to trade normally, and other classes of creditors, such as trade creditors, would not be affected.

Eligible Companies

The Accelerated Financial Safeguard procedure is only available to companies that have failed to agree on a restructuring plan on a unanimous basis in the context of *conciliation* proceedings.

To be eligible for the Accelerated Financial Safeguard, the debtor must fulfill three conditions:

- as is the case for regular Safeguard proceedings, the debtor must (a) not be in cessation of payments (*cessation de paiements*) and (b) face difficulties which it is not in a position to overcome;
- the debtor must be subject to ongoing *conciliation* proceedings when it applies for the opening of the Accelerated Financial Safeguard;
- in the context of *conciliation* proceedings, the debtor must have prepared a draft safeguard plan to protect its operations in the long run, likely to be supported by financial creditors (*i.e.*, credit institutions that are eligible to be on a creditors' committee and bondholders that are eligible to participate in the bondholders' general assembly), representing a two-thirds majority of its financial indebtedness.

Procedure

Where Accelerated Financial Safeguard is opened, the credit institution committee and the bondholders' general assembly are convened and are required to vote on the proposed Safeguard plan within a minimum period of eight days of delivery of the proposed plan (as compared to a minimum period of 15 days for the regular Safeguard).

For their claim to be taken into account in the Safeguard plan (as would be the case in a regular Safeguard proceedings), creditors that are members of the committee of credit institutions and bondholders must file a proof of claim within two months from the publication of the judgment opening the Accelerated Financial Safeguard. However, if creditors, members of the committee of credit institutions and the bondholders' general assembly do not file their claims within the above-mentioned two-month period, then:

(i) if they were party to the *conciliation* proceedings, their claims are required to have been included on the list of claims established by the debtor and certified by its statutory auditors (which has to be provided to the court at the opening of the Accelerated Financial Safeguard), and thereby deemed to have been filed; or

(ii) if they were not party to the *conciliation* proceedings, their claim will not be enforceable during the Accelerated Safeguard Proceeding and will therefore not be included in the plan.

Duration

The total duration of the Accelerated Financial Safeguard (*i.e.*, the period between the judgment opening the Accelerated Financial Safeguard and the judgment adopting the plan) is one month, unless the court decides to extend it by one additional month.

Conclusion

The Accelerated Financial Safeguard procedure adopted in France in 2011 is designed to streamline and accelerate pre-insolvency proceedings of qualifying large companies faced with purely financial difficulties. ■

Developments in Italy

Financing the Restructuring Process: The New Italian Approach

Interim and bridge financing is often critical to the success of a reorganization process. The latest reforms of the Italian bankruptcy law focus on rendering such financing a viable option for institutional lenders and other market participants.

Italian bankruptcy law has been extensively reformed in recent years to reduce the incidence of business liquidations and provide incentives for the reorganization of failing businesses. Originally, the Italian bankruptcy system was centered on the idea that failing businesses should be liquidated, and the typical outcome of an insolvency procedure was the liquidation of the debtor's assets. Meanwhile, pre-insolvency restructurings were carried out outside of a clear legal framework, and the provision of new financing was subject to an obscure legislation and inconsistent court rulings. This exposed debtors and creditors to significant risks of clawback actions, and possible criminal liability for deepening the debtor's insolvency, in any subsequent bankruptcy. As a result, restructurings were strongly discouraged and seldom carried out.

The reforms enacted since 2005 have aimed at increasing the efficiency of the bankruptcy system by providing new tools and modifying existing procedures to prevent the debtor's insolvency and

reorganize its business. The “restructuring agreements” pursuant to Article 182-bis of the Italian Bankruptcy Law are one of the most important innovations introduced by such reforms and resemble prepackaged reorganization plans under U.S. chapter 11. Restructuring agreements need to (a) gather the consensus of creditors holding at least 60% of the total credits in relation to an industrial and financial recovery plan certified by an independent third-party expert, (b) ensure that non-voting creditors are paid in full and (c) be filed with, and approved by, the bankruptcy court. Further, the “new” composition with creditors provided by Article 160 *et seq.* of the Italian Bankruptcy Law is the most notable example of a procedure which has been radically modified to become a tool to preserve the going concern value of a business rather than to obtain a fast liquidation of the debtor's assets. Under the new procedure, a debtor in financial distress may propose to its creditors a reorganization plan that can restructure the business by any means, provided that such plan is, among other things, (i) certified by an independent third-party expert and (ii) approved by: (A) creditors holding at least the majority of the credits entitled to vote and by the majority of classes if the plan provides for the establishment of classes of credits, as well as (B) by the bankruptcy court. Cram down of dissenting creditors is possible if the plan is approved by the required majorities and the court finds that dissenting creditors will receive under the

plan at least as much as they would receive under any available alternatives.

While such reforms focused on creating appropriate legal frameworks to carry out in-court and out-of-court restructurings, the Italian legislator has failed for a long time to address the issue pertaining to financing extended to debtors during the restructuring phase, which is often a critical step to keeping the business afloat, since distressed companies typically face cash shortfalls as they seek to finalize their reorganization plan. As a result, notwithstanding the global financial crisis, restructuring proceedings have been rarely deployed in the Italian market after their introduction.

In order to address this shortcoming, the Law No. 122 of July 30, 2010 introduced a new Article 182-*quater* and a new Article 217-*bis* to the Italian Bankruptcy Law, providing, among other things, for, respectively, super-priority status and safe harbor provisions for financing granted in the context of restructuring processes.

In particular, according to Article 182-*quater*, financings granted by financial institutions pursuant to an approved restructuring agreement or composition with creditors enjoy super-priority status vis-a-vis all other credits, while Article 217-*bis* exempts such transactions, among others, from criminal liability in case of subsequent bankruptcy. In addition,

shareholders' loans extended pursuant to one of the above indicated procedures are also exempted from criminal liability and enjoy the same super-priority status in respect to 80% of their value.

Furthermore, Article 182-*quater* also sets forth that financing granted by financial institutions or shareholders "in view of" (*i.e.*, before) the approval of a restructuring agreement or composition with creditors enjoys the same super-priority status above indicated, provided that such financing is explicitly mentioned in the reorganization plan certified by the independent third-party expert and that its super-priority status is expressly approved by the bankruptcy court.

Therefore, as indicated by the first available decisions on the matter, Article 182-*quater* requires courts to apply a double-tiered standard of review: a general review of the reasonableness and feasibility of the reorganization plan, if the financing is granted to the debtor after the approval of its restructuring agreement or composition with creditor, and a specific finding that the *interim* and bridge financing was necessary to the restructuring and that its super-priority status was justified, when such financing was granted before the approval of the restructuring agreement or composition with creditors.

The introduction of super-priority rules coupled with safe harbor provisions against

criminal liability risks have rendered the granting of financing in the context of restructuring proceedings a viable option for banks and other financial institutions. The experience since the introduction of the latest amendments to the Italian Bankruptcy Law enables one to draw the conclusion that restructuring agreements and preventive compositions with creditors will be the procedures of choice in all cases when the granting of new financing is necessary to the restructuring process. ■

This publication is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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