JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 6 ▪ NO. 5 ▪ SEPTEMBER/OCTOBER 2007

BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

U.S. BANKRUPTCY COURT DENIES FAILED HEDGE FUNDS' REQUEST FOR CHAPTER 15 RECOGNITION

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Two hedge funds affiliated with Bear Stearns & Co., Inc., the fifth-largest investment firm in the U.S., recently failed in a bid to obtain recognition under chapter 15 of the Bankruptcy Code of winding-up proceedings commenced in the Cayman Islands at the end of July for two of the firm's hedge funds that were casualties of the sub-prime mortgage meltdown. News of the filings in the Caymans led to speculation that the precedent would encourage other failed hedge funds to liquidate in the Caymans, where judges are perceived as favoring management over creditors. According to some estimates, three out of four hedge funds globally are incorporated in the western Caribbean islands. The islands of the Caribbean also are favored by special purpose vehicles that issue collateralized debt (or loan) obligations.

In a pair of decisions issued on August 30, 2007, Bankruptcy Judge Burton R. Lifland denied petitions under chapter 15 of the Code for recognition in the U.S. of the pending Cayman proceedings. Although Judge Lifland's decisions do not leave the funds without recourse in attempting to prevent piecemeal dismantling of their assets, substantially all of which are (or at one time were) located in the U.S., his rulings do seriously hamper the funds' ability to coordinate those efforts under the auspices and protection of chapter 15 in the U.S. while seeking to liquidate their assets in a non-U.S. forum. The rulings suggest that U.S. bankruptcy courts interpreting newly minted chapter 15 will not rubber-stamp requests designed to take advantage of the broad range of relief available under the statute by way of assistance to qualifying bankruptcy and insolvency proceedings commenced abroad.

CHAPTER 15

October 17, 2007, will mark the second anniversary of the effective date of chapter 15 of the Bankruptcy Code, enacted as part of the comprehensive bankruptcy reforms implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Governing cross-border bankruptcy and insolvency cases, chapter 15 is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law ("UNCITRAL") in 1997 to deal with the rapidly expanding volume of international insolvency cases.

Chapter 15 replaces section 304 of the Bankruptcy Code. Section 304 allowed an accredited representative of a debtor in a foreign insolvency proceeding to commence a limited "ancillary" bankruptcy case in the U.S. for the purpose of enjoining actions against the foreign debtor or its assets located in the U.S. The policy behind section 304 was to provide any assistance necessary to assure the economic and expeditious administration of foreign insolvency proceedings. Chapter 15 continues that practice, but establishes new rules and procedures applicable to transnational bankruptcy cases that will have a markedly broader impact than section 304.

PROCEDURE

Under chapter 15, a duly accredited representative of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign proceeding" is defined as

> a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation.

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a "main" proceeding — a case pending in whatever country contains the debtor's "center of main interests" ("COMI") — and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment." The debtor's registered office or habitual residence, in the case of an individual, is presumed to be a debtor's COMI, a presumption, according to the statute's legislative history, included "for speed and convenience of proof where there is no serious controversy." An "establishment" is defined by statute to be "any place of operations where the debtor carries out a nontransitory economic activity."

The Bankruptcy Code does not specify what evidence is required to rebut the presumption that COMI is the debtor's place of registration or incorporation. Various factors have been deemed relevant by courts and commentators in examining the issue, including the location of the debtor's headquarters, managers, primary assets, or creditors and which jurisdiction's law would apply to most disputes. Chapter 15 expressly directs courts to look for guidance to the interpretation of COMI by foreign jurisdictions under similar statutes, such as the EC Regulation on Insolvency Proceedings and the U.K. Enterprise Act of 2002. Additional guidance can be found in the Legislative Guide to the Model Law adopted by UNCITRAL on June 25, 2004 (the "Guide"), and an extensive body of legal commentary developed during the 10 years since the Model Law was finalized in 1997. The Guide explains that employing COMI as the basis for extending recognition for a main proceeding was modeled on the use of that concept in the EU Convention on Insolvency Proceedings. The regulation adopting the EU Convention provides that COMI is "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." The concept is thus quite similar to the concept of "principal place of business" under U.S. law.

Chapter 15 requires that, if the U.S. bankruptcy court is provided with sufficient evidence (delineated in the statute) attesting to the legitimacy of a pending foreign bankruptcy or insolvency proceeding, it "shall" enter an "order of recognition."

INTERIM RELIEF

Pending a decision on recognition, the court is empowered to grant certain kinds of provisional relief. Chapter 15 of the Bankruptcy Code authorizes the court, "where relief is urgently needed to protect the assets of the debtor or the interests of the creditors," to stay any execution against the debtor's assets, entrust the administration of the debtor's assets to a foreign representative, or suspend the right to transfer, encumber, or otherwise dispose of any of the debtor's assets. Any provisional relief granted pending approval of a request for recognition terminates at such time that the bankruptcy court rules on the request, unless the court expressly orders otherwise.

Although varying in certain details, the message borne by these rulings is clear: U.S. bankruptcy courts are casting a critical eye on the attempts of offshore-based hedge funds to enlist the aid of chapter 15 to sort out their financial woes.

BROAD POWERS UPON RECOGNITION

Upon recognition of a foreign "main" proceeding, certain provisions of the Bankruptcy Code automatically come into force, while others may be deployed in the bankruptcy court's discretion by way of "additional assistance" to the foreign bankruptcy case. Among these are the automatic stay (or an equivalent injunction) preventing creditor collection efforts with respect to the debtor or its assets located in the U.S. (section 362, subject to certain enumerated exceptions), the right of any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that interest (section 361), and restrictions on the debtor's ability to use, sell, or lease its U.S. property outside the ordinary course of its business (section 363). In contrast, if the foreign proceeding is recognized as a "nonmain" proceeding, then the bankruptcy court *may*, but is not required to, grant a broad range of provisional and other relief designed to preserve the foreign debtor's assets or otherwise provide assistance to a main proceeding pending elsewhere.

Once a foreign main proceeding is recognized by the bankruptcy court, the foreign representative is authorized to operate the debtor's business much in the same way as a chapter 11 debtor-in-possession. He can also commence a full-fledged bankruptcy case under any other chapter of the Bankruptcy Code, so long as the foreign debtor is eligible to file for bankruptcy in the U.S. and the debtor has U.S. assets.

The foreign representative in a recognized chapter 15 case is conferred with some of the powers given to a bankruptcy trustee under the Bankruptcy Code, although they do not include the ability to invalidate preferential or fraudulent asset transfers or obligations, unless a case is pending with respect to the foreign debtor under another chapter of the Bankruptcy Code. The foreign representative may also intervene in any court proceedings in the U.S. in which the foreign debtor is a party and can sue and be sued in the U.S. on the foreign debtor's behalf.

THE HEDGE FUNDS

Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (collectively, the "Funds"), are Cayman Islands-exempted limited liability companies with registered offices in the Cayman Islands. The Funds are open-ended investment companies that invested in a wide variety of securities, including asset-backed securities, mortgage-backed securities, derivatives, swaps, forward contracts, and futures. A Massachusetts corporation administers the Funds. The administrator served as the Funds' registrar and transfer agent and provided day-to-day administrative services. This included accounting and clerical services; processing of the issuance, transfer, and redemption of shares; shareholder, potential investor, and public relations; distributing annual reports and account statements; maintaining the Funds' principal administrative records; and paying the Funds' expenses.

The books and records of the Funds are maintained by the administrator in Delaware. Deloitte & Touche, Cayman Islands, signed off on the Funds' most recent audited financial statements. Bear Stearns Asset Management ("BSAM"), incorporated in New York, is the Funds' investment manager, and the assets managed by BSAM are located in New York. All or nearly all of the Funds' other assets (receivables from broker dealers) are also located in New York. The Funds' investor registers are maintained in Ireland by an affiliate of the administrator.

By late May of 2007, both of the Funds suffered a significant devaluation of their asset portfolios as a consequence of the well-publicized volatility in the markets triggered by the subprime mortgage meltdown. Margin calls and default notices ensued, after which many counterparties to trade agreements with the Funds exercised their rights to seize and/or sell Fund assets that had been the subject of repurchase agreements or had been pledged as collateral.

After their boards of directors authorized the Funds to file winding-up petitions under the Companies Law of the Cayman Islands, the Cayman Grand Court appointed joint provisional liquidators of the Funds on July 31, 2007. The liquidators filed chapter 15 petitions in New York on the same day, seeking recognition of the Cayman winding-up proceedings as main proceedings and provisional relief pending the decision on recognition in the form of a temporary restraining order preventing efforts to seize the Funds' U.S. assets. Judge Lifland granted the request for emergency injunctive relief after a hearing held on August 9, 2007. Except for an ambiguous statement filed by one of the Funds' creditors requesting a determination that any finding concerning COMI should not control choice of law in actions brought by the liquidators in the U.S., no one either objected or responded to the chapter 15 petitions.

THE BANKRUPTCY COURT'S RULING

Emphasizing that recognition under chapter 15 "is not to be rubber stamped by the courts," the bankruptcy court carefully examined whether the Cayman proceedings qualified as either main or nonmain proceedings under chapter 15. It concluded that they did not.

The court acknowledged that the liquidators were accredited representatives of a debtor in a foreign bankruptcy or insolvency proceeding. Even so, the court explained, to be recognized under chapter 15, a foreign proceeding must meet the definitional requirements in the statute for either a main or a nonmain proceeding.

Based solely on the pleadings filed in support of the chapter 15 petitions, however, the court concluded that the Funds' COMI is in the U.S., not the Cayman Islands. According to the court, "[t]he only adhesive connection with the Cayman Islands that the Funds have is that they are registered there." Given the absence of anything but a tenuous connection with the Caymans, the bankruptcy court ruled that "the presumption that the COMI is the place of the Funds' registered offices has been rebutted by evidence to the contrary."

The court also denied the liquidators' alternative request for recognition of the Cayman Islands proceedings as foreign nonmain proceedings. Explaining that under Cayman Islands law, "exempted companies" are statutorily prohibited from engaging in business in the Cayman Islands except in furtherance of business carried on in other countries, the bankruptcy court ruled that the liquidators had not proved that the Funds had even an "establishment" in the Cayman Islands.

OUTLOOK

The Funds were not left without the ability to obtain relief from U.S. courts by Judge Lifland's ruling: the judge extended the temporary restraining order previously entered by an additional 30 days to give the liquidators time to decide whether or not chapter 7 or 11 cases should be commenced on behalf of the Funds. Given the location of substantially all of their assets and operations in the U.S., the Funds could likely have met the Bankruptcy Code's filing requirements for those chapters. On September 21, 2007, however, the liquidators sought yet another extension of the restraining order, contending that a chapter 7 or chapter 11 filing is not a viable option because the resulting legal costs would reduce the modest pool of funds available for distribution to creditors.

Judge Lifland's decisions are not the first rulings denying recognition under chapter 15 of a foreign main proceeding involving a Cayman Islands hedge fund. In the late summer of 2006, Bankruptcy Judge Robert D. Drain, in *In re SPhinX, Ltd.*, denied a petition seeking recognition of liquidation proceedings in the Cayman Islands as foreign main proceedings because the evidence did not support a finding that the debtor-hedge funds' COMI was in the Cayman Islands, and it appeared that the liquidators' motive for seeking recognition was to gain a tactical advantage in pending litigation involving the debtors. However, the judge ruled that recognition as a foreign *nonmain* proceeding was warranted, even though the Cayman liquidation did not qualify as a main proceeding and even though no such proceeding was pending elsewhere. In *dicta*, Judge Drain suggested that if the parties involved had not objected to the Cayman Islands proceeding being recognized as main, recognition would have been warranted solely because there were no objections and no other proceeding had been commenced elsewhere. Judge Drain's ruling was affirmed in all respects by a New York district court

NEWSWORTHY

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, and ***Heather Lennox (Cleveland)*** have been selected for inclusion in the 2008 *Best Lawyers in America* guide.

David G. Heiman (Cleveland) and ***Gregory M. Gordon (Dallas)*** hosted an audio conference on May 1, 2007, for Beard Group Law and Business Publishers concerning "Handling Complex Chapter 11 Restructuring Issues."

An article written by ***Heather Lennox (Cleveland)***, ***Michelle M. Harner***, and ***Eric R. Goodman*** entitled "Reinstatement v. Cramdown: Do Secured Creditors Win or Lose?" was published in the August 2007 edition of *Norton Journal of Bankruptcy Law and Practice*.

Gregory M. Gordon (Dallas) was quoted in an article entitled "Creative collection gambit works: Fraudulent transfer law used in a high-profile Hollywood case" that appeared in the September 3, 2007, edition of *The National Law Journal*.

Adam Plainer (London) and ***Andrew L. Rotenberg (London)*** were among the practitioners in the field of corporate restructuring and insolvency recommended in the 2007/08 edition of *The UK Legal 500*.

An article written by ***Brad B. Erens (Chicago)***, ***Jayant W. Tambe (New York)***, and ***Mark G. Douglas (New York)*** entitled "U.S. Refuses to Rubber-Stamp Failed Hedge Funds' Chapter 15 Petition" appeared in the September 6, 2007, edition of *Bankruptcy Law 360*.

An article written by ***Brad B. Erens (Chicago)*** and ***Mark G. Douglas (New York)*** entitled "Bidders Beware: Private-Equity Club Deals Could Be Challenged in Bankruptcy" appeared in the September 2007 edition of *The Bankruptcy Strategist*.

An article written by ***Paul Bromfield (London)*** entitled "Understanding 'COMI': Where Are We?" appeared in the September 2007 edition of *In-House Lawyer*.

An article written by ***Mark G. Douglas (New York)*** entitled "Choice of Venue: Sound Strategy or Forum Shopping?" appeared in the Summer 2007 edition of the ABA Litigation Section's *Bankruptcy Litigation*.

Paul D. Leake (New York) has been nominated for appointment to the Bankruptcy & Corporate Reorganization Committee of the New York City Bar for the term beginning September 2007.

in July of 2007. According to Judge Lifland, the absence of any objection is largely irrelevant. The court, he remarked, "must make an independent determination as to whether the foreign proceeding meets the definitional requirements" of chapter 15.

Although varying in certain details, the message borne by these rulings is clear: U.S. bankruptcy courts are casting a critical eye on the attempts of offshore-based hedge funds to enlist the aid of chapter 15 to sort out their financial woes.

The liquidators appealed Judge Lifland's denial of their petitions for recognition on September 10, 2007. Regardless of the outcome on appeal, the rulings represent a significant step forward in the evolution and development of chapter 15 as a vehicle for coordinating cross-border bankruptcy cases.

In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (In Provisional Liquidation), 2007 WL 2479483 (Bankr. S.D.N.Y. Aug. 30, 2007), *as amended*, No. 07-12383 (BRL) (Bankr. S.D.N.Y. Sept. 5, 2007).

In re SPhinX, Ltd., 351 B.R. 103 (Bankr. S.D.N.Y. 2006), *aff'd*, 2007 WL 1965597 (S.D.N.Y. July 5, 2007).

A version of this article originally appeared in the September 6, 2007, editions of *Bankruptcy Law 360* and *Securities Law 360*.

ENRON REDUX: ROUND TWO GOES TO CLAIMS PURCHASERS/TRADERS

Mark G. Douglas

In previous editions of the *Business Restructuring Review*, we reported on a pair of highly controversial rulings handed down in late 2005 and early 2006 by the New York bankruptcy court overseeing the chapter 11 cases of embattled energy broker Enron Corporation and its affiliates. In the first, Bankruptcy Judge Arthur J. Gonzalez held that a claim is subject to equitable subordination under section 510(c) of the Bankruptcy Code even if it is assigned to a third-party transferee who was not involved in any misconduct committed by the original holder of the debt. In the second, Judge Gonzalez broadened the scope of his cautionary tale, ruling that a transferred claim should be disallowed under section 502(d) of the Bankruptcy Code unless and until the transferor returns payments to the estate that are allegedly preferential.

Although immediately appealed, the rulings had players in the distressed-securities market scrambling to devise better ways to limit their exposure by building stronger indemnification clauses into claims-transfer agreements. Their "buyer beware" approach, moreover, was greeted by a storm of criticism from lenders and traders alike, including the Loan Syndications and Trading Association; the Securities Industry and Financial Markets Association; the International Swaps and Derivatives Association, Inc.; and the Bond Market Association. According to these groups, if *caveat emptor* is the prevailing rule of law, claims held by a bona fide purchaser can be equitably subordinated even though it may be impossible for the acquiror to know, even after conducting rigorous due diligence, that it was buying loans from a "bad actor."

An enormous amount of attention was focused on the appeals, with industry groups, legal commentators, Enron creditors, distressed investors, academics, and other interested parties seeking the appellate court's leave to register their views on the issues involved and the impact of the rulings on the multibillion-dollar market for distressed claims and securities. The vigil ended on August 27, 2007. In a carefully reasoned 53-page opinion, District Judge Shira A. Scheindlin vacated both of Judge Gonzalez's rulings, holding that "equitable subordination under section 510(c) and disallowance under section 502(d) are personal disabilities that are not fixed as of the petition date and do not inhere in the claim."

STATUTORY PROVISIONS INVOLVED

The Bankruptcy Code creates a mechanism to deal with creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or postbankruptcy asset transfers that can be recovered because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) of the Bankruptcy Code provides that the court shall disallow any claim asserted by a creditor who falls into one of these categories, "unless such entity or transferee has

KEY POINTS

- **As a general rule, whether a transfer is in the form of a sale or an assignment will determine whether the transferee's claims can be subject to equitable subordination under section 510(c) or disallowance under section 502(d) based upon the transferor's misconduct.**
- **In most cases, purchased claims will be insulated from subordination and/or disallowance, while assigned claims will not.**
- **Not every purchaser of a claim will be automatically exempt from subordination exposure. Claims purchased in bad faith and claims bought by those with actual notice of the seller's misconduct who engage in misconduct themselves will still be subject to equitable subordination.**
- **Not all claims of assignees who take from bad actors will automatically be subject to equitable subordination. The claim of an assignee who qualifies as a holder in due course or can rely on the "doctrine of latent equities" (depending upon which state's law governs the contract) may be protected from subordination.**
- **Because postpetition assignees of claims, including negotiable instruments, cannot take an instrument "without notice that it is overdue," they cannot qualify as holders in due course.**

paid the amount, or turned over any such property, for which such entity or transferee is liable." The purpose of the provision is to promote the pro rata distribution of the bankruptcy estate among all creditors and to coerce payment of judgments obtained by the trustee.

Equitable subordination is a common-law doctrine predating the enactment of the Bankruptcy Code, designed to remedy misconduct that causes injury to creditors (or shareholders) or confers an unfair advantage on a single creditor at the expense of others. The remedy is now codified in section 510(c) of the Bankruptcy Code, which provides that "the court may . . . under principles of equitable subordination, subordinate for purposes of distribution 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." The statute, however, does not define the circumstances under which subordination is warranted, leaving the development of such criteria to the courts.

In 1977, the Fifth Circuit Court of Appeals in *In re Mobile Steel Co.* articulated what has become the most commonly accepted standard for equitably subordinating a claim. Under the *Mobile Steel* test, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant) and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have since refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and noninsiders in assessing the level of misconduct necessary to warrant subordination.

ENRON

Enron Corporation and approximately 90 affiliated companies began filing for chapter 11 protection in December of 2001. Shortly before filing for bankruptcy, Enron borrowed $3 billion under short- and long-term credit agreements from a consortium of banks, including Fleet National Bank. Citibank N.A. and Chase Manhattan Bank served as co-administrative agents. Citibank later filed a proof of claim for amounts due under the agreements on behalf of all participating banks, including Fleet.

During the course of Enron's bankruptcy, Fleet sold its claims against Enron to various entities, some of which later transferred the claims again to other acquirors. The claims ultimately came to be held by five separate distressed-investment funds (collectively referred to as the "transferees"), none of which had loaned money to Enron or had any existing relationship with the company.

Enron sued the banks in 2003, claiming, among other things, that Fleet and certain of its affiliates were the recipients of prebankruptcy preferential or constructively fraudulent transfers and that Fleet aided and abetted Enron's accounting fraud, resulting in injury to Enron's creditors and conferring an unfair advantage on Fleet. None of the allegations dealt with purported misconduct related to the credit agreements or transfers made or obligations incurred in connection with the agreements. Instead, Enron's allegations concerned an unrelated prepaid forward transaction involving the same lenders that took place in 2000. In a separate proceeding filed in 2005, Enron sought to subordinate and disallow Fleet's claims under the credit agreements even though the claims had been transferred to the transferees. The transferees moved to dismiss the proceedings.

THE BANKRUPTCY COURT'S RULINGS

The bankruptcy court denied the motion to dismiss Enron's equitable subordination claims. Observing that "[t]here is no basis to find or infer that transferees should enjoy greater rights than the transferor," the court concluded that transferred claims are still subject to equitable subordination in the hands of a blameless transferee. The bankruptcy court gave short shrift to the transferees' contention that subordination of an assigned claim in the hands of a blameless transferee would adversely impact the claims-trading market. The risk of equitable subordination, the court emphasized, is a danger of which potential acquirors are well aware and for which, in fact, they specifically account by incorporating indemnifying language in any transfer agreement. Eliminating such risks by providing special protection to purchasers of claims subject to subordination, the bankruptcy court explained, "would create a 'special' class of claimholders," a concept that is supported by neither the Bankruptcy Code nor case law interpreting it.

In a separate opinion, the court addressed dismissal of Enron's causes of action against the transferees under section 502(d). Consistent with its previous determination, the bankruptcy court reaffirmed the principle that a transferred claim is subject to the same shortcomings, including any defenses, to which it was subject in the hands of the original holder of the obligation.

The bankruptcy court rejected the transferees' argument that the plain language of the statute supports the position that a claim can be disallowed only if the holder of the claim can be a defendant in an avoidance or recovery proceeding. According to the court, section 502(d) clearly applies to "any claim" of an entity from whom property or its value can be recovered — it does not require that the claim be related to an avoidable transfer or that such a transfer or other basis for liability occur after a creditor acquires a claim. Observing that "[t]he Court has not found any case law mandating that the creditor who received an avoidable transfer be the same entity that actually asserts such claim against the debtor in the bankruptcy proceeding in order for a debtor to assert a section 502(d) disallowance against the claim," the bankruptcy court ruled that the transferees' claims were subject to the same defenses that applied to them when the claims were held by Fleet.

Both rulings were appealed by the transferees, all but one of which settled before the district court issued its ruling.

THE DISTRICT COURT'S RULING: KEY DISTINCTION BETWEEN ASSIGNMENT AND SALE

Noting that the issue before it "is complex and of first impression in this Circuit," the district court commenced its analysis by examining the important distinction between the legal concepts of "sale" and "assignment." Although each is a form of transfer, the court explained, the terms are not synonymous and have very different legal consequences for the transferee:

> With respect to assignments, "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor." In other words, "an assignee of a claim takes with it whatever limitations it had in the hands of the assignor . . . ." By contrast, these assignment law principles do not apply to sales. A purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances.
>
> These distinctions apply with the same force to transfers of debt and claims. An assignee of a claim takes no more than the assignor had to give. A purchaser of a claim may take more. Although characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities of claimants. A personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but it will not travel to the transferee if the claim is *sold*.

The court then discussed certain exceptions to the general rule that an assignor cannot give more than he has. The first exists for holders in due course of negotiable instruments who, to qualify for that status, must take an instrument: (i) for value; (ii) in good faith; and (iii) without notice that the instrument is overdue or has been dishonored, or of any defense or claim to it. Any holder in due course will take an instrument free from all competing claims to it and, with certain exceptions, all defenses of any party to the instrument with whom the holder has not dealt. A postpetition assignee of a claim, however, cannot qualify as a holder in due course because it cannot take the instrument "without notice that it is overdue."

The second exception to the general rule is the "third-party latent-equities doctrine," which provides that an assignee without notice takes property free and clear from the latent equities of third parties other than the debtor. Many states, however, including New York, do not recognize the doctrine in the context of transfers of "choses in action," which include bankruptcy claims.

Having drawn the distinction between assignments and sales, the court proceeded to an examination of the language of sections 510(c) and 502(d) to determine whether, as Enron contended, "all rights among competing claims to a bankruptcy estate are fixed and determined" as of the bankruptcy petition date, such that the claims transferred were "forever tainted" as of that point in time. The district court concluded otherwise.

The language of section 510(c), the court explained, reveals that equitable subordination cannot be "fixed" on the petition date because: (i) a claim or interest can be subordinated only after notice and a hearing; (ii) the remedy is permissive, not mandatory; (iii) subordination can be based upon postpetition conduct; and (iv) inasmuch as *Mobile Steel* dictates that equitable subordination is not available to creditors who did not suffer injury, creditors who acquired their claims postpetition and after the alleged misconduct upon which equitable subordination is based "may not be entitled to that remedy . . . [such that] the circumstances of other creditors can become relevant post-petition and may alter the availability of equitable subordination."

Likewise with disallowance of a claim under section 502(d), the district court emphasized. The plain language of the provision indicates that: (i) court action is necessary before a claim will be disallowed; (ii) disallowance is completely contingent on the recipient's refusal or failure to return an avoidable transfer; and (iii) disallowance can be based solely on the postpetition receipt of and failure to return an avoidable transfer.

Next, the court addressed the threshold question of law before it: Are equitable subordination and disallowance under the relevant statutes "attributes of a claim or are they personal disabilities of particular claimants?" If attributes, the court explained, they will travel with the claim regardless of the method of transfer, whereas if they are personal disabilities, their application to transferees "depends on whether the transfer was by way of sale or assignment."

Examining the language, history, and application of equitable subordination, and noting the absence of any precedent on point, the district court concluded that Congress "intended to create a personal disability" when it enacted section 510(c). Relevant case law and the provision's legislative history, the court emphasized, focus on misconduct committed by the holder of the claim or, stated differently, focus on the "claimant rather than the claim." In fact, the court explained, Congress expressly rejected a broader wording of the provision that would have provided for subordination "on equitable grounds," opting instead for a version that actually limits the scope of the remedy. The court viewed the absence of any precedent equitably subordinating the claim of a transferee based upon the conduct of the transferor as a testament to the validity of its conclusion.

According to the district court, by expressly extending its rulings to all transfers of bankruptcy claims, the bankruptcy court "ignored the distinctions between assignments and sales and never addressed whether equitable subordination travels with the claim or is a personal disability." If a claimant purchases its claim, as opposed to taking it by assignment, operation of law, or subrogation, the court explained, "assignment law principles have no application with respect to personal disabilities of claimants . . . [and] purchasers are protected from being subject to the personal disabilities of their sellers." This distinction, the court observed, is "particularly imperative" in the distressed-debt market, where sellers are frequently anonymous and buyers have no way of knowing whether the seller (or any preceding transferee) has engaged in misconduct or received an avoidable transfer. According to the district court, it is unclear how such "unknowable risk" could be priced by the market. By contrast, the court explained, parties to true assignments can readily contract around the risk of subordination or disallowance by means of indemnification clauses drafted to protect the assignee.

The district court reached a similar conclusion regarding section 502(d): the "language and structure of the statute is plain and requires the entity that is asserting the claim be the same entity (*i.e.*, 'such entity') that is liable for receipt of a failure to return property." This result, the court emphasized, comports with one of the provision's primary purposes in coercing the return of assets obtained by means of an avoidable transfer. This goal would not be served if a claim could be disallowed in the hands of an entity that is not the recipient of an avoidable transfer and could therefore not be compelled to return the assets conveyed. Such a result, the court reasoned, would also be inconsistent with the statute's coercive, rather than punitive, nature. Applying section 502(d) to purchasers of claims would be punitive "because they have no option to surrender something they do not have."

Relying on indemnity agreements to ameliorate the risk of disallowance, the court explained, would be problematic for two reasons: (i) standardized indemnity agreements did not come into use until years after the enactment of section 502(d), so it is doubtful at best that lawmakers intended reliance on such agreements as a means to protect claims purchasers from having their purchased claims disallowed; and (ii) such agreements do not exist in a substantial portion of the market, which involves anonymous trading in distressed debt. According to the court, the handful of existing decisions that have found section 502(d) liability to ride along with a transferred claim are flawed because they fail to distinguish between claims that are sold and claims that are merely assigned.

Having concluded that Congress intended sections 510(c) and 502(d) to create personal, rather than portable, liabilities, the district court refused to tailor its ruling to account for any policy concerns articulated by either the litigants or other interested parties. Even so, the court briefly discussed policy concerns regarding the possibility that claims tainted by misconduct can be "washed" simply by transferring them to innocent transferees.

Acknowledging that the availability of a direct action against the transferor "is not a perfect substitute" due to burden of proof and the time value of money issues, the court downplayed the magnitude of any added burden associated with the unavailability of recourse to the transferor, observing that it is unlikely that transferors "will routinely be able to immunize themselves through sales" and characterizing the potential for protracted and costly litigation above and beyond what would be required to subordinate or disallow a claim as "somewhat exaggerated." So too, the court emphasized, "[i]nsolvency of the transferor is not of grave concern in the big picture." According to the court, the "more likely scenario" is that a lender in financial trouble who is anxious to sell its claims would be compelled to do so by means of an assignment that includes representations, warranties, and indemnities — circumstances under which "there is no concern of loss to the estate because the transferee's claim *would* be disallowed."

Even so, the district court acknowledged, claim "washing" may be possible in some cases:

> At the end of the day, however, there can be no dispute that in limited circumstances, a bad faith transferor may be able to sell its claim to a bona fide purchaser for value, effectively "wash" its claim in the hands of the purchaser, take the proceeds and run, to the detriment of other creditors. However, the risk of that scenario is outweighed by the countervailing policy at issue, namely the law's consistent protection of bona fide purchasers for value . . . . This Court finds that the balance struck by the foregoing legal analysis is fair: the burden and risk is better carried by creditors as a whole in favor of the bona fide purchaser in the context of a sale, but better carried by the assignee in favor of the creditors in the context of an assignment, particularly given the ability of parties to an assignment to obtain indemnities and warranties.

Finally, addressing the effect that its interpretation of the statute would have on the market, the district court stated that "the two opinions below unnecessarily reached beyond the facts of the cases before the court" because none of the transferees at issue acquired its claim in the distressed-debt market. According to the court, "[t]hat overreaching resulted in the outcry from commentators and *amici curiae*, who have expressed great concern that the effect of these opinions will wreak havoc in the markets for distressed debt." That result, the court concluded, "has now been avoided."

OUTLOOK

District Judge Scheindlin's ruling in *Enron* is not the end of the story for either the litigants involved or players in the distressed-debt market. In addition to vacating Bankruptcy Judge Gonzalez's rulings, Judge Scheindlin remanded the cases below to determine whether the transfers involved were in the form of an assignment or a sale. The nature of the transaction will determine whether the remaining nonsettling transferee's claims can be subject to equitable subordination and/or disallowance based upon the transferor's alleged misconduct. If Judge Gonzalez finds that the transfer was via sale, the transferee's claims will be protected from subordination or disallowance. Otherwise, it will have to rely upon its indemnity agreement with the transferor because, as a postpetition transferee, it cannot be a holder in due course, and New York law, which governs the transfer agreements, does not recognize the doctrine of latent equities.

The message borne by *Enron* is undoubtedly a welcome one for players in the distressed-claims and securities-trading markets. Consistent with the district court's ruling, transferors should try to structure a transaction as a sale rather than an assignment to limit potential exposure. In cases where assignment is the only option, a carefully drafted indemnity agreement may be the only recourse. Finally, whether *Enron* will withstand additional appellate review remains to be seen at this juncture.

On September 24, 2007, Judge Scheindlin denied a request by Springfield Associates LLC, which had purchased claims against Enron after it filed for chapter 11 protection, for leave to appeal her ruling. In doing so, the judge stated that an early appeal of the ruling could postpone litigation against Enron's lenders scheduled to commence in March of 2008.

In re Enron Corp., 2007 WL 2446498 (S.D.N.Y. Aug. 27, 2007).

In re Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977).

BIDDERS BEWARE: PRIVATE-EQUITY CLUB DEALS COULD BE CHALLENGED IN BANKRUPTCY

Brad B. Erens and Mark G. Douglas

The aggregate value of private-equity acquisitions worldwide in 2006 exceeded $660 billion. If this number seems mind-boggling, consider that this record-breaking volume of transactions appears well on the way to being eclipsed in 2007. Even with corporate financing for leveraged buyouts harder to come by as a consequence of the sub-prime mortgage fallout, there is, by some estimates, $300 billion sitting globally in private-equity funds. Already on tap or completed in 2007: a $32 billion takeover of energy company TXU Corp. by Kohlberg Kravis Roberts (soon to go public) and Texas Pacific Group; Blackstone Real Estate Advisors' acquisition of Equity Office Property Trust, a national network of office buildings, in a transaction valued at up to $38.7 billion (the largest private-equity buyout of all time); the $7.4 billion acquisition announced on May 14, 2007, of an 80.1 percent stake in DaimlerChrysler and its related financial-services business by Cerberus Capital Management; the acquisition announced on June 30, 2007, of Bell Canada by Ontario Teachers' Pension Plan, Providence Equity Partners, and Madison Dearborn Partners LLC for $48.8 billion in the largest leveraged buyout ever; newly public Blackstone Group's $26 billion offer for Hilton Hotels; the $26 billion acquisition of credit card payment processor First Data Corp. by Kohlberg Kravis Roberts; and, most recently, the August 30, 2007, sale by The Home Depot, Inc., of HD Supply, its wholesale distribution business, to a group of private-equity firms consisting of Bain Capital Partners, The Carlyle Group, and Clayton, Dubilier & Rice for $8.5 billion. More deals are on the way.

Private-equity funds have raised record amounts of capital and are taking bigger and bigger companies private. Eight out of the 10 largest private-equity buyouts have occurred since the beginning of 2006. As private-equity funds and transactions have grown larger, however, they have invited increased scrutiny. One area of concern has been directed toward the increasing incidence of private-equity funds joining forces to acquire businesses. Some have argued that these relationships may result in depressed acquisition prices. For example, General Electric, which put its plastics business up for sale in April of 2007 for approximately $10 billion, insisted that private-equity bidders cannot talk to one another about teaming up in connection with any acquisition. The U.S. Department of Justice entered the fray last fall. Deviating from their traditional hands-off approach to the buyout business, regulators sent letters, initially to four of the largest private-equity firms, requesting information on recent deals, apparently in an effort to determine whether any of the record-breaking deals in 2006 involved collusion among competing bidders or were otherwise anti-competitive.

In the next wave of bankruptcies and restructurings, private-equity transactions may increasingly start to focus on distressed companies. Federal bankruptcy law has long been concerned with maximizing the value of a debtor or its assets in any sale. The Bankruptcy Code establishes a framework of rules formulated to facilitate sales of a debtor's assets either as part of a chapter 11 plan or pursuant to a stand-alone sale transaction. Those rules are designed to ensure that the highest and best offer is made for a debtor's assets and that, once approved by the court, any sale is "final," in the sense that a good-faith purchaser can be confident that it acquires unblemished and unencumbered title to the assets. Notwithstanding the strong policy favoring finality of asset sales, however, the Bankruptcy Code at the same time provides a mechanism for invalidating sale transactions that are tainted by collusion.

INVALIDATION OF COLLUSIVE SALES IN BANKRUPTCY

Section 363(b) of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to sell estate assets (including all or substantially all of a debtor's business or property) outside of a chapter 11 plan. The sale can be free and clear of competing claims and interests under the conditions specified in section 363(f). Most bankruptcy courts will approve a nonordinary-course asset sale if the DIP or trustee demonstrates that a business justification supports the transaction, the sale was negotiated at arm's length and in good faith, the proposed purchaser has submitted the highest and best offer for the assets, and the sale is in the best interests of creditors and the estate.

Any order approving a sale under section 363(b) is stayed until 10 days after it is entered (absent a contrary directive by the court), at which point the order becomes "final," unless it is the subject of a timely appeal or motion for rehearing. Moreover, unless the appellant obtains a further stay pending the resolution of its appeal, any reversal or modification of the sale order on appeal has no effect on the validity of the sale to a good-faith purchaser. Finality is critical to the bankruptcy sale process. It gives prospective purchasers a measure of assurance that the sale will be final and the parties can proceed to consummate the transaction without any fear that it will be undone, which generally makes purchasers willing to pay more for the assets in question.

Notwithstanding the importance of finality to the bankruptcy sale process, the Bankruptcy Code creates a mechanism to invalidate sales that are tainted by fraud, collusive bidding, or other misconduct. Section 363(n) provides as follows:

> The trustee may avoid a sale under this section if the sale price was controlled by an agreement among potential bidders at such sale, or may recover from a party to such agreement any amount by which the value of the property sold exceeds the price at which such sale was consummated, and may recover any costs, attorneys' fees, or expenses incurred in avoiding such sale or recovering such amount. In addition to any recovery under the preceding sentence, the court may grant judgment for punitive damages in favor of the estate and against any such party that entered into such an agreement in willful disregard of this subsection.

Section 363(n) is a statutory exception to the rule of finality of bankruptcy sale orders. As courts of equity, bankruptcy courts have traditionally possessed the authority to set aside sales "tinged with fraud, error, or similar defects which would in equity affect the validity of any private transactions" and when "compelling equities outweigh the interests in finality."

A sale can be invalidated under section 363(n) only if: (i) there is an agreement; (ii) between potential bidders; (iii) that controlled the price at bidding. The agreement can be either written or oral. The parties must have intended the agreement to control the price, not merely affect it. The existence of a joint bid does not in and of itself amount to collusive bidding. Section 363(n) applies to both public auctions and private sales.

While the case law under section 363(n) remains relatively sparse, it appears that courts are most concerned with situations where one potential bidder agrees not to bid on an asset, or drops out of the bidding, so that another bidder can prevail at the auction at a lower price than if there had been competitive bidding, with the two bidders later adjusting the "spoils" of this process between them. As a result, section 363(n) has generally been applied only in the most obvious and blatant collusive-bidding circumstances. Still to be seen is the extent to which bankruptcy courts may attempt to infer agreements to control the price at an auction from circumstantial evidence, rather than as a result of a clear agreement to do so.

While the case law under section 363(n) remains relatively sparse, it appears that courts are most concerned with situations where one potential bidder agrees not to bid on an asset, or drops out of the bidding, so that another bidder can prevail at the auction at a lower price than if there had been competitive bidding, with the two bidders later adjusting the "spoils" of this process between them.

Nothing in section 363(n) expressly exempts bidders from liability under applicable antitrust laws for collusive bidding as a restraint of trade under section 1 of the Sherman Act. Nonbankruptcy courts have consistently held that agreements to submit noncompetitive "rigged bids" are a form of price fixing that constitute per se violations of that statute. Such violations may subject the defendant to treble damages and, potentially, even criminal liability, although criminal prosecution is unlikely if a joint enterprise is "open and notorious." In addition, a private right of action is available to the aggrieved party (presumably, the seller) to impose civil liability under the statute.

The antitrust field has developed a body of case law as to when a plaintiff may use circumstantial evidence to show the existence of an agreement to restrain trade under section 1 of the Sherman Act. Under that law, the plaintiff relying on such evidence "must show the inference of conspiracy is reasonable in light of the competing inference of independent action." Moreover, as noted by an Indiana district court in *Boyer v. Gildea*, "[b]ecause there is often a fine line separating unlawful concerted action from legitimate business practices, conduct that is as consistent with permissible competition as with illegal conspiracy does not, standing alone, support an inference of antitrust conspiracy."

Addressing the application of federal antitrust law in the bankruptcy context, the court in *Boyer* ruled that circumstantial evidence of a collusive agreement would be insufficient to show such an agreement if "it is as compatible with permissible conduct as it is with impermissible conduct, and the Plaintiff cannot point to any evidence tending to exclude the possibility that the Defendant's conduct was permissible." Based on that standard, the court found that the circumstantial evidence in that case, comprised mostly of various discussions and negotiations among the bidders and an actual agreement between the bidders after the sale, was insufficient to show a collusive agreement, especially since it appeared that one of the bidders ultimately could not offer a competitive bid on its own, instead needing to find a partner to place such a bid and obtain financing. Bankruptcy courts might analogize to *Boyer* and similar cases to determine whether facts short of an actual, proven agreement that one bidder refrain from bidding can support a section 363(n) claim.

Published opinions finding the existence of collusive bidding remain rare. Even so, if the court determines that a sale is tainted by bid rigging, two primary possible remedies are available: (i) avoidance of the sale transaction; or (ii) recovery from the buyer of damages equal to the amount by which the actual value of the asset exceeds the price at which the sale was consummated. In addition, any costs, attorneys' fees, or expenses incurred in avoiding a collusive sale or recovering the shortfall may be recovered by the trustee or DIP. Punitive damages may also be assessed against colluding bidders who act in willful disregard of section 363(n).

Both of the primary remedies are problematic for any buyer of assets in bankruptcy. Avoiding the sale transaction means that the sale will be unwound. Besides creating a variety of logistical issues, this means that any increase in value to the target subsequent to the sale, including as a result of investments or operational changes effectuated by the purchaser, may revert to the debtor. As a result of logistical issues, it

FROM THE WIRE

VOLUME OF BUSINESS BANKRUPTCIES ON THE UPTICK

Statistics recently released by the Administrative Office of the U.S. Courts confirmed previous predictions that business bankruptcies in the United States would rise by more than 50 percent in 2007. 6,705 businesses declared bankruptcy in the second quarter of 2007, evidencing upward trends amounting to:

- A 7 percent increase over the first quarter of 2007;
- A 38 percent year-over-year increase from the second quarter of 2006; and
- A 45 percent increase for the first half of 2007 by comparison with the first half of 2006.

Driving the increase, according to some commentators, are a slowing economy and an increase in the cost of doing business, as well as serious economic issues, including the impact of increased energy, raw-material, and labor costs; the effects of a tightening of monetary policy by the Federal Reserve during the preceding two years; and the "decimated" housing market and its ramifications for consumers and businesses.

may be more likely that a court would instead order damages to be assessed against the purchaser equal to the difference between the "actual" value of the target and the price paid. However, a bankruptcy court has considerable discretion in determining the "actual" value of assets that are sold in a collusive-sale transaction. As a result, the court may determine that the actual value is well in excess of what the purchasers believe the true value to be at the time of the auction, especially since the court will be making that determination in the context of a sale that it already has ruled was tainted. In addition, the availability of punitive damages as a remedy for "willful" bid rigging subjects an acquiror to additional and not readily ascertainable exposure in connection with a collusive-sale transaction.

Finally, one issue that has arisen in the courts is the length of time that a party can bring suit to avoid a sale transaction under section 363(n). The longer the period of time after a sale transaction a suit is brought, the more prejudicial it likely will be to the buyer. Neither section 363(n) nor any other provision in the statute specifies a limitation period for challenges to a sale on the basis of collusion. Most courts, however, have ruled that a motion to invalidate a sale under section 363(n) must be filed within the one-year period governing requests under Fed. R. Civ. P. 60(b)(3) for relief from a judgment or order on the basis of fraud, misrepresentation, or other misconduct, which applies to bankruptcy cases pursuant to Fed. R. Bankr. P. 9024.

Boyer v. Gildea, 2006 WL 2868924 (N.D. Ind. Oct. 5, 2006).

A version of this article originally appeared in the September 2007 edition of *The Bankruptcy Strategist*. It has been reprinted here with permission.

EUROPEAN FOCUS—UNDERSTANDING "CENTRE OF MAIN INTERESTS": WHERE ARE WE?

Paul Bromfield

2002 was a seminal year for restructuring and insolvency professionals in the U.K. In November of that year, the eagerly anticipated Enterprise Act of 2002, which was intended to lay the statutory foundations for the "rescue culture," received royal assent. Six months earlier, with considerably less fanfare, the EC Regulation on Insolvency Proceedings (EC No. 1346/2000) (the "Regulation") was introduced throughout the EU (except Denmark). A clear understanding of how these twin pieces of law operate is crucial when reviewing a stakeholder's options once a company becomes distressed.

Nearly five years on and it is clear that the Enterprise Act of 2002, apart from generating a relatively modest amount of case law around the edges, largely on procedural matters, is a reasonably well-understood piece of legislation. The Regulation is anything but well understood.

BACKGROUND

At the heart of the Regulation is the concept of a company's "centre of main interests," or COMI. All companies are envisaged to have one, and as will be seen below, the geographical location of a company's COMI will govern whether the courts of a particular member nation can open insolvency proceedings against that company, irrespective of where its registered office is located. It can no longer be assumed, for example, that an English-registered company can be placed into English insolvency proceedings in every case. This is a novel situation for English judges, who now have to ask themselves, "Do I have international jurisdiction (under the Regulation) as well as domestic jurisdiction (under the Insolvency Act of 1986) to place a particular company into, for example, administration?"

Almost unbelievably, the cornerstone concept of COMI is not defined in the Regulation. One is forced to look to the recitals for any sort of guidance. Recital 13 of the Regulation provides that:

> [T]he centre of main interests should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.

Further assistance is found in Article 3(1) of the Regulation, which provides that the place of a company's registered office shall, in the absence of proof to the contrary, be presumed to be the place where its COMI is located.

The history of the Regulation since its inception is one of advisors and courts in various member nations grappling with: (i) what the words of Recital 13 mean; and (ii) how strong the Article 3(1) rebuttable presumption is. The paucity of the definition has been brought into sharper focus in recent years, with increasing amounts of capital finding a home in increasingly complex capital structures of companies that do business on a cross-border basis. With the proliferation of cross-border commercial activity, it is inevitable that a proportion of these businesses will become distressed, and as they do, the opportunity to use the Regulation and the potentially powerful concept of COMI increases.

Where a company produces its finished goods in one jurisdiction, has employees in another jurisdiction, is initially financed by its local bank (which might then sell its position to a number of international hedge funds), and has customers throughout the EU and possibly beyond, working out where its COMI is located can be a daunting task. Some have argued that, even though a stated aim of the Regulation is to prevent forum shopping, this is exactly what it has encouraged — by removing certainty as to where insolvency proceedings can be opened against a particular company. This has led to instances where there has been a conscious shift of COMI as a means of implementing a financial restructuring. Such an approach has been *de rigueur* in Germany of late. Deutsche Nickel and, more recently, Schefenacker successfully shifted COMI to England as a prelude to entering into English-company voluntary arrangements with their creditors.

WHY IS COMI SO IMPORTANT?

The Regulation classifies insolvency proceedings in one of two ways. If an insolvency proceeding is opened in the country where a company has its COMI, those insolvency proceedings will be classified as "main" proceedings. If an insolvency proceeding is opened elsewhere (for which purpose an "establishment" in that country is required), the insolvency proceedings will be classified as "territorial" or "secondary" proceedings. Secondary proceedings can coexist with main proceedings, and indeed, a key aspect of the Regulation is the way in which it governs how main proceedings and secondary proceedings operate in conjunction with one another.

For advisors looking for certainty among a body of case law that will be developed over time from the U.K. to the U.S. via Mexico, Eritrea, and the British Virgin Islands, the road ahead will be challenging.

Main proceedings in one member state will be recognized automatically in other member nations such that the law governing the main proceedings, subject to a number of exceptions, will govern the insolvency proceedings in relation to the company across all jurisdictions of the EU. The main-proceedings office holder (a legal entity akin to a bankruptcy trustee in the U.S.) has the authority to collect in and deal with all assets of the company in the EU as if the law governing the process under which the office holder was appointed extended to the other member states. However, the jurisdiction of the main-proceedings office holder is ousted in a particular member nation if secondary proceedings are opened in that member nation. Office holders appointed in relation to territorial or secondary proceedings (*i.e.*, in a jurisdiction where COMI does not exist) only have authority to deal with assets in that particular jurisdiction and will only be recognized in that jurisdiction. An appointment as a main-proceedings office holder is the holy grail for insolvency practitioners, and COMI is central in achieving this.

WHAT DETERMINES COMI?

This is the key question to which, unfortunately, there is still not a clear answer. As courts throughout the various member nations attempt to come to terms with the concept of COMI, only one major case (*Re Eurofood IFSC Ltd*) has been referred to the European Court of Justice ("ECJ") with respect to this issue. Arising out of the Parmalat collapse, Eurofood IFSC Ltd, an Irish subsidiary in the Parmalat group, was first placed into provisional liquidation in Ireland and, shortly afterwards, was placed into extraordinary administration in Italy. The extraordinary administration was categorized by the Italian court as main proceedings. Following that, the Irish court opened full winding-up proceedings over Eurofood and concluded that Eurofood's COMI was in Ireland. That action was appealed to the Irish Supreme Court, which referred matters to the ECJ.

Although advisors waited with a degree of bated breath for the ECJ's decision, they were ultimately to be disappointed. Despite some encouragement from the Advocate General (a functionary who renders advisory opinions to the court) in his official opinion to the ECJ, the ECJ itself did not elaborate on what was meant in Recital 13 by the words "administration of interests" or "ascertainable by third parties," and hence there is still a lack of higher-court guidance on the fundamentals of COMI beyond that which is being developed by individual member nations' courts. In the main, these have been decisions of lower courts, often in response to uncontested *ex parte* applications.

Nevertheless, in the English courts at least, a line of authority is starting to emerge which suggests that the "administration of a company's interests" is something akin to the performance of head-office-type functions. As for the identity of the elusive "third parties," it seems the perception of a company's creditors will be a significant factor. Examples of what constitute head-office functions that have emerged from English cases such as *Re Enron Directo SA*, *Re Daisytek-ISA Ltd/ISA Daisytek SAS*, *Crisscross Communications*, *MG Rover,* and *Collins & Aikman*, among others, are:

- Internal accounting;
- Treasury management;
- Human resources;
- Purchasing control;
- Contract pricing control;
- IT systems;
- Strategic control;
- General supervision; and
- Corporate identity and branding.

In addition, the domicile of directors and the place where board meetings take place have also been held to be of significance.

While not in any way determinative as to what constitutes COMI, the criteria above at least provide a flavor of how the English courts have been approaching this issue.

WHEN IS COMI DETERMINED?

It may be apparent from what has been said so far that it is quite possible for COMI to shift jurisdictions. There is nothing to stop a company that is "administering its interests" in one country from relocating that administration to another country. So at what point in time is COMI assessed? In the English case of *Shierson v Vlieland-Boddy*, the court in the first instance took the view that COMI should be measured as of the date the judgment opening the insolvency proceedings is delivered, and not at any earlier point in time (such as the date the application for the insolvency proceedings is in fact lodged with the court). In the Court of Appeal (a rare Court of Appeal decision on COMI, albeit a discrete aspect of it), it was held that COMI should be measured at the time when the court is first required to decide whether to open insolvency proceedings — normally the hearing date of the relevant application.

In the later case of *Re Staubitz-Schreiber*, the ECJ reached a different conclusion when it held that COMI should be tested at the time when the request to open insolvency proceedings was made — in other words, at the time the application for the insolvency is lodged with the court. Any attempt to shift COMI after that date would be ineffective for the purposes of determining where a debtor's COMI was located.

WHO DETERMINES COMI?

If a particular member-nation court is asked to hold that a company's COMI is in the jurisdiction of that member state and the court accedes to such a request—that is, the court that first asserts jurisdiction over the matter—it is to that court that any appeal against a finding on COMI must be brought. What the Regulation does not permit is a situation where main proceedings can be opened in multiple jurisdictions, with individual courts throughout the EU taking it upon themselves to make a finding of COMI with complete lack of regard to another member-nation court's earlier finding of COMI. This would result in legal chaos. Clearly, to operate effectively, there must be mutual trust and understanding between the various courts of the member nations. Despite some early problems in France, Italy, and Germany, this seems to be settling down now. Indeed, the case of *Hans Brochier Ltd v Exner* demonstrates that the English court is more than ready to reverse its own earlier finding of COMI.

On the face of it, this is all very sensible, but the irony is that it often creates what is referred to as "the race" to the court. Creditors of a company in one jurisdiction may seek to open insolvency proceedings earlier than they may otherwise have done if they take the view that other creditors, or the debtor itself, will seek to open insolvency proceedings elsewhere. This is not exactly conducive to the modern-day rescue culture.

UNRESOLVED ISSUES

While there is reasonable certainty in relation to when COMI is to be tested and who determines COMI, there remains considerable uncertainty in relation to:

- The development of consistent COMI criteria;
- The practical effect of a successful appeal against COMI where main proceedings have been in operation for some time; and
- The strength of the registered-office presumption.

UNCITRAL MODEL LAW ON CROSS-BORDER INSOLVENCY

It should also be noted that COMI has an even broader reach now as a result of the adoption by certain countries (including the U.K. and the U.S.) of the UNCITRAL Model Law on Cross-Border Insolvency (in the U.S., via enactment of chapter 15 of the Bankruptcy Code). The Model Law (which is potentially available to all countries around the world), like the Regulation, relies on the concept of COMI as a means of establishing jurisdiction over main and nonmain proceedings. It too contains no definition of COMI, but envisages that courts in adopting states will look to the Regulation cases and the decisions of courts of other countries which have adopted the Model Law as a means of clarifying the COMI concept.

For advisors looking for certainty among a body of case law that will be developed over time from the U.K. to the U.S. via Mexico, Eritrea, and the British Virgin Islands, the road ahead will be challenging.

Re Eurofood IFSC Ltd (Case C-341/04).

Re Enron Directo SA (unrep., 4 July 2002).

Re Daisytek-ISA Ltd/ISA Daisytek SAS [2003] BCC 562.

Crisscross Communications (unrep., 20 May 2003).

MG Rover (unrep., 14 August 2006).

Collins & Aikman (unrep., 15 July 2005).

Shierson v Vlieland-Boddy [2005] EWCA Civ. 974.

Re Staubitz-Schreiber (Case C-1/04) [2006] BCC 639.

Hans Brochier Ltd v Exner [2006] EHWC 2594 (Ch).

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DELAWARE SUPREME COURT LIMITS SCOPE OF "ZONE OF INSOLVENCY" FIDUCIARY DUTIES

Eric N. McKay

In a significant Delaware law decision regarding creditors' ability to sue corporate fiduciaries, the Delaware Supreme Court recently addressed the issue of whether a corporate director owes fiduciary duties to the creditors of a company that is insolvent or in the "zone of insolvency." In *North American Catholic Educ. Programming Found., Inc. v. Gheewalla*, the court concluded that directors of a solvent Delaware corporation that is operating in the zone of insolvency owe their fiduciary duties to the corporation and its shareholders, and not creditors. The court also ruled that the fiduciary duties of directors of an insolvent corporation continue to be owed to the corporation. In the case of an insolvent corporation, however, creditors, as the true economic stakeholders in the enterprise, have standing to pursue derivative claims for directors' breaches of fiduciary duty to the corporation.

BACKGROUND

North American Catholic Educational Programming Foundation, Inc. (the "Foundation"), held certain radio-wave spectrum licenses. The Foundation then joined with other license holders, and in March 2001, all of them entered into a master agreement with Clearwire Holdings, Inc. ("Clearwire"), a Delaware corporation. Goldman Sachs & Co. ("Goldman Sachs") provided funding to Clearwire and appointed three directors to Clearwire's board of directors. Each of these three directors worked for Goldman Sachs.

Under the master agreement, Clearwire agreed to acquire the spectrum licenses of the Foundation and the other license holders for $24.3 million. In June 2002, however, the market for wireless spectrum collapsed, making available a surplus of spectrum. Clearwire entered into negotiations with the Foundation and the other license holders to rid itself of its obligations under the master agreement. Eventually, Clearwire reached an agreement with all of the license holders except for the Foundation. By October 2003, Clearwire had been unable to obtain any further financing and effectively went out of business.

The Foundation sued the Goldman Sachs directors, alleging, among other things, that the directors had breached their fiduciary duties to the Foundation. According to the Foundation, because Clearwire was either insolvent or in the zone of insolvency, the Goldman Sachs directors owed fiduciary duties to the Foundation, as a substantial creditor of Clearwire. Notably, the Foundation's complaint asserted a "direct" cause of action — *i.e.*, one alleging particularized harm to the Foundation individually — for breach of fiduciary duty. In fact, the Foundation waived any claims it could have pursued derivatively.

Gheewalla provides important guidance to directors, creditors, and their professionals. It establishes that, irrespective of whether a Delaware corporation is within the zone of insolvency or insolvent, individual creditors cannot assert direct claims for breach of fiduciary duty against directors.

The Goldman Sachs directors moved to dismiss the complaint on the ground that, among other things, as a matter of law, creditors of a Delaware corporation that is insolvent or within the zone of insolvency are unable to assert direct claims against directors for breach of fiduciary duty. The Delaware Chancery Court agreed with the directors and dismissed the complaint, although it dismissed one of the claims for failure to satisfy pleading requirements.

THE DELAWARE SUPREME COURT'S RULING

On appeal, the Delaware Supreme Court affirmed the decision of the Delaware Chancery Court. The court first turned its attention to whether Delaware law recognizes a creditor's right to bring direct fiduciary-duty claims against the directors of a corporation operating in the zone of insolvency. In holding that Delaware law does not recognize such a right, the court explained:

> When a solvent corporation enters the zone of insolvency the focus for Delaware directors does not change: Directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

The court also noted that creditors, unlike shareholders, already have a host of protections available to them, including contractual agreements, security instruments, the implied covenant of good faith and fair dealing, and fraudulent conveyance laws, that "render the imposition of an additional, unique layer of protection through direct claims for breach of fiduciary duty unnecessary." The court also agreed with the Chancery Court's reasoning that:

> [A]n otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership — as well as the ability to negotiate in good faith with its creditors — goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors.

The court also closed the door on a creditor's right to bring a direct breach-of-fiduciary-duty claim against directors of an insolvent corporation. The court reasoned that such a right would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interests of an insolvent corporation. According to the court, a direct right of action would create a conflict between the duty of the directors to "maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors." The court explained that it is important to allow a director to "engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation." The court did not, however, leave creditors without recourse for a breach of fiduciary duty by a director. It made clear that creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for a breach of fiduciary duty.

ANALYSIS

Gheewalla provides important guidance to directors, creditors, and their professionals. It establishes that, irrespective of whether a Delaware corporation is within the zone of insolvency or insolvent, individual creditors cannot assert direct claims for breach of fiduciary duty against directors. In the case of an insolvent corporation, however, creditors can assert derivative claims on behalf of the corporation against directors. It should be noted that the ruling is limited to breach of fiduciary-duty claims: it does not restrict other kinds of claims or rights that may be asserted by creditors directly against a corporation under a contract, agreement, or applicable law. Also, the ruling may engender increased litigation over when a corporation becomes "insolvent" and which parties should have the right to prosecute derivative claims.

North American Catholic Educ. Programming Found., Inc. v. Gheewalla, 2007 WL 1453705 (Del. May 18, 2007).

POST-*TRAVELERS* DECISIONS CONTINUE THE DEBATE REGARDING THE ALLOWABILITY OF UNSECURED CREDITORS' CLAIMS FOR POSTPETITION ATTORNEYS' FEES

Ross S. Barr

Recently, in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, the U.S. Supreme Court resolved a conflict among the circuit courts of appeal by overruling the Ninth Circuit's *Fobian* rule, which dictated that attorneys' fees are not recoverable in bankruptcy for litigating issues "peculiar to federal bankruptcy law." In reaching its decision, the Supreme Court reasoned that the *Fobian* rule's limitations on attorneys' fees find no support in either section 502 of the Bankruptcy Code or elsewhere. Perhaps more importantly, however, because the debtor did not raise such arguments below, the Supreme Court declined to express an opinion regarding whether other principles of bankruptcy law might provide an independent basis for disallowing the claims of an unsecured creditor for postpetition attorneys' fees. As a result, *Travelers* will force an ongoing debate regarding the allowability of such claims. Interestingly, following *Travelers*, two bankruptcy courts have already issued contrary opinions on this issue, thus signaling that there is no end in sight to the debate over this important issue.

PRE-*TRAVELERS* DECISIONS

Prior to *Travelers*, the majority of courts that had considered the issue held that an unsecured or undersecured creditor is not entitled to recover postpetition attorneys' fees and other costs as part of its claim. Such courts relied on all or some of the following four primary reasons for denying such claims:

(1) Construing the plain language of section 506(b) of the Bankruptcy Code under the legal maxim of *expressio unius est exclusio alterius* (*i.e.*, the express mention of one thing excludes all others) dictates such a result. Section 506(b) of the Bankruptcy Code provides, in pertinent part, that "[t]o the extent that an allowed secured claim is [oversecured], there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement *or State statute* under which such claim

arose" (italicized text added in 2005). Thus, such courts held that because Congress mandated that creditors are entitled to postpetition fees and costs, including attorneys' fees, only to the extent that their claims are oversecured, it implicitly denied such fees and costs to creditors whose claims are not oversecured.

(2) The Supreme Court's opinion and reasoning in *United Savings Assoc. of Texas v. Timbers of Inwood Forest Assocs., Ltd*., mandate the conclusion that unsecured creditors are not entitled to such fees and costs. In *Timbers*, the Supreme Court held that postpetition fees and costs could be paid only out of a creditor's equity cushion, such that an undersecured creditor was not entitled to payment of such fees and costs.

(3) The plain language of section 502(b) of the Bankruptcy Code supports this conclusion: "[I]f an objection to claim is filed, the court shall determine the amount of such claim . . . as of the date of the filing of the petition." Thus, if an unsecured creditor's claim is determined as of the petition date, it cannot, by definition, include postpetition fees and costs.

(4) Allowing certain types of creditors (such as contract claimants that had prepetition agreements with the debtor that contained attorneys' fees provisions) to recover their fees, while other unsecured creditors (such as tort claimants and trade creditors) cannot recover such fees as part of their unsecured claims, would be inequitable, and contrary to the important bankruptcy principle of equality of distribution.

Still, prior to *Travelers,* other courts (albeit a minority thereof) had held that unsecured creditors could include postpetition attorneys' fees in their claims where appropriate. In doing so, those courts relied on all or some of the following reasons for their holdings:

(1) The Bankruptcy Code broadly defines the word "claim" in section 101(5) to include contingent claims. As of the petition date, attorneys' fees allowed pursuant to a prepetition agreement are contingent claims that fit within such definition.

(2) Section 502(c) of the Bankruptcy Code authorizes courts to estimate and allow contingent claims as of the petition date.

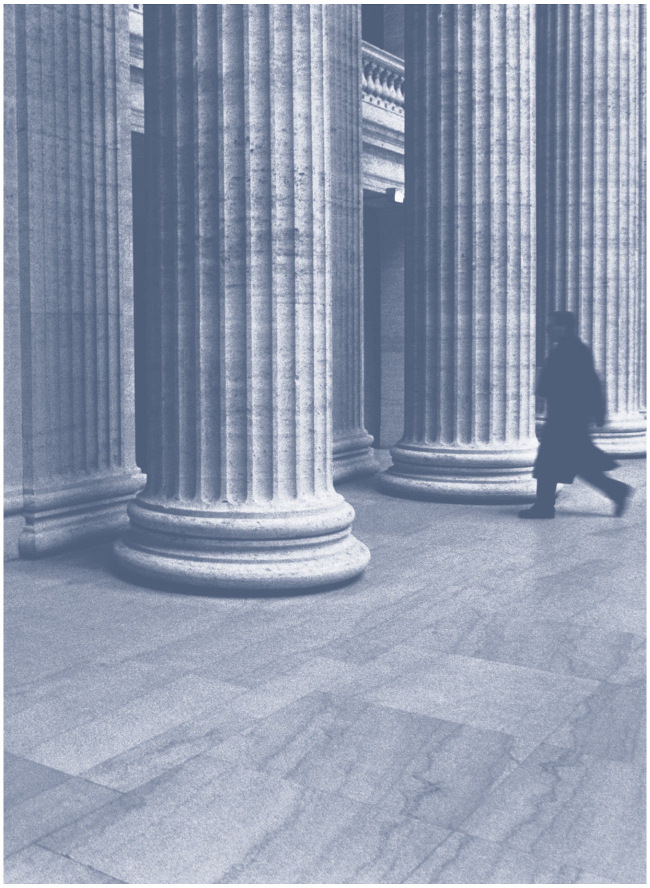
(3) Attorneys' fees are not one of the exceptions to the allowability of claims enumerated in section 502(b). Thus, they must be allowable pursuant to section 502.

(4) Section 506(b) is not relevant to an unsecured creditor's claim because that section concerns only claims of secured creditors.

Accordingly, such courts held that where the creditor had a prepetition agreement with the debtor that provided for attorneys' fees, its fee claim was contingent as of the petition date and thus allowable.

POST-*TRAVELERS* DECISIONS

Only two days following the issuance of *Travelers*, an Idaho bankruptcy court denied a creditor's claim for attorneys' fees in *In re Astle*. However, *Astle* concerned the claim of an oversecured creditor, not an undersecured or unsecured creditor. Nevertheless, *Astle* merits discussion because it construed



If courts construe the Bankruptcy Code to allow unsecured creditors to file claims for postpetition attorneys' fees, costs, and other similar charges, there could be a significant shift in the composition of recoveries to unsecured creditors.

language added to section 506(b) of the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Section 506(b) now provides, in pertinent part, that an oversecured creditor may claim "any reasonable fees, costs, or charges provided under the agreement or State statute under which such claim arose." Prior to 2005, the provision omitted any reference to "State statute."

In *Astle*, a power company, which was granted a lien during the case — and, as a result, became an oversecured creditor — as "adequate assurance" of the debtor's payment of its electric bills pursuant to section 366 of the Bankruptcy Code, claimed that it was entitled to postpetition attorneys' fees incurred in pursuing its claim. Having no prepetition contract with the debtor, the creditor claimed entitlement to attorneys' fees under a general Idaho statute providing for the recovery of attorneys' fees by the prevailing party in any civil action on a commercial transaction. The issue before the court was whether the language "under which such claim arose" applied not only to an "agreement" (which is already established), but also to a "State statute," such that attorneys' fees will be awarded to oversecured creditors only where such entitlement arose from the same statute under which such creditors' underlying secured claim arose. The court held that Congress's placement of "or State statute" between "agreement" and "under which such claim arose," and not after the latter phrase, clearly evidenced its intent to provide for an award of fees, costs, or charges arising in either an agreement or a statute. Thus, because the creditor's claim arose under federal bankruptcy law (not the general Idaho statute regarding attorneys' fees), the court denied its claim for postpetition attorneys' fees.

Less than two months later, a California bankruptcy court issued a decision regarding a claim for postpetition attorneys' fees. This time, however, the claim was that of an unsecured creditor. In *In re Qmect, Inc.*, the court held that an unsecured creditor's allowed claim included postpetition attorneys' fees payable in accordance with the provisions of its prepetition contract with the debtor. The court followed the pre-*Travelers* minority position, stating that: (i) the Bankruptcy Code broadly defines a "claim" to include contingent claims; (ii) as of the petition date, postpetition attorneys' fees are contingent claims; and (iii) nothing in section 502(b) dictates that such claims should be disallowed. In addressing the section 506(b) argument left open by the Supreme Court in *Travelers*, the court reasoned that because the title of section 506(b) is "Determination of Secured Status," that provision would not be the logical place to provide for the disallowance of an element of an unsecured claim. Rather, it reasoned that "[i]f Congress . . . had wanted to disallow claims for post-petition attorneys' fees, the logical place for it to have done so was surely in 11 U.S.C. § 502(b)."

The *Qmect* court also relied on an equitable reason as support for its holding. In particular, the court stated that "[i]t would seem highly inequitable to permit the estate to recover fees incurred in [*sic*] post-petition with a creditor while at the same time denying the creditor the right even to include its post-petition fees in its unsecured claim." It emphasized that the strongest rationale for prohibiting the inclusion of postpetition attorneys' fees in a prepetition unsecured claim is that, unless a debtor is solvent, such inclusion will diminish other unsecured creditors' distribution. However, the court noted that this rationale is equally applicable to secured claimants, who clearly can claim postpetition attorneys' fees to the extent that they are oversecured. Finally, the court stressed that its holding would further an important policy of bankruptcy law: the preservation of nonbankruptcy legal rights.

Shortly thereafter, a Florida bankruptcy court issued a decision in line with the pre-*Travelers* majority position, and contrary to *Qmect,* in *In re Electric Machinery Enterprises*. The court first outlined the four primary reasons why courts have concluded that an unsecured creditor is not entitled to attorneys' fees (discussed above) and stated that those reasons mandated the same conclusion in the case before it. Importantly, the court added that it was mindful of the implications that a contrary decision would have on the administration of a bankruptcy estate: "There would be no finality to the claims process as bankruptcy courts would constantly have to revisit the issue of the amount of claims to include ever-accruing attorneys' fees." The administrative inconvenience this would cause in a chapter 11 case would, in the court's estimation, be intolerable. Finally, the court declined to follow the minority view because, among other things, those cases involved solvent estates. With a solvent estate, the court explained, the payment of postpetition attorneys' fees to certain unsecured creditors would not diminish other unsecured creditors' recoveries but would be paid out of the surplus that would otherwise be distributed to the debtor. By contrast, the court concluded, the case before it involved a clearly insolvent estate, where creditors would not be paid in full.

CONCLUSION

Post-*Travelers* rulings confirm that the pre-*Travelers* debate regarding the allowability of unsecured creditors' claims for postpetition attorneys' fees, costs, and other similar charges will almost certainly endure until either there is a consensus regarding the issue at the appellate level or the Supreme Court determines to intervene to resolve any split among the circuit courts of appeal.

This seemingly peripheral issue can have important implications. If courts construe the Bankruptcy Code to allow unsecured creditors to file claims for postpetition attorneys' fees, costs, and other similar charges, there could be a significant shift in the composition of recoveries to unsecured creditors. The winners as a result would be contract creditors who are sophisticated enough to bargain for a provision granting them attorneys' fees, costs, and other charges, and creditors who are fortunate enough to benefit from state statutes that provide for an award of fees and costs in addition to other recoveries. Other unsecured creditors and bankruptcy courts forced to shoulder the administrative burden of processing "moving target" claims would be the losers.

Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co., 127 S. Ct. 1199 (2007).

In re Fobian, 951 F.2d 1149 (9th Cir. 1991).

United Savings Assoc. of Texas v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365 (1988).

In re Astle, 364 B.R. 743 (Bankr. D. Idaho 2007).

In re Qmect, Inc., 368 B.R. 882 (Bankr. N.D. Cal. 2007).

In re Electric Machinery Enterprises, 371 B.R. 549 (Bankr. M.D. Fla. 2007).

BUSINESS RESTRUCTURING REVIEW

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

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