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# FROM THE TOP: SUPREME COURT "BRIGHT-LINE" RULING ON SCOPE OF CHAPTER 11 TRANSFER TAX EXEMPTION BAD NEWS FOR PRE-CONFIRMATION ASSET SALES IN BANKRUPTCY

*Jeffrey B. Ellman and Mark G. Douglas*

The ability to sell assets during the course of a chapter 11 case without incurring the 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.*, mortgage recordation) qualify for the tax exemption have been a focal point of vigorous dispute in bankruptcy and appellate courts for more than a quarter century, resulting in a split on the issue among the federal circuit courts of appeal and, finally, the U.S. Supreme Court's decision late in 2007 to consider the question.

The Supreme Court resolved that conflict decisively when it handed down its long-awaited ruling on June 16, 2008. The missive, however, is decidedly unwelcome news for any chapter 11 debtor whose reorganization strategy includes a significant volume of pre-confirmation asset divestitures under section 363(b) of the Bankruptcy Code. The 7-2 majority of the Court ruled that section 1146(a) of the Bankruptcy Code establishes "a simple, bright-line rule" limiting the scope of the transfer tax exemption to "transfers made pursuant to a Chapter 11 plan that has been confirmed."

## 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.

Section 1146(a) of the Bankruptcy Code (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, to be exempt from taxes, asset transfers must be made as part of a confirmed chapter 11 plan, or whether the exemption may apply to sale transactions occurring at some other time during a bankruptcy case (particularly if the sale is important to the eventual confirmation of a plan).

Chapter 11 of the Bankruptcy Code contemplates the sale of a debtor's assets under two circumstances. First, a plan of reorganization (or liquidation) may provide for the sale of individual assets or even the debtor's entire business. Approval of a sale pursuant to a plan is subject to all of the requirements governing plan confirmation. This means, for example, that creditors whose claims are "impaired" (adversely affected, such as by receiving less than full payment) have the opportunity 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. Selling assets under a plan thus requires higher procedural hurdles and would occur only at the end of the case, when all of the terms of a chapter 11 plan have been developed.

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." A bankruptcy court will generally approve a proposed asset sale under section 363(b) if the business justification supporting the sale is sound. 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. Moreover, because assets can be sold free and clear of liens, claims, or other encumbrances under the circumstances delineated in section 363(f), value can be generated quickly (taking advantage of market opportunities) and without the need to resolve most disputes involving the property until sometime later in the case.

Still, courts are sometimes reluctant to use section 363 as a vehicle for selling all, or a substantial portion, of a debtor's assets outside the plan process. The reluctance arises because a significant-asset sale involving substantially all of the assets of the estate is a critical (probably *the* critical) aspect of the debtor's overall reorganization (or liquidation) strategy. While creditors have the right to object to a section 363(b) sale, they do not enjoy the more substantial protections of the chapter 11 plan-confirmation process, even though the transaction may be tantamount to, or dictate certain terms of, a chapter 11 plan.

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. Before the U.S. Supreme Court examined the issue, four federal circuit courts of appeal had an opportunity to weigh in on whether section 363(b) sales outside the context of a plan qualify for the section 1146 exemption. The remaining decision at the circuit level concerning section 1146 addressed whether transactions involving nondebtors may be exempt.

## 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.

Given the prevalence of pre-confirmation section 363(b) asset sales in chapter 11 cases as a means of generating value for the estate and creditors, *Piccadilly* is decidedly unwelcome news. It may, in fact, portend a major shift in chapter 11 reorganization strategies.

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 four years. In the first of those decisions, *In re T.H. Orlando Ltd.*, the court of appeals adopted an 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."

### *PICCADILLY CAFETERIAS*

The Eleventh Circuit had a second opportunity to examine the scope of section 1146 in 2007. 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. ("Piccadilly"), a 60-year-old company that was once one of the nation's most successful cafeteria chains, 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").

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 ("FDOR"), one of the relevant taxing authorities, 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 FDOR's objection. FDOR 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 FDOR 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, it noted in its decision 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."

FDOR 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."

The Supreme Court granted FDOR's petition for certiorari on December 7, 2007. The Court, in its only bankruptcy decision thus far in 2008, handed down its ruling on June 16, 2008.

## THE SUPREME COURT'S RULING

Writing for the 7-2 majority, Justice Clarence Thomas observed, "While both sides present credible interpretations of § 1146(a), [FDOR] has the better one." He acknowledged that Congress could have used more precise language in the statute to remove any ambiguity concerning its scope. Even so, Justice Thomas characterized the interpretation espoused by Piccadilly (and adopted by the Eleventh Circuit) as less plausible because it "places greater strain on the statutory text than the simpler construction advanced by [FDOR] and adopted by the Third and Fourth Circuits."

Even assuming that the language of section 1146(a) is sufficiently ambiguous to warrant further inquiry, Justice Thomas wrote, the ambiguity must be resolved in FDOR's favor. He rejected Piccadilly's argument that if Congress had intended to limit section 1146(a) to post-confirmation transfers, it would have made its intent plain by including an express temporal limitation in the language of the provision, as it has done elsewhere in the statute. He similarly found unavailing Piccadilly's contention that, based upon other provisions in the Bankruptcy Code, the term "under" preceding "a plan confirmed" in section 1146(a) should be read broadly to mean "in accordance with" rather than "authorized by." It was unnecessary for Congress

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# NEWSWORTHY

An article written by ***Corinne Ball (New York)*** entitled "Credit Crisis Enables Bold Strikes by Investors" appeared in the June 26 edition of the *New York Law Journal*. Her article entitled "Unaddressed Issues Scuttle Delphi Bankruptcy Plan" was published in the April 24 edition of the *New York Law Journal*.

***Charles M. Oellermann (Columbus)*** participated in a bankruptcy continuing legal education seminar sponsored by the Columbus Bar Association on May 2. The topic of his presentation was "First Day Orders and Procedures."

On June 18, the New York Office hosted "The Convergence of Private Capital—Private Equity, Buyout, Real Estate, and Hedge Funds," a panel discussion followed by a reception attended by nearly 200 Jones Day clients and friends. Presentations during the panel discussion were delivered by ***Paul D. Leake (New York)***, ***Robert A. Profusek (New York)***, and ***Michael J. Haas (Cleveland)***.

On June 5, ***Daniel P. Winikka (Dallas)*** moderated a panel discussion entitled "Credit Bidding: Stacking the Deck in Favor of the Secured Lender/Distressed Investor" at the AIRA 24th Annual Bankruptcy and Restructuring Conference in Las Vegas.

***Gregory M. Gordon (Dallas)*** participated in a panel discussion on June 7 concerning "Getting Hired and Getting Paid: Controlling the Risks" at the AIRA 24th Annual Bankruptcy and Restructuring Conference in Las Vegas. The subject of his presentation was "Overview of Issues Related to Professional Retention in Bankruptcy Cases."

An article written by ***Erica M. Ryland (New York)*** and ***Mark G. Douglas (New York)*** entitled "Rediscovering Chapter 9—Part II" appeared in the June 2008 edition of *The Bankruptcy Strategist.*

***Tobias S. Keller (San Francisco)*** sat on a "Distressed Investor and Lending Panel" sponsored by FTI Corporate Finance in San Francisco on June 19.

An article written by ***Erica M. Ryland (New York)*** and ***Mark G. Douglas (New York)*** entitled "Rediscovering Chapter 9—Part I" appeared in the May 2008 edition of *The Bankruptcy Strategist.*

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "When Brokers Go Broke" appeared in the April 11 edition of *Bankruptcy Law360*, *Securities Law360*, and *Finance Law360*.

An article written by ***Pedro A. Jimenez (New York)*** and ***Mark G. Douglas (New York)*** entitled "Two and One-Half Years and Counting: The Rapidly Maturing Jurisprudence of Chapter 15 of the Bankruptcy Code" was published in the May/June edition of *Pratt's Journal of Bankruptcy Law*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "When Brokers Go Broke: Subprime Meltdown May Mean More Stockbroker Bankruptcies" was published in the April/May edition of the *Association of Insolvency & Restructuring Advisors Newsletter*.

On August 1, ***Ryan T. Routh (Cleveland)*** sat on a panel discussing "Understanding Today's Capital Markets" at the ABI's 4th Annual Mid-Atlantic Bankruptcy Workshop in Cambridge, Maryland.

On August 1, ***Carl E. Black (Cleveland)*** facilitated a panel discussion entitled "Navigating the New Claims Rules" at the ABI's 4th Annual Mid-Atlantic Bankruptcy Workshop in Cambridge, Maryland.

An article written by ***Mark G. Douglas (New York)*** entitled "For Calpine Stakeholders, Plan Participation Was Key" appeared in the April 25 edition of *Bankruptcy Law360* and *Energy Law360.* His article entitled "IP Perspective: Actual Test and *Footstar* Approach Govern DIP's Ability to Assume Patent and Technology License" was published in the May 2008 edition of *Corporate Counsel's Licensing Letter*.

to include more specific temporal language in section 1146(a), Justice Thomas wrote, "because the phrase 'under a plan confirmed' is most naturally read to require that there be a confirmed plan at the time of the transfer."

The justice also emphasized that, even if the Court were to adopt Piccadilly's broad construction of "under" in section 1146(a), it would be unavailing because Piccadilly had not even submitted a chapter 11 plan to the bankruptcy court at the time its assets were sold under section 363(b). Adopting Piccadilly's approach, Justice Thomas observed, would make the tax exemption depend on "whether a debtor-in-possession's actions are consistent with a legal instrument that does not exist—and indeed may not even be conceived of—at the time of the sale." According to Justice Thomas, even reading section 1146(a) in context with other provisions of the statute, "we find nothing justifying such a curious interpretation of what is a straightforward exemption." Contextually speaking, he explained, section 1146(a)'s placement in a subchapter of the Bankruptcy Code entitled "postconfirmation matters" further undermines Piccadilly's argument that the provision was intended to cover pre-confirmation asset transfers.

Justice Thomas then turned to various arguments made by FDOR based upon traditional canons of statutory construction, including the following: (i) Congress's failure to clarify section 1146, despite having amended the Bankruptcy Code several times since 1979 (most recently in 2005, after the rulings in *NVR* and *Hechinger*), indicates that lawmakers saw no reason to modify the provision, as interpreted by the Fourth and Third Circuits; and (ii) federal interference with the administration of a state's taxation scheme is discouraged, such that, consistent with the "federalism canon," articulated by the Supreme Court in *California State Board of Equalization v. Sierra Summit, Inc.*, courts should proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed. He found the latter to be "decisive" in determining how section 1146(a) should be applied.

Piccadilly's effort to evade the federalism canon, Justice Thomas wrote, "falls well short of the mark because reading § 1146(a) in the manner Piccadilly proposes would require us to do exactly what the canon counsels against." Moreover, he emphasized, Piccadilly premised its entire argument on the idea that section 1146(a) is ambiguous, a foundation that the federalism canon expressly renders inadequate to support any finding that Congress has clearly expressed its intention to provide a transfer tax exemption for pre-confirmation transfers.

Justice Thomas also rejected Piccadilly's contention that section 1146(a) should be interpreted "liberally" in keeping with: (i) chapter 11's twin objectives of preserving going concerns and maximizing property available to satisfy creditors; and (ii) the "remedial" nature of chapter 11 and the Bankruptcy Code as a whole. Far from having a single remedial purpose, Justice Thomas wrote, "Chapter 11 strikes a balance between a debtor's interest in reorganizing and restructuring its debts and the creditors' interest in maximizing the value of the bankruptcy estate." According to Justice Thomas, the Bankruptcy Code also accommodates state interests in regulating property transfers by generally leaving the determination of property rights in estate assets to state law. "Such interests often do not coincide," he observed, concluding that in this case, "[w]e therefore decline to construe the exemption granted by § 1146(a) to the detriment of the State."

Finally, Justice Thomas addressed Piccadilly's argument that construing section 1146(a) to exempt only post-confirmation transfers would amount to an "absurd" policy and ignore the practical realities of chapter 11 cases that increasingly involve pre-confirmation sales as part of a reorganization strategy. Agreeing with the Fourth Circuit's reasoning in *NVR* that Congress struck a reasonable balance in section 1146(a) by making the tax exemption available only in cases where the debtor has successfully confirmed a plan, Justice Thomas wrote, "[W]e see no absurdity in reading § 1146(a) as setting forth a simple, bright-line rule instead of the complex, after-the-fact inquiry Piccadilly envisions." Furthermore, he concluded that "it is incumbent upon the Legislature, and not the Judiciary, to determine whether § 1146(a) is in need of revision."

The 7-2 majority of the court accordingly reversed the Eleventh Circuit's judgment and remanded the case below for further proceedings consistent with its ruling. Chief Justice Roberts and Justices Scalia, Kennedy, Souter, Ginsburg, and Alito joined in the majority opinion. Justice Breyer, joined by Justice Stevens, filed a dissenting opinion.

## DISSENTING OPINION

In his dissent, Justice Breyer wrote that the language of section 1146(a) is "perfectly ambiguous" as to whether a transfer can qualify for the tax exemption if it is "under a plan" that at the time of the transfer "either *already has been* or *subsequently is* 'confirmed.' " Explaining that none of the text-based arguments "point[ ] clearly in one direction rather than the other," and that the canons of interpretation "offer little help," Justice Breyer reasoned that, in the absence of any clear guidance, the appropriate inquiry should be why and for what reasonable purpose Congress insisted upon temporal limits.

According to Justice Breyer, the majority's temporal restriction would not serve in any way either chapter 11's basic objectives or the specific purpose of section 1146(a) (*i.e.*, to encourage and facilitate bankruptcy asset sales). From the perspective of these purposes, he wrote, "[I]t makes no difference whether a transfer takes place before or after the plan is confirmed." In either case, the tax exemption puts money in the hands of creditors or the estate that would otherwise be paid to taxing authorities. Moreover, Justice Breyer emphasized, "In both instances the confirmation of the related plan assures the legitimacy (from bankruptcy law's perspective) of the plan that provides for the assets transfer."

Confining the tax exemption to post-confirmation transfers, Justice Breyer explained, clearly "inhibits the statute's efforts to achieve its basic objectives." According to him, deferring asset sales until the end of a chapter 11 case to avoid paying transfer taxes could result in "far more serious harm" to creditors or the reorganized debtor due to the loss of "extra revenues that a speedy sale might otherwise produce." Faulting the majority for failing to consider the statutory language in light of its basic purpose in applying the canons of construction, Justice Breyer advocated a less rigid construction of section 1146(a)'s requirements:

> What conceivable reason could Congress have had for silently writing into the statute's language a temporal distinction with such consequences? The majority can find none. It simply says that the result is not "absurd" and notes the advantages of a "bright-line rule." . . . I agree that the majority's interpretation is not absurd and do not dispute the advantages of a clear rule. But I think the statute supplies a clear enough rule—transfers are exempt when there is confirmation and are not exempt when there is no confirmation. And I see no reason to adopt the majority's preferred construction (that only transfers completed after plan confirmation are exempt), where it conflicts with the statute's purpose.

## OUTLOOK

Given the prevalence of pre-confirmation section 363(b) asset sales in chapter 11 cases as a means of generating value for the estate and creditors, *Piccadilly* is decidedly unwelcome news. It may, in fact, portend a shift in chapter 11 reorganization strategies where asset sales are anticipated. If obtaining a section 1146 tax exemption is important, *Piccadilly* may result in a debtor's deferring major asset divestitures to the end of the case, while at the same time potentially formulating and seeking confirmation of a chapter 11 plan on a much accelerated basis.

Prior to the Supreme Court's ruling in *Piccadilly*, a majority of lower courts had sided with the Second and Eleventh Circuits and adopted the more liberal interpretation that section 1146 applies to pre-confirmation asset sales under section 363(b). Although this approach was by no means universally accepted among lower courts, the law laid down by *Piccadilly* invalidates the practice followed by a significant majority of bankruptcy courts.

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

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

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

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

*State of Florida Dept. of Rev. v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 484 F.3d 1299 (11th Cir.), *cert. granted*, 128 S. Ct. 741 (2007), *rev'd and remanded*, 2008 WL 2404077 (June 16, 2008).

*California State Board of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844 (1989).

# *BEAR STEARNS* REDUX: RULING DENYING CHAPTER 15 RECOGNITION TO CAYMAN ISLANDS HEDGE FUNDS UPHELD ON APPEAL

*Pedro A. Jimenez and Mark G. Douglas*

The failed bid of liquidators for two hedge funds affiliated with defunct investment firm Bear Stearns & Co., Inc., to obtain recognition of the funds' Cayman Islands winding-up proceedings under chapter 15 of the Bankruptcy Code was featured prominently in business headlines during the late summer and fall of 2007. News of the July 2007 filings fueled speculation that offshore investment funds, of which it is estimated that approximately 75 percent are registered in the western Caribbean, would potentially utilize chapter 15 of the Bankruptcy Code to thwart creditor action or litigation in the U.S. while attempting to wind up their affairs in non-U.S. jurisdictions perceived to be more management-friendly.

In a pair of decisions issued on August 30, 2007 (and later amended on September 5), bankruptcy judge Burton R. Lifland denied recognition of the Cayman proceedings as either "main" or "nonmain" foreign proceedings under chapter 15. In *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), *amended and superseded by* 374 B.R. 122 (Bankr. S.D.N.Y. 2007), Judge Lifland ruled that the funds, whose operations, assets, managers, clients, and creditors were not located in the Caymans, failed to prove either that their "center of main interests" was located in the Caymans or that they even maintained an "establishment" there. The judge did so despite the absence of any objection to the liquidators' petitions for recognition under chapter 15. His rulings sent a clear message that U.S. bankruptcy courts interpreting the newly minted chapter 15 will not rubber-stamp requests designed to take advantage of the broad range of relief available under the statute to assist qualifying bankruptcy and insolvency proceedings commenced abroad.

The missive was decidedly unwelcome news for a great number of offshore hedge funds and other investment vehicles scrambling to sort out financial woes precipitated by the subprime-mortgage crisis. Even so, trepidation in the hedge-fund community over the hard-line approach adopted in *Bear Stearns* was ameliorated somewhat by the prospect that the ruling might be overturned during the appellate process, which the liquidators began in earnest in September 2007. The first (and apparently last) round of the appellate process ended on May 22, 2008. In a carefully reasoned 35-page opinion parsing the language, background, and objectives of chapter 15, U.S. district court judge Robert W. Sweet affirmed Judge Lifland's rulings in all respects. After their decision not to appeal Judge Sweet's ruling, the liquidators' gambit to use chapter 15 as a means of preventing piecemeal liquidation of the Cayman Islands hedge funds' U.S. assets has ended in defeat.

## CHAPTER 15

April 17, 2008, marked the two-and-one-half-year 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 replaced 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 ensure 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 Bankruptcy Code does not define COMI. However, section 1516(c) provides that the debtor's registered office or habitual residence, in the case of an individual, is presumed to be the debtor's COMI. According to the statute's legislative history, this presumption was included "for speed and convenience of proof where there is no serious controversy." An "establishment" is defined to be "any place of operations where the debtor carries out a nontransitory economic activity."

In the absence of a provision in the Bankruptcy Code specifying what constitutes COMI for a corporate debtor, various factors have been deemed relevant by courts and commentators in examining COMI, including the location of the debtor's headquarters, managers, employees, investors, 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 European Union Regulation on Insolvency Proceedings (2000) and the U.K. Cross-Border Insolvency Regulation of 2006. 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 and in the wake of chapter 15's enactment in 2005. 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 Regulation. The EU Regulation provides that COMI "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." The concept is equivalent to the "principal place of business" under U.S. law.

Recognition of a foreign insolvency proceeding as a main proceeding has marked advantages over recognition as a nonmain proceeding—perhaps most significantly, the triggering of the automatic stay under section 362 of the Bankruptcy Code. If the U.S. bankruptcy court is provided with sufficient evidence (delineated in the statute) establishing the legitimacy of a pending foreign bankruptcy proceeding (main, nonmain, or both), it "shall" enter an "order of recognition." As a practical matter, recognition under chapter 15 is a prerequisite to nearly any kind of judicial relief for a foreign debtor in the U.S. If the court refuses to recognize a foreign proceeding under chapter 15, it has the power to issue any appropriate order necessary to prevent the foreign representative from obtaining comity or cooperation from other U.S. courts, although the representative may still sue in U.S. courts to collect on claims belonging to the debtor and does not need bankruptcy-court authority to act extra-judicially on behalf of the debtor in the U.S.

## 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.

## 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 it can sue and be sued in the U.S. on the foreign debtor's behalf.

### *BEAR STEARNS*

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 administered 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 Fund's 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.

*Bear Stearns* fortifies a theme that has been recurring among U.S. bankruptcy courts called upon to apply the new statutory infrastructure regulating cross-border bankruptcy cases. In short, U.S. courts will not rubber-stamp recognition requests under chapter 15.

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

The bankruptcy court issued its ruling on August 30, 2007. Emphasizing that recognition under chapter 15 "is not to be rubber-stamped by the courts," the 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, "The 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.

The liquidators appealed the rulings to the district court on September 10, 2007. Judge Lifland agreed to stay the effect of his decision pending the outcome of the appeal.

## THE DISTRICT COURT'S RULING

District judge Sweet prefaced his discussion of the legal issues involved by remarking that "[t]he process by which the financial problems of insolvent hedge funds are resolved appears to be of transcendent importance to the investment community and perhaps even to society at large." He also observed that, surprisingly, none of the Funds' creditors or investors appeared in the proceeding to support or challenge Judge Lifland's ruling, although several noted commentators and other parties submitted their views on the controversy as friends of the court.

Judge Sweet rejected the liquidators' contention that chapter 15 "was enacted to foster comity" and courts should therefore apply the statute "pragmatically, based on their understanding that recognition should be withheld only in very limited circumstances." Although relief granted upon recognition of a foreign proceeding under chapter 15 "is largely discretionary and turns on subjective factors that embody principles of comity," the judge explained, recognition "turns on the strict application of objective criteria." Both the language of the statute and its legislative history, Judge Sweet observed, "require a factual determination with respect to recognition before principles of comity come into play."

Noting that there was no dispute concerning the factual premises underlying Judge Lifland's legal conclusions, Judge Sweet concluded that, taken as a whole, the evidence presented below did not constitute "substantive economic activity in the Cayman Islands." According to Judge Sweet, the bankruptcy court: (i) is permitted to conduct its own independent analysis of the evidence regarding COMI (notwithstanding the lack of a challenge to the chapter 15 petition from any creditor or party in interest); (ii) correctly determined that chapter 15's evidentiary presumption arising from incorporation had been rebutted by unchallenged facts; and (iii) properly concluded that the Funds' COMI is in New York. The absence of any objection to recognition, he emphasized, is irrelevant:

> Appellants' emphasis on the fact that their petition was unopposed is unavailing. The lack of objection to the petition may result from any number of considerations, unknown to the courts but subject to any assumption. That absence does not relieve the bankruptcy court of its duty to apply the statute as written.

Judge Sweet also did not fault Judge Lifland's conclusion that the liquidators failed to satisfy their burden of demonstrating that the Funds had an "establishment" in the Cayman Islands, as required for recognition of a foreign nonmain proceeding under chapter 15. According to Judge Sweet, auditing activities and preparation of incorporation papers performed by a third party do not in plain-language terms constitute "operations" or "economic activity" by the Funds.  Moreover, he emphasized, the Funds had no assets in the Cayman Islands at the time the chapter 15 petitions were filed, a circumstance that "supports the conclusion that nonmain recognition would be inappropriate." Finally, Judge Sweet ruled that evidence submitted by the liquidators after the bankruptcy court conducted a hearing on their recognition petitions was inadmissible and that even if it were admissible, it would not alter his conclusions.

### OUTLOOK

Judge Sweet's ruling in *Bear Stearns* is bad news for offshore hedge funds that carry on a significant volume of business in the U.S. but are organized as "letter box" companies in foreign jurisdictions. Without the ability to obtain recognition under chapter 15 of insolvency proceedings commenced outside the U.S. due to the absence of any meaningful contacts with the country in question, the only recourse available to companies with tangible U.S. assets is a chapter 7 or chapter 11 bankruptcy filing (assuming they are otherwise eligible for relief under those chapters). The liquidators elected not to appeal Judge Sweet's ruling, which now punctuates their stymied attempt to effect an orderly liquidation of the Funds' U.S. assets under the aegis of chapter 15.

*Bear Stearns* fortifies a theme that has been recurring among U.S. bankruptcy courts called upon to apply the new statutory infrastructure regulating cross-border bankruptcy cases. In short, U.S. courts will not rubber-stamp recognition requests under chapter 15. The ruling also illustrates an important distinction between chapter 15 and former section 304 ancillary proceedings. Before the enactment of chapter 15 in 2005, access to U.S. bankruptcy courts by an accredited representative of a foreign debtor was not dependent on recognition. Instead, the various forms of relief available under section 304 were discretionary and based on subjective factors influenced by comity. As *Bear Stearns* demonstrates, that is no longer the case.

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*In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 2008 WL 2198272 (S.D.N.Y. May 27, 2008).

## COLLATERAL SURCHARGE DENIED DESPITE INADEQUACY OF CARVE-OUT DUE TO EXPRESS WAIVER IN DIP FINANCING AGREEMENT

*Nathan P. Lebioda and Mark G. Douglas*

As a general rule, absent an express agreement to the contrary, expenses associated with administering the bankruptcy estate, including pledged assets, are not chargeable to a secured creditor's collateral or claim but must be paid out of the estate's unencumbered assets. Recognizing, however, that the bankruptcy estate may be called upon to bear significant expense in connection with preserving or disposing of encumbered assets as part of an overall reorganization (or liquidation) strategy, U.S. bankruptcy law has long recognized an exception to this general principle in cases where reasonable and necessary expenses directly benefit the secured creditor. Thus, section 506(c) provides that a debtor-in-possession ("DIP") or trustee "may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property."

Costs must be both necessary to preserve or dispose of collateral and reasonable to qualify for the section 506(c) surcharge. Consistent with the statute's underlying purpose in preventing a secured creditor from realizing a windfall when the estate shoulders expenses that would otherwise be borne by the creditor if it had foreclosed on collateral, such costs and expenses must also directly (rather than incidentally) benefit the secured creditor. Direct benefit to the secured creditor generally means that the expense in question preserves or increases the value of the collateral. If an expense satisfies the requirements of section 506(c), proceeds from the sale or other disposition of the collateral must be used first to pay the surcharged expense, with the excess applied to payment of the claim(s) secured by the property.

Secured creditors may also expressly consent to payment of certain costs and expenses of administering a bankruptcy estate from their collateral. Such administrative "carve-outs" are common in chapter 11 cases involving a debtor with assets that are fully or substantially encumbered by the liens of pre-bankruptcy lenders. As part of a post-petition financing or cash collateral agreement, a pre-bankruptcy lender may agree that a specified portion of its collateral can be used to pay administrative claims, such as professional fees and expenses incurred by a DIP, trustee, or official committee; statutory fees; or "burial" costs that may be incurred if a chapter 11 case is later converted to a chapter 7 liquidation.

The quid pro quo for an administrative carve-out in a post-petition financing or cash collateral agreement, however, is commonly waiver of the ability to surcharge under section 506(c). Because the total amount of administrative costs incurred in connection with a chapter 11 case is difficult to predict at the outset of the bankruptcy, a carve-out accompanied by a surcharge waiver must be negotiated carefully to ensure as nearly as possible that there will be adequate funds available to meet anticipated administrative expenses. A ruling recently handed down by the Ninth Circuit Court of Appeals illustrates what can happen when a carve-out later proves to be inadequate to satisfy costs in a chapter 11 case bordering on administrative insolvency. In a matter of apparent first impression in the Ninth Circuit, the court of appeals held in *Weinstein, Eisen & Weiss v. Gill (In re Cooper Commons LLC)* that professional fees and expenses incurred by a chapter 11 DIP could not be paid from the DIP lender's collateral because the DIP waived its right to seek a section 506(c) surcharge and failed to negotiate an adequate carve-out in connection with the financing.

### *COOPER COMMONS*

Real estate developer Cooper Commons LLC ("Cooper") filed for chapter 11 protection in 2002 during the construction and sale of a 62-unit condominium development in West Hollywood, California. Prior to filing for bankruptcy, Cooper had received approximately $16 million in financing from Comerica Bank ("Comerica") to fund development of the project. In order to salvage its investment, Comerica agreed to provide an additional $7 million to Cooper in three separate court-approved post-petition financing transactions that would allow Cooper to complete the condominium-construction project. The law firm Weinstein, Eisen & Weiss ("Weinstein") served as Cooper's chapter 11 counsel and negotiated each of the DIP financing agreements. The agreements included a $50,000 carve-out for administrative and professional fees. Each of the agreements also contained a waiver of Cooper's right to surcharge Comerica's collateral under section 506(c).

A secured creditor's collateral can be surcharged pursuant to section 506(c) only if an expense incurred by the estate to preserve or dispose of the collateral directly benefits the secured creditor, *unless the secured creditor agrees otherwise*. *Cooper Commons* demonstrates that courts will strictly enforce any carve-out/waiver agreement negotiated at arm's length, even if it means that administrative claims cannot be paid in full and confirmation of a chapter 11 plan for the debtor is impossible.

The bankruptcy court ordered the appointment of a chapter 11 trustee for Cooper in 2003. Estimating that it would cost several million dollars to complete the condominium project, the trustee negotiated yet another financing agreement with Comerica. The agreement, which was later approved by the court, included a carve-out in the amount of approximately $890,000 for "the actual and necessary fees and costs of the Trustee and his professionals . . . approved by an order of the Court after notice and an opportunity for hearing." Weinstein, realizing that Cooper's bankruptcy estate was administratively insolvent and could not pay the full amount of the legal fees and expenses incurred by Cooper when it was a DIP, appealed the financing order to a bankruptcy appellate panel for the Ninth Circuit, which affirmed the ruling below. Weinstein then appealed to the Ninth Circuit Court of Appeals, which dismissed the appeal as being moot because Weinstein failed to obtain a stay of the financing order pending its appeal.

Two years afterward, the trustee's carve-out proved to be inadequate, and Comerica agreed to an additional $250,000 carve-out from its cash collateral. Weinstein objected to the trustee's motion seeking bankruptcy-court approval of the augmented carve-out, arguing that the augmentation would result in unfair treatment to other administrative claimants.

The court overruled the objection. After the district court affirmed the ruling on appeal, Weinstein appealed to the Ninth Circuit.

### THE NINTH CIRCUIT'S RULING

Weinstein fared no better in the court of appeals, which addressed the issue as a matter of apparent first impression. The Ninth Circuit rejected Weinstein's assertion that "the future of bankruptcy law is at stake in this case . . . [because it] will have opened the door to side deals" allowing secured lenders and trustees to rearrange statutory payment priorities for their benefit. Characterizing the situation before it as decidedly "less momentous," the court explained that the section 506(c) waiver negotiated by Weinstein on Cooper's behalf was unambiguous and expressly provided that any carve-out payable to Weinstein and other professionals retained by Cooper was limited to $50,000. By contrast, the subsequent financing agreement between the trustee and Comerica was expressly limited to fees up to the specified amount incurred by the trustee. As a consequence, the Ninth Circuit concluded, Weinstein had no claim against Comerica's collateral.

According to the court of appeals, Comerica acted properly when limiting the use of its cash collateral to "the services necessary for the ongoing management by the Trustee of the estate." Because the funds were already subject to Comerica's lien, the Ninth Circuit emphasized, Comerica was free to specify the particular expenses it was willing to carve out from its collateral. Weinstein, the court explained, had "no direct, pecuniary interest in the encumbered assets of the estate."

### OUTLOOK

*Cooper Commons* is a cautionary tale. Administrative insolvency is a risk in almost every chapter 11 case, even if the DIP's financial outlook at the inception of the case is rosy. Weinstein obviously believed that a $50,000 carve-out was sufficient when it negotiated the DIP financing agreements. That judgment later proved to be flawed, as Cooper's chapter 11 case dragged on for another two years and costs mounted to the point where it was impossible for Cooper's estate to pay the full amount of its post-trustee and pre-trustee administrative claims. A secured creditor's collateral can be surcharged pursuant to section 506(c) only if an expense incurred by the estate to preserve or dispose of the collateral directly benefits the secured creditor, *unless the secured creditor agrees otherwise*. *Cooper Commons* demonstrates that courts will strictly enforce any carve-out/waiver agreement negotiated at arm's length, even if it means that administrative claims cannot be paid in full and confirmation of a chapter 11 plan for the debtor is impossible.

Even if the law firm could have overcome the formidable obstacle erected by the unambiguous terms of loan documentation it negotiated in connection with Cooper's DIP financing, Weinstein would have assumed the additional burden of demonstrating that professional fees incurred by Cooper conferred a direct benefit upon Comerica. The likelihood of prevailing on such an argument is limited at best.

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*Weinstein, Eisen & Weiss v. Gill (In re Cooper Commons LLC)*, 512 F.3d 533 (9th Cir. 2008).

*Weinstein, Eisen & Weiss v. Gill (In re Cooper Commons LLC)*, 430 F.3d 1215 (9th Cir. 2005).

# CAN AN EXECUTORY CONTRACT LOSE ITS EXECUTORINESS? "MAYBE," SAYS THE SECOND CIRCUIT

*Mark G. Douglas*

The ability of a chapter 11 debtor-in-possession ("DIP") or bankruptcy trustee to assume or reject unexpired leases or contracts that are "executory" as of the bankruptcy filing date is one of the most important entitlements created by the Bankruptcy Code. It allows a DIP to rid itself of onerous contracts and to preserve contracts that can either benefit its reorganized business or be assigned to generate value for the bankruptcy estate and/or fund distributions to creditors under a chapter 11 plan. The fundamental importance of affording the DIP or trustee adequate time to decide whether a given contract should be assumed or rejected, even when the attendant delay and uncertainty may subject nondebtor contracting parties to considerable prejudice, is deeply rooted in the fabric of U.S. bankruptcy jurisprudence. As demonstrated by a ruling recently handed down by the Second Circuit Court of Appeals, courts only rarely find that the right to assume or reject can be compromised or abridged under circumstances not expressly spelled out in the Bankruptcy Code. In *COR Route 5 Co. v. The Penn Traffic Co. (In re The Penn Traffic Co.)*, the court of appeals held that post-petition completion of performance by a nondebtor party to a contract that was executory as of the chapter 11 petition date cannot strip the DIP of the right to assume or reject the contract.

## ASSUMPTION AND REJECTION OF EXECUTORY CONTRACTS AND UNEXPIRED LEASES

Section 365(a) of the Bankruptcy Code provides that, with certain exceptions delineated elsewhere in the statute, "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." The trustee's power to assume or reject is conferred upon a DIP under section 1107(a) of the Bankruptcy Code. Rejection results in breach of the contract, with any claim for damages treated as a pre-petition claim against the estate on a par with the claims of other unsecured creditors (unless the debtor has posted security). Assumption of a contract requires, among other things, that the DIP cure all existing monetary defaults and provide adequate assurance of its future performance.

Bankruptcy courts will generally approve assumption or rejection of a contract if presented with evidence that either course of action is a good business decision. Upon assumption, most kinds of executory contracts may also be assigned by the DIP or trustee to third parties under the circumstances specified in section 365. Except with respect to certain kinds of contracts, such as nonresidential real property leases and aircraft and parts lease agreements, the DIP or trustee may decide to assume or reject at any time up to confirmation of a chapter 11 plan. However, any nondebtor party to a contract may seek to compel the DIP or trustee to assume or reject the contract prior to confirmation, in which case the bankruptcy court must decide what period of time is reasonable to make the decision. Pending the decision to assume or reject, the trustee or DIP is generally obligated to keep current on obligations that become due under the contract post-petition.

> The Second Circuit avoided adopting a bright-line rule on the issue, opting instead to leave open the possibility that post-petition events can strip a DIP of its rights under section 365 by revoking a contract's "executory" status on the petition date.

The Bankruptcy Code does not define "executory." The legislative history of section 365 refers with approval to the definition articulated by the famous commentator and scholar Professor Vern Countryman, who in 1973 defined an "executory" contract as "[a] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other." Most courts accept this or a substantially similar definition of the term. If a contract or agreement is not executory, it may be neither assumed nor rejected (although the contract may give rise to either an estate asset or obligation).

As a general rule, whether a contract is executory (and may be assumed or rejected) is determined as of the bankruptcy petition date. Some courts, however, have ruled that even though a contract was executory on the petition date, post-petition events can alter the contract's status, so that it can no longer be assumed or rejected. This is sometimes referred to as the "post-petition evaluation principle." Courts have invoked it in cases where, for example: (i) the contract expired post-petition by its terms, such that there were no longer any obligations to assume or reject; or (ii) the DIP affirmatively acted in a way that affected the existence of outstanding performance obligations (*e.g.*, by ceasing to operate or discharging an employee covered by an employment agreement). In *Penn Traffic*, the Second Circuit, without categorically rejecting the idea that such a principle might apply under certain circumstances, ruled that the nondebtor's completion of performance post-petition could not strip the DIP of the right to reject a construction agreement that was executory as of the bankruptcy petition date.

### *PENN TRAFFIC*

The Penn Traffic Company ("PTC"), a leading food retailer in the U.S., owned a parcel of land and certain improvements adjacent to the Towne Center shopping mall in Fayetteville, New York. COR Route 5 Company, LLC ("COR"), a commercial real estate developer, also owned land near the shopping mall. PTC's real property could not have been developed into a modern suburban supermarket as part of the mall without the inclusion of COR's contiguous and connecting real property. PTC accordingly entered into a "project agreement" with COR providing for the exchange of land, site preparation and construction of a supermarket, reimbursement by COR of construction costs incurred by PTC, and PTC's conveyance to COR of the land on which the supermarket is situated, after which the facility would be leased back to and operated by PTC.

PTC and certain affiliates filed for chapter 11 protection in May 2003 in New York. At the time of the filing, COR had performed all of its obligations under the project agreement except for reimbursement of PTC construction costs (approximately $3.5 million) and the tender of a lease to PTC, which had not yet conveyed the supermarket property to COR. The property was subsequently appraised at nearly $10 million.

In March 2004, COR tendered the reimbursement costs due under the project agreement as well as a signed lease. PTC declined to accept the tender. Instead, it sought court authority in November 2004 to reject the project agreement. The bankruptcy court denied the motion, ruling that the project agreement was no longer executory, and could not be assumed or rejected, after COR tendered its performance. PTC appealed to the district court, which reversed the court's ruling that executory status should be assessed at the time of assumption or rejection and take into account post-petition performance. On remand, the bankruptcy court ultimately granted PTC's motion to reject the project agreement, finding that rejection was in PTC's best interests. COR appealed the rejection order all the way to the Second Circuit.

### THE SECOND CIRCUIT'S RULING

The court of appeals affirmed, ruling that the nondebtor party to a contract that is executory on the petition date cannot, by post-petition tender or performance of its own outstanding obligations, "deprive the debtor of the ability to exercise its statutory right to reject the contract as disadvantageous to the estate." The plain language of section 365, the court explained, permits a DIP or trustee to assume or reject an executory contract "at any time before the confirmation of a plan." Counterparties seeking an earlier determination, the court emphasized, may seek a court order requiring the debtor to assume or reject a contract by a specified deadline.

According to the Second Circuit, it need not determine "the precise contours of the test for executoriness" because the bankruptcy court determined that the parties' unperformed obligations under the project agreement satisfied the "Countryman standard" as of the bankruptcy petition date. It rejected COR's contentions that the agreement should not be treated as an executory contract because the agreement is actually a "financing lease," a "prepaid option," or a form of secured real estate transaction that is not subject to the rules governing executory contracts in section 365 of the Bankruptcy Code. The facts of this case, the court concluded, do not support the legal conclusion that the project agreement was anything other than an executory contract.

Emphasizing that "[e]xecutoriness and the debtor's rights with respect to assumption or rejection of an executory contract are normally assessed as of the petition date," the Second Circuit distinguished the facts in this case from those considered by courts that have invoked the "post-petition evaluation principle." In this case, the court explained, the project agreement had not expired prior to PTC's decision to reject it, nor had PTC acted affirmatively in any way that affected the existence of outstanding performance obligations. The court acknowledged that the Bankruptcy Code creates an uneven playing field when it comes to executory contracts, but for important reasons:

> Sympathy for the non-debtor that may, through no fault of its own, bear some significant burden from the debtor's rejection of an executory contract due to the happenstance of an unforeseen bankruptcy proceeding is understandable. The notion that a non-debtor could prevent the exercise of § 365 rights with regards to an executory contract through post-petition performance of the non-debtor's contractual obligations is, however, inconsistent with both the plain language and the policy of the Code. . . . The Code does not condition the right to assume or reject on lack of prejudice to the non-debtor party, and the satisfaction of claims at less than their full non-bankruptcy value is common in bankruptcy proceedings, as is the disruption of non-debtors' expectations of profitable business arrangements.

In keeping with the policy considerations underlying section 365, the court emphasized, the power to elect whether to assume or reject an executory contract is "that of the debtor alone," regardless of the "onerous dilemmas" faced by a non-debtor contracting party forced to languish in statutory limbo while the DIP or trustee deliberates on the question. The debtor's interests, the Second Circuit concluded, "are paramount in the balance of control."

## OUTLOOK

*Penn Traffic* could have squelched any further debate (at least in the Second Circuit) concerning the right of a DIP or trustee to assume or reject contracts that are executory as of the bankruptcy petition date, but it does not. The Second Circuit avoided adopting a bright-line rule on the issue, opting instead to leave open the possibility that, under certain circumstances, post-petition events can strip a DIP of its rights under section 365 by revoking a contract's "executory" status on the petition date. This approach was characterized by the court as a "deviation from the general rule." The Bankruptcy Code generally establishes the bankruptcy petition date as the point of reference for determining the legal status of various rights, claims, and interests, unless it expressly provides otherwise. Under the Second Circuit's ruling, a DIP in some cases may still face the risk of forfeiting its right to assume or reject a contract under the "post-petition evaluation principle."

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*COR Route 5 Co. v. The Penn Traffic Co. (In re The Penn Traffic Co.)*, 524 F.3d 373 (2d Cir. 2008).

V. Countryman, *Executory Contracts in Bankruptcy*, 57 *Minn. L. Rev.* 439 (1973).

*Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054 (3d Cir. 1988).

*In re Spectrum Info. Techs., Inc.*, 193 B.R. 400 (Bankr. E.D.N.Y. 1996).

*In re Total Transp. Serv., Inc.*, 37 B.R. 904 (Bankr. S.D. Ohio 1984).

*In re Pesce Baking Co., Inc.*, 43 B.R. 949, 957 (Bankr. N.D. Ohio 1984).

# SELLER BEWARE: YET ANOTHER CAUTIONARY TALE FOR DISTRESSED-DEBT TRADERS

*Mark G. Douglas*

Participants in the multibillion-dollar market for distressed claims and securities had ample reason to keep a watchful eye on developments in the bankruptcy courts during each of the last three years. Controversial rulings handed down in 2005 and 2006 by the bankruptcy court overseeing the chapter 11 cases of failed energy broker Enron Corporation and its affiliates had traders scrambling for cover due to the potential that acquired claims/debt could be equitably subordinated or even disallowed, based upon the seller's misconduct. Although the severity of the cautionary tale writ large in the bankruptcy court's *Enron* decisions was ultimately ameliorated on appeal in the late summer of 2007 by district court judge Shira A. Scheindlin, the 20-month ordeal (and the uncertainty it spawned) left a bad taste in the mouths of market participants. 2008 has so far proved to be little better in providing traders with any degree of comfort with respect to claim or debt assignments involving bankrupt obligors. This time, moreover, the trouble concerns standard provisions contained in nearly every bank loan-transfer agreement, which have rarely been subject to challenge or analysis in the courts. In *In re M. Fabrikant & Sons, Inc.*, a New York bankruptcy court recently took a hard look at the standard transfer forms and definitions to determine whether a seller's reimbursement rights were transferred along with the debt.

### DISTRESSED CLAIMS/DEBT TRADING

Although the distressed-securities market is largely unregulated, industry participants and trade consortia—such as the Loan Syndications and Trading Association ("LSTA"); the Securities Industry Association; the International Swaps and Derivatives Association, Inc.; and the Bond Market Association—have implemented standards, forms, and procedures to govern purchase and sale transactions. LSTA's standardized Purchase and Sale Agreement for Distressed Trades, LSTA Standard Terms and Conditions (the "LSTA Standards"), provides a fairly comprehensive boilerplate for most sale/assignment transactions. Even so, as demonstrated by the bankruptcy court's ruling in *In re M. Fabrikant & Sons, Inc.*, parties relying on the LSTA Standards must be vigilant to ensure that transfer documentation unambiguously distinguishes between rights that are being transferred and rights that are to be retained by the seller/assignor.

### BACKGROUND

M. Fabrikant & Sons, once one of the world's largest manufacturers and distributors of diamonds, filed for chapter 11 protection together with its subsidiary Fabrikant-Leer International, Ltd. (collectively referred to as "Fabrikant"), in New York on November 17, 2006. Shortly thereafter, the bankruptcy court entered an order authorizing Fabrikant to use cash collateral pledged to a consortium of bank lenders (collectively, the "original lenders") as security for nearly $162 million in pre-petition loans. The cash collateral order, which conferred administrative-priority status upon claims asserted by the original lenders for reimbursement of certain expenses (the "Reimbursement Rights"), provided as follows:

> In addition to the fees, costs, charges and expenses authorized under the Pre-Petition Agreements, the Debtors shall pay in accordance with the procedures set forth in the following sentences, as allowed post-petition administrative expenses entitled to the priority and security afforded to the Adequate Protection Claim, all of Collateral Agent's and each Lender's reasonable (in all respects) attorneys' and other professionals' fees and reimbursable expenses arising from or related to (a) this Order, including without limitation the negotiating, closing, documenting and obtaining of Court approval thereof, (b) all proceedings in connection with any Disposition (as such term is defined below), (c) all proceedings in connection with the interpretation, amendment, modification, enforcement, enforceability, validity or implementation of the Pre-Petition Agreements or this Order at any time, (d) all other matters and proceedings arising in or related to the Debtors' bankruptcy cases, and (e) all reasonable expenses, costs and charges in any way or respect arising in connection with the foregoing (collectively, the "Lender Expenses").

Shortly after entry of the cash-collateral order, the original lenders sold their loans on the secondary market to other entities (collectively, the "current lenders"). The sale transactions were effected by means of transfer documents that in form or substance incorporated the LSTA Standards. The transfer agreements defined "Transferred Rights" to include:

> any and all of Seller's right, title, and interest in, to and under the Loans and Commitments (if any) and, to the extent related thereto, the following (excluding, however, the Retained Interest, if any)
>
> * * * *
>
> (e) all claims (including "claims" as defined in Bankruptcy Code Section 101(5)), suits, causes of action, and any other right of Seller . . . that is based upon, arises out of or is related to any of the foregoing, including, to the extent permitted to be assigned under applicable law, all claims (including contract claims, tort claims, malpractice claims, . . . ) suits, causes of action, and any other right of Seller . . . against any attorney, accountant, financial advisor, or other Entity arising under or in connection with the Credit Documents or the transactions related thereto or contemplated thereby.

Judge Bernstein's ruling indicates that the rights assigned to a buyer using the LSTA Standards are broad and include both contingent (and even post-petition) claims. The decision also fortifies the conventional wisdom that transfer documents should be drafted carefully to spell out explicitly which rights, claims, and interests are not included in the sale.

The "Retained Interest" carved out from the transfer was defined as follows:

> the right retained by Seller to receive . . . payments or other distributions, whether received by setoff or otherwise, of cash (including interest), notes, securities or other property (including Collateral) or proceeds paid or delivered in respect of the Pre-Settlement Date Accruals or the Adequate Protection Payments (if any); provided that Retained Interest shall not include any PIK Interest.

"Adequate Protection Payments" was defined in the transfer agreements to be amounts (other than payment-in-kind interest) ordered to be paid by the bankruptcy court as adequate protection under an "Adequate Protection Order." Finally, each seller agreed to indemnify the buyer (and pay its attorneys' fees and expenses) if the buyer was forced to disgorge or reimburse any payments or property received by the seller in connection with the "Transferred Rights" or any other claim that the seller might have against Fabrikant.

In October 2007, Fabrikant's official creditors' committee sued the original lenders, seeking, among other things, to avoid the liens securing their pre-petition loans. The original lenders incurred substantial legal fees in connection with the litigation. When Fabrikant proposed a chapter 11 plan that failed to provide for payment of these legal fees, the original lenders objected to the plan. They contended that the legal fees constituted Reimbursement Rights that were Retained Interests not transferred to the buyers under the LSTA Standards and that the failure to provide for payment in full of the fees violated various provisions of the Bankruptcy Code governing plan confirmation. According to the original lenders, the Reimbursement Rights were not transferable because the rights: (i) do not qualify as "claims" under the Bankruptcy Code's definition, which excludes claims that arise after the bankruptcy petition date, such as the Reimbursement Rights; (ii) are personal to the sellers, such that they could not have intended to transfer the rights while leaving themselves open to a lawsuit by the committee; (iii) are "counterclaims" expressly preserved for the original lenders in the court's cash collateral order; and (iv) are future rights that cannot be assigned.

### THE BANKRUPTCY COURT'S RULING

Chief bankruptcy judge Stuart M. Bernstein overruled the objections to plan confirmation interposed by the original lenders, which had standing to object by virtue of their alleged Reimbursement Rights as administrative claims against the estate. In doing so, he rejected their arguments against a finding that the Reimbursement Rights were transferred to the current lenders as part of the loan-sale transaction, ruling, as a consequence, that the Reimbursement Rights need not be paid in full under the plan. Observing that the LSTA Standards represent an "all-encompassing assignment of rights," Judge Bernstein concluded that the Reimbursement Rights fell squarely within the definition of "Transferred Rights." Such rights, the judge emphasized, are contingent indemnification rights related to and arising in connection with the original loan documents or related transactions and therefore fall within the Bankruptcy Code's broad definition of "claims" as well as the even broader category of rights or claims that qualified as Transferred Rights under the LSTA Standards. The judge found the original lenders' remaining arguments to be unpersuasive, explaining that: (i) the Reimbursement Rights, which covered a much broader category of expenses than avoidance-litigation costs, were valuable to whomever held the debt, not merely the sellers; (ii) to the extent that such rights could be characterized as "counterclaims," they were transferred by the original lenders along with the debt; and (iii) the Reimbursement Rights were not unassignable future rights because they were created prior to the debt-sale transaction.

### OUTLOOK

Until *Fabrikant*, none of the definitions in the LSTA Standards had been tested by the courts. Judge Bernstein's ruling indicates that the rights assigned to a buyer using the LSTA Standards are broad and include both contingent (and even post-petition) claims. The decision also fortifies the conventional wisdom that transfer documents should be drafted carefully to spell out explicitly which rights, claims, and interests are not included in the sale. Sellers, for example, that may be subject to lender liability exposure should ensure that they preserve reimbursement or similar rights by negotiating explicit carve-outs in connection with the sale transaction.

*Fabrikant* represents yet another cautionary tale for distressed-market participants. Unlike the *Enron* rulings, however, which focus on the risk of equitable subordination or disallowance of claims asserted by an assignee or buyer based upon the seller's misdeeds, the message borne by *Fabrikant* is "seller beware" rather than "caveat emptor."

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*In re M. Fabrikant & Sons, Inc.*, 385 B.R. 87 (Bankr. S.D.N.Y. 2008).

*In re Enron Corp.*, 379 B.R. 425 (S.D.N.Y. 2007).

## FAILURE OF CREDITOR CLASS TO CAST VOTE ON CHAPTER 11 PLAN DOES NOT EQUATE TO ACCEPTANCE

*Joseph Tiller and Mark G. Douglas*

The solicitation of creditor votes on a plan is a crucial part of the chapter 11 process. At a minimum, a chapter 11 plan can be confirmed only if at least one class of impaired creditors (or interest holders) votes to accept the plan. A plan proponent's efforts to solicit an adequate number of plan acceptances, however, may be complicated if creditors or other enfranchised stakeholders neglect (or choose not) to vote. The Bankruptcy Code does not provide a mechanism to force creditors to vote, nor does it clearly spell out the consequences of not voting where none of the creditors or interest holders in a given class have voted to accept or reject a chapter 11 plan. The lack of any clear guidance on this important issue has spawned a rift in the courts. In *In re Vita Corp.*, an Illinois district court recently addressed the ramifications of a creditor class's failure to vote in its entirety, ruling that classes in which all impaired creditors fail to cast ballots either accepting or rejecting a plan are not deemed to have accepted the plan for purposes of confirmation.

### CHAPTER 11 VOTING AND CONFIRMATION RULES

Chapter 11 plan confirmation is governed by Bankruptcy Code section 1129, which provides for both consensual and nonconsensual confirmation. The rules governing consensual confirmation, which are set forth in section 1129(a), include the requirement that "with respect to each class of claims or interests (A) such class has accepted the plan; or (B) such class is not impaired under the plan." Another requirement is that "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider."

In the absence of nonimpairment or approval by each impaired class, confirmation is possible only under chapter 11's "cram-down" standards, which are contained in section 1129(b). The rules governing nonconsensual confirmation similarly include the requirement that at least one impaired class must vote to accept the plan.

Bankruptcy Code section 1126 spells out the chapter 11 voting requirements. Under this provision, a class of claims has accepted a plan if the plan has been accepted by creditors "that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors . . . that have accepted or rejected such plan." A class of interests accepts a plan if the plan has been accepted by interest holders "that hold at least two-thirds in amount of the allowed interests of such class held by holders of such interests . . . that have accepted or rejected such plan." A class that is unimpaired by a plan is deemed to accept it. Any class whose members are to receive nothing under a plan is deemed to reject the plan.

As noted, the statute does not specify what happens if all the creditors or interest holders in a class entitled to vote fail to do so for whatever reason. The failure of enfranchised stakeholders to cast a vote can pose a significant problem, especially if the chapter 11 plan provides for treatment of one or more classes that contain only a single creditor or a handful of creditors, such that one creditor's failure to cast a vote means that the statutory acceptance majorities cannot be attained.

The legislative history of section 1126, S. Rep. No. 95-989, 95th Cong., 2d Sess. 123 (1978), provides as follows:

> This section requires a plan to be actively accepted. If a creditor does not cast a ballot, the amount owed to that creditor, and the creditor as a member of the class, is not included in the computation of whether the class accepted the plan. The Senate Committee comment to this section makes this clear, "[t]he amount and number are computed on the basis of claims actually voted for or against the plan, not as under chapter X [formerly section 501 *et seq.* of this title] on the basis of the allowed claims in the class."

Notwithstanding what would appear to be a clear indication that the failure to vote should not be counted as an acceptance or rejection, this issue continues to generate confusion in the courts. Some courts, including the Tenth Circuit Court of Appeals, have held that a nonvoting class is deemed to have accepted a plan. In *In re Ruti-Sweetwater, Inc.*, the Tenth Circuit reasoned that refusing to deem the failure of an impaired class to vote to be acceptance of the plan "would be to endorse the proposition that a creditor may sit idly by, not participate in any manner in the formulation and adoption of a plan in reorganization and thereafter, subsequent to the adoption of the plan, raise a challenge to the plan for the first time." According to the court of appeals, such an approach "would effectively place all reorganization plans at risk in terms of reliance and finality." Other courts, representing the majority position, have ruled that a nonvoting class is not deemed to have accepted a plan. An Illinois district court recently weighed in on this controversial issue in *Vita Corporation*.

### *VITA CORPORATION*

Vita Corporation operates an Old Chicago restaurant franchise in Peoria, Illinois. Vita filed for chapter 11 protection in 2006 in Illinois. Its proposed plan of reorganization created nine classes of creditors, six of which were impaired. Three classes cast ballots in sufficient majorities to accept the plan, but the creditors in the other three classes did not cast votes to accept or reject the plan. Because Vita did not receive any ballots rejecting the plan, it sought confirmation of the plan under section 1129(a).

At the confirmation hearing, the bankruptcy court questioned whether the failure of the three classes to vote should be considered acceptance of the plan by those classes. Acknowledging the existence of a split of authority on the question and the lack of any binding precedent in the Seventh Circuit, the court denied confirmation of the plan, ruling that "[s]ections 1129(a)(8) and 1126(c) require the affirmative assent of a creditor as the necessary means by which that creditor accepts a plan" and that "[a] creditor's failure to return a ballot rejecting the plan, does not constitute the creditor's deemed acceptance of the plan." Vita appealed.

### THE DISTRICT COURT'S DECISION

The district court affirmed the ruling. Noting that the Seventh Circuit has not yet addressed the question, the district court agreed with the bankruptcy court's conclusion that section 1126 "plainly" requires each creditor to affirmatively accept the plan in order to constitute acceptance. In addition, the district court explained, Bankruptcy Rule 3018(c) provides that "[a]n acceptance or rejection shall be in writing . . . [and] be signed by the creditor or equity security holder or an authorized agent." The rule's express requirement of a written ballot accepting a plan, the court emphasized, stands in stark contrast to other provisions of the Bankruptcy Code that allow a failure to act to be deemed an acceptance, such as section 1126(f), which specifically deem an unimpaired class to have accepted without voting.

The ruling underscores the importance of maintaining active lines of communication with key creditor constituencies during a chapter 11 case (particularly during the vote-solicitation period) to ensure that the proponent can muster an adequate number of acceptances in the form of timely submitted ballots to obtain confirmation of a plan, either consensually or otherwise.

The court rejected the contrary approach advocated by the Tenth Circuit in *Ruti-Sweetwater*, characterizing the decision as "result-oriented" and contrary to the dictates of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure. According to the court, the Bankruptcy Code specifically provides for an alternative means of obtaining confirmation if a class of impaired creditors does not cast a ballot—section 1129(b)'s cram-down provisions. This alternative, the court emphasized, would appear to be superfluous if courts were to presume that nonvoting impaired class members had accepted a proposed plan. By ignoring "precise requirements" established by the statute and the rules implementing it, the district court cautioned, a court becomes a legislative body and impermissibly implements policy.

## CONCLUSION

*Vita Corporation* widens the split of authority on the question of whether an impaired class whose creditors fail to vote is deemed to have accepted a chapter 11 plan for purposes of confirmation. From the perspective of plan proponents, the ruling underscores the importance of maintaining active lines of communication with key creditor constituencies during a chapter 11 case (particularly during the vote-solicitation period) to ensure that the proponent can muster an adequate number of acceptances in the form of timely submitted ballots to obtain confirmation of a plan, either consensually or otherwise. Plan proponents may be unable to rely on inaction as a surrogate for affirmative acceptance.

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*In re Vita Corp.*, 380 B.R. 525 (C.D. Ill. 2008).

*In re Eagle-Picher Industries, Inc.*, 203 B.R. 256 (S.D. Ohio 1996).

*In re Westwood Plaza Apartments, Ltd.*, 192 B.R. 693 (E.D. Tex. 1996).

*In re M. Long Arabians*, 103 B.R. 211 (Bankr. 9th Cir. 1989).

*In re Smith*, 357 B.R. 60 (Bankr. M.D.N.C. 2006).

*In re Jim Beck, Inc.*, 207 B.R. 1010 (Bankr. W.D. Va. 1997).

*In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988).

*In re Campbell*, 89 B.R. 187 (Bankr. N.D. Fla. 1988).

*In re Adelphia Communications Corp.*, 368 B.R. 140 (Bankr. S.D.N.Y. 2007).

# IN BRIEF: GOOD-FAITH CHAPTER 11 FILING DETERMINATION DEFEATS FIDUCIARY DUTY BREACH CLAIM

*Mark G. Douglas*

For the third time in as many years, the Delaware Chancery Court has handed down an important ruling interpreting the interaction between federal bankruptcy law and Delaware corporate law. The thorny question this time was whether a bankruptcy court's determination that the directors of a corporation acted in good faith when they authorized a chapter 11 filing precluded a subsequent claim that the directors breached their fiduciary duties by doing so. The Delaware Chancery Court concluded that it did, ruling in *Nelson v. Emerson* that a minority shareholder's claims for breach of fiduciary duty must be dismissed because a bankruptcy court's finding that a chapter 11 filing was not made in bad faith "precludes a finding that the Company's directors violated their fiduciary duties by filing for bankruptcy."

## BACKGROUND

Repository Technologies, Inc. ("Repository"), marketed, supplied, and maintained customer relationship software pursuant to licensing agreements with its customers. William G. Nelson IV was a minority shareholder in the company, beginning in 1996. Nelson also sat on Repository's board from 1996 until 2006 and served as the company's chief executive officer from 2002 to 2004. A majority stake in the company was held by E. James Emerson and Kathleen Emerson, who also served as Repository's officers and directors.

Nelson extended financing to Repository in 2002 in the form of a line of credit that was ultimately increased to nearly $1.75 million. By the middle of 2004, however, Repository's balance sheet reflected more than $2.5 million in liabilities compared to no more than $500,000 in assets. Even so, and despite the company's failure to make any payments on the debt to Nelson, Repository was able to secure additional financing from an unrelated lender in October 2004 in the amount of over $200,000.

Nelson purchased the bank debt in 2006, becoming Repository's sole secured creditor. Immediately afterward, he sent a letter to Repository's board demanding that past-due interest payments on Repository's $2 million in debt (nearly $510,000) be made current within 15 days, failing which he considered an act of default to have occurred. Repository responded by filing for chapter 11 protection in Illinois on April 25, 2006.

Nelson moved to dismiss the chapter 11 case as having been filed in bad faith, contending, among other things, that Repository could not effectuate a chapter 11 plan, that there was a continuing loss to or diminution of the estate during the bankruptcy, and that Repository's assets and business had been grossly mismanaged. More specifically, Nelson alleged that the Emersons breached their fiduciary duties by "authorizing exorbitant salaries and benefits for themselves when the company was insolvent." He also claimed that the company filed for chapter 11 protection "with the sole purpose of preventing [Nelson] from potentially exercising his state court rights" and that "evidence of self dealing and mismanagement suggest[s] a filing other than in good faith." Finally, Nelson contended that the bankruptcy filing was undertaken in bad faith because it risked damaging Repository's "single most valuable asset"—its reputation among customers in the software community. Repository responded by suing to have Nelson's secured claims either recharacterized as equity or equitably subordinated.

Consolidating the trials on both matters, the bankruptcy court granted Nelson's motion to dismiss in February 2007. The ruling, however, was based solely on Repository's inability to confirm a feasible chapter 11 plan, given the court's decision to recharacterize only $240,000 of the debt to Nelson as equity. The court explicitly rejected Nelson's other arguments, stating, among other things, that Nelson had not proved the existence of any continuing loss to or diminution of the estate or any mismanagement, and that "the bankruptcy filing cannot be held to be in bad faith."

Both Nelson and Repository appealed to the district court, which affirmed the bankruptcy court's ruling in full. In doing so, the court rejected Nelson's contention that language in the bankruptcy court's opinion that "the bankruptcy filing [could] not be held to be in bad faith" should be stricken as dicta. According to the district court, the "language [was] part of the Bankruptcy Court's holding because Nelson based his dismissal motion on [Repository's] bad faith." One month after Repository's chapter 11 case was dismissed, a receiver was appointed for the company's assets. The receiver later approved the sale of all of Repository's assets (including causes of action) to Nelson.

In May 2007, Nelson sued the Emersons in Delaware state court for breach of their fiduciary duties to Repository. According to the complaint, the Emersons breached their fiduciary duties by: (i) paying themselves excessive compensation while Repository was insolvent; and (ii) causing the company to file for chapter 11. The Emersons moved to dismiss the complaint on the grounds of collateral estoppel, arguing that the very same issues raised by Nelson in the complaint had already been adjudicated by the bankruptcy and district courts.

## THE CHANCERY COURT'S RULING

The Delaware Chancery Court (in an unpublished opinion) ruled in favor of the Emersons. Nelson claimed that collateral estoppel does not apply because the only issue essential to the district court's ruling was that Repository could not effectively reorganize, and the rest of the court's findings were therefore dicta. He also contended that the bad-faith filing issue before the Delaware court was not the same issue determined by the bankruptcy court because the legal standards are different. The Chancery Court rejected both arguments. According to the court, the bankruptcy and district courts specifically addressed Nelson's bad-faith filing and excessive-compensation claims, and their findings on those issues were both necessary and essential components of their rulings.

The Chancery Court also rejected Nelson's argument that his claims cannot be precluded because the legal standard employed by the bankruptcy court in determining that Repository's chapter 11 filing was not made in bad faith is different from the standard used by Delaware courts to evaluate a breach-of-fiduciary-duty claim. It concluded with the following observation:

> [T]he directors of a Delaware corporation do not commit a breach of fiduciary duty if they have the corporation file a non-frivolous claim, seeking to recharacterize certain debt to equity in order to protect the interests of the company's equity holders. In such a circumstance, the non-frivolous, good faith nature of the lawsuit makes filing that lawsuit a decision that is protected by the business judgment rule. To hold that this sort of decision is a basis for director liability if the company loses in Bankruptcy Court would discourage directors from exercising their business judgment by subjecting them to a judicially invented English Rule that makes them personally liable for the winner's costs and damages simply because of an adverse judgment.

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*Nelson v. Emerson*, 2008 WL 1961150 (Del. Ch. May 6, 2008).


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