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Mark G. Douglas

Conflicts arising from the seeming incongruity between the Bankruptcy Code and other federal statutes governing the way that companies in various industry sectors are regulated have figured prominently in recent headlines involving companies such as PG&E, Enron, and any number of telecoms. Bankruptcy and appellate courts are increasingly called upon to resolve these conflicts in a way that harmonizes as nearly as possible the competing policy concerns involved. One such dispute — the ability of a bankruptcy court to modify or terminate contracts regulated by the Federal Energy Regulatory Commission ("FERC") — was the subject of highly controversial rulings handed down during the last 18 months by the United States Court of Appeals for the Fifth Circuit and a New York district court. These decisions have added more fuel to a controversy that may ultimately have to be resolved by the U.S. Supreme Court.

BANKRUPTCY JURISDICTION AND REJECTION OF EXECUTORY CONTRACTS

By statute, U.S. district courts are given original and exclusive jurisdiction over every bankruptcy "case." In addition, they are conferred with non-exclusive jurisdiction over all "proceedings arising under" the Bankruptcy Code as well as those "arising in or related to cases under" the Code. Finally, district courts are granted exclusive jurisdiction over all the property of a debtor's estate, including, as relevant here, contracts, leases, and other agreements that are still in force when a debtor files

for bankruptcy protection. That jurisdiction typically devolves automatically upon the bankruptcy courts, each of which is a unit of a district court, by standing court order.

A bankruptcy court's exclusive jurisdiction over unexpired — or "executory" — contracts and leases empowers it to authorize a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to either "assume" (reaffirm) or "reject" (breach) almost any executory contract during the course of a bankruptcy case in accordance with the strictures of Bankruptcy Code section 365. Assumption generally allows the DIP to continue performing under the agreement, after curing outstanding defaults, or to assign the agreement to a third party as a means of generating value for the bankruptcy estate. Rejection frees the DIP from rendering performance under unfavorable contracts. Rejection constitutes a breach of the contract, and the resulting claim for damages is deemed to be a pre-petition claim against the estate on a par with other general unsecured claims.

Accordingly, the power granted by Congress under section 365 is viewed as vital to the reorganization process because it can relieve the debtor's estate from burdensome obligations that can impede a successful reorganization. The court will authorize assumption or rejection if it is demonstrated that either course of action represents an exercise of sound business judgment. This is a highly deferential standard akin in many respects to the business judgment rule applied to corporate fiduciaries.

THE FEDERAL POWER ACT AND THE FILED-RATE DOCTRINE

Public and privately operated utilities providing interstate utility service within the U.S. are regulated by the Federal Power Act ("FPA") under the supervision of FERC. Although contract rates for electricity are privately negotiated, those rates must be filed with FERC and certified as "just and reasonable" to be lawful. FERC has "exclusive authority" to determine the reasonableness of the rates.

Based on this statutory mandate, courts have developed the "filed-rate doctrine," which provides that a utility's "right to a reasonable rate [under the FPA] is the right to the rate which the Commission files or fixes, and . . . except for review of the Commission's orders, [a] court can assume no right to a different one on the ground that, in its opinion, it is the only or the more reasonable one." Under the filed-rate doctrine, the reasonableness of rates and agreements regulated by FERC "may not be collaterally attacked in state or federal courts. The only appropriate forum for such a challenge is before the Commission or a court reviewing the Commission's order."

Although FERC has exclusive authority to modify a filed rate, its discretion is not unfettered. FERC may not change a filed rate solely because the rate affords the utility "less than a fair return" because "the purpose of the power given to the Commission . . . is the protection of the public interest, as distinguished from the private interests of the utilities." FERC can change a filed rate only when "the rate is so low as to adversely affect the public interest — as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."

If a utility files for bankruptcy, FERC's exclusive discretion in this realm could be interpreted to run afoul of the bankruptcy court's exclusive jurisdiction to authorize the rejection of an electricity supply agreement based on the debtor's business judgment that the rates charged under the agreement are unreasonable. This was the thorny issue addressed by both the Fifth Circuit Court of Appeals in August of 2004 in connection with the Mirant Corporation chapter 11 cases and, most recently, a New York district court's January 2006 decision rendered in connection with the Calpine Corporation chapter 11 cases.

THE FIFTH CIRCUIT'S RULING IN *MIRANT*

Mirant Corporation and 82 of its subsidiaries (collectively, "Mirant") filed voluntary chapter 11 petitions in 2003. Prior to filing for bankruptcy, Mirant, one of the largest regulated public utilities in the U.S., agreed to purchase certain electric generation facilities from Potomac Electric Power Company ("PEPCO"). In connection with the sale, PEPCO was to assign to Mirant several purchase power agreements (each, a "PPA"), which are long-term, fixed-rate contracts pursuant to which PEPCO agreed to purchase electricity from outside suppliers. Because certain of the PPAs required PEPCO to obtain the PPA supplier's consent to assignment, the purchase agreement provided that, if PEPCO could not obtain such consent,

the unassigned PPAs would be subject to a "back to back" agreement.

Under a back-to-back agreement, PEPCO would continue to comply with the terms of any unassigned PPAs, and Mirant would agree to purchase an amount of electricity from PEPCO equal to PEPCO's obligations under the unassigned PPAs at the rate set forth in the applicable PPA. After PEPCO was unable to obtain the required consent to assign two of the PPAs, Mirant and PEPCO entered into such an agreement, which the parties filed with FERC. FERC subsequently approved the wholesale electricity rates set forth in the agreement.

The practical ramifications of the rulings for potential debtors seeking to disavow onerous FERC-regulated contracts are fairly clear. At best, unless a convincing case can be made that the regulated rates themselves are not the primary impetus for terminating the contracts, rejection under section 365(a) of the Bankruptcy Code would not appear to be a viable option.

Because of the significant financial losses experienced by Mirant under the back-to-back agreement, Mirant sought court authorization to reject the agreement after it filed for bankruptcy. It also sought an injunction preventing FERC or PEPCO from taking any actions to require Mirant to abide by the terms of the agreement. The bankruptcy court granted Mirant's request for injunctive relief, but did not rule on Mirant's motion to reject the back-to-back agreement.

Instead, the litigation continued in the district court, which withdrew the reference of the proceeding to resolve the potential conflict between the FPA and the Bankruptcy Code. The court ultimately ruled that FERC has exclusive authority under the FPA to determine the reasonableness of wholesale rates charged for electric energy sold in interstate commerce, and those rates can be challenged only in a FERC proceeding, not through a collateral attack in state or federal court. According to the district court, the Bankruptcy Code does not provide an exception to FERC's authority under the FPA, and therefore, Mirant had to seek relief from the filed rate in the back-to-back agreement in a FERC proceeding. The court accordingly denied Mirant's motion to reject the agreement and vacated the injunction issued below. Mirant appealed to the Fifth Circuit.

The Court of Appeals reversed. Initially, it determined that although the filed-rate doctrine prevents a district court from hearing breach of contract claims that challenge a filed rate, a court is permitted to grant relief in situations where the claim is based upon another rationale. Thus, the Fifth Circuit explained, the FPA does not prevent a court from ruling on a motion to reject a FERC-approved rate-setting agreement so long as the proposed rejection does not represent a challenge to the agreement's filed rate. PEPCO's claim arising from rejection of the agreement, the Court of Appeals emphasized, would be calculated based on the filed rate. Moreover, the Fifth Circuit emphasized, even though Mirant's desire to reject the agreement was motivated in part by the lower prevailing market rate, its business justification was also premised on the existence of excess supply and the consequent lack of any need for the energy covered by the contract. The Court of Appeals accordingly concluded that rejection of the agreement was not a challenge to the filed rate, and that the FPA did not preempt a ruling on Mirant's motion.

The Fifth Circuit rejected FERC's argument that anything less than full payment would constitute a challenge to the filed rate, observing that "any effect on the filed rates from a motion to reject would result not from the rejection itself, but from the application of the terms of a confirmed reorganization plan to the unsecured breach of contract claims." It went on to note that, although the Bankruptcy Code contains numerous limitations on a debtor's right to reject contracts, "including exceptions prohibiting rejection of certain obligations imposed by regulatory authorities," there is no exception that prohibits a debtor's rejection of wholesale electricity contracts that are subject to FERC's jurisdiction. Concluding that "Congress intended § 365(a) to apply to contracts subject to FERC regulation," the Fifth Circuit held that the court's power to authorize rejection of the back-to-back agreement does not conflict with the authority conferred upon FERC to regulate rates for the interstate sale of electricity. It accordingly reversed the decision below.

THE NEW YORK DISTRICT COURT'S RULING IN *CALPINE*

In the aftermath of California's energy crisis of 2000-2001, power provider and federally regulated public utility Calpine Corporation entered into long-term wholesale electric power agreements with several entities, including Pacific Gas and Electric and Southern California Edison (referred to collectively as the "counter-parties"). The agreements were duly submitted to FERC and complied with the applicable filing rules and regulations.

Calpine sought chapter 11 protection in December 2005, a victim of overleveraging and a steep rise in the price of natural gas, which it relied on heavily to fuel its power plants. Anticipating Calpine's bankruptcy filing, certain of the counter-parties commenced a proceeding before FERC to compel Calpine to continue performing under the power agreements. Calpine responded by suing FERC in the bankruptcy court to enjoin FERC from requiring Calpine's continued performance. Calpine contemporaneously sought bankruptcy court authority to reject the power agreements because they were the "most financially burdensome" of its many energy contracts.

Shortly thereafter, FERC issued an order in which, based upon the Fifth Circuit's ruling in *Mirant*, FERC acknowledged that the FPA does not preempt section 365 of the Bankruptcy Code, but stated that any standard governing Calpine's attempt to reject the power agreements should take the public interest into account. Calpine's rejection motion was ultimately withdrawn from the bankruptcy court to the district court, based upon the latter's determination that the dispute required material consideration of conflicting federal statutes and neither *Mirant* nor the FERC order definitively resolved the issues.

After discussing the background of the FPA and the filed-rate doctrine, the district court emphasized that the power agreements were filed with FERC and, "under normal conditions, altering the rates, terms, conditions, or duration of the contracts would require FERC involvement and approval." According to the court, these requirements are not eliminated merely because Calpine filed for bankruptcy:

> There are no provisions in the FPA that specifically limit FERC jurisdiction in the bankruptcy context. Quite the contrary, FERC, in its charge to maintain reasonable rates and uphold the public interest, must also consider the financial ability of a utility to continue service under a filed rate, a responsibility that would include similar considerations to those in the bankruptcy court. . . . Conversely, FERC's lack of authority to modify a filed contract solely because it is in the interest of a private utility, suggests Congress thought no forum ought to have such authority.

The district court found "little evidence" in the Bankruptcy Code of congressional intent to limit FERC's regulatory authority, remarking that "[a]bsent overriding language, the Bankruptcy Code should not be read to interfere with FERC jurisdiction."

The court acknowledged that the scope of a bankruptcy court's power and jurisdiction is broad. Even so, it explained, if a bankruptcy court's power, including the power to authorize the rejection of a contract, conflicts with a federal regulatory regime, "the power of the bankruptcy court must yield to that of the federal agency." According to the court, the Bankruptcy Code itself supports this conclusion by exempting agency action from the scope of the automatic stay. As a consequence, the court reasoned, "it is clear that the bankruptcy court's authority cannot be exercised so as to interfere with the jurisdiction of a federal agency acting in its regulatory capacity."

As framed by the district court, the dispositive issue is whether rejection of the power agreements would directly interfere with FERC's exclusive jurisdiction over wholesale power contracts "or otherwise constitutes a collateral attack on the filed rate." The court concluded that it would — rejection of the agreements, which even Calpine admitted was motivated by its dissatisfaction with the below-market rates, would infringe upon FERC's exclusive province to regulate the rates, terms, conditions, and duration of wholesale energy contracts. The court gave short shrift to Calpine's contention that because rejection would result in breach of the agreements, it was thereby removed from FERC's exclusive jurisdiction, which extends to approval, modification, or termination of energy contracts, but not breaches. According to the district court, "the 'breach' here does not create a typical dispute over the terms of a contract, but the unilateral termination of a regulatory obligation."

WHAT'S NEW AT JONES DAY?

Corinne Ball (New York) and **Pierre-Nicolas Ferrand (Paris)** were named among the "World's Leading Lawyers" by *Chambers Global* for 2006.

Corinne Ball (New York), **Heather Lennox (Cleveland)**, **Richard A. Chesley (Chicago)**, **Jeffrey B. Ellman (Atlanta)**, **Richard Engman (New York)**, **Adam Plainer (London)**, **Erica M. Ryland (New York)**, **Carl E. Black (Cleveland)**, **Veerle Roovers (New York)**, and **Ryan T. Routh (Cleveland)** are part of a team of Jones Day attorneys representing Dana Corporation and 40 of its U.S. subsidiaries in connection with their chapter 11 filings on March 3, 2006, in the United States Bankruptcy Court for the Southern District of New York.

A team of Jones Day attorneys including **Gregory M. Gordon (Dallas)**, **Henry L. Gompf (Dallas)**, **Daniel P. Winikka (Dallas)**, **Richard A. Chesley (Chicago)**, and **Robert J. Graves (Chicago)** represented Kaiser Aluminum Corporation and 25 of its affiliates in connection with the confirmation on February 6, 2006, of a joint plan of reorganization under which the companies were able to eliminate approximately $3.1 billion in debt.

Corinne Ball (New York) spoke on April 6, 2006, at the spring meeting of the American Bar Association in Tampa, Florida. The topic of her presentation was "Negotiating Cash Collateral Orders in the Era of Ad Hoc Committees."

An article written by **Paul D. Leake (New York)** and **Mark G. Douglas (New York)** entitled "Caveat Emptor: Claim in Innocent Transferee's Hands Can Be Equitably Subordinated Based Upon Transferor's Misconduct" appeared in the March 2006 edition of *Pratt's Journal of Bankruptcy Law*.

Daniel P. Winikka (Dallas) spoke on March 3, 2006, at the 21st Annual Advanced ALI-ABA Course of Study: Corporate Mergers and Acquisitions. The topic of his presentation was "How to Handle Distressed Sale Transactions."

An article written by **Ryan T. Routh (Cleveland)** and **Mark G. Douglas (New York)**, entitled "A Question of Reasonableness: Default Interest Payable to Oversecured Creditor Subject to Limitations," appeared in the April 2006 edition of the *ABF Journal*.

Cases in which courts have exercised jurisdiction over breach of wholesale energy contracts, or where FERC has declined jurisdiction, the district court emphasized, involved alleged breaches that could be resolved by application of simple contract principles that were well within the jurisdiction of the courts involved. Regulatory approval of the power agreements by FERC, the court reasoned, transformed the agreements into something more than simple contracts:

> [J]ust as regulatory action was required to transform the terms and conditions of the Power Agreements from mere contracts into regulated duties . . . so also is regulatory action from FERC required to eliminate those duties. . . . With rejection, a bankruptcy court eliminates those duties. But what FERC giveth, only FERC may taketh away.

Acknowledging that its ruling was ostensibly at odds with the Fifth Circuit's *Mirant* decision, the district court explained that, in fact, the *Mirant* rationale is entirely consistent with its own conclusions. In *Mirant*, the court explained, the Fifth Circuit held that although the FPA preempts a breach of contract claim challenging a filed rate, courts are permitted "to grant relief in situations where the breach of contract claim is based upon another rationale." The stated justification for rejection in *Mirant* was not the disparity between contract and market rates, but the fact that Mirant did not need the energy at all. By contrast, Calpine was seeking nothing more than rate relief — its rejection motion clearly stated that it needed relief from the power agreements because it was being forced to sell energy at far below-market rates.

Finally, the district court observed, its conclusion is consistent with general policy considerations. According to the court, by holding that FERC has exclusive jurisdiction to modify or terminate the power agreements under the circumstances of this case, "an issue of great public interest will be heard in a branch accountable to the electorate in a forum that specializes in considering the public interest."

Based upon its determination that FERC has exclusive jurisdiction over modification or termination of the power agreements, the district court vacated the injunction issued by the bankruptcy court and dismissed Calpine's motion to reject the agreements.

OUTLOOK

Although they reach different conclusions, *Mirant* and *Calpine* are similar in many respects. Both decisions are emblematic of the way that most courts approach a potentially irreconcilable conflict between two federal statutes. Wherever possible, courts attempt to resolve such conflicts in a way that gives due consideration to the important policy considerations associated with both statutes. In *Mirant*, that resolution was reached by means of a determination that the rejection of an executory agreement establishing presumptively reasonable utility rates is not tantamount to a collateral attack on the reasonableness of the rates — provided rejection is not motivated solely by a desire to take advantage of lower market rates. Stated differently, the Fifth Circuit found that there was no conflict between the statutes.

Calpine picks up where *Mirant* left off, but only to a point. Unlike in *Mirant*, the debtor's rationale for rejecting the wholesale power agreements in *Calpine* was addressed squarely to the reasonableness of the rates under the contracts, which were below market value. Given FERC's exclusive jurisdiction under the FPA to determine whether rates are reasonable, the district court in *Calpine* had little difficulty resolving the resulting conflict in favor of FERC. This conclusion appears to have been based in large part upon the court's perception that the specific policy considerations entrusting wholesale power rate regulation authority to FERC should outweigh the more general policy considerations empowering a bankruptcy court to authorize the rejection of any contract that burdens the estate.

Such preemption is not without support in the Bankruptcy Code. Section 1129(a)(6) provides that a chapter 11 plan may not be confirmed unless "[a]ny governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval." As noted, the Bankruptcy Court also exempts regulatory agency action from the scope of the automatic stay. Thus, Congress expressly anticipated situations in which other federal regulatory schemes would establish limitations on a bankruptcy court's otherwise exclusive jurisdiction to deal with a debtor's executory contracts.

Unfortunately, Congress expressly limited these circumstances to chapter 11 plans and actions to enforce a federal agency's regulatory powers during the course of a bankruptcy case. Both the *Mirant* and *Calpine* courts readily acknowledged that the Bankruptcy Code does not on its face contain any special restrictions on the ability of a trustee or DIP to reject a FERC-regulated rate agreement under section 365(a) of the Bankruptcy Code. Still, both the Fifth Circuit and the New York district court have created limitations on that power where they perceive it directly conflicts with FERC's regulatory powers.

Moreover, even where there is no intrusion, the Fifth Circuit postulated that a different standard should apply for rejection, remarking that the "[u]se of the business judgment standard would be inappropriate in this case because it would not account for the public interest inherent in the transmission and sale of electricity." Instead, the Court of Appeals suggested, rejection of an executory power contract should be permitted only upon a showing that: (a) the contract is burdensome to the estate; (b) the equities favor rejection; and (c) the rejection "would further the Chapter 11 goal of permitting the successful rehabilitation of debtors." In applying this test, courts should give particular consideration to the public interest and should ensure that the rejection will not disrupt power delivered "to other public utilities or to consumers."

In *Calpine*, the district court was even less generous with a bankruptcy court's retained prerogative to modify FERC-regulated contracts. Given the "business judgment" standard

traditionally applied to executory contract rejection and its concerns regarding the important policy implications of allowing "a bankruptcy court to sit in judgment of FERC's determination of the public interest," the district court expressed the (purely advisory) view that FERC's jurisdiction should necessarily preempt a bankruptcy court's discretion to authorize rejection in all instances.

The problem is that neither exclusion of FERC contracts from the scope of section 365 altogether nor a heightened standard for the rejection of FERC-regulated rate agreements is found anywhere in the Bankruptcy Code. Congress has clearly delineated restrictions on the ability to reject other kinds of agreements (*e.g.*, collective bargaining agreements or retiree benefit contracts) where it saw fit to provide special consideration to the non-debtor parties to the agreement. The absence of any such express limitations with respect to FERC-regulated rate agreements suggests that *Mirant* and *Calpine* may be open to challenge — so much so, that the U.S. Supreme Court may be asked to resolve the issue definitively.

The practical ramifications of the rulings for potential debtors seeking to disavow onerous FERC-regulated contracts are fairly clear. At best, unless a convincing case can be made that the regulated rates themselves are not the primary impetus for terminating the contracts, rejection under section 365(a) of the Bankruptcy Code would not appear to be a viable option.

In re Mirant Corp., 378 F.3d 511 (5th Cir. 2004).

In re Calpine Corp., 337 B.R. 27 (S.D.N.Y. 2006).

In Brief: Supreme Court Ruling on Sovereign Immunity

Revisiting an issue that it left unresolved 10 years ago, the U.S. Supreme Court ruled on January 23, 2006, in *Central Virginia Community College v. Katz* that the states agreed not to assert sovereign immunity from a bankruptcy trustee's suit to avoid a preferential transfer when they ratified the Constitution's bankruptcy clause. In its first bankruptcy ruling of 2006, the Court reexamined its 1996 decision on the scope of a state's 11th Amendment immunity in *Seminole Tribe of Florida v. Florida*. Both the majority and the dissenters in *Seminole* assumed that a statement in that case — that Congress lacks authority under Article I to abrogate a state's immunity — would apply in the bankruptcy context.

Writing for the 5-4 majority in *Katz*, Justice John Paul Stevens explained that the statement in *Seminole* was nothing more than non-binding dicta, and concluded that the "relevant 'abrogation' is the one effected in the plan of the [Constitutional] Convention, not by statute." In a dissenting opinion, Justice Clarence Thomas, joined by Chief Justice John G. Roberts, Jr., and Justices Antonin Scalia and Anthony M. Kennedy, argued that "history confirms that the adoption of the Constitution merely established federal power to legislate in the area of bankruptcy law, and did not manifest an additional intention to waive States' sovereign immunity against suit." According to the dissent, the bankruptcy clause is no different from other Article I provisions, such as the patent and commerce clauses, that were "motivated by the Framers' desire for nationally uniform legislation," yet do not authorize abrogating state immunity.

Section 106(a) of the Bankruptcy Code provides that a "governmental unit" is deemed to waive sovereign immunity in connection with litigation commenced under many provisions of the Bankruptcy Code, including preference and fraudulent transfer avoidance actions and proceedings seeking to establish the dischargeability of a debt. Previous rulings handed down by the Supreme Court and the highest appellate courts cast doubt on the validity of section 106(a). *Katz* would appear to have put an end to the debate, but not entirely. Although the majority opinion concludes that, in ratifying the Constitution, the states "acquiesced in a subordination of whatever sovereign immunity they might otherwise have asserted in proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts," Justice Stevens cautioned that not every bankruptcy law may properly impinge on state sovereignty. This leaves open the possibility that section 106(a) may not pass muster in situations not involving a bankruptcy court's *in rem* jurisdiction over a debtor's property or its debts.

Central Virginia Community College v. Katz, 126 S. Ct. 990 (2006).

CRAMDOWN OF SECURED CREDITOR UNDER CHAPTER 11 PLAN REQUIRES MARKET RATE OF INTEREST

H. Joseph Acosta

If the proponent of a chapter 11 plan cannot obtain the requisite percentage of creditor votes to achieve consensual confirmation of the plan, the plan may still be confirmed under certain circumstances over the objection of dissenting classes of creditors. Non-consensual confirmation, commonly referred to as a "cramdown," requires the debtor to prove that its proposed plan does not discriminate unfairly against the non-accepting class and is otherwise fair and equitable. Although these cramdown standards seem fairly straightforward, their application can sometimes be extremely complicated. Such was the case in the chapter 11 bankruptcy of American HomePatient, Inc., where the Sixth Circuit Court of Appeals was asked to determine, using the "fair and equitable" standard, what the appropriate cramdown interest rate should be for an impaired class of secured creditors that had rejected the debtor's chapter 11 plan.

CRAMDOWN

The cramdown provisions in the chapter 11 context appear in section 1129(b) of the Bankruptcy Code. Section 1129(b)(1) provides that a bankruptcy court may confirm a plan of reorganization, despite objections by 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." A plan discriminates unfairly if it treats a dissenting class of creditors less favorably than other classes of creditors that are similarly situated in terms of their legal rights to payment.

Whether the proposed treatment of a class is "fair and equitable" hinges on whether the creditors in the class are secured or unsecured. For a dissenting class of unsecured creditors, section 1129(b)(2)(B) provides that a plan will be deemed fair and equitable if, among other things, no class of claimants or interest holders that are junior in priority to the dissenting class receive any property on account of their junior claims or interests. This principle is sometimes referred to as the "absolute priority rule."

For a dissenting class of secured creditors, section 1129(b)(2)(A) provides that a plan will be deemed fair and equitable if it allows creditors to retain liens securing their claims and receive deferred cash payments equivalent to the present value of their claims, as of the effective date of the plan. The deferred cash payment requirement essentially entails providing secured creditors with an appropriate rate of interest that will allow them to realize the present value of their claims, notwithstanding that they will be paid over time under the proposed plan. The Bankruptcy Code does not specify, however, how bankruptcy courts are to calculate the appropriate cramdown interest rate.

The U.S. Supreme Court recently provided limited guidance in applying the "fair and equitable" standard to secured creditors in *Till v. SCS Credit Corp*. There, the Supreme Court evaluated four widely used methods of calculating the cramdown interest rate (the coerced loan, presumptive contract rate, formula rate, and cost of funds approaches) and concluded that all but the formula rate approach suffered from serious flaws. According to the Supreme Court, "[e]ach of these [other] approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value." In contrast, the Supreme Court observed, "the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings."

Under the formula rate approach, a bankruptcy court begins its analysis by looking at the national prime rate, "which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation and the relatively slight risk of default." The bankruptcy court is then required to adjust the prime rate to take into account that "bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers." In this regard, the Supreme Court noted that courts which have used the prime rate have generally approved adjustments from 1 to 3 percent.

Till, however, was a chapter 13 consumer bankruptcy case. Even the Supreme Court acknowledged that its reasoning might be of limited application in the chapter 11 context, where there is a more robust market for debtor-in-possession financing, and "it might make sense to ask what rate an efficient market would produce" in picking a cramdown rate of interest. This was the issue addressed by the Sixth Circuit in *American HomePatient*.

AMERICAN HOMEPATIENT

American HomePatient was a large, publicly held company, with more than 280 affiliates and subsidiaries in 35 states, specializing in providing home health-care services and products. Between 1994 and 1998, it borrowed between $278 and $290 million, primarily to implement its strategy of investing in dozens of new branch offices. To obtain such funding, American HomePatient had given the lenders that provided this funding a security interest in its assets.

After it filed for chapter 11 protection in 2002, American HomePatient filed a plan of reorganization that proposed to pay back the lenders over a certain period of time with interest, using an interest rate equivalent to a six-year Treasury note plus 3.5 percent (or 6.785 percent). The lenders rejected the proposed treatment of their secured claims under the plan, arguing, among other things, that the appropriate interest rate should be substantially higher. American HomePatient thus sought to confirm the plan over the lenders' dissent pursuant to the cramdown provisions in the Bankruptcy Code.

Because the Supreme Court's ruling in *Till* was rendered after the debtor's plan had been confirmed, the bankruptcy court did not have the benefit of the decision in rendering its ruling. Instead of using the formula rate, as prescribed by *Till*, the bankruptcy court, relying on existing Sixth Circuit precedent, employed the coerced loan theory to determine the appropriate cramdown interest rate to apply to the lenders' claims. Under this theory, courts treat the deferred payment obligation under a chapter 11 plan as a coerced loan, where the rate of return for the lender corresponds to the rate that the lender would charge a third party, with similar terms, duration, collateral, and risk. After the bankruptcy court's order confirming the chapter 11 plan was affirmed by the district court, the lenders appealed to the Sixth Circuit.

THE SIXTH CIRCUIT'S RULING

Relying on the Supreme Court's rejection of the coerced loan approach in *Till*, the lenders argued, on appeal, that the bankruptcy court's decision should be reversed on the basis that it did not use the correct cramdown approach. The Sixth Circuit disagreed. Because *Till* was decided in the context of a chapter 13 case, the Sixth Circuit found that the ruling had limited application in chapter 11 cases.

According to the Sixth Circuit, in chapter 13 cases the use of the formula approach is appropriate because, as the Supreme Court noted, there is no readily apparent chapter 13 cramdown market rate of interest. This is due to the fact that every cramdown loan in a chapter 13 case is imposed by the court on the secured creditor, which otherwise would not likely elect to continue its relationship with the debtor. The Court of Appeals observed, however, that "the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession." Accordingly, the Sixth Circuit explained, "when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."

Based on this reasoning, the Sixth Circuit refused to "blindly adopt *Till*'s endorsement of the formula approach" and, instead, concluded that a bankruptcy court must use a market rate in chapter 11 cases. The Sixth Circuit added the caveat, however, that when no efficient market exists for a chapter 11 debtor, then the bankruptcy court must employ the formula approach, as prescribed by *Till*.

Applying these principles to the cramdown rate in American HomePatient's plan, the Sixth Circuit found that the bankruptcy court had in fact sought to determine what an efficient market would have produced for the loan that the lenders had provided pre-bankruptcy, albeit under the rubric of the coerced loan theory. According to the Sixth Circuit, the bankruptcy court had properly weighed the testimony of the various experts opining at the confirmation hearing and carefully considered the circumstances. The lenders' expert testified that a composite rate of interest, blending the rate for various tiers of financing (*i.e.*, senior debt, mezzanine debt, and equity), should be used because it represented a loan that, while theoretical, could have been obtained by the debtors,

given their leveraged position. On the other hand, American HomePatient's expert testified that the lenders' loan represented typical senior debt, the market for which demanded a rate that was closer to the one American HomePatient proposed in its plan. The bankruptcy court ultimately agreed with American HomePatient's expert, finding the lenders' multitiered financing approach inapplicable. It also disfavored the composite rate because such rate would have provided the lenders with "a premium on their return because the debtor filed for bankruptcy." Finding no error with this reasoning, the Sixth Circuit affirmed the order confirming American HomePatient's plan.

LOOKING FORWARD

Because of *Till*'s recent pronouncement, the opinions addressing its applicability in chapter 11 cases are sparse. As noted by the Sixth Circuit, although some commentators have suggested that *Till*'s formula approach should be applied in all bankruptcy cases, only a handful of courts have issued opinions in this area — and with mixed results. It would appear that the Supreme Court has simply left this area of law to be resolved by the lower courts. Because of the implications on the rate of return that secured lenders are entitled to receive in chapter 11 cases, however, lenders will be watching carefully to see whether courts line up behind *American HomePatient* or simply adopt the formula approach prescribed by *Till* as the default.

In re American HomePatient, Inc., 420 F.3d 559 (6th Cir. 2005).

Till v. SCS Credit Corp., 541 U.S. 465 (2004).

EVER-EXPANDING SECTION 363(B): COMPENSATION OF ATTORNEY AUTHORIZED AS NON-ORDINARY COURSE USE OF ESTATE PROPERTY

Debra K. Simpson and Mark G. Douglas

The retention and compensation of bankruptcy professionals have recently been the focus of a fair amount of controversy, particularly in complex "mega" cases involving a full panoply of sophisticated lawyers, accountants, and financial advisors. More than ever before, bankruptcy courts have been called upon to scrutinize potentially disqualifying conflicts of interest and non-traditional compensation arrangements to ensure that proposed professional retentions comply with the Bankruptcy Code's rigorous requirements.

The statutory procedures governing professional retentions and compensation in bankruptcy are well established. Even so, a ruling recently handed down by a New York district court suggests that the mechanism traditionally employed to engage a professional may not be the exclusive means of doing so, albeit in a narrow range of circumstances. In *In re Enron Corp.*, the court held that a debtor-in-possession ("DIP") can be authorized to retain and pay a law firm to represent employees as an appropriate non-ordinary course use of estate assets.

RETENTION AND COMPENSATION OF PROFESSIONALS IN BANKRUPTCY

Bankruptcy trustees, DIPs, and statutory committees are permitted to retain a wide variety of professionals, including lawyers, accountants, auctioneers, and investment bankers, to represent their interests during a bankruptcy case. In most cases, professionals are engaged pursuant to sections 327(a) and 1103 of the Bankruptcy Code, which authorize these entities, subject to bankruptcy court approval, to employ "disinterested" professionals to represent them during the course of the bankruptcy. A trustee or DIP may also retain a lawyer for a "special purpose" other than acting as general bankruptcy counsel under section 327(e) (*e.g.*, in connection with discrete litigation, real estate, or labor matters).

Professionals retained under sections 327 or 1103 are paid in accordance with the interim and final compensation procedures delineated in sections 330 and 331 of the Bankruptcy Code. Those procedures contemplate court scrutiny of services for which compensation is sought, and the discretion to reduce, or in some cases augment, the allowed amount of fees based upon the court's determination of what is reasonable and necessary under the circumstances.

Alternatively, section 328 provides for the retention and compensation of professionals "on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, or on a contingent fee basis." If the bankruptcy court approves a fee arrangement under section 328, it retains the discretion to revisit that decision and modify the compensation to be paid, but only if the terms specified in the retention order "prove to have become improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions."

A separate provision in the Bankruptcy Code governs non-ordinary course expenditures of estate assets for purposes other than compensating professionals retained under sections 327, 328, or 1104. Section 363(b) provides that a trustee or DIP, with bankruptcy court approval, "may use, sell, or lease, other than in the ordinary course of business, property of the estate." In considering a request to use estate assets outside the ordinary course of a debtor's business, courts use the "business judgment" test. That is, courts generally will grant the request if the debtor articulates a sound business reason for the use of the assets. Whether a DIP can rely on section 363(b), rather than section 327, to justify the retention of a lawyer was addressed by the New York district court in *Enron*.

THE DISTRICT COURT'S RULING IN *ENRON*

Enron Corporation and approximately 90 affiliated companies began filing for chapter 11 protection in December of 2001. Both Enron and the creditors' committee appointed in the cases were authorized to retain counsel under sections 327(a) and 1103, respectively. Enron also sought and obtained court authority to retain special counsel under section 327(e) to represent the company in connection with various investigations into its affairs being conducted by Congress, the Securities and Exchange Commission, the Department of Labor, and the Department of Justice. On the recommendation of its lawyers, who determined that various Enron employees should retain independent counsel in connection with the government investigations, Enron filed an application with the bankruptcy court to retain (and pay) lawyers for its employees.

Enron cited sections 105(a) (giving the bankruptcy court broad equitable powers), 327, and 363(b) as the statutory predicates for the retention. According to Enron, its reorganization efforts would benefit from the expedient completion of the investigations, and independent counsel for the employees would facilitate that goal because the employees would be both more likely to focus on their work and more willing to cooperate if assured that their rights were being protected. Enron also claimed that having one law firm represent all the employees would facilitate the coordination of employee responses to investigators' requests. If retained, Enron stated, special counsel would represent only those employees who were not themselves the target of investigation. In addition, Enron argued that the proposed retention was supported by a "sunshine policy" in chapter 11 cases, which favors actions designed to reveal the causes of losses to creditors.

The creditors' committee opposed the retention, contending, among other things, that it was not in Enron's best interests because some of the employees might provide testimony adverse to the company's economic interests. The bankruptcy court approved Enron's motion under sections 105(a), 327, and 363(b), ruling that Enron had demonstrated a need for retaining lawyers on behalf of its employees and that any potentially negative impact on Enron from certain employees' testimony was outweighed by the benefits provided by the representation. The committee appealed the ruling.

The committee fared no better before the district court. Among other things, the committee argued that section 363(b) cannot be used to approve the payment of legal fees because section 327(e) expressly contemplates the retention by a DIP of a "special purpose" attorney. The district court rejected this argument, explaining that courts are not prohibited from authorizing a certain category of payments under section 363(b) simply because another section

of the Bankruptcy Code also relates to the same category. According to the court, even though section 327(e) provides for the retention of attorneys (and therefore payment of their legal fees under sections 330, 331, or 328), nothing in section 327 "suggests that Congress intended [section 327(e)] to be the exclusive authority" for doing so. Moreover, the court observed, section 327(e) provides for the retention of an attorney to represent a DIP, not third parties such as a debtor's employees.

The decision is important because it illustrates the expanding versatility of section 363(b) as a vehicle for authorizing the expenditure of estate funds to pay for a wide range of costs and expenses deemed necessary to the success of a chapter 11 case.

The district court then addressed the committee's contention that the retention did not represent a sound exercise of Enron's business judgment. At the outset, it found lacking any evidence of undue influence on the part of Enron insiders such that the proposed retention should be subjected to heightened scrutiny rather than the business judgment test. Based upon the sound reasons articulated by Enron before the bankruptcy court to justify the retention, the district court concluded that deference to Enron's business judgment was appropriate under the circumstances. It accordingly affirmed the bankruptcy court's ruling.

OUTLOOK

The significance of the district court's ruling in *Enron* lies primarily outside the realm of professional retention and compensation in a bankruptcy case — if Enron were attempting to hire lawyers to represent itself, there is little room for doubt that sections 363(b) and 105(a) would not be the appropriate statutory predicates. In addition, the employees themselves could not have relied on any of the provisions in question to retain and have the estate pay the attorneys; in fact, the employees, as creditors, would have to establish that their actions somehow made a "substantial contribution" to the chapter 11 case and that, therefore, payment of their attorneys' fees was appropriate under section 503 of the Bankruptcy Code.

Even so, the decision is important because it illustrates the expanding versatility of section 363(b) as a vehicle for authorizing the expenditure of estate funds to pay for a wide range of costs and expenses deemed necessary to the success of a chapter 11 case. In addition to providing authority for retaining and compensating professionals, section 363(b) has recently been successfully relied upon as authority for paying the pre-petition claims of "critical" vendors, a practice that, when based upon the controversial "doctrine of necessity," has been increasingly subjected to criticism.

In re Enron Corp., 335 B.R. 22 (S.D.N.Y. 2005).

DRAW ON LETTER OF CREDIT NOT LIMITED BY CAP ON LANDLORD CLAIMS

Nicholas M. Miller and Joshua P. Weisser

Parties to commercial transactions routinely employ letters of credit as a means of minimizing credit exposure and shifting the risk of non-performance. As a general rule, even a bankruptcy filing by the account debtor will not prevent the beneficiary from drawing on a letter of credit because the letter of credit is not deemed property of the debtor's bankruptcy estate, and the obligation of the issuing bank to honor the letter of credit is wholly independent of the account debtor's obligation to pay the underlying debt. This "independence principle" is crucial to the efficient operation of the credit markets and the cornerstone of letter-of-credit law.

Letters of credit have become an increasingly common feature of commercial leases as an alternative to traditional security deposits. In this context, the general rule permitting unfettered access to the proceeds of a letter of credit notwithstanding a bankruptcy filing by the obligor may conflict with certain limitations contained in the Bankruptcy Code on the maximum claim allowed to a landlord for damages resulting from breach of a lease. This apparent conflict was addressed in a ruling recently handed down by the Fifth Circuit Court of Appeals. In *In re Stonebridge Technologies, Inc.*, the Court of Appeals held that a landlord could draw down on a letter of credit even though the amount in question exceeded the statutory cap on landlord claims because the landlord never filed a proof of claim in the lessee's bankruptcy case.

LETTERS OF CREDIT AND THE INDEPENDENCE PRINCIPLE

The ordinary letter-of-credit scenario involves three distinct obligations: (i) the account debtor's obligation to make payment or perform under a contract or lease; (ii) the issuing bank's obligation to pay on the letter of credit when presented by the beneficiary; and (iii) the account debtor's obligation to reimburse the issuer. As a general rule, the issuer's obligation to pay the beneficiary when presented with a demand that conforms with the specifications stated in the letter of credit is completely independent of any obligations arising under the contract between the account debtor and the beneficiary. This rule is sometimes referred to as the "independence principle." As applied, it means that neither the letter of credit nor its proceeds belong to the account debtor, and neither constitutes property of the debtor's estate if it later files for bankruptcy.

It has become increasingly common for landlords to obtain security deposits in the form of letters of credit. The latter offer certain advantages over traditional security deposits. Among these are the landlord's ability to draw on the proceeds as a remedy for breach even if the lessee files for bankruptcy protection. On the flip side, letter-of-credit transactions are more complex than traditional security deposits, and more actions are required after delivery to recover funds under a letter of credit.

REAL PROPERTY LEASE CLAIMS IN BANKRUPTCY

Notwithstanding the independence principle, a bankruptcy filing by the lessee could prevent a landlord from taking full advantage of security given under a lease in the form of a letter of credit. This is so because the Bankruptcy Code caps the maximum claim allowed to a landlord arising from the termination of a lease. Under section 502(b)(6), claims resulting from termination of a lease are limited to the rent reserved by the lease, without acceleration, for the greater of either (i) one year or (ii) 15 percent of the remaining lease term (not to exceed three years). The remaining lease term is measured by the earlier of the petition date or the date on which the landlord repossessed or the debtor surrendered the property. The cap is intended to compensate the landlord for the loss associated with the termination of the lease while at the same time preventing the lease-termination claim from overwhelming the pool of general unsecured claims.

In the case of a secured landlord, most courts hold that the deposit or other security must be applied towards the capped claim, and that any excess must be returned to the bankruptcy estate. This approach, however, would appear to be fundamentally at odds with the independence principle, which removes the proceeds in their entirety from the reach of the lessee's bankruptcy estate. This incongruity was the subject of the Fifth Circuit's ruling in *Stonebridge Technologies*.

STONEBRIDGE TECHNOLOGIES

Stonebridge Technologies, Inc., and EOP-Colonnade of Dallas Limited Partnership (the "landlord") entered into a lease agreement for certain office space in 2001. Stonebridge's obligations under the lease were secured by a $1.4 million irrevocable standby letter of credit issued by the Bank of Oklahoma. As partial security for its potential obligation to reimburse the bank in the event of a draw on the letter of credit, Stonebridge executed a secured note in the amount of $1.25 million.

Stonebridge owed the landlord back rent and other miscellaneous charges under the lease when it filed for bankruptcy in 2001. When it failed to pay post-petition rent, the landlord sought an order from the bankruptcy court compelling payment of all amounts outstanding. Stonebridge and the landlord ultimately reached a settlement whereby Stonebridge would reject the existing lease and enter into a new short-term lease for the premises. The bankruptcy court order authorizing rejection of the lease fixed the landlord's claims for unpaid pre- and post-petition rent but did not address the issue of rejection damages. The landlord never filed a proof of claim for amounts due under the lease.

Shortly before the court authorized rejection of the lease, the landlord initiated a draw request for the full amount of the letter of credit. The undisputed amount of the landlord's rejection damages at the time was between $1.5 and $1.6 million, based on the acceleration formula under the lease. The rejection damage cap in section 502(b)(6) would have limited the landlord's damages to approximately $1.35 million. The bank honored the letter of credit and disbursed $1.4 million to the landlord.

Stonebridge confirmed a liquidating chapter 11 plan. The liquidating trustee sued the landlord, claiming, among other things, that the landlord had prematurely drawn on the letter of credit and that any proceeds exceeding the section 502(b)(6) cap should be returned to Stonebridge's estate. The bankruptcy court's ruling in favor of the trustee was affirmed on appeal by the district court.

The Fifth Circuit Court of Appeals reversed. It ruled that the landlord did not draw on the letter of credit prematurely because, in accordance with the independence principle, the letter of credit was not estate property. The terms of the letter of credit, the Fifth Circuit explained, permitted the landlord to make a demand if, among other things, there was a "monetary default" that remained uncured for at least five days after delivery of a notice of default to the debtor. These conditions were fulfilled. In addition, the Court of Appeals noted, a provision in the letter of credit authorizing the landlord to draw down the proceeds in the event of Stonebridge's insolvency — an unenforceable "*ipso facto*" clause under section 365(e)(1) of the Bankruptcy Code if applied to trigger forfeiture of a debtor's rights — was valid in this case because it did not involve Stonebridge or property of its bankruptcy estate.

Stonebridge Technologies highlights the need for landlords to carefully evaluate their claims and the extent of their security before filing a proof of claim.

Regarding the section 502(b)(6) cap, the Fifth Circuit held that a "claim of a lessor against the assets of the estate is an essential precondition to applying the damages cap at all." Because the landlord had not filed a proof of claim in Stonebridge's chapter 11 case, the Court of Appeals explained, other decisions requiring landlords to remit security applied in excess of the statutory limitation were distinguishable. To hold otherwise, the Fifth Circuit observed, would convert section 502(b)(6) "into a self-effectuating avoiding power that would allow the trustee to bring an adversary proceeding against a lessor who exercises his rights under a letter of credit." According to the Court of Appeals, this would be a clear departure from the plain language of section 502(b)(6), which "allows only one thing — disallowance of the filed claim to the extent that it exceeds the statutory cap."

OUTLOOK

Stonebridge Technologies highlights the need for landlords to carefully evaluate their claims and the extent of their security before filing a proof of claim. In *Stonebridge Technologies*, had the landlord filed a proof of claim, its claim for damages arising from rejection of the lease (principally future rent) would have been subject to the statutory cap, and it would have been compelled to return nearly $100,000 in proceeds from the letter of credit to the bankruptcy estate. With different facts, the forfeited security could have been even greater.

Most courts hold that section 502(b)(6) limits a landlord's claim even if the debtor posted a security deposit in an amount exceeding the cap. Some courts, including the Third Circuit Court of Appeals, have applied the same reasoning to limit lease rejection claims where the security posted was a letter of credit. In *Stonebridge Technologies*, the Fifth Circuit suggests that these cases are distinguishable because the landlords filed proof of their claims. Given the purpose of section 502(b)(6) and the increasing reliance of commercial lessors on letters of credit as an alternative to traditional security deposits, the distinction may be one of form over substance.

In re Stonebridge Technologies, Inc., 430 F.3d 260 (5th Cir. 2005).

Solow v. PPI Enterprises, Inc. (In re PPI Enterprises, Inc.), 324 F.3d 197 (3d Cir. 2003).

Redback Networks, Inc. v. Mayan Networks Corp. (In re Mayan Networks Corp.), 306 B.R. 295 (Bankr. 9th Cir. 2004).

20 LARGEST PRE-PACKAGED AND PRE-NEGOTIATED PUBLIC BANKRUPTCIES

Company	Filing Date	Assets (Billions)	Confirm Date
Conseco, Inc.	12/18/02	$61.4	09/09/03
The FINOVA Group, Inc.	03/07/01	$14.1	08/10/01
NTL, Inc.	05/08/02	$13.0	09/06/02
Reliance Group Holdings, Inc.	06/12/01	$12.6	11/07/05
NRG Energy, Inc.	05/14/03	$10.8	11/24/03
XO Communications, Inc.	06/17/02	$7.9	11/15/02
Home Holdings, Inc.	01/15/98	$7.6	06/09/98
Williams Comms. Group, Inc.	04/22/02	$6.0	09/30/02
McLeodUSA, Inc. (2002)	01/30/02	$4.8	04/05/02
CHS Electronics, Inc.	04/04/00	$3.6	07/27/00
Southland Corp.	10/24/90	$3.4	02/21/91
SpectraSite Holdings, Inc.	11/15/02	$3.2	01/28/03
Sunbeam Corp.	02/06/01	$3.1	11/25/02
United States Leather, Inc.	05/11/98	$2.6	07/07/98
Trans World Airlines, Inc. (1995)	06/30/95	$2.5	08/04/95
Sun Healthcare Group, Inc.	10/14/99	$2.5	02/06/02
RCN Corporation	05/27/04	$2.3	12/08/04
Leap Wireless International, Inc.	04/13/03	$2.2	10/21/03
Atlas Air Worldwide Holdings, Inc.	01/30/04	$2.1	07/16/04
AMF Bowling, Inc.	07/03/01	$1.7	02/01/02

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