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RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

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IN THIS ISSUE

GLOBAL FOCUS: SOLVENT RESTRUCTURING OF DANA'S U.K. PENSION LIABILITIES

Adam Plainer

London partner Adam Plainer led a team of Jones Day professionals in connection with a successful restructuring of Dana Corporation's U.K. pension liabilities.

Ohio-based, 102-year-old automobile parts manufacturer Dana Corporation and 40 of its subsidiaries filed for chapter 11 protection in the U.S. in March 2006. Dana's operations, however, extend well beyond the borders of the U.S.—the company has 46,000 employees in 28 countries. Integrating a complex restructuring of Dana's U.S. operations in chapter 11 with Dana's extensive operations and obligations abroad has posed some unique challenges to Jones Day's restructuring professionals. One of these involved the successful solvent restructuring of Dana's businesses in the U.K., completed in April 2007. The restructuring, by way of a company voluntary arrangement, or "CVA," allowed an otherwise healthy business to deal with overwhelming liabilities to its pension plans. The process demonstrates the opportunities within the U.K. for consensual, management-led restructuring but also shows the growing problems that groups attempting to restructure U.K. businesses have with respect to pension liabilities.

COMPANY VOLUNTARY ARRANGEMENTS

The U.K. insolvency regime (largely using the Insolvency Act of 1986) offers many different methods for dealing with insolvencies and restructurings. A CVA in particular is a consensual arrangement, by which, if at least 75 percent of creditors by value agree to the company's proposal, the arrangement succeeds and dissenting creditors are crammed down. Secured creditors may not be prejudiced by a CVA, so it is a more viable option where there are few or no secured creditors. In essence it is a contract between the company and its creditors that, if accepted, and provided the terms of the CVA proposal are complied with, allows the company to continue in business, having compromised and dealt with its existing debts. The main reason CVAs have not been used more widely is that there is no moratorium at the outset preventing creditors from taking enforcement action against the company. Also, unlike schemes of arrangement, a procedure under the Companies Act of 1985 enabling a compromise or arrangement between a company and its creditors, its members, or any class of them, subject to ratification by the court, there are no provisions for different classes of creditors.

PENSIONS REGIME

The pensions regime in the U.K. has been significantly overhauled by changes to legislation in 2003 and 2004. One of the most substantial changes has been a significant increase in the liabilities that a company is compelled to pay upon the termination of a defined-benefit pension plan, or on an employer leaving a multi-employer plan, which are now calculated on the annuitized "buyout" liability basis, usually giving rise to a deficit several times greater than the ongoing liability presented on a balance sheet. This means that the termination, or even the freezing of accrual, of such plans has become increasingly rare, and purchasers frequently refuse to acquire pension liabilities when acquiring U.K. businesses. Larger groups of companies with a history of acquisition and disposal commonly find themselves with significant liabilities relating to businesses that have now been sold, which are therefore disproportionate for the remaining businesses.

Further, any attempt to restructure by divestiture can be hampered because of the liabilities that would become due when a company is either sold or loses all its employees in a business sale. It is very common for this liability to exceed the business value, effectively causing the seller to lose money in the sale. Attempts to structure a disposal to avoid this liability will fall afoul of anti-avoidance legislation, which, as discussed below, can give rise to personal liability for officers and liability for wider groups of affiliated companies.

The new regime also includes the Pension Protection Fund, or "PPF," modeled on the U.S. Pension Benefit Guaranty Corporation ("PBGC"), which provides pensions, up to certain limits, for members of defined-benefit pension plans whose benefits have not been fully funded following the insolvency of the sponsoring employer. In order to protect the PPF from unnecessary claims, the same legislation created a regulator, the Pensions Regulator, which has a number of powers in relation to preserving the funding of U.K. pension plans.

A team of Jones Day attorneys including Adam Plainer, Sion Richards, John J. Papadakis, Chris Papanicolaou, John R. Phillips, Linton J. Bloomberg, Kay V. Evans, Victoria Ferguson, Claire L. Martin-Royle, Rosalind J. Connor, Simon Leslie, Simon J. Kiff, Anna Cutfield, and Anna Copestake represented Dana Corporation in connection with a successful restructuring of its U.K. businesses.

The most notable of the powers of the Pensions Regulator are its so-called "moral hazard" powers. These are the power to issue contribution notices, requiring an immediate payment into the plan, against the sponsoring employer of a defined-benefit plan or against any group company or officer, for any action taken that adversely impacts the full funding of the plan, and the power to issue a financial support direction to demand further contributions or support from a group company if the plan's actual sponsor is deemed "insufficiently resourced."

These powers can extend to any group company with a one-third or more interest or common interest in the voting stock or board of the sponsoring employer and, so far as the U.K. legislation is concerned, to a company in any jurisdiction. Whether and to what extent these powers are enforceable in non-U.K. jurisdictions against those companies has yet to be seen, but they would certainly be enforceable against their U.K. assets, and to date most companies have seen the risk as significant enough that they have tended to negotiate with the Pensions Regulator to ensure that they are not at risk.

The Pensions Regulator has the power to issue preclearance in relation to actions and circumstances, confirming that it will not use its moral-hazard powers unless circumstances change or have not been fully disclosed. A large number of these are given each year, and any restructuring involving a group that sponsors a defined-benefit pension plan in the U.K. will be advised to seek clearance.

On June 18, 2007, the Pensions Regulator issued its first financial support direction in an order against Sea Containers Limited, a Bermuda company in chapter 11 in the U.S., in relation to its subsidiary's sponsorship of two U.K. defined-benefit pension plans. Enforceability is likely to be tested in the coming months.

THE DANA EXPERIENCE

The Dana U.K. companies sponsored four defined-benefit plans that had varying profiles of members, benefits, and liabilities. Without these liabilities, the business of the Dana U.K. companies was solvent. With them, the disposal of any U.K. businesses as part of a global restructuring was prohibitively expensive. The pension liabilities represented the overwhelming majority of the creditors of the U.K. by value. There were no secured creditors, and the Dana U.K. companies were maintaining payments to the trade creditors.

Unlike in the U.S., where the PBGC takes on an early role, the PPF cannot take over a pension plan until the occurrence of an "insolvency event"—here, the filing of the CVA proposal. As a result, negotiations were carried out over a long period with all four pension plans, with valued assistance from the PPF. The agreement of the PPF as well as the four plans was necessary for the CVA. (As an aside, it was not possible to restructure using a scheme of arrangement, as this is not an "insolvency event" for purposes of the PPF).

It was also necessary to obtain the agreement of the Pensions Regulator. Because the purpose of the CVA is to compromise the liability to the pension plans, the CVA falls within the circumstances where the Pensions Regulator can issue a contribution notice, and therefore a clearance statement from the regulator was a necessary prerequisite to the CVA on behalf of all group companies and the U.K. company officers.

Negotiating with the Pensions Regulator presented a different challenge than the other constituencies. The PPF has the concerns of a creditor and is primarily concerned with maximizing its returns. The Pensions Regulator, by contrast, has broader concerns, and, whereas it is concerned about the return to and solvency of the PPF, it is also concerned with the wider issues of protecting pensions and preserving jobs.

Negotiations also involved many other interested parties, such as union representatives, lenders to the wider group of companies, and those interested in the chapter 11 cases of Dana and its U.S. subsidiaries. As a result, the negotiations were extremely complex and delicate.

STRUCTURE OF THE RESTRUCTURING

Following the case of *L. v. M*, which was decided by the U.K. courts in late 2006, it became clear that it was possible to achieve a restructuring by way of a CVA in a special-purpose vehicle to which had been allocated the pension liabilities of other group companies. The advantage of having the CVA in a special-purpose vehicle, leaving the rest of the U.K. companies untainted, is clearly significant.

This structure is still relatively new for pension liabilities, and the Dana circumstances were unusual and probably unique in two aspects. First, the existence of four separate plans that needed to allocate liabilities to the special-purpose vehicle involved complex negotiation and technical processes. Second, the short period of time in which the allocation took place required amendments to the four plans and the consent and cooperation of all involved.

CONCLUSION

This case demonstrates a number of trends in the U.K. The need to negotiate with the U.K. Pensions Regulator and PPF has become a necessary part of any restructuring where there is any exposure to U.K. defined-benefit pension plans. The use of the special-purpose vehicle is likely to become a common method of dealing with these liabilities, now that the PPF, the Pensions Regulator, and the courts have all signaled their approval.

CVAs have not often been used for larger restructurings due particularly to the lack of a moratorium, but they can be a very effective "out of court" restructuring tool, and it is likely that we will see an increase in their use in the more complex workouts.

London associate Rosalind J. Connor assisted in the preparation of this article.

FOCUS ON EUROPE: RECENT DEVELOPMENTS AFFECTING DISTRESSED-ASSET INVESTORS AND LENDERS IN GERMANY

Volker Kammel and Christian Staps

IMPACT ON INVESTMENTS FROM PROPOSED CHANGES IN LAW GOVERNING LIMITED LIABILITY COMPANIES

The German limited liability company (*Gesellschaft mit beschränkter Haftung,* abbreviated "*GmbH*") is by far the most popular corporate form used by investors in German businesses. At the end of May, the German government published a draft Act on the Modernization of the Law on Limited Liability Companies and the Prevention of Malpractice (generally referred to as "MoMiG"). Once enacted, this law will be the most substantial reform in the 115-year history of the German Law on Limited Liability Companies and will have a very significant impact on future investments involving GmbHs. MoMiG is expected to become effective in the first six months of 2008. While changes to the draft may still occur, it is expected that fundamental reforms will be enacted.

ACCELERATING INCORPORATION

The MoMiG draft aims to facilitate and accelerate the founding of GmbHs, mainly by providing for the following measures:

- Reduction of the amount of the statutory minimum equity (share capital) from €25,000 to €10,000 and providing for an "entrepreneur's GmbH" *(Unternehmergesellschaft (haftungsbeschränkt))* that can be incorporated with less than the statutory minimum equity but must save 25 percent of its annual profits until it has increased its share capital to the minimum equity amount.
- Standardization of the incorporation process by introducing templates for a company's articles of association and trade register application. Use of these templates will reduce founding formalities from full notarial recording of the articles of association to a mere certification of signatures.
- Acceleration of the registration process. An electronic trade register and online filing were already introduced as of the beginning of 2007. The MoMiG draft further accelerates the registration of the GmbH in the trade register by abolishing the requirement that any permits required for the business of the company must have been granted before the GmbH can be registered.

SIMPLIFYING SHARE PURCHASES

MoMiG will ensure that the identity of a GmbH's shareholders is disclosed to the public. Existing laws already require the directors of a GmbH to submit a list of shareholders to the trade register when the company is founded and to update the list in the event of a change in shareholders. Once submitted to the trade register, the shareholder list is available to the general public so that the identity of the shareholders can be established. The MoMiG draft provides for further incentives to ensure that shareholder lists are kept up to date. This was not always the case in the past. Following a change of shareholders, the company is required to consider as shareholders only those persons who are on the shareholder list submitted to the trade register. Because only such persons will be entitled to voting rights and dividends, buyers will need to ensure that the shareholder list is updated. The exercise of voting rights and other shareholder rights by a buyer will also be deemed valid if the updated shareholder list is submitted to the trade register immediately after the exercise of such rights.

MoMiG will enable a bona fide acquisition of GmbH shares from a person who is on the list of shareholders even if he or she is not the true holder of the shares. Under current law, a flaw in a chain of acquisitions bestowing title on an existing "shareholder" may make a share purchase from that person invalid. The MoMiG draft allows the buyer to acquire the shares even if the seller does not hold title, if the seller has been on the shareholder list submitted to the trade register for at least three years, no objection to the list was filed, and the buyer is not aware (or not culpably unaware) of the defect in the title of the seller. Under certain circumstances, a bona fide acquisition of shares is also possible under the MoMiG draft even if the seller has been on the shareholder list for less than three years.

LIMITING CAPITAL MAINTENANCE RULES

Payment of funds by a GmbH to its shareholders is currently limited by capital maintenance rules aimed at preventing the distribution of share capital to shareholders. German courts have interpreted these rules broadly, which, among other

NEWSWORTHY

Corinne Ball (New York), ***Jeff B. Ellman (Atlanta)***, ***Gregory M. Gordon (Dallas)***, ***David G. Heiman (Cleveland)***, ***Paul D. Leake (New York)***, ***Heather Lennox (Cleveland)***, and ***Charles M. Oellermann (Columbus)*** were listed in *Chambers USA* as being among "America's Leading Lawyers for Business" for 2007.

Brad B. Erens (Chicago) and ***Heather Lennox (Cleveland)*** spoke on June 22 in Chicago at the 10th Annual Conference on Corporate Reorganizations, sponsored by Renaissance American Management, Inc., and the Beard Group. Mr. Erens discussed bankruptcy and liability risks associated with dividend recapitalizations, and Ms. Lennox discussed restructuring issues and trends in the automotive industry. ***Corinne Ball (New York)*** was honored at the conference as one of the Outstanding Restructuring Lawyers from 2006.

Paul D. Leake (New York) chaired a panel discussion concerning "Hedge Fund and Private Equity Firms in Debt Restructurings" on June 21 at INSOL International's New York Seminar.

An article cowritten by ***Paul D. Leake (New York)*** and ***Mark G. Douglas (New York)*** entitled "Charting the Evolution of the Chapter 11 Transfer Tax Exemption: Different Subsection, Same Lack of Clarity" appeared in the June 2007 edition of *Pratt's Journal of Bankruptcy Law*.

An article written by ***Daniel P. Winikka (Dallas)*** entitled "Focus on Feasibility" appeared in the April/May 2007 edition of *Pratt's Journal of Bankruptcy Law*.

Adam Plainer (London) chaired the 2007 IIR Corporate Restructuring Conference in London on July 11.

Tobias S. Keller (San Francisco) gave a presentation to the San Francisco Bar Association (Commercial Law and Bankruptcy Section) on April 10 in San Francisco concerning "The Distressed Debt Market: Implications for Corporate Restructuring." On July 24, he discussed "Mega Billion Dollar Buyouts as a Source of Deal Flow for the Middle Market Community" as part of a 2007 Webinar Series sponsored by the Turnaround Management Association.

Carl E. Black (Cleveland) was awarded an "Up and Coming" designation in the field of Bankruptcy/Restructuring in the 2007 edition of *Chambers USA*.

An article written by ***Ben Rosenblum (New York)*** entitled "Avoiding Forfeiture of Estate Causes of Action Triggered by Conversion to Chapter 7" was published in the June 27, 2007, edition of *Bankruptcy Law 360*.

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 "Chapter 11: Solution to Stockholder Voting Requirements?" was published in the May 10, 2007, edition of *Bankruptcy Law 360*.

An article written by ***Mark G. Douglas (New York)*** entitled "Focus on Cross-Border Bankruptcies: Chapter 15 Update" was published in the April/May 2007 edition of *Pratt's Journal of Bankruptcy Law*. His article entitled "Application of the Absolute Priority Rule to Pre-Chapter 11 Plan Settlements: In Search of the Meaning of 'Fair and Equitable' " appeared in the June 2007 edition of *Pratt's Journal of Bankruptcy Law*.

things, restricts the ability of a GmbH to extend loans to shareholders and can impede the operation of an intercompany cash-management system designed to regulate intercompany loans. MoMiG leaves the capital maintenance rules in place but limits the scope of their applicability:

- A GmbH will be able to extend loans to a shareholder if its claim to repayment of the loan is valued at par (*i.e.*, the shareholder can be expected to repay the loan).
- Capital maintenance rules will not restrict payments to a shareholder under a "domination" or "profit and loss transfer agreement" (*i.e.*, an agreement whereby one company controlled by another agrees, principally for tax purposes, to channel net profits to the controlling company).

FACILITATING THE REPAYMENT OF SHAREHOLDER LOANS

The MoMiG draft proposes to simplify the complex rules on shareholder loans that are currently in force:

- It provides for the subordination of all shareholder loans to the claims of ordinary creditors in an insolvency proceeding involving the GmbH. The current distinction between shareholder loans granted while a company is already in financial difficulties (so-called "equity-replacing loans" or "equitably subordinated loans") and other shareholder loans will be redundant.

- Exceptions that have proved to be important specifically to distressed-debt investors will continue to apply: loans of a shareholder who holds 10 percent or less of the shares and is not a director of the company will not be subordinated. There is no subordination of loans if the lender buys shares of the GmbH while it is already in financial distress, with the aim of restructuring the company. "Financial distress" refers to the inability of the GmbH to settle its liabilities that are due (illiquidity), pending illiquidity or overindebtedness.
- The MoMiG draft allows GmbHs to repay shareholder loans prior to insolvency, even if the company is in financial difficulties. The only restriction is that, in a subsequent insolvency, the insolvency administrator will be entitled to set aside any repayment that occurred during the year preceding the insolvency application and demand that the funds be returned to the estate. This is a major change to existing law, which prevents the repayment of equity-replacing shareholder loans for as long as the company is in financial difficulties, even if it is not insolvent.

TAX NEWS: DEDUCTIBILITY OF LOSSES AND INTEREST-DEDUCTION LIMITATION

A newly introduced German income tax law will have a very significant effect on distressed-asset investments and leveraged buyouts. The law restricts the deductibility of losses carried forward and limits the deduction of interest payable on debt financing by corporations that are subject to either full corporate or limited tax liability in Germany. The law is scheduled to become effective on January 1, 2008. The following new rules will apply.

If more than 50 percent of the share capital, the participation rights, or the voting rights in a corporation is transferred directly or indirectly to a buyer (or a party related to the buyer) within a five-year period, then losses carried forward by the corporation prior to such acquisition will no longer be deductible from its future earnings for tax purposes. If more than 25 percent of the share capital, the participation rights, or the voting rights is transferred within a five-year period, the corporation will not be able to deduct a pro rata share of its carried-forward losses from its future earnings. These rules will also apply to situations comparable to a share acquisition (*e.g.*, a subscription to new shares issued by the corporation).

The new interest-deduction limitation rules will apply to any form of debt financing (shareholder, related-party, and/or third-party financing) made available to an entity, regardless of whether it is a corporation or a partnership. Interest expense will be fully deductible up to an amount equal to the interest income generated by the entity in the same fiscal year. The deduction of further interest expense ("Net Interest") will be limited to 30 percent of the entity's EBITDA.

Net Interest, however, will be fully deductible if:

- It does not exceed €1 million in the respective year and, if the recipient is a shareholder or party related to a shareholder, if the interest payment is at arm's length.
- The entity does not belong to a group of companies, or belongs to a group of companies but is not included in the consolidated financial statements of the group, provided that not more than 10 percent of the Net Interest is paid to: (i) a shareholder who holds directly or indirectly more than 25 percent of the company's stock; (ii) any party related to the shareholder; or (iii) a third party who may take recourse to the shareholder or the related party.
- With respect to an entity that belongs to a group of companies and is included in the group's consolidated financial statements, the equity ratio of the entity as of the date of the previous balance sheet is equal to or higher than the equity ratio of the consolidated group, and not more than 10 percent of the Net Interest is paid by the entity to: (i) a shareholder who holds directly or indirectly more than 25 but less than 50 percent of the entity's stock; (ii) any party related to such shareholder; or (iii) a third party who may take recourse to such shareholder or the related party.

CAN A SECURITY INTEREST CREATED BY A GLOBAL ASSIGNMENT OF TRADE RECEIVABLES BE CHALLENGED IN THE ASSIGNOR'S INSOLVENCY PROCEEDING?

The assignment of all existing and future trade receivables (referred to as a "global assignment") to a lender in order to secure loans is a very popular form of security in Germany. Various judgments of German Higher Regional Courts (*Oberlandesgerichte*), however, have in the recent past raised concerns of financial institutions involved in asset-based lending that such global assignments would not survive the insolvency of an assignor.

The courts lowered the threshold for avoidance of a security interest granted on receivables generated during the three-month period preceding the filing of an insolvency application with respect to the assignor (the most critical look-back period under German insolvency law). Specifically, the courts interpreted a provision of the German Insolvency Code to permit a challenge to security interests in receivables generated during the three-month look-back period as part of a global assignment if:

- The receivables were created in the last month before the insolvency application; or
- The receivables were created in the second and third months before the insolvency application, and (i) the assignor was unable to settle its due liabilities at the time, or (ii) the lender was aware that the assignment would disadvantage other creditors.

Because the most recent trade receivables (specifically, those created in the last month prior to the insolvency application) are the most valuable, these rulings substantially impair the security interest created by a global assignment and the asset base against which banks are willing to extend financing. Lenders have cause for hope, however, as some Regional Courts (*Landgerichte*) have refused to follow this approach. According to their view, an assignment of trade receivables generated during the three months preceding the filing of an insolvency application can be challenged only if the assignor is unable to settle its due liabilities at the time the receivables are generated and the lender is aware of the assignor's inability to do so. The risk that an assignment of recently created trade receivables can be challenged will be reduced significantly if the Regional Courts' view prevails. The question is the subject of an appeal to the German Federal Supreme Court (*Bundesgerichtshof*), the highest appellate court, which hopefully will resolve the issue by the end of 2007.

A detailed Jones Day *Commentary* entitled "German Tax Law: The New Rules Limiting Interest Deductions" can be found at http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4346.

CHARTING THE EVOLUTION OF THE CHAPTER 11 TRANSFER TAX EXEMPTION: DIFFERENT SUBSECTION, SAME LACK OF CLARITY

Paul D. Leake and Mark G. Douglas

The ability to sell assets during the course of a chapter 11 case without incurring transfer taxes customarily levied on such transactions outside of bankruptcy often figures prominently in a potential debtor's strategic bankruptcy planning. However, the circumstances under which a sale and related transactions (*e.g.*, recording of mortgages) qualify for the tax exemption have been a focal point of dispute for many courts, including no less than four circuit courts of appeal. Unfortunately, these appellate rulings have done little to clarify exactly what types of asset dispositions made during the course of a chapter 11 case are exempt from tax. Adding to the confusion is a widening rift in the circuit courts of appeal concerning the tax exemption's application to asset sales occurring prior to confirmation of a chapter 11 plan.

TAX-FREE TRANSFERS UNDER THE BANKRUPTCY CODE

Section 1146(a) of the Bankruptcy Code provides that "the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under [the Bankruptcy Code], may not be taxed under any law imposing a stamp tax or similar tax." A "transfer" includes a sale of property or the grant of a mortgage lien. To qualify for the exemption, a transfer must satisfy a three-pronged test: (i) the tax must be a "stamp or similar" tax; (ii) the tax must be imposed upon the "making or delivery of an instrument of transfer"; and (iii) the transfer must be "under a plan confirmed" pursuant to section 1129 of the Bankruptcy Code.

Bankruptcy Code section 1146(a) (changed from section 1146(c) as part of the 2005 bankruptcy amendments) serves the dual purpose of providing chapter 11 debtors and prospective purchasers with some measure of tax relief while concurrently facilitating asset sales in bankruptcy and enhancing a chapter 11 debtor's prospects for a successful reorganization. Several areas of controversy have arisen concerning the scope of the section 1146(a) tax exemption. One area of debate concerns whether, in order to be exempt from taxes, asset transfers must be made as part of a confirmed chapter 11 plan, as opposed to in a separate transaction occurring at some other time during a bankruptcy case.

Chapter 11 of the Bankruptcy Code contemplates the sale of a debtor's assets under two circumstances. In the first, a plan of reorganization (or liquidation) may include among its terms a provision transferring individual assets or even the debtor's entire business. This means that creditors whose claims are "impaired" (adversely affected, such as by receiving less than full payment) have the ability to veto the sale if they vote in sufficient numbers to reject the plan as a whole and are otherwise successful in preventing it from being confirmed.

Circumstances may dictate that waiting to sell assets until confirmation of a plan at the end of a chapter 11 case is impossible or imprudent. Accordingly, assets can also be sold at any time during a bankruptcy case under section 363(b) of the Bankruptcy Code. That provision authorizes a trustee or chapter 11 debtor-in-possession, subject to court approval, to "use, sell, or lease, other than in the ordinary course of business, property of the estate." Section 363(b) sales are an invaluable tool for generating value for a bankruptcy estate that can be used to fund a plan of reorganization or pay creditor claims. Still, courts are sometimes critical of section 363 as a vehicle for selling all, or a substantial portion, of a debtor's assets. The criticism arises because creditors, while having the right to object to a section 363(b) sale, do not enjoy, in the context of such a sale, the protections of the chapter 11 plan-confirmation process, even though the transaction may be tantamount to a chapter 11 plan, given the importance of a sale of all or substantially all of the debtor's assets to the overall reorganization (or liquidation) strategy.

The interplay between section 363(b) and section 1146 has been a magnet for controversy. The phrase "under a plan confirmed" in section 1146(a) is ambiguous enough to invite competing interpretations concerning the types of sales that qualify for the tax exemption. To date, four federal circuit courts of appeal have had an opportunity to weigh in on whether section 363(b) sales qualify for the section 1146 exemption. The remaining decision at the circuit level concerning section 1146 addresses whether transactions involving nondebtors may be exempt. Unfortunately, these rulings have done little to resolve what continues to be a growing controversy.

THE CIRCUITS WEIGH IN

The Second Circuit first addressed this issue more than 20 years ago in *City of New York v. Jacoby-Bender*, articulating the general rule that a sale need not take place as part of confirmation, so long as "consummation" of the plan depends on the sale transaction. Many lower courts have interpreted *Jacoby-Bender* to sanction tax-exempt, preconfirmation asset sales under section 363(b). Fourteen years later, the Fourth Circuit applied a restrictive approach to tax-exempt asset transfers in chapter 11, concluding in *In re NVR LP* that the term "under" should be construed as "[w]ith the authorization of" a chapter 11 plan. Explaining that the ordinary definition of "under" is "inferior" or "subordinate," the court observed that "we cannot say that a transfer made prior to the date of plan confirmation could be subordinate to, or authorized by, something that did not exist at the date of transfer—a plan confirmed by the court." The Fourth Circuit accordingly ruled that more than 5,000 real property transfers made by NVR during the course of its 18-month-long chapter 11 case did not qualify for the exemption.

In 2003, the Third Circuit Court of Appeals was the next to take up the gauntlet, and it effectively sided with the Fourth Circuit in taking a restrictive view of the section 1146 exemption in *Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Investment Company of Delaware, Inc.)*. Rejecting the expansive interpretation adopted by many lower courts in determining what constitutes a transfer "under" a confirmed plan of reorganization, the court of appeals held that real estate transactions consummated during the debtor's chapter 11 case were not exempt from transfer and recording taxes because the bankruptcy court authorized the sales under section 363, and they occurred prior to confirmation of a plan of reorganization.

The Eleventh Circuit addressed the scope of the section 1146 tax exemption in two rulings, both of which were handed down in the last three years. In the first of those decisions, *In re T.H. Orlando Ltd.*, the court of appeals adopted a very expansive approach to section 1146 in examining whether a transfer must involve the debtor and estate property to qualify for the section 1146 safe harbor. Examining the language of section 1146, the Eleventh Circuit concluded that a transfer "under a plan" refers to a transfer "authorized by a confirmed

Chapter 11 plan," and a plan "authorizes any transfer that is necessary to the confirmation of the plan." It accordingly ruled that a refinancing transaction that did not involve the debtor or property of its estate, but without which the debtor would not have been able to obtain funds necessary to confirm a plan, was exempt from Florida's stamp tax under section 1146, "irrespective of whether the transfer involved the debtor or property of the estate."

THE LATEST WORD: *PICCADILLY CAFETERIAS*

In 2007, the Eleventh Circuit had a second opportunity to examine the scope of section 1146. In *State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, the court of appeals considered whether the tax exemption applies to a sale transaction under section 363(b) of the Bankruptcy Code. Piccadilly Cafeterias, Inc., filed a chapter 11 case in 2003 for the purpose of consummating a sale of substantially all of its assets under section 363(b) to Piccadilly Acquisition Corporation ("PAC"), with which the debtor had executed an asset purchase agreement shortly before filing for bankruptcy.

In all jurisdictions, asset divestitures should be structured in such a way that they can be fairly characterized as having been consummated as part of, or in connection with, a reorganization or liquidation strategy that results in a confirmed chapter 11 plan.

In conjunction with its section 363(b) motion, Piccadilly requested a determination that the sale transaction was exempt from taxes under section 1146. The Florida Department of Revenue ("DOR") opposed both the sale and the transfer tax exemption. Piccadilly also sought approval of a global settlement reached with the unsecured creditors' committee and a committee of its senior noteholders. The settlement resolved the priority of distribution among Piccadilly's creditors and, according to Piccadilly, was in many ways "analogous to confirmation of a plan."

The bankruptcy court approved the sale of Piccadilly's assets to PAC for $80 million and held that the sale was exempt from stamp taxes under section 1146. It also approved the global settlement. Shortly after the sale order became final, Piccadilly filed a liquidating chapter 11 plan, which the bankruptcy court ultimately confirmed over DOR's objection. DOR also commenced an adversary proceeding against Piccadilly seeking a declaration that the $39,200 in stamp taxes otherwise payable in connection with the sale was not covered by section 1146. Both Piccadilly and DOR sought summary judgment.

The bankruptcy court granted summary judgment to Piccadilly, ruling that the asset sale was exempt from stamp taxes under section 1146. The court reasoned that the sale of substantially all of Piccadilly's assets was a transfer "under" its confirmed chapter 11 plan because the sale was necessary to consummate the plan. The district court upheld that determination on appeal. However, in its decision it noted that the parties had addressed their arguments to whether, in general, section 1146 exempts stand-alone sale transactions under section 363(b) from tax, rather than whether the tax exemption applied specifically to the sale of Piccadilly's assets. Thus, the district court concluded that specific application of the exemption to the sale of Piccadilly's assets was an issue not properly before it. Even so, the court expressly affirmed the bankruptcy court's implicit conclusion that section 1146 may apply "where a transfer is made preconfirmation."

DOR fared no better on appeal to the Eleventh Circuit. Noting that "[t]his court has yet to squarely address whether the [section 1146] tax exemption may apply to pre-confirmation transfers," the court of appeals briefly recounted the history of this issue at the appellate level, concluding that "the better reasoned approach" is found in *Jacoby-Bender* and *T.H. Orlando*, which looks "not to the timing of the transfers, but to the necessity of the transfers to the consummation of a confirmed plan of reorganization." According to the Eleventh Circuit, the language of section 1146 can plausibly be read to support either of the competing interpretations proffered by the parties. Even so, given the statutory ambiguity, lawmakers' intentions under section 1146 can be divined by reference to other provisions of the Bankruptcy Code that expressly and unambiguously create temporal restrictions, while section 1146 does not. If Congress includes specific language in one part of a statute "but omits it in another section of the same Act," the Eleventh Circuit emphasized, "it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion."

Finally, the court of appeals observed, "the strict temporal construction of [section 1146] articulated by the Third and Fourth Circuits ignores the practical realities of Chapter 11 reorganization cases." Even transfers expressly contemplated in a plan, the Eleventh Circuit explained, "will not qualify for the tax exemption unless they occur after the order confirming the plan is entered." According to the court, it is just as likely that a debtor may be required to close on a sale transaction as a condition precedent to the parties' willingness to proceed with confirmation. Rejecting the restrictive approach taken by the Third and Fourth Circuits, the Eleventh Circuit held that the section 1146 tax exemption "may apply to those pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation sale and the confirmed plan." However, because the exemption's application to the sale of Piccadilly's assets (as opposed to generally) was not properly before it, the court of appeals did not rule on this issue. It stated that "we leave for another day an attempt to set forth a framework for determining the circumstances under which [section 1146's] tax exemption may apply to pre-confirmation transfers."

ANALYSIS

With *Piccadilly Cafeterias*, the rift among the circuits is widening, with little hope of resolution any time soon. On one side of the divide sit the Third and Fourth Circuits, which have determined that section 1146 is unambiguous and applies only to postconfirmation transfers under a plan. On the other side are the Second and Eleventh Circuits, the rulings of which can fairly be construed to apply section 1146 to preconfirmation sales under section 363(b) (including, in the case of the Eleventh Circuit, to transfers of nondebtor property), so long as they bear some nexus to confirmation of a chapter 11 plan. Thus, the debate concerning the scope of the chapter 11 tax exemption continues.

Despite what can be characterized as an evenly pitched battle at the circuit-court level, a majority of lower courts have sided with the Second and Eleventh Circuits and adopted the more liberal interpretation that section 1146 applies to preconfirmation asset sales under section 363(b). Construing the exemption to encompass most transfers of estate property during the course of a chapter 11 case is arguably more consistent with the objective of chapter 11 as a vehicle for both rehabilitating an ailing enterprise and maximizing the value of a debtor's assets for the benefit of its estate and creditors. Still, this approach is by no means universally accepted even among lower courts, particularly where a proposed sale has little or no nexus with a contemplated chapter 11 plan.

In light of the hard-line approach advocated by the Third and Fourth Circuits, chapter 11 debtors and their professionals in these jurisdictions may be well advised to consider an overall reorganization strategy that entails asset divestitures at the plan-confirmation stage if they want the benefit of section 1146's tax exemption. In all jurisdictions, asset divestitures should be structured in such a way that they can be fairly characterized as having been consummated as part of, or in connection with, a reorganization or liquidation strategy that results in a confirmed chapter 11 plan.

State of Florida v. T.H. Orlando Ltd. (In re T.H. Orlando Ltd.), 391 F.3d 1287 (11th Cir. 2004).

City of New York v. Jacoby-Bender, 758 F.2d 840 (2d Cir. 1985).

Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Investment Company of Delaware, Inc.), 335 F.3d 243 (3d Cir. 2003).

In re NVR LP, 189 F.3d 442 (4th Cir. 1999).

State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.), 484 F.3d 1299 (11th Cir. 2007).

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INSIDER'S ACQUISITION OF CLAIMS TO CREATE ACCEPTING IMPAIRED CLASS CONSTITUTES IMPERMISSIBLE GERRYMANDERING

Mark G. Douglas

The strategic importance of classifying claims and interests under a chapter 11 plan is sometimes an invitation for creative machinations designed to muster adequate support for confirmation of the plan. Although the Bankruptcy Code unequivocally states that only "substantially similar" claims or interests can be classified together, it neither defines "substantial similarity" nor requires that all claims or interests fitting the description be classified together. It has been left to the courts to develop hard-and-fast rules on classification, and the results have occasionally been inconsistent or controversial. An enduringly prominent bone of contention in the ongoing plan-classification dispute concerns the legitimacy of separately classifying similar, but arguably distinct, kinds of claims in an effort to create an accepting impaired class. Sometimes referred to as class "gerrymandering," this practice was the subject of a ruling recently handed down by the Third Circuit Court of Appeals. In *In re Machne Menachem, Inc.*, the court upheld an order vacating confirmation of a chapter 11 plan because an insider of the debtor purchased unsecured claims during the case to ensure that an impaired unsecured class would vote in favor of the plan.

VOTING AND PLAN CONFIRMATION IN CHAPTER 11

A fundamental precept underpinning the chapter 11 process is that stakeholders involved in the bankruptcy case have the right to vote for or against confirmation of a chapter 11 plan that specifies how their respective claims or interests are to be treated going forward. Confirmation of a plan is possible under two circumstances: (i) the requisite majorities of creditors and equity interest holders in every "class" (explained below) vote in favor of the plan (or are deemed to do so by reason of being "unimpaired"); or (ii) despite the absence of acceptance by all classes, the plan meets certain minimum standards of fairness spelled out in the nonconsensual confirmation, or "cramdown," provisions of the Bankruptcy Code.

Voting in chapter 11 is conducted by classes, rather than individual creditors or shareholders. This means that a dissenting individual creditor or shareholder can be outvoted if the remaining class members hold enough of the claims or interests in the class to achieve the voting majorities specified in the Bankruptcy Code for class acceptance. As such, how a claim or interest is classified can have a significant impact on the debtor's prospects for confirming a chapter 11 plan—a creditor, for example, whose claim is substantial enough to give it voting control of a class may be able to block confirmation.

Confirmation is possible only if at least one "impaired" class of creditors or shareholders in the plan votes to accept it (without counting insider votes). This requirement, which appears in section 1129(a)(10) of the Bankruptcy Code, operates as a statutory gatekeeper to cramdown. Cramdown is a powerful remedy—it imposes a binding reorganization (or liquidation) scheme upon a body of dissenting creditors and other stakeholders predicated upon sometimes complicated judicial determinations concerning asset and claim valuation, feasibility, and other important issues. Section 1129(a)(10) is premised on the policy that, before compelling stakeholders to bear the risks of error necessarily associated with cramdown, at least one class whose members are not being paid in full (or whose claims or interests are otherwise "impaired") is willing to go along with the chapter 11 plan.

CLASSIFICATION OF CLAIMS AND INTERESTS UNDER A PLAN

Section 1122 of the Bankruptcy Code provides that, except with respect to a class of "administrative convenience" claims (*i.e.*, relatively small unsecured claims, such as trade claims below a certain dollar amount), a plan may place a claim or interest in a particular class only "if such claim or interest is substantially similar to the claims or interests of such class." The statute, however, does not define "substantially similar." This was left to the courts, relying upon past practice under the former Bankruptcy Act and lawmakers' statements in connection with the enactment of the Bankruptcy Code indicating that the term should be construed to mean similar in legal character or effect as a claim against the debtor's assets or as an interest in the debtor. Thus, interests, such as stock, may not be classified together with claims, such as trade or bond debt, because the relationship between the debtor and its creditors, who assume credit risk but not enterprise risk, is fundamentally different from the relationship between the debtor and its stockholders, who do shoulder that risk as investors.

In passing on the propriety of a plan's claims-classification scheme, courts generally examine the nature of the claim (*e.g.*, senior or subordinated, secured or unsecured) and the relationship of the claim to the debtor's property. For example, secured claims must be classified separately from unsecured claims, and priority claims should not be placed in the same class as general unsecured claims.

A CLASSIFICATION CONTROVERSY: GERRYMANDERING

Although the Bankruptcy Code provides that only substantially similar claims may be classified together, it does not *require* that all such claims be placed into a single class. Substantially similar claims may be divided into separate classes if separate classification is reasonable. The proponent of a chapter 11 plan has wide latitude in determining whether similar claims may be classified separately. Thus, for example, separate classification of substantially similar unsecured claims has been approved where: (i) certain unsecured creditors, such as unionized employees or vendors, will continue to have a relationship with the debtor after confirmation of a plan; (ii) separate classification is necessary to preserve the debtor's ability to leave unimpaired low-interest long-term bond debt by reinstating the maturity of the obligation; (iii) separate classification of unsecured debt is necessary to enforce the terms of a prebankruptcy subordination agreement; or (iv) the unique nature of "future claims" in mass tort cases (particularly asbestos claims that will be paid from a trust created under section 524(g) of the Bankruptcy Code) makes it appropriate to classify such claims apart from general unsecured claims that are matured, liquidated, and noncontingent.

As a general rule, shared interest in voting for or against a plan is a prerequisite to jointly classifying claims or interests. This ensures that dissenting creditors or shareholders can be outvoted in their class only by creditors or shareholders with similar economic interests with respect to the debtor and/or its assets. When claims of the same nature are classified separately, the classification must be a reasonable means of achieving the goals of the Bankruptcy Code. For example, although trade and unsecured institutional creditors should not be classified separately in most cases, separate classification of such claims may be appropriate if institutional lenders are willing to accept debt or stock under a plan, while trade creditors would prefer a pro rata cash payment.

A classification scheme designed to fabricate an accepting impaired class under section 1129(a)(10) is sometimes referred to as class "gerrymandering." The practice can involve, among other things: (i) joint classification of claims whose holders are favorable to a plan with the claims of creditors who are not, with the expectation that supporting claims will sufficiently outnumber dissenting claims to ensure acceptance of the plan by the class as a whole; or (ii) separately classifying the claims of dissenting creditors from the claims of creditors favorable to the plan to ensure that the dissenting creditors cannot defeat cramdown confirmation. The latter form of gerrymandering has arisen almost exclusively in single-asset real estate cases, where the plan proponent attempts to classify the mortgagee's unsecured deficiency claim apart from the claims of other unsecured creditors. The practice has been invalidated by a majority of the circuit courts of appeal that have faced the issue, including the Fifth Circuit in *In re Greystone III Joint Venture* and the Fourth Circuit in *In re Bryson Properties, XVIII*. A slightly different form of class gerrymandering was the subject of the Third Circuit's unpublished ruling in *Machne Menachem*.

MACHNE MENACHEM

Machne Menachem, Inc. ("Machne"), a nonprofit company that operated a summer camp for Orthodox Jewish boys, filed for chapter 11 protection in 2001 in Pennsylvania. Machne proposed a third amended plan of reorganization in 2003 under which there were two classes of unsecured creditors—Class 4, containing general unsecured claims, and Class 5, containing insider unsecured claims. Prior to seeking confirmation of the plan in 2004, the son of one of Machne's directors, apparently at the debtor's bidding, purchased the claims of four of the 17 unsecured creditors in Class 4, after which the claims were reassigned to Class 5. Two of the claims were purchased at face value, while the other two claims were purchased at roughly half of face value.

Class 4 was impaired—the claims in the class were to be paid in full within 45 days of the plan's effective date with cash generated from postconfirmation operations. The class accepted the plan because seven of its members (holding approximately $34,500 in claims) voted in favor of the plan, only four creditors (holding approximately $13,230 in claims) in the class rejected it, and two creditors (holding approximately $17,800 in claims) did not timely submit their ballots. Class 5 was also impaired by the plan and voted to reject it.

A former director of Machne who had filed a competing chapter 11 plan objected to confirmation of Machne's plan, claiming that, because of the claims acquisition and subsequent reclassification, the plan violated section 1129(a)(3) of the Bankruptcy Code, which mandates that a plan have been "proposed in good faith and not by any means forbidden by law." The bankruptcy court confirmed Machne's chapter 11 plan on June 23, 2004, concluding that "the mere fact that the debtor purchased a creditor's interest for the purpose of securing approval or rejection of a plan did not necessarily amount to bad faith."

The district court vacated the confirmation order on appeal, ruling that the claims purchase and subsequent reclassification made Machne's plan unconfirmable. In doing so, the court explained that the voting in Class 4, which was the only accepting impaired class, was manipulated because, if the class had contained the four acquired claims that were reassigned to Class 5, Class 4 might have voted to reject the plan. Without any basis for determining whether Class 4 would have accepted the plan in the absence of the debtor's manipulation, the district court concluded that the purchase and reclassification of claims effectively "gerrymandered" Class 4 to secure confirmation.

The court rejected Machne's contention that the claims acquisition was motivated by its desire to maintain good relations with food vendors. The evidence indicated that only one of the four purchased claims was held by a food vendor, and Machne had moved to disallow the claims of all the other food vendors. The district court also ruled that the payment of creditors "outside of a plan of reorganization" constituted bad faith under section 1129(a)(3). Finally, because two of the claims purchased from Class 4 were bought for less than face value, while Class 4 creditors were to be paid in full over time under the plan, the court held that the plan violated section 1129(a)(4) of the Bankruptcy Code, which requires "the same treatment for each claim or interest of a particular class."

As a general rule, acquiring claims for the purpose of facilitating or blocking confirmation of a plan does not amount to bad faith under section 1129(a)(3). However, buying claims with an ulterior motive (*i.e.,* intent other than to protect a legitimate interest as a creditor) is generally deemed to be objectionable.

Machne fared no better with the Third Circuit on appeal. In affirming the district court's ruling, the court of appeals emphasized that vote manipulation by the gerrymandering of classes "seriously undermines" the "critical confirmation requirements set out in Section 1129(a)(8) (acceptance by all impaired classes) and Section 1129(a)(10) (acceptance by at least one impaired class in the event of a 'cramdown')." By orchestrating the acceptance of Class 4 through reducing the number of votes necessary to achieve acceptance by the class, the Third Circuit explained, Machne engaged in impermissible gerrymandering.

ANALYSIS

As a general rule, acquiring claims for the purpose of facilitating or blocking confirmation of a plan does not amount to bad faith under section 1129(a)(3). However, buying claims with an ulterior motive (*i.e.*, intent other than to protect a legitimate interest as a creditor) is generally deemed to be objectionable. In *Machne Menachem*, the Third Circuit adopted the approach taken by other courts that have found the existence of bad faith in cases involving a debtor that arranges for an insider or affiliate to purchase claims for the purpose of blocking or confirming a chapter 11 plan.

The circumstances involved in *Machne Menachem*, including the timing of the claims acquisitions, the impact they had on the class composition, and the debtor's inability to come up with a plausible explanation for buying the claims in question, made a strong case for vote manipulation and class gerrymandering. The manipulation was so transparent that, upon becoming aware of the pending claims acquisitions, the competing plan proponent (unsuccessfully) sought to enjoin the transfers. Attempts to influence or manipulate voting in other cases may be less obvious.

In re Machne Menachem, Inc., 2007 WL 1157015 (3d Cir. Apr. 19, 2007).

Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture), 995 F.2d 1274 (5th Cir. 1991).

Travellers Ins. Co. v. Bryson Props., XVIII (In re Bryson Props., XVIII), 961 F.2d 496 (4th Cir. 1992).

In re Figter Ltd., 118 F.3d 635 (9th Cir. 1997).

In re Holly Knoll Partnership, 167 B.R. 381 (Bankr. E.D. Pa. 1994).

In re Applegate Property, Ltd., 133 B.R. 827 (Bankr. W.D. Tex. 1991).

TESTING THE LIMITS OF LENDER LIABILITY IN DISTRESSED-LOAN SITUATIONS

Debra K. Simpson and Mark G. Douglas

As has been well publicized recently, businesses are increasingly turning to private investment firms for needed financing, via either secured or unsecured loans or equity investments. When some of those businesses inevitably head into chapter 11, private investment firms sometimes find themselves defending their conduct vis-à-vis the ailing companies. In a decision sure to give such firms comfort, a Delaware bankruptcy court recently denied equitable subordination of a private investment firm's claims in respect of loans made to a debtor and its affiliates shortly before their bankruptcy filing and refused to recharacterize those loans as equity. The bankruptcy court also dismissed breach-of-fiduciary-duty claims against a former director of the debtor, who was a partner in the investment firm, as well as aiding-and-abetting claims against the firm itself.

BACKGROUND

In June 2005, a little more than one year prior to the bankruptcy filing by Radnor Holdings Corp. and its affiliates (collectively, "Radnor"), Radnor's financial advisor counseled that it would be in the company's best interests to raise a combination of debt and equity to fund working-capital needs and expansion plans. To determine market interest in such a transaction, the financial advisor contacted several private investment firms, including Tennenbaum Capital Partners, LLC ("Tennenbaum"), which indicated that it was willing to provide financing and/or new capital on an expedited basis.

Tennenbaum agreed to loan Radnor $95 million on a senior secured basis (the "Senior Financing") and to purchase $25 million of Radnor's preferred stock, which included detachable warrants giving Tennenbaum the right to acquire common stock based on Radnor's gross earnings. At the time, Radnor had outstanding $70 million in senior secured notes, $130 million in unsecured notes, and a revolving credit facility. The proceeds of the Senior Financing were applied to, among other things, redeem all of the existing senior secured notes and pay down the credit facility. In connection with the new financing, Tennenbaum entered into an investor rights agreement with Radnor's shareholders that gave Tennenbaum the right to: (i) designate one member and one observer to Radnor's board; (ii) increase Tennenbaum's representation on the board if Radnor did not meet certain gross-earnings thresholds; and (iii) veto certain employment agreements and transactions with affiliates. Tennenbaum later exercised its right to designate one member and one observer to the board, designating José E. Feliciano, a partner in Tennenbaum, as a board member and another individual as the board observer. At the time the rights agreement was signed, Radnor represented to Tennenbaum that it was solvent.

Cash flow and liquidity problems resulting from a steep decline in earnings prompted Radnor to seek a further $23.5 million capital infusion from Tennenbaum in 2006. Tennenbaum, however, was willing to provide the funds only in the form of a secured loan, which it did on April 4, 2006 (the "Additional Financing"). Tennenbaum also agreed to roll over $3.2 million in interest due on the Senior Financing into the Additional Financing. In connection with the second financing transaction, Radnor again represented to Tennenbaum that it was solvent.

Radnor's board of directors approved each of the financing transactions. Mr. Feliciano was not a member of the board at the time it approved the Senior Financing and, because of his affiliation with Tennenbaum, abstained from voting on the Additional Financing. In addition, 95 percent of Radnor's unsecured noteholders consented to the Additional Financing.

In June 2006, Radnor's revolving credit facility lenders threatened to cut off funding under Radnor's working-capital facility; in July 2006, they actually did so, precipitating Radnor's chapter 11 filing in August 2006. Mr. Feliciano resigned from Radnor's board in June 2006, and the following month, Radnor approached Tennenbaum about providing a stalking-horse bid for Radnor's assets through a chapter 11 sale process. Although hesitant to do so, Tennenbaum agreed because, without a stalking-horse bid, Tennenbaum believed that Radnor would lose substantial value due to either a prolonged reorganization case or a liquidation. After Radnor's chapter 11 filing, the bankruptcy court approved as being in the best interests of Radnor's estate auction procedures for Radnor's assets that included Tennenbaum's stalking-horse bid.

The bankruptcy court later authorized Radnor's official committee of unsecured creditors to commence litigation on behalf of the estate against Tennenbaum and Mr. Feliciano. In its complaint, the committee sought, among other things, to: (i) recharacterize the financing provided by Tennenbaum as equity; (ii) equitably subordinate Tennenbaum's claims; (iii) recover damages for Mr. Feliciano's alleged breach of his duty of loyalty to Radnor; and (iv) recover damages for Tennenbaum's alleged aiding and abetting a breach of fiduciary duty.

RECHARACTERIZATION, EQUITABLE SUBORDINATION, AND FIDUCIARY DUTIES

Recharacterization of debt as equity is a common-law equitable remedy principally imposed in cases where an insider purports to loan money to an undercapitalized company. In many such cases, creditors argue that the money should be considered a capital contribution and treated as equity rather than debt. Although some courts have adopted multifactor tests for analyzing recharacterization claims, in *Cohen v. KB Mezzanine Fund II (In re SubMicron Systems Corp.)*, the Third Circuit rejected what it deemed to be a "mechanistic scorecard," opting instead to focus on the parties' intent at the time of the transaction through a common-sense evaluation of the facts and circumstances.

Equitable subordination, a common-law remedy codified in section 510(c) of the Bankruptcy Code, seeks to remedy misconduct that causes injury to creditors (or shareholders), or confers an unfair advantage on a single creditor at the expense of other creditors. Under section 510(c), bankruptcy courts may use equitable subordination to subordinate "all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." Under prevailing case law, the party seeking subordination must prove that: (i) the claimant engaged in inequitable conduct; (ii) such conduct either caused injury to the company's creditors or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim is not inconsistent with the Bankruptcy Code. The degree of inequitable conduct required varies, depending upon whether or not the creditor is an "insider" of the debtor. For insiders, inequitable conduct is generally found if the claimant has:

(i) committed fraud or illegality or breached its fiduciary duties; (ii) left the debtor undercapitalized; or (iii) used the debtor as a mere instrumentality or alter ego.

The ruling is instructive both in assessing the risks associated with distressed investment opportunities and in gauging the limitations of lender proactivity in striving to limit credit exposure in the event of a bankruptcy filing.

Directors of a corporation owe certain fiduciary duties to the corporation and its stockholders, one of which is the duty of loyalty. The duty of loyalty generally requires that directors and officers act in the interests of the corporation and its stockholders and subordinate any conflicting interests. In assessing whether a director's conduct amounts to an actionable violation of a fiduciary duty, courts generally apply a principle of deference referred to as the "business judgment rule." As enunciated by the Delaware Supreme Court in *Brehm v. Eisner*, courts will defer to directors' business decisions

> unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

THE BANKRUPTCY COURT'S DECISION IN *RADNOR*

In considering the committee's recharacterization claim, the bankruptcy court determined that Radnor and Tennenbaum had intended all of the loans to be true debt instruments rather than equity. The court rejected the committee's allegation that, because Tennenbaum knew of Radnor's liquidity crisis when it made the loans, "no prudent lender" would have extended the financing. According to the court, it is perfectly legitimate for a lender to loan additional funds to a distressed borrower as a way to protect an existing loan.

The bankruptcy court concluded that Tennenbaum did not exercise a sufficient degree of control over Radnor to justify recharacterization of its debt as equity. Tennenbaum's designation of Mr. Feliciano as only one of four board members, the court noted, was immaterial to the control issue. The court likewise held that Tennenbaum's receipt of nonpublic information (via its role as lender), its unexercised right to obtain additional board seats, and its right to obtain additional equity did not constitute the level of control necessary to support recharacterization. The inquiry, the court emphasized, should focus on whether the lender exercised control over the debtor's day-to-day operations, which Tennenbaum did not.

Addressing the committee's equitable-subordination claim, the bankruptcy court determined that Tennenbaum had at all times acted in good faith to maximize Radnor's value to all constituents. It concluded that Tennenbaum had not acted inequitably and had neither injured Radnor's creditors nor created an unfair advantage for itself. The court found, moreover, that: (i) the loans enhanced Radnor's liquidity (thus allowing its operations to continue); (ii) the Senior Financing reduced the company's net indebtedness; and (iii) the unsecured noteholders (who held a majority of the seats on the committee) expressly consented to the Additional Financing. The court rejected the committee's contention that Tennenbaum was an insider of Radnor, finding that Tennenbaum had never exerted control over Radnor's day-to-day operations and thus was not a "person in control" of Radnor, such that it would qualify as an insider under the statutory definition of the term. Explaining that any influence that Tennenbaum had over Radnor was merely indirect, arising from Tennenbaum's rights under the loan documents, the court stated that reasonable financial controls negotiated at arm's length do not convert a lender to an insider. In the absence of any evidence of inequitable conduct by Tennenbaum, the court ruled that equitable subordination of its claims was unwarranted.

The bankruptcy court concluded that the committee's breach-of-fiduciary-duty claim against Mr. Feliciano also lacked merit. Neither of the two transactions cited in the complaint—the Additional Financing and Tennenbaum's stalking-horse bid—involved Mr. Feliciano. He abstained from voting on the financing and had resigned his seat on the board prior to any discussions concerning a possible stalking-horse bid. In addition, the court emphasized, the evidence did not indicate Mr. Feliciano used his board seat to pressure the other directors into approving either transaction. Explaining that, under Delaware law, an insider's bid to purchase a company or its assets is not a per se breach of fiduciary duty, the court ruled that Mr. Feliciano did not breach his fiduciary duties by using his knowledge about Radnor in connection with the stalking-horse bid. Moreover, the bankruptcy court concluded, it had previously determined that the stalking-horse bid was in Radnor's best interests and the bid later proved to benefit Radnor, circumstances that precluded any finding of fiduciary improprieties on the part of Mr. Feliciano.

Turning to the aiding-and-abetting claims against Tennenbaum, the bankruptcy court noted that, under Delaware law, the committee was required to prove that a fiduciary relationship existed, a fiduciary duty was breached, and the nonfiduciary defendant knowingly participated in that breach. According to the court, even if Radnor's board owed fiduciary duties to unsecured creditors, none of its actions would have breached those duties. Delaware law, the court explained, does not require an insolvent company's board to cease operations and liquidate. Rather, the court observed, "directors of an insolvent company may pursue strategies to maximize the value of the company, including continuing to operate in the hope of turning things around." Subject to the business-judgment rule, the board may approve actions that could potentially improve results—even if such actions increase the company's liabilities.

The bankruptcy court determined that Radnor's board had a good-faith basis for continuing the company's business plan in an attempt to turn the company around, instead of liquidating, because unsecured creditors would have incurred a substantial loss if Radnor had liquidated prior to closing on the Senior Financing. In the absence of any breach of fiduciary duty to Radnor, the court ruled, the committee's aiding-and-abetting claim against Tennenbaum must fail. Furthermore, the court held, the committee could not prove that Tennenbaum knowingly participated in a breach of a fiduciary duty because Tennenbaum had reasonably relied on Radnor's officers' representations that the company was solvent at the time of the loans.

ANALYSIS

Radnor Holdings can be viewed as a case study on the limits of lender liability in "distressed loan" situations. Private equity and hedge funds are deploying enormous resources in distressed markets as primary lenders, second-lien lenders, and investors both in and outside of bankruptcy. The ruling is instructive both in assessing the risks associated with distressed investment opportunities and in gauging the limitations of lender proactivity in striving to limit credit exposure in the event of a bankruptcy filing. The messages borne by *Radnor Holdings* are that: (i) without any evidence of bad faith, improper motive, or undue influence or control, secured lenders need not be wary of exercising their bargained-for rights and remedies; (ii) making additional loans to a distressed company in an effort to protect existing loans does not in and of itself warrant recharacterization or equitable subordination of the lender's claims if the borrower later files for bankruptcy; and (iii) a company's board cannot be second-guessed for pursuing informed turnaround strategies, including the incurrence of additional debt, in a good-faith effort to regain fiscal well-being. All of this should come as welcome news for lenders and corporate fiduciaries.

Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006).

Cohen v. KB Mezzanine Fund II (In re SubMicron Systems Corp.), 432 F.3d 448 (3d Cir. 2006).

Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

EXPLORING THE BOUNDARIES OF THE "INDEPENDENCE PRINCIPLE"

Robert E. Krebs and Mark G. Douglas

Much has been written recently about the impact of a bankruptcy filing on the right of a nondebtor landlord to draw on a letter of credit posted as security for the tenant's obligations under a lease of nonresidential real property. The focus of recent court rulings and commentary, however, has generally been directed to various restrictions, such as the statutory cap placed on damage claims under commercial leases, on the lessor's ability to apply the full amount of the proceeds of a letter of credit to the lessee's obligations, notwithstanding the common-law "independence principle" that, as a general rule, operates to make a lessor's remedies under a letter of credit inviolate in the event of a bankruptcy filing by the lessee.

A recent decision by the Eleventh Circuit Court of Appeals illustrates another potential hazard for lessors who believe their rights under a real property lease are fully secured by a letter of credit. In *In re Builders Transport, Inc.*, the court of appeals held that a standby letter of credit beneficiary was required under section 542 of the Bankruptcy Code to turn over proceeds of a letter of credit improperly retained after the commencement of a bankruptcy case by the lessee.

DRAWDOWN AND DISTRIBUTION OF LETTER OF CREDIT PROCEEDS

A typical letter of credit transaction securing a lease involves three independent sets of obligations: (a) the lessee's obligations to perform under the terms of the lease; (b) the letter of credit issuer's obligation to pay the amount of any draw under the letter of credit when presented by the lessor beneficiary; and (c) the lessee's obligation to reimburse the letter of credit issuer for the amounts drawn on the letter of credit. Under what is commonly referred to as the "independence principle," the obligation of the issuer to pay the beneficiary upon presentment of the letter of credit is independent from the lessee's obligations under the lease. As a result, the letter of credit is not property of the debtor's bankruptcy estate and, as a general rule, the automatic stay does not prevent the beneficiary from presenting and drawing on the letter of credit after the lessee files for bankruptcy. Once the letter of credit is drawn, however, distribution of the cash proceeds is subject to the terms of the lease that the letter of credit secures. The Court of Appeals for the Eleventh Circuit addressed certain complications that arise once a letter of credit is drawn during the course of a chapter 11 case in *Builders Transport*.

BUILDERS TRANSPORT

Prior to filing for chapter 11 protection in 1998, South Carolina–based trucking concern Builders Transport, Inc. ("BTI"), entered into a sale-leaseback transaction with an unrelated entity ("Two Trees") to realize a capital-loss carryforward that could be used if and when BTI later generated income to offset the loss. Under the terms of the transaction, BTI sold its headquarters facility to Two Trees for $3.5 million and leased the facility back from Two Trees. The lease agreement provided for a 60-month term with an option for BTI to renew for four additional 60-month terms. The lease also required BTI to obtain a letter of credit in the amount of $1.6 million in favor of Two Trees to secure BTI's lease obligations.

Two Trees entered into a separate loan agreement pursuant to which it borrowed the $3.5 million used to purchase the headquarters facility from BTI. The amount of BTI's monthly lease payment under the terms of the lease between BTI and Two Trees equaled the amount required to service the monthly debt, and BTI's lease payments went directly to Two Trees' lender pursuant to the terms of the loan documents. However, the lease payments due under the initial term of the lease did not fully amortize Two Trees' mortgage—had BTI fulfilled its rent obligations under the initial 60-month term, Two Trees still would have owed its lender more than $2 million.

Prior to the expiration of the initial 60-month lease term, BTI and its parent filed for chapter 11 protection in Georgia. When it soon became evident that the debtors had no prospects for reorganizing, BTI obtained court approval to sell certain assets to Schneider National, Inc. ("Schneider"). Pursuant to their asset purchase agreement, BTI and Schneider agreed that they would jointly occupy the headquarters property and share in the obligation to make rent payments under the terms of the lease with Two Trees.

Shortly after consummation of the sale and occupation of the headquarters facility by Schneider, BTI's lender sent a default and acceleration notice to the letter of credit issuer, notifying it that BTI's obligations under the lease agreement were immediately due. In response to the default notice, the issuer notified Two Trees' lender that the letter of credit would expire in 30 days because the lease obligations of BTI had been accelerated. Before the letter of credit expired, Two Trees' lender drew down the entire amount of the $1.6 million letter of credit. The lender then applied the proceeds against Two Trees' debt incurred in connection with the purchase of the headquarters facility. BTI's lender reimbursed the letter of credit issuer for the full amount of the $1.6 million draw on the letter of credit. Less than six months after the sale to Schneider, both BTI and Schneider had vacated the headquarters facility, and Two Trees sold the facility to a third party shortly thereafter. Neither Two Trees nor its lender filed a proof of claim in BTI's chapter 11 case.

The ruling recognizes, as most courts have, that the independence principle protects a letter of credit beneficiary's right to draw on a letter of credit, even in the event of a bankruptcy filing by the account debtor.

One month later, BTI commenced litigation against Two Trees, its lender, and certain principals of Two Trees, alleging that the $1.6 million proceeds of the letter of credit were property of BTI's chapter 11 estate to the extent the proceeds exceeded the amount of Two Trees' allowed claim for lease-rejection damages under applicable nonbankruptcy law. The bankruptcy court ruled that the excess letter of credit proceeds were property of BTI's estate. In a subsequent order, it directed the defendants to pay damages to BTI in the amount of approximately $1.2 million, finding that Two Trees' allowed claim for lease-rejection damages amounted to approximately $400,000 under South Carolina law. Because the damage claim did not exceed the statutory cap set forth in section 502(b)(6) of the Bankruptcy Code (the greater of one year's rent, or 15 percent, not to exceed three years, of the rent reserved for the remaining term), the court did not apply the cap to limit the landlord's allowed lease-rejection claim. The district court affirmed those rulings on appeal, and the defendants appealed to the Eleventh Circuit.

THE ELEVENTH CIRCUIT'S RULING

On appeal to the Eleventh Circuit, the defendants argued that, under the doctrine of independence, the proceeds of the letter of credit were not property of the estate subject to turnover under section 542 of the Bankruptcy Code. The court of appeals rejected this contention, drawing a distinction between the initial draw on a letter of credit, which is protected under the doctrine of independence, and the right to the proceeds of the drawn letter of credit, which is not. "[O]nce the proceeds of a letter of credit have been drawn down," the Eleventh Circuit explained, "the underlying contracts become pertinent in determining which parties have a right to those proceeds." According to the court, BTI's turnover action challenged the application of the letter of credit proceeds under the terms of the lease agreement, not the propriety of the initial draw on the letter of credit. As a result, the court of appeals ruled, the doctrine of independence is not applicable.

The Eleventh Circuit then examined the provisions of the lease agreement to determine what obligations were secured by the letter of credit. In addition to rent, the defendants argued, the lease provided that BTI was obligated to secure Two Trees' mortgage obligation to its lender. The court of appeals rejected this argument, finding that neither the unambiguous terms of the lease nor any other evidence supported the claim that the letter of credit secured anything more than BTI's lease obligations. Accordingly, the Eleventh Circuit ruled, the letter of credit secured only the landlord's claim against BTI (approximately $400,000), and any excess proceeds of the letter of credit were property of BTI's estate subject to turnover under section 542.

The court of appeals rejected the argument that the full $1.6 million letter of credit proceeds were "special" damages arising from BTI's breach of the lease, to which, according to the terms of the agreement, they were entitled to recover, up to the amount of Two Trees' outstanding mortgage debt. The Eleventh Circuit characterized as "unsustainable" the defendants' claims that the entire arrangement was intended to be a secured-financing transaction, rather than a lease, such that the letter of credit also acted as security for Two Trees' mortgage obligations.

Finally, the Eleventh Circuit harmonized its ruling with the 2005 decision handed down by the Fifth Circuit Court of Appeals in *In re Stonebridge Technologies Inc.*, where the court ruled that a proof of claim having been filed by the lessor against the estate is a precondition to applying the damages cap under section 502(b)(6). In the case before it, the Eleventh Circuit noted, the statutory cap was never at issue because the landlord's actual damage claim calculated according to applicable nonbankruptcy law did not exceed the limitation. The turnover litigation commenced by BTI, the court emphasized, "was not predicated on the fact that its lessor's assignee retained funds in excess of the § 502(b)(6) damages cap, but rather on the fact that its lessor's assignee was not entitled to retain the funds pursuant to the underlying lease agreement."

ANALYSIS

The Eleventh Circuit's decision in *Builders Transport* is not groundbreaking. The ruling recognizes, as most courts have, that the independence principle protects a letter of credit beneficiary's right to draw on a letter of credit, even in the event of a bankruptcy filing by the account debtor. Also, the decision recognizes, as most courts have, that a letter of credit beneficiary is entitled to the proceeds of a letter of credit only up to the amount of the damages secured by the letter of credit. Interestingly, the court of appeals was able to sidestep one of the most potentially sticky legal issues posed by the scenario before it—the Eleventh Circuit did not have to decide whether section 502(b)(6) limits the claim of a landlord who draws on a letter of credit but never becomes directly involved in the lessee's bankruptcy case by filing a proof of claim.

In re Builders Transport Inc., 471 F.3d 1178 (11th Cir. 2006).

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

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