JONES DAY®

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 7 ▪ NO. 5 ▪ SEPTEMBER/OCTOBER 2008

BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

DELAWARE BANKRUPTCY COURT DENIES DEBTORS THE ABILITY TO ASSUME AND REJECT INDIVIDUAL LEASES UNDER A MASTER LEASE AGREEMENT

Mark A. Cody and Timothy Hoffmann

In almost all large chapter 11 cases where a debtor leases significant amounts of real property, the debtor's ability to assume or reject its unexpired leases plays a significant role in the restructuring of the debtor's business operations. The ability to assume necessary leases, while at the same time eliminating future obligations under leases that are not essential to the debtor's reorganization, provides the debtor with significant flexibility when formulating a financial restructuring plan. Generally, bankruptcy courts show great deference to a debtor's business judgment when the debtor decides to assume or reject an unexpired lease. As such, courts rarely prevent a debtor from assuming or rejecting an unexpired lease, if the debtor has demonstrated a sound business reason for the decision.

As evidenced by a ruling recently handed down by a Delaware bankruptcy court in *In re Buffets Holdings, Inc.*, however, a debtor's discretion to assume or reject its unexpired leases may not exist in situations where an individual lease is part of a master agreement. Instead, a debtor may need to determine whether to assume or reject the master agreement as a whole, rather than each agreement on an individual basis. This was the result in the *Buffets Holdings* case, where the debtors eventually rejected two master lease agreements after the bankruptcy court prevented the debtors from assuming or rejecting the individual leases contained under those master agreements. As a result, it is important for a debtor to carefully review its rights and obligations under master agreements when formulating a plan to restructure its business operations.

THE *BUFFETS HOLDINGS* DECISION

The *Buffets Holdings* debtors operate a large steak-buffet restaurant chain, which includes more than 600 company-operated restaurants. Prior to seeking chapter 11 relief in Delaware in January 2008, the *Buffets Holdings* debtors participated in a series of financial restructuring transactions that ultimately allowed them to refinance their secured debt and issue a dividend to their shareholders. The financial restructuring included a sale/leaseback transaction that involved 29 of the debtors' restaurant locations. As part of this sale/leaseback transaction, the debtors entered into certain master lease agreements that governed the debtors' leases on their individual restaurant locations. After their chapter 11 filing, the *Buffets Holdings* debtors, in an attempt to streamline their operations, sought to assume and reject certain individual leases without assuming or rejecting the related master lease agreements that governed the individual leases. In response, FP1 LLC and FP2 LLC, the debtors' landlords under the master lease agreements, filed objections and argued that the debtors could not separate the individual leases from their respective master lease agreements and therefore had to assume or reject the master lease agreements as a whole. After considering the parties' respective positions, the bankruptcy court agreed with the landlords' position.

In reaching its decision, the bankruptcy court initially noted that when a debtor attempts to assume an unexpired lease, the debtor must assume the lease in its entirety. Stated otherwise, a debtor cannot retain and enforce portions of a lease that the debtor views as favorable, while rejecting the remaining, unfavorable portions of the lease. In situations where an individual lease contains separate, severable agreements, however, a debtor may determine which individual agreements to assume and which individual agreements to reject. Thus, the *Buffets Holdings* debtors' ability to assume or reject their individual leases hinged on whether the bankruptcy court viewed the individual leases as separate agreements, as opposed to mere components of the master lease agreements.

In addressing the question of whether the master lease agreements constituted single integrated contracts, the bankruptcy court, citing numerous other bankruptcy and district court decisions, determined that it must apply state, rather than federal, law. After a brief review of the relevant state law, the *Buffets Holdings* court determined that the "intent of the parties" governed whether the master lease agreements were single, integrated contracts and that, absent some form of ambiguity in the master lease agreement, the agreement's plain language provided the best evidence of the debtors' and the landlords' intent. The court found that the master lease agreement was not ambiguous, and it therefore focused its analysis on the plain language of the master lease agreement.

If applied broadly, the *Buffets Holdings* decision likely will have a significant impact on almost any chapter 11 case in which a debtor is party to master agreements.

In its analysis, the bankruptcy court initially addressed what the debtors and the official committee of unsecured creditors perhaps viewed as their strongest evidence — that the total rent due under the master lease agreements was apportionable to the individual leases contained thereunder. Both the debtors and the creditors' committee argued that the apportionment of rent was a "critical" factor in demonstrating that the parties intended the individual leases to be severable from the master lease agreements. In support of their argument, the debtors and the creditors' committee cited to both state and bankruptcy court decisions holding that contracts are divisible when one party's performance consists of separate and distinct components, and the consideration transferred under the contract is apportionable to the individual components contained within the contract.

The bankruptcy court, while acknowledging that the ability to apportion consideration under a master agreement is a potential factor that a court may consider, decided that the apportionment of rent under the master lease agreements was not a conclusive factor. It reasoned that, standing alone, the apportionment of payments among individual components was not always determinative of whether parties intended to treat a contract as divisible. In reaching this determination, the bankruptcy court cited the Seventh Circuit's 2006 decision in *In re United Airlines, Inc.*, in which the court of appeals held that an agreement to lease space at an airport and to repay certain bond debt was a single integrated contract, even though the agreement provided for separate payments on account of the lease obligation and the bond debt. The Seventh Circuit's holding relied on the fact that, despite the apportionment of payments between the lease obligation and the bond debt, the parties to the agreement would not have entered into the agreement if it did not include both the lease and the bond components.

In addition to the payment provisions, the *Buffets Holdings* debtors and the creditors' committee also cited to other provisions in the agreements in an attempt to demonstrate that the master agreements were divisible. For example, the debtors and the creditors' committee cited to several provisions within the master agreements that allowed the underlying mix of individual leases to change under certain, specific circumstances. The bankruptcy court, once again disagreeing with the debtors' and the committee's position, found that the fact that the mix of individual leases governed by the master agreements may change under certain circumstances did not indicate that the parties intended the individual leases to be separate agreements under all circumstances.

Similarly, the creditors' committee cited to other provisions in the master lease agreements that, in the event of a tenant default under an individual lease, permitted the landlords to seek remedies under either the individual lease or the master lease agreements as a whole. Rather than characterize these provisions as evidence that the parties intended to sever the individual leases, however, the *Buffets Holdings* court decided that it was customary for contracts to allow a party flexibility in choosing what remedies to pursue in the event of default. In support of its conclusion that the parties intended the master lease agreements to constitute single, integrated contracts, the court cited to provisions in the master lease agreements that held individual tenants liable not only for the lease payments under their individual leases but also the aggregate amount of payments under all of the individual leases covered by the master lease agreements. In addition, the master lease agreements required the continued payment of the total rent due thereunder, even in the event of the destruction of one or more of the individual leased locations.

The committee attempted to argue that such provisions constituted "cross-default" provisions that were invalid under relevant bankruptcy law. The bankruptcy court, however, decided that the individual leases were "economically interdependent," and as a result, the provisions with respect to the payment of the aggregate amounts due under the master lease agreement were valid. Further, because the individual leases were "economically interdependent," the bankruptcy court concluded that the landlords' economic interest was in the aggregate package of leases and thus, allowing the debtors to assume or reject leases on an individual basis would deny the landlords the benefit of their bargain.

Finally, while the *Buffets Holdings* court based its holding upon the plain language of the master lease agreements, the court also examined the course of prior dealings between the debtors and the landlords. From this examination, the bankruptcy court determined that the negotiations between the parties provided further evidence that the parties intended the master lease agreements to be indivisible. Specifically, the bankruptcy court noted that the landlords insisted on the master lease structure, and the debtors agreed to it to obtain favorable lease terms and to gain treatment of the leases as "operating leases" for accounting purposes. Thus, the *Buffets Holdings* court decided that even if the master lease agreements had been ambiguous, the course of dealings between the parties indicated their intent to treat the agreements as single, integrated contracts.

THE RAMIFICATIONS OF THE *BUFFETS HOLDINGS* DECISION

The flexibility to restructure a debtor's operations through the assumption or rejection of executory contracts and unexpired leases often is one of the primary benefits a business receives from a chapter 11 filing. As a result, if applied broadly, the *Buffets Holdings* decision likely will have a significant impact on almost any chapter 11 case in which a debtor is party to master agreements.

The 2005 amendments to section 365(d)(4) of the Bankruptcy Code, which establishes the deadline for a debtor to assume or reject a nonresidential real property lease, already have forced debtors to decide whether to assume or reject their unexpired leases on a significantly expedited basis. As a result of the 2005 amendments, debtors with a large number of real property leases must now perform a significant amount of prepetition planning with respect to the restructuring of their operations prior to the petition date. The level of planning required is even greater, however, for debtors that are party to a significant number of leases subject to a master agreement. In this scenario, a debtor must analyze its leases both individually and on a master lease basis in light of the *Buffets Holdings* decision.

The *Buffets Holdings* decision also may limit a debtor's ability to renegotiate more favorable lease terms with a lessor prior to a bankruptcy. Typically, a debtor may use its ability to assume or reject an unexpired lease within a bankruptcy case as leverage to renegotiate the lease to obtain more favorable terms. This negotiation often occurs as part of an attempted out-of-court restructuring and is most effective in scenarios where it is in the lessor's economic interests to ensure a continued stream of payments under a lease, even if such payments are in an amount less than originally negotiated. In situations involving a master lease agreement, however, the *Buffets Holdings* decision may reduce significantly a debtor's leverage to renegotiate an individual unexpired lease, because the debtor would have to assume or reject the master agreement as a whole. As a result, a landlord may be much less flexible in terms of renegotiating the economic terms of an individual lease that is part of a master agreement.

The *Buffets Holdings* decision also may have ramifications after a debtor has filed a bankruptcy petition. For example, in the context of a retail chapter 11 case, the ruling may significantly limit a debtor's ability to shed unprofitable lease locations subject to a master lease agreement through the rejection of individual leases. The impact of the decision is not limited to the retail industry, however, and would have a similar impact on almost any other chapter 11 debtor whose individual leases are part of a master agreement.

In conclusion, the *Buffets Holdings* opinion could have far-reaching implications for bankruptcy and nonbankruptcy practitioners alike. Nonbankruptcy practitioners and business professionals should take note of the bankruptcy court's decision when structuring leasing arrangements. How these agreements are structured will have a direct impact on the ability of a company to utilize the benefits of section 365 of the Bankruptcy Code in the event of a future bankruptcy filing. In turn, once a company finds itself in financial distress, restructuring professionals should review all master lease/contract arrangements to determine whether the agreements are severable in light of the *Buffets Holdings* decision. Further, restructuring professionals should assess the economic impact on the company's business in the event a bankruptcy court were to follow the *Buffets Holdings* ruling.

In re Buffets Holdings, Inc., 387 B.R. 115 (Bankr. D. Del. 2008).

In re United Airlines, Inc., 453 F.3d 463 (7th Cir. 2006).

NEWSWORTHY

The Turnaround Management Association will present ***Corinne Ball (New York)*** with its 2008 "International Turnaround Company of the Year" Award at the 2008 TMA Convention in New Orleans on October 29 for her work as lead counsel for Dana Corporation in the restructuring of the company and its affiliates. Other members of the Jones Day team of professionals that represented Dana include ***Heather Lennox (Cleveland)***, ***Jeffrey B. Ellman (Atlanta)***, ***Richard H. Engman (New York)***, ***Pedro A. Jimenez (New York)***, ***Robert W. Hamilton (Columbus)***, ***Brett J. Berlin (Atlanta)***, ***Veerle Roovers (New York)***, ***Carl E. Black (Cleveland)***, ***Ryan T. Routh (Cleveland)***, and ***Thomas A. Wilson (Cleveland)***.

David G. Heiman (Cleveland), ***Corinne Ball (New York)***, ***Heather Lennox (Cleveland)***, and ***Aldo L. LaFiandra (Atlanta)*** were included in the 2009 edition of "The Best Lawyers in America" in the practice field "Bankruptcy and Creditor-Debtor Rights Law." Mr. Heiman and Ms. Ball have been awarded that designation each year for the last 25 and 10 years, respectively.

Richard H. Engman (New York) sat on a panel discussing "Claims Trading: Implications for the Chapter 11 Process, Pitfalls for the Claims Trader" on September 27 at the National Conference of Bankruptcy Judges' annual meeting in Scottsdale, Arizona. On October 24, he will preside over a discussion entitled "Buying a Distressed or Bankrupt Company" at the 24th Annual Advanced ALI-ABA Corporate Mergers and Acquisitions Course of Study in New York.

An article written by ***Corinne Ball (New York)*** and ***Chip MacDonald (Atlanta)*** entitled "Bank Failures Create Attractive Opportunities" was featured in the "Distressed Mergers & Acquisitions" column of the August 28 edition of the *New York Law Journal*.

Tobias S. Keller (San Francisco) gave a presentation to the Cyberspace Committee of the Business Law Section of the State Bar of California on August 5 entitled "Current Developments Under the Uniform Commercial Code and the Bankruptcy Code for the Cyberspace Lawyer." On September 25, he sat on a panel discussing "Repos and Swaps and Derivatives" at the Fall Meeting of the ABA Committee on Business Bankruptcy in Scottsdale, Arizona.

Daniel P. Winikka (Dallas) spoke on a panel discussing issues for directors of financially distressed companies at a meeting of the National Association of Corporate Directors in Denver on September 10.

Corinne Ball (New York) moderated a panel discussion regarding "Feasibility: Delphi, Dura and Solutia: The Impact of DIP Loans, Exit Financing and Emerging from Chapter 11" on September 26 at the National Conference of Bankruptcy Judges' annual meeting in Scottsdale, Arizona.

Tobias S. Keller (San Francisco) participated in a panel discussion entitled "Don't Be a Stranger in a Strange Land — Chapter 11 Explained" at the 81st Annual Meeting of the State Bar of California on September 27 in Monterey, California.

An article written by ***Jeffrey B. Ellman (Atlanta)*** and ***Mark G. Douglas (New York)***, entitled "Supreme Court 'Bright-Line' Ruling on Scope of Chapter 11 Transfer Tax Exemption Is Bad News for Pre-Confirmation Asset Sales In Bankruptcy," was published in the September 2008 edition of *Pratt's Journal of Bankruptcy Law*. Their article entitled "Court's Piccadilly Decision Draws Bright Line" appeared in the July 11 edition of *Bankruptcy Law360*.

An article written by ***Nathan Lebioda (New York)*** and ***Mark G. Douglas (New York)***, entitled "*Cooper Commons* Carve-Out, A Cautionary Tale," appeared in the August 15 edition of *Bankruptcy Law360*.

OVERSECURED CREDITOR ENTITLED TO DEFAULT INTEREST IF COLLATERAL SOLD UNDER SECTION 363(b)

Mark G. Douglas

An oversecured creditor's right to interest, fees, and related charges as part of its allowed secured claim in a bankruptcy case is well established in U.S. bankruptcy law. Less clear, however, is whether that entitlement encompasses interest at the default rate specified in the underlying contract between the creditor and the debtor. The answer to that question can be a thorny issue in chapter 11 cases because the Bankruptcy Code provides that a chapter 11 plan may cure and reinstate most defaulted obligations, and courts disagree as to whether the power to cure defaults nullifies all consequences of default, including the obligation to pay default interest. The Ninth Circuit Court of Appeals recently had an opportunity to examine the interplay between these seemingly incongruous provisions of the Bankruptcy Code. In *General Elec. Capital Corp. v. Future Media Productions, Inc.*, the court reversed a bankruptcy court order disallowing default interest and costs as part of the claim of a secured creditor whose collateral was sold by the debtor outside of a chapter 11 plan, ruling that the court erred by applying the Bankruptcy Code's plan confirmation provisions in a situation where cure and reinstatement of the secured creditor's debt was neither contemplated nor possible.

ALLOWANCE OF DEFAULT INTEREST AS COMPONENT OF ALLOWED SECURED CLAIM

Debts and other obligations, secured or otherwise, are generally classified as "claims" in the Bankruptcy Code. This means that a secured obligation may give rise to both a secured claim, to the extent that the value of any property securing it is equal to or greater than the face amount of the underlying debt, and an unsecured claim, to the extent of any deficiency in the collateral value. In accordance with section 506(a) of the Bankruptcy Code, the value of the debtor's interest in assets securing a debt determines whether the debt gives rise to an allowed secured claim, an allowed unsecured claim, or both.

If a creditor turns out to be "oversecured" because its collateral value exceeds the face amount of the underlying debt, section 506(b) provides that it may recover interest and related costs as part of its allowed secured claim:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

Although the provision clearly expressly refers to "interest on such claim . . . provided for under the agreement or State statute," it does not specify whether any distinction should be made between ordinary and default rate interest. Most courts, consistent with the Supreme Court's 1989 ruling in *United States v. Ron Pair Enterprises, Inc.*, have allowed (or at least recognized a presumption of allowability for) default interest provided in a contract as part of a secured creditor's claim, provided the rate is not unenforceable under applicable nonbankruptcy law. As discussed below, however, some courts have concluded otherwise if the debtor proposes to "cure" the obligation as part of its chapter 11 plan.

CURE OF DEFAULTED OBLIGATIONS UNDER A CHAPTER 11 PLAN

As a general rule, contract law does not give a party in breach or default of a contract the right to rectify, or "cure," its breach or default absent the express agreement of the parties. The Bankruptcy Code changes this rule under certain circumstances. Section 1123(a)(5)(G) states that a proposed chapter 11 plan shall "provide adequate means for the plan's implementation, such as . . . curing or waiving of any default." As it applies to claims (as distinguished from executory contracts and unexpired leases), the cure concept also appears in the statute's provision regarding the concept of "impairment." Specifically, section 1124(2) provides that a class of claims is "impaired" under a plan (and therefore entitled to vote to accept or reject it) unless the plan, "notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment of such claim or interest after the occurrence of a default," (i) cures any such default, (ii) reinstates the maturity of the claim, and (iii) compensates the claimant for any damages incurred in reasonably relying on such contractual provision or such applicable law.

The reasoning of *Future Media* confines the default-rate interest debate to situations involving cure under section 1124(2). Still, the ruling does little to resolve a thorny issue in bankruptcy jurisprudence that has persisted for nearly 15 years.

Some courts, following the approach articulated in the Ninth Circuit's 1988 ruling *In re Entz-White Lumber & Supply, Inc.*, have held that, because curing a default nullifies its consequences, a debtor curing a default as part of its chapter 11 plan need pay interest on the outstanding obligation only at the pre-default rate specified in the governing contract. This approach, however, represented the minority view even before 1994, when Congress added section 1123(d) to the Bankruptcy Code to prevent mortgagees from realizing a windfall at the expense of unsecured creditors by forcing debtor-homeowners who wished to cure defaults to pay the bulk of their income to satisfy the secured creditor's claims for mortgage arrears and related charges. Section 1123(d) (which closely tracks a similar provision in chapter 13) provides that:

> Notwithstanding subsection (a) of this section and sections 506(b), 1129(a)(7), and 1129(b) of this title, if it is proposed in a plan to cure a default the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

On its face, the provision would appear to overrule the *Entz-White* approach. Even so, some courts have ruled even after the enactment of section 1123(d) that a debtor need pay only pre-default interest to cure and render a defaulted obligation unimpaired under a chapter 11 plan in accordance with section 1124(2). The Ninth Circuit recently had an opportunity to revisit the continued vitality of its approach on this issue in *Future Media*.

FUTURE MEDIA

Multimedia accessory manufacturer Future Media Productions, Inc. ("Future Media"), entered into a loan agreement in 2004 with General Electric Capital Corporation ("GECC"). Under the agreement, GECC provided the company with a term loan in the amount of $10.5 million and a revolving line of credit in the amount of $5 million. The loan bore pre-default interest at an index rate plus 1.5 percent per annum, with default interest to accrue at an additional 2 percent per annum. The loan agreement also obligated Future Media to pay attorneys' fees and costs incurred by GECC in enforcing its rights under the contract.

Future Media defaulted on the loan in March 2005, after which default interest commenced to accrue. Concluding that an orderly liquidation of its assets was the best option, Future Media filed for chapter 11 protection on February 16, 2006, in California. The bankruptcy court later approved an agreement with GECC (which was oversecured) permitting the company to use GECC's cash collateral, but reserved for later determination any final decision on whether the allowed amount of its secured claim would include interest at the default rate and related costs. Shortly afterward, the debtor was authorized to sell substantially all of its assets in a sale conducted under section 363(b) of the Bankruptcy Code. The court ultimately ruled that GECC was entitled to interest at the pre-default rate only and that it was not entitled to attorneys' fees or costs. In doing so, it relied on *Entz-White* as authority for limiting GECC's claim. GECC appealed directly to the Ninth Circuit Court of Appeals.

THE NINTH CIRCUIT'S RULING

The Ninth Circuit reversed. Citing the Supreme Court's 2007 ruling in *Travelers Cas. & Sur. Co. of Amer. v. Pac. Gas & Elec. Co.* for the proposition that creditor entitlements in bankruptcy arise from underlying substantive laws creating the debtor's obligations, the court of appeals reasoned that a default rate of interest should be enforced "subject only to the substantive law governing the loan agreement, unless a provision of the Bankruptcy Code provides otherwise." In this case, the Ninth Circuit concluded that neither applicable state law nor the Bankruptcy Code prohibited GECC from receiving default interest as part of its allowed secured claim.

The court of appeals declined to decide whether *Entz-White* was overruled by section 1123(d). Even so, it faulted the bankruptcy court's reliance on the ruling. *Entz-White*, the Ninth Circuit emphasized, involved cure of a defaulted obligation under section 1124(2) to render the claim unimpaired for purposes of voting on a chapter 11 plan, rather than a section 363(b) sale of collateral and payment of a secured creditor's claim from the proceeds. It rejected as uncompelling other court rulings that have transposed principles applied in connection with section 1124(2) to circumstances involving the sale of a secured creditor's collateral under section 363(b), concluding that nothing in the statute precludes payment of default interest as part of the creditor's allowed secured claim:

> Because the Bankruptcy Code does not provide a "qualifying or contrary provision" to the underlying substantive law here, the bankruptcy court's extension of *Entz-White* to the loan agreement's default rate was error. Consistent with the Supreme Court's holding in *Travelers*, we hold that the parties' arms length bargain, governed by New York law, controls.

ANALYSIS

The reasoning of *Future Media* confines the default-rate interest debate to situations involving cure under section 1124(2). Still, the ruling does little to resolve a thorny issue in bankruptcy jurisprudence that has persisted for nearly 15 years. Moreover, reconciling an approach that awards default interest (and related costs) to an oversecured creditor, unless the debtor is proceeding toward confirmation of a chapter 11 plan that proposes to cure the secured obligation, is no easy matter, particularly when it would appear to contradict the express language of section 1123(d). Many courts confronted with the incongruity of *Entz-White* with section 1123(d) have chosen to side-step the issue or to fashion creative rationales, tenable or otherwise, for retaining a legal approach that is undoubtedly popular with debtors intent upon avoiding the contractual consequences of default in a bankruptcy case. For example, in *In re Sweet*, a Colorado bankruptcy court concluded that section 1123(d) does not abrogate the *Entz-White* line of cases because the provision does not apply in all circumstances, such as the one before it, where no right to cure existed under either the underlying promissory note or applicable state law absent initiation of foreclosure proceedings. *Future Media* continues in that vein.

General Elec. Capital Corp. v. Future Media Productions, Inc., 536 F.3d 969 (9th Cir. 2008).

Great W. Bank & Trust v. Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.), 850 F.2d 1338 (9th Cir. 1988).

United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989).

In re Sweet, 369 B.R. 644 (Bankr. D. Col. 2007).

Travelers Cas. & Sur. Co. of Amer. v. Pac. Gas & Elec. Co., 127 S. Ct. 1199 (2007).

In re Zamani, 390 B.R. 680 (Bankr. N.D. Cal. 2008).

CONTRACT REJECTION CLAIMS ELIGIBLE FOR SETOFF UNDER SECTION 553: REJECTING THE *DELTA* APPROACH

Timothy Hoffmann and Mark G. Douglas

A creditor's ability in a bankruptcy case to exercise rights that it has under applicable law to set off an obligation it owes to the debtor against amounts owed by the debtor to it, thereby converting its unsecured claim to a secured claim to the extent of the setoff, is an important entitlement. Setoff rights are generally preserved in a bankruptcy case under section 553 of the Bankruptcy Code. The provision, however, does not create a setoff right, but provides merely that the Bankruptcy Code shall not "affect" setoff rights that exist under applicable nonbankruptcy law as of the bankruptcy petition date. A Delaware bankruptcy court recently had an opportunity to consider whether a claim arising from the rejection in bankruptcy of a prepetition contract, which the Bankruptcy Code designates a prepetition claim, can be set off against the nondebtor contract party's prepetition obligation to the debtor. In *CDI Trust v. U.S. Electronics, Inc. (In re Communication Dynamics, Inc.)*, the court ruled that the setoff was appropriate, adopting the majority view on the issue and repudiating a competing (and widely criticized) approach taken by a New York bankruptcy court in its 2006 ruling in *In re Delta Airlines*.

SETOFFS AND THE RELATION-BACK RULE

Section 553 of the Bankruptcy Code provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ." A creditor is precluded by the automatic stay from exercising its setoff rights without bankruptcy court approval. The stay, however, merely suspends the exercise of setoff pending an orderly examination of the respective rights of the debtor and the creditor by the court, which will generally permit the setoff if the requirements (including mutuality) under applicable law are met, except under circumstances where it would be inequitable to do so. By contrast, if there is a right of recoupment (*i.e.*, where mutual obligations arise under the same contract), the exercise of the right does not require court authority and the automatic stay does not apply.

By its terms, section 553 is limited to mutual obligations arising prior to a bankruptcy filing. By operation of sections 365 and 502 of the Bankruptcy Code, this would appear to include claims for damages arising from the rejection by a chapter 11 debtor-in-possession or bankruptcy trustee of any prepetition contract or agreement that qualifies as "executory." Specifically, section 365(g) provides that the rejection of an executory contract is deemed to constitute a breach of that contract as of the date immediately prior to the filing of the bankruptcy petition. Section 502(g) provides that a claim arising from the rejection of "an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed . . . or disallowed . . . the same as if such claim had arisen before the date of the filing of the petition." This concept is sometimes referred to as the "relation-back rule."

Even so, at least one court has determined that section 553 prohibits setoffs involving executory contract rejection damage claims. In *In re Delta Airlines, Inc.*, a New York bankruptcy court, emphasizing that section 553 expressly and unambiguously precludes any other section of the Bankruptcy Code from "affecting" the right of setoff that a creditor may have as of the petition date, concluded that sections 365(g) and 502(g) of the Bankruptcy Code cannot be considered in deciding whether a creditor may utilize a rejection damages claim for the purposes of setoff. In other words, according to the *Delta* court, if a setoff right does not exist under nonbankruptcy law as of the bankruptcy petition date, no setoff right is preserved or created by section 553.

This holding has been widely criticized as being contrary to the express language of the Bankruptcy Code and the principles underpinning section 553. According to some commentators, there is no sound justification for concluding that lawmakers intended to exempt from section 553 claims expressly designated as arising prepetition by operation of sections 365(g) and 502(g). The gist of the criticism is that: (i) sections 365(g) and 502(g) do not create contract rejection damage claims — such claims arise when a contract is executed, although they are "contingent" or "unmatured" until the contract is breached (such as upon rejection in a bankruptcy case); and (ii) section 553 does not require a creditor to have a right of setoff that could be exercised under state law at the time the bankruptcy case is commenced — if a creditor on the petition date holds an unmatured or contingent claim that later matures or becomes fixed such that the creditor has a right of setoff under state law, section 553 should apply to recognize the right. The bankruptcy court in *Communication Dynamics* also rejected the *Delta* court's approach.

COMMUNICATION DYNAMICS

On May 8, 2002, Communication Dynamics, Inc. ("CDI"), the parent of the cable television products distributor TVC Communications Inc. ("TVC"), and its subsidiary, US Electronics, Inc. ("USE"), entered into an asset purchase agreement with USE Acquisition, LLC (now referred to as "ICX"). Under the asset purchase agreement, ICX purchased certain business assets of USE for which it paid $20 million in cash and delivered two notes (the "USE Notes") in the aggregate face amount of $5 million. Twelve days later, ICX, CDI, and TVC executed a distribution agreement whereby TVC obtained the exclusive right to market and committed to purchase a minimum amount of the product manufactured by ICX. Under the same distribution agreement and the USE Notes, ICX gave TVC a 25-cent discount for each unit it sold. This discount was credited against the principal owed by ICX under the USE Notes.

Four months afterward, CDI and six of its affiliates, including TVC (collectively, the "debtors"), filed for chapter 11 protection in Delaware. ICX expressed concern about TVC's ability to comply with the distribution agreement. Due to the size of the cure payment necessary to satisfy TVC's anticipated obligations under the distribution agreement (approximately $1.3 million), the debtors decided to reject the agreement. ICX subsequently asserted a secured proof of claim in the amount of approximately $4.8 million and an unsecured claim in the amount of approximately $10.1 million. According to ICX, the secured claim represented the portion of its rejection damages subject to setoff against the sums it owed the debtors under the USE Notes.

The bankruptcy court confirmed the debtors' joint chapter 11 plan in May 2004. The plan called for the debtors to transfer certain property and rights, including the USE Notes, to a liquidating trust (the "Trust") created for the benefit of creditors. The trustee sued ICX for amounts allegedly due under the USE Notes, seeking, among other things, a declaratory judgment that ICX had no right of setoff based upon its contract rejection claim.

No other court has followed *Delta*'s pronouncements concerning the invalidity of setoffs involving contract rejection claims. The reasoning of *Communication Dynamics* is more consistent with the application of section 553. For now, the *Delta* court's approach on section 553 and rejection damage claims is in the distinct minority.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court ruled in favor of ICX. In doing so, the court expressly rejected the approach articulated in *Delta*. At the outset, the court noted that because the bankruptcy court in *Delta* determined that the obligation asserted to give rise to a right of setoff did not even constitute a debt, such that it could not be a claim in bankruptcy, the court's conclusion with respect to the setoff issue was nothing more than dicta. Still, the bankruptcy court rejected as unpersuasive the *Delta* court's basic premise regarding section 553's preclusion of offset rights from extending to rejection damages claims. According to the court in *Communication Dynamics*, a literal interpretation of the term "affecting," as used by the *Delta* court, could lead to absurd and unintended results, such as: (i) the elevation of rejection damages to administrative-expense status, in direct contravention of congressional will as expressed in section 365(g); and (ii) precluding a landlord from setting off a prepetition security deposit against its rejection damages claim.

The bankruptcy court in *Communication Dynamics* generally agreed with ICX's reasoning, holding that the language of section 553 is ambiguous and must be considered together with other provisions of the Bankruptcy Code, such as sections 365(g), 502(g), and 101 (the last defining "debt" and "claim" broadly to include unmatured, contingent, disputed, and unliquidated claims). Viewed in conjunction, the court concluded, these provisions mandate that a rejection damages claim is a prepetition claim subject to setoff against any prepetition debt owed by the creditor to the debtor. It also articulated a second rationale for its conclusion – namely, that section 553 references the Bankruptcy Code for determining when a claim arises, but the Bankruptcy Code looks to state law to determine the substance of that claim. Sections 365(g) and 502(g), the court emphasized, do not actually affect the substance of a claim, but only specify when a given rejection damages claim arises. Therefore, the court concluded, section 553's preclusion of any Bankruptcy Code provision "affecting" a setoff right under applicable nonbankruptcy law is not meant to apply to sections 365(g) and 502(g).

OUTLOOK

No other court has followed *Delta*'s pronouncements concerning the invalidity of setoffs involving contract rejection claims. The reasoning of *Communication Dynamics* is more consistent with the application of section 553. For now, the *Delta* court's approach on section 553 and rejection damage claims is in the distinct minority.

CDI Trust v. U.S. Elec., Inc. (In re Commun. Dynamics, Inc.), 382 B.R. 219 (Bankr. D. Del. 2008).

In re Delta Airlines, Inc., 341 B.R. 439 (Bankr. S.D.N.Y. 2006).

RULING CONFIRMING PRIMACY OF FEDERAL BANKRUPTCY LAW OVER STATE LAW PROHIBITING ASSIGNMENT OF INSURANCE POLICIES GOOD NEWS FOR CHAPTER 11 PLAN ASBESTOS TRUSTS

Benjamin Rosenblum

Over the last few decades, many companies have been inundated with claims for personal injury, wrongful death, or property damage relating to the presence of, or exposure to, asbestos or asbestos-containing products. More than a few otherwise viable companies have buckled under the weight of these claims, and several of them have turned to bankruptcy as a means of addressing and managing their asbestos-related liabilities. One of the mechanisms available to a company seeking to address its asbestos liabilities is the creation of an asbestos trust through the confirmation of a chapter 11 plan of reorganization. Once such a trust is established, asbestos claims are channeled to the trust, and claimants are typically enjoined from taking any action to recover on any asbestos-related claim other than through the trust's claims-resolution procedures.

In addressing asbestos liabilities, whether in bankruptcy or otherwise, disputes between the company and its insurers are common, if not inevitable. In *In re Federal-Mogul Global Inc.*, a Delaware bankruptcy court was recently tasked with resolving a dispute between the debtor and its insurers. The issue was whether assignment of asbestos insurance policies to an asbestos trust established under section 524(g) of the Bankruptcy Code is valid and enforceable against the insurers, notwithstanding anti-assignment provisions in (or incorporated in) the policies and applicable state law. Despite a Ninth Circuit ruling that could be interpreted to support the insurers' position, the bankruptcy court held that assignment of the insurance policies was proper because the Bankruptcy Code preempts any contrary contractual or state law anti-assignment provisions.

ASBESTOS TRUSTS IN BANKRUPTCY

Section 524(g) of the Bankruptcy Code, which was added to the statute in 1994, establishes a procedure for dealing with future personal-injury asbestos claims against a chapter 11 debtor. The procedure entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor. All claims based upon asbestos-related injuries are channeled to the trust. Section 524(g) was enacted in response to lawmakers' concerns that future claimants – persons who have been exposed to asbestos but have not yet manifested any signs of illness – are protected, and it recognizes that these claimants would be ill-served if asbestos companies are forced into liquidation. The statute contains detailed requirements governing the nature and scope of any injunction issued under section 524(g) in connection with the confirmation of a chapter 11 plan under which a trust is established to deal with asbestos claims. Almost every section 524(g) trust is funded at least in part by the proceeds of insurance policies that the debtor has in effect to cover asbestos or other personal-injury claims. The debtor's plan of reorganization typically provides for an assignment of both the policies and their proceeds to the trust. Such an assignment, however, may violate the express terms of the policies or applicable nonbankruptcy law.

THE ESTATE, THE PLAN, AND PREEMPTION

Section 541 of the Bankruptcy Code provides that the filing of a bankruptcy case creates an estate. With some exceptions, the estate comprises all legal or equitable interests of the debtor in property as of the commencement of the case. Specifically included within this estate are all "[p]roceeds . . . from property of the estate" and "[a]ny interest in property that the estate acquires after commencement of the case." The majority of courts have concluded that a debtor's insurance policies are property of the bankruptcy estate.

Section 1123 of the Bankruptcy Code provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, a plan shall . . . provide adequate means for the plan's implementation, such as . . . [a] transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan . . . ." Reading sections 541 and 1123 together, it would appear that despite any otherwise applicable nonbankruptcy law that provides otherwise, a plan may provide for the transfer of property of the estate, such as an insurance policy, to an entity such as an asbestos trust established under section 524(g).

However, section 1142 of the Bankruptcy Code, which generally addresses "implementation" of a chapter 11 plan, provides that "[n]otwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation *relating to financial condition*, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court." Section 1142, which was implemented in 1978 together with the rest of the Bankruptcy Code, has been construed to preempt only nonbankruptcy laws relating to financial condition.

In its 2003 ruling in *Pacific Gas & Electric Company v. California ex rel. California Dept. of Toxic Substances Control*, the Ninth Circuit Court of Appeals interpreted section 1123's preemption to be coextensive with section 1142's preemption. To reach this result, the Ninth Circuit relied on two presumptions: first, Congress would not lightly preempt state law, particularly in areas of traditional state regulation, and second, absent a clear indication to the contrary, Congress would not intend to drastically change bankruptcy law and practice from the law and practice under the Bankruptcy Act – the predecessor statute to the modern Bankruptcy Code. The precursor to section 1123 under the former Bankruptcy Act did not contain any preemptive language, and the preemptive language in section 1123 was added in 1984 pursuant to what were termed "technical" rather than substantive amendments. Because of this statutory history and context, and due to a general presumption that Congress does not undertake lightly to preempt state law, the Ninth Circuit interpreted the preemptive text of section 1123 to be no more broad than the already existing "notwithstanding" clause of section 1142 of the Bankruptcy Code, which, as noted, preempts only nonbankruptcy laws, rules, or regulations "relating to financial condition." Under this approach, a state law or contract provision prohibiting assignment of an insurance policy would not be preempted by contrary provisions in a chapter 11 plan.

THE BANKRUPTCY COURT'S RULING IN *FEDERAL-MOGUL*

The same issue was recently considered by the Delaware bankruptcy court overseeing the chapter 11 cases of international auto parts manufacturer Federal-Mogul Global Inc. and its 156 subsidiaries, which filed for chapter 11 protection in 2001. However, the bankruptcy court came to a different conclusion, ruling that under section 1123 of the Bankruptcy Code, the assignment of policy proceeds to an asbestos trust is not prohibited by anti-assignment provisions in insurance policies. In doing so, the court explicitly rejected the Ninth Circuit's interpretation in *Pacific Gas & Electric*. In the bankruptcy court's view, the plain language of section 1123 indicates that its preemptive scope is not limited to laws relating to financial condition. It also emphasized that section 1123, rather than other provisions of the Bankruptcy Code, was the controlling statutory provision under the circumstances.

According to the court, *Pacific Gas & Electric* squarely conflicts with the rationale of the Court of Appeals for the Third Circuit (which includes Delaware) in *In re Combustion Engineering, Inc.* and other courts that have considered the issue. Acknowledging that there is a presumption against preemption, the court explained that this presumption is overcome where Congress's desire to preempt state law is clear. The bankruptcy court emphasized that, when read according to its plain meaning, section 1123 expresses Congress's clear statement of intent to supersede all other laws, and an interpreting court is bound to consider first and foremost the plain statutory text. Put another way, Congress meant what it said.

The bankruptcy court further explained that it would be inappropriate to look to other sections of the Bankruptcy Code to limit the scope of section 1123. For instance, the insurers argued that section 363 of the Bankruptcy Code, which permits a debtor-in-possession to use, sell, or lease property of the estate "notwithstanding any provision in a contract, a lease, or applicable law that is conditioned on the insolvency or financial condition of the debtor," should control under the circumstances. The bankruptcy court rejected this argument as well as the similar argument (accepted by the Ninth Circuit in *Pacific Gas & Electric*) that section 1142's language should be imported into the section 1123 preemption analysis. According to the *Federal-Mogul* court, the controlling statutory provision is section 1123 — not section 363 or 1142 — and when Congress uses particular language in one section of a statute but omits it in another, the difference is presumed to manifest a purposeful and intentional distinction in meaning.

The insurers also argued that the insurance policies were executory contracts that could not be assigned under section 365 of the Bankruptcy Code. This argument too met with little success. The bankruptcy court concluded that the contracts were not executory (and section 365 therefore did not apply) because all premiums under the policies had been paid prepetition, and the remaining obligations under the policies (relating to cooperation, retrospective premiums, deductibles, and notice provisions) were ministerial in nature and did not render the policies executory.

ANALYSIS

The bankruptcy court's ruling in *Federal-Mogul* is a favorable development for companies wishing to address their asbestos liabilities through a chapter 11 plan of reorganization by means of the trust mechanism contained in section 524(g). Asbestos trusts, as creatures of federal law, act as successors to the debtor's asbestos liabilities. *Federal-Mogul* holds that insurance policies associated with these liabilities may be transferred to these specialized trusts notwithstanding state law anti-assignment clauses to the contrary. By promoting the transferability and utility of a bankruptcy estate's property, the holding should contribute to maximizing the value of a chapter 11 debtor's assets and may, as a result, increase recoveries for asbestos claimants. The obvious losers in this case are the debtors' prepetition insurers.

Although the *Federal-Mogul* court's reasoning focused primarily on the plain language of the statute, the court's interpretation of such language is not free from controversy. On the one hand, *Federal-Mogul* and certain of the authorities cited therein stand for the proposition that section 1123's preemption is broad by relying on the plain meaning of the statutory text. On the other hand, the Ninth Circuit's ruling in *Pacific Gas & Electric* construes the preemptive scope much more narrowly by interpreting section 1123 in light of its statutory history and context. Under *Federal-Mogul*'s interpretation, any applicable nonbankruptcy law is preempted, while under the Ninth Circuit's view, only nonbankruptcy law relating to financial condition is preempted. Given these conflicting authorities, the debate concerning the scope of section 1123 will undoubtedly continue, and how courts resolve the issue going forward will be extremely important both inside and outside the asbestos context.

In re Federal-Mogul Global Inc., 385 B.R. 560 (Bankr. D. Del. 2008).

Pac. Gas & Elec. Co. v. California ex rel. California Dept. of Toxic Substances Control, 350 F.3d 932 (9th Cir. 2003).

In re Combustion Engineering, Inc., 391 F.3d 190 (3d Cir. 2004).

ABSENCE OF ACTUAL HARM TO CREDITORS DEFEATS EQUITABLE SUBORDINATION BID

Mark G. Douglas

The power to alter the relative priority of claims due to the misconduct of one creditor that causes injury to others is an important tool in the array of remedies available to a bankruptcy court in exercising its broad equitable powers. By subordinating the claim of an unscrupulous creditor to the claims of blameless creditors who have been harmed by the bad actor's misconduct, the court has the discretion to implement a remedy that is commensurate with the severity of the misdeeds but falls short of the more drastic remedies of disallowance or recharacterization of a claim as equity. As illustrated by a ruling recently handed down by the Fifth Circuit Court of Appeals, however, purported creditor misconduct in and of itself does not warrant subordination of a claim. In *In re SI Restructuring, Inc.*, the Fifth Circuit reversed an order equitably subordinating secured claims for the repayment of "eleventh hour" insider financing provided to the debtors to stave off bankruptcy, holding that subordination was inappropriate, given the lack of evidence that other creditors were injured in any way as a consequence of the insider creditors' alleged misconduct.

EQUITABLE SUBORDINATION

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

In 1977, the Fifth Circuit Court of Appeals in *In re Mobile Steel Co.* articulated what has become the most commonly accepted standard for equitably subordinating a claim. Under the *Mobile Steel* test, a claim can be subordinated if the claimant engaged in some type of inequitable conduct that resulted in injury to creditors (or conferred an unfair advantage on the claimant), and if equitable subordination of the claim is consistent with the provisions of the Bankruptcy Code. Courts have since refined the test to account for special circumstances. For example, many make a distinction between insiders (*e.g.*, corporate fiduciaries) and noninsiders in assessing the level of misconduct necessary to warrant subordination. For insiders, inequitable conduct is generally found if the claimant has: (i) committed fraud or illegality or breached its fiduciary duties; (ii) left the debtor undercapitalized; or (iii) used the debtor as a mere instrumentality or alter ego. By contrast, as expressed by many courts, subordination of the claim of a noninsider creditor requires a showing of "gross misconduct tantamount to fraud, misrepresentation, overreaching or spoliation." As demonstrated by *SI Restructuring*, however, misconduct or procuring an unfair advantage can properly be a basis for equitable subordination only if other creditors are actually injured because of it.

SI RESTRUCTURING

Schlotzsky's, Inc., and its affiliates ("Schlotzsky's"), an international franchise restaurant chain with locations in 35 states and six foreign countries, experienced a severe cash shortage throughout 2003. Two of its directors at the time, John and Jeffrey Wooley (the "Wooleys"), loaned Schlotzsky's $1 million in April 2003 on a secured basis with collateral consisting of the company's royalty streams from franchisees, its intellectual property rights, and other intangibles. They agreed to make the loans only after other financing options fell through. The Wooleys and Schlotzsky's were separately represented in connection with the financing, the terms of which were approved by the audit committee of the company's board as a related-party transaction. The loans were fully disclosed in the company's SEC filings.

Schlotzsky's cash shortage persisted through the fall of 2003, when the company's general counsel contacted the International Bank of Commerce ("IBC") about the possibility of additional financing. IBC declined to lend directly to Schlotzsky's but indicated in October that it would be willing to loan $2.5 million to the Wooleys, with the expectation that the funds would then be loaned by them to the company. The need for additional financing was discussed at an October 31, 2003, meeting of the company's board of directors. IBC approved the loan on November 10, after which a special meeting of the Scholtzsky's board was called for November 13 and directors were provided with copies of the loan documentation. The second loan from the Wooleys was also to be secured by the company's franchisee royalty income, intellectual property rights, and other intangibles.

The Fifth Circuit's ruling in *SI Restructuring* underscores the remedial, rather than penal, nature of equitable subordination under section 510(c) of the Bankruptcy Code. Under the Fifth Circuit's holding, in the absence of any harm to other creditors or the debtor, equitable subordination of a claim is not the appropriate remedy. The decision also demonstrates the importance of developing a meticulous evidentiary record in litigating causes of action that hinge upon the bankruptcy court's discretion in exercising equitable remedies.

At the time, the Wooleys had personally guaranteed $4.3 million of the company's debt. As part of the second financing transaction, the Wooleys agreed to collateralize their personal guarantee obligations with the same collateral that secured both loans. The board, having been informed that payroll could not be met and that the company would default on another secured debt obligation without the cash infusion, formally approved the second loan transaction on November 13 during a telephone conference. All of the noninterested directors in attendance voted in favor of the loan, which was also approved by an independent audit committee and disclosed in SEC filings.

Scholtzsky's filed for chapter 11 protection in August 2004 in Texas. The company's unsecured creditors' committee (later succeeded by the administrator of the debtors' chapter 11 plans) sued to subordinate the Wooleys' secured claims under section 510(c). During the ensuing trial, the bankruptcy court found that the Wooleys had engaged in inequitable conduct in connection with the November 2003 loan by breaching their fiduciary duties as officers and directors in presenting the loan transaction to the company's board as a *fait accompli* with no options at the eleventh hour. The court also questioned the propriety of the loan's secured status if it was truly intended to be a temporary bridge loan pending procurement of permanent financing. Finally, the bankruptcy court determined that the Wooleys' insistence that their contingent guarantee obligation be secured in connection with the transaction, which effectively released them as guarantors at the expense of the corporation and its unsecured creditors, was a clear instance of "unfair advantage."

The bankruptcy court made no specific findings that the Wooleys' actions in connection with either of the 2003 loans resulted in any harm to Schlotzsky's or its unsecured creditors. Even so, the court equitably subordinated their secured claims based upon both loans to the claims of other secured creditors. After the district court upheld that determination on appeal, the Wooleys appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

The Fifth Circuit reversed. *Mobile Steel*, the court emphasized, mandates that a claim should be subordinated "only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct." Observing that "equitable subordination is remedial, not penal," the Fifth Circuit concluded that equitable subordination is therefore inappropriate "in the absence of actual harm." The bankruptcy court made no specific findings that anyone was harmed due to the Wooleys' alleged misconduct. The Fifth Circuit's independent review of the record did not lead it to conclude otherwise.

According to the Fifth Circuit: (i) unsecured creditors were not harmed when the 2003 loans were secured by the company's assets because the loan proceeds were used to pay unsecured creditors and keep the company operating; (ii) although securing the Wooleys' personal guarantees with company assets arguably amounted to unfair advantage, no harm resulted because the guarantee obligations were never triggered; and (iii) the complaint's asserted basis for harm to unsecured creditors amounted to a "deepening insolvency" theory of damages (*i.e.*, unsecured creditors were harmed because the value of the company deteriorated as a result of the November 2003 loan transaction, thus diminishing the funds available to distribute in respect of unsecured claims), which the Fifth Circuit characterized as invalid. Even if the deepening-insolvency theory were valid, the court of appeals explained, the evidence clearly showed that, at the time of the second loan, the company was generally paying its debts as they matured and was neither undercapitalized nor insolvent. Based on these determinations, the Fifth Circuit reversed the rulings below and entered judgment in favor of the Wooleys.

ANALYSIS

The Fifth Circuit's ruling in *SI Restructuring* underscores the remedial, rather than penal, nature of equitable subordination under section 510(c) of the Bankruptcy Code. Under the Fifth Circuit's holding, in the absence of any harm to other creditors or the debtor, equitable subordination of a claim is not the appropriate remedy. The decision also demonstrates the importance of developing a meticulous evidentiary record in litigating causes of action that hinge upon the bankruptcy court's discretion in exercising equitable remedies. Finally, *SI Restructuring* indicates that courts are generally loath to second-guess corporate fiduciaries exercising their business judgment at a time when the corporation is struggling to stay afloat, particularly when their actions are the product of informed decisions that are subject to full disclosure.

Wooley v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355 (5th Cir. 2008).

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

BUSINESS RESTRUCTURING REVIEW

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

Executive Editor: Charles M. Oellermann
Managing Editor: Mark G. Douglas
Contributing Editor: Scott J. Friedman

If you would like to receive a complimentary subscription to *Business Restructuring Review*, send your name and address to:

Jones Day
222 East 41st Street
New York, New York
10017-6702
Attn.: Mark G. Douglas, Esq.

Alternatively, you may call (212) 326-3847 or contact us by email at mgdouglas@jonesday.com.

Three-ring binders are also available to readers of *Business Restructuring Review.* To obtain a binder free of charge, send an email message requesting one to mgdouglas@jonesday.com.