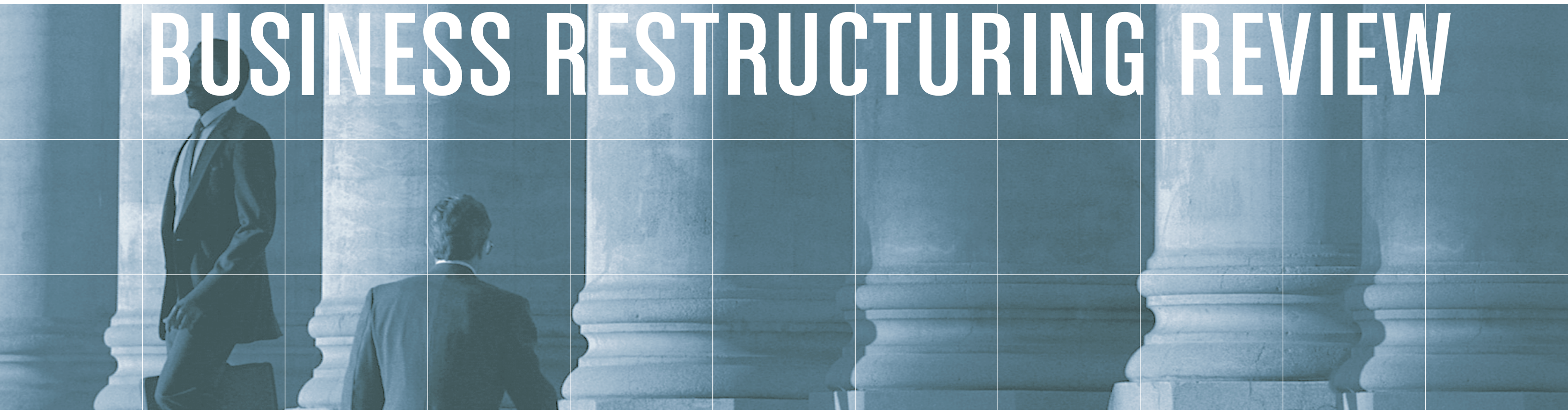
JONES DAY®

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 8 ▪ NO. 4 ▪ JULY/AUGUST 2009

BUSINESS RESTRUCTURING REVIEW



IN THIS ISSUE

COMMERCIAL LOAN DRIVEN BY "NAKED GREED" WARRANTS EQUITABLE SUBORDINATION OF CLAIM

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.

A Montana bankruptcy court recently had an opportunity to consider whether the alleged misdeeds of a secured lender in connection with "aggressive" financing provided to a company merited equitable subordination of the lender's claim. In *Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, the court ordered that a senior secured claim asserted by the lender in the amount of $232 million based upon a new syndicated loan product marketed to the owner of a chapter 11 debtor be subordinated to the claims of a bank that provided debtor-in-possession financing, administrative claims, and the claims of the debtor's unsecured creditors. According to the bankruptcy court, the lender's actions in making the loan "were so far overreaching and self-serving that they shocked the conscience of the Court" because the lender's conduct amounted to "naked greed," having been "driven by the fees it was extracting from the loans it was selling."

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."

YELLOWSTONE CLUB

The Yellowstone Club and its affiliates ("Yellowstone") operate a membership-only, master-planned unit development located on 13,500 acres of private land near the northwest corner of Yellowstone National Park. The club was established in the 1990s by Timothy L. Blixseth ("Blixseth") and his former wife, Edra, with the intention of developing a private ski and golf community for the "ultra-wealthy." To jump-start development, the Blixseths sold equity interests to various people referred to as "pioneer" and "frontier members."

In 2005, Credit Suisse was "trying to break new ground with a product by doing real estate loans in the corporate bank loan market" by means of a new kind of syndicated term loan. This syndicated loan product had previously been marketed by Credit Suisse to other master-planned residential and recreational communities such as Tamarack Resort, Promontory, Ginn, Turtle Bay, and Lake Las Vegas. The terms of the Credit Suisse loan agreements permitted equity holders to draw down sizable distributions from all or part of the loan proceeds.

In many respects, *Yellowstone Club* is a primer on the kind of conduct lenders should avoid to minimize the risk of equitable subordination in a bankruptcy case. Equitable subordination of the claims of a noninsider is very rare and requires a showing of mis- or malfeasance bordering on egregious misconduct—which is precisely what the bankruptcy court found. Other cases are likely to impose a greater strain on a bankruptcy court's mental compass in deciding whether to deploy its broad equitable discretion to subordinate a claim.

In September 2005, Credit Suisse and Blixseth entered into a $375 million credit agreement. According to the agreement, $209 million of the loan proceeds were designated to be used as "distributions or loans" for "purposes unrelated" to Yellowstone. In addition, up to $142 million was authorized to be used for investments in "unrestricted subsidiaries" for "purposes unrelated" to Yellowstone's development. Credit Suisse received a $7.5 million fee in exchange for the financing. Thus, the bulk of the loan proceeds were earmarked for purposes unrelated to Yellowstone.

Prior to entering into the credit agreement with Credit Suisse, Yellowstone carried a debt loan ranging from a low of between $4 million and $5 million to a high of approximately $60 million under a revolving line of credit. Yellowstone's debts on the day before the closing amounted to no more than $20 million owed under a revolving line of credit and a term loan with American Bank. In the nine months that Yellowstone had been operating prior to executing the credit agreement with Credit Suisse, the club missed its profitability projections by a substantial amount.

Credit Suisse maintained that it did a "fair amount of due diligence" prior to making the loan but acknowledged that it never requested audited financial statements from Yellowstone and appeared to have relied exclusively on historical and future projections provided by Blixseth and Yellowstone. Credit Suisse relied almost exclusively on a new form of appraisal methodology—"total net value"—which does not comply with the Financial Institutions Recovery, Reform, and Enforcement Act of 1989.

On the closing date of the loan transaction in September 2005, Credit Suisse wired approximately $342 million to Yellowstone, representing the total loan amount of $375 million less fees, administrative costs, and $24 million to pay off pre-existing debt. On the same day, Blixseth caused approximately $209 million of the loan proceeds to be transferred out of Yellowstone to Blixseth Group Inc. ("BGI"), a Blixseth-owned holding company that controlled Yellowstone. Nearly all of the $209 million proceeds were then disbursed to various personal accounts and to satisfy Blixseth's obligations. The immediate transfer of funds out of Yellowstone was not memorialized in any contemporaneous loan documents but was instead reflected on Yellowstone's books with a simple journal entry. No promissory note was created until May 2006, when BGI executed a $209 million unsecured demand note, which was backdated to September 30, 2005.

After the loan closing in 2005, Yellowstone was never current in its accounts payable. Although faced with chronic cash-flow problems, Yellowstone sought additional capital infusions from members rather than make a demand on the BGI note. In November 2008, Yellowstone filed for chapter 11 protection in Montana. Shortly after the filing and in anticipation of an auction sale of Yellowstone's assets, Credit Suisse commenced litigation seeking a judgment fixing the allowed amount of its secured claim against Yellowstone and determining the priority of its liens. Yellowstone and its official committee of unsecured creditors responded by commencing an adversary proceeding seeking equitable subordination of Credit Suisse's secured claim to the claims of all other pre- and post-bankruptcy creditors. The two proceedings were ultimately consolidated.

THE BANKRUPTCY COURT'S INTERIM RULING

In an interim and expedited ruling designed to facilitate the anticipated auction of Yellowstone's assets, the bankruptcy court concluded that equitable subordination was appropriate, observing that "Credit Suisse's actions in the case were so far overreaching and self-serving that they shocked the conscience of the court." In offering a new financial product for sale, the court explained, Credit Suisse was offering the owners of luxury second-home developments the opportunity to extract their profits upfront by "mortgaging their development projects to the hilt." Credit Suisse would lend on a nonrecourse basis, earn a substantial fee, and minimize its potential exposure by selling off most of the credit to loan participants. The development owners would take most of the money out as a profit dividend, which saddled their developments with enormous debt.

Credit Suisse and Yellowstone's owners would benefit, the bankruptcy court emphasized, "while their developments—and especially the creditors of their developments—bore all the risk of loss." The court further noted that other resorts that had borrowed from Credit Suisse under the same or similar syndicated loan products ultimately failed, including Tamarack Resort, Promontory, Lake Las Vegas, Turtle Bay, and Ginn. According to the court, "If the foregoing developments were anything like this case, they were doomed to failure once they received their loans from Credit Suisse." Explaining that Credit Suisse earned fees by selling loans under a loan scheme whereby developers of high-end residential resorts were encouraged to take unnecessary loans, the court observed that "[t]his program essentially puts the fox in charge of the hen house and was clearly self-serving for Credit Suisse."

According to the bankruptcy court, the fee structure was the catalyst for the most shocking aspect of the new loan product. A sophisticated lender such as Credit Suisse, the court noted, knew or should have known the impact on Yellowstone's balance sheets of immediately distributing the loan proceeds, yet Credit Suisse proceeded with the transaction, turning a "blind eye" to Yellowstone's financial statements after having performed no meaningful due diligence. The only plausible explanation for Credit Suisse's actions, the court concluded, was that the lender's conduct was "driven by the fees it was extracting from the loans it was selling, and letting the chips fall where they may." The court had little trouble concluding that Credit Suisse's claim should be equitably subordinated under section 510(c):

> The naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position, shocks the conscience of this Court. While Credit Suisse's new loan product resulted in enormous fees to Credit Suisse in 2005, it resulted in financial ruin for several residential resort communities. Credit Suisse lined its pockets on the backs of the unsecured creditors. The only equitable remedy . . . is to subordinate Credit Suisse's first lien position to that of CrossHarbor's superpriority debtor-in-possession financing and to subordinate such lien to that of the allowed claims of unsecured creditors.

Having subordinated Credit Suisse's secured claim, the court nevertheless directed that, at the upcoming auction of Yellowstone's assets, Credit Suisse would be permitted to credit-bid its allowed secured claim of $232 million. However, because Credit Suisse's claim had been equitably subordinated, the court decreed that Credit Suisse was obligated to provide sufficient funds to pay Yellowstone's postpetition lenders, all administrative claims, and the allowed unsecured claims asserted by Yellowstone's nonmember creditors. The bankruptcy court did not subordinate Credit Suisse's claim to the claims of Yellowstone Club members who had received distributions.

OUTLOOK

Yellowstone Club is emblematic of the aggressive lending practices that transpired during the real estate boom that preceded a recession triggered by the sub-prime mortgage meltdown. The case illustrates that these practices during the height of the boom were not limited to the residential home mortgage industry, but also occurred in connection with commercial loans. Tellingly, most commercial lenders, including Credit Suisse, abandoned this variety of syndicated loan product in short order, after it became clear that the transactions were fraught with lender liability exposure.

In many respects, *Yellowstone Club* is a primer on the kind of conduct lenders should avoid to minimize the risk of equitable subordination in a bankruptcy case. Equitable subordination of the claims of a noninsider is very rare and requires a showing of mis- or malfeasance bordering on egregious misconduct—which is precisely what the bankruptcy court found. Other cases are likely to impose a greater strain on a bankruptcy court's mental compass in deciding whether to deploy its broad equitable discretion to subordinate a claim. *Yellowstone Club* is also one of the few cases holding that a noninsider's claim can be equitably subordinated for actions that were not based on insider information or special access or control over the debtor.

POSTSCRIPT

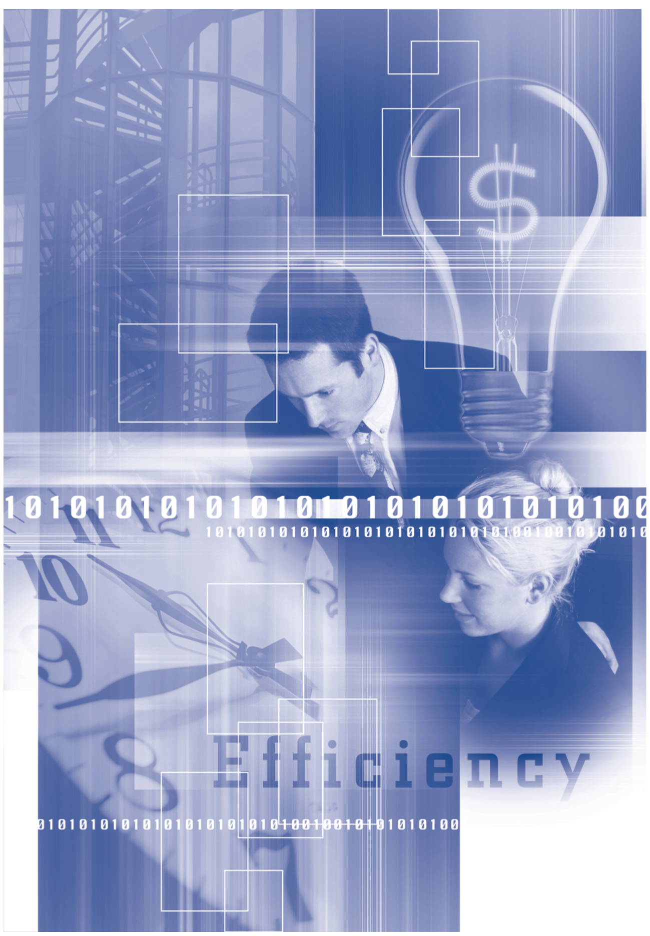
At the time its assets were to be auctioned, Yellowstone had in hand a stalking-horse bid of $100 million. As noted, Credit Suisse sought the right to credit-bid the remainder of its secured claims, agreeing to pay a cash portion to pay off those claims ahead of it. In early June 2009, the parties held a live auction in court, which ultimately concluded in a sale to CrossHarbor Capital Partners LLC, the stalking-horse bidder, for $115 million.

On June 29, 2009, Yellowstone, Credit Suisse, and the Official Committee of Unsecured Creditors filed a stipulation effecting a global settlement. The parties agreed, among other things, that: (i) the interim and partial order of May 13, 2009, equitably subordinating Credit Suisse's claim would be vacated; and (ii) all claims brought by or against Credit Suisse would be dismissed with prejudice. Later that day, the bankruptcy court issued an order vacating its interim and partial order of May 13, 2009. Thus, the court's equitable subordination ruling has no precedential value. Still, the message borne by it for lenders is unmistakable.

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

Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mountain Club LLC), Adv. Proc. No. 09-00014 (Bankr. D. Mont. May 13, 2009) (partial and interim order).

Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mountain Club LLC), Adv. Proc. No. 09-00014 (Bankr. D. Mont. June 29, 2009) (order vacating May 13, 2009, order).



SECOND CIRCUIT RULING MAKES PENSION PLAN TERMINATION IN BANKRUPTCY MORE EXPENSIVE

Mark G. Douglas

The perceived ease with which financially strapped companies have been able to jettison billions of dollars in pension liabilities has figured prominently in headlines for many years. Assumption of these obligations by the Pension Benefit Guaranty Corporation ("PBGC") contributed to a PBGC deficit that aggregated nearly $33.5 billion for the first half of fiscal year 2009—the largest in the agency's 35-year history—representing an increase over fiscal year 2008's $11 billion shortfall. Despite airline relief provisions contained in pension reforms enacted in 2006 designed to staunch the flow of PBGC assets, the agency's overall financial outlook is bleak, given a nationwide underfunding of defined-benefit pension plans that, according to PBGC's estimates, may be as high as a half-trillion dollars, and the looming (or already filed) bankruptcies of a slew of U.S. automakers, parts suppliers, retailers, and other companies with significant underfunded pension liabilities.

Termination of one or more defined-benefit pension plans has increasingly become a significant aspect of a debtor employer's reorganization strategy under chapter 11 of the Bankruptcy Code, providing a way to contain spiraling labor costs and facilitate the transition from defined-benefit-based programs to defined-contribution programs such as 401(k) plans. However, when the Employee Retirement Income Security Act of 1974 ("ERISA") was amended in 2006 to impose a "termination premium" payable upon the "distress termination" of a pension plan, it was unclear to what extent chapter 11 would continue to be beneficial to employers intent upon using bankruptcy to contain spiraling labor costs. That issue has now been tested in the courts. A ruling recently handed down as a matter of first impression by the Second Circuit Court of Appeals indicates that, if followed by other courts, terminating a pension plan in a bankruptcy reorganization will be a more expensive exercise. In *Pension Benefit Guar. Corp. v. Oneida Ltd.*, the court of appeals held that the termination premium payable upon a distress or involuntary termination of a pension plan in bankruptcy becomes payable only upon the terminating employer's receipt of a discharge, such that any claim based upon the premiums cannot be treated as a prepetition unsecured claim.

ERISA AND PBGC

The respective rights and obligations of employers and retirees vis-à-vis pension benefits are generally governed not by the Bankruptcy Code, but by ERISA, which provides the primary regulatory framework and protection for pension benefits. Enacted in 1974, ERISA is a comprehensive regulatory scheme intended to protect the interests of employee benefit plan participants and beneficiaries and to preserve the integrity of trust assets. On a basic level, it establishes minimum participation, vesting, and funding standards and contains detailed reporting and disclosure requirements. ERISA also created PBGC to act as both the regulatory watchdog and the guarantor, at least to a certain extent, for the pension and related rights of the U.S. workforce. PBGC today is responsible for pension programs covering 1.3 million people. It pays about 640,000 people actual benefits worth about $4.3 billion a year.

Companies pay insurance premiums to PBGC, and if an employer can no longer support its pension plan, PBGC takes over the assets and liabilities and pays promised benefits to retirees up to certain limits. The maximum annual guaranteed benefit for plans assumed by the agency in 2009 is $54,000 for a straight life annuity at age 65. If PBGC recovers assets in excess of the guarantee, it allocates those assets to participants in accordance with a statutory scheme. PBGC finances payments to employees under terminated plans through five sources of income: (i) insurance premiums paid by current sponsors of active plans (for plans sponsored in 2009, $34 per year per single-employer plan participant, although companies posing high risks of underfunding must pay an additional variable-rate premium equal to $9 for every $1,000 of unfunded vested benefits); (ii) assets from terminated plans taken over by PBGC; (iii) recoveries from former sponsors of terminated plans; (iv) PBGC's own investments; and (v) in connection with certain distress and involuntary plan terminations occurring on or after January 1, 2006, an annual "termination premium" of $1,250 per participant payable in each of the three years after the termination.

PBGC insures only "defined-benefit" plans. These are plans under which benefits are defined by a formula, where the employer contributes the statutorily determined amounts to a pension fund. The amount of retirement income an employee will receive generally depends on the employee's length of service and salary. Actuaries perform complex calculations regulated by ERISA and the Internal Revenue Code to determine the amount of the required minimum periodic funding contributions the employer must make. Not all plans are defined-benefit plans. Many employers have "defined-contribution" plans instead. In these plans, the employer may contribute a certain amount for each participant (who typically contributes most of the funds to the plan), but the employer makes no promise regarding the ultimate benefit or amount that each participant will receive. Defined-contribution plans, such as 401(k) plans, are not guaranteed by PBGC.

There are several ways for a defined-benefit plan to terminate under ERISA. In a "standard termination," an employer can voluntarily terminate its plan so long as the plan has sufficient assets to pay all future benefits. The employer remains liable to PBGC for all plan benefit liabilities. An employer can also voluntarily act to terminate its plan in a "distress termination" if each member of its controlled group experiences one of the following circumstances: (i) liquidation in bankruptcy; (ii) a reorganization in bankruptcy in which the court approves the termination after determining "that, unless the plan is terminated, [the employer] will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process"; and (iii) a nonbankruptcy situation where a distress termination is necessary because without it, the employer would be unable to pay its debts when they matured and would be unable to continue in business, or because the costs of providing pension coverage have become unreasonably burdensome solely as a result of a decline in the employer's workforce. The standard set forth in (ii) above is commonly referred to as the "reorganization test."

Upon termination of a plan, PBGC assumes responsibility for guaranteed benefits and attempts to collect funds from the employer. An employer cannot effectuate either a standard

NEWSWORTHY

Paul D. Leake (New York), ***Pedro A. Jimenez (New York)***, ***Ross S. Barr (New York)***, and ***Jennifer J. O'Neil (New York)*** are representing Proliance International, Inc., a designer, manufacturer, and marketer of heat exchange products and temperature control parts for the automotive and light truck aftermarket, in connection with the company's chapter 11 filing in Delaware on July 2.

Corinne Ball (New York), ***Thomas F. Cullen (Washington)***, ***Todd S. Swatsler (Columbus)***, ***Robert W. Hamilton (Columbus)***, ***Steven C. Bennett (New York)***, ***Todd R. Geremia (New York)***, and ***Veerle Roovers (New York)*** successfully obtained on behalf of Chrysler LLC a ruling from the Second Circuit Court of Appeals affirming the New York bankruptcy court's June 2009 order approving the sale of substantially all of Chrysler LLC's assets to a consortium of investors led by Fiat S.p.A., pursuant to section 363 of the Bankruptcy Code. After issuing its emergency ruling on June 5 from the bench, affirming the bankruptcy-court order over the objections of certain Indiana pension funds, the Second Circuit Court of Appeals handed down its written ruling on the matter on August 5. In its decision, the Second Circuit affirmed the sale order in all respects, holding, among other things, that: (i) the sale did not constitute an impermissible *sub rosa* chapter 11 plan and prevented further, unnecessary losses; (ii) the bankruptcy court properly held that consent to the sale order's release of all liens on Chrysler's assets was validly provided by the collateral trustee, who had authority to act on behalf of all first-lien credit holders; and (iii) the pension funds lacked standing to raise the issue of whether the U.S. Secretary of the Treasury exceeded his statutory authority by using TARP money to finance the sale of Chrysler's assets.

Heather Lennox (Cleveland), ***Rick Engman (New York)***, ***Robert W. Hamilton (Columbus)***, and ***Ryan Routh (Cleveland)*** are leading a team of Jones Day attorneys advising Metaldyne Corporation, a leading designer and producer of engine, driveline, and chassis products, in connection with its chapter 11 filing in New York and the sale of substantially all of its operating assets and the stock of certain of its foreign subsidiaries as going concerns under a court-supervised sale process pursuant to section 363 of the Bankruptcy Code.

Richard L. Wynne (Los Angeles) and ***Lori Sinanyan (Los Angeles)*** are representing an ad hoc committee of noteholders of Station Casinos, Inc., which filed for chapter 11 protection on July 28 in Nevada.

Daniel P. Winikka (Dallas) moderated a panel on June 12 discussing "In-Court vs. Out-of-Court Restructurings" at the annual conference of the Association of Insolvency & Restructuring Advisors in Orlando.

Kevyn D. Orr (Washington) was appointed in July for a three-year term to the advisory board of the *American Bankruptcy Institute Law Review*.

Laurent Assaya (Paris) sat on a panel discussing the crucial role of available funding in a successful turnaround at the Turnaround Management Association's European Conference on June 19 in Amsterdam.

or distress termination if terminating the plan would violate the terms and conditions of an existing collective bargaining agreement. However, a plan sponsor seeking a distress termination while in bankruptcy may nullify a contractual bar to plan termination by obtaining court authority to reject or modify the bargaining agreement under section 1113 of the Bankruptcy Code. Finally, PBGC itself can move to terminate a company's pension plan if certain statutory criteria are met (*e.g.*, the company defaults on its minimum funding requirements or PBGC determines that it will be exposed to unreasonable risk in the long run if the plan continues). PBGC need not consult with union representatives before terminating a plan on its own initiative, although PBGC is reluctant to terminate a plan in violation of a collective bargaining agreement.

2006 PENSION REFORMS

In early 2006, President George W. Bush signed the Deficit Reduction Act of 2005 ("DRA"), which amended ERISA to add a new premium of $1,250 per participant per year for three years after a plan is terminated, whether through a distress termination or an involuntary termination initiated by PBGC, and whether inside or outside bankruptcy. The provision was originally enacted as a temporary measure but was subsequently made permanent in the Pension Protection Act of 2006 ("PPA"). Under the amendment, if a plan is terminated during a chapter 11 case, the termination premium does not become due until *after* the debtor emerges from bankruptcy, while a company that liquidates in bankruptcy incurs no premium. However, PBGC regulations provide that if any member of a controlled group is not liquidating, the termination premium applies to the nonliquidating member(s). ERISA now contains a "General Rule" and a "Special Rule" governing single-employer plan terminations.

The "General Rule" provides that:

> [i]f there is a termination of a single-employer plan [under the circumstances specified], there shall be payable to [PBGC], with respect to each applicable 12-month period, a premium at a rate equal to $1,250 multiplied by the number of individuals who were participants in the plan immediately before the termination date.

However, the "Special Rule" provides that if a plan is terminated during a chapter 11 reorganization case, "[the General Rule] shall not apply to such plan until the date of the discharge or dismissal of [the debtor] in such case."

> *Oneida Limited* is unquestionably a positive development for PBGC, especially because the ruling is the only decision at the circuit level to address the issue to date. Unless and until a competing view emerges in subsequent decisions, terminating a pension plan in a bankruptcy reorganization has become a significantly more expensive proposition.

Under the General Rule, the "applicable 12-month period" runs from the "first month following the month in which the termination date occurs" and requires payment for a total of three years. By contrast, under the Special Rule, the applicable 12-month period does not commence until "the first month following the month which includes the earliest date as of which each [debtor] is discharged or dismissed" from the bankruptcy case.

These changes were enacted against the backdrop of successive pension plan terminations in the chapter 11 cases of high-profile steelmakers, automobile parts suppliers, and airlines and reflected lawmakers' perceptions that it had become too easy to shed liabilities from pension plan obligations. As articulated by the House Committee on Education and the Workforce, "The bankruptcy courts should not be used as a mechanism for eliminating the burden of an underfunded pension plan," justifying "an additional premium paid to the PBGC to recognize [that] the agency's assumption of unfunded plan liabilities is reasonable."

ONEIDA LIMITED—FIRST TEST IN THE COURTS OF THE NEW PREMIUM

Flatware maker Oneida Ltd. ("Oneida") filed a "prenegotiated" chapter 11 case on March 19, 2006, in New York. During its reorganization proceedings, Oneida terminated one, but not all, of its pension plans and entered into a settlement agreement with PBGC fixing the agency's secured claims for past-due minimum funding contributions, as well as employer liability under ERISA and "traditional" premium claims. Under the agreement, Oneida reserved the right to challenge PBGC's claim for the new termination premium.

Oneida's confirmed chapter 11 plan became effective on September 15, 2006, making Oneida the first reorganized company subject to the new termination premium assessment. Oneida immediately sought a declaratory judgment from the bankruptcy court that the termination premium claims were pre-petition claims covered by the PBGC settlement agreement and therefore discharged by confirmation of Oneida's chapter 11 plan. PBGC, arguing that the dispute's resolution required substantial and material consideration of ERISA as well as bankruptcy law, responded by moving to withdraw the reference of the matter so that the litigation could be adjudicated by a federal district court. The district court denied the motion, ruling that the determination of what is a "claim" and whether it has been discharged is something that bankruptcy courts routinely do and that the determination was merely a "simple application" rather than a "significant interpretation" of ERISA's new termination premium provision.

On cross-motions for summary judgment later filed in the bankruptcy court, the court held that the termination premium was a pre-petition claim within the meaning of the Bankruptcy Code because it was a "classic contingent claim." Interpreting the term "claim" broadly, and relying on rulings in other cases that pension liabilities are contingent pre-petition claims, the bankruptcy court found telling the fact that, although the Bankruptcy Code was significantly overhauled just a few months prior to enactment of the DRA as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the amendments did not include a provision making the yet-to-be-enacted termination premiums priority or nondischargeable claims.

THE SECOND CIRCUIT'S RULING

On direct appeal to the Second Circuit Court of Appeals rather than the district court because the question involved "a question of law as to which there is no controlling decision of the court of appeals for the circuit or of the Supreme Court of the United States, or involves a matter of public importance," a three-judge panel of the court of appeals unanimously reversed.

Analyzing the plain language of the General Rule and the Special Rule as well as the legislative history of the termination premium, the panel concluded that Congress unequivocally intended that the termination liability would not arise until after a reorganized employer emerges from bankruptcy. The Second Circuit examined the substantive nonbankruptcy law that gave rise to the obligation to determine the nature of the claim:

> Here, the substantive, non-bankruptcy law giving rise to Oneida's obligation to pay a Termination Premium is the Special Rule, which unambiguously states that where a pension plan is terminated in connection with an employer's bankruptcy reorganization, the General Rule—which creates PBGC's right to a Termination Premium—"shall not apply to such plan until the date of the discharge or dismissal of [the employer]." . . . The obvious purpose of this rule is to prevent employers from evading the Termination Premium while seeking reorganization in bankruptcy. Although in the context of a private contract, this language might not control the question of whether a "claim" existed, Congress may prescribe when a claim will be legally effective for the purposes of the Bankruptcy Code, at least where, as here, the non-bankruptcy statute *explicitly* discusses how the obligation should be treated in bankruptcy.

According to the court of appeals, what happened in the *Oneida* case is not a situation, as the bankruptcy court erroneously perceived, where an obligation had already been created prior to bankruptcy but is subject to a contingency. Rather, the Second Circuit explained, "an employer's obligation to pay a Termination Premium on a pension plan that is terminated during the course of the bankruptcy does not even arise until the bankruptcy itself is terminated." "No matter how broadly the term 'claim' is construed," the court of appeals emphasized, "it cannot extend to a right to payment that does not yet exist under federal law." Thus, the court found no ambiguity in the statutory language. Even so, it analyzed the legislative history of the DRA and the PPA, concluding that "[t]reating the Special Rule as a pre-petition claim would directly thwart Congress's aim in establishing the Special Rule."

OUTLOOK

Oneida Limited is unquestionably a positive development for PBGC, especially because the ruling is the only decision at the circuit level to address the issue to date. Unless and until a competing view emerges in subsequent decisions, terminating a pension plan in a bankruptcy reorganization has become a significantly more expensive proposition. For example, if the termination premium had been part of ERISA when United Air Lines was authorized to terminate its four pension plans in what was then and still is the largest PBGC assumption in history, the termination premium would have aggregated almost $460 million.

At this juncture, the impact *Oneida Limited* will have on a potential debtor employer's strategic planning in anticipation of a possible chapter 11 filing remains to be seen. The venue selected for a filing will unquestionably be a key consideration. In addition, plan feasibility in any chapter 11 case pending in the Second Circuit must include an examination of a reorganized company's ability to satisfy any anticipated termination premium payment obligations. Whether such obligations must or even could be treated as administrative expenses of the chapter 11 estate is an open question. It is not clear in the Second Circuit's ruling whether the termination premium is an obligation of the bankruptcy estate or the reorganized company. It is also unclear whether PBGC will take the premium into account when negotiating settlements of plan termination liabilities.

Finally, the Second Circuit's ruling in *Oneida Limited* may have thrown a wrench into traditional bankruptcy jurisprudence regarding the issue of when a claim arises. The prevailing view in bankruptcy is that a claim under a pre-petition contract arises at the time the contract is executed, even though the claim may be contingent or unliquidated until sometime after one party to the contract files for bankruptcy protection. *Oneida Limited* suggests that a different rule applies to pre-petition pension plans terminated during a bankruptcy case.

Pension Benefit Guar. Corp. v. Oneida Ltd., 562 F.3d 154 (2d Cir. 2009).

IN BRIEF: FROM THE TOP

Bankruptcy and U.S. Supreme Court watchdogs awaiting dispositive resolution of a long-standing circuit split on the power of bankruptcy courts to enjoin litigation against nondebtors under a chapter 11 plan were in for a disappointment when the Supreme Court finally handed down its ruling on June 18, 2009, in two consolidated appeals involving asbestos-related claims directed against former chapter 11 debtor Johns Manville Corporation.

The cases—*The Travelers Indemnity Co. v. Bailey* and *Common Law Settlement Counsel v. Bailey*—have a long and tortuous history spanning a quarter-century. Manville was the leading producer of asbestos products in the U.S. for more than 50 years, many of which resulted in asbestos-related illnesses. Escalating liabilities from a blizzard of asbestos litigation propelled Manville into chapter 11 in 1982. Manville's primary insurer was Travelers, which, together with other insurance companies, ultimately provided most of the $850 million in funding for a plan of reorganization confirmed in 1986 that set up a trust to pay all asbestos claims against Manville. The chapter 11 plan and the bankruptcy-court order confirming it released Travelers and the other insurers from all liabilities and enjoined all litigation against Travelers based upon asbestos claims against Manville, channeling all such claims to the trust. Specifically, the confirmation order prohibited all persons from commencing any action against any of the settling insurance companies "for the purpose of, directly or indirectly, collecting, recovering or receiving payment of, on or with respect to any Claim . . . or other Asbestos

Obligation." Recognizing that the bankruptcy estate's greatest asset was the insurance proceeds, the court's injunction channeled to the trust any and all claims that were "based upon, arose out of, or related to" Manville's insurance policies. The Second Circuit Court of Appeals upheld the confirmation order on appeal in 1988.

Despite the injunction, asbestos plaintiffs in droves began suing the insurance companies directly in the years following confirmation of Manville's chapter 11 plan, alleging that the insurers themselves had engaged in wrongdoing by failing to disclose the dangers of asbestos exposure. On Traveler's request, the bankruptcy court enjoined all of the actions, and in 2004 the court issued an order clarifying that the scope of the injunction contained in its 1986 confirmation order extended to direct actions by asbestos claimants against Travelers—in effect, staying an action by one nondebtor against another nondebtor. The district court affirmed the ruling on appeal in 2006.

However, the Second Circuit reversed in 2008, concluding that the bankruptcy court lacked jurisdiction to enjoin direct action claims against Travelers and the other insurers. According to the Second Circuit, a bankruptcy court has jurisdiction only to enjoin third-party nondebtor claims that directly affect the rest of the bankruptcy estate. "The bedrock jurisdiction issue in this case," the court of appeals remarked, "requires a determination as to whether the bankruptcy court had jurisdiction over the disputed statutory and common law claims."

The Supreme Court agreed to hear the cases on December 12, 2008, to resolve a long-standing circuit split on the issue. The Court handed down its ruling on June 18, 2009. Unfortunately, the ruling does not resolve the controversy.

Delivering the majority opinion, from which two justices dissented, Justice David H. Souter reversed and remanded the Second Circuit's decision, concluding that it was error for the court of appeals to reevaluate the bankruptcy court's exercise of jurisdiction in 1986, when it entered the order confirming Manville's chapter 11 plan. Direct action claims, Justice Souter explained, including actions brought under state consumer-protection statutes or common law alleging that Travelers conspired with other insurers and with asbestos manufacturers to hide the dangers of asbestos or failed to warn the public about the dangers of asbestos, are "policy claims" expressly enjoined by the bankruptcy court's 1986 confirmation order. Moreover, he emphasized, whether the bankruptcy court had jurisdiction to enter the injunction in 1986 was not an issue properly before either the Second Circuit in 2008 or the Supreme Court. As a consequence, Justice Souter concluded that the Second Circuit erred in holding that the 1986 confirmation order was unenforceable because the bankruptcy court exceeded its jurisdiction. Once the order became final on direct review, Justice Souter explained, the parties and those in privity with them were bound by its terms under principles of res judicata.

Finally and most notably, Justice Souter noted that the court was not resolving whether a bankruptcy court in 1986, or today, could "properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing," or whether any particular party is bound by the 1986 orders, which is a question the Second Circuit did not consider. A channeling injunction of the sort issued by the bankruptcy court in 1986, Justice Souter explained, would have to be measured against the requirements of section 524(g) of the Bankruptcy Code, which Congress added in 1994 precisely to address this issue. Thus, the circuit split on this controversial and important issue continues.

Justice John Paul Stevens, joined by Justice Ruth Bader Ginsburg, dissented, concluding that the injunction bars "only those claims against Manville's insurers seeking to recover from the bankruptcy estate for Manville's misconduct, not those claims seeking to recover against the insurers for their own misconduct."

In other bankruptcy-related matters, the Supreme Court agreed on June 8 to review an appeals-court decision from September 2008 that invalidated part of the 2005 bankruptcy reforms prohibiting lawyers from advising their clients to incur more debt in anticipation of a bankruptcy filing. In *Milavetz, Gallop & Milavetz, P.A. v. U.S.*, the Eighth Circuit Court of Appeals ruled that new section 526(a)(4) of the Bankruptcy Code violates the First Amendment's right to freedom of speech by preventing "attorneys from fulfilling their duty to clients to give them appropriate and beneficial advice." In addition to this issue, the Supreme Court will decide whether the court of appeals correctly held that the 2005 amendments do not violate the First Amendment by requiring bankruptcy lawyers to identify themselves in their advertising as "debt relief agencies." The case will be argued sometime after the Supreme Court begins its next term in October.

After granting a temporary stay of the bankruptcy court's May 31 order approving the sale of the bulk of U.S. automaker Chrysler's assets to a consortium led by Italian automaker Fiat S.p.A. on June 7, the Supreme Court on June 9, in an unsigned, two-page ruling, held that certain Indiana pension and construction funds failed to meet the standards for a stay pending appeal of the sale order. The court did not decide the merits of the attempted appeal and said the stay ruling applied to "this case alone."

On June 15, the Supreme Court agreed to hear a bankruptcy case addressing whether the Due Process Clause of the Fifth Amendment is violated if a chapter 13 debtor gives notice by mail to a lender that a student loan will be paid under a plan and then discharged, rather than commencing an adversary proceeding seeking a determination that the loan is dischargeable absent payment in full upon a showing of "undue hardship."

The Travelers Indemnity Co. v. Bailey, 129 S. Ct. 2195 (2009).

Milavetz, Gallop & Milavetz, P.A. v. U.S., 129 S. Ct. 2766 (2009).

U.S. v. Milavetz, Gallop & Milavetz, P.A., 129 S. Ct. 2769 (2009).

United Student Aid Funds Inc. v. Espinosa, 129 S. Ct. 2791 (2009).

Indiana State Police Pension Trust v. Chrysler LLC, 129 S. Ct. 2275 (2009).

LIMITING THE ROLE OF BUSINESS JUDGMENT IN AUTHORIZING KERP PAYMENTS

Fan B. He and Mark G. Douglas

Changes made to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") raised the bar for providing incentives that had been offered routinely to management of a chapter 11 debtor by way of a severance or key employee retention plan ("KERP") designed to ensure that vital personnel would be willing to steward the company through its bankruptcy case, whether it involved reorganization or liquidation. Sections 503(c)(1) and 503(c)(2) place strict limitations on severance and KERP payments to "insiders." In addition, section 503(c)(3) of the Bankruptcy Code mandates that transfers or obligations outside the ordinary course of business be "justified by the facts and circumstances of the case." However, courts applying section 503(c)(3) have not been able to settle on a clear standard to evaluate the payments. Earlier this year, a Texas bankruptcy court examined the issue and articulated its own standard. In *In re Pilgrim's Pride Corp.*, the court ruled that, under section 503(c)(3), a payment to an insider that is not in the ordinary course of business may be granted administrative expense priority only if the court finds, independent of the debtor's business justification, that the payment is in the best interest of the parties.

LIMITATIONS ON PRIORITY CLAIMS OF KEY EMPLOYEE INSIDERS

Enacted as part of BAPCPA's sweeping reforms, section 503(c) was intended to limit the scope of KERPs and other similar plans to attract managers to remain with the company during its chapter 11 bankruptcy case. Prior to the amendments, managers were frequently given lucrative compensation packages as part of a KERP, with the resulting obligations treated as administrative expense priority claims under section 503 of the Bankruptcy Code. Administrative status for such claims gave insider managers a great deal of leverage, particularly because a chapter 11 plan cannot be confirmed unless either such claims are paid in full or the claimant agrees otherwise.

Section 503(c) limits the allowance and payment of such administrative expense claims, reflecting the general disfavor of giving preferential treatments to a debtor's "insiders" (which include, among others, directors, officers, and other controlling individuals or entities) at the expense of the bankruptcy estate. It provides that, notwithstanding the general rule stated in section 503(b) regarding the allowance of administrative expenses:

> there shall neither be allowed, nor paid—
>
> (1) a transfer made to, or an obligation incurred for the benefit of, an insider of the debtor for the purpose of inducing such person to remain with the debtor's business, absent a finding by the court based on evidence in the record that—
>
> (A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;
>
> (B) the services provided by the person are essential to the survival of the business; and
>
> (C) either—
>
> (i) the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or
>
> (ii) if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred;
>
> (2) a severance payment to an insider of the debtor, unless—
>
> (A) the payment is part of a program that is generally applicable to all full-time employees; and
>
> (B) the amount of the payment is not greater than 10 times the amount of the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made; or
>
> (3) other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case, including transfers made to, or obligations incurred for the benefit of, officers, managers, or consultants hired after the date of the filing of the petition.

Sections 503(c)(1) and 503(c)(2) deal with KERP payments and severance payments, respectively. In addition, section 503(c)(3) imposes a general catchall limitation with respect to payments or obligations that are both outside the ordinary course of business and not justified by the facts and circumstances of the case. Lawmakers did not enunciate detailed criteria governing the strictures of section 503(c)(3), reserving for the bankruptcy courts the discretion to determine whether the provision's conjunctive requirements have been satisfied.

Before BAPCPA, courts generally applied the business judgment rule to determine whether nonordinary-course payments to insiders under KERPs or similar programs should be permitted. This meant that debtors only had to provide a legitimate business justification for the payments, which was a low threshold. In the relatively brief period since 2005, only a handful of courts have analyzed the catchall provision of section 503(c)(3), with mixed results as to whether the business judgment rule or a different test is the appropriate standard to evaluate a proposed expenditure or obligation that falls thereunder.

For example, in *In re Nobex Corp.*, a Delaware bankruptcy court in 2006 endorsed the business judgment rule and went so far as to conclude that section 503(c)(3) merely reiterates the standard under section 363(b) of the Bankruptcy Code, pursuant to which courts authorize the use, sale, or lease of estate property outside the ordinary course of business based on the business judgment rule. Later in the same year, a New York bankruptcy court suggested in *In re Dana Corporation* that the "sound business judgment test" is the appropriate test for evaluating proposed payments governed by section 503(c)(3). This test derives from pre-BAPCPA cases and takes into account, in addition to business judgment, whether a KERP is financially reasonable and fair and conforms to industry standards and the level of due diligence the debtor exercised in formulating the program. More recently, the bankruptcy court in *Pilgrim's Pride* considered the appropriate standard for evaluating a payment to an insider under section 503(c)(3).

PILGRIM'S PRIDE

Pilgrim's Pride Corp. and its affiliates (the "debtors"), the nation's second-largest chicken producer for the consumer market, filed for chapter 11 protection in December 2008 in Texas. On December 16, 2008, the debtors' chief executive officer, J. Clinton Rivers ("Rivers"), and chief operating officer, Robert A. Wright ("Wright"), agreed to resign from their respective positions. On January 2, 2009, the debtors sought court authority to employ Rivers and Wright as consultants for three- and four-month terms, respectively, at essentially their pre-resignation salaries. The United States Trustee (the "U.S. Trustee") objected to the motion, contending that the consulting agreements violated section 503(c).

At the hearing on the motion, the debtors' chief restructuring officer testified that the debtors did not require consulting services from Rivers and Wright, but that the consulting agreements were necessary to prevent Rivers and Wright from soliciting the debtors' customers on behalf of the debtors' competitors. Thus, the debtors were seeking court approval of the agreements to purchase "time-limited non-competition agreements."

THE BANKRUPTCY COURT'S RULING

The court evaluated the motion in two stages: (i) whether the noncompetition consulting agreements violated any of the various subsections of section 503(c); and (ii) if not, whether such nonordinary course of business expenditures should be allowed as administrative expenses. According to the court, section 503(c)(1) does not apply because the purpose of the consulting agreements was not to retain Rivers and Wright, but to prohibit them from working with the debtors' competitors. The bankruptcy court also rejected the U.S. Trustee's argument that payments under the consulting agreements were tantamount to severance as part of the debtors' termination of Rivers and Wright and should therefore be evaluated under section 503(c)(2).

A debtor's business judgment may not end the inquiry under section 503(c)(3), but even under a standard similar to that adopted in *Pilgrim's Pride*, the debtor's business judgment continues to play a significant role in the assessment of whether payments will be authorized under that subsection.

The court concluded that, although payments under the consulting agreements did not fall under sections 503(c)(1) and (c)(2), section 503(c)(3) applied because the proposed payments under the agreements represented transfers to an insider outside the ordinary course of business. Notably, in reaching this conclusion, the court expressly refrained from ruling on whether section 503(c)(3) extends beyond transactions with insiders.

The bankruptcy court then examined what standard should govern proposed payments or obligations under section 503(c)(3). The court rejected the debtors' argument that the business judgment standard should apply, reasoning that if it did, section 503(c)(3) would be redundant, given that section 363(b)(1) already governs transfers made outside the ordinary course of business. In addition, the court noted, the text of section 503(c)(3) requires debtors to demonstrate that a transfer or obligation is justified by the "facts and circumstances of the case." This "justification" clause, the bankruptcy court explained, suggests that Congress intended the court to "play a more critical role in assessing transactions" under section 503(c)(3), as opposed to deferring to the business judgment of the debtor or a bankruptcy trustee.

The court in *Pilgrim's Pride* declared that, consistent with lawmakers' goal to have the bankruptcy courts assess the value to the debtor of a proposed payment or obligation, under section 503(c)(3), "even if a good business reason can be articulated for a transaction, the court must still determine that the proposed transfer or obligation is justified in the case before it." This standard, the court emphasized, requires the court to play a greater role by making its own determination that the transfer serves the interests of the creditors and the estate, regardless of a debtor's business judgment:

> Given the obvious conflict of interest between a debtor's estate and insiders—who may themselves have been responsible in whole or part for devising and internally approving the proposed transaction—the argument underlying application of the business judgment rule (that officers and directors will fulfill their fiduciary responsibilities) lacks its usual weight.

Applying this standard, the court held that the obligations under the consulting agreements should be authorized under section 503(c)(3) as administrative expense claims. According to the court, the debtors not only provided valid business reasons for entering into the agreements, but demonstrated that the consulting agreements were in the best interests of creditors and the estate. Specifically, the debtors presented evidence that Rivers and Wright were knowledgeable about the debtors' customers, had contacts with those customers, and were likely to use such knowledge and contacts to divert those customers to one of the debtors' competitors, at a potential cost of hundreds of millions of dollars. Weighed against the $500,000 in aggregate to be paid to Rivers and Wright under the agreements, the cost to the estate was small. The bankruptcy court, however, reserved for another day any ruling on the U.S. Trustee's contention that administrative priority for claims arising under the consulting agreements was unjustified because Rivers and Wright were already obligated not to compete under their respective resignation agreements. The court observed that it was confident that the debtors and their counsel were justified in seeking additional assurance of noncompetition by entering into the consulting agreements.

OUTLOOK

Pilgrim's Pride provides another court's view concerning how Congress may have intended section 503(c)(3) to apply. The bankruptcy court's conclusion that the inquiry into justification should involve an independent examination by the court of the best interests of the estate notwithstanding the debtor's business judgment is undeniably a departure from the approach taken by other courts. Such an independent evaluation will necessarily be fact-specific, and any bankruptcy court taking this approach will have broad discretion to determine which transfers and obligations are "justified."

The additional examination by the court under the *Pilgrim's Pride* approach would appear to make section 503(c)(3) more restrictive. It bears noting, however, that in *Pilgrim's Pride*, the bankruptcy court ultimately deferred to the debtors' business judgment. Thus, a debtor's business judgment may not end the inquiry under section 503(c)(3), but even under a standard similar to that adopted in *Pilgrim's Pride*, the debtor's business judgment continues to play a significant role in the assessment of whether payments will be authorized under that subsection.

In re Pilgrim's Pride Corp., 401 B.R. 229 (Bankr. N.D. Tex. 2009).

In re Nobex Corp., 2006 WL 4063024 (Bankr. D. Del. Jan. 19, 2006).

In re Dana Corporation, 358 B.R. 567 (Bankr. S.D.N.Y. 2006).

EXPLORING THE ROLE OF CREDITORS' COMMITTEES IN DIRECTING THE AFFAIRS OF A CHAPTER 11 DEBTOR

Michelle M. Beck and Mark G. Douglas

Chapter 11 of the Bankruptcy Code allows the existing management of a debtor to remain in control of the company as a "debtor in possession" ("DIP") while negotiating a restructuring (or liquidation) of its affairs in the form of a chapter 11 plan. Among other things, this means that the DIP is authorized to operate its business in the ordinary course without bankruptcy-court approval and that the court will generally defer to the DIP's business judgment in doing so. One of the underlying policies of the Bankruptcy Code is that the persons in the best position to operate the debtor's business are its current management team, rather than newly appointed outsiders with little familiarity with the debtor's business operations.

In some instances, however, the court or parties in interest lose faith in the DIP's ability to exercise sound business judgment. At other times, the DIP may be overly influenced or controlled by a third party. In such circumstances, the Bankruptcy Code establishes specific mechanisms to ensure that the interests of the estate and all stakeholders are protected. These include procedures for: (i) terminating the DIP's exclusive right to propose and solicit acceptances of a chapter 11 plan; (ii) the appointment of an examiner to investigate the debtor's affairs; or (iii) in cases of fraud, mismanagement, or other specified types of misconduct or incompetence, the appointment of a chapter 11 trustee to manage the debtor's affairs and steward it toward confirmation of a chapter 11 plan.

Creditors and other stakeholders also play a role in acting as a watchdog over a DIP's conduct, most notably in the form of official committees of creditors (or shareholders) appointed in a chapter 11 case that are conferred with statutory powers under section 1103 of the Bankruptcy Code. These powers include, among other things, the ability to: (i) consult with the DIP or chapter 11 trustee concerning administration of the case; (ii) investigate the DIP's conduct and affairs to evaluate whether its business should be continued; (iii) participate in the formulation of a chapter 11 plan; (iv) request the appointment of a trustee or examiner; and (v) "perform such other services as are in the interest of those represented." A ruling recently handed down by an Illinois bankruptcy court addresses the breadth of an official committee's role in seeking court intervention to control a DIP's management of its business affairs. In *In re Commercial Mortgage and Finance Company*, the court granted a motion by the official committee of unsecured creditors to impose liens on the assets of a chapter 11 debtor's wholly owned nondebtor subsidiaries to secure creditors' recoveries against the debtor-parent and to restrict the ability of the debtor and its subsidiaries to enter into loan transactions and transfer bank deposits.

COMMERCIAL MORTGAGE

Commercial Mortgage and Finance Company ("CMFC") filed for chapter 11 protection in October 2008 in Illinois. Prior to its filing, CMFC and its wholly owned subsidiaries made mortgage loans to third parties. CMFC's creditors made unsecured loans to CMFC, which, in turn, loaned such funds to its wholly owned subsidiaries. These subsidiaries would then loan funds to third parties, oftentimes on an unsecured basis. At the time of its chapter 11 filing, CMFC had no secured creditors, and its assets included the equity in its wholly owned subsidiaries, as well as the significant debt owed by the subsidiaries to CMFC. CMFC's subsidiaries did not file for chapter 11 protection.

CMFC had suffered operating losses throughout the decade prior to its bankruptcy filing and acknowledged that any chapter 11 plan would provide for the orderly liquidation of its assets (including the sale and liquidation of the assets of its subsidiaries) and cessation of its business. Based upon those circumstances and admissions, the official committee of CMFC's unsecured creditors (the "Committee") sought an order from the bankruptcy court: (i) imposing liens and encumbrances on the assets of CMFC's nondebtor subsidiaries to secure recoveries for CMFC's creditors ; (ii) restricting the ability of CMFC and its subsidiaries to enter into new loan transactions; and (iii) directing

that any proceeds from the sale of CMFC or its subsidiaries, or their respective assets, be deposited into a restricted, segregated bank account.

According to the Committee, it was the "[c]ourt's responsibility to protect creditors' interests from the actions of inexperienced, incapable, or foolhardy management, whether old or new." CMFC countered that, as a DIP, it had the authority to operate the estate in the ordinary course of business and that the Committee was attempting to usurp this right.

In its decision, the bankruptcy court explained that, pursuant to section 1107(a) of the Bankruptcy Code, a DIP's right to conduct ordinary-course business affairs is subject "to such limitations as the court may prescribe," particularly where such limitations are imposed to protect creditors' interests. Furthermore, the court noted, when a DIP is liquidating its business, its business decisions are not entitled to the same degree of deference as those of a reorganizing debtor.

The bankruptcy court then addressed whether it had the equitable power to impose liens on the assets of CMFC's nondebtor subsidiaries for the benefit of CMFC's creditors. The court acknowledged that each corporation is a separate legal entity and that, unlike a subsidiary's stock, a subsidiary's assets are not part of the parent company's bankruptcy estate. Even so, the bankruptcy court concluded, "the assets of subsidiaries should be subject to the debts of creditors of the parent corporation where necessary to avoid fraud and injustice." Moreover, the court stated, "courts may extend jurisdiction to the assets of a debtor's subsidiaries to restrain the subsidiaries from using their assets to the detriment of the interests of the debtor's creditors." In fact, the court remarked, "pursuant to 11 U.S.C. § 105, courts have a duty to preserve the assets of the debtor and its subsidiaries for the benefit of creditors when a plan includes the sale and liquidation of all of the assets of the debtor and its subsidiaries."

Commercial Mortgage illustrates the extent to which official committees can have significant influence over the administration of chapter 11 cases.

CMFC argued that the imposition of liens on its assets and the assets of its nondebtor subsidiaries for the benefit of CMFC's unsecured creditors amounted to a *sub rosa* chapter 11 plan that would give the Committee's constituency priority to the detriment of administrative claimants, including real estate tax, utility, payroll, and other administrative claims. The court rejected this argument, explaining that the secured claims would be capped at the priority levels set forth in section 507 (delineating the hierarchy of priority unsecured claims), that CMFC had no secured creditors, and that CMFC would be liquidated rather than reorganized. Moreover, the bankruptcy court explained, the aim of the proposed liens was to prevent CMFC "from dissipating its assets under the guise of independent action on the part of its subsidiaries."

Next, the court considered whether its equitable powers extended to restricting loan transactions among CMFC, its subsidiaries, and third parties. Among other things, CMFC argued that the Committee's mandate under section 1103(c) of the Bankruptcy Code did not extend to seeking such relief from the court. Noting that official committees generally act in an advisory capacity to the trustee or DIP, the court emphasized that a committee can also properly engage in a very broad range of additional activities. In particular, the court explained, section 1103(c)(5) states that an official committee can "perform such other services as are in the interest of those represented." Looking to prior case law, the court concluded that the general language of section 1103(c)(5) should be construed to embrace only duties similar in nature to those listed in sections 1103(c)(1)–(4). For example, an official committee cannot partake in legislative lobbying activities that are independent of the bankruptcy case.

In this instance, the bankruptcy court determined that the relief requested by the Committee fell within the scope of section 1103(c). The court concluded that "[i]n light of the unique circumstances, including Debtor's ten consecutive years of operating losses, the imminent liquidation plan and the lack of any secured creditors," the Committee's motion to restrict loan transactions should be granted. For the same reasons, the court approved the Committee's request to require that proceeds from the sale of CMFC or its subsidiaries, or their respective assets, be deposited into a separate, restricted bank account.

OUTLOOK

Commercial Mortgage illustrates the extent to which official committees can have significant influence over the administration of chapter 11 cases. The result reached in *Commercial Mortgage* is unusual in terms of the scope of the relief granted to the Committee.

In re Commercial Mortgage and Finance Co., 2009 WL 589673 (Bankr. N.D. Ill. Mar. 6, 2009).

AMENDMENTS TO RUSSIAN INSOLVENCY LAW ENACTED

On April 28, 2009, the president of the Russian Federation signed into law amendments to the Russian Law on Insolvency (Bankruptcy) of October 26, 2002 (Federal Law No. 127-FZ) (the "Insolvency Law") that should be considered by all creditors doing business with financially troubled Russian companies, directors and other controlling persons of Russian companies, and participants in the market for distressed Russian assets.

Many of the changes reflect pro-creditor concepts that were introduced in another series of amendments adopted just before the end of 2008, but other aspects of the new amendments are likely to make it more difficult and time-consuming for creditors to obtain payment on their claims.

The 2009 amendments introduce two new concepts governing the obligation of the directors of a Russian company to file a petition with the *Arbitrazh* court (state commercial court) for insolvency: "insufficiency of assets" and "inability to pay." "Insufficiency of assets" means that the aggregate value of a debtor's monetary obligations under "civil" transactions and mandatory payments (taxes and duties) exceeds the value of the debtor's assets. This is similar to the "balance sheet test" of solvency in U.S. and English law. "Inability to pay" refers to a debtor's inability to satisfy monetary obligations due to capital inadequacy—a rough equivalent of the "cash flow test" in U.S. and English law.

Under the amended Insolvency Law, a company's general director is obligated to file an insolvency petition within one month of learning that the company meets either of these criteria—a requirement that, according to some commentators, creates disturbing restrictions on the scope of potential alternatives for dealing with financial problems to avoid insolvency, such as debt or corporate restructuring.

The amended law also implements secondary liability of any "controlling person" as well as directors for a debtor's obligations, by providing that, upon a finding of liability, such parties must compensate the debtor-company for "damages inflicted on creditors' assets," a concept defined as any decrease in value of a debtor's assets and/or any increase in the value of claims against a debtor's assets, as well as other consequences of transactions or legally significant acts performed by the debtor that make it impossible for creditors to satisfy their claims out of the debtor's assets. A "controlling person" is not liable for damages if he can prove that he acted in good faith and reasonably in the debtor's interests. Directors are also liable for a debtor-company's obligations if the debtor's books and records are inaccurate or incomplete.

The new provisions provide additional grounds for challenging transfers by a debtor that can be voided by an insolvency officer (*i.e.*, an external administrator or bankruptcy receiver) on his own initiative or in accordance with any directive issued after a duly constituted creditors' meeting. Under the amended Insolvency Law, "suspicious transactions" and "transactions with a preference" entered into by a debtor are subject to challenge in court. Any action by a debtor to perform obligations arising from civil, labor, family, tax, customs, or procedural law may also be challenged in court. "Suspicious transactions" include: (i) any transaction entered into by a debtor within one year prior to becoming the subject of an insolvency petition, or afterward, involving inadequate consideration; and (ii) any transaction entered into by a debtor "for the purpose" of inflicting damage on creditors' proprietary interests in a debtor's assets, so long as damage actually results and the other party to the transaction was aware of the debtor's intent.

A "transaction with a preference" is defined in the amended Insolvency Law as a transaction entered into by a debtor for the preference of a creditor, subject to certain exceptions, including transactions entered into by the debtor in the ordinary course of business. If a suspicious transaction or a transaction with a preference is invalidated by the court, the transferred assets must be returned to the bankruptcy estate for distribution among creditors.

According to commentators, the new amendments to the Insolvency Law are intended to prevent asset stripping in a company on the verge of insolvency and to expand bankruptcy assets through the filing of claims against third parties. Moreover, the provisions relating to challenging transactions could constitute an extremely powerful tool in the hands of an insolvency officer. At this juncture, it remains to be seen how effective the amended law will be in achieving those goals.

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.

JONES DAY HAS OFFICES IN:

ATLANTA
BEIJING
BRUSSELS
CHICAGO
CLEVELAND
COLUMBUS
DALLAS
DUBAI
FRANKFURT
HONG KONG
HOUSTON
IRVINE
LONDON
LOS ANGELES
MADRID
MEXICO CITY
MILAN
MOSCOW
MUNICH
NEW DELHI
NEW YORK
PARIS
PITTSBURGH
SAN DIEGO
SAN FRANCISCO
SHANGHAI
SILICON VALLEY
SINGAPORE
SYDNEY
TAIPEI
TOKYO
WASHINGTON