Shearman & Sterling LLP

2010 Bankruptcy Law: The Year in Review

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The insolvency law arena saw many important developments in 2010. Even as the financial markets and the broader economy showed signs of recovery, the 2008 financial crisis continued to have a lasting impact as significant case law decisions dealing with the events surrounding the crisis were handed down. In the *Lehman* bankruptcy, previously untested derivative safe harbors were challenged in front of courts for the first time. Secured creditors saw their credit bidding rights infringed upon. Junior creditors, whose ranks often were filled by activist investors, creatively used the cram down provisions of the Bankruptcy Code to force nonconsensual restructurings on senior lenders. The Fifth Circuit rendered the first ever court of appeals decision dealing with chapter 15.

Perhaps, the most important development of all, however, was not a decision by any court, but rather an act of Congress. The Dodd-Frank Act, spurred by the experiences of the financial crisis with entities too interconnected and too big to fail, introduced an entirely new insolvency regime for systemically significant financial companies.

Dodd-Frank and the Creation of an Orderly Liquidation Authority

New federal receivership powers created under the Orderly Liquidation Authority for dealing with failures of systemically important financial companies.

On July 21, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), heralded as the most significant new financial regulation since the Great Depression. Title II of the Dodd-Frank Act creates a framework to govern the potential downfall of U.S. financial businesses considered "too big to fail." The framework includes a new federal receivership procedure, entitled the orderly liquidation authority (the "OLA"), for significant, interconnected non-bank financial businesses whose unmanaged collapse could jeopardize the national economy. The OLA, with the FDIC as receiver, will form part of a new regulatory framework intended to improve economic stability, mitigate systemic risk, and end the practice of taxpayer-financed "bailouts." It is generally modeled on the Federal Deposit Insurance Act (the "FDIA"), which deals with insured bank insolvencies, and also borrows from the United States Bankruptcy Code (the "Bankruptcy Code"), which the OLA will supplant in cases where it is invoked. Entities that transact with financial businesses that may be subject to the OLA should consider their rights and risks under this new regime.

While the OLA provisions of the Dodd-Frank Act are currently in effect, the FDIC has stated its intention to issue regulations later this year to clarify various interpretive issues.

Eligible Financial Companies

The Dodd-Frank Act sets forth five categories of "financial companies" eligible for OLA receivership: (i) bank holding companies, (ii) non-bank financial companies supervised by the Federal Reserve Board (the "FRB"), (iii) companies predominantly engaged in activities that are financial in nature, (iv) subsidiaries of any of the preceding three classes of financial companies (except for insured depository institutions or regulated insurance companies), and (v) any brokers or dealers that are registered with the Securities and Exchange Commission and members of the Securities Investor Protection Corporation. Although insurance companies are not eligible for federal receivership, they may be deemed to present a systemic risk pursuant to the OLA and be forced into liquidation or rehabilitation under state insurance laws if the applicable state insurance regulator does not act in a timely manner.

The second category, non-bank financial companies supervised by the FRB, is potentially very broad, depending on the determinations of the Financial Stability Oversight Council, which determines whether a nonbank financial company is systemically-significant and, on that basis, could receive FRB supervision. Additionally, the third category, consisting of companies, other than banks, that are "predominantly engaged in financial activities" is also very broad. In order for a company to fall within this category at least 85% of its annual gross revenues must be derived from activities that are financial in nature, including the ownership or control of one or more insured depository institutions. Many activities qualify as financial in nature, such as lending, derivatives trading, insuring against loss or harm, providing financial or economic advisory services and underwriting, dealing in, or making a market in securities.

Appointing a Federal Receiver

A federal receiver will be appointed under the OLA if the relevant authorities conclude that a financial company's failure would pose a systemic risk to the national economy. The appointment process is initiated upon a written recommendation from and a determination by the Federal Reserve Board of Governors and the FDIC (or the SEC, if the entity in question is a broker or dealer, or the director of the Federal Insurance Office, if the entity in question is an insurance company) that there is a systemic risk. A recommendation can be made by Federal Reserve and the FDIC's own initiative, or at the direction of the Secretary of the Treasury (the "Secretary"). Recommendations must, among other things, include, (i) an evaluation of whether the financial company is in default or in danger of default; (ii) a description of the effect of the default on the financial stability of the United States; (iii) an evaluation of the likelihood for a private sector alternative to prevent the default; (iv) an evaluation of why a case under the Bankruptcy Code is not appropriate; and (v) an evaluation of the effects of receivership on creditors, counterparties, and shareholders of the financial company and other market participants.

The Secretary, after consulting the President of the United States, must seek the appointment of the FDIC as receiver if, based upon the written recommendation received, he or she makes a series of prescribed determinations, including that an unavoidable systemic risk exists that can be mitigated through federal receivership. The Secretary must also determine that resolution under state or federal law, such as the Bankruptcy Code, would have adverse effects on the financial stability of the United States and that no viable private sector alternative is available.

Following a determination to appoint the FDIC as receiver, the Secretary must notify the FDIC and the financial company. If management of the financial company consents, the FDIC will be appointed as receiver. To encourage their cooperation, directors and officers who consent to appointment of the FDIC as receiver are absolved of liability to stakeholders with respect to submitting to the receivership. If they do not consent, the Secretary must petition the District Court for the District of Columbia, for authorization to appoint the FDIC. The court, in turn, will consider this petition on a strictly confidential basis, deciding whether the Secretary's determination was "arbitrary and capricious," a very deferential standard.

The Bankruptcy Code will continue to play a lead role in the restructuring of distressed financial companies, even with the enactment of the Dodd-Frank Act. The Senate Banking Committee's report states that "there is a strong presumption that the bankruptcy process will continue to be used to close and unwind failing financial companies." The Bankruptcy Code is preempted, however, where the very high initiation criteria have been satisfied and the FDIC is appointed as receiver under the OLA to protect the national economy. Further, the existence of a pending case under the Bankruptcy Code does not prevent application of the OLA and the subsequent appointment of a federal receiver will terminate any case under the Bankruptcy Code.[1]

Receivership Powers of the FDIC

The Dodd-Frank Act provides to the FDIC a broad range of powers similar to those powers granted to the FDIC when handling insolvent depository institutions under the FDIA. As receiver, the FDIC succeeds to the rights, title, and privileges of the financial company. It takes control of all the assets and operates them with every power of the financial company's shareholders, officers, and directors. Accordingly, the FDIC may wind up the financial company's affairs in any manner it deems appropriate, including the sale of assets or the transfer of assets to a bridge financial company (discussed below). It must, however, operate the liquidation in order to maximize returns, minimize losses, and mitigate adverse effects to the financial system at large.

The Dodd-Frank Act provides the FDIC with a broad range of powers to carry out the liquidation. It has unilateral authority to determine whether to allow or disallow claims.[2] It may disaffirm or repudiate contracts or leases where performance is too burdensome and such disaffirmance or repudiation would promote the orderly administration of the financial company. Significantly, it may do so regardless of whether a contract or lease is executory. It can enforce any contract, despite so-called *ipso facto* clauses, which provide for immediate termination or acceleration of a contract upon insolvency. As receiver, the FDIC also has the power to sue to avoid fraudulent transfers, preferences, and improper setoffs.

All of these powers can be exercised within the protection of an automatic stay. The Dodd-Frank Act prohibits courts from taking any action that would prevent the FDIC from exercising its responsibilities as receiver. Further, upon the FDIC's request, courts are required to provide a 90-day stay of any judicial action to which the financial company is made a party.

Procedures for Preserving the Core Business

Federal receivership under the OLA will not necessarily result in shutting down the financial company's business, as suggested by the name "orderly liquidation authority." Indeed, the FDIC is granted broad powers to restructure the business (so long as a new legal entity is created in the process), as this assists in satisfying one of the Dodd-Frank Act's primary goals – preserving value and maximizing creditor recovery.[3] The FDIC can exercise these powers without the court approval typically required for non-ordinary course transactions in a chapter 11 proceeding. Providing this ability to rapidly close transactions is critical, given that financial businesses are

1. This may create the opportunity for dissident creditor groups in a chapter 11 case to threaten to seek the appointment of the FDIC as receiver in order to create bargaining leverage.

2. However, distributions on claims must follow a set of priorities, such as similarly situated claimants must (subject to limited exceptions) be treated in a similar manner. Moreover, claims determinations are subject to judicial review.

3. The FDIC is expected to use company "resolution plans" and credit exposure reports – which the Dodd-Frank Act requires large bank holding companies and systemically important financial institutions to prepare and update on a regular basis – as a tool to help it efficiently evaluate alternative resolution strategies.

grounded in trust and confidence, which can quickly erode when a transaction is mired in legal proceedings. Accordingly, the FDIC can choose from a variety of restructuring solutions, more akin to the solutions available for dealing with banks under the FDIA.

The FDIC may choose to effectuate a restructuring through organizing the sale of certain assets of the financial company or through organizing an acquisition of the financial company itself. The ability to sell certain assets and contracts allows the FDIC to create and then spin-off a "good company," similar to a tactic often employed under the FDIA, where separate "good bank" and "bad bank" entities are created in the context of bank receiverships. The FDIC may arrange for all these transactions to occur without the input or consent of stakeholders, such as creditors and contract counterparties. By contrast, sale transactions under the Bankruptcy Code require that all stakeholders receive notice and an opportunity to be heard.

If a transaction with a private party is not readily available, the FDIC may create a bridge financial company to temporarily assume certain assets and liabilities. Although the ability to create and utilize a bridge company is an extremely broad power, the Dodd-Frank Act does place some limits on the FDIC. First, except in limited circumstances, the FDIC must treat similarly situated creditors equally when transferring assets or liabilities to the bridge company. Additionally, the bridge company can have only a limited life (up to a maximum of two years in most cases), as it must serve as a bridge to a permanent, private transaction.

Special Provisions Related to Derivatives

Throughout the liquidation process, derivatives counterparties receive special protections not afforded by the Dodd-Frank Act to other counterparties. These special protections are consistent with derivatives safe harbors under the Bankruptcy Code and the FDIA, although with two important differences, by generally allowing parties to derivatives contracts to exercise contractual rights to terminate, liquidate, and accelerate in the event of a contract counterparty insolvency.

These special protections are necessary because derivatives contracts involve significant amounts of money and can be extremely volatile, subjecting parties to potentially massive amounts of shifting liability. Moreover, the prevalent use of such contracts has led to increasingly interconnected financial businesses. Accordingly, derivatives counterparties must be able to promptly close out contracts to prevent liquidity crises that could result in domino-effect insolvencies throughout the financial sector. The safe harbor provisions are designed to contain the systemic effects of any one company's insolvency.

The Dodd-Frank Act places two limitations on protected derivative counterparties, which diverge from the protections afforded under the Bankruptcy Code. First, a protected party may not terminate, liquidate or net a derivative contract by reason of the FDIC's appointment as receiver until 5:00 p.m. (Eastern Time) on the business day following the date of appointment. Further, a protected party may not exercise such rights if it receives a notice that its contract has been transferred to another financial business, including a bridge company. These provisions provide the FDIC one day (or, more likely, one weekend, because the practice under the FDIA has been to appoint receivers on Fridays in order to allow FDIC staff the weekend to arrange the seized institution's affairs) to avert widespread closeouts of derivative contracts and thereby prevent the confusion and disarray that occurred after Lehman's filing. The second limitation is a ban on walk-away clauses. When most derivatives contracts are terminated, the party out-of-the-money makes a termination payment to the in-the-money party. A walk-away clause, however, allows a non-defaulting party to avoid such an obligation and walk-away. These clauses are unenforceable under the Dodd-Frank Act.

Allocating the Costs of the Receivership Process

The Dodd-Frank Act responds to the public's outrage at the recent federal "bailouts" by explicitly stating that no taxpayer funds can be used to prevent a financial company from being liquidated and that taxpayers shall not bear any losses from the exercise of OLA authority. Instead, the costs of receivership are to be borne by those with interests in the financial company and by the company's assets. Where even these sources are insufficient to cover the costs of liquidation, other large financial companies will be held accountable through assessments.

Although losses may not be suffered as the result of a liquidation, the FDIC may incur temporary debts to pay the upfront costs of a liquidation. This amount is subject to limits. During the first 30 days of a liquidation, any debts the FDIC incurs may not exceed 10% of the fair value of the total consolidated assets available for repayment of the financial company under OLA receivership. This limit rises after 30 days, however, to 90% of the fair value of the total consolidated assets. Additionally, where necessary or appropriate, the FDIC, in its discretion, may fund the orderly liquidation of a financial company. It may accomplish this through, among other things, purchasing debt obligations or assets of the financial company, providing guarantees in respect of the financial company's assets, and assuming or guaranteeing the obligations of the financial company. The FDIC may not, however, acquire equity interests in the financial company.

If the FDIC is unable to repay its obligations incurred in connection with a receivership within 60 months of their incurrence, it is required to make one or more risk-based assessments, first against certain claimholders that received additional payments under the receivership and then against certain large financial companies. Financial companies subject to assessment are generally those companies with total consolidated assets of equal to or greater than $50 billion. The FDIC must impose any assessments on these subject financial companies at a graduated rate, meaning higher assessments for companies with more assets. ■

Developments in Secured Creditors' Rights

Applicable Rate of Interest on Cramdown Notes

Supreme Court ruling in Till *not applied by Eastern District of Texas Bankruptcy Court in determination of appropriate cramdown interest rate under section 1129(b)(2)(A)(i) for a corporate chapter 11 debtor.*

There were a number of cases in 2010 in which plans of reorganization were confirmed over the dissent of secured creditors. Section 1129(b) of the Bankruptcy Code provides that a plan can be confirmed over the dissent of an impaired class of creditors if the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[4] In order for a plan that seeks to cramdown a class of secured claims to be fair and equitable, the plan must provide for one of three alternatives: (i) a holder of secured claims must retain its lien while also receiving deferred cash payments totaling at least the allowed amount of its claim, of a value, as of the effective date of the plan of at least the value of the secured creditor's collateral; (ii) if the plan contemplates a sale of the secured assets, the secured creditor must be given a lien on the proceeds of the sale and afforded the opportunity to "credit bid" the value of its debt for the assets during the sale process; or (iii) the holder of the secured claim must receive the "indubitable equivalent" of its claim.[5]

The first of the three alternatives, which includes what is often referred to as a "cramdown note," has raised significant legal issues because the Bankruptcy Code does not state how the stream of payments, including any interest payable on the note, should be calculated in determining the value as of the effective date of the plan. Given this silence, courts have adopted four differing approaches to determine the appropriate rate of interest on a cramdown note: (i) the "formula" approach; (ii) the "presumptive loan" approach; (iii) the "coerced loan" approach; and (iv) the "cost of funds" approach.

The formula approach begins with the national prime rate of interest and adds a premium to it to reflect the risks involved in lending funds to a company emerging from bankruptcy. The presumptive loan approach focuses on the rate of interest present in the parties' underlying prepetition loan agreement and bases the cramdown note rate on that interest rate, but allows both parties to show evidence suggesting that an adjustment is warranted.

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4. 11 U.S.C. § 1129(b)(1).

5. 11 U.S.C. § 1129(b)(2).

The coerced loan approach determines the appropriate cramdown rate by looking to the market to see the rate at which the reorganized debtor would be able to obtain a loan of a similar duration and risk. Finally, the cost of funds approach focuses on the creditor's cost of funds. This approach determines the cramdown rate by looking to the rate of interest that the creditor itself would have to pay to finance the funds in question.

While courts are far from reaching a consensus as to which of these four approaches is appropriate for determining the rate of interest on a cramdown note in a chapter 11 case, the Supreme Court has provided some support in favor of the formula approach in *Till v. SCS Credit Corp.*,[6] a chapter 13 case. The Supreme Court stated that the formula approach is appropriate for individual debtor cases because it takes an easily attainable national prime rate and adjusts it according to the facts of the particular bankruptcy proceeding. *Till*, however, noted that because there may be a wider market for corporate, as opposed to individual, debt, a bankruptcy court presiding over a corporate chapter 11 may find it more appropriate to ask "what rate an efficient market would produce."[7]

The United States District Court for the Eastern District of Texas chose to focus on this statement in holding that the formula approach was not appropriate in determining the rate of interest for a chapter 11 cramdown note. In its decision in *Good v. RMR Invs., Inc.*,[8] the court decided that the terms of the underlying contract presented the appropriate cramdown rate of interest. The debtors' plan, which the secured creditors did not accept, followed a formula approach that provided for a cramdown note with an interest rate equal to the prime rate plus two percent. The secured creditors objected to this interest rate and asked the bankruptcy court to set the rate at 15 percent, the prepetition default rate of interest in the underlying loan documents. The bankruptcy court sustained the secured creditor's objection, and the debtors, after a failed motion for reconsideration, appealed to the district court arguing that *Till* mandated a "prime plus" formula approach.

The district court agreed with the bankruptcy court and held that *Till* was not binding in chapter 11 cases. The court noted that *Till* was a plurality opinion that addressed chapter 13 cramdown rates, and thus did not control cases under chapter 11 of the Bankruptcy Code. The district court focused on *Till*'s statement that a market rate of interest may be appropriate for chapter 11 proceedings in holding that they were not required to apply a formula approach to the determination of an appropriate cramdown interest rate. The district court affirmed the bankruptcy court's determination that the 15 percent cramdown interest rate was appropriate. *Good* provides secured lenders with helpful precedent to argue that in determining the interest rate for a chapter 11 cramdown note, a higher interest rate such as a contractual default rate is more appropriate than the *Till* "prime plus" formula approach.

Enforceability of Intercreditor Agreements

Enforceability of intercreditor agreements in cramdowns questioned.

The enforceability of intercreditor agreements in bankruptcy proceedings has become an issue as more debtors that issued multiple tiers of secured debt attempt to

6. 541 U.S. 465 (2004).

7. *Id.* at 476 n.14.

8. 428 B.R. 249 (E.D. Tex. 2010).

reorganize in chapter 11. Two recent cases, *In re Ion Media Networks*[9] and *In re TCI 2 Holdings, LLC*[10] present opposing views regarding the extent to which an intercreditor agreement restricts the rights of junior secured lenders in bankruptcy.

The *Ion Media* decision focused on provisions in an intercreditor agreement that restricted second lien creditors from making any claims that the first lien creditor's liens were unperfected. Ion Media issued $725 million of first lien debt and $405 million of second lien debt in 2005. Both the first lien and the second lien loans were secured by a lien on substantially all of the assets of the company. The first lien and second lien lenders entered into an intercreditor agreement which set forth the priorities of the parties as to the collateral and stated that "any nonperfection of any lien purportedly securing" any of the assets would not affect such priorities.[11]

The issue in Ion Media revolved around whether the first lien lenders had appropriately obtained a security interest in the debtor's licenses with the FCC. While the security agreement executed between the parties expressly included FCC licenses as collateral, the agreement also contained an exclusion of certain "special property" from the collateral pool. The second lien lenders argued that this special property exclusion covered the FCC licenses. The second lien lenders objected on the ground that the plan overvalued the first lien collateral by including the value of the FCC licenses. They argued that the FCC licenses could not properly be considered part of the collateral. As such, the second lien lenders contended that their objections were not barred by any provisions of the intercreditor agreement preventing nonperfection objections because the FCC licenses were never even collateral on which security interests could be perfected.

The bankruptcy court, however, disagreed with this view. The court found the parties knew of the potential difficulty in taking security over the FCC licenses and intended the second lien lenders would always be subordinate. The intercreditor agreement covered "purported" liens, which included liens asserted over the FCC licenses. The bankruptcy court wrestled with two competing public policy concerns: (i) creating certainty in the enforcement of bargained-for agreements between creditors and (ii) having claims amongst creditors settled by the Bankruptcy Code. The court came out in favor of the first of these two concerns, holding that the intercreditor agreement was "an enforceable contract under section 510(a) [of the Bankruptcy Code], and the court will not disturb the bargained-for rights and restrictions governing the second lien debt currently held by the [second lien lenders]."[12]

While the *Ion Media* court strictly enforced the restrictions in the intercreditor agreement against second-lien creditors, the TCI 2 court found that such enforcement was not required in a cramdown. TCI 2 dealt with the bankruptcy of the Trump Entertainment Resorts in Atlantic City, New Jersey. At the time of filing, the debtors had approximately $488 million of first lien debt and $1.125 billion in second lien notes outstanding. Two competing plans of reorganization were filed, one by the first lien lenders and another by the second lien noteholders with the support of the debtor. Under the first lien plan, the first lien lenders would receive 100 percent of the equity in the reorganized debtor, while the second lien noteholders would

9. Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund, Ltd. (In re Ion Media Networks, Inc.), 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

10. 428 B.R. 117 (Bankr. D.N.J. 2010).

11. Ion Media., 419 B.R. at 594.

12. *Id.* at 595.

be wiped out. Under the second lien plan, the second lien noteholders and unsecured creditors would receive subscription rights to acquire 70 percent of the reorganized debtor, the second lien noteholders would receive an outright distribution of five percent of the stock in the reorganized debtor, and the first lien lenders would receive $125 million in cash from the rights offering and a cramdown note payable with a market rate of interest.

The first lien lenders voted against the second lien plan and argued that it violated the terms of the intercreditor agreement, which required that the first lien lenders be paid in full before the second lien could obtain any recovery. The first lien lenders further argued that the deferred cash payments they would receive on the cramdown note did not constitute payment in full, and thus no recovery could be given to the second lien creditors.

The *TCI 2* court rejected this argument, relying on the language of the cramdown provisions of Bankruptcy Code section 1129(b). The court acknowledged that section 510(a) of the Bankruptcy Code makes intercreditor agreements enforceable as to consensual plans of reorganization, but focused on the text of section 1129(b)(1), which provides that a cramdown plan could be confirmed "notwithstanding section 510(a)" of the Bankruptcy Code. The court reasoned that the only logical interpretation of the "notwithstanding section 510(a)" language found in section 1129(b)(1) was that "if a nonconsensual plan meets all of the § 1129(a) and (b) requirements, the court 'shall confirm the plan'" even despite its failure to adhere to the underlying intercreditor agreement.[13] On this basis, the court stated that it was not required to determine whether the second lien plan violated the intercreditor agreement because "even if such a violation occurred, it would not impede the confirmation" of the second lien plan.[14] While the court eventually found both the first lien and the second lien plans to be confirmable, it chose to confirm the second lien plan because of the large creditor base that had indicated a preference for it.

Credit Bidding Limited in Cramdown

Secured creditor's right to credit bid not absolute even where cramdown plan contemplates an asset sale.

A secured creditor's right to credit bid its debt if its collateral is sold pursuant to section 363(b) of the Bankruptcy Code is well established. Recent cases, however, have raised the question of whether a secured creditor always has the right to credit bid its debt where the sale occurs pursuant to a plan of reorganization. The issues were discussed in the Third Circuit's decision in *In re Philadelphia Newspapers, LLC*.[15]

Philadelphia Newspapers, LLC and certain of its affiliates owned and operated several print newspapers that they acquired in July 2000. Part of the funding for the acquisition came from a $295 million loan secured by a first priority lien on substantially all of the debtors' real and personal property. At the time of the bankruptcy filing, the outstanding first lien debt was approximately $318 million. On August 20, 2009, the debtors filed a joint plan of reorganization that provided for substantially all of the debtors' assets to be sold at a public auction, free and clear of all liens pursuant to sections 1123(a) and (b) of the Bankruptcy Code. In conjunction with the filing of the plan of reorganization, the debtors filed a motion for approval of

13. TCI 2, 428 B.R. at 140-41.

14. *Id.* at 141.

15. 599 F.3d 298, 303 (3d Cir. 2010).

bid procedures that required all bidders to fund the purchase with cash. The requirement of cash bids would preclude secured creditors from credit bidding.

On October 8, 2009, the bankruptcy court rejected the proposed bid procedures and issued an order permitting the lenders to credit bid. The bankruptcy court held that although the plan purported to proceed under the indubitable equivalent prong of section 1129(b)(2)(A), the plan was really structured as a sale and, as such, the lenders must be permitted to credit bid their debt at the sale of the collateral in order for cram down to be possible.

On appeal, the district court held that a plan sale does not automatically implicate credit bidding rights. The district court found section 1129(b)(2)(A) of the Bankruptcy Code to be clear in providing three distinct alternative arrangements for plan confirmation that a debtor can select. The district court held that this language proved that Congress intended three alternative paths to confirmation and the bankruptcy court erred in its conclusion that the lenders had a statutory right to credit bid. In reaching its decision, the district court observed that "the very vagueness of the term 'indubitable equivalent' is an invitation ... to craft an appropriate treatment of a secured creditor's claim, separate and apart from ... subsection (ii) [of section 1129(b)(2)(A)]."[16]

The Third Circuit affirmed the district court's decision, concluding that the plain and unambiguous language of section 1129(b)(2)(A) permits a plan to provide the indubitable equivalent of a secured claim by allowing an asset sale in which secured lenders cannot credit bid. The Third Circuit held that the disjunctive nature of section 1129 shows that a plan can be confirmed so long as it meets any one of the three subsections, and that the path chosen by the plan proponent does not dictate which requirements must be met for confirmation. Although the Third Circuit observed that the term "indubitable equivalent" is broad, it concluded that the term was not unclear or ambiguous and that, in the context of section 1129(b)(2)(A) of the Bankruptcy Code, it means the "unquestionable value of a lender's secured interest in the collateral."[17]

In a lengthy dissent, Circuit Judge Ambro, a former practicing bankruptcy attorney, argued that Congress intended for a sale, subject to a right to credit bid, to be the exclusive method through which a plan could provide for collateral to be sold free of liens. Judge Ambro made clear that few courts in the last 30 years have interpreted section 1129(b)(2)(A) of the Bankruptcy Code the way the majority had in its decision. Furthermore, Judge Ambro highlighted the practical problems associated with the majority's decision in that secured creditors rely on their ability to credit bid and such a decision may ultimately increase the cost of credit. Lastly, he argued that when read together, sections 1129(b)(2)(A), 363(k), 1111(b) and 1123(a)(5)(D) "are part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation, regardless of the mechanism chosen, and thereby ensure that the rights of secured creditors are protected while maximizing the value of the collateral to the estate and minimizing deficiency claims."[18] Providing secured creditors the right to credit bid in the context of a plan that contemplates the sale of collateral free and clear of all liens furthers this comprehensive arrangement.

16. *In re Philadelphia Newspapers, LLC*, 418 B.R. 548, 568 (E.D. Pa. 2009).

17. 599 F.3d. at 310.

18. *Id.* at 334.

After *Philadelphia Newspapers*, a bankruptcy court in the Northern District of Illinois was presented with bidding procedures that sought to prevent secured lenders from credit bidding in a sale pursuant to a plan of reorganization. In *In re River Road Hotel Partners, LLC*,[19] the bankruptcy court, relying on Judge Ambro's dissent, held that the debtors could not sell their assets free and clear of liens under the indubitable equivalent prong of section 1129(b)(1)(A).

The bankruptcy court also declined to find that cause existed to deny secured creditors the right to credit bid because the debtors did not present evidence showing that the secured lenders had breached their prepetition contracts with the debtors and did not provide any specific evidence to show that credit bidding would chill overall bidding at an auction.

While the Third Circuit's decision in *Philadelphia Newspapers* raised concerns for many secured creditors that wished to credit bid their claims, *River Road Hotel Partners* makes it clear that courts outside of the Third Circuit will not necessarily follow the majority's reasoning. Rather, *River Road Hotel Partners* shows that secured lenders in cases outside of the Third Circuit may find success in arguments based on the reasoning of Judge Ambro's *Philadelphia Newspapers* dissent. Additionally, secured lenders may begin considering taking proactive steps to maintain credit bidding rights, such as conditioning their consent to the use of cash collateral on not being denied the right to credit bid, or by asking for similar protections in connection with providing DIP financing or consenting to priming DIP liens. ■

19. No. 09-462, slip op. at 3 (Bankr. N.D. Ill. Oct. 5, 2010).

Debtor-in-Possession Financing

DIP Financing orders overturned on appeal do not invalidate liens or debt received by a DIP lender if credit was extended to the debtor in good faith.

The United States District Court for the Southern District of New York reiterated, to the comfort of many lenders, that reversal on appeal of an order approving debtor-in-possession ("DIP") financing does not invalidate the debt or liens granted to the post-petition lenders, if credit is extended in good faith. The decision also reaffirmed the importance of seeking a stay pending appeal of an order approving DIP financing in a bankruptcy case. See *A&K Endowment, Inc. v. Gen. Growth Props., Inc.* (*In re Gen. Growth Props., Inc.*).[20]

In conjunction with its April 2009 chapter 11 filing, General Growth Properties, Inc. and various affiliates (collectively, "GGP") sought court approval of a DIP financing arrangement. A&K Endowment ("A&K") objected because it wanted certain property carved out from the DIP lenders' collateral. The bankruptcy court overruled A&K's objection and entered an order authorizing GGP to enter into the DIP facility. The order stated that the terms and conditions of the DIP facility had been negotiated in good faith and at arms' length between GGP and the DIP lenders. Subsequently, GGP closed on the DIP facility and the DIP lenders funded the loan.

A&K appealed and the district court ruled that the appeal was moot. The district court noted that an appeal from a bankruptcy court order, under section 364 of the Bankruptcy Code, is moot where a lender extended credit in good faith and the authorization appealed from has not been stayed. It found that:

> The purpose of § 364 "is to overcome parties' reluctance to lend to a bankrupt firm by assuring them that, so long as they are relying in good faith on a bankruptcy judge's approval of the transaction, they need not worry about their priority merely because some creditor is objecting to the transaction and is trying to get the district court or the court of appeals to reverse the bankruptcy judge."[21]

Misconduct that could be interpreted by the courts to good destroy "good faith" includes acts that involve "fraud, collusion between the purchaser and other bidders or the trustee, or an attempt to take grossly unfair advantage of other bidders."[22]

The district court found that GGP and the DIP lenders acted, and the bankruptcy court order approving the DIP facility was entered, in good faith. A&K did not dispute

20. 423 B.R. 716 (S.D.N.Y. 2010).

21. *Id.* at 721 (citation omitted).

22. *Id.* at 722 (citations omitted).

these findings. A&K did not seek a stay pending appeal and the DIP facility had already been closed. While A&K argued that its interest in the collateral constituted only a very small portion and that it would have been prohibitively expensive to obtain a bond (as would normally be required to receive a stay pending appeal), the court found that there is no exception that allows an appellant to forego seeking a bond where it would be too expensive and that A&K could have sought a limited bond.

Although the district court found the appeal moot, for the sake of completeness, it addressed and rejected each of A&K substantive challenges. The court found that the DIP financing was necessary to preserve the assets of, or otherwise provide a benefit to, GGP's estate – it was required to maintain GGP's centralized business operations. It also ruled that the repayment of the prepetition bridge facility was necessary as it had to be repaid to allow the collateral to be used for the DIP facility.

Finally, the court held that A&K's contention that GGP violated its fiduciary duty and contractual obligations by entering into the DIP facility was without merit. The district court cited the bankruptcy court and stated that "'[i]t is absolutely standard black letter law that covenants and conditions are inevitably breached in bankruptcy. Even agreements designed to govern actions in bankruptcy are generally unenforceable.'"[23]

This decision reassures future DIP lenders that if a DIP facility is entered into in good faith, the lenders need not be apprehensive that any collateral and priorities received would be set aside if the order is reversed on appeal. On the other hand, parties contesting a DIP facility should also be sure to seek a stay pending appeal to ensure that the appeal will not be dismissed as a threshold matter as moot. ■

23. *Id.* at 726 (citation omitted).

Developments in Distressed Mergers and Acquisitions

Leveraged Buyouts

Payments to selling shareholders may not be "settlement payments" protected from fraudulent conveyance attacks where a court collapses a series of transactions related to a leveraged buyout.

In a leveraged buyout ("LBO"), a target company's stock is purchased by a third-party acquirer using financing secured by the assets of the target. On the strength of robust leveraged finance markets, LBOs became increasingly common throughout 2005 to 2007. In this short three-year span, at least 313 significant LBOs, worth approximately $630 billion, were completed in the United States alone. In the economic downturn that followed, several LBO targets ended up in bankruptcy, due in large part an inability to repay the debt used to finance their LBOs.

The Bankruptcy Code provides an avenue for a debtor-target to avoid the debt and/or liens incurred as a result of an LBO if the LBO constitutes a fraudulent conveyance. An LBO is deemed to constitute a fraudulent transfer when the target (i) did not receive reasonably equivalent value and (ii) was left insolvent, lacked the ability to pay its debts as they become due or was left with unreasonably small capital in light of the target's significant debt obligations. Notwithstanding a determination that an LBO constitutes a fraudulent conveyance, courts have held that section 546(e) of the Bankruptcy Code protects payments made to sellers where the payment made by the debtor-target to the selling shareholder is a "settlement payment" made through an intermediary stockbroker, financial institution, financial participant, or securities clearing agency.[24] Because shareholders typically receive corporate distributions through a stockbroker or request that payments be made directly to a bank account, the market generally perceived such payments to be "settlement payments" and thus, insulated from a debtor-target's fraudulent conveyance attack.

The recent decision of *In re Mervyn's Holdings, LLC*,[25] casts doubt on the market's general perception of relative safety. In denying a motion to dismiss, the *Mervyn's* court ruled that the section 546(e) safe harbors did not protect a selling shareholder on the basis of its decision to "collapse" the steps of the LBO into a single transaction. The *Mervyn's* decision is noteworthy in that it departs from the general trend of insulating selling shareholders from fraudulent conveyance attacks by use of the section 546(e) safe harbor for "settlement payments."

24. *See e.g.*, *In re Resorts Int'l, Inc.*, 181 F.3d 505 (3d. Cir. 1999); *In re Hechinger Inv. Co. v. Fleet Retail Fin. Group*, 274 B.R. 71 (D. Del. 2002); *Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.)*, 366 B.R. 318 (Bankr. D. Del. 2007), *aff'd*, 388 B.R. 46 (D. Del. 2008), *aff'd*, 590 F.3d 252 (3d Cir. 2009), *cert. denied*, 130 S. Ct. 2389 (2010).

25. 426 B.R. 488 (Bankr. D. Del. 2010).

Mervyn's involved a relatively straightforward LBO transaction. Mervyn's LLC ("Mervyn's"), a nationwide retailer of affordable fashion and home décor products, was a wholly owned subsidiary of Target Corporation ("Target"). In 2004, Target decided to divest the Mervyn's business to a group of private equity funds (the "Private Equity Sponsors"). Intending to spin-off Mervyn's valuable real estate assets, the Private Equity Sponsors formed Mervyn's Holdings LLC ("Mervyn's Holdings") and several bankruptcy remote entities (the "MDS Companies") – as vehicles to complete the LBO transaction. Under the terms of the sale, Target agreed to convert Mervyn's from a corporation into a limited liability company and to convey 100% of its interest in Mervyn's to Mervyn's Holdings. Additionally, Target was prohibited from transferring any of Mervyn's real estate assets prior to the closing. In order to fund the transaction, Mervyn's Holdings and the Private Equity Sponsors borrowed funds against Mervyn's real estate assets and incurred substantial obligations. Substantially all of the loan proceeds were paid to Target. Pursuant to the terms of the LBO transaction, Mervyn's real estate assets were subsequently transferred from Mervyn's Holdings to the MDS Companies, which then leased the real estate back to Mervyn's at substantially increased rent in order to fund the acquisition debt and extract the value of the real estate. Mervyn's received no residual interest in any of the real estate it held prior to the LBO nor did it receive any of the proceeds of the sale.

Mervyn's filed for bankruptcy on July 29, 2008. The official committee of unsecured creditors, acting on behalf of Mervyn's, instituted an adversary proceeding alleging that the 2004 sale transaction constituted an actual and constructive fraudulent conveyance under section 544 of the Bankruptcy Code and that Target was liable under section 550 of the Bankruptcy Code as a transferee of the sale proceeds. Target subsequently moved to dismiss the adversary proceeding. Judge Kevin Gross of the United States Bankruptcy Court for the District of Delaware denied Target's motion to dismiss and held that the "settlement payment" safe harbors contained in section 546(e) did not protect a selling shareholder from fraudulent conveyance actions where a court has decided to "collapse" the component transactions of an LBO into a single conveyance.

Under the facts of the case, the court found that it must collapse the LBO transactions, the execution of the purchase agreement, the stripping of the real estate assets and the leases, into a single conveyance. The court looked to *United States v. Tabor Court Realty Corp.*[26] for the proposition that when a series of transactions were "part of an integrated transaction," courts may look "beyond the exchange of funds" and "collapse" the individual transactions of a leveraged buyout. Additionally, *Tabor* provided that courts should consider the overall financial consequences to the creditors in such transactions.

In collapsing the LBO transaction, Judge Gross applied a three-factor test: "First, whether all of the parties involved had knowledge of the multiple transactions. Second, whether each transaction would have occurred on its own. And third, whether each transaction was dependent or conditioned on other transactions."[27]

Applying the three-factor test to the Mervyn's LBO, the court held that Target had constructive knowledge of the transactions that were going to take place subsequent to the conveyance of its membership

26. 803 F.2d 1288, 1302 (3d Cir. 1986).

27. *In re Mervyn's Holdings, LLC*, 426 B.R. at 497 (citations omitted).

interests to Mervyn's Holdings. The court also found that all of the transactions comprising the 2004 sale required the execution of the Equity Purchase Agreement between the parties. Judge Gross stated that the clause requiring Target to convert Mervyn's into a limited liability company was of particular concern because Target would not have been able to transfer its membership interest in Mervyn's without such conversion. He also found that the component transactions – the conversion of Mervyn's from a corporation to a limited liability company, the clause prohibiting the sale of Mervyn's real estate assets, the letters of credit from the banks, the execution of the sale and the substantial increase in the rents – were each dependent on the others.

The court also looked to the financial consequences on the creditors and found them to be "devastating" on Mervyn's creditors insofar as Mervyn's was left with $22 million of working capital and over $800 million of additional debt. For these reasons, the court found that Mervyn's had successfully stated facts sufficient to support a claim for fraudulent conveyance; however, he did not rule on the merits of the fraudulent conveyance claim itself.

The court also rejected Target's argument that even if the court held that the LBO constituted a fraudulent conveyance, the settlement payments safe harbors of section 546(e) protect Target as a transferee of the sale proceeds. Section 544(b) of the Bankruptcy Code authorizes the trustee to "avoid any transfer of interest of the debtor in property or any obligation incurred by the debtor that is void under applicable law. Section 546(e), however, provides that notwithstanding section 544, "the trustee may not avoid a transfer that is a . . . settlement payment, as defined by section 101 or 741 of [the Bankruptcy Code], made by or to a . . . financial institution." A "settlement payment" is generally the transfer of cash or securities made to complete a securities transaction.

While the court noted that the definition is "extremely broad" and encompasses almost all types of securities transactions, it found that section 546(e) generally does not apply to "collapsed" transactions.[28] Second, although "settlement payments" include payments for non-publicly traded securities, section 546(e) did not apply because not all of the component transactions were "settlement payments" within the parameters of the applicable safe harbor. The court rejected Target's attempt to frame the transaction as solely the transfer of Target's membership interests in Mervyn's in exchange for a cash payment of the loan proceeds.

While the bankruptcy court did not rule on the merits of the fraudulent conveyance action, the *Mervyn's* decision is significant as it evidences the possibility that courts may begin to more closely scrutinize LBO transactions to determine the effects of such transactions on the parties involved.

Break-Up Fees Reexamined

Third Circuit affirms standard for approval of break-up fees – "actually necessary" to preserving estate value.

Frequently, debtors seek to effect a sale of all or part of their assets pursuant to section 363 of the Bankruptcy Code, which authorizes a debtor to use, sell or lease assets of the estate outside of the ordinary course of business. Such "section 363 sales" typically involve an auction that uses an initial bidder, known as the "stalking

28. *Id.* at 500.

horse" bidder, who sets the minimum price and relevant transaction terms for the sale on which other bidders submit competing bids. Bankruptcy courts often award stalking horse bidders certain bid protections, such as a break-up fee of between 3% and 5% of the purchase price and reimbursement of expenses, in the event the stalking horse bidder does not "win" at the auction or the court does not approve the sale transaction. The theory behind awarding bid protections is that the stalking horse bidder typically expends significant time and effort in performing due diligence and initiating the sale process resulting in a net benefit to the estate in the form of a higher purchase price.

Bid protections are subject to the approval of the bankruptcy court, and there is a split among circuits as to the appropriate amount of scrutiny a court should apply in reviewing a break-up fee. Some courts apply a "business judgment" standard, which involves a relatively high level of deference to the debtor's initial agreement to the bid protections. Other courts apply a "best interests of the estate" standard, which involves an inquiry into whether the break-up fee benefits the estate and its creditors in context of the transaction as a whole. Courts in the Third Circuit, applying the most stringent test, evaluating bid protections according to the standard for allowance of administrative expense claims – i.e., that the break-up fee is "actually necessary" to preserve the value of the estate.

In *In re Reliant Energy Channelview LP*,[29] the Third Circuit Court of Appeals applied the "actually necessary" standard in denying a break-up fee for a stalking horse bidder where the bid was not conditioned on the approval of the break-up fee. In so holding, the court ruled that where bids are conditioned on the *seeking* of, as opposed to actual approval of bid protections, break-up fees are not "necessary" to preserve value of the estate.

Reliant Energy Channelview LP and Reliant Energy Services Channelview LLC (together, "Reliant"), producers of electricity to the Texas market, filed chapter 11 bankruptcy petitions on August 20, 2007. Reliant engaged consultants regarding a sale of its largest asset, a power plant in Channelview, Texas. Reliant received 12 bids from potential acquirers of the power plant; however, many of these bids were contingent upon the bidder obtaining financing. Kelson Channelview LLC ("Kelson"), after submitting a bid of $468 million not contingent on financing was selected as the winning bidder. Consequently, Kelson entered into an Asset Purchase Agreement ("APA") with Reliant to purchase the power plant.

The APA provided that Reliant would seek, but was not required to obtain, an order approving certain "bid protections and procedures" for Kelson's benefit if the bankruptcy court determined that there should be an auction for the power plant before its sale. The bid protections included a $15 million break-up fee, approximately three percent of Kelson's bid, as well the reimbursement of up to $2 million for expenses incurred in the sale process. As required by the APA, Reliant sought authorization from the bankruptcy court to sell the power plant to Kelson without conducting an auction.

At the hearing, a purported equityholder of Reliant objected to the motion, and the bankruptcy court subsequently delayed its ruling. Reliant then asked the court to approve the bid protections afforded to Kelson under the APA. Fortistar, LLC ("Fortistar"), which had previously

29. 594 F.3d 200 (3d Cir. 2010).

submitted a losing, financing-contingent bid, objected to the request and asserted that it was willing to enter a "higher and better" bid at auction, but that bid protections afforded Kelson would be a deterrent to it doing so. The bankruptcy court held a hearing to consider the bid protections. At the hearing, the bankruptcy court refused to authorize the $15 million break-up fee, but did approve the $2 million reimbursement provision. Additionally, the bankruptcy court declined to approve the sale of the power plant without an auction. Accordingly, Kelson did not participate at the auction and asserted that its offer was no longer available. Fortistar submitted the winning bid, which topped Kelson's bid by $32 million. Reliant did not pay Kelson the $15 million break-up fee as had been requested pursuant to the APA. Kelson appealed the bankruptcy court's denial of the $15 million break-up fee. The district court affirmed the bankruptcy court's ruling. Kelson then appealed to the Third Circuit Court of Appeals.

The court of appeals, in denying the Kelson bid protections, reiterated that the applicable standard in the Third Circuit is the same as is used for all administrative expense claims, i.e., the standard set forth in *Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl Energy, Inc.)*.[30] Under *O'Brien*, the allowance of break-up fees, like that of all other administrative expenses, is dependent on the requesting party's ability to show that the fees were actually necessary to preserve the value of the estate. The court recognized that there were two ways a break-up fee could preserve the value of the estate: (i) by inducing a stalking horse bidder to make its initial bid before the bankruptcy court ordered the auction and/or (ii) by inducing a stalking horse bidder to adhere to its bid after the court ordered the auction.

While Kelson's bid "undoubtedly provided a benefit to the estate by establishing a minimum price and a complete set of offer terms," the court found that this was not sufficient enough to preserve value of the estate. The court rejected Kelson's argument that the provision of a break-up fee was necessary to entice it to bid, as it found that the facts did not support Kelson's assertions. Specifically, Kelson did not condition its bid on the actual allowance of a break-up fee, but rather, Kelson merely conditioned its bid on Reliant's *promise to seek* court authority for the break-up fee. Accordingly, the Third Circuit found that Kelson did in fact make its bid without the assurance of a break-up fee and this undermined Kelson's argument that the fee was needed to induce it to bid.

The court then evaluated whether the break-up fee was needed to induce Kelson to adhere to its bid. The court acknowledged that a break-up fee benefits the estate to the extent a bidder remains committed to a purchase. However, there was no reason to believe that bidders who already have made a full and complete bid necessarily will abandon their efforts without assurance of a break-up fee. The court did not take issue with the bankruptcy court's ruling that the provision for the break-up fee would deter other possible purchasers from bidding for the power plant and would outweigh any possible benefit achieved for the estate by keeping Kelson committed to its bid. Specifically, the court found the bankruptcy court's ruling justified by (i) Fortistar's assertion that it planned to continue bidding, (ii) the binding language of the APA, and (iii) the logical belief that Kelson would not abandon a fully negotiated agreement if no other bidder materialized.

30. 181 F.3d 527 (3d Cir. 1999).

The *Reliant Energy* decision confirms the heightened scrutiny applicable to the approval of break-up fees in the Third Circuit. Additionally, it provides a cautionary tale of the importance of careful drafting of bid protections in section 363 sales. In order to maximize the likelihood of obtaining court approval of break-up fees, a stalking horse bidder should require that its bid is expressly conditioned on the actual bankruptcy court approval of its bid protections and break-up fe e.

Strategic Investors

Investors with ulterior motives risk having their votes designated.

This past economic cycle has seen an increase in so-called "loan-to-own" investing – the purchase of debt, often at a significantly reduced value, by a strategic investor desiring to acquire control of an entity that is on the cusp of bankruptcy. Generally, the Bankruptcy Code is neutral with respect to the actions of distressed investors and fully allows such investors the opportunity to participate in the bankruptcy process, including through voting on a plan of reorganization. A creditor's ability to vote on a plan of reorganization is one of the most fundamental rights in chapter 11 bankruptcies. Nevertheless, the Bankruptcy Code provides bankruptcy courts with discretion to "designate" or disqualify votes not made in good faith.

Section 1126(e) of the Bankruptcy Code provides, "[o]n request of a party in interest . . . the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title." 11 U.S.C. § 1126(e). Neither the term "good faith" nor "not in good faith" is defined in the Bankruptcy Code. Instead, these concepts have been left to case law. Generally, bad faith – i.e., an absence of good faith – may be found where a claim holder attempts to extract or extort a personal advantage not available to other creditors or where a creditor acts in furtherance of an ulterior motive, unrelated to its claim or interests as a creditor.[31] Courts have developed several "badges of bad faith" which may justify disqualification, including efforts to: (i) assume control of the debtor; (ii) put the debtor out of business or otherwise gain a competitive advantage; (iii) destroy the debtor out of pure malice; or (iv) obtain benefits available under a private agreement with a third party which is dependent on the debtor's failure to reorganize.

In *In re DBSD North America, Inc.*,[32] Judge Gerber of the Bankruptcy Court for the Southern District of New York disqualified the votes cast by DISH Network Corporation ("DISH") in opposition to the proposed plan of reorganization offered by the debtor DBSD North America, Inc. ("DBSD") because DISH had acted in "bad faith" by acquiring its claims for the purpose of acquiring control of DBSD.

DBSD is a development-stage enterprise formed in 2004 to develop an integrated mobile satellite and terrestrial service network to deliver wireless satellite communications services to mass-market consumers. DBSD was still at a development stage during the pendency of its bankruptcy case and, as such, did not have significant operations from which to generate revenues or cash flow. Its satellite system, however, had substantial value. DISH, a provider of satellite television, had

31. *See In re Dune Deck Owners Corp.*, 175 B.R. 839, 844 (Bankr. S.D.N.Y. 1995).

32. 421 B.R. 133 (Bankr. S.D.N.Y. 2009).

previously made significant investments in TerreStar Corporation, a direct competitor of DBSD.

DBSD filed for bankruptcy on May 15, 2009 and filed an amended plan of reorganization and related disclosure statement on June 26, 2009. Under the plan, DBSD proposed to satisfy its prepetition first lien secured debt of approximately $40 million through the issuance of a modified promissory note under an amended first lien facility. Shortly after DBSD had submitted its plan of reorganization and disclosure statement (each of which disclosed the proposed treatment of the first lien secured debt), DISH purchased the entirety of the first lien secured debt at par for $40 million. Additionally, DISH purchased a substantial amount of DBSD's second lien debt post-filing of DBSD's bankruptcy petition, but only from holders not bound by a plan support agreement to support DBSD's plan of reorganization. DISH subsequently voted all of its claims to reject DBSD's proposed plan of reorganization.

In granting DBSD's motion to designate DISH's votes, the bankruptcy court reviewed key principles from a leading case on vote designation, *In re Allegheny International, Inc.*[33] In *Allegheny*, Japonica Partners ("Japonica"), a proponent of a plan of reorganization, purchased claims against the debtor, at increasing prices, to gain control of the reorganized debtor and to block confirmation of an alternative plan that would have denied Japonica the opportunity to acquire the control for which Japonica had acquired its claims. The *Allegheny* court ruled that Japonica's purchase of its claims was not in good faith because the particular claims that Japonica purchased, and the manner in which they were purchased, revealed that Japonica's interest was to assume control over the debtor. The *Allegheny* court found that this interest was fundamentally different than the desire of a typical creditor or investor seeking to maximize the recovery of its claim. Further, the court found that Japonica had cast its vote with an ulterior purpose aimed at gaining some advantage to which it would not otherwise be entitled to receive – i.e., assuming control of the debtor.

Judge Gerber held that *DBSD* was a classic case for application of the *Allegheny* doctrine and ultimately found that DISH's actions in the case demonstrate that it did not purchase and vote its claims in order to gain financially by way of a distribution, but rather sought to assume control of DBSD. Judge Gerber highlighted that DISH had purchased all of the first lien secured debt at par, knowing DBSD's plan of reorganization proposed replacing such debt with an amended facility that DISH did not want. Judge Gerber reasoned that when a creditor acquires debt so late in the plan process, there is an inference that the creditor has done so for an "ulterior motive" because the creditor cannot otherwise realize a profit.[34] Additionally, Judge Gerber found that DISH's acquisition of second lien secured debt that was not subject to the plan support agreement further demonstrated the inference of an "ulterior motive" and the similarity to *Allegheny*. Lastly, DISH's purpose in acquiring debt was to advance its effort to take control over the debtor, as was also evident as in *Allegheny*.

33. 118 B.R. 282 (Bankr. W.D. Pa. 1990).

34. Importantly, Judge Gerber distinguished DISH from a typical creditor – either a creditor victim to the financial distress of the company who is left holding the bag when the debtor fails or an investor of distressed debt seeking to profit from the spread between its purchase price for the distressed debt and the ultimate distributions on such debt under a plan.

The bankruptcy court rejected DISH's assertion that it had been a "model citizen" in so far as it had acted in strictly within the confines of the bankruptcy process. While the court found that DISH had not misbehaved as badly as some other investors in chapter 11 cases, the determinative issue was the motive behind creditor's actions.

The bankruptcy court's decision on designation was upheld on appeals to both the district court and the Second Circuit.[35] Because designation relies heavily on the particular facts of each case, the Second Circuit held that considerable deference should be given to the decision of the trial court. It then canvassed the existing case law and found that DISH's actions fell within the "general constellation" of conduct warranting designation. The court identified certain factors which were indicia of DISH's bad faith: (i) DISH's position as a competitor; (ii) DISH's willingness to overpay for the claims it acquired; (iii) DISH's attempt to propose a competing plan; and (iv) DISH's desire to obtain a blocking position and control over the bankruptcy process.

As important as its reasoning in upholding the designation of DISH's votes were the qualifications that the Second Circuit placed on its ruling. The court noted that designation was a remedy that should be used sparingly; its application should be "the exception, not the rule."[36] The court also went to lengths to make clear that strategic investments by a potential acquirer in a debtor's capital structure are not *per se* prohibited:

> We emphasize, moreover, that our opinion imposes no categorical prohibition on purchasing claims with acquisitive or other strategic intentions. On other facts, such purchases may be appropriate. Whether a vote has been properly designated is a fact-intensive question that must be based on the totality of the circumstances, according considerable deference to the expertise of bankruptcy judges.[37]

While *DBSD* arguably did not break new ground on the issue of vote designation under section 1126(e) of the Bankruptcy Code, the decision highlights the risks that strategic investors face in attempting to acquire control of distressed companies. Vote designation remains an extraordinary remedy often reserved for those circumstances where a strategic investor has acted with particularly egregious "bad faith" conduct and attempted to advance strategic investment interests wholly apart from maximizing recoveries on a long-debt position.

Mootness in Connection with Section 363 Sales

Appeals of asset sales may be mooted under section 363(m) if a stay pending appeal is not obtained and the transaction is allowed to close.

Section 363(m) of the Bankruptcy Code creates a rule of "statutory mootness," which bars appellate review of a sale of assets authorized under subsection (b) or (c) of section 363 so long as the sale was made to a good-faith purchaser and was not stayed pending appeal. Specifically, section 363(m) provides:

35. 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part by* 2011 WL 350480 (2d. Cir. Feb. 7, 2011).

36. 2011 WL 350480 (2d. Cir. Feb. 7, 2011) at *17.

37. *Id.* at *20.

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.[38]

Because section 363(m) restricts the ability of a court to review consummated bankruptcy sales other than with respect to the "good faith" aspect of the sale, section 363(m) moots a broader range of cases than are barred under traditional doctrines of mootness. Accordingly, section 363(m) generally enhances sale values for the estate, as potential acquirers have comfort that their acquisitions, in most instances, will be insulated from appellate review.

Recently, in *Contrarian Funds LLC v. Aretex, LLC (In re WestPoint Stevens, Inc.)*,[39] the United States Court of Appeals for the Second Circuit further emphasized that, in the absence of a stay pending appeal, section 363(m) of the Bankruptcy Code renders an appeal of a section 363 sale statutorily moot. Specifically, the court held that where the parties agree to defer determination of certain narrow allocation aspects, but permit the closing of the sale to proceed, section 363(m) precludes further appellate review of the sale.

WestPoint Stevens, Inc. ("WestPoint"), a manufacturer and distributor of textiles, filed for chapter 11 bankruptcy protection on June 1, 2003. WestPoint's creditor constituency consisted primarily of two creditor groups – a group holding approximately 54% of the first lien secured debt led by Wilbur Ross ("Contrarians") and a Carl Icahn led group holding approximately 40% of the first lien secured debt and 51% of the second lien secured debt ("Aretex"). WestPoint originally intended to effectuate a consensual reorganization under the Bankruptcy Code, but it eventually became apparent that reorganization was not a realistic solution, in part because the Contrarians and Aretex each insisted on controlling the reorganized WestPoint debtor. Accordingly, WestPoint concluded that a sale of substantially all of its assets pursuant to section 363(b) of the Bankruptcy Code was the only viable option.

Both the Contrarians and Aretex submitted bids to acquire WestPoint's assets at auction. After a competitive round of bidding, WestPoint declared Aretex the winning bidder. Aretex's bid did not provide for a cash payment in full to holders of prepetition first and second lien secured debt, but rather sought to satisfy the prepetition debt through the issuance of equity interests in the newly formed entity acquiring the assets. Specifically, the Aretex bid contemplated the formation of a new entity to acquire the assets, the purchase of a $187 million equity stake in the new entity by Carl Icahn and a release of the prepetition first and second liens in exchange for $489 million in equity to the first lien secured lenders and $95 million in equity to the second lien secured lenders.

The Contrarians objected to the proposed sale on the basis that (i) their claims were being satisfied with an illiquid asset and (ii) the Aretex bid violated the terms of an intercreditor agreement between the first lien secured lenders and the second lien secured lenders because the proposed sale provided a distribution to the second lien secured lenders prior to the repayment in

38. 11 U.S.C. § 363(m).

39. 600 F.3d 231 (2d Cir. 2010).

full to the first lien secured lenders. The bankruptcy court overruled the Contrarians' objection and entered an order authorizing the sale (the "Sale Order"). The Contrarians immediately appealed the Sale Order and filed a motion for stay pending appeal with the bankruptcy court. The bankruptcy court denied the motion and the Contrarians filed with the district court a motion for a stay pending appeal. Prior to the district court hearing the motion, the parties entered into a stipulation (the "Stay Stipulation"), which provided, *inter alia*, that the Contrarians would withdraw their motion with prejudice and WestPoint would place the equity interests of the acquiring entity into escrow pending further determination of the proper allocation of interests. Subsequently, WestPoint closed the asset sale and the new entity controlled by Carl Icahn began running the business.

On appeal, the district court initially dismissed as moot any claims that it believed challenged the validity of the closed sale; however, the court interpreted the Stay Stipulation as effectuating a stay of the claim satisfaction and prepetition lien release provisions of the sale – i.e., the equity interest distribution provisions of the sale. The district court then vacated the bankruptcy court's ruling as it found that there was no statutory basis for authorizing the lien release and claim satisfaction provisions of the Sale Order because it violated the terms of the intercreditor agreement.

Aretex appealed to the Court of Appeals for the Second Circuit. On appeal, the Contrarians advanced two principal arguments: (i) that the Stay Stipulation stayed the lien release and claim satisfaction provisions of the Sale Order, and, therefore, any challenges to those provisions were not mooted under section 363(m), and (ii) even if the Stay Stipulation did not effectuate a stay of such provisions of the Sale Order, a ruling on those provisions did not affect the "validity" of the sale, and, therefore, was not mooted under section 363(m).

The Second Circuit concluded that the Contrarian's second argument lacked merit in light of the integral nature of the lien release and claim satisfaction provisions of the sale. While the court noted that a narrow exception might lie for challenges to the Sale Order that were divorced from the overall transaction and would not affect the considerations on which the purchaser relied, that was simply was not the case under the applicable facts. The lien release and claim satisfaction provisions, in conjunction with the *pro rata* distribution provisions of the acquiring entity's equity interests, were essential to Aretex's acquiring control of the WestPoint business. Accordingly, the court found the Contrarians' challenge to such integral and integrated provisions of the Sale Order was statutorily moot in the absence of a stay pending appeal.

The court then turned to the issue of whether the Stay Stipulation stayed the lien release and claim satisfaction provisions and thus whether to allow appellate review of these provisions. The court found that the Stay Stipulation generally accomplished two goals: it (i) permitted the closing of the sale and (ii) deferred the allocation of certain of the equity interests in the acquiring entity until a proper distribution of those rights had been determined. Significantly, nothing within the four corners of the Stay Stipulation stayed the lien release and claim satisfaction provisions of the Sale Order. Given the centrality of these provisions to addressing the ultimate issue of controlling WestPoint's business, the court found that it was implausible that the Stay Stipulation would stay those portions of the sale without any explicit mention of them. Accordingly, the court found that by its very terms the Stay Stipulation did not stay the lien release and claim satisfaction provisions, and thus the dispute with respect to those provisions was statutorily moot.

Finally, the court addressed the distribution of the equity interests in the acquiring entity that had been stayed by the Stay Stipulation. The court found that the original distribution of the equity interests violated the intercreditor agreement between the prepetition first and second lien secured lenders. In looking to the Sale Order, the Stay Stipulation and the intent of the parties in reaching these agreements, the court remanded the allocation issue to the bankruptcy court with instructions to allocate the equity interests in a manner that did not disrupt Aretex's controlling interest. The *Contrarian Funds* case serves as a reminder that in the context of a section 363 sale, it is necessary to obtain a stay pending appeal in order to withstand a challenge based upon mootness. ■

Gifts to Junior Classes in Plans of Reorganization

Second Circuit Rejects Gifting Doctrine

DBSD joins the Third Circuit's *Armstrong* decision[40] in upholding the absolute priority rule at the expense of the "gifting doctrine." In a significant departure from prior practice that could have profound implications for many chapter 11 cases, the Second Circuit, in *DBSD*,[41] rejected the so-called "gifting doctrine" under which senior creditors sometimes shift value to junior creditors or equityholders without regard to the absolute priority rule that ordinarily governs distributions in a chapter 11 case.

In *DBSD*, Sprint, an unsecured creditor, objected to the debtor's plan by arguing that it violated the absolute priority rule. Specifically, the plan provided a distribution to existing shareholders while a class of unsecured creditors had voted against the plan and would not be paid in full. The so-called absolute priority rule effectively provides that if a class of unsecured creditors does not receive property of a value equal to the full amount of the creditors' allowed claims, then unless the class votes to accept the plan, no subordinated creditor or equityholder may receive "any property" "under the plan on account of such junior claim or interest."[42]

The debtors, together with the creditors committee argued that the absolute priority rule did not prohibit the proposed plan because the distributions to equity were a "gift" from an undersecured creditor.

DBSD argued that the courts have created a "gifting doctrine" that permits a secured creditor to gift a portion of the proceeds of its collateral to junior stakeholders without violating the absolute priority rule (even when the gift "skips" an intermediate class of creditors). Because the secured creditors were receiving less than a full recovery, DBSD contended the shares and warrants to be distributed to existing shareholders effectively belonged to the secured creditors and were not "property of the estate" implicating the absolute priority rule. Moreover, because there were good reasons to ensure the post-petition cooperation of the parent equityholder, the distribution of shares and warrants allegedly was not a distribution "on account of" claims. Finally, DBSD argued that gifting should be permitted for policy reasons, because bankruptcy policy encourages compromises and settlements, and gifting facilitates the accelerated resolution of bankruptcy cases.

40. In re Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005).

41. Although the Second Circuit in *DBSD* affirmed the lower courts' decisions with regard to vote designation (as discussed above), it reversed on a separate appeal by another creditor (*i.e.*, Sprint) alleging the plan to be an improper gifting arrangement that violated the Bankruptcy Code's absolute priority rule. The Second Circuit appeal was argued in 2010 and an order granting Sprint's appeal was entered on December 6, 2010. *See* 627 F. 3d 496 (2d Cir.). The court did not issue its written opinion, however, until February 7, 2011. *See* 2011 WL 350480 (2d. Cir.).

42. 11 U.S.C. § 1129(b)(2)(B).

Recognizing the existence of a "gifting doctrine," the bankruptcy court ruled that the proposed distribution of shares and warrants to equityholders was a permissible gift from the holders of the second lien debt, who were senior to Sprint but are receiving less than a 100% recovery. The bankruptcy court found that a class of undersecured creditors can make a voluntary gift to a junior class and "skip" an intermediate objecting class without violating the absolute priority rule. The district court concurred, concluding that (i) because holders of second lien debt were undersecured, the property to be gifted to the existing shareholders was property to which the lienholders were otherwise legally entitled, and (ii) the secured lenders therefore could dispose of such property as they pleased because the absolute priority rule "does not apply." The absolute priority rule applies only to distributions of estate property, which was not at issue according to the district court because the assets being gifted were fully encumbered.

Siding with Sprint on virtually every argument raised in its brief, the Second Circuit upheld the absolute priority rule and more or less eliminated the so-called "gifting doctrine" in New York and other Second Circuit jurisdictions. The Second Circuit found that gifting was inconsistent with the clear language of section 1129(b). The *SPM* case, a First Circuit decision frequently cited as giving rise to the "gifting doctrine," involved a chapter 7 case.[43] Chapter 7, however, does not implicate the absolute priority rule because section 1129(b) applies only in chapter 11 cases. Further, the *SPM* court had already lifted the stay, and so the property in question rightly belonged to the secured creditors. The Second Circuit distinguished or disagreed with several other gifting cases.

The Second Circuit had no doubt that the stock and warrants distributed to DBSD's equityholders were "property" distributed "under the plan." Encumbered property is *not* property of a secured creditor, but rather is part of the bankruptcy estate. Additionally, the Supreme Court has held that a stakeholder receives property "on account of" a claim when they receive property "because of" the claim.[44] The proposed distribution to equityholders in *DBSD* was being made "because of" the equity held by the parent regardless of any incidental post-effective date benefits that also may have motivated the gift.

The Second Circuit held that "[w]e need not decide whether the Code would allow the existing shareholder and Senior Noteholders to agree to transfer shares outside of the plan . . . ."[45] This unresolved issue will almost certainly lead parties to create structures for gifting outside of a plan. However, agreements to share distributions raise concerns over whether such arrangements must be disclosed to the bankruptcy court, especially if the agreements involve insider equityholders. Furthermore, the exemption from securities laws under section 1145 of the Bankruptcy Code may not apply to securities gifted outside a plan.

As a result of the Second Circuit's decision, unsecured creditors, in some cases, could have more bargaining power throughout the chapter 11 process. In cases where a "tip" to equity makes sense, unsecured creditors will be entitled to a tip of their own. Moreover, adherence to the absolute priority rule may make the achievement of a confirmable plan more difficult (and more expensive). ■

44. *See Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 449 (1999).

45. 2011 WL 350480 (2d Cir. Feb. 7, 2011) at *11.

Safe Harbor Contract Developments

Flip Clauses in Collateralized Debt Obligation Transactions

"Flip clauses" in CDO documentation may constitute unenforceable ipso facto *provisions.*

One of the key issues currently being litigated in the Lehman Brothers chapter 11 bankruptcy case is the validity of "flip clauses" in synthetic collateralized debt obligation ("CDO") transactions. Flip clauses – designed to reorder payment priorities in CDO transactions – seek to ensure that a defaulting swap counterparty is not paid any termination amounts under the swap until the noteholders are paid in full. Flip clauses are intended to prevent a defaulting swap counterparty from benefiting as a result of its own default at the expense of the noteholders.

In the Lehman bankruptcy, a synthetic CDO transaction governed by an English law trust deed (the equivalent of a U.S. trust indenture) contained a "flip clause" that changed the priority of payments upon the default of the swap counterparty. Pursuant to the CDO transaction, Lehman Brothers Special Financing Inc. ("LBSF") entered into a swap agreement with a special purpose vehicle that issued notes to various noteholders. Lehman Brothers Holdings Inc. ("LBHI") guaranteed LBSF's obligations in respect of the swap agreement. When LBHI commenced its chapter 11 case on September 15, 2008, it triggered an event of default under the swap. Upon the default, the holders of the special purpose vehicle notes, Perpetual Company Limited ("Perpetual"), directed the collateral trustee, BNY Corporate Trustee Services Limited ("BNY"), to give effect to the flip clause, making the noteholders first in priority, and liquidate the collateral securing the notes and the swap agreement and distribute the proceeds in accordance with the altered priority of payments. When BNY refused to comply, Perpetual sought a judgment in an English court directing BNY to enforce the security over the collateral and declaring that BNY was obligated to make distributions in accordance with the flip clause. LBSF intervened and argued that the flip clause is invalid under U.S. bankruptcy law.

Under English common law, pursuant to the "anti-deprivation rule," contracts cannot provide that someone's property is taken away from them upon bankruptcy and is not available for their creditors. The High Court Justice of London applied this rule but nevertheless found that the flip clause is valid, effective and enforceable under English law. LBSF appealed to the English Court of Appeal, which similarly ruled in favor of Perpetual 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. The High Court noted that any deprivation had taken place before LBSF had commenced its bankruptcy case. LBSF again appealed and on March 26, 2010, the Supreme Court of England and Wales granted permission to appeal the Court of Appeal's decision.

During the pendency of the English proceeding, LBSF commenced an adversary proceeding in the Lehman chapter 11 cases against BNY seeking a declaratory judgment that the flip clause is invalid under U.S. bankruptcy law. LBSF, as the swap counterparty, asserted that the flip clause is an unenforceable *ipso facto* provision under the Bankruptcy Code[46] and to enforce such a provision would be a violation of the automatic stay.[47] LBSF and BNY filed cross-motions for summary judgment.

On January 25, 2010, the bankruptcy court entered a memorandum decision granting summary judgment in favor of LBSF. As a preliminary matter, the court held that because it was interpreting the U.S. Bankruptcy Code, it was not required to defer to the determinations of the English courts. It then ruled that: (i) the flip clause is an unenforceable *ipso facto* clause and enforcement of such provision is a violation of the automatic stay; (ii) the trust deed that contained the flip clause is not safe harbored under section 560 of the Bankruptcy Code; and (iii) the flip clause is not a subordination agreement that must be given effect in bankruptcy.[48]

On the *ipso facto* issue, the court concluded that the flip clause was unenforceable because (i) the provision appeared in the transaction documents which qualified as "executory contracts" and (ii) the *ipso facto* protection was available to LBSF at the time of LBHI's chapter 11 filing, notwithstanding that LBSF itself had not commenced a chapter 11 case at that time (in fact, it did not file for bankruptcy protection until nearly three weeks later). In reaching the conclusion that the *ipso facto* protections were available to LBSF upon its parent's chapter 11 filing, the court primarily relied on equitable factors and did not cite any supporting case law.

With respect to the safe harbor issue, the court held that the trust deed containing the flip clause did not qualify for safe harbor treatment because it was not sufficiently integrated into the related swap agreement. The court also held that because the safe harbor deals expressly with "liquidation, termination or acceleration," as opposed to the alteration of payment priority, the flip clause did not qualify for safe harbor treatment. On the subordination agreement issue, the court held that notwithstanding the Bankruptcy Code's express recognition of subordination agreements, the flip clause could not be given effect because of the separate prohibition in the Bankruptcy Code against *ipso facto* clauses.

BNY sought permission to appeal the bankruptcy court's memorandum decision and on September 20, 2010, the United States District Court for the Southern District of New York granted BNY permission. 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 bankruptcy court's decision. BNY filed an opening brief arguing that the bankruptcy court's decision must be

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46. Under the Bankruptcy Code, contractual provisions that purport to modify or terminate an "executory" contract (a contract where performance is due on both sides) based on the bankruptcy of either party are unenforceable upon the commencement of the bankruptcy case. Such provisions are commonly referred to as *ipso facto* clauses (the Latin phrase meaning "by the fact itself"), because the fact of bankruptcy or insolvency itself purports to trigger the termination or modification.

47. The automatic stay prohibits parties from taking any action, based upon a prepetition obligation of the debtor, that has the adverse effect on the debtor's property.

48. Under the Bankruptcy Code, a subordination agreement is enforceable in bankruptcy to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

overturned because it is unsupported by fundamental principles of bankruptcy law and improperly invalidates investor protections essential to the transactions at issue. BNY argued that (i) the flip clause is not an impermissible *ipso facto* clause because the transaction is governed by English law and the English courts have already ruled that the priority flip occurred automatically upon LBHI's bankruptcy filing on September 15, 2008, well in advance of LBSF's own bankruptcy filing; (ii) even if the priority flip provision is an *ipso facto* clause, it is protected by the Bankruptcy Code's section 560 safe harbor; (iii) the flip clause is an enforceable subordination agreement; and (iv) the heart of the dispute is between the swap counterparty and the noteholders in the transaction but the current proceeding is only between the swap counterparty and the trustee. The International Swaps and Derivatives Association, Inc. and the Securities Industry and Financial Markets Association filed amicus briefs in support of BNY, urging the district court to reject the bankruptcy court's decision. Shortly after submission of these opening briefs, the parties reached a settlement, the terms of which are confidential. As a condition of settlement, the U.S. bankruptcy adversary proceeding, the U.S. district court appeal and the Supreme Court of the United Kingdom appeal were all dismissed.

Notwithstanding the resolution of this particular lawsuit between LBSF and BNY, this "flip clause" issue is not yet fully resolved. As of the date of this article, there are two adversary proceedings pending in the Lehman chapter 11 cases that relate to this dispute. Furthermore, while the Supreme Court of the United Kingdom appeal is dismissed as to BNY and Perpetual, there are other noteholders involved in this appeal. Oral arguments were heard on March 1-3, 2011.

Setoff

Triangular setoff not permitted under section 553 of the Bankruptcy Code due to lack of "mutuality"; Bankruptcy Code derivative safe harbors do not excuse compliance with section 553 requirements when asserting setoff.

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 debtor. Many commercial contracts provide that a creditor may offset amounts the debtor owes against amounts the creditor owes to the debtor or its affiliates. In *In re SemCrude, L.P.*,[49] the court held that a "triangular" setoff clause cannot overcome the mutuality requirement of Bankruptcy Code section 553 and denied the creditors' motion to lift the automatic stay to offset amounts owed to the debtor against amounts owed by the debtor's affiliate. Chevron USA, Inc. sought to set off its prepetition debts to the debtor, SemCrude, against amounts owed to Chevron by affiliate debtors of SemCrude. The contracts at issue expressly provided for multiparty setoff. The bankruptcy court held that (i) 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 (ii) the plain meaning of section 553 required mutuality and it was impossible to contractually create an exception to this requirement. After the bankruptcy court issued its ruling, Chevron filed a motion to reconsider based on the theory that the underlying energy contracts were "forward contracts" entitled to derivative contract safe harbor treatment and thus, the mutuality requirements under section 553 were inapplicable

49. 399 B.R. 388 (Bankr. D. Del. 2009), *aff'd*, 428 B.R. 590 (D. Del. 2010).

(this is a similar argument to that raised in the *Swedbank* case discussed below). The bankruptcy court held that Chevron was not entitled to raise new legal theories in a motion to reconsider and refused to consider the merits of the argument. The decision was subsequently affirmed by the district court.

The Bankruptcy Court for the Southern District of New York in the *Lehman* bankruptcy also addressed mutuality in the context of the Bankruptcy Code's safe harbors for derivative contracts.[50] Swedbank AB was a creditor of Lehman Brothers Holding Inc. ("LBHI") and certain affiliates as a result of the early termination of certain derivative transactions under an ISDA Master Agreement. LBHI also maintained a deposit account with Swedbank which had a balance of approximately 2 million Swedish Krona as of the date of the petition. Swedbank froze the account, prohibiting LBHI from withdrawing funds, but allowing other parties to deposit funds. A little over a year following LBHI's bankruptcy filing, the account had grown to approximately 85 million Swedish Krona (roughly $11.7 million), which Swedbank sought to setoff against its $32 million claim against LBHI.

LBHI filed a motion to prohibit the setoff and release the funds in the frozen account. LBHI argued that the funds in the account consisted of post-petition deposits that lacked mutuality with LBHI's indebtedness under the terminated swap transactions. Swedbank argued that its setoff rights under the ISDA Master Agreement were protected under the safe harbors of Bankruptcy Code sections 560 and 561, and thus were not subject to the automatic stay. Swedbank acknowledged that temporal mutuality did not exist between any pre-petition indebtedness of LBHI and funds deposited in the account post-petition. Swedbank argued, however, that section 560 permits a derivative-contract counterparty to exercise any "contractual right" of setoff, notwithstanding any other provisions of the Bankruptcy Code, including the mutuality requirements of section 553.

The bankruptcy court sided with LBHI, finding that the mutuality requirement of section 553 is not overridden by the derivative safe harbors. The court found that the safe harbor provisions were silent as to whether the mutuality requirements of section 553 were inapplicable to derivative contracts and therefore refused to "read in" such an exception. The court held that in order to set off: '"(1) the amount owed by the debtor must be a prepetition debt; (2) the debtor's claim against the creditor must also be prepetition; and (3) the debtor's claim against the creditor and the debt owed must be mutual.'"[51] The court found there was no mutuality because Swedbank's claims arose prepetition while most of the funds in the deposit account accrued post-petition.[52]

Together, *SemCrude* and *Swedbank* demonstrate a trend toward strict judicial enforcement of the mutuality requirement of section 553 from two of the most influential bankruptcy courts in the country.

A third important case addressing setoff from this past year came out of the Bankruptcy Court for the District of Montana.

50. *See In re Lehman Bros. Holdings Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010).

51. Id. at 107 (quoting *In re Lehman Bros. Holdings, Inc.*, 404 B.R. 752, 757 (Bankr. S.D.N.Y. 2009).

52. The bankruptcy court decision was subsequently affirmed on appeal to the district court. The district court ruled primarily on the basis that the legislative history of the safe harbors did not support Swedbank's arguments. *See In re Lehman Bros. Holdings, Inc.*, 2011 WL 350280 (S.D.N.Y. Jan. 27, 2011).

In *Crum v. Blixeth (In re Big Springs Realty LLC)*,[53] the court held that a defendant waives his right to a jury trial by asserting setoff as an affirmative defense. In that case, the chapter 11 trustee commenced an adversary proceeding against defendant Blixeth. In his answer to the complaint, Blixeth asserted several affirmative defenses, including setoff, and demanded a jury trial. The trustee argued that by asserting setoff, Blixeth was essentially asserting a claim against the estate, although he never filed a proof of claim. The trustee argued that by asserting a claim, Blixeth was submitting himself to the bankruptcy court's jurisdiction and thereby waived the right to a jury trial. The court agreed and found that asserting a right to setoff amounted to an informal proof of claim. The *Big Spring Realty* arguably is consistent with established Supreme Court precedent such as *Granfinanciera, S.A. v. Nordberg*[54] and *Langenkamp v. Culp*,[55] which holds that a third party submits itself to the jurisdiction of the bankruptcy court when it asserts a claim against the debtor's estate. ■

53. 430 B. R. 629 (Bankr. D. Mont. 2010).

54. 492 U.S. 33 (1989).

55. 498 U.S. 42 (1990).

Disclosure Requirements Under Federal Rule of Bankruptcy Procedure 2019

Proposed changes to Rule 2019 may impose new disclosure requirements on members of ad hoc committees.

Prior to 2007, ad hoc committees actively participated in chapter 11 cases without having to divulge much information under section 2019 of the Federal Rules of Bankruptcy Procedure ("Rule 2019"). In the past three years, however, some courts have required that members of ad hoc committees submit detailed statements about their interests and claims in the case, including sensitive proprietary information about its investment strategies. This caused many ad hoc committee members to rethink their membership on these committees and led to the proposal of significant changes to Rule 2019.

Current Rule

Typically, ad hoc committees are comprised of noteholders or other claimants who agree to share the cost of advisory services in connection with pursuing common goals in a bankruptcy case. Once the ad hoc committee is formed and files a notice of appearance, Federal Rule of Bankruptcy Procedure 2019 requires that the committee divulge specific information concerning each member. At present, Rule 2019(a) provides that the verified statement of "every entity or committee representing more than one creditor or equity security holder" must include "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."[56] If an ad hoc committee files a verified statement that does not include this information, the debtor or other party in interest may file a motion to compel the ad hoc committee to comply with Rule 2019. The consequences of noncompliance with the disclosure requirements are specified in 2019(b), which authorizes the court to (i) deny the committee the right to intervene in the bankruptcy case, (ii) examine any operative instrument authorizing the committee to represent its members and grant appropriate relief, or (iii) hold "any authority, acceptance, rejection or objection given, procured, or received by an entity or committee" invalid.[57] This is particularly devastating to a group of noteholders or creditors who want to file an objection, because they are left with a choice between divulging sensitive information concerning their investment strategies or risking rejection of their objection and possibly denial of their ability to intervene in the case.

56. Fed. R. Bankr. P. 2019(a).

57. Fed. R. Bankr. P. 2019(b).

Background

Before 2007, most courts ordinarily would not force ad hoc committees to strictly comply with Rule 2019 and would permit submissions of merely the names and addresses of the members and the aggregate amount of the holdings by the group. However, in 2007, the Bankruptcy Court for the Southern District of New York issued a landmark decision in *In re Northwest Airlines Corp.*[58] that changed the landscape and put informal committees on notice that under the current Rule 2019 they may be forced to make significant disclosures about their claims or interests in the proceeding. The bankruptcy court held that an ad hoc committee of equity security holders (which was made up of hedge funds and other investment entities) was obligated to provide detailed information of each member's claims as required by Rule 2019. In its decision, the court reasoned that the rule should be applied "as written."

Shortly following the *Northwest Airlines* decision, the U.S. Bankruptcy Court for the Southern District of Texas issued a bench ruling in *In re Scotia Development LLC*[59] in which it denied the debtor's motion to compel an ad hoc noteholder group to file an amended Rule 2019 statement disclosing detailed information about the members of the group and their trading positions. These two cases set the stage for the debate about whether strict compliance with Rule 2019 is necessary.

From April 2007 until December 2009, the issue lay dormant in the courts. However, during that time the Securities Industry and Financial Markets Association (SIFMA) and the Loan Syndications and Trading Association (LSTA) actively sought to repeal Rule 2019. In August 2009, the Advisory Committee on Bankruptcy Rules recommended changes to Rule 2019 that placed more disclosure requirements on ad hoc committees rather than less.

Recent Developments in the Case Law

In December 2009, Bankruptcy Judge Mary F. Walrath of the Bankruptcy Court for the District of Delaware reignited the debate over Rule 2019 with her decision in *In re Washington Mutual*,[60] Judge Walrath ruled than an informal group of noteholders was required to disclose the trading positions of each member. She concurred with the rationale of *Northwest Airlines* and examined both the text and legislative history of Rule 2019. Judge Walrath also noted that ad hoc committees are formed to gain leverage or influence in a bankruptcy case. Because of this, Judge Walrath suggested that the members of a class of creditors may even owe fiduciary duties to the other members of the class.[61] Ultimately, Judge Walrath found that Rule 2019 applied to the informal group of noteholders and therefore extensive disclosure, as provided for by a strict reading of Rule 2019, was required.

Following this decision, in early 2010, three other bankruptcy judges in the Third Circuit issued conflicting rulings on this issue. On January 20, 2010, Christopher S. Sontchi, a judge in the U.S. Bankruptcy Court for the District of Delaware, issued a written opinion in *In re Premier International Holdings, Inc. (Six Flags)*.[62] Judge Sontchi

58. 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

59. No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007).

60. 419 B.R. 271 (Bankr. D. Del. 2009).

61. This was a rather controversial suggestion, as creditors traditionally have not been viewed as owing a fiduciary duty to other creditors who they are not purporting to represent.

held that under the plain meaning of Rule 2019, an informal bondholders' committee did not constitute a "committee representing more than one creditor" as required by the rule and therefore, disclosure was not required. On the very same day, Judge Brendan L. Shannon of the same court issued an unpublished bench ruling in *In re Accuride Corp.*[63] that an ad hoc noteholders committee was required under Rule 2019 to disclose information concerning their interests. Finally, on February 3, 2010, in *In re Philadelphia Newspapers LLC*,[64] Judge Stephen Raslavich of the U.S. Bankruptcy Court for the Eastern District of Pennsylvania, held that a "steering group of pre-petition lenders" was not an "entity" within the meaning of Rule 2019 "because it is not an organization that has a legal identity apart from its individual members." He also found that the steering group was not a "committee" because it was not court-appointed and only represented its members, not a larger group. Therefore, the steering group was not required to divulge information regarding acquisition and/or divestiture dates and prices. These cases demonstrate the lack of uniformity in the application of the current version of Rule 2019.

Proposed Changes to Rule 2019 and Status of Changes

Currently, Rule 2019 is in the amendment process. In order to amend a Federal Rule of Bankruptcy Procedure, multiple groups and committees must review the proposed changes. First, the Advisory Committee on Bankruptcy Rules presents a proposed rule, publishes it, and announces a time period during which the public may comment on the proposed changes. After the comment period has expired, the Advisory Committee will examine the rule and make adjustments based upon the public's suggestions. Next, the proposed rule is sent to the Committee on Rules of Practice and Procedure (the "Standing Committee") for review. If the Standing Committee accepts the changes, they will recommend that the new rule be presented to the full Judicial Conference. If the full Judicial Conference approves the changes, they will send it to the U.S. Supreme Court for review. If the Supreme Court accepts the changes and Congress does not veto the changes, then the amendment will go into effect.

During the past year, Rule 2019 has gone through the majority of these steps and has changed drastically. In August of 2009, the Advisory Committee on Bankruptcy Rules recommended changes to Rule 2019 that placed more disclosure requirements on "committees" rather than less. In August 2009, the Advisory Committee published the proposed change and requested comments up until February 16, 2010. On February 5, 2010, a public hearing took place before the Rules Committee and included testimony by financial advisors, legal counsel, and the LSTA. On May 27, 2010, the Advisory Committee published a substantially revised proposal for Rule 2019 which removes the price disclosure requirement for any claim or interest, and removes the date purchased disclosure requirement (except when a member of an unofficial group or committee claims to represent any entity in addition to the members of the group or committee and in that case the date disclosure is limited to the quarter and year of acquisition). However, the proposal also expands the definition of "disclosable

62. 423 B.R. 58 (Bankr. D. Del. 2010).

63. Case No. 09-13449 (Bankr. D. Del. Jan. 20, 2010).

64. 422 B.R. 553 (Bankr. E.D. Pa. 2010).

economic interest," requires disclosure of the nature and amount of disclosable economic interest by each member (not in the aggregate), requires additional verified 2019 statements when material changes occur, and exempts administrative agents under credit agreements and groups composed of insiders or affiliates from having to file a Rule 2019 statement.

On June 15, 2010, the Standing Committee approved the amendments to Rule 2019 and recommended that they be presented to the full Judicial Conference. On September 14, 2010, the Judicial Conference met and approved the amendments recommended by the Committee on Rules of Practice and Procedure. It is anticipated that the U.S. Supreme Court will review and approve this amendment in April 2011. If the Supreme Court approves the amendment and if Congress does not veto it, then the revised Rule 2019 will go into effect on December 1, 2011.

Conclusion

As the rule stands right now, bankruptcy courts may still require ad hoc committee members to disclose valuable information about the claims and interests they hold, such as the amount of their interest, the price that they paid for that interest, and the date of acquisition. In fact, as recently as September 15, 2010, at least one court still required significant disclosure under Rule 2019.[65] As courts continue to strictly construe Rule 2019 vis-a-vis ad hoc committees, policy makers are trying to change the rule. If the proposed amendments become effective on December 1, 2011, then they will have a substantial impact on who must disclose information and how much information each group member must disclose. It is important for potential members of ad hoc committees to be aware of impact of the proposed changes. ■

65. In *In re Milacron, Inc.*, 436 B.R. 515 (Bankr. S.D. Ohio 2010), the U.S. Bankruptcy Court for the Southern District of Ohio found that a group of noteholders was required to disclose information about the identity and interests of the group's members. The court was swayed in part by the fact that the noteholders had referred to themselves as "it," suggesting that that they were acting as a collective entity under Rule 2019.

Claims

Claims Trading

Purchaser of a claim is not required to file supporting documents if validity of the claim is adequately diligenced.

Claims trading is a common occurrence during a bankruptcy case, as creditors often do not wish to wait until the end of a bankruptcy case to realize a recovery on their claims. Unlike public securities trading, which is regulated by federal securities laws, bankruptcy claims trading is largely unregulated. This creates a claims trading market for opportunity, hedge and private equity funds and other traders with experience in claims trading or with knowledge of the specifics of a given bankruptcy case in which they have the opportunity to reap substantial gains, especially if claims are acquired at steep discounts.

The claims trading market has undergone extraordinary growth in recent years in both business and consumer bankruptcy cases as a result of the implementation of electronic case filing and other technological developments. Claims traders can now easily identify debtors and collect information on any bankruptcy related filing. Further, the electronic case filing streamlines the traders' proof of claim filings. They no longer need to undertake the cumbersome exercise of mailing original hard copies for filing or requesting the return of stamped copies of filed documents. These increased efficiencies in the claims trading market, while beneficial to the claims traders, have in some cases created a large disparity between the claims traders and claimholders who are not familiar with the bankruptcy claims process.

Because of the disparity in resources and expertise between creditors and sophisticated claims traders, bankruptcy courts have tried to play a role in monitoring and even preventing claims trading despite the lack of express authority from the Bankruptcy Code and the Bankruptcy Rules. This authority, however, has limits, as the United States Court of Appeals for the Sixth Circuit indicated in *B-Line, LLC v. Wingerter* (*In re Wingerter*).[66]

In *Wingerter*, the court of appeals reversed the Bankruptcy Appellate Panel and found that a purchaser of a claim does not violate any Bankruptcy Rules, and is therefore not subject to any sanctions, when the purchaser files a proof of claim without supporting documentation or an explanation of why such documents were not available if the purchaser conducted reasonable diligence regarding the validity of the underlying claim.

Gerald and Janet Wingerter filed for chapter 13 bankruptcy. B-Line, LLC ("*B-Line*"), a large purchaser of consumer bankruptcy claims, purchased a claim against the

66. 594 F.3d 931 (6th Cir. 2010).

Wingerters from an intermediary that was not the original creditor. The intermediary, Covenant Management LLC ("Covenant"), warranted that the claim was valid. Covenant had a strong, consistent track record of providing enforceable claims to B-Line (only 2 out of the 1,017 claims B-Line purchased from Covenant were ever found to be invalid). Based on that relationship, B-Line relied on Covenant's warranty and, in addition, conducted its own review of all of the account information prior to purchasing the claim. B-Line further conducted additional diligence prior to filing a proof of claim against the Wingerters.

The Wingerters objected to B-Line's proof of claim for lack of information and supporting documentation. B-Line was unable to obtain copies of supporting documents and as a result, withdrew its proof of claim. Even after such withdrawal, however, the bankruptcy court issued a series of orders directing B-Line to explain both its business and practices generally and its handling of the claim against the Wingerters. After various evidentiary hearings, the court issued an opinion sanctioning B-Line for violating Bankruptcy Rule 9011(b) for its failure to make a "reasonable pre-filing inquiry" that the claim was valid and supported by the evidence.

B-Line appealed to the Bankruptcy Appellate Panel which dismissed the appeal on procedural grounds. The Sixth Circuit Court of Appeals reversed both decisions. With respect to the violation of Bankruptcy Rule 9011(b), the court found that the bankruptcy court's factual findings were clearly erroneous. It specifically noted that: (i) B-Line did receive warranties about the validity of the claim purchased from Covenant; (ii) B-Line did conduct due diligence before purchasing the claim; and (iii) B-Line conducted additional reviews prior to submitting the proof of claim. Further, according to the Sixth Circuit, a court should evaluate the reasonableness of the conduct under the circumstances rather than using the benefit of hindsight when determining whether conduct is sanctionable. B-Line's conduct was deemed reasonable under the circumstances: it reviewed all of the account information for obvious flaws; it compared all of the account information against the electronic records of the bankruptcy court; it conducted searches on various electronic databases and it repeated its research after buying, and prior to filing the claim. The Sixth Circuit further remarked that holders of an unscheduled, purchased claim need not always attach copies of the claim's originating documents to its proof of claim or provide an explanation for their absence.

This decision further advances the growth of the claims trading market. Among other things, to the extent this decision is followed by other courts, claims traders in both consumer and business bankruptcy cases can now rely on electronic information rather than original documentation in trading and filing bankruptcy claims.

When a Claim Arises

In a departure from longstanding Third Circuit precedent, claims against a debtor are deemed to arise when the conduct giving rise to the claim occurred.

For over two decades, courts in the Third Circuit adhered to the much-criticized rule announced in *In re Frenville*,[67] that a claim for bankruptcy purposes does not arise until the underlying cause of action arises under applicable state law. For the next 20 years, courts in the Third Circuit followed this rule despite intense criticism and rejection by nearly every other circuit. *JELD-WEN v. Van Brunt*,[68] decided in June 2010, finally overruled the much-maligned *Frenville* decision, and adopted the more widely-accepted approach that a claim generally arises in the bankruptcy context when the conduct giving rise to the claim occurred.

Grossman's Inc. ("Grossman's") was a home improvement and lumber retailer in upstate New York. In 1977, Mary Van Brunt, the appellant in the case, bought products from Grossman's that she used to remodel her home. These products allegedly contained asbestos. In 1997, Grossman's filed for protection under chapter 11 of the Bankruptcy Code. Several months later, the bankruptcy court confirmed Grossman's plan of reorganization, which purported to discharge all claims against Grossman's that had arisen prepetition. It was not until 2006, almost a decade after Grossman's exited chapter 11, that Mrs. Van Brunt began experiencing symptoms of mesothelioma as a result of her exposure to asbestos.

In considering Mrs. Van Brunt's case, the Third Circuit explicitly overruled *Frenville* and held that a claim arises when "an individual is exposed prepetition to a product or other conduct giving rise to an injury, which underlies a 'right to payment' under the Bankruptcy Code."[69] In issuing this decision, the court highlighted one of the common criticisms of *Frenville* by noting that the *Frenville* test "does not account for the fact that a 'claim' can exist under the [Bankruptcy] Code before a right to payment exists under state law."[70]

A fundamental policy underlying the Bankruptcy Code is providing the debtor with a fresh start. One way to ensure the debtor receives this fresh start is to broadly define what constitutes a claim. Section 101(a)(5) of the Bankruptcy Code expansively defines a claim as "a right to payment" or a "right to an equitable remedy for a breach of performance if such breach gives rise to a right to payment," regardless of whether such right is unliquidated, contingent, unmatured or disputed.[71] The legislative history with respect to section 101(a)(5) indicates that Congress intended for the definition of claim to be broadly construed so that all of the debtor's legal obligations, no matter how uncertain, would be treated in bankruptcy. This broad construction helps facilitate the debtor's fresh start. *Frenville* was widely criticized as improperly narrowing the definition of claims, thwarting congressional intent, and restricting a debtor's ability to achieve a fresh start. In overturning *Frenville* and adopting a broader definition of "claim," the *JELD-WEN* court brought the Third Circuit in line with rulings in other circuits and freed lower courts from the inconsistencies resulting from the application of the *Frenville* rule. ■

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

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

69. *Id.* at 125.

70. *Id.* at 121.

71. 11 U.S.C. § 101(a)(5).

Intellectual Property – Rejection of Trademark Licenses

Treatment of trademark licenses may be governed by bankruptcy courts' equitable powers.

Section 365 of the Bankruptcy Code allows a trustee or debtor in possession to assume or reject executory contracts. While the Bankruptcy Code leaves the term "executory contract" undefined, it is widely accepted that an executory contract is one where the obligations of both parties are so far unperformed that a failure by either party to perform would amount to a material breach of the contract. Intellectual property ("IP") licenses can be considered executory contracts when both parties to the contract have ongoing, material obligations to perform. Examples of the types of obligations commonly found to make an IP contract executory are: the obligation to pay royalties, the duty to indemnify, the duty to maintain confidentiality, the obligation to adhere to quality standards, and the duty to refrain from using IP when its exclusive use has been granted to a licensee.

As discussed below, absent section 365(n), if a debtor were to reject an IP license, the license would be deemed terminated and the licensee would have a general unsecured claim for damages resulting from the loss of the license. This result could have potentially disastrous effects on the licensee's business. As a result, Congress enacted the Intellectual Property Licenses in Bankruptcy Act, which is codified in section 365(n) of the Bankruptcy Code, to protect the rights of licensees when a licensor files for bankruptcy. When a debtor rejects an IP licensing agreement, section 365(n) allows the licensee to treat the license as terminated or to elect to retain certain of its rights under the license as they existed immediately prior to the licensor's bankruptcy. The protection of 365(n), however, is not absolute. The Bankruptcy Code's definition of "intellectual property" does not include trademarks, an exclusion that the legislative history of section 365(n) suggests was deliberate. Because courts often find IP licenses to be executory contracts, and trademark licenses are excluded from the protections of section 365(n), trademark licensees are vulnerable in the event of a licensor's bankruptcy.

Against this background, the Third Circuit was confronted with a trademark license dispute in *In re Exide Technologies*.[72] In that decision, the court held that a trademark license, when viewed as one part of a largely completed asset sale, was not an executory contract, and, therefore, could not be rejected by the debtor. In 1991, Exide Technologies ("Exide") sold its battery business to EnerSys Delaware, Inc. ("EnerSys"). The sale was memorialized in a series of four agreements: (i) an Asset Purchase Agreement; (ii) a Trademark and Trade Name License Agreement; (iii) an Administrative Services Agreement; and (iv) a Letter Agreement. Under the terms

72. 607 F.3d 957 (3d Cir. 2010), cert denied, No. 10-422, 2011 WL 588851 (Feb. 22, 2011).

of the agreements, EnerSys was granted an exclusive license to use the Exide name in its battery business in perpetuity. Almost a decade after the transaction took place, Exide sought to revive its battery business and attempted to terminate EnerSys' license. Exide ultimately filed a chapter 11 petition in 2002, and pursuant to section 365 of the Bankruptcy Code, sought to reject the license agreement with EnerSys and regain use of the Exide name for its own battery business.

The bankruptcy court ruled that all four of the sale agreements constituted a single integrated transaction, and because there were remaining obligations related to the sale by both parties, the contracts were executory. This decision was upheld by the district court. On appeal, the Third Circuit reversed these rulings. While the Third Circuit agreed that the four agreements should be read as one, the court held that the agreements were not executory, and therefore could not be rejected. The Third Circuit found that EnerSys had substantially performed under the agreements by paying the entire purchase price and operating under the agreements for 10 years. The court rejected Exide's arguments that EnerSys' ongoing responsibility to adhere to certain quality standards and refrain from using the Exide name outside of the battery business amounted to material ongoing obligations that outweighed EnerSys' substantial performance under the contracts. The Third Circuit held that because EnerSys substantially performed, the contracts were not executory and could not be rejected by the debtor.

In a separate concurring opinion, Judge Ambro expressed his view that a debtor's rejection of a trademark license does not necessarily deprive a licensee of all rights. Judge Ambro did not find the fact that trademarks were left out of the definition of intellectual property in the Bankruptcy Code evidence that it was Congress' intention that trademark licensees receive no protection in the event of a licensor's bankruptcy. Rather, citing the additional issues that trademarks (as opposed to patents or copyrights) raise, Judge Ambro concluded that Congress left trademarks out of the definition of intellectual property because it needed to study the issue further. Therefore, he reasoned, the protection of trademark licensees was left to the bankruptcy courts' equitable power.

Exide, and particularly Judge Ambro's concurrence, if adopted in other circuits, could expand the protections afforded to trademark licensees. Following this decision, debtor licensors must carefully consider the rights of licensees when deciding whether to reject those contracts. ■

Modification of Retiree Benefits Plans

Section 1114 requirements, including the 180-day prepetition look back period, apply even to retirement plans that, outside of bankruptcy, could have been unilaterally terminated or modified by the employer.

Another 2010 Third Circuit decision highlights the need for debtors with significant employee retirement benefit obligations to engage in strategic pre-bankruptcy planning. Section 1114 of the Bankruptcy Code prohibits a debtor from terminating or modifying retiree benefits without permission from an authorized representative of the retirees or court approval. Before a debtor can seek court approval of retiree benefit modifications, it must show that it provided a proposal to the retirees' representative and attempted to reach a mutually agreeable settlement which the representative refused "without good cause." Importantly, section 1114 applies not only to modifications to retiree benefits made while the debtor is in bankruptcy, but also to those made within the 180-day period prior the debtor's bankruptcy filing. If a debtor modifies retiree benefits within this 180 day period, and it is determined that the debtor was insolvent when these modifications were made, the court will order the benefits reinstated as they were prior to the modification.

In *IUE-CWA v. Visteon Corp.*,[73] the Third Circuit addressed a debtor's ability to modify retiree benefits in light of specific contractual provisions allowing for unilateral modification or termination. The agreements governing retiree benefits in *Visteon* provided that the debtor retained the right to terminate or modify any and all benefits unilaterally and without reservation. After filing for bankruptcy, Visteon sought court authorization to terminate retiree benefits, arguing that it was not required to comply with section 1114 because the agreement allowed for unilateral termination. Both the bankruptcy court and district court agreed with Visteon and allowed the modification without consulting the retirees' representative.

The Third Circuit reversed the lower courts and found that the plain language of section 1114 was unambiguous and clearly applied to **all** retiree benefits. Although the Third Circuit acknowledged that its decision went against the majority of lower courts that had addressed the issue, the court reasoned that Congress had explicitly excluded certain benefits from the scope of section 1114, demonstrating that if Congress had intended to limit the application of section 1114, it would have done so explicitly.

The *Visteon* decision is notable because it provides retirees with rights in bankruptcy that they would not have had outside of Visteon's bankruptcy. Because of the importance of Third Circuit decisions generally in bankruptcy matters, would-be debtors that are formulating a bankruptcy strategy should consider the *Visteon* ruling if they intend to terminate retiree benefits during the bankruptcy or in the 180 days prior to filing. ■

73. 612 F.3d 210 (3d Cir. 2010).

Appointment of Examiner

The appointment of an examiner in cases where unsecured debts exceed $5 million may not be mandatory.

Section 1104(c) of the Bankruptcy Code provides that upon the request of a party in interest, and after notice and a hearing, the court "shall order the appointment of an examiner to conduct an investigation of the debtor as is appropriate . . . if such appointment is in the best interests of creditors, any equity security holders, and other interests of the estate; or the debtor's . . . unsecured debts . . . exceed $5,000,000."[74] A majority of courts considering this issue have found the language of section 1104(c) mandatory, meaning that an examiner must be appointed if the $5 million threshold is satisfied and a request is made. These same courts, however, have used the phrase "as is appropriate" to exercise their discretion in determining the scope of the examiners duties, and thereby have attempted to mitigate any deleterious effects on the chapter 11 process.[75]

A recent bankruptcy court decision from the District of Delaware rejected the majority view and refused to grant requests by the convertible noteholders' and equityholders' ad hoc committees for the appointment of an examiner. In *In re Spansion, Inc.*,[76] the debtors filed a plan of reorganization under which equityholders received nothing and convertible noteholders received very little. Shortly before the confirmation hearing, the ad hoc committees requested the appointment of an examiner. The court refused the request and stated that ordering the appointment of an examiner only to severely limit his or her duties under the "as is appropriate" language of section 1104(c) was a wasteful exercise and could not be the result Congress intended.

The court's decision in *Spansion* is in direct contrast to the plain language of the statute and long-standing precedent.[77] However, the factual circumstances of *Spansion* may limit its future applicability. Judge Carey seemed to rely heavily on the fact that the request for an examiner was made just prior to the confirmation hearing. He stated that both ad hoc committees had vigorously represented their interests throughout the case and that the committees' reasons for request-

74. 11 U.S.C. § 1104(c).

75. Indeed, in a bench ruling in the Owen Corning bankruptcy, the court ordered the appointment of an examiner, but explicitly refused to grant the examiner any powers or duties. In re Owens Cornings, No. 00-3837, Document No. 7984 (Bankr. D. Del. Apr. 23, 2003).

76. 426 B.R. 114 (Bankr. D. Del. 2010).

77. See Loral Stockholders Protective Comm. v. Loral Space & Commc'ns Ltd. (In re Loral Space & Commc'ns, Ltd.), No. 04 Civ. 8645RPP, 2004 WL 2979785 (S.D.N.Y. Dec. 23, 2004) (reversing a bankruptcy court's refusal to appoint an examiner because it would be wasteful and holding that the plain language of the statute and its legislative history mandated the appointment of an examiner).

ing the appointment of an examiner were for reasons more suited to confirmation objections. Nonetheless, despite the unique factual circumstances of *Spansion*, following that decision, three other Delaware bankruptcy courts also have found the appointment of an examiner to be unwarranted.[78] As a result, it is uncertain whether *Spansion* will spark a growing trend towards rejecting the appointment of an examiner even in cases where the $5 million threshold is met. ■

78. See In re Magna Entm't Corp., No. 09-10729 (Bankr. D. Del. Apr. 20, 2010); In re HSH Delaware GP LLC, No. 10-10187 (Bankr. D. Del. Apr. 23, 2010); In re Washington Mut., Inc., No. 08-12229 (Bankr. D. Del. May 5, 2010).

Cross-Border Restructuring – Chapter 15 Cases

Important chapter 15 decisions were handed down in 2010, including the first ever court of appeals chapter 15 decision. These cases provide additional guidance on how U.S. courts will treat foreign insolvency proceedings that purport to affect U.S. entities or property.

Avoidance Actions

Foreign-law avoidance actions may be brought in chapter 15 cases.

The Fifth Circuit issued the first court of appeals opinion concerning chapter 15 in *In re Condor Insurance Limited*.[79] *Condor* considered whether foreign avoidance law may be used by a foreign representative in a chapter 15 proceeding to pursue defendants and assets in the U.S. The U.S. Bankruptcy Court for the Southern District of Mississippi held that the Bankruptcy Code did not provide standing to foreign representatives seeking to pursue avoidance actions based on foreign law and accordingly dismissed the foreign representative's adversary proceeding. The district court affirmed. The Fifth Circuit, however, reversed the lower courts and held that foreign representatives in a chapter 15 proceeding may seek to avoid fraudulent conveyances under non-U.S. law.

Condor Insurance Limited ("Condor Insurance") was an insurance and surety bond company incorporated in the Caribbean island of Nevis. In November of 2006, creditors of Condor initiated a "winding up" proceeding in Nevis. Official liquidators were appointed. Condor Insurance had transferred over $313 million in assets to an affiliated company in the United States, Condor Guaranty, Inc. ("Condor Guaranty") in an alleged fraudulent conveyance under Nevis law. The Nevis liquidators initiated a chapter 15 proceeding in the Southern District of Mississippi. The bankruptcy court recognized the Nevis "winding up" proceeding as a foreign main proceeding and the Nevis liquidators as foreign representatives. The liquidators commenced an adversary proceeding against Condor Guaranty to avoid the alleged fraudulent transfers and recover the assets.

The Bankruptcy Code does not explicitly address whether a U.S. court may apply non-U.S. avoidance law in a chapter 15 proceeding. The Fifth Circuit considered whether section 1521(a) of the Bankruptcy Code prohibited foreign representatives from bringing a foreign avoidance action in a chapter 15 proceeding. Section 1521(a)(7) explicitly provides that a foreign repre-

79. 601 F.3d 319 (5th Cir. 2010).

sentative is not given certain "avoidance powers" as defined under the Bankruptcy Code, including the power to avoid fraudulent transfers under U.S. law.

In considering whether section 1521(a) applied to foreign avoidance laws, the Fifth Circuit noted that if Congress had wanted to prevent foreign representatives from bringing non-U.S. avoidance actions in a chapter 15 proceeding, then it would have expressly included language stating this intent. Since Congress did not explicitly exclude foreign avoidance actions, the Fifth Circuit declined to extend the limitations of section 1521 to include foreign law actions. The Fifth Circuit also reasoned that the purpose and structure of chapter 15 "suggests a broad reading of the powers granted to the district court in order to advance the goals of comity to foreign jurisdictions."[80] The Fifth Circuit also noted that permitting foreign representatives to bring foreign avoidance actions in a chapter 15 proceeding was consistent the old section 304 of the Bankruptcy Code (the predecessor to chapter 15) as evidenced by prior case law.[81]

In *Condor*, the Fifth Circuit heavily emphasized the purpose of the UNCITRAL Model Law and the intent of Congress in incorporating these provisions into chapter 15. The Fifth Circuit acknowledged that chapter 15 was intended to facilitate cooperation between U.S. courts and foreign bankruptcy proceedings and read the Bankruptcy Code in that light. It will be particularly interesting in the coming year to see how far the appellate courts are willing to stretch the Bankruptcy Code to facilitate cooperation between courts. As time goes on and chapter 15 cases travel through the appeals process, the body of higher court law dealing with chapter 15 will develop further.

Comity

Comity may be a basis for enforcement of foreign orders in chapter 15 cases, but its reach may be limited where U.S. interests would not be adequately protected.

Significant case law developments also occurred in 2010 with regard to chapter 15 comity. Two particularly important decisions concerned the enforcement of foreign orders and the allowance of a chapter 7 case in conjunction with a chapter 15 proceeding and a foreign main proceeding. These two decisions have provided important guidance to foreign debtors about when bankruptcy courts will be willing to stretch existing jurisdictional parameters to accommodate foreign main proceedings.

In *In re Metcalfe & Mansfield Alternative Investments*,[82] Judge Glenn of the U.S. Bankruptcy Court for the Southern District of New York held that a Canadian order may be enforced in the United States even if the relief that it grants would not be available under the U.S. Bankruptcy Code. In *Metcalfe*, a Canadian insolvency proceeding was initiated to restructure approximately C$32 billion in asset backed commercial paper notes. After extensive negotiations, a plan of reorganization was developed that provided certain plan participants with, among other things, a global release from liability claims related to the third-party commercial paper market in Canada. This release included third-party non-debtors. The Ontario Superior Court of Justice carefully considered whether it had the power to issue such a broad release and determined that the release was proper

80. *Id.* at 325.

81. *See Metzeler v. Bouchard Transp. Co. (In re Metzeler)*, 78 B.R. 674 (Bankr. S.D.N.Y. 1987).

82. 421 B.R. 685 (Bankr. S.D.N.Y. 2010).

because it was heavily negotiated by all parties and was necessary to restore confidence in Canada's financial markets. This order was ultimately affirmed by the Ontario Court of Appeal in August 2008 and the plan went effective in 2009. In November 2009, the *Metcalfe* court-appointed monitor filed a chapter 15 petition in the Southern District of New York and sought to enforce the Canadian order.

Although the monitor appointed for Metcalfe argued that the third-party non-debtor releases would be available under U.S. bankruptcy law, the *Metcalfe* court noted that the question was not whether U.S. courts could have reached the same conclusion, but rather whether "foreign orders should be enforced in the United States in this chapter 15 case."[83] The *Metcalfe* court recognized that it had the authority to refuse to enforce any foreign order that "would be manifestly contrary to the public policy of the United States,"[84] but that this power should be narrowly construed. In evaluating whether the foreign order should be applied in the U.S., the *Metcalfe* court considered whether the principles of comity supported enforcement and whether the procedures used in Canada met fundamental standards of fairness. Ultimately, the *Metcalfe* court determined that the Canadian insolvency proceedings were fair and reasoned that the U.S. and Canada share similar common law traditions and principles of law and that courts regularly grant comity to Canadian proceedings. The *Metcalfe* court also noted that a chapter 15 debtor could receive relief that "could not be entered in a plenary chapter 11 case."[85]

The *Metcalfe* decision represents a significant step in the chapter 15 line of cases. Until early 2010, it was unclear how much deference U.S. bankruptcy courts would give to a substantive legal determination by a foreign court in a foreign main proceeding. By enforcing a foreign court order on the basis of the principles of comity, the *Metcalfe* decision may be used in the future to support enforcement of foreign court orders offering relief that would normally not be available to a debtor in the United States. Metcalfe, though, may be limited as precedent. For example, the court explicitly noted that the foreign order came from Canada and the U.S. courts regularly recognize Canadian decisions. Thus, if a chapter 15 foreign representative seeks to enforce another country's court order, *Metcalfe* may not carry strong precedential weight. Additionally, the specific release in dispute was granted during a time when the entire Canadian financial system was in crisis and the policy reasons may have had a larger impact than they would during a period of greater economic certainty. Finally, although this type of release is not usually permitted by U.S. bankruptcy courts, it is not a clear violation of public policy. Therefore, presenting a foreign court order that is more clearly against U.S. public policy may not result in a similar holding.

In March 2010, the U.S. Bankruptcy Court for the Western District of Pennsylvania issued an important opinion concerning chapter 15 and abstention in *In re RHTC Liquidating Co.*[86] In that case, a Canadian parent company filed for bankruptcy relief in Canada and promptly filed a chapter 15 proceeding for its U.S. subsidiary. The Canadian court appointed a monitor, who was recognized as the foreign representative in the chapter 15 proceeding. During the course of the case, all of RHTC's assets

83. *Id.* at 696.

84. *Id.* at 697.

85. *Id.* at 696.

86. 424 B.R. 714 (Bankr. W.D. Pa. 2010).

were sold. These assets were located in the U.S., and RHTC's primary place of business was Erie, Pennsylvania. After the sale, a monetary transfer of at least $700,000 was made from the U.S. subsidiary to the Canadian parent. Shortly thereafter, creditors of the U.S. subsidiary filed an involuntary chapter 7 petition against the subsidiary. The *RHTC* court considered whether dismissal of the chapter 7 proceeding was warranted when a chapter 15 case had already been initiated.

The *RHTC* court held that dismissal of the chapter 7 proceeding was not warranted as the foreign representative did not meet his burden to show that "the purposes of chapter 15 ... would be best served by such dismissal or suspension" under section the abstention provisions of section 305(a)(2) of the Bankruptcy Code.[87] The *RHTC* court also noted that the funds to be distributed to creditors were derived from the sale of assets in the U.S. and that there was little legal certainty as creditors would most likely anticipate that liquidation would occur in the U.S. and not in Canada. Additionally, the *RHTC* court reasoned that the U.S. creditors would not benefit from dismissal of the chapter 7 case, as the foreign representative had not attempted to have the intercompany transfer disallowed. There was a real concern that the U.S. creditors were not being adequately protected in the Canadian proceeding. Finally, the *RHTC* court acknowledged that although it recognized the Canadian proceeding as a "foreign main proceeding," the initial chapter 15 order reserved rights concerning the distribution of assets to U.S. creditors.

The *RHTC* case is particularly important because it is one of the first cases concerning section 305(a)(2) as it relates to chapter 15. This case is also significant because it demonstrates that U.S. bankruptcy courts will not blindly act to accommodate foreign jurisdictions, especially when it determines that to do so would be harmful to U.S. citizens. Here, the U.S. bankruptcy court determined that the creditors were not being adequately protected due to the large monetary transfer out of the company and therefore permitted the chapter 7 case to proceed. ■

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87. *Id.* at 720.

This memorandum 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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