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FLYi, INC. – IMPORTANT APPLICATION OF *OWENS CORNING* STANDARD FOR SUBSTANTIVE CONSOLIDATION BY DELAWARE BANKRUPTCY COURT

Paul D. Leake and Brad B. Erens led Jones Day's representation of FLYi and Independence Air in their chapter 11 cases.

PAUL D. LEAKE

BRAD B. ERENS

On March 15, 2007, with Jones Day's assistance as bankruptcy counsel, FLYi, Inc. ("FLYi"), Independence Air, Inc. ("Independence"), and their affiliated debtors (collectively, the "Debtors") obtained confirmation of their chapter 11 plan under the "cramdown" provisions of the Bankruptcy Code. The plan, which became effective on March 30, 2007, will distribute approximately $150 million to unsecured creditors. In ruling on confirmation of the plan, the U.S. Bankruptcy Court for the District of Delaware was required to make one of its first applications of the Third Circuit's decision in *Owens Corning* on the doctrine of substantive consolidation. In the ruling, Judge Mary Walrath affirmed that substantive consolidation is a "rare" remedy that should not be used as a sword to improve recoveries for a specific group of creditors at the expense of other creditors.

In the FLYi case, the two main debtors were FLYi, a holding company, and Independence, the FLYi subsidiary that conducted the Debtors' airline operations. The other debtors were affiliated companies with few or no assets or creditors. After operating as a regional carrier for major airlines, including United Airlines, for 12 years and as an independent, low-fare carrier under the name "Independence Air" for approximately a year and a half, the Debtors suffered increasing operating losses that led them to file for protection under chapter 11 of the Bankruptcy Code on November 7, 2005.

A team of Jones Day attorneys including Paul D. Leake (New York), Brad B. Erens (Chicago), Robert W. Hamilton (Columbus), and Mark A. Cody (Chicago) represented FLYi, Inc., Independence Air, Inc., and their affiliated debtors in achieving confirmation of their chapter 11 plan and implementing an orderly liquidation through bankruptcy.

At the outset of the chapter 11 filings, the Debtors obtained authority from the bankruptcy court to attempt to sell their business as a going concern or to find an investor to provide additional capital. No potential bidder or investor, however, offered a transactional alternative that was more favorable to the value of the Debtors' estates than the value that would be obtained by discontinuing operations and conducting an orderly liquidation. Accordingly, on January 5, 2006, the Debtors obtained authority to cease business operations and begin the process of liquidating their assets and winding down their affairs. To that end, the Debtors rejected their remaining aircraft leases and abandoned their remaining owned aircraft.

The largest claims in the Debtors' chapter 11 cases were the hundreds of millions of dollars in claims held by lessors whose aircraft leases were rejected by Independence and the undersecured deficiency claims of creditors that made loans to Independence secured by abandoned aircraft. In most cases, Independence's lease or loan obligations were guaranteed by FLYi. These creditors therefore generally had claims against both FLYi and Independence. As a result, there were three categories of unsecured creditors in the case — FLYi-only creditors, Independence-only creditors, and "crossover" creditors, which consisted in the main of the aircraft-related creditors with primary claims against Independence and guaranties from FLYi. The largest group of FLYi-only creditors consisted of the holders of the approximately $125 million in FLYi's 6% convertible notes (the "Convertible Notes"). QVT Financial LP ("QVT"), a multibillion-dollar hedge fund, purchased approximately 60% of the Convertible Notes after the filing of the bankruptcy cases. The Independence-only creditors consisted generally of nonaircraft contract-rejection claimants, general trade creditors, and International Lease Finance Corporation ("ILFC"), which had leased aircraft to Independence without requiring a guaranty from FLYi.

The Debtors' largest asset was a contract-rejection claim in the chapter 11 bankruptcy case of United Airlines. In that bankruptcy, United rejected its code-sharing agreements with the Debtors pursuant to which Independence Air's predecessor, Atlantic Coast Airlines, had operated as a regional carrier or United. After a contested hearing, the judge in the United bankruptcy allowed the Debtors' claim for $500 million. United, the United creditors' committee, and FLYi all appealed the ruling. With Jones Day's assistance, the Debtors negotiated a settlement of that claim, and of Independence's unfair-competition claim against United, in the total amount of $750 million. The $750 million claim was worth approximately $150 million in reorganized United stock under United's bankruptcy plan.

After negotiations with the creditors' committee, the Debtors and the committee reached an agreement regarding the terms of the Debtors' chapter 11 plan. The agreed-upon plan did not provide for the substantive consolidation of the estates of FLYi and Independence. Instead, the plan separately classified claims against FLYi and Independence, respectively, and treated the assets of FLYi and Independence as separate. The decision not to pursue a plan predicated upon substantive consolidation was informed by the Third Circuit's decision in *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005), in which the Third Circuit held that substantive consolidation is an "extreme" remedy to be used "sparingly."

In addition, the plan included a release by the Debtors of their estates' pre-petition claims against the Debtors' present and former officers, their directors, and certain other parties

(collectively, the "Debtor Parties"). The Debtors, with Jones Day's assistance, had reached an agreement with the creditors' committee on a protocol by which the committee would conduct an investigation of those pre-petition claims against the Debtor Parties. The plan provided that the Debtors would release all causes of action arising prior to bankruptcy that they might have had against the Debtor Parties. The protocol set a deadline of April 11, 2007, for the committee to assert any such causes of action. After its investigation, the committee determined not to pursue any such actions.

Nonconsolidation of the estates of FLYi and Independence left open two significant issues between the two companies: (i) the allocation of the proceeds of the $750 million settlement with United Airlines; and (ii) the treatment of FLYi's net pre-petition intercompany claim against Independence (the "Intercompany Claim"), which was on the Debtors' books and records in the amount of approximately $285.5 million. The creditors' committee requested that the United settlement be allocated 50% to FLYi and 50% to Independence and that the Debtors make such other adjustments as determined equitable. The Debtors believed, however, that it was likely that FLYi would receive substantially less than 50% of the settlement if the allocation were to be litigated, and they also believed that a significant amount of the Intercompany Claim likely would not be treated as valid if litigated. The ultimate compromise embodied in the plan allocated the United settlement 50/50 between FLYi and Independence creditors and provided for no consideration to be paid on account of the Intercompany Claim.

The Debtors' plan was overwhelmingly accepted by all classes of voting creditors except the class of holders of Convertible Notes controlled by QVT. The only creditors to file material objections to the plan were QVT, which as noted above was a FLYi-only creditor, and ILFC, an Independence-only creditor. Among their objections, QVT and ILFC argued that the FLYi and Independence estates should have been substantively consolidated or, at a minimum, that the recoveries to the holders of guaranty claims, or crossover creditors, should have been reduced to account for the risk of substantive consolidation. Substantive consolidation would have materially increased the recovery to QVT and ILFC by vitiating the guaranties.

Judge Walrath ultimately concluded that substantive consolidation was inappropriate under the circumstances, following the Third Circuit's ruling in *Owens Corning*, because that ruling expressly prohibited the use of substantive consolidation for the type of "affirmative" purpose sought by the objectors: that is, to reduce unilaterally the recoveries of a specific group of creditors—the crossover creditors—so that other creditors, including the objectors, could obtain greater recoveries under the plan. The bankruptcy court's ruling underscores the principle that separate legal entities are presumed to remain separate in chapter 11 unless the "extreme remedy" of substantive consolidation is warranted by compelling circumstances.

AD HOC COMMITTEE DISCLOSURE REQUIREMENTS—A BITTER PILL TO SWALLOW FOR DISTRESSED INVESTORS

Paul D. Leake and Mark G. Douglas

An essential part of the chapter 11 process is constructive dialogue and negotiation among all stakeholders involved in the bankruptcy case, with a view toward building a consensus on the terms of a confirmable chapter 11 plan. The Bankruptcy Code establishes a framework to promote such interaction by providing for the appointment of official committees of creditors and shareholders entrusted by statute with the duty to participate in the formulation of a chapter 11 plan.

Collective stakeholder participation in a chapter 11 case, however, extends beyond membership on committees officially sanctioned by the Bankruptcy Code. Unofficial, or "ad hoc" committees, have also long played prominent roles in bankruptcy cases. Like official committees of unsecured creditors, shareholders, retirees, or other creditor groups, ad hoc committees commonly retain professionals and participate in a chapter 11 case by filing pleadings, appearing before the bankruptcy court, and otherwise seeking to influence the outcome of the reorganization and the ultimate recovery on their claims or interests. By acting collectively, ad hoc committee members share the costs of participating in a chapter 11 case and have the ability to wield greater influence than they would if acting alone. The Bankruptcy Code itself acknowledges that unofficial committees can play an important role in a chapter 11 case by providing in sections 503(b)(3)(D) and (4) that costs, including professional fees, incurred by such committees (and certain other parties in interest) in making a "substantial contribution" to the case will be paid by the estate as priority administrative expenses.

The members of an official committee bear fiduciary duties to both the bankruptcy estate and the committee's constituency. Official creditors' committees also have a duty (added to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005) to provide access to information for their creditor constituents and are obligated to solicit and receive comments from creditors concerning developments in the chapter 11 case. Any fees and expenses of their professionals must be allowed by the bankruptcy court before being paid by the estate.

Ad hoc committees, by contrast, are largely unregulated. For this reason, they are sometimes the preferred mechanism for creditors and shareholders, such as hedge funds and other "distressed" investors, who want to wield enhanced influence and bargaining power in a chapter 11 case without being subject to the statutory obligations borne by official committees and the same degree of bankruptcy-court scrutiny. Even so, the conduct of unofficial committees is subject to a certain amount of scrutiny by means of information disclosure requirements contained in the Federal Rules of Bankruptcy Procedure. Rulings recently handed down by the bankruptcy court overseeing the chapter 11 case of Northwest Airlines illustrate that complying with these requirements may be seriously problematic for hedge funds and other distressed investors. As a result of these and other similar rulings, those investors, who take great pains to keep confidential information concerning the timing and pricing of their acquisition of claims or shares in a chapter 11 debtor, may no longer be inclined to sit on ad hoc committees.

BANKRUPTCY RULE 2019

Rule 2019(a) of the Federal Rules of Bankruptcy Procedure provides that, in a case under chapter 9 or chapter 11 of the Bankruptcy Code, any entity or committee (other than an official committee) representing more than one creditor or equity security holder and, unless otherwise directed by the court, every indenture trustee, must file a verified statement with the court disclosing the following information (emphasis added):

(1) the name and address of the creditor or equity security holder;

(2) *the nature and amount of the claim or interest and the time of acquisition thereof unless it is alleged to have been acquired more than one year prior to the filing of the petition*;

(3) a recital of the pertinent facts and circumstances in connection with the employment of the entity or indenture trustee, and, in the case of a committee, the name or

NEWSWORTHY

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, and ***Paul D. Leake (New York)*** were recognized by the K&A Restructuring Register as being among the outstanding attorneys practicing in restructuring, reorganization, insolvency, and bankruptcy in the United States in 2007.

Paul D. Leake (New York) and ***Corinne Ball (New York)*** were featured in New York Super Lawyers—Metro Edition for 2007.

Corinne Ball (New York) and ***Brad B. Erens (Chicago)*** were featured as Highly Recommended Restructuring Lawyers in the 2007/2008 Practical Law Company's *Cross-Border Restructuring and Insolvency Handbook*.

Adam Plainer (London) was recognized as a Legal Expert in Insolvency and Corporate Recovery in the 2007 *Legal Business Legal Experts Guide*.

Heather Lennox (Cleveland) sat on a panel discussing "The Administratively Insolvent Debtor" at the William J. O'Neill Bankruptcy Seminar in Cleveland on April 27, 2007.

An article cowritten by ***Paul D. Leake (New York)*** and ***Mark G. Douglas (New York)*** entitled "Ad Hoc Committee Disclosure Requirements: A Bitter Pill to Swallow for Distressed Investors" appeared in the May 2007 edition of *The Bankruptcy Strategist*.

Tobias S. Keller (San Francisco) sat on a panel discussing "The Distressed Debt Market: Impact and Implications for Corporate Restructuring" at a meeting of the Commercial Law and Bankruptcy Section of the Bar Association of San Francisco held on April 10, 2007.

Jeffrey B. Ellman (Atlanta) and ***Ryan T. Routh (Cleveland)*** were instructors at a Beard Group Audio Conference Continuing Legal Education presentation on May 8, 2007, regarding "Twenty-Day Claims under Section 503(b)(9) of the Bankruptcy Code."

Joseph M. Witalec (Columbus) sat on a panel discussing "Post-BAPCPA Chapter 11 Practice and Issues" at the Columbus Bar Association's Bankruptcy Law Institute on May 4, 2007.

An article written by ***Ryan T. Routh (Cleveland)*** entitled "Bankruptcy Courts Rule On 20-Day Claims" appeared in the May 14, 2007, edition of *Bankruptcy Law 360*.

An article written by ***Timothy Hoffmann (Chicago)*** entitled "Ch. 11: Solution to Stockholder Voting Requirements?" appeared in the May 11, 2007, edition of *Bankruptcy Law 360.*

An article written by ***Mark G. Douglas (New York)*** entitled "Disenfranchising Creditors in Chapter 11: In Search of the Meaning of 'Bad Faith' Under Section 1126(e)" was published in the March 2007 edition of *Pratt's Journal of Bankruptcy Law*. His article entitled "Curbing a Debtor's 'Absolute' Right to Convert" appeared in the March 23, 2007, edition of *Bankruptcy Law 360.* His article entitled "Choice Of Venue: Sound Strategy Or Forum Shopping?" was published in the May 4, 2007, edition of *Bankruptcy Law 360*.

names of the entity or entities at whose instance, directly or indirectly, the employment was arranged or the committee was organized or agreed to act; and

(4) with reference to the time of the employment of the entity, the organization or formation of the committee, or the appearance in the case of any indenture trustee, *the amounts of claims or interests owned by the entity, the members of the committee or the indenture trustee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof*.

The consequences of noncompliance with the disclosure requirements are specified in Rule 2019(b), which authorizes the court, upon finding that any entity covered by Rule 2019(a) has failed to comply with either the rule or "any other applicable law regulating the activities and personnel" of the entity, to deny the offender any right to be heard or intervene in the bankruptcy case. The bankruptcy court may also examine any operative instrument authorizing the entity to represent its constituency, and any claim or interest acquired by any entity or committee either before or after the chapter 11 filing date, "and grant appropriate relief." Finally, the court may invalidate any authority given to, or votes on a chapter 11 plan procured by, any entity failing to comply with either Rule 2019(a)'s disclosure requirements or the chapter 11 vote-solicitation requirements specified in section 1125 of the Bankruptcy Code.

The purpose of Rule 2019 and its predecessors in the former Bankruptcy Act and accompanying rules is to provide for disclosure of the composition and activities of groups acting in a representative capacity in order to help foster fair and equitable plans free from deception and overreaching. Its technical requirements are neither complicated nor particularly demanding. Rule 2019's profile, however, recently became much more prominent as a consequence of the bankruptcy court's ruling in *Northwest Airlines*.

NORTHWEST AIRLINES: RULE 2019 EMERGES FROM OBSCURITY

Sixteen months after Northwest Airlines and three affiliates filed for chapter 11 protection in September of 2005, and the day before the debtors filed a plan of reorganization, an ad hoc committee of equity security holders filed a notice of appearance in the case. Its January 16, 2007, verified statement under Rule 2019(a) identified 11 committee members, including hedge funds and other investment entities, that collectively owned 16,195,200 shares of Northwest's common stock and $164.7 million in claims against the debtors, some of which had been acquired after the bankruptcy petition date. The statement was later supplemented to disclose the addition of two members, so that the committee's aggregate holdings consisted of more than 19 million shares of stock (of approximately 87 million shares outstanding) and more than $264 million in claims. The Rule 2019(a) statement did not disclose the amount of claims or interests owned by individual committee members, the specific dates on which such claims or interests were acquired, the amounts paid for them, or any post-acquisition sales or dispositions.

The ad hoc committee immediately filed a motion with the bankruptcy court for an order directing the appointment of an official committee of equity security holders (since withdrawn) and sought certain discovery in connection with the motion. Northwest responded on February 9, 2007, by filing a motion for a protective order, the imposition of civil contempt sanctions, and an order directing the ad hoc committee to supplement its 2019(a) statement with more detailed information concerning individual committee members' stock and claim holdings, including the dates of acquisition, the acquisition prices, and the details of any post-acquisition divestitures. The ad hoc committee opposed the motion, contending that Rule 2019(a), which by its express terms covers "every entity or committee representing more than one creditor or equity security holder," may apply to the committee's lawyers, who "represent" all committee members, but does not apply to each individual member, which "represents" no one but itself, even though it sits on a committee. Moreover, the committee contended, the information already contained in its Rule 2019(a) statement was adequate to satisfy the rule's purpose in promoting the formulation of a fair chapter 11 plan through an above-board negotiation process.

THE BANKRUPTCY COURT'S 2019(a) RULING

On February 26, 2007, Bankruptcy Judge Allan Gropper issued a memorandum decision requiring the ad hoc committee to provide the detailed information requested by Northwest. Judge Gropper rejected the committee's interpretation of Rule 2019(a), explaining that the members of the ad hoc committee were clearly acting collectively in seeking the appointment of an official equity committee and in litigating discovery issues, so that the ad hoc committee as well as its lawyers can fairly be characterized as "representing" the interests of multiple shareholders within the strictures of the rule. Observing that "[a]d hoc or unofficial committees play an important role in reorganization cases," the judge traced the history of Rule 2019(a) and its predecessors back to the 1930s, when disclosure requirements were first promulgated to remedy perceived abuses by unofficial committees in equity receiverships and other corporate reorganizations. "The Rule is long-standing," Judge Gropper wrote, "and there is no basis for failure to apply it as written."

SUBSEQUENT EVENTS

The ruling sent shock waves through the distressed investment community, whose players have increasingly included hedge funds, private equity investors, and other distressed investors. The decision represents one of the first tests of the extent to which hedge funds must reveal trading information to the public when they act collectively in a chapter 11 case.

On March 1, 2007, the ad hoc committee sought a stay of Judge Gropper's order and court authority to file the required information under seal, contending that the trading information represents trade secrets and confidential commercial information which no other committee or party has previously been required to file publicly in any other chapter 11 case. According to the committee, public disclosure of such information would cause irreparable harm to its members because other investors need not make the same disclosure and can use the information to gain an unfair advantage in the market for distressed securities. Judge Gropper granted the stay pending resolution of the appeal.

PUBLIC ACCESS TO DOCUMENTS IN BANKRUPTCY

The ad hoc committee's motion to file the requested information under seal implicated section 107(a) of the Bankruptcy Code, which recognizes the right of public access to documents in a bankruptcy case. It provides that "[e]xcept as provided in subsection (b) of this section, a paper filed in a case under this title and the dockets of a bankruptcy court are public records and open to examination by an entity at reasonable times without charge." The scope of the provision extends to nearly all documents filed with the court, with certain exceptions.

The right of access to public documents is not absolute—confidentiality may be justified in certain designated circumstances. Thus, section 107(b)(2) of the Bankruptcy Code provides in relevant part that, if an interested party so requests, "the bankruptcy court shall . . . protect an entity with respect to a trade secret or confidential research, development, or commercial information." Rule 9018 of the Federal Rules of Bankruptcy Procedure similarly authorizes the court to issue any order necessary "to protect the estate or any entity in respect of a trade secret or other confidential research, development, or commercial information."

On March 9, 2007, Judge Gropper denied the ad hoc committee's request to seal the trading information. In his ruling, the judge was critical of the committee's characterization of trading positions as "commercial information," explaining that "any interest that the individual Committee members may have in keeping this information confidential is overridden by the interests that Rule 2019 seeks to protect." Moreover, Judge Gropper emphasized, whether or not the ad hoc committee is acting as a fiduciary to Northwest's other stockholders,

> Rule 2019 is based on the premise that the other shareholders have a right to information as to Committee member purchases and sales so that they [can] make an informed decision whether this Committee will represent their interests or whether they should consider forming a more broadly-based committee of their own.

The judge directed the ad hoc committee to file an amended Rule 2019(a) statement containing the trading information within three business days.

Hedge funds and other distressed investors closely guard trading information, such as the acquisition price of stock or claims, public disclosure of which would compromise their ability to maximize investment returns. If Judge Gropper's disclosure ruling is upheld on appeal, there may well be a chilling effect on who agrees to serve on ad hoc committees going forward.

On the same day that Judge Gropper issued that ruling, certain members of the ad hoc committee filed a motion asking the court to reconsider its original ruling directing the committee members to disclose trading information. According to the committee members, an examination of the history and purpose of Rule 2019's disclosure requirements indicates that the term "committee" in Rule 2019 was not intended to encompass an informal creditor group "more appropriately described as a 'consortium'—financial institutions combining to undertake an operation beyond the resources of any member." The Loan Syndications and Trading Association ("LSTA") and Securities Industry and Financial Markets Association ("SIFMA"), two of the nation's leading industry groups in the debt and equity markets, joined in the motion on March 15, 2007. In their joinder motion, LSTA and SIFMA expressed concern "that the Rule 2019 Decision will have a serious detrimental impact on the willingness and ability of many stakeholders to participate in future chapter 11 cases." Moreover, they noted, there are "countless examples" in chapter 11 cases where "groups of stakeholders have cooperated, many times in the guise of 'ad hoc' committees, to create imaginative and strikingly successful solutions"—a positive contribution by sophisticated stakeholders that may be forfeited by requiring the disclosure of proprietary and highly confidential information.

Judge Gropper denied the motion on March 15, 2007, ruling that the individual committee members lacked standing to move for reconsideration of an order directed at the ad hoc committee and characterizing the reconsideration motion as "totally frivolous."

WHERE DO WE GO FROM HERE?

The ad hoc committee appealed Judge Gropper's ruling denying its motion to file members' trading information under seal. However, the nine remaining members of the committee, which once consisted of as many as 17 shareholders claiming to own 27% of Northwest's common stock, filed the required information with the court on March 21, 2007.

The ad hoc committee also filed a notice of appeal from Judge Gropper's initial February 26, 2007, disclosure ruling on March 26, 2007. At a March 15, 2007, hearing, Judge Gropper denied the ad hoc committee's request for a stay pending the resolution of its section 107(b) appeal. However, the court gave the committee until March 25, 2007, to seek a stay from the district court. The committee elected not to seek a stay pending the resolution of either appeal.

Hedge funds and other distressed investors closely guard trading information, such as the acquisition price of stock or claims, public disclosure of which would compromise their ability to maximize investment returns. If Judge Gropper's disclosure ruling is upheld on appeal, there may well be a chilling effect on who agrees to serve on ad hoc committees going forward. Hedge funds and other distressed investors have made and continue to make enormous investments in all levels of the capital structures of distressed companies. As a consequence, these funds and investors have regularly assumed prominent roles in major chapter 11 cases. The level of this involvement, at least in the ad hoc committee context, could change significantly if such investors are discouraged from participating because of disclosure requirements in the federal bankruptcy laws.

EPILOGUE

Northwest Airlines is not the only chapter 11 case in which ad hoc committees have battled against disclosure of trading information under Rule 2019(a). Unlike in *Northwest Airlines*, some committees have succeeded in resisting the disclosure requirements. Barely three weeks after Judge Gropper issued his latest ruling on committee disclosure requirements under Rule 2019(a), Judge Richard S. Schmidt of the U.S. Bankruptcy Court for the Southern District of Texas denied a motion filed by chapter 11 debtor Scotia Pacific Company LLC ("Scopac") to compel an ad hoc noteholder group consisting principally of hedge and private equity funds to file an amended Rule 2019(a) statement disclosing information concerning the composition of the committee and its members' trading positions. In denying Scopac's motion at a hearing held on April 10, 2007, the judge observed that the noteholder group was "not a committee" within the meaning of Rule 2019(a), but merely a "bunch of creditors" represented by a single law firm.

SIFMA and LSTA filed an *amicus* brief in opposition to the disclosure motion, citing the same concerns articulated in *Northwest Airlines* and indicating that this controversial issue is far from resolved. On April 27, 2007, Scopac filed a motion asking Judge Schmidt to reconsider his ruling, based upon previous representations by the noteholder group in the chapter 11 cases that they were indeed functioning as an ad hoc committee. Judge Schmidt denied Scopac's motion on May 22, 2007. It is anticipated that the company will appeal Judge Schmidt's original ruling.

In re Northwest Airlines Corp., 2007 WL 609214 (Bankr. S.D.N.Y. Feb. 26, 2007).

In re Northwest Airlines, Inc., 2007 WL 724977 (Bankr. S.D.N.Y. Mar. 9, 2007).

In re Scotia Development LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007) (unpublished order entered eight days following denial of motion at April 10, 2007, hearing).

FOCUS ON FEASIBILITY

Daniel P. Winikka

One of the most significant changes to chapter 11 of the Bankruptcy Code in the 2005 amendments was the absolute limit placed on extensions of the exclusivity periods. Courts no longer have the discretion to extend a debtor's exclusive periods to file and solicit a plan beyond 18 months and 20 months, respectively, after the petition date. Although the legislative history contains no explanation for why this change was made, Congress presumably intended to accelerate the reorganization process or facilitate the prospects for competing plans in large, complex cases. Given that the first cases filed after the amendments took effect in October 2005 are now just reaching the 18-month milestone, it remains to be seen what effect this change will have.

For a number of reasons, however, one result of the new exclusivity limits is likely to be increased litigation over, and an increased focus on, the plan "feasibility" requirement. As an initial matter, parties have greater incentives to challenge the feasibility of a plan. A creditor group may challenge feasibility in an attempt to delay the case until the creditor group can file its own plan, or where competing plans have been filed, in an attempt to defeat the competing plan. Moreover, in a competing-plan context, the relative feasibility of the plans may become a focus in soliciting creditor support. Plans may also be more vulnerable to feasibility attacks. Debtors will have had less time in chapter 11 to demonstrate that operational and strategic changes are likely to lead to the projected improvements in financial performance under the proposed plan. In addition, in light of the substantial debate in recent years over repeat chapter 11–filing rates and the contention by some commentators that higher repeat-filing rates are partly attributable to a purported lack of enforcement of the feasibility requirement, it is possible that courts will require a plan proponent to demonstrate a higher likelihood of success to meet the feasibility requirement. Add to these factors the increasing prevalence of hedge funds and other distressed investment funds that often take an active, aggressive role in the restructuring and have the financial wherewithal to propose competing plans and litigate their positions, and the potential for increased litigation over feasibility appears all the more likely.

THE FEASIBILITY REQUIREMENT

Pursuant to section 1129(a)(11) of the Bankruptcy Code, a plan of reorganization may be confirmed only if "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan . . . ." This "feasibility" requirement had its origins in various provisions of the Bankruptcy Act of 1898, which required that the court find the plan "feasible." As the United States Supreme Court stated in 1936 in *Tennessee Pub. Co. v. American Nat. Bank*: "However honest in its efforts the debtor may be, and however sincere its motives, the district court is not bound to clog its docket with visionary or impracticable schemes for resuscitation." The oft-cited modern-day incantation of this maxim was articulated by the Ninth Circuit Court of Appeals in *Matter of Pizza of Hawaii*, which remarked that the purpose of subsection 1129(a)(11) is "to avoid confirmation of visionary schemes which promise creditors more under a proposed plan than the debtor can possibly attain after confirmation."

Consistent with the plain language of the text, courts have uniformly held that the feasibility requirement does not require a guarantee of the plan's success, but rather that the plan offer "a reasonable prospect" or "reasonable assurance" of success. Courts, however, have sometimes varied widely in their determination of how likely success has to be under the circumstances presented.

The plan proponent bears the burden of proof to establish by a preponderance of the evidence that the plan is feasible. Factors recognized by the courts as relevant to evaluating the feasibility of a proposed plan of reorganization include the prospective earnings or earning power of the debtor's business, which must be based on sound and reasonable assumptions; the adequacy of the capital structure and working capital for the debtor's post-confirmation business; the debtor's ability to meet its capital-expenditure requirements; economic conditions; the capability of management and the likelihood that current management will continue; and any other material factors that would affect the successful implementation of the plan.

Courts have an affirmative obligation to evaluate a plan's likelihood of success and to make a particular finding as to feasibility. Thus, when feasibility is not contested, at a minimum the court must itself ensure that there is adequate evidence to support a finding that the plan is feasible. This typically will consist of the unimpeached testimony from an officer of the debtor (or representative of the plan proponent) and possibly the debtor's financial advisor or other retained expert, if applicable. The extent of the court's role and analysis, however, may vary considerably, depending upon whether there is an active creditor constituency in the case. In small-business cases where there is no active creditor involvement, the court can serve an important role in ensuring that the debtor has undertaken the necessary planning and analysis and can adequately explain the basis for projections and related assumptions. While the court will not conduct its own analysis of the debtor's prospects for success, the court does play an important gatekeeper role by ensuring that the debtor has undertaken the appropriate planning and analyses.

In large corporate chapter 11 cases, however, the debtor's projections and the adequacy of the debtor's capital structure upon emergence typically have been evaluated not only by the debtor's retained financial advisors, but also by the financial advisors for the various creditor constituencies. And when confirmation is uncontested, the court is presented with uncontested expert testimony regarding the reasonableness of the projections and adequacy of the capital structure. In these circumstances, the court's role is essentially limited to reviewing the uncontested testimony and, to the extent that the court determines it necessary, requesting further explanation or clarification. In other words, the court will not perform any independent assessment of the reliability and accuracy of the uncontested testimony, and it would be a rare case where the court determines that the feasibility requirement is not met.

CHALLENGES TO FEASIBILITY

When feasibility is contested, the court, consistent with its role in adjudicating any complex commercial dispute, will weigh the competing evidence and expert testimony and determine whether the plan proponent has met its burden to establish that the plan is feasible. Although courts have adopted varying views as to how likely success has to be for the plan proponent to meet its burden, if the purpose of the feasibility requirement is to avoid confirmation of "visionary or impracticable schemes" that are likely to be followed by a need for further reorganization, one would expect that, most of the time, the plan proponent, with its supporting expert testimony, will prevail in a dispute over the feasibility requirement.

Over the last few years, however, several factors have raised the visibility of failures by companies after emerging from chapter 11. There have been a significant number of repeat chapter 11 filings, so-called Chapter 22s, in recent years. Moreover, based on empirical findings relating to repeat-filing rates, there has been much debate regarding the role of bankruptcy courts in large chapter 11 cases and, in particular, whether there exists a harmful competition among courts for large cases. In connection with this debate, some commentators have contended that the Delaware and New York bankruptcy courts, purportedly in an effort to attract large cases, have abdicated their responsibility to enforce the "feasibility" requirement under the Bankruptcy Code. Given the prevalence of this debate and the number of repeat filings, courts may be increasingly likely to require a higher threshold of proof (*i.e.*, a higher level of assurance of success) to satisfy the feasibility requirement.

> Perhaps the most important step a debtor can take in avoiding a feasibility attack is to keep its creditor constituencies informed and involved throughout the process.

Regardless of whether courts may apply a higher threshold, when feasibility is challenged, and especially when there is a competing plan or the prospect of a competing plan, support of the debtor's various stakeholders will play a key role in the outcome. If the plan is broadly supported by the debtor's constituencies, the court may very well conclude that the feasibility requirement has been met, even if the court is concerned from the evidence that the debtor's assumptions and projections are aggressive and prospects for success somewhat questionable. In fact, some courts have expressly concluded that the threshold for feasibility is reduced if plan confirmation is widely supported by creditors.

Conversely, if the feasibility of the plan is challenged by constituencies that will have a significant stake in the reorganized entity, as opposed to merely an out-of-the-money constituency seeking to leverage a nuisance settlement, the court is likely to require the plan proponent to establish that the plan have a higher likelihood of success, especially where the challenging constituency is proposing to file its own plan that does not have the same risks of failure.

When there are competing plans, the relative feasibilities of the plans may become a determining factor in which plan is confirmed. If multiple plans are being solicited simultaneously, the disclosure statements may contain plan proponents' contentions or opinions regarding the deficiencies of the competing plan, including the risks that the competing plan will not be consummated or reasons why projections underlying the competing plan may not be met. In this situation, creditors are typically sent a ballot on which they are asked to accept or reject each plan and, if accepting each plan, indicate which plan they prefer. Although bankruptcy courts are required to consider the preferences of creditors when choosing between confirmable plans, the bankruptcy courts are not bound by those preferences and generally have determined to balance creditor preferences with other factors, including the relative feasibilities of the plans. Thus, if each plan receives the requisite acceptances for each impaired class and there is not an overwhelming preference among the creditors for one plan over another, the relative feasibilities of the two plans may well determine which plan prevails. Even in cases where there is a clear creditor preference for one plan over another, the less preferred plan may still prevail if the preferred plan has substantially less assurance of success. For example, one plan may contemplate the sale of the debtor's assets and payment of cash to creditors, while the other plan is dependent upon the future success of the debtor's operational changes and strategies—success that the court may determine, after considering the evidence, is questionable.

AVOIDING FEASIBILITY PROBLEMS

There are a number of things that debtors can do throughout the restructuring process to minimize the possibility of a plan-feasibility challenge. As early as possible in the process, a debtor should develop its strategic business plan and begin implementation of the operational changes contemplated therein. It is critical to have at least some track record of operating results prior to the development of financial projections, and the longer the period of operating results is, the more supportable the financial projections will be.

Once negotiations with creditors on the terms of the reorganization begin, those negotiations should take into account the ability to defend the proposed capital structure upon emergence, including the ability to demonstrate the availability of sufficient liquidity to operate the business and meet any post-bankruptcy debt service obligations. There can often be a substantial period of time between the commencement of negotiations and actual plan confirmation, and operating results or changes in industry conditions during that time may necessitate revisions to the financial projections and the obligations contemplated by the plan. Thus, to the extent the payment of cash or the issuance of debt instruments to creditors is contemplated, it may be necessary to negotiate some form of "relief provision" that would permit a reduction or modification of the obligation if, at the time of confirmation, it turns out that there is insufficient liquidity to support the required payments. For example, a class of creditors may be offered a pro rata share of a specific amount of cash if exit financing sufficient to enable such payment can be obtained or, if sufficient exit financing cannot be obtained, promissory notes to be paid over time.

With respect to the development of the business plan and financial projections, it is best to take a conservative approach and to ensure adequate involvement of operational management. Projections that forecast dramatic improvements over a short period of time or performance that is significantly greater than historical results are vulnerable to attack. Thorough testimony to support the reasonableness of the assumptions underlying the projections will be critical in the event of a feasibility challenge. This includes assumptions regarding general business and economic conditions and industry trends as well as operational and financial assumptions. The debtor's performance to date will often be the most important factor in establishing that it is reasonable to expect that the debtor will meet or exceed projections. It is also important to provide testimony establishing that the debtor will remain viable even if it falls short of the projections. This may include, for instance, testimony about the existence of excess liquidity to deal with unforeseen events.

Perhaps the most important step a debtor can take in avoiding a feasibility attack is to keep its creditor constituencies informed and involved throughout the process. For instance, creditors should be given the opportunity to review and comment on the business plan before major steps to implement it are taken. Creditors should also be given access to information relating to the development of the financial projections as soon as practicable so that any issues can be vetted as early as possible. Ultimately, the best defense against any feasibility challenge is broad creditor support of the plan.

Tennessee Pub. Co. v. American Nat. Bank, 299 U.S. 18 (1936).

Matter of Pizza of Hawaii, Inc., 761 F.2d 1374 (9th Cir. 1985).

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APPLICATION OF THE ABSOLUTE PRIORITY RULE TO PRE-CHAPTER 11 PLAN SETTLEMENTS: IN SEARCH OF THE MEANING OF "FAIR AND EQUITABLE"

Mark G. Douglas

"Give-ups" by senior classes of creditors to achieve confirmation of a plan have become an increasingly common feature of the chapter 11 process, as stakeholders strive to avoid disputes that can prolong the bankruptcy case and drain estate assets by driving up administrative costs. Under certain circumstances, however, senior-class "gifting" or "carve-outs" from senior-class recoveries may violate a well-established bankruptcy principle commonly referred to as the "absolute priority rule," a maxim predating the enactment of the Bankruptcy Code, which established a strict hierarchy of payment among claims of differing priorities. The rule's continued application under the current statutory scheme has been a magnet for controversy.

Most of the court rulings handed down recently concerning this issue have examined the rule's application to the terms of a proposed chapter 11 plan that provides for the distribution of value to junior creditors without paying senior creditors in full. A decision recently issued by the Second Circuit Court of Appeals, however, indicates that the dictates of the absolute priority rule must be considered in contexts other than confirmation of a plan. In *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, the Second Circuit ruled that the most important consideration in determining whether a pre-plan settlement of disputed claims should be approved as being "fair and equitable" is whether the terms of the settlement comply with the Bankruptcy Code's distribution scheme.

CRAMDOWN AND THE FAIR AND EQUITABLE REQUIREMENT

If a class of creditors or shareholders votes to reject a chapter 11 plan, it can be confirmed only if the plan satisfies the requirements of section 1129(b) of the Bankruptcy Code. Among these is the mandate that a plan be "fair and equitable" with respect to dissenting classes of creditors and shareholders.

Section 1129(b)(2) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a dissenting impaired class of unsecured claims if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, no creditor of lesser priority, or shareholder, receives any distribution under the plan. This requirement is sometimes referred to as the "absolute priority rule."

Section 1129(b)(2) has been the focus of considerable debate in the courts. One of the most significant disputes concerns the propriety of an increasingly common, albeit controversial, practice in large chapter 11 cases—whether section 1129(b)(2) allows a class of senior creditors voluntarily to cede a portion of its recovery under a plan to a junior class of creditors or shareholders, while an intermediate class is not receiving payment in full.

LEGITIMACY OF SENIOR-CLASS "GIVE-UPS" UNDER THE ABSOLUTE PRIORITY RULE

Notwithstanding section 1129(b)(2)'s preclusion of distributions to junior classes of claims or interests in cases where it applies, some courts have ruled that a plan does not violate the "fair and equitable" requirement if a class of senior creditors agrees that some of the property that would otherwise be distributed to it under the plan can be given to a junior class of creditors or shareholders. In doing so, many courts rely on a 1993 decision involving a chapter 7 case issued by the First Circuit Court of Appeals in *In re SPM Manufacturing Corp.*

In *SPM*, a secured lender holding a first-priority security interest in substantially all of a chapter 11 debtor's assets entered into a "sharing agreement" with general unsecured creditors to divide the proceeds that would result from the reorganization, presumably as a way to obtain their cooperation in the case. After the case was converted to a chapter 7 liquidation, the secured lender and the unsecured creditors tried to force the chapter 7 trustee to distribute the proceeds from the sale of the debtor's assets in accordance with the sharing agreement. The agreement, however, contravened the Bankruptcy Code's distribution scheme because it provided for distributions to general unsecured creditors before payment of priority tax claims. The bankruptcy court ordered the trustee to ignore the sharing agreement and to distribute the proceeds of the sale otherwise payable to the unsecured creditors in accordance with the statutory distribution scheme. The district court upheld that determination on appeal.

The First Circuit reversed, reasoning that, as a first-priority secured lienor, the lender was entitled to the entire amount of any proceeds of the sale of the debtor's assets, whether or not there was a sharing agreement. According to the court, "[w]hile the debtor and the trustee are not allowed to pay nonpriority creditors ahead of priority creditors . . . , creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."

Other courts have cited *SPM* as authority for confirming a nonconsensual chapter 11 plan (or a settlement) in which a senior secured creditor assigns a portion of its recovery to creditors (or shareholders) who would otherwise receive nothing by operation of section 1129(b)(2). Still, the concept of allowing a senior creditor or class of creditors to assign part of its recovery under a chapter 11 plan to junior creditors or stockholders who would otherwise receive nothing by operation of section 1129(b)(2) is controversial. So much so, in fact, that the Third Circuit in 2005 declared the practice invalid under certain circumstances in *In re Armstrong World Indus., Inc.*

ARMSTRONG WORLD INDUSTRIES

Floor and ceiling products manufacturer Armstrong World Industries, Inc., whose chapter 11 case was filed in the United States Bankruptcy Court for the District of Delaware, proposed a chapter 11 plan under which unsecured creditors (other than asbestos claimants) would recover approximately 59.5% of their claims and asbestos personal-injury creditors would recover approximately 20% of an estimated $3.1 billion in claims. In addition, the plan provided that Armstrong's shareholders would receive warrants to purchase new common stock in the reorganized company valued at $35 million to $40 million. A key provision of the plan was the consent of the class of asbestos claimants to share a portion of its proposed distribution with equity. The plan provided that if Armstrong's class of unsecured creditors (other than asbestos claimants) voted to reject the plan, asbestos claimants would receive new warrants but would automatically waive their distribution, causing equity holders to obtain the warrants that otherwise would have been distributed to the asbestos claimants.

Armstrong's general unsecured creditors voted against the plan. The court denied confirmation, ruling that distribution of new warrants to the class of equity holders over the objection of the general unsecured creditors' class violated the "fair and equitable" requirement of section 1129(b)(2)(B)(ii). In doing so, it distinguished, or characterized as "wrongly decided," cases in which the courts have not strictly applied section 1129(b)(2). It found *SPM* to be inapposite because the distribution in *SPM* occurred in a chapter 7 case, "where the sweep of 11 U.S.C. § 1129(b)(2)(B)(ii) does not reach," and SPM's unsecured creditors, rather than being deprived of a distribution, were receiving a distribution ahead of priority, such that "the teachings of the absolute priority rule—which prevents a junior class from receiving a distribution ahead of the unsecured creditor class—are not applicable." The court also found that the sharing agreement in *SPM* might be more properly construed as an ordinary "carve-out," whereby a secured party allows a portion of its lien proceeds to be paid to others as part of a cash collateral agreement.

The Third Circuit affirmed on appeal, adopting substantially all of the lower court's reasoning regarding the strictures of the absolute priority rule. According to the court of appeals, allowing the distribution scheme proposed in Armstrong's plan "would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context."

Armstrong and most other court rulings construing the "fair and equitable" requirement in section 1129(b) involve proposed distribution schemes under a chapter 11 plan. In many cases, however, the framework of a plan may be dictated in large part by agreements or settlements negotiated among the debtor and various significant creditor groups prior to confirmation. It is well understood that a bankruptcy court will approve a proposed settlement only if it is "fair and equitable" (or, as articulated by some courts, "fair and reasonable") as well as in the best interests of the estate. Less clear, however, is whether that determination encompasses examination of a pre-plan settlement to ensure that its terms comply with the Bankruptcy Code's distribution scheme, and more specifically, the absolute priority rule. Any lingering doubt concerning that issue was eradicated, at least in the Second Circuit, by the ruling in *Iridium*.

IRIDIUM

Iridium Operating LLC is a former Motorola, Inc., subsidiary, incorporated in 1991 to provide global satellite-based telecommunications services. The company filed for chapter 11 protection in 1999 shortly after creditors filed involuntary chapter 11 petitions against certain affiliates. At the time of the chapter 11 filings, the companies (collectively referred to as "Iridium") had amassed nearly $4 billion in debt, including $800 million in financing provided by a consortium of lenders (the "Lenders"), represented by JP Morgan Chase Bank ("Chase"). According to the Lenders, the loans were secured by liens on all of Iridium's assets, including roughly $156 million in cash deposits held in various accounts at Chase, a satellite operations center, $243 million in reserve capital calls, 66 satellites, and various causes of action.

The creditors' committee appointed in Iridium's chapter 11 cases vigorously contested the validity of the Lenders' asserted possessory and contractual liens on Iridium's cash, which the committee argued were avoidable as preferences because the cash was transferred to Chase within 90 days of the bankruptcy filings. It also sought to pursue claims against Motorola for breach of contract, breach of fiduciary duty, and avoidance of a fraudulent transfer in connection with its 1993 spinoff of Iridium, but lacked money to fund the litigation.

The committee and the Lenders ultimately reached a settlement of their dispute and sought court approval of the agreement. The settlement conceded the validity of the Lenders' liens and provided for the distribution of the estate's cash to the Lenders and to a litigation vehicle established for the purpose of suing Motorola. Any recoveries from the litigation were to be divided among the Lenders, administrative creditors, and the estate (to be distributed under a future chapter

11 plan). Any of the $37.5 million in cash used to fund the litigation vehicle remaining at the end of the litigation was to be paid directly to Iridium's unsecured creditors, whether or not the Lenders' claims or administrative claims were paid in full.

Motorola objected to the settlement, arguing that it violated the absolute priority rule by providing for the payment of estate assets to lower-priority creditors (the litigation vehicle and the unsecured creditors) before any payments would be made to Motorola on account of its administrative claims. The bankruptcy court approved the settlement over Motorola's objection, and the district court affirmed on appeal.

THE SECOND CIRCUIT'S RULING

The court of appeals vacated the ruling. At the outset, the Second Circuit distinguished the case before it from *SPM*, where there was no dispute that the lender had valid and perfected liens on substantially all of the debtor's assets. As such, the court explained that "we need not decide if *SPM* could ever apply to Chapter 11 settlements, because it is clear that the Lenders did not actually have a perfected interest in the cash on hand."

> At this juncture, it remains to be seen what kinds of settlement agreements would pass muster under the Second Circuit's unique formulation of the "fair and equitable" standard.

The Second Circuit then directed its attention to the standards applied to proposed settlements. Although the Bankruptcy Code expressly makes the "fair and equitable" requirement applicable only in cases of nonconsensual confirmation of a plan, the Second Circuit explained, the Supreme Court has held "that a settlement presented for approval as part of a plan of reorganization, because it constitutes part of the plan, may only be approved if it, too, is 'fair and equitable' in the sense of conforming to the absolute priority rule." Less clear, the court acknowledged, is the rule's application to pre-plan settlements, when the nature and extent of the bankruptcy estate and claims against it are not fully resolved.

The Second Circuit rejected application of the absolute priority rule to all pre-plan settlements, observing that "a rigid per se rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements." Mindful that rejecting strict application of the rule in all cases increases the risk that parties to a settlement may engage in improper collusion, the court of appeals opted instead for stricter scrutiny in the settlement-approval process. It concluded that "whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable.' " Under this standard, the Second Circuit explained, whether a settlement complies with the statute's priority scheme "will often be the dispositive factor." Even so, the court observed, settlements that deviate in minor respects from that scheme may be approved, if the "remaining factors weigh heavily in favor of approving a settlement" and the court clearly articulates the reasons for approving it.

Examining the bankruptcy court's reasons for approving the settlement between the Lenders and the creditors' committee, the Second Circuit faulted only one aspect of the court's analysis—the absence of any explanation for authorizing an agreement whose terms violated the absolute priority rule. Because "no reason has been offered to explain why any balance left in the litigation trust could not or should not be distributed pursuant to the rule of priorities," the court vacated the order approving the settlement and remanded the case below for consideration of that issue.

WHERE DO WE GO FROM HERE?

Taken together, *Armstrong* and *Iridium* erect stringent standards to govern agreements, either as part of a chapter 11 plan or a pre-plan settlement, that provide for distributions of assets in a way that deviates from the absolute priority rule. Even so, the rulings should not be read as a blanket prohibition of senior-class gifting, which continues to be a vital part of an overall negotiating strategy in chapter 11. First, the absolute priority rule applies only in cases involving the nonconsensual confirmation of a chapter 11 plan—if an intervening class of creditors does not object to a senior-class give-up as a means of achieving consensual confirmation, the rule does not come into play. In addition, cases involving carve-outs from recoveries that would otherwise go exclusively to a senior class of secured creditors (as in *SPM*) are far more likely to pass muster under the standards articulated in *Iridium* and *Armstrong.*

The Second Circuit did not break new ground in ruling that the terms of a pre-plan settlement should comply with the absolute priority rule. In fact, the *Iridium* ruling is more flexible than at least one prior circuit-court precedent. In *In re AWECO, Inc.*, the Fifth Circuit held that the absolute priority rule must apply to pre-plan settlements, concluding that "a bankruptcy court abuses its discretion in approving a [pre-plan] settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors." In *Iridium*, the Second Circuit declared that the rule stated in *AWECO* is "too rigid," emphasizing that "a rigid per se rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements." Instead, the Second Circuit determined that a pre-plan settlement may deviate from the Bankruptcy Code's priority rules if the "remaining factors weigh heavily in favor of approving a settlement" and the court clearly articulates the reasons for approving it. At this juncture, it remains to be seen what kinds of settlement agreements would pass muster under the Second Circuit's unique formulation of the "fair and equitable" standard.

Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007).

Official Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.), 984 F.2d 1305 (1st Cir. 1993).

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

United States v. AWECO, Inc. (In re AWECO, Inc.), 725 F.2d 293 (5th Cir. 1984).

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AVOIDING FORFEITURE OF ESTATE CAUSES OF ACTION TRIGGERED BY CONVERSION TO CHAPTER 7

Benjamin Rosenblum

The ability to borrow money during the course of a bankruptcy case is an important tool available to a chapter 11 debtor-in-possession ("DIP"). Oftentimes, the debtor's most logical choice for a lender is one with an existing pre-bankruptcy relationship with the debtor. As a condition to making new loans, however, lenders commonly require the debtor to waive its right to pursue avoidance or lender liability actions against the lender based upon pre-bankruptcy events. Normally, this type of waiver does not prohibit official creditors' committees from bringing these causes of actions, derivatively, on behalf of the estate—but the waiver provision may limit the amount of time that the committee has to bring these claims.

An interesting issue arises when the case does not go as well as planned and converts from a chapter 11 reorganization to a chapter 7 liquidation. Suppose the chapter 7 trustee wants to prosecute an avoidance action against the lender: does the waiver bind the trustee, as the successor to the DIP, or does the trustee succeed to the rights of the creditors' committee? The Tenth Circuit Court of Appeals recently considered this issue in *Hill v. Akamai Tech., Inc. (In re Ms55, Inc.)*. In a matter of first impression for the circuit, the court ruled that the only rights a chapter 7 trustee inherits from a creditors' committee are derivative of the debtor's rights and therefore are barred if waived by the debtor.

AVOIDANCE POWERS AND STANDING TO SUE

A bankruptcy trustee is endowed with the authority to avoid and recover certain transfers for the benefit of the estate. Among other things, this authority includes the power to bring fraudulent transfer and preference actions. The DIP—a concept that can be characterized as a union of the debtor with the estate—has substantially all of the same powers and rights as a bankruptcy trustee. Accordingly, it is the DIP's role to prosecute avoidance actions, in the first instance. However, in some cases, this task may be shifted to the shoulders of another in keeping with the concept of "derivative standing."

An official committee of unsecured creditors is appointed in almost every large chapter 11 case. Although such a committee has no power under the Bankruptcy Code to bring avoidance actions in its own right, most courts have held that a committee may pursue such actions in the name of the estate where, for example, the DIP or trustee unjustifiably refuses to prosecute colorable claims. Still, in such circumstances, the committee's ability to pursue avoidance claims is merely derivative of the DIP's rights, and any recovery is for the benefit of the bankruptcy estate.

The Bankruptcy Code does not explicitly state when, if ever, a creditors' committee ceases to exist. Nonetheless, most courts conclude that a committee dissolves upon conversion of the case from chapter 11 to chapter 7. Upon conversion, the debtor and the estate are divorced, resulting in two separate and distinct entities: a debtor (now out of possession) and a chapter 7 trustee. Importantly, however, the chapter 7 trustee is bound by the acts of its predecessor, the DIP, because, as the Eighth Circuit Court of Appeals has stated, "[c]reditors must be able to deal freely with debtors-in-possession, within the confines of the bankruptcy laws, without fear of retribution or reversal at the hands of a later appointed trustee."

Yet this seemingly clear principle blurs when applied to a situation where a DIP waives estate causes of action against a post-petition lender with the reservation that the creditors' committee may still pursue such actions derivatively. This confusion is due, in part, to the fact that this arrangement is somewhat awkward; the DIP, as the representative of the bankruptcy estate, agrees to waive certain estate causes of action, but such actions can still be maintained by another party in the estate's name. Nonetheless, such waivers are routine in DIP financing orders. Accordingly, it is important to know whether a subsequent chapter 7 trustee is bound by the DIP's waiver or whether the trustee can inherit the derivative rights of the creditors' committee.

There is authority that suggests that if a committee files a complaint on behalf of the estate prior to being disbanded, the cause of action may be inherited by a chapter 7 trustee. For example, in *Official Unsecured Creditors' Committee v. Rachles (In re S. Rachles, Inc.)*, a creditor's committee commenced avoidance actions against an individual transferee shortly before the case converted to chapter 7. Although the trustee filed his own complaint seeking to avoid the transfer, a question arose as to whether the trustee's complaint was timely filed, so the trustee sought to be substituted as plaintiff in the adversary proceeding filed by the committee. The court permitted the substitution, emphasizing that the proceeding was commenced by the committee on behalf of the estate.

Unsecured committees may be forced to take a hard look at potential causes of action against DIP lenders earlier in the chapter 11 process to ensure that litigation involving colorable claims is filed as soon as possible because of the risk of forfeiture upon conversion.

Suppose, however, the obstacle confronting the trustee was not a statute of limitations, but instead, a waiver on the part of the DIP, and suppose further that the committee was authorized but failed to commence the action before the case was converted. Could the chapter 7 trustee still succeed to the committee's rights under those circumstances? The Tenth Circuit recently addressed this issue in *Ms55*.

THE TENTH CIRCUIT'S RULING IN *Ms55*

Ms55, Inc. ("Ms55"), filed a chapter 11 petition in July of 2001 in the United States Bankruptcy Court for the District of Colorado. Shortly afterward, Ms55 filed a motion seeking authorization to use its cash on hand, which was subject to security interests held by certain of pre-petition secured creditors, and to incur additional post-petition indebtedness. Akamai Technologies ("Akamai") had previously provided secured financing to Ms55. An official committee of unsecured creditors was appointed in August of 2001. Later that month, the bankruptcy court entered a final order approving Ms55's financing motion. Included in the financing order was a provision that shielded secured creditors, such as Akamai, from "any and all claims," except those that could be brought by the creditors' committee. The financing order contained other provisions confirming that it bound parties other than Ms55 and was intended to survive conversion to a chapter 7 case.

The case converted to chapter 7 two years later, and a trustee was appointed. Almost a year afterward, the trustee commenced an adversary proceeding against Akamai seeking to avoid alleged fraudulent and preferential transfers. Akamai moved for summary judgment, claiming that such actions were barred by the financing order. The bankruptcy court denied Akamai's motion but was reversed on appeal by the district court. The trustee appealed the ruling to the Tenth Circuit.

The court of appeals upheld the reversal. Noting that there were essentially two questions before it, the Tenth Circuit first set out to determine whether, as a contractual matter, Ms55, as a DIP, waived its right along with the right of the chapter 7 trustee to bring avoidance actions against Akamai. After determining that it did, the court then considered whether the trustee could still exercise the authority reserved to the creditors' committee in the financing order to bring such a claim.

In addressing this question, the court observed that "*the bankruptcy trustee has no greater rights than the debtor has*." The court also emphasized that a creditors' committee does not have its own right to bring avoidance actions. Instead, the Tenth Circuit explained, when a creditors' committee is allowed to bring an avoidance action, it is solely in the name of the debtor. Moreover, upon conversion, the court noted, the creditors' committee ceases to exist. According to the Tenth Circuit, because, as a contractual matter under the waiver provision, the only party able to bring such a claim is the creditors' committee, and because the creditors' committee no longer exists, there simply is no party that can bring the action. In other words, the court remarked, "[t]he derivative rights exist like a sword in a stone, but there is no Arthur to claim them."

ANALYSIS

The Tenth Circuit's ruling is undoubtedly a welcome development for post-petition lenders intent upon limiting their potential exposure arising from pre-bankruptcy financing relationships with a company that has sought chapter 11 protection. From a post-petition lender's perspective, the decision highlights the importance of strong waiver language that is broad enough to cover claims brought by any trustee appointed in the case (either a chapter 7 or a chapter 11 trustee).

On the other side of the coin, the message borne by the decision for committees is that the risk of forfeiting estate causes of action against post-petition lenders in the event of conversion can be minimized by harder bargaining at the inception of a chapter 11 case to ensure that any waiver language in a DIP financing order expressly reserves the right to sue to a chapter 7 trustee, any chapter 7 creditors' committee, or any other entity created for the purpose of prosecuting causes of action on behalf of the estate, such as a litigation trust (a strategy that was recently attempted without success in the chapter 11 case of World Health Alternatives, Inc.). Alternatively, creditors' committees may be forced to take a hard look at potential causes of action against DIP lenders earlier in the chapter 11 process to ensure that litigation involving colorable claims is filed as soon as possible because of the risk of forfeiture upon conversion.

Given the facts of the case before it, the Tenth Circuit did not address whether the waiver would have precluded a chapter 11 trustee from suing Akamai on behalf of the estate. As a general rule, the acts of a DIP are binding on any trustee subsequently appointed in chapter 11 or chapter 7. Under certain circumstances, however, a bankruptcy court will scrutinize agreements entered into by a debtor

while in possession to determine, for example, whether there is evidence of fraud or prejudice to the estate that might justify invalidating an agreement or waiver of rights. Notwithstanding the general rule, most DIP lenders insist upon waiver language in a financing order that expressly extends the scope of a waiver to include any trustee subsequently appointed in the bankruptcy case.

Hill v. Akamai Tech., Inc. (In re Ms55, Inc.), 477 F.3d 1131 (10th Cir. 2007).

Armstrong v. Norwest Bank, Minneapolis, N.A., 964 F.2d 797 (8th Cir. 1992).

Official Unsecured Creditors' Committee v. Rachles (In re S. Rachles, Inc.), 131 B.R. 782 (Bankr. D.N.J. 1991).

In re World Health Alternatives, Inc., No. 06-10166 (Bankr. D. Del. Sept. 8, 2006) (unpublished order denying committee's motion to create trust and transfer to trust committee's rights to receive and distribute collateral carve-out and pursue estate causes of action against lender in the event cases were converted to chapter 7).

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