JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 6 ▪ NO. 2 ▪ MARCH/APRIL 2007

BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

FIRST OPINIONS: BANKRUPTCY COURTS' RECENT RULINGS ON TWENTY DAY CLAIMS

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As part of the 2005 revisions of the Bankruptcy Code, Congress greatly enhanced the priority of claims asserted by suppliers of goods to debtors in the 20-day period immediately prior to a debtor's bankruptcy filing by enacting new section 503(b)(9). This new provision raises several interesting issues, some of which were addressed by two recent cases examining the question of when such claims are to be paid.

THE LANGUAGE OF SECTION 503(b)(9)

Section 503(b)(9) of the Bankruptcy Code provides an administrative priority for claims — so-called Twenty Day Claims — for goods received by a debtor in the 20-day period immediately proceeding the debtor's bankruptcy filing. Specifically, this new provision provides:

> After notice and a hearing, there shall be allowed administrative expenses . . . including . . . the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

A simple reading of this section presents several questions:

What are "goods"? The term is not defined in the statute. One likely source of a definition is the Uniform Commercial Code, which includes a very broad definition of "goods" that has been utilized by bankruptcy courts in other contexts.

How is the "value of goods" determined? The agreed-upon purchase price might be considered strong or even conclusive evidence of the value of the goods, but arguably should simply create an evidentiary presumption that a debtor might seek to rebut.

How is it determined when goods are "received"? Arguably, when delivery occurs should be determined under state law, but the statute offers no guidance, and creditors or debtors might argue that actual possession is necessary under the statute.

How is the "ordinary course" of the debtor's business determined? It likely will be determined by reference to existing bankruptcy case law interpreting the phrase "ordinary course" in other contexts, but there are reasonable arguments that such interpretations are not well suited for use in the context of section 503(b)(9) due to the different purpose of this provision.

While one can argue that these questions should be answered in the manner suggested above, even the most basic questions that arise from a simple reading of the provision have not been definitively answered, making it clear that Congress left open a number of issues in enacting this provision.

HOW IS A TWENTY DAY CLAIM ASSERTED?

In addition to the above issues that are apparent after reviewing the face of section 503(b)(9), other issues lurk below its surface. In fact, one important practical issue is how a claimant is to procedurally assert its Twenty Day Claim. In this regard, neither the statute nor case law provides a clear answer.

On the one hand, administrative claims (if not paid in the ordinary course) are asserted through the filing with the bankruptcy court of a request for allowance and payment on the main docket of the bankruptcy case and request the court's attention to grant affirmative relief. On the other hand, pre-petition claims are normally asserted through the proof-of-claim process and not on the main docket. Proofs of claim do not demand the immediate attention of the court but are deemed valid unless a party-in-interest objects. Twenty Day Claims, however, are both administrative claims and pre-petition claims. Accordingly, the process under which they are to be asserted is simply not clear.

From a legal perspective, Twenty Day Claims arguably should be filed as part of the proof-of-claim process because such claims — like other types of priority pre-petition claims — are subject to Federal Rules of Bankruptcy Procedure that govern the assertion of pre-petition claims and objections thereto. Practical considerations strongly support the same result. From a simple administrative standpoint, no debtor in a medium-sized or large chapter 11 case — and no bankruptcy court — will want hundreds of requests for payment flooding the main bankruptcy docket and demanding the court's and the debtor's time in the midst of other key restructuring activities. The proof-of-claim process is more easily administered by the debtor and more efficient for the court. Moreover, proofs of claim can be filed by the claimant itself and need not be filed by an outside attorney, which typically would be required in filing a request for payment of administrative expense on the docket.

Whatever the rule, creditors should keep a sharp eye on any procedural requirements adopted in their particular case and, where unclear, seek clarification to ensure that they do not inadvertently waive their rights to this new and valuable priority.

WHEN IS A TWENTY DAY CLAIM TO BE PAID?

Another important issue that is left open by the provision is when a Twenty Day Claim is to be paid. The only applicable statutory requirement is that Twenty Day Claims, like other administrative claims, must be paid by the effective date of the debtor's chapter 11 plan. Prior to the enactment of new section 503(b)(9), administrative claim jurisprudence left questions of timing of payment of administrative claims to the discretion of the bankruptcy court. This statutory flexibility resulted in a variety of decisions, with some courts ordering that payment of certain kinds of administrative claims be delayed until the end of a chapter 11 case, while others ordered payment of other kinds of administrative claims at earlier points in time. Whether this case law continues to apply to Twenty Day Claims is an open issue.

> While a seemingly minor revision to the Bankruptcy Code, the enactment of section 503(b)(9) has greatly shifted the dynamic between debtors and their suppliers in a number of interesting, untested, and unexpected ways.

Instead of simply applying traditional tests to the question of when section 503(b)(9) claims should be paid, a bankruptcy court could rule in a number of ways, including by authorizing: (a) payment in the ordinary course at the start of the bankruptcy case; (b) payment as soon as the claim is allowed; (c) payment at the end of the case, upon plan confirmation; or (d) payment at the discretion of the debtors.

This timing-of-payment issue is the subject of two recent decisions of bankruptcy courts located within the Third Circuit: *In re Bookbinders' Restaurant, Inc.* out of the Eastern District of Pennsylvania and *In re Global Home Products, LLC* out of the District of Delaware.

BOOKBINDERS

In *Bookbinders*, the debtor and various holders of Twenty Day Claims resolved such claims, which were liquidated and allowed in agreed-upon amounts. One of the creditors thereafter asserted that it was entitled to immediate payment of its allowed Twenty Day Claim. The court rejected the supplier's argument that Twenty Day Claims must be paid immediately as a matter of law but reserved the question of whether it would order the claim paid in an exercise of the court's discretion.

In reaching this holding, the court relied on three primary facts. First, it noted that nothing in the text of section 503(b) (including subsection (9)) requires immediate payment of such claims. Second, the court noted that the normal rationale for paying post-petition administrative claims is that such claims arise from ordinary-course transactions with the post-petition debtor-in-possession and thus may be payable under section 363(c) of the Bankruptcy Code. By contrast, the court explained, Twenty Day Claims do not arise from transactions with the debtor-in-possession but instead arise from transactions with the pre-petition debtor, making section 363(c) completely inapplicable. Finally, the court noted that, in other provisions of the Bankruptcy Code, Congress made it clear when claims were to be paid as a matter of law, and concluded that "had Congress intended to provide §503(b)(9) claimants with some type of enhanced right to payment after allowance of the expense, I am convinced that it would have made its intent express in the statute."

While the reasoning of the court suggested that it would not be inclined to order immediate payment of Twenty Day Claims, the court ultimately held that it was within its discretion to order such claims paid, and the court scheduled an evidentiary hearing on that question. The creditor, however, realizing that it was unlikely to prevail, withdrew the motion prior to hearing.

GLOBAL HOME PRODUCTS

In *Global Home Products*, shortly after the debtor's bankruptcy filing, a supplier to the debtor filed a motion seeking immediate allowance and payment of its Twenty Day Claim. Unlike in *Bookbinders*, however, the debtor did not argue that all Twenty Day Claims should be paid at the end of the case as a matter of law, and the creditor did not argue that all such claims should be paid immediately as a matter of law. Instead, both the debtor and the creditor agreed that the normal standards applicable to payment of post-petition administrative claims would apply.

The court then applied the extant standard tests for determining the timing of payment of administrative claims in the District of Delaware, including consideration of prejudice to the debtor and hardship to the claimant. In this regard, the debtor produced evidence that it did not have sufficient cash to pay all of its Twenty Day Claims and that a court order requiring it to pay such claims could violate its post-petition financing facility's terms and would cause its reorganization efforts to collapse. Because the creditor could afford to wait for payment and was not itself in financial distress, the bankruptcy court ultimately concluded that the balance of equities favored the debtor. Thus, immediate payment was not required.

Ultimately, the results in *Bookbinders* and *Global Home Products* are somewhat unsatisfying, as both courts applied (or ruled that they would apply) the traditional test for whether administrative claims should be paid and did not address the special nature of Twenty Day Claims or clearly articulate a rationale justifying application of the old tests in this new context. That said, the fact that the court ruled in favor of the debtor in both cases suggests that, whatever the logic applied, creditors may have a difficult time obtaining rulings from bankruptcy courts ordering immediate payment of such claims.

CONCLUSION

While a seemingly minor revision to the Bankruptcy Code, the enactment of section 503(b)(9) has greatly shifted the dynamic between debtors and their suppliers in a number of interesting, untested, and unexpected ways. The decisions of the courts in *Bookbinders* and *Global Home Products* represent bankruptcy courts' initial efforts at interpreting some of the many interesting facets of this new Code section, which will likely be the subject of substantial litigation and dispute for years to come.

In re Bookbinders' Restaurant, Inc., 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006).

In re Global Home Products, LLC, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006).

DISENFRANCHISING CREDITORS IN CHAPTER 11: IN SEARCH OF THE MEANING OF "BAD FAITH" UNDER SECTION 1126(e)

Mark G. Douglas

The ability of a creditor whose claim is "impaired" to vote on a chapter 11 plan is one of the most important rights conferred on creditors under the Bankruptcy Code. The voting process is an indispensable aspect of safeguards built into the statute designed to ensure that any plan ultimately confirmed by the bankruptcy court meets with the approval of requisite majorities of a debtor's creditors and shareholders and satisfies certain minimum standards of fairness. Under certain circumstances, however, a creditor can be stripped of its right to vote on a plan as a consequence of its conduct during the course of a chapter 11 case. A ruling recently handed down by the bankruptcy court presiding over the bankruptcy cases of Adelphia Communications Corporation and its affiliates carefully examines the concept of creditor disenfranchisement in chapter 11. In *In re Adelphia Comm. Corp.,* the court refused to disqualify under section 1126(e) of the Bankruptcy Code the votes of three separate groups of creditors that voted to support the debtors' chapter 11 plan. "Designation," or disqualification, of their votes was unwarranted, the court held, because (i) the creditors' alleged conduct in seeking to benefit their economic interests, though it may have been overly aggressive, did not justify the "draconian" remedy of disenfranchisement; and (ii) the inherent conflict of interest arising from a creditor holding claims against multiple debtors, or claims against a single debtor in different classes, does not in and of itself represent an ulterior motive or "bad faith" warranting designation of a vote.

CHAPTER 11 PLAN VOTING PROCEDURES

The preferred culmination of the chapter 11 process is confirmation of a chapter 11 plan specifying how the claims and interests of all stakeholders in the bankruptcy case are to be treated going forward. Creditors, shareholders, and other stakeholders have a voice in the confirmation process through the Bankruptcy Code's plan voting procedures. Holders of allowed claims and interests have the right to vote to accept or reject a chapter 11 plan. Claimants

NEWSWORTHY

On March 23, 2007, ***David G. Heiman (Cleveland)*** was named president of the American College of Bankruptcy, the premier U.S. organization for bankruptcy and restructuring professionals.

Corinne Ball (New York) sat on an "International Restructuring Panel" discussing the "Challenges of Restructuring in International Environments" on February 16, 2007, at the Third Annual Wharton Restructuring Conference in Philadelphia. On March 2, 2007, she gave a presentation on "Buying a Distressed or Bankruptcy Company" at the 22nd Annual Corporate Mergers & Acquisitions seminar jointly sponsored by the American Law Institute and the American Bar Association in San Francisco. She sat on a panel discussing "Who Should Investigate? Who Should Sue?" on March 24, 2007, at the 2007 Annual Meeting of the American College of Bankruptcy in Washington.

Gregory M. Gordon (Dallas) and ***Debra K. Simpson (Dallas)*** cowrote an article entitled "Code Limits Incentives for Top Talent" that was published in the January/February 2007 edition of *Executive Legal Adviser*.

An article written by ***Brad B. Erens (Chicago)*** and ***Mark G. Douglas (New York)*** entitled "Stock Trading Injunctions in Chapter 11: The Poison Pill Alternative" appeared in the February 2007 edition of *The Bankruptcy Strategist*.

Volker Kammel (Frankfurt) spoke on January 22, 2007, at the 2nd Annual Forum on Distressed Debt & Restructurings sponsored by C5 in Frankfurt. The subject of his presentation was "How to Conduct a Successful Due Diligence on Distressed Assets."

Corinne Ball (New York) chaired a panel discussion on March 15, 2007, entitled "Hot Issues Affecting Second Lien Debt" at the annual spring meeting of the American Bar Association, Business Law Section, in Washington. Her "Distressed Mergers & Acquisitions" column entitled "Delphi and Pre-emptive Takeovers in Chapter 11" appeared in the February 22, 2007, edition of the *New York Law Journal*. The article was prepared with the assistance of ***Sarah M. Friedman (New York)*** and ***Joshua P. Weisser (New York)***.

Gregory M. Gordon (Dallas) recorded a podcast for *Texas Lawyer* on February 8, 2007, entitled "A Loan or an Investment? Recharacterizing Debt as Equity." The podcast is available at no charge at www.texaslawyer.com.

An article written by ***David A. Beck (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Transforming Debt to Equity: Fourth Circuit Rules that Bankruptcy Courts Have the Power to Recharacterize" appeared in the February 2007 edition of the *ABF Journal*.

An article written by ***Mark G. Douglas (New York)*** entitled "In Search of the Meaning of 'Utility'" was published in the February 23, 2007, edition of *Bankruptcy Law 360*.

or equity interest holders whose claims or interests are not "impaired," however, are deemed conclusively to accept the plan, and stakeholders who receive nothing under a plan are deemed to reject it. Any holder of a claim or interest to which an objection has been filed does not have the right to vote the portion of the claim or interest objected to, unless it obtains an order temporarily allowing the claim for voting purposes pending resolution of the merits of the objection. Most unliquidated or contingent claims may be estimated for purposes of voting on a plan.

Voting rights can have a significant impact on the ultimate fate of a chapter 11 plan. If a creditor holds a significant bloc of claims in a single class under a plan, it may be able to prevent confirmation of the plan, or force the plan proponent to comply with the Bankruptcy Code's "cramdown" requirements to achieve confirmation. Creditors holding a blocking position or having sufficient influence to create one through deal making with other creditors commonly use the resulting leverage to maximize their recoveries under the plan, sometimes at the expense of creditors who lack the same negotiating power. In some cases, the accumulation of claims and voting power can even be an effective means to gain control of a company in chapter 11.

DISQUALIFICATION OF VOTES

The drafters of the Bankruptcy Code recognized that the chapter 11 voting process can sometimes be abused by the unscrupulous. Section 1126(e) of the Bankruptcy Code provides:

> On request of a party in interest, and after notice and a hearing, 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.

"Designation" of a vote means that the vote is disqualified or disallowed. Section 1126(e) expands the disqualification procedures that existed under chapter X of the former Bankruptcy Act. Previously, a bankruptcy court was authorized to disqualify claims or stock for the purpose of determining the requisite majorities for acceptance of a plan if the holders of those claims or interests did not accept or reject the plan in good faith. The provision's purpose was to prevent speculators who had acquired claims or stock at depressed prices from exercising unfair veto power over the debtor's reorganization, and to keep creditors and stockholders from securing advantages by refusing to vote in favor of a plan unless they received preferential treatment.

Section 1126(e) is broader than its predecessor under the Bankruptcy Act — it authorizes the court to disallow votes that are not cast, procured, or solicited in good faith, or in accordance with the provisions of the Bankruptcy Code. The bankruptcy court has broad discretion in determining whether to "designate" a vote. The statute does not explain what kind of conduct amounts to bad faith, which is necessarily a flexible concept that has been left to the courts to define, based upon the facts and circumstances of each individual case. Instances of bad faith identified by the courts can be grouped into three general categories:

(i) Use of obstructive tactics or hold-up techniques by a creditor to extract better treatment for its claim than that given to the claims of similarly situated creditors in the same class;

(ii) Casting a vote for the ulterior purpose of securing some advantage to which the creditor would not otherwise be entitled; and

(iii) Casting a vote motivated by something other than protection of a creditor's own self-interest.

Votes, for example, have been deemed to be tainted if designed to assume control of the debtor, put the debtor out of business or otherwise gain a competitive advantage, destroy the debtor out of pure malice, or obtain benefits available under a private side agreement with a third party that depends on the debtor's inability to reorganize. These factors have been identified by some courts as "badges of bad faith." Standing alone, a creditor's "selfish motive" for casting its vote is not a basis for disqualification under section 1126(e). Given the practical ramifications of barring an impaired creditor from exercising such a fundamental entitlement, most courts consider designation to be the "exception rather than the rule" or even a "drastic remedy." As such, the party seeking designation of a vote bears a heavy burden of proof.

The analysis becomes more complicated in large chapter 11 cases involving affiliated debtors. The existence of intercompany debts, an extensive body of creditors asserting multiple claims of varying priorities against one debtor or claims against more than one debtor based upon intercompany guarantees, and intercreditor or subordination agreements makes determining a creditor's motives in voting no simple matter.

Lawmakers attempted to address the potential problems arising from one of these eventualities — a creditor holding claims against the same debtor classified in competing classes — when enacting the Bankruptcy Code in 1978. The House version of the bill that later became the Bankruptcy Code originally contained a provision that would have expressly authorized the court to designate the vote of an "entity that has, with respect to such class, a conflict of interest that is of such a nature as would justify exclusion of such entity's claim or interest" from the computation involved in determining whether a class has accepted or rejected a chapter 11 plan. The provision, however, did not appear in the Senate version of the draft legislation and never made its way into the statute. At the time, a leading sponsor of the legislation, Senator Dennis DeConcini, expressed the view that Congress deemed the provision unnecessary because a bankruptcy court's broad equitable powers under section 105(a) of the Bankruptcy Code give the court the power to disqualify a creditor from voting its claims on the basis of conflict of interest.

The message borne by *Adelphia* is that most kinds of overreaching or overly aggressive creditor conduct designed to extract greater value, concessions, or benefits under a plan may be objectionable but are not sanctionable under section 1126(e).

A challenge to the bona fides of creditor votes in favor of a plan based upon conduct amounting to overreaching and conflicts of interest confronted the bankruptcy court in *Adelphia*.

ADELPHIA COMMUNICATIONS

Adelphia Communications Corporation, once the nation's fifth-largest cable services company, with 5.7 million subscribers in more than 31 states, filed for chapter 11 protection in June of 2002. On July 31, 2006, the bankruptcy court approved the sale of the bulk of Adelphia's assets to Time Warner NY Cable and Comcast Corporation for $17.6 billion. The court confirmed a joint chapter 11 plan for Adelphia and its affiliated debtors on January 5, 2007, that distributes the companies' remaining $15 billion in assets. The confirmation order, however, was stayed on January 24, 2007, pending the resolution of an appeal to the district court, which initially required the appellants to post a $1.3 billion bond as a prerequisite to the issuance of a stay. By order dated February 12, 2007, the district court vacated its stay of the order confirming Adelphia's plan. The plan became effective on the following day.

The fitful progress of Adelphia's chapter 11 cases, which involved more than 230 subsidiaries, multiple tranches of secured and unsecured debt, a host of complicated intercompany relationships, and multiple ad hoc creditors' committees or groups, was accentuated by rancorous disputes between certain groups of major creditors. The antagonists involved were predominantly investors in distressed debt, many of whom held claims in more than one of the numerous classes of unsecured claims treated under Adelphia's chapter 11 plan.

Among them was a group consisting of certain holders of Adelphia's senior notes (the "ACC Bondholders Group"). The ACC Bondholders Group objected to confirmation of the plan and appealed the confirmation order. It also sought a court order designating the votes cast in favor of the plan by three separate groups of creditors who held both senior notes and notes issued by an indirect subsidiary of Adelphia, Arahova Communications Corp. (collectively referred to as the "Targeted Creditors").

A central feature of Adelphia's chapter 11 plan is a settlement of intercompany disputes. The settling parties include Adelphia's creditors' committee, several unofficial committees comprised of Adelphia and Arahova creditors, the Targeted Creditors, and various individual creditors. As part of the settlement, the plan contains releases, exculpation, and fee reimbursements for committee members and individual creditors, including senior noteholders, who signed on to the settlement and agreed to support the plan. These benefits are denied to creditors who chose not to support the settlement and the plan. The Targeted Creditors voted all of their claims in support of the plan. The ACC Bondholders Group vehemently opposed both the plan and the underlying settlement.

According to the ACC Bondholders Group, the Targeted Creditors filed numerous motions during the chapter 11 case seeking to thwart judicial determination of interdebtor issues as part of a "scorched earth litigation strategy" that, if successful, would have been devastating to creditor recoveries, in an effort to extract a greater distribution under Adelphia's plan. The Targeted Creditors, the ACC Bondholders Group alleged, also engaged in tactics, such as thinly veiled threats of litigation and onerous discovery requests, designed to strong-arm dissenting creditors into accepting the settlement and voting in favor of the plan. Taken as a whole, the ACC Bondholders Group maintained, this conduct warranted designation of the Targeted Creditors' votes under section 1126(e).

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied the motion. In prefacing its discussion, the court explained that "[t]he ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case." This right should not be denied, the court emphasized, "except for highly egregious conduct."

Addressing allegations by the ACC Bondholders Group that the Targeted Creditors had obtained special consideration under the plan in the form of releases, exculpation, and fee reimbursement, the court held that although such matters might support an objection to confirmation, they "are not matters of the type that warrant disqualification of the Targeted Creditors' votes." Even accepting as true the allegations that the Targeted Creditors were overly aggressive and overreaching in acting to benefit their economic interests in securing confirmation, the court explained, complaints concerning their conduct are properly addressed as part of the plan confirmation process. According to the court, whether or not the provisions in the plan favorable to the Targeted Creditors would pass muster under the Bankruptcy Code's confirmation requirements, they are "all variants of measures to advance one's interests in maximizing recoveries under a reorganization plan, which have consistently been held to be acceptable exercises of creditor power."

Next, the court turned to the allegations that the Targeted Creditors' votes in favor of the plan were driven by an ulterior motive — namely, the desire to maximize their recovery in another class, of another debtor (Arahova), under Adelphia's joint chapter 11 plan. None of the conduct alleged to have been engaged in by the Targeted Creditors, the bankruptcy court reasoned, falls within the broad categories of actionable abuse that has led courts in the past to designate votes. Objectionable motives under section 1126(e), the court emphasized, have not historically included the motive "to maximize an economic recovery, or to hedge, by owning bonds of multiple debtors in a single multi-debtor chapter 11 case, or . . . to hold bonds in different, antagonistic, classes of a particular debtor in a single chapter 11 case."

Inherent conflicts of interest between creditor classes, the court explained, exist in most chapter 11 cases, whether within a single debtor or across multiple debtors, competing for maximized shares of a limited pot of assets. Even so, the court concluded, holding or acquiring claims of different debtors in the same chapter 11 case is not the sort of ulterior motive or "bad faith" that has previously been held to justify vote designation. It accordingly ruled that "a creditor's ownership of claims in several debtor entities does not, by itself, amount to bad faith under section 1126(e), and does not afford a sufficient basis on which to qualify votes of creditors who have voted to accept the plan."

Two additional considerations, the court emphasized, suggest that this approach is the correct one. First, the court explained, "the law has long upheld creditors' efforts to maximize their individual recoveries in their self interest as creditors under a plan." Although subject to the "ulterior interest exception," ordinary recovery-maximization strategies cannot be said to exclude holding long positions in bonds of various debtors.

Finally, the bankruptcy court examined the "conflict of interest" subsection that was ultimately excluded from section 1126 as originally enacted in 1978. Congress's decision to omit the clause and the "marked reluctance" of courts to interpret section 105(a) expansively to give courts powers that are not expressly delineated elsewhere in the Bankruptcy Code led the bankruptcy court to resolve that disqualifying votes under the circumstances before it "would be too much of a jump."

OUTLOOK

Under the *Adelphia* court's formulation of the "bad faith" standard in section 1126(e), a wide range of creditor conduct would appear to be permissible, as long as it serves the goal of maximizing recovery and/or can be remedied through less "draconian" means than disenfranchising the offending creditor. Whether or not this approach is the right one, the message it conveys is likely to make the chapter 11 process more contentious in some cases. A chapter 11 plan is almost always a product of negotiation and cooperation among stakeholders who work together to achieve a mutually satisfactory solution regarding the future of the debtor and the treatment of its obligations and ownership interests. The message borne by *Adelphia* is that most kinds of overreaching or overly aggressive creditor conduct designed to extract greater value, concessions, or benefits under a plan may be objectionable but are not sanctionable under section 1126(e). Given the reality that "distressed" investors involved in chapter 11 cases are more likely than most creditors to play hardball at the plan-negotiating table, *Adelphia* may actually encourage the sort of intractable conduct that the court found to be objectionable and unproductive, yet outside the scope of section 1126(e).

Nonetheless, the bankruptcy court's analysis of the conflict-of-interest issue is consistent with the commercial realities of large chapter 11 cases and the relevant language and legislative history of the Bankruptcy Code. Large chapter 11 cases commonly involve several debtors, multiple layers of debt and stock, complicated intercompany relationships, and creditors asserting claims of varying priorities against a single debtor or claims against more than one debtor. Equating inherent conflicts of interest arising from this practical reality with "bad faith" for purposes of vote designation could result in the wholesale disenfranchisement of the very creditors who have the greatest stake in ensuring that a chapter 11 case culminates successfully with a confirmed plan.

In re Adelphia Comm. Corp., 2006 WL 3609959 (Bankr. S.D.N.Y. Dec. 11, 2006).

A version of this article was published in the April 2007 edition of Pratt's Journal of Bankruptcy Law. *It has been reprinted here with permission.*

CHOICE OF BANKRUPTCY VENUE: SOUND STRATEGY OR FORUM SHOPPING?

Mark G. Douglas

One of the most significant considerations in a prospective chapter 11 debtor's strategic pre-bankruptcy planning is the most favorable venue for the bankruptcy filing. Given varying interpretations of certain important legal issues in the bankruptcy courts (*e.g.,* the ability to pay the claims of "critical" vendors at the inception of a chapter 11 case, to include non-debtor releases in a chapter 11 plan, or to reject collective bargaining agreements) and the reputation, deserved or otherwise, that certain courts or judges may be more "debtor-friendly" than others, choice of venue (if a choice exists) can have a marked impact on the progress and outcome of a chapter 11 case.

The Southern District of New York and Delaware have long been the preferred forums for large chapter 11 cases. Given New York's recognized status as the financial capital of the U.S. (and arguably the world), the fact that its bankruptcy courts regularly preside over a significantly greater proportion of complex chapter 11 restructurings than courts located elsewhere is not surprising. Delaware's courts have similarly developed considerable experience and expertise in complex chapter 11 cases, but the district's prominence as a frequent venue for chapter 11 "mega" cases may be based in part on the statutory venue requirements that apply to bankruptcy filings.

The rules that determine which particular venue is appropriate for a bankruptcy filing permit a debtor to file for chapter 11 protection in the bankruptcy court located in the debtor's state of incorporation, which for a significant percentage of corporations is Delaware. Even so, because a large number of companies do not do business or own assets in the state in which they are incorporated, state of incorporation as a basis for venue has been criticized as providing a pretext for "forum shopping" that permits a chapter 11 debtor to sort out its financial problems far removed from creditors and other parties with a stake in the outcome of the case.

The perception that chapter 11 forum shopping has been abused led to the introduction of legislation in 2005 to eliminate state of incorporation as a stand-alone basis for venue and to prevent "piggyback" chapter 11 filings by a subsidiary for the sole purpose of manufacturing venue for its corporate parent. The legislation was motivated in part by recent estimates that creditors achieve smaller recoveries in bankruptcies filed in Delaware or New York than in other states. These restrictions, however, were not incorporated into the sweeping bankruptcy reforms enacted as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Still, recent developments suggest that bankruptcy courts may be casting a more critical eye on a chapter 11 debtor's chosen venue, particularly if the nexus between the venue and the debtor's business, assets, and creditors is no more than tenuous.

VENUE OF A BANKRUPTCY CASE

A bankruptcy case (except a case under chapter 15) may be filed in any federal district court containing the debtor's "domicile, residence, principal place of business . . . or principal assets in the United States . . . for the one hundred and eighty days immediately preceding" the filing of the case. The debtor may also file for bankruptcy in the district in which a case is pending concerning any affiliate, general partner, or partnership of the debtor. Consistent with general rules governing the proper venue for litigation in federal courts, a corporation's "domicile" is generally held to be its state of incorporation. Although technically filed in the district court, bankruptcy cases are automatically referred to the bankruptcy court in that district pursuant to standing orders of reference. Bankruptcy courts are actually units or divisions of the federal district courts.

In some cases, more than one venue may satisfy the statutory requirements. If so, any party-in-interest (or the court on its own initiative) claiming that an alternative venue is more appropriate may seek to have venue transferred to any other bankruptcy court that satisfies the venue requirements. The bankruptcy court is authorized to transfer venue of a case to another district "in the interests of justice or for the convenience of the parties." Neither the Bankruptcy Code nor the rules effectuating its provisions specify how this standard is to be applied. Courts typically consider a number of factors in making this determination, including the proximity to the court of creditors and witnesses necessary to administer the bankruptcy estate, the location of the debtor's assets, the economic administration of the estate, and the necessity for ancillary administration if the debtor ends up liquidating its assets.

Considering alternative venues for a chapter 11 case is an important and perfectly legitimate aspect of any prospective debtor's pre-bankruptcy planning. If more than one venue is available for a bankruptcy filing, it is incumbent upon the debtor-company and its professionals to consider carefully which venue is most likely to achieve the goals of the chapter 11 filing consistent with important policy considerations designed to promote the debtor's prospects for a successful chapter 11 case while protecting the interests of other stakeholders involved.

If bankruptcy cases involving the same debtor, or a debtor and an affiliate, are pending in more than one court, the bankruptcy court in which the first case was filed first may determine, "in the interests of justice or for the convenience of the parties," the court or courts in which the cases should proceed. Proceedings before any other court are stayed pending the initial court's decision on a motion to transfer venue.

MALDEN MILLS

The United States Bankruptcy Court for the District of Massachusetts recently had an opportunity to examine the venue rules in connection with chapter 11 cases filed on January 10, 2007, in Delaware by Malden Mills Industries, Inc. and its affiliates (collectively, "Malden").

Malden, the Massachusetts-based manufacturer of Polartec® fleece blankets and apparel for such customers as Lands' End, The North Face, and the Pentagon, filed for bankruptcy protection in the 1980s and, more recently, November 2001 in Massachusetts, where the company has been based for 101 years. The company confirmed a plan of reorganization in October 2003 in which its existing owner, Aaron Feuerstein, ceded control of Malden to a creditor group led by its largest senior lender, GE Capital Corp., but retained an option to buy back the company over the next two years for $96 million to $120 million. A creditors' trust created under the plan (the "Creditor Trust") received 26 percent of Malden's common stock. All or nearly all of Malden's assets, employees, and operations are located in Massachusetts. Malden is incorporated in Delaware but has never had any meaningful operations in the state.

Its plan of reorganization having been substantially consummated, Malden sought a final decree closing its chapter 11 cases. In connection with its request, Malden and its agent bank, GE Capital Commerce Finance, solicited the Creditor Trust's assent to entry of a final decree, representing that the "aggressive push to close the cases" was not motivated by anything other than a desire to tie up loose ends. The Massachusetts bankruptcy court, with the Creditor Trust's consent, entered a final decree in the cases on December 28, 2006, and closed the cases on January 9, 2007.

The following day, Malden filed for chapter 11 protection in Delaware with the professed intention of effectuating a sale of substantially all of its assets under section 363(b) of the Bankruptcy Code. Initially, the stalking-horse bidder in the proposed $44 million sale was Boston-based Gordon Brothers Group LLC. Another bidder, Philadelphia-based Chrysalis Capital Partners LLC, emerged shortly after the filing to match Gordon's offer, but with less costly overbid protections.

Contending that it had been misled into agreeing to entry of a final decree in the 2001 chapter 11 cases without knowing that Malden planned to refile for bankruptcy in Delaware, the Creditor Trust applied to the Massachusetts bankruptcy court for an order vacating the final decree and transferring venue of the newly filed chapter 11 cases from Delaware to Massachusetts.

THE BANKRUPTCY COURT'S RULING

The Massachusetts bankruptcy court granted both requests. Addressing the motion to vacate its December 28, 2006, final decree, the court explained that the entry of a final decree closing a bankruptcy case after the estate has been fully administered does not prevent the court from reopening the case for "cause" under section 350(b) of the Bankruptcy Code. "Cause" existed in this case, the court emphasized, due to the "unnecessary lack of candor" exhibited by Malden and its agent in soliciting the assent of the Creditor Trust under "false pretenses." According to the court, this lack of candor was clearly designed to expedite the case closure process and "to facilitate the Delaware filing in an attempt to gain some tactical advantage on the inevitable venue transfer motion." Malden and its agent's actions in seeking the Creditor Trust's assent with the knowledge that Malden would immediately file for chapter 11 in Delaware and their misleading explanation for expedited closure of the existing cases, the bankruptcy court remarked, "demonstrated a serious breach of the duty of candor, which the Court cannot condone." It accordingly vacated the final decree.

Turning to the venue transfer motion, the bankruptcy court explained that, because it had vacated the final decree, Malden's chapter 11 cases were still pending before it. This meant that the venue transfer request was properly addressed to it, rather than the Delaware bankruptcy court. Examining the factors considered in connection with a venue transfer motion, the court ruled that the District of Massachusetts was the more appropriate forum. Malden's contacts with Delaware, the court explained, are minimal, its operations, assets, employees, and managers, plus most of its creditors, being situated in Massachusetts. Malden's venue selection, the court observed, "was not based on the convenience of these constituencies given their geographical connection to Massachusetts, and one might even surmise that it was designed to make the venue inconvenient and expensive for some."

Moreover, the bankruptcy court emphasized, having presided over Malden's previous reorganization, it is very familiar with Malden, many of the other stakeholders in the cases, the terms of the company's most recently confirmed chapter 11 plan, and the legal issues involved. Acknowledging Malden's "extreme plight," the bankruptcy court concluded that it, like the Delaware bankruptcy court, is capable of facilitating the "quick" section 363 sale driving Malden's decision to resort to chapter 11 once again.

WHERE DO WE GO FROM HERE?

Considering alternative venues for a chapter 11 case is an important and perfectly legitimate aspect of any prospective debtor's pre-bankruptcy planning. If more than one venue is available for a bankruptcy filing, it is incumbent upon the debtor-company and its professionals to consider carefully which venue is most likely to achieve the goals of the chapter 11 filing consistent with important policy considerations designed to promote the debtor's prospects for a successful chapter 11 case while protecting the interests of other stakeholders involved.

Malden Mills demonstrates where strategic planning can cross the line into abuse. Interestingly, the bankruptcy court acknowledged that its ruling on *vacatur* of the final decree "would have been different" had the debtor and its agent not intentionally misled the Creditor Trust in obtaining its assent to closure. The implied subtext is that the court itself felt deceived by conduct it clearly considered duplicitous and bordering on sanctionable. For this reason, *Malden Mills* is an unusual case.

That is not to say that the ultimate outcome of the venue transfer motion would have been different, but it might have been a closer call. Moreover, absent *vacatur* of the final decree, any venue transfer request would have been properly addressed to the Delaware, rather than the Massachusetts, bankruptcy court. The Massachusetts court expressed confidence that the Delaware court would have ruled the same way, given Malden's lack of any meaningful contact with Delaware, other than a Delaware certificate of incorporation, and the existence of a proactive creditor group voicing vigorous opposition to Malden's choice of venue.

Malden's underlying strategy in filing for bankruptcy again as a way of facilitating a sale of the company was ultimately successful. The bankruptcy court approved the sale of substantially all of Malden's assets to Chrysalis Capital Partners on February 26, 2007, for approximately $44 million. On March 7, 2007, Malden filed a motion seeking to convert its chapter 11 cases to a chapter 7 liquidation. The new textile-manufacturing entity is called Polartec LLC.

In re Malden Mills Industries, Inc., 2007 WL 140818 (Bankr. D. Mass. Jan. 22, 2007).

PONZI SCHEME TRANSFERS BY HEDGE FUND TO BROKER AVOIDED IN BANKRUPTCY

Bronson J. Bigelow and Mark G. Douglas

In a decision with potential far-reaching effects on Wall Street firms servicing hedge funds as prime brokers, on February 15, 2007, a New York bankruptcy court ordered Bear Stearns to disgorge nearly $160 million that it received in the form of margin payments, position closeouts, and fees from a hedge fund that had engaged in a Ponzi scheme because, among other things, the broker failed to adequately monitor the activities of the fund before it collapsed in 2000. If the court's decision is upheld on appeal, broker-dealers might be obligated to oversee more diligently the activities of their lucrative clients.

FACTUAL BACKGROUND

Manhattan Investment Fund, Ltd. (the "Fund"), a hedge fund created and used by Michael Berger ("Berger") through his wholly owned company Manhattan Capital Management, Inc. ("MCM"), maintained an account at Bear Stearns. The monies in the account were used by the Fund to engage in securities trading. The account was subject to an industry-standard account agreement, which contained boilerplate provisions granting Bear Stearns: (1) discretion to set the level of maintenance margin; (2) a security interest in all monies held in the account; (3) sole discretion to prevent the Fund from withdrawing any monies credited to the account as long as any short positions remained open; and (4) sole discretion to use any and all monies credited to the Fund's account to liquidate the Fund's open short positions with or without the Fund's consent.

According to the Bankruptcy Court, in December 1998, Bear Stearns was put on notice of possible fraud being perpetuated by Berger. A senior managing director and salesperson at Bear Stearns was informed that the Fund was reporting 20 percent profit a year. Yet the same individual understood that the Fund was losing money based upon his participation in risk-related conference calls in which the Fund was mentioned. After going through some internal channels and confirming that the Fund was losing money in its Bear Stearns account, Bear Stearns contacted Berger regarding the discrepancy. Berger explained that the discrepancy was due to the fact that Bear Stearns was one of eight or nine prime brokers utilized by the Fund. Despite continued suspicion and rising margin requirements, Bear Stearns did not verify Berger's representation until many months later, when Bear Stearns discovered that it was the only prime broker for the Fund.

On January 14, 2000, following an investigation into the Fund's trading activities, the SEC discovered that the Fund was in fact a Ponzi scheme, and it filed a securities-fraud complaint against the Fund, MCM, and Berger. The Fund, through its receiver, filed a bankruptcy petition on March 7, 2000. The receiver was later appointed chapter 11 trustee of the Fund and on April 24, 2000, commenced an adversary proceeding against Bear Stearns seeking, among other things, the avoidance of 18 transfers totaling $141.1 million in margin payments, which Berger caused to be transferred to the Fund's Bear Stearns account from the Fund's account with the Bank of Bermuda, and which were then used by the Fund to engage in securities trading.

The bankruptcy court's ruling in *Manhattan Investment Fund* suggests that blind reliance on the "stockbroker exception" in section 546(e), the "mere conduit" exception to "transferee" status in section 550, and the "good faith" safe harbor in section 548(c) is misplaced and that brokers bear a heavier burden of inquiry concerning the activities of their clients incident to establishing "good faith."

THE BANKRUPTCY COURT'S OPINION

The bankruptcy court granted summary judgment to the trustee and ordered Bear Stearns to pay nearly $160 million to investors in the Fund. The bankruptcy court held that:

- The margin payments transferred into the Fund's Bear Stearns account were made by the Fund with actual intent to hinder, delay, or defraud its creditors and therefore subject to avoidance under section 548(a)(1)(A) of the Bankruptcy Code;

- Because the transfers were made to open new short positions or to comply with margin requirements, they "fit squarely" within the definition of margin payments, which are protected from avoidance by a bankruptcy trustee under section 546(e) of the Bankruptcy Code, known as the "stockbroker defense," unless made with actual intent to hinder, delay, or defraud creditors;

- Transfers made to Bear Stearns in furtherance of a fraudulent Ponzi scheme were effectuated with actual intent to defraud creditors, so that the "stockbroker defense" does not preclude avoidance of the payments;

- Bear Stearns qualified as an "initial transferee" under section 550(a)(1) of the Bankruptcy Code, rather than a "mere conduit" that did not exercise dominion and control over the funds, and therefore was liable to return the payments;

- Public policy did not prevent recovery of the margin payments; and

- Bear Stearns could not rely upon the good-faith defense under section 548(c) of the Bankruptcy Code.

Bear Stearns argued that it was a "mere conduit" as opposed to an "initial transferee" and thus was not required to return the margin payments. The bankruptcy court rejected this argument, holding that Bear Stearns exercised "dominion and control" over the transfers, noting that Bear Stearns used the funds in the account to cover all open positions the Fund had with Bear Stearns, positions for which Bear Stearns would have been liable if the transfers had not been made. Moreover, under the account agreement, Bear Stearns had a security interest in any monies transferred, held transferred monies as collateral for short sales, had the right to and did in fact prohibit the Fund from withdrawing any monies so long as the short positions remained open, and had the right to and did in fact use the monies to purchase covering securities, at its discretion. In sum, because Bear Stearns had the ability to exercise control and use the transferred monies to protect itself, it was not a "mere conduit."

The bankruptcy court also rejected Bear Stearns' argument that finding a securities brokerage as an initial transferee, based on boilerplate provisions in the industry-standard account agreement, would expose all broker-dealers to massive liability and would cripple the securities industry. The court noted that the provisions of the Bankruptcy Code permit margin payments to be avoided in only limited circumstances (*i.e.,* in cases of actual, rather than constructive, fraud) and that, since the Bankruptcy Code specifically allows for avoidance of margin payments, it cannot be said that allowing exactly that is contrary to public policy.

Finally, the bankruptcy court held that Bear Stearns could not rely upon the good-faith defense under section 548(c) of the Bankruptcy Code because it found that Bear Stearns either knew or should have known of Berger's fraud beginning in December 1998. The bankruptcy court noted that the standard for determining whether the transferee lacked knowledge of the fraud (so as to have been acting in good faith) was objective and courts look to what the transferee knew or should have known. The bankruptcy court held that "Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong . . . [d]iligence required consulting easily attainable sources of information that would bear on the truth of any explanation received from the wrongdoer."

CONCLUSION

Lawmakers clearly recognized the importance of minimizing disruption to the nation's securities markets when they added the "stockbroker's defense" in section 546(e) to the Bankruptcy Code in 1982. Comparable safe harbors were enacted in 1984, 1990, and 2005 to protect margin, settlement, or other payments under repurchase, swap, and master netting agreements. In all of these cases, however, the safe harbor does not preclude avoidance of transfers made with the actual intent to hinder, delay, or defraud creditors.

Brokers have long relied on section 546(e), the "mere conduit" exception to "transferee" status in section 550, and the "good faith" safe harbor in section 548(c) to insulate themselves from potential exposure when a customer winds up in bankruptcy and the trustee scrutinizes payments or transfers made within the statutory avoidance periods. The bankruptcy court's ruling in *Manhattan Investment Fund* suggests that blind reliance on these provisions is misplaced and that brokers bear a heavier burden of inquiry concerning the activities of their clients incident to establishing "good faith."

Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund Ltd.), 2007 WL 60843 (Bankr. S.D.N.Y. Jan. 9, 2007).

Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund Ltd.), 2007 WL 534547 (Bankr. S.D.N.Y. Feb. 15, 2007).

TOP 10 PUBLIC-COMPANY BANKRUPTCY FILINGS

Company	Petition Date	Assets
WorldCom, Inc.	July 21, 2002	$10.4 billion
Enron Corp.	December 2, 2001	$6.6 billion
Conseco, Inc.	December 18, 2002	$6.1 billion
Pacific Gas and Electric Company	March 6, 2001	$3.6 billion
Texaco, Inc.	March 12, 1987	$3.5 billion
Financial Corp. of America	September 9, 1988	$3.4 billion
Refco Inc.	October 17, 2005	$3.3 billion
Global Crossing, Ltd.	January 28, 2002	$3.0 billion
Bank of New England Corp.	January 7, 1991	$2.9 billion
Calpine Corporation	December 20, 2005	$2.7 billion

THE INABILITY TO SATISFY COMMON STOCKHOLDER VOTING REQUIREMENTS: IS BANKRUPTCY A POTENTIAL SOLUTION?

Timothy Hoffmann

Metromedia International Group, Inc.'s board of directors faced a perplexing dilemma. Approached with an attractive offer from a potential purchaser, the board wanted to sell the corporation's primary asset and cease operations. In order to consummate the transaction, however, Delaware law and the company's certificate of incorporation required approval from the majority of Metromedia's common stockholders. Metromedia's advisors informed Metromedia's directors they could not hold a shareholder meeting or solicit proxies due to the company's failure to comply with federal reporting requirements. As a result, the directors believed they could not obtain the required shareholder approval.

The board decided to pursue an alternate route to complete the transaction — bankruptcy. Their strategy contemplated finalizing an agreement to sell Metromedia's controlling equity interest in Magitcom, a profitable mobile telephone provider in the Republic of Georgia, after which Metromedia would file a chapter 11 petition and a motion seeking court approval of the Magitcom sale under section 363 of the Bankruptcy Code. Metromedia would then seek to confirm a liquidating chapter 11 plan.

To ensure that Metromedia's "impaired" creditors would vote in favor of the chapter 11 plan, the board entered into a voting lock-up agreement with the company's preferred stockholders. During the course of negotiations, the board provided the preferred stockholders with certain nonpublic information regarding the company's financial status. Based upon this information, the preferred shareholders negotiated a favorable financial position for themselves with respect to the proposed transaction and bankruptcy.

Before Metromedia filed for bankruptcy, however, two large Metromedia common stockholders sued in Delaware Chancery Court to enjoin the Magitcom sale as well as the effectiveness of the lock-up agreement. The court ultimately ruled in favor of the plaintiff-stockholders, finding that the board's proposed strategy constituted "inequitable conduct."

THE LEGAL STANDARD

Under Delaware law, stockholders maintain a fundamental right to vote on certain corporate matters. For example, Delaware courts consistently reverse board actions that interfere with the stockholders' franchise in connection with director elections. In this context, any board action "designed principally to interfere with the effectiveness of a [stockholder] vote" is subject to intense judicial scrutiny, and the board "bears the heavy burden of demonstrating a compelling justification for such action." Under the "compelling justification" standard, Delaware courts look beyond directors' honesty and subjective good-faith beliefs, the typical anchors of the less stringent business-judgment rule.

Outside of the director-election context, however, Delaware courts seldom employ the "compelling justification" standard. They generally do so only when "self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of the stockholders."

In this case, the Delaware Chancery Court determined that Metromedia's directors did not act in either self-interest or contrary to the wishes of the stockholder majority in resolving to file for bankruptcy as a means to consummate the proposed sale. According to the court, the common stockholders seeking to enjoin the sale represented the view of only a minority of Metromedia's stockholders. As such, the court declined to apply the "compelling justification" standard.

Even so, the court determined that Metromedia's directors could not utilize bankruptcy as a vehicle for consummating the Magitcom sale. Mindful of the broad discretion that directors hold under the business-judgment rule and related doctrines, the court ruled that the board's strategy exceeded certain equitable bounds.

First, the court found the directors' proposed use of the bankruptcy process to be inequitable because, among other things, Metromedia was a solvent company with little debt and substantial cash flow. Explaining that no economic reason existed for Metromedia to seek bankruptcy relief and that the anticipated filing was driven principally by the board's desire to avoid a common stockholder vote on the Magitcom sale, the court concluded that a chapter 11 filing under the circumstances would constitute "bad faith," despite the absence of any insolvency requirement for a bankruptcy filing. Second, the court determined that the lock-up agreement provided Metromedia's preferred shareholders with voting rights to which they were not entitled under the corporation's charter, which gave common stockholders the right to vote on fundamental corporate changes. The proposed bankruptcy strategy, the court emphasized, inequitably reallocated control of the company from common stockholders to preferred stockholders and creditors, a course of action that was untenable in the absence of insolvency.

The court decreed that the Magitcom sale could be consummated only if the transaction was approved pursuant to a vote of Metromedia's common shareholders. The court advised the board to seek an exemption from SEC reporting requirements in order to hold a shareholder meeting for that purpose and emphasized that it held the authority to appoint a receiver for Metromedia if the board failed to abide by its ruling.

OUTLOOK

Principles of corporate governance that determine how a company functions outside of bankruptcy are transformed, and in some cases abrogated, once the company files for chapter 11 protection, when the debtor's board succeeds to management of a "debtor-in-possession" that bears fiduciary obligations to the chapter 11 estate and all stakeholders involved in the bankruptcy case. Although shareholders may still have the right to convene meetings post-bankruptcy for, among other things, the election of directors, major corporate decisions, such as significant asset sales, are no longer subject to shareholder approval, except to the extent that any proposed sale must be approved by "impaired" creditors and shareholders pursuant to the chapter 11 plan confirmation process. Instead, decisions involving nonordinary-course business transactions must be approved by the bankruptcy court as an exercise of the debtor-in-possession's sound business judgment.

This is precisely why Metromedia's board opted for a bankruptcy filing as a means of skirting SEC reporting requirements that precluded convening a meeting of the company's common stockholders for the purpose of voting on the Magitcom sale. The Chancery Court understandably concluded that their plan to abrogate shareholder voting rights was objectionable as a matter of Delaware law, given the company's financial health, but the court's observations *in dicta* concerning the "bad faith" of a bankruptcy filing under the circumstances bear closer scrutiny. Many public companies, solvent or insolvent, file for chapter 11 with the intention of effectuating a sale of substantially all or significant portions of their assets. The ability in bankruptcy to, among other things, sell assets free and clear of competing claims and interests, to avoid certain transfer taxes, and to consummate sales expeditiously without the need for shareholder approval makes chapter 11 the preferred mechanism for many asset sale transactions. Few bankruptcy courts find that such filings amount to "bad faith" warranting dismissal.

Esopus Creek Value LP v. Hauf, 913 A.2d 593 (Del. Ch. 2006).

FROM THE TOP

Mark G. Douglas

The U.S. Supreme Court has issued two bankruptcy rulings so far in 2007. On February 21, 2007, the Court ruled in *Marrama v. Citizens Bank of Massachusetts* that a debtor who acts in bad faith in connection with filing a chapter 7 petition may forfeit the right to convert his case to a chapter 13 case. On March 20, 2007, the Court ruled in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.* that the Bankruptcy Code does not prohibit a creditor's contractual claim for attorneys' fees incurred in connection with litigating the validity in bankruptcy of claims based upon the underlying contract. These rulings are briefly discussed below.

MARRAMA V. CITIZENS BANK OF MASSACHUSETTS

In *Marrama*, the debtor transferred valuable residential real estate into a revocable trust in August of 2002, for no consideration, and designated himself as sole beneficiary and his girlfriend as sole trustee, all for the purpose of putting the property beyond the reach of creditors. He filed for chapter 7 protection seven months afterward. In his bankruptcy filings, the debtor acknowledged being beneficiary of the trust but represented that his interest had no value and denied making any property transfers within the year preceding his bankruptcy filing. He also asserted that he was not entitled to any tax refunds, when, in fact, he was owed a refund exceeding $11,000. Instead of responding to the chapter 7 trustee's inquiries regarding the discrepancies, the debtor sought to convert his case to one under chapter 13. After the trustee opposed the conversion, the debtor asserted that his misstatements and omissions were inadvertent. The bankruptcy court refused to permit the conversion because the debtor had acted in bad faith. That determination was upheld on appeal by the bankruptcy appellate panel, and the First Circuit Court of Appeals affirmed. The Supreme Court agreed to hear the case on June 12, 2006.

Section 706(a) provides that a chapter 7 debtor "may" convert to chapter 13 "at any time," language that many courts have interpreted as giving the debtor an unconditional right to convert its case from a liquidation proceeding to a chapter 13 case. Writing for the 5-4 majority, Justice John Paul Stevens noted that, although courts are virtually unanimous in holding that a debtor's pre-petition bad-faith conduct may act as a bar to relief under chapter 13, some courts have suggested that even a bad-faith debtor has an absolute right to convert a chapter 7 case into a chapter 13 case, even though the case may thereafter be dismissed or immediately reconverted to chapter 7 as a consequence of the misconduct. "While other Courts of Appeals and bankruptcy appellate panels have refused to recognize any 'bad faith' exception to the conversion right created by § 706(a)," Justice Stevens wrote, "we conclude that the courts in this case correctly held that Marrama forfeited his right to proceed under Chapter 13."

Justice Stevens concluded that section 706(d) of the Bankruptcy Code, which provides that "a case may not be converted to a case under another chapter unless the debtor may be a debtor under such chapter," expressly conditions a chapter 7 debtor's right to convert on his ability to qualify as a debtor under chapter 13. "In practical effect," the justice observed, "a ruling that an individual's Chapter 13 case should be dismissed or converted to Chapter 7 because of prepetition bad-faith conduct, including fraudulent acts committed in an earlier Chapter 7 proceeding, is tantamount to a ruling that the individual does not qualify as a debtor under Chapter 13." Those who act in bad faith, Justice Stevens concluded, are not members of the class of "honest but unfortunate debtor[s]" that the bankruptcy laws were enacted to protect.

Justices Anthony M. Kennedy, David H. Souter, Ruth Bader Ginsburg, and Stephen Breyer joined the majority opinion. Justice Samuel A. Alito Jr., joined by Chief Justice John G. Roberts Jr., Justice Antonin Scalia, and Justice Clarence Thomas, filed a dissenting opinion, arguing that nothing in section 706(a) or any other provision of the Bankruptcy Code "suggests that a bankruptcy judge has the discretion to override a debtor's exercise of the § 706(a) conversion right on a ground not set out in the Code."

TRAVELERS

Travelers Casualty & Surety Co. ("Travelers") issued a $100 million surety bond assuring payment of workers' compensation benefits to injured employees of Pacific Gas and Electric Co. ("PG&E"). PG&E executed a series of indemnity agreements in favor of Travelers in connection with the issuance of the bonds. In the indemnification agreements, PG&E promised to pay attorneys' fees incurred by Travelers in enforcing the agreements, by litigation or otherwise.

PG&E filed for chapter 11 protection on April 6, 2001. Travelers asserted a proof of claim for contingent liabilities arising under the indemnification agreements, none of which had matured at the time of the bankruptcy filing (or, as it turned out, came to mature during PG&E's chapter 11 case). Travelers also claimed a contingent right to subrogation.

PG&E objected to the claims, contending that they were disallowed by operation of sections 502(e)(1)(B) and 509(a) of the Bankruptcy Code, which, under certain circumstances, bar contingent reimbursement and contribution claims and claims for subrogation asserted by codebtors or parties that provide security for an obligation of the debtor. Travelers ultimately acknowledged in a stipulation with PG&E that its contingent claims were invalid.

Travelers asserted, however, that it was entitled to recover legal fees incurred in prosecuting its claim from PG&E's bankruptcy estate, as provided in the indemnity agreements. The bankruptcy court disallowed Travelers' claim in its entirety, citing *Fobian v. Western Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991), as authority for denying that portion of the claim consisting of attorneys' fees. That ruling was upheld on appeal by the district court and the Ninth Circuit.

The Supreme Court vacated the decisions below and remanded the case for additional consideration consistent with its ruling. Justice Samuel A. Alito Jr., writing for a unanimous court, explained that, under the "American rule," "the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser." However, he added, this default rule can be overcome either by statute or by an "enforceable contract" allocating attorneys' fees. According to Justice Alito, a contract allocating attorneys' fees that is enforceable under applicable nonbankruptcy law is enforceable in bankruptcy except if the Bankruptcy Code provides otherwise, which it does not.

Of the nine grounds for disallowing a filed claim specified in section 502(b), Justice Alito explained, only subsection (b)(1), which disallows any claim that is "unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured," could conceivably create a basis for disallowing Travelers' claim for attorneys' fees. This provision, Justice Alito wrote, is "most naturally understood" to provide that, with limited exceptions, any defense to a claim that is available outside of the bankruptcy context is also available in bankruptcy. He also explained that this reading of section 502(b) is consistent with the well-settled maxim that "[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provision of the Bankruptcy Code."

Justice Alito also examined section 502(b)(4), which expressly disallows claims for a particular category of attorneys' fees — those for services rendered to a debtor to the extent the claimed fees "excee[d] the reasonable value of such services." The existence of that provision, Justice Alito reasoned, suggests that, in its absence, a claim for such fees would be allowed in bankruptcy to the extent enforceable under state law.

In disallowing Travelers' claim for contractual attorneys' fees, Justice Alito noted, the Ninth Circuit acknowledged that, under at least certain circumstances, a "prevailing party in a bankruptcy proceeding may be entitled to any award of attorney fees in accordance with applicable state law." Even so, the Court of Appeals rejected Travelers' claim based solely on a rule of its "own creation — the so-called *Fobian* rule." In *Fobian v. Western Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991), the Ninth Circuit Court of Appeals ruled that a secured creditor who prevailed on an objection to confirmation of a chapter 12 plan was not entitled to an award of attorneys' fees from the estate, despite a provision in the note for payment of fees and costs incurred in collection, because the issues litigated involved not basic contract enforcement questions, but issues peculiar to federal bankruptcy law.

On March 20, 2007, the Court ruled in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.* that the Bankruptcy Code does not prohibit a creditor's contractual claim for attorneys' fees incurred in connection with litigating the validity in bankruptcy of claims based upon the underlying contract.

Because the *Fobian* rule finds no support in federal bankruptcy law, the Supreme Court ruled, the Ninth Circuit erred in disallowing Travelers' claim for attorneys' fees. The absence of any textual support in the Bankruptcy Code, wrote Justice Alito, "is fatal for the *Fobian* rule." Consistent with the Supreme Court's previous pronouncements regarding creditors' entitlements in bankruptcy, he observed that "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." According to Justice Alito, neither the Ninth Circuit nor PG&E has offered any reason why that presumption is overcome, because the attorneys' fees in question were incurred litigating issues of federal bankruptcy law.

Justice Alito concluded that the Bankruptcy Code does not "clearly and expressly" compel courts to follow the *Fobian* rule. In fact, he noted, the statute says nothing about unsecured claims for contractual attorneys' fees incurred in connection with litigating issues of bankruptcy law. As such, Justice Alito remarked, "[i]n light of the broad, permissive scope of § 502(b)(1), and our prior recognition that 'the character of [a contractual] obligation to pay attorney's fees presents no obstacle to enforcing it in bankruptcy,' it necessarily follows that the *Fobian* rule cannot stand."

Finally, Justice Alito declined to address PG&E's contention that, because section 506(b) expressly provides for attorneys' fees and costs as part of an oversecured creditor's allowed secured claim, the Bankruptcy Code disallows the claims of unsecured creditors for such fees, explaining that the argument was not raised in the lower courts and stating that "[w]e express no opinion with regard to whether, following the demise of the *Fobian* rule, other principles of bankruptcy law might provide an independent basis for disallowing Travelers' claim for attorney's fees."

Marrama v. Citizens Bank of Massachusetts, 127 S. Ct. 1105 (2007).

Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co., 2007 WL 816795 (Mar. 20, 2007).

BUSINESS RESTRUCTURING REVIEW

Business Restructuring Review is a publication of the Business Restructuring & Reorganization Practice of Jones Day.

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