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BUSINESS RESTRUCTURING REVIEW

IN THIS ISSUE

1 **Disenfranchising Strategic Investors in Chapter 11: "Loan to Own" Acquisition Strategy May Result in Vote Designation**
A New York district court affirmed a ruling disallowing the votes of a creditor that purchased the debtors' secured debt at par, after the debtors had filed a chapter 11 plan that proposed to satisfy the secured debt in full, to block plan confirmation and take control of the debtors.

5 **Credit Bidding in a Sale Under a Plan Is Not a Right: The Third Circuit's *Philadelphia Newspapers* Decision**
The Third Circuit affirmed a ruling denying a secured creditor the ability to credit-bid its claims under a "cramdown" chapter 11 plan proposing the sale of the creditor's collateral.

9 **Close Scrutiny of Breakup Fees in Bankruptcy Asset Sales Continues**
The Third Circuit had an opportunity to revisit section 503(b)'s application to breakup fees, ruling that such fees may be allowed only if they are necessary to induce a stalking-horse bidder either to enter into a transaction or to adhere to its bid after the court orders a public auction.

12 **Cross-Border Bankruptcy Battleground: The Importance of Comity (Part II)**
The role of comity in cross-border bankruptcy cases both within and outside the framework of chapter 15 was highlighted by rulings in the *Metcalfe & Mansfield* and *Lehman Brothers* bankruptcy cases.

17 **A Claim by Any Other Name: Court Disallows 503(b)(9) Claims Under Section 502(d)**
A Virginia bankruptcy court held that 20-day claims held by avoidable transfer recipients must be disallowed under section 502(d) pending the return of prepetition payments subject to avoidance in preference litigation.

21 **From the Top, in Brief: 2010 U.S. Supreme Court Bankruptcy Rulings**
The U.S. Supreme Court has handed down two decisions involving issues of bankruptcy law thus far in 2010.

22 **Chapter 15 Debut in the Circuits**
The Fifth Circuit held that, as chapter 15 was intended to facilitate cooperation between U.S. courts and foreign bankruptcy proceedings, a bankruptcy court has authority to permit relief under foreign avoidance law.

27 **Contract Law Update: Is an Executed Term Sheet a Binding Contract or an Unenforceable "Agreement to Agree"?**
The Appellate Division of the New York State Supreme Court held that a term sheet expressly providing that binding terms will be established only upon the completion of definitive loan documentation does not create an enforceable agreement to lend.

DISENFRANCHISING STRATEGIC INVESTORS IN CHAPTER 11: "LOAN TO OWN" ACQUISITION STRATEGY MAY RESULT IN VOTE DESIGNATION

Mark G. Douglas

The ability of a creditor whose claim is "impaired" to vote on a chapter 11 plan is one of the most important rights conferred on creditors under the Bankruptcy Code. The voting process is an indispensable aspect of safeguards built into the statute to ensure that any plan ultimately confirmed by the bankruptcy court meets with the approval of requisite majorities of a debtor's creditors and shareholders and satisfies certain minimum standards of fairness. Under certain circumstances, however, a creditor can be stripped of its right to vote on a plan as a consequence of its conduct during the course of a chapter 11 case.

In *In re DBSD North America, Inc.*, a New York bankruptcy court ruled in December 2009 that the votes of a creditor which purchased the debtors' senior secured debt at par, after the debtors had filed a chapter 11 plan that proposed to satisfy the senior secured debt in full (by means of a modified note under an amended first-lien credit facility), should be "designated" (*i.e.*, disallowed) pursuant to section 1126(e) of the Bankruptcy Code. The creditor's acknowledged purpose in buying the debt and voting to reject the chapter 11 plan was to take control of the debtor. The bankruptcy court concluded that the creditor's conduct warranted designation of its votes, observing that:

> [w]hen an entity becomes a creditor late in the game paying . . . [100 cents] on the dollar, as here, the inference is compelling that it has done so not to maximize the return on its claim, acquired only a few weeks earlier, but to advance an "ulterior motive" condemned in the case law.

According to the court, the creditor had an "ulterior motive" in acting not to maximize its interest as a creditor, but purely as a prospective owner of the reorganized debtors. A New York district court affirmed the ruling on March 24, 2010. The rulings have been appealed to the Second Circuit Court of Appeals and serve as a cautionary tale to prospective strategic investors pursuing a "loan to own" strategy.

CHAPTER 11 PLAN VOTING PROCEDURES

The preferred culmination of the chapter 11 process is confirmation of a chapter 11 plan specifying how the claims and interests of all stakeholders in the bankruptcy case are to be treated going forward. Depending on the provisions of the plan, classes of creditors, shareholders, and other stakeholders are provided with a voice in the confirmation process through the Bankruptcy Code's plan voting procedures. Generally, holders of allowed claims and interests have the right to vote to accept or reject a chapter 11 plan. Claimants or interest holders whose claims or interests are not "impaired," however, are deemed conclusively to accept the plan, and stakeholders who receive nothing under a plan are deemed to reject it. Any holder of a claim or interest to which an objection has been filed does not have the right to vote the portion of the claim or interest objected to, unless it obtains an order temporarily allowing the claim or interest for voting purposes pending resolution of the merits of the objection. Unliquidated or contingent claims may be estimated for purposes of voting on a plan.

Only a handful of chapter 11 vote-designation cases have reached the circuit courts of appeal since 1978, and the Second Circuit will have an opportunity to address the issue as a matter of first impression.

Voting rights can have a significant impact on the ultimate fate of a chapter 11 plan. If a creditor holds a significant bloc of claims in a single class under a plan, it may be able to prevent confirmation of the plan or force the plan proponent to comply with the Bankruptcy Code's "cramdown" requirements to achieve confirmation. Creditors holding a blocking position or having sufficient influence to create one through dealmaking with other creditors commonly use the resulting leverage to maximize their recoveries under the plan, sometimes at the expense of creditors who lack the same negotiating power. In some cases, the accumulation of claims and voting power can even be an effective means to gain control of a company in chapter 11.

DISQUALIFICATION OF VOTES

The drafters of the Bankruptcy Code recognized that the chapter 11 voting process can sometimes be abused by the unscrupulous. Section 1126(e) of the Bankruptcy Code provides:

> On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.

"Designation" of a vote means that the vote is disqualified or disallowed. Section 1126(e) expands the disqualification procedures that existed under chapter X of the former Bankruptcy Act. Under the Bankruptcy Act, a bankruptcy court was authorized to disqualify claims or stock for the purpose of determining the requisite majorities for acceptance of a plan if the holders of those claims or interests did not accept or reject the plan in good faith. The provision's purpose was to prevent speculators who had acquired claims or stock at depressed prices from exercising unfair veto power over the debtor's reorganization and to keep creditors and stockholders from securing advantages by refusing to vote in favor of a plan unless they received preferential treatment. Section 1126(e) is broader than its predecessor under the Bankruptcy Act—it authorizes the court to disallow votes that are not cast, procured, or solicited in good faith or in accordance with the provisions of the Bankruptcy Code. The bankruptcy court has broad discretion in determining whether to designate a vote.

The statute does not explain what kind of conduct amounts to bad faith, which is necessarily a flexible concept that has been left to the courts to define according to the facts and circumstances of each individual case. Court findings of bad faith, however, appear to center around certain types of conduct; instances of bad faith identified by the courts can be grouped into three general categories:

(i) Use of obstructive tactics or holdup techniques by a creditor to extract better treatment for its claim than the claims of similarly situated creditors in the same class;
(ii) Casting a vote for the ulterior purpose of securing some advantage to which the creditor would not otherwise be entitled; and
(iii) Casting a vote motivated by something other than protection of a creditor's own self-interest.

Votes, for example, have been deemed to be tainted if designed to assume control of the debtor, put the debtor out of business or otherwise gain a competitive advantage, destroy the debtor out of pure malice, or obtain benefits available under a private side agreement with a third party that depends on the debtor's inability to reorganize. These factors have been identified by some courts as "badges of bad faith." Standing alone, however, a creditor's "selfish motive" for casting its vote is not a basis for disqualification under section 1126(e). Given the practical ramifications of barring an impaired creditor from exercising a fundamental entitlement, most courts consider designation to be the "exception rather than the rule" or even a "drastic remedy."

The seminal case addressing vote designation in chapter 11 is a Pennsylvania bankruptcy court's 1990 decision in *In re Allegheny International, Inc.* In that case, the court designated the votes of Japonica Partners, a hedge fund that acquired claims against a chapter 11 debtor with the "ulterior motive" of seizing control of the debtor. The court concluded that Japonica was manipulating the bankruptcy process because it was acting not to protect its interests as a creditor, but as an opportunistic investor that bought up claims 22 months into the case after the debtor had filed its chapter 11 plan and disclosure statement. Among other things, the evidence showed that Japonica purchased claims in classes with diametrically opposed interests in pending avoidance and lender liability litigation and that the amounts and prices of claims acquired by Japonica clearly indicated it was orchestrating a scheme to block confirmation of the debtor's chapter 11 plan and propose a competing plan. The bankruptcy court in *DBSD North America* looked to *Allegheny* for guidance in assessing whether a creditor's conduct in acquiring claims to block confirmation of a plan warranted designation of its votes under section 1126(e).

DBSD NORTH AMERICA

DBSD North America, Inc., is a development-stage enterprise formed in 2004 to develop an integrated mobile satellite and terrestrial services network to deliver wireless satellite communication services to mass-market consumers. The company and its subsidiaries (the "debtors") filed for chapter 11 protection in New York on May 15, 2009. Shortly after the debtors filed an amended chapter 11 plan, DISH Network Corporation ("DISH"), a competing satellite services provider, purchased $40 million in principal amount of the debtors' first-lien working capital facility debt. DISH thereby acquired all of the claims in Class 1 of the debtors' plan. A DISH affiliate then purchased $111 million in principal amount (less than all) of the second-lien claims classified separately under the plan, which proposed to convert the second-lien debt to equity. The second-lien claims purchase was made only after determining that the sellers were not bound by a plan support agreement. DISH paid 100 cents on the dollar for the first-lien debt.

DISH voted all of its claims against the plan. As a consequence, Class 1 would have rejected the plan. However, the debtors sought a court order designating the Class 1 votes. Bankruptcy judge Robert E. Gerber sided with the debtors, finding that:

> DISH's acquisition of First Lien Debt was not a purchase to make a profit on increased recoveries under a reorganization plan. . . [but] [r]ather . . . DISH made its investment in this chapter 11 case, and has continued to act, not as a traditional creditor seeking to maximize its return on the debt it holds, but as a strategic investor, "to establish control over this strategic asset."

Judge Gerber based his decision upon the timing of DISH's claim purchases shortly before confirmation, the inflated price DISH paid for the debt, and internal DISH documents, as well as testimony that revealed its plans to use the debt purchase as a means to "control the bankruptcy process" and "acquire control" of the company, which was a "potentially strategic asset."

According to Judge Gerber, the circumstances represented a classic case for application of *Allegheny*, as well as the

ruling's identification of "efforts to assume control of the debtor" as a badge of bad faith. As Judge Gerber observed, DISH's conduct in seeking to block a plan that would have repaid its first-lien claims with a promissory note, in favor of proposing its own plan, which would have given it control of the debtors, "is indistinguishable in any legally cognizable respect from the conduct that resulted in designation in *Allegheny*, and DISH's vote must be designated for the same reasons."

Judge Gerber rejected DISH's argument that its conduct was that of a "model bankruptcy citizen" in that it had not "moved to terminate exclusivity" or "proposed a competing plan." This line of defense was belied by the fact that, on the morning of the scheduled confirmation hearing (and after the close of briefing on the designation motion), DISH filed a motion seeking court authority to terminate the debtors' exclusivity and to propose its own chapter 11 plan.

DISH appealed the ruling to the district court, which affirmed. According to district judge Lewis A. Kaplan, the bankruptcy court's finding that DISH had acted as a strategic investor to obtain control over the debtor was not clearly erroneous and was sufficient to support the court's finding of a lack of good faith for purposes of section 1126(e).

OUTLOOK

DBSD North America does not represent the first instance that Judge Gerber has considered the standards for vote designation under section 1126(e). In his 2006 ruling in *In re Adelphia Comm. Corp.*, Judge Gerber, acknowledging that "[t]he ability to vote on a reorganization plan is one of the most sacred entitlements that a creditor has in a chapter 11 case," wrote that "[w]hile creditor tactics, activities or requests (or plan provisions that result from them) may be objectionable, the Code provides for other ways to address concerns that arise from such (such as upholding objections to confirmation) without the draconian measure of denying one's franchise to vote." Thus, Judge Gerber declined a request to designate votes in the *Adelphia* case.

In *DBSD North America*, Judge Gerber reaffirmed the legitimacy of vigorous advocacy by creditors, including extremely aggressive actions, provided that such conduct is calculated "to increase their recoveries as creditors holding long positions in debt." DISH's undoing was that it "acted to advance strategic investment interests wholly apart from maximizing recoveries on a long position in debt it holds." Given the ruling in *Adelphia*, Judge Gerber's decision to designate votes in *DBSD North America* appears to be a consequence of what he perceived to be particularly egregious facts.

As noted, DISH has appealed the district court's ruling to the Second Circuit Court of Appeals. Only a handful of chapter 11 vote-designation cases have reached the circuit courts of appeal since 1978, and the Second Circuit will have an opportunity to address the issue as a matter of first impression.

In re DBSD North America, Inc., 421 B.R. 133 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010).

In re Allegheny International, Inc., 118 B.R. 282 (Bankr. W.D. Pa. 1990).

In re Adelphia Comm. Corp., 359 B.R. 54 (Bankr. S.D.N.Y. 2006).

CREDIT BIDDING IN A SALE UNDER A PLAN IS NOT A RIGHT: THE THIRD CIRCUIT'S *PHILADELPHIA NEWSPAPERS* DECISION

Nicholas C. Kamphaus

Secured lenders are not as protected in bankruptcy as they might have thought, at least in the Third Circuit. In *In re Philadelphia Newspapers, LLC*, the court of appeals sent shock waves through the commercial lending industry by ruling that a dissenting class of secured creditors can be stripped of any right to credit-bid its claims under a chapter 11 plan that proposes an auction sale of the creditors' collateral free and clear of liens. The highly anticipated decision is clearly not the result that secured lenders had hoped for, and the ruling has left lenders scrambling to devise new strategies to protect themselves in chapter 11 cases.

THE DEBTORS

Philadelphia Newspapers LLC and its affiliates (the "Debtors") own and operate the local newspapers *The Philadelphia Inquirer* and the *Philadelphia Daily News*, as well as the online publication philly.com. Their financing came mainly through a $295 million senior secured credit facility entered into with various lenders (collectively, the "Lender Group"). Due to the tribulations of the newspaper business as a whole, the Debtors were forced to file for protection under chapter 11 of the Bankruptcy Code on February 22, 2009, in Philadelphia.

THE PLAN SALE

The Debtors filed their chapter 11 plan on August 20, 2009. Under the plan, substantially all of the assets of the Debtors would be sold free and clear of liens pursuant to an auction, with the proceeds of the auction, less a carve-out for certain expenses, passing to the Lender Group. The Debtors' proposed bidding procedures for the auction incorporated a "stalking horse" bid for the assets from a consortium consisting of existing equity holders who controlled approximately 50 percent of the outstanding equity interests in the Debtors. This bid would provide $37 million in cash for the Lender Group, which, along with certain additional distributions of property, would result in a recovery by the Lender Group of approximately $66.5 million on account of their secured claim of more than $300 million.

The Lender Group publicly noted that it believed the stalking-horse bid was too low, and it announced its intention to "credit-bid" at the auction, setting off any amount bid for the assets against amounts the Debtors owed the Lender Group under the secured credit facility, which was secured by those same assets. The Debtors filed a motion to approve the proposed bidding procedures on August 28, 2009. Notably, the proposed bidding procedures required that bids must be all-cash, prohibiting the Lender Group from credit bidding at the auction. The Lender Group objected to the proposed bidding procedures, arguing that the Bankruptcy Code requires that a secured lender be permitted to credit-bid at a sale of its collateral as part of a chapter 11 plan.

THE "FAIR AND EQUITABLE" TEST

The Lender Group argued that the plain meaning of section 1129(b) of the Bankruptcy Code, which sets forth the requirements for a "cramdown" chapter 11 plan, precludes the Debtors from conducting a sale of collateral free of liens under a plan without affording the secured party the right to credit-bid. Section 1129(b)(1) requires, among other things, that in order to be confirmed over the dissent of a class of creditors or interest holders, the plan must be "fair and equitable" with respect to the dissenting class. Section 1129(b)(2) addresses the "fair and equitable" requirement for different types of claims. Section 1129(b)(2)(A) provides three alternative ways to achieve confirmation over the objection of a dissenting class of secured claims: (i) the secured claimant's retention of its liens and receipt of deferred cash payments equal to the value, as of the plan effective date, of its secured claim; (ii) the sale, "subject to section 363(k)," of the collateral free and clear of all liens, with attachment of the liens to the proceeds and treatment of the liens under option (i) or (iii); or (iii) the realization by the secured creditor of the "indubitable equivalent" of its claim.

The Lender Group argued that this structure makes clear that all sales of collateral free of liens under a chapter 11 plan fall under section 1129(b)(2)(A)(ii), and thus, a secured creditor always has the right to credit-bid in such a sale, unless its class consents to the plan. The Debtors countered that the "fair and equitable" requirements are set in the disjunctive, such that so long as the Lender Group realizes the "indubitable equivalent" of its secured claims, it need not be afforded the right to credit-bid in the sale.

COLLATERAL VALUATION AND THE SECTION 1111(b) ELECTION

The Lender Group further argued that the Bankruptcy Code's protections for secured claimants militate in favor of a right to credit-bid in any sale, either during the course of the bankruptcy or as part of the chapter 11 plan. In particular, section 1111(b) provides that a secured creditor with recourse against a debtor on account of a secured claim can elect to have its entire claim treated as secured, rather than bifurcated into a secured claim to the extent of the value of the collateral and an unsecured claim for the deficiency. However, section 1111(b) provides that the election is not available if the collateral is sold under section 363 of the Bankruptcy Code or under a chapter 11 plan.

Section 1111(b) is intended to protect a secured creditor against the possibility that the debtor can realize a windfall if collateral is assigned a low value (due to depressed market conditions or valuation error) and the creditor's secured claim is stripped down to the depressed value of its security interest. The exception for collateral that is sold is premised upon the idea that protection against low valuation is not necessary when the market determines the value of the collateral. In *Philadelphia Newspapers*, the Lender Group argued that section 363(k), which allows a secured claimant to credit-bid, is an essential part of a secured creditor's protection because it ensures that the secured creditor is satisfied with the sale price (otherwise it would outbid, using the value of its secured claim, and simply take the collateral).

According to the Debtors, Congress could have explicitly made all sales of collateral free of liens under a plan subject to a secured creditor's right to credit-bid, but it failed to do so. Also, the Debtors claimed, allowing the Lender Group to credit-bid might drive away other potential bidders, who would be reluctant to engage in the diligence necessary to make a bid because the Lender Group could simply outbid them at no actual cost. Thus, the Debtors argued, any right of the Lender Group to credit-bid could actually allow the Lender Group to acquire the company or its assets for an inadequate price.

Chief bankruptcy judge Stephen Raslavich refused to allow the Debtors' assets to be sold without affording the Lender Group the right to credit-bid its claims. The court held that the more reasonable interpretation of the "fair and equitable" test for treatment of secured creditors is that the requirement in section 1129(b)(2)(A)(ii) for a sale under a plan to be "subject to" a secured creditors' right to credit-bid applies to all sales under a plan. Section 1129(b)(2)(A)(iii), the court reasoned, is implicated only when a plan provides for the abandonment of collateral to secured creditors or the substitution of collateral.

According to the bankruptcy court, credit bidding is designed to protect against low-ball judicial valuation of collateral. The court rejected the Debtors' argument that allowing credit bidding could actually chill the bidding process, reasoning that, because recoveries to all claimants other than the Lender Group were fixed, the existence of any higher bid would affect only the Lender Group's returns. As the Lender Group wanted to credit-bid, the court declined to second-guess it as to the course of action that would provide it with the greatest recovery.

The district court reversed on appeal, approving the bidding procedures. Among other things, it reasoned that the plain meaning of section 1129(b)(2)(A), particularly the use of the disjunctive "or," indicates that the three tests for satisfying the "fair and equitable" test are alternatives. Moreover, the district court emphasized, nothing in section 1129(b)(2)(A) links the requirements for "fair and equitable" treatment under a plan to the ability of a secured claimant to make a section 1111(b) election.

THE THIRD CIRCUIT'S RULING

A divided panel of the Third Circuit affirmed the district court's ruling on appeal. The court of appeals reiterated the district court's reliance on the importance of the plain-meaning rule and the use of the disjunctive "or" in section 1129(b)(2)(A). According to the majority ruling, the "indubitable equivalent" prong—section 1129(b)(2)(A)(iii)—does not itself require that a secured creditor be permitted to credit-bid its claim. Instead, the court held, the "indubitable equivalent" alternative unambiguously requires a secured creditor to realize "the unquestionable value" of the creditor's secured interest in the collateral. The Lender Group argued that, under existing Third Circuit precedent, the amount of a secured creditor's successful credit bid for its collateral determines the value of that

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Corinne Ball (New York) was named a "Dealmaker of the Year" for 2010 by *The American Lawyer* for her work in connection with the groundbreaking chapter 11 cases of Chrysler LLC and its affiliates.

Simon Powell (Hong Kong) has been recognized by *Chambers Asia* as one of the finest attorneys in the Restructuring/Insolvency practice area for 2010.

Adam Plainer (London) has been recommended as an expert in the field of Corporate Restructuring and Insolvency in the 2010 edition of *Legal Experts*.

Kevyn D. Orr (Washington) was selected to vice-chair the American Bar Association Business Bankruptcy Committee's Subcommittee on Administration, U.S. Trustee, Jurisdiction & Venue and Courts.

Thomas A. Howley (Houston) and ***Daniel B. Prieto (Dallas)*** were designated Texas "Rising Stars" for 2010 in the field of Bankruptcy & Creditor/Debtor Rights by *Super Lawyers* magazine.

Bennett L. Spiegel (Los Angeles), ***Richard Wynne (Los Angeles)***, and ***Michaeline Correa (San Francisco)*** participated in the California Bankruptcy Forum's 22nd Annual Insolvency Conference on May 21 in Monterey, California. The topic of Mr. Wynne's presentation was "The Post-General Motors Chapter 11: Is Nothing Sacred Anymore?"

Erin N. Brady (Los Angeles) and ***Lori Sinanyan (Los Angeles)*** were designated "Rising Stars" in the field of Bankruptcy & Creditor/Debtor Rights by *Super Lawyers* magazine.

collateral, and thus, assuring the realization of the "indubitable equivalent" of a secured claim requires affording secured creditors the right to credit-bid for their collateral. Under this reasoning, even if the "indubitable equivalent" test could be utilized, the right to credit-bid would still be required. The majority of the Third Circuit panel disagreed, holding that the value of the collateral could be determined in other ways. It refused to conclude as a matter of law that the auction could not possibly allow the Lender Group to realize the "indubitable equivalent" of its secured claims. Whether the results of the auction in fact satisfy this test, the court explained, remains open for dispute at the plan confirmation stage.

In rejecting the Lender Group's argument that section 1129(b)(2)(A) should be read in conjunction with section 1111(b), the majority opinion held that Congress did not intend secured creditors to have the right to credit-bid whenever their collateral is sold under a plan, because the right to credit-bid is not absolute. In particular, the court explained that a sale of collateral can occur in bankruptcy without allowing the secured creditor to credit-bid when: (i) the court orders that a credit bid should be disallowed "for cause" under section 363(k) itself; or (ii) the collateral is sold subject to the lien under section 1129(b)(2)(A)(i), in which case the future payments required to be made to the secured creditors must

have a present value equal only to the judicial valuation of the security interest in the collateral. Thus, the court reasoned, there is no overarching scheme in the Bankruptcy Code to protect the value of secured claims by means of the right to credit-bid.

Philadelphia Newspapers is admittedly a setback for secured creditors relying on the protection of credit bidding in bankruptcy. According to some observers, the ruling may encourage debtors, unsecured creditors, and other stakeholders whose interests are not aligned with those of secured creditors to propose plans that provide for sales of lender collateral without honoring secured creditors' credit-bidding rights.

Judge Thomas L. Ambro, a former bankruptcy practitioner, wrote a vigorous 48-page dissent. Judge Ambro opined that section 1129(b)(2)(A) can reasonably be read as outlining the different requirements to satisfy the "fair and equitable" test, but that only one of the three requirements is applicable to any given class of secured creditors under a plan. The applicable requirement is determined by the treatment of the class of secured creditors. In addition, Judge Ambro would have applied the context of section 1111(b) and the legislative history of the provisions to conclude that "the Code requires cramdown plan sales free of liens to fall under the specific requirements of § 1129(b)(2)(A)(ii) and not to the general requirement of subsection (iii)." Finally, the judge observed that the panel's ruling would not prevent the bankruptcy court from finding "that the debtors' plan is a thinly veiled way for insiders to retain control of an insolvent company minus the debt burden the insiders incurred in the first place." A bankruptcy judge, he remarked, could also rule that the plan is not "fair and equitable."

THE AFTERMATH

Philadelphia Newspapers is admittedly a setback for secured creditors relying on the protection of credit bidding in bankruptcy. According to some observers, the ruling may encourage debtors, unsecured creditors, and other stakeholders whose interests are not aligned with those of secured creditors to propose plans that provide for sales of lender collateral without honoring secured creditors' credit-bidding rights. A debtor or a creditors' committee, for example, might threaten to propose a cramdown plan that denies credit-bidding rights as leverage in order to obtain concessions from senior lenders during the plan negotiation process. On the flip side, lenders may be inclined to insist early on in a chapter 11 case (*i.e.*, in connection with DIP financing or cash collateral agreements) that sales be conducted through stand-alone auctions under section 363(b) with credit-bidding rights.

The events that have transpired in the *Philadelphia Newspapers* bankruptcy since the Third Circuit issued its opinion illustrate how secured creditors may be able to work around the decision. The Lender Group petitioned the Third Circuit for rehearing en banc, but the petition was summarily denied, with only Judge Ambro stating that he would have granted rehearing.

However, on April 28, 2010, the Lender Group prevailed in the auction held pursuant to the bidding procedures approved by the Third Circuit, purchasing substantially all of the Debtors' assets for approximately $138.9 million. In order to make such a bid, the Lender Group was required to obtain financing to pay this amount in cash. But because the bidding procedures provide that any extra cash generated by the auction must flow back to the Lender Group, the Lender Group will recover much of this purchase price under the plan.

The ultimate result in *Philadelphia Newspapers* raises the question of just how important the right to credit-bid actually is. The answer should not be oversimplified. For instance, credit documents may allow the entire amount of a syndicated secured lending facility to be credit-bid at the direction of a majority or supermajority of the lenders, despite the dissent of other lenders. In such a case, the credit documents generally would not require minority lenders to contribute additional funds for such a bid. Thus, if there is no right to credit-bid in a sale under a plan, the lending syndicate may not be able to raise the funds necessary to purchase the collateral with cash and achieve the same result. This means that the right to credit-bid may be essential to overcome collective-action difficulties in some circumstances.

Philadelphia Newspapers comes closely on the heels of the September 2009 ruling in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), in which the Fifth Circuit similarly considered whether section 1129(b)(2)(A)(ii) is the only avenue to confirmation of a plan under which the collateral securing the claims of a dissenting secured class is to be sold. The court of appeals ruled that section 1129(b)(2)(A)(ii) does not always provide the exclusive means by which to confirm a reorganization plan where the sale of a secured party's collateral is contemplated. Rather, the Fifth Circuit held that, where sale proceeds provide a secured creditor with the indubitable equivalent of its collateral, confirmation of a plan is possible under section 1129(b)(2)(A)(iii). In addition, consistent with its conclusion that the sale transaction in the chapter 11 plan accomplished that result, the court rejected an argument by noteholders that confirmation was improper because they had not been afforded the opportunity to credit-bid their claims for the assets.

It remains to be seen how other courts will come down on this important issue, but at present the momentum appears to be in favor of allowing plan proponents to limit secured creditors' rights to credit-bid in a sale of their collateral under a chapter 11 plan.

In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010).

In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009).

CLOSE SCRUTINY OF BREAKUP FEES IN BANKRUPTCY ASSET SALES CONTINUES

Dennis N. Chi

Section 363(b)(1) of the Bankruptcy Code authorizes a bankruptcy trustee or chapter 11 debtor in possession, "after notice and a hearing," to use, sell, or lease property of the state outside the ordinary course of business. While a sale under section 363(b)(1) is most frequently undertaken by means of a public auction, in which assets are generally sold to the highest bidder, the bankruptcy court may also approve a private sale entered into between the debtor and a purchaser.

Generally speaking, the initial bidder in a public auction held under section 363—the "stalking-horse bidder"—sets the minimum price and other terms of the transaction. Because of the time and effort expended by the stalking-horse bidder in performing due diligence and engaging in the negotiations necessary to arrive at the initial bid, bankruptcy courts will generally allow reasonable bid protections for the bidder in the event the court does not approve the sale or the stalking-horse bidder does not prevail at the auction. These bid protections often include reimbursement of expenses incurred by the bidder in connection with the transaction, a "breakup" fee equal to a specified percentage of the bidder's purchase price, auction procedures, and certain other rights related to the stalking-horse bid. These bid protections are typically the subject of extensive negotiations.

Outside bankruptcy, such protections are typically accorded deference under the business judgment rule. In the bankruptcy context, however, three different approaches have been applied by courts in assessing the propriety of bid protections. Some courts apply a "business judgment" standard to the issue, which, of all the approaches followed by the various courts, involves the highest degree of deference to the debtor's decision to agree to the bidding protections in question. Other courts apply stricter scrutiny, requiring evidence that proposed bid protections are in the "best interests of the estate." Finally, some courts, particularly in the Third Circuit, have generally allowed or disallowed bid protections, including breakup fees, according to the standards

governing the allowance of administrative expenses under section 503(b) of the Bankruptcy Code.

The Third Circuit Court of Appeals recently had an opportunity to revisit the application of the section 503(b) administrative-expense standard to breakup fees. In *In re Reliant Energy Channelview LP*, the court of appeals reaffirmed its previous rulings, holding that such fees may be allowed only if they are necessary to induce a stalking-horse bidder either to enter into a transaction or to adhere to its bid after the court orders a public auction.

RELIANT ENERGY

Reliant Energy Channelview LP and its affiliate, Reliant Energy Services Channelview LLC (collectively, the "debtors"), owners and operators of a cogeneration power plant in Channelview, Texas, filed for chapter 11 protection in Delaware in 2007. In 2008, the debtors decided to sell their Texas power plant. With the assistance of consultants with expertise in the energy industry, the debtors contacted 115 potentially interested purchasers and sought bids in a private bidding process. A total of 12 bids were submitted for the plant. The winning bid was submitted by Kelson Channelview LLC ("Kelson"), in the amount of $468 million. Unlike many of the bids submitted with a financing contingent in a difficult business environment, Kelson's bid was not contingent on financing.

Under the asset purchase agreement with Kelson, the debtors were required to seek: (i) an order of the bankruptcy court authorizing the sale without an auction; and (ii) if the court determined that there should be a public auction, an order approving certain "bid protections and procedures" for Kelson's benefit. The bid protections included: (i) a $5 million minimum overbid threshold; (ii) a $15 million breakup fee; and (iii) reimbursement of up to $2 million in expenses incurred by Kelson in connection with the sale process.

The bankruptcy court delayed ruling on the debtors' motion to authorize the sale without conducting a public auction after one of the debtors' equity holders objected to the expedited pace of the transaction. Confronted with the delay, the debtors, with the support of their creditors, asked the bankruptcy court to approve the bid protections. Fortistar, LLC ("Fortistar"), a competing bidder that previously submitted a losing bid based on contingent financing, objected, asserting that it was willing to enter a "higher and better" bid at auction, but claimed that the $15 million breakup fee and the $2 million expense reimbursement would be a deterrent to its competing bid.

The bankruptcy court ultimately refused to approve the $15 million breakup fee, but it approved both the $5 million overbid threshold and the expense reimbursement provision. The court also refused to authorize the sale of the plant without an auction. Kelson declined to participate in the auction that ensued, arguing that its initial bid was no longer available. Fortistar ultimately submitted the winning bid, which topped Kelson's bid by $32 million. The debtors paid Kelson approximately $1.2 million for expense reimbursement, but in light of the court's ruling, they did not pay Kelson any breakup fee.

Kelson appealed to the district court, arguing, among other things, that as a stalking-horse bidder, it should have been entitled to a breakup fee as a matter of fundamental fairness. The district court affirmed the rulings below, after which Kelson appealed denial of its breakup fee to the Third Circuit.

THE THIRD CIRCUIT'S RULING

The Third Circuit affirmed. In its decision, the court of appeals cited its 1999 ruling in *Calpine Corp. v. O'Brien Environmental Energy, Inc.*, where the court held that a breakup fee is allowable only if it is "necessary to preserve the value of the estate" under section 503(b) of the Bankruptcy Code. According to the Third Circuit, there are two ways that a breakup fee can preserve the value of an estate: (i) by inducing the stalking-horse bidder to make an initial bid; and (ii) by inducing the bidder to adhere to its bid after the court orders an auction.

Kelson's bid, the court of appeals emphasized, was conditioned on the debtors' mere "promise" to *seek* court approval of the breakup fee, rather than court approval itself or Kelson's actual receipt of the breakup fee. As such, the court found that the breakup fee was not necessary to preserve the value of the debtors' estate because the fee did not "induce"

Kelson's bid. The fact that Kelson submitted its bid before court approval with the explicit understanding that it might not receive the fee supported the Third Circuit's determination that the breakup fee was not necessary to induce Kelson's bid. In addition, the court held that the breakup fee was not needed to maintain Kelson's bid from the estate's standpoint once an auction was ordered, because there was no reason to believe Kelson would have abandoned its fully negotiated agreement, and in any event, there was another willing and able bidder—Fortistar—waiting in the wings.

Reliant Energy illustrates the importance that courts in the Third Circuit place on public auctions in conducting bankruptcy asset sales and indicates that bankruptcy courts will continue to scrutinize closely the necessity of breakup fees in such sales. Under this ruling, courts in the Third Circuit will continue to review breakup fees, applying the standard for administrative-expense allowance under section 503(b).

The Third Circuit concluded that, although the debtors' estates might have benefited to the extent that the grant of the breakup fee would have secured Kelson's adherence to its earlier bid in a public auction, this benefit was outweighed by the potential harm to the estate that a breakup fee would cause by deterring other bidders from participating in the bidding process.

The Third Circuit rejected Kelson's argument that, because none of the debtors' creditors or equity holders objected to the breakup-fee request, the business judgment rule was the proper standard to apply. According to the court, in accordance with *O'Brien*, the section 503(b) standard applies and is not satisfied merely because no objections are interposed. The court also rebuffed Kelson's claim that it was entitled to the breakup fee as a matter of "fundamental fairness" because: (i) Kelson did not raise the argument in the bankruptcy court; and (ii) the two types of claims are clearly distinct—a breakup fee under section 503(b) is a statutory claim, whereas a breakup-fee claim predicated on "fundamental fairness" is a common-law or equitable claim.

Finally, the Third Circuit rejected Kelson's argument that the debtors were estopped from opposing Kelson's appeal because they supported the request for a breakup fee in the bankruptcy court. A chapter 11 debtor in possession, the court emphasized, has a fiduciary duty to maximize the value of the estate. In this case, the debtors argued convincingly that if they had adhered to their earlier position in the face of the changed circumstances, they would have harmed the estate and violated their fiduciary duty. As such, the Third Circuit ruled that the debtors were not estopped from opposing the appeal.

OUTLOOK

Reliant Energy illustrates the importance that courts in the Third Circuit place on public auctions in conducting bankruptcy asset sales and indicates that bankruptcy courts will continue to scrutinize closely the necessity of breakup fees in such sales. Under this ruling, courts in the Third Circuit will continue to review breakup fees applying the standard for administrative-expense allowance under section 503(b).

In re Reliant Energy Channelview LP, 594 F.3d 200 (3d Cir. 2010).

Calpine Corp. v. O'Brien Environmental Energy, Inc., 181 F.3d 527 (3d Cir. 1999).

CROSS-BORDER BANKRUPTCY BATTLEGROUND: THE IMPORTANCE OF COMITY (PART II)

Mark G. Douglas and Nicholas C. Kamphaus

The process whereby U.S. courts recognize and enforce the judicial determinations and proceedings of courts abroad (commonly referred to as "comity") has been an integral part of U.S. jurisprudence for hundreds of years. Comity plays an important role in cross-border bankruptcy cases involving debtors that are subject to bankruptcy or insolvency proceedings outside the U.S. but have creditors or assets in the U.S. Comity is among the fundamental principles underpinning chapter 15 of the Bankruptcy Code, as well as provisions in U.S. bankruptcy law governing cross-border cases that preceded chapter 15's enactment in 2005.

The extent to which U.S. and foreign bankruptcy laws are inconsistent is an important component in a U.S. court's determination of whether a foreign court's decrees should be enforced in the U.S. under principles of comity. Conflicts of law in the realm of cross-border bankruptcy cases were the subject of two rulings handed down by New York bankruptcy courts in early 2010. In *In re Metcalfe & Mansfield Alternative Investments*, bankruptcy judge Martin Glenn, by way of "additional assistance" in a chapter 15 case involving a Canadian debtor, enforced a Canadian court's order confirming a restructuring plan that contained nondebtor releases and injunctions, even though it was uncertain whether a U.S. court would have approved the releases and injunctions in a case under chapter 7 or 11 of the Bankruptcy Code. In *In re Lehman Brothers Holdings, Inc.*, bankruptcy judge James M. Peck refused to recognize rulings by U.K. courts that validated a "flip clause" in a swap agreement that shifted the priority of claims between a noteholder and its swap counterparty, a Lehman Brothers affiliate, due to the U.S. bankruptcy filing of the parent company. Even though the priority shift was valid under U.K. law, the court declined to recognize the rulings notwithstanding principles of comity, because it concluded that the flip clause, a common risk-mitigation technique in swap transactions, was an *ipso facto* clause unenforceable under U.S. law. These rulings indicate that comity continues to be a significant consideration in cross-border bankruptcy cases involving the conflicting laws of different nations, both within and outside chapter 15. In Part I of this article, which appeared in the March/April 2010 edition of the *Business Restructuring Review* (Vol. 9, No. 2), we addressed the court's ruling in *Metcalfe & Mansfield*. Part II discusses the bankruptcy court's decision in *Lehman Brothers*.

COMITY

As noted, U.S. courts apply general principles of comity in determining whether to recognize and enforce foreign judgments. In its 1895 ruling in *Hilton v. Guyot*, the U.S. Supreme Court held that a U.S. court should enforce the judgment and that the issue should not be "tried afresh" if a foreign forum provides

> a full and fair trial abroad before a court of competent jurisdiction, conducting the trial upon regular proceedings, after due citation or voluntary appearance of the defendant, and under a system of jurisprudence likely to secure an impartial administration of justice between the citizens of its own country and those of other countries, and there is nothing to show either prejudice in the court, or in the system of laws under which it was sitting.

Comity has long been an important consideration in cross-border bankruptcy and insolvency cases. Prior to the enactment of chapter 15 in 2005, section 304 of the Bankruptcy Code governed proceedings commenced by the accredited representatives of foreign debtors in the U.S. that were "ancillary" to bankruptcy or insolvency cases filed abroad. Ancillary proceedings were typically commenced under section 304 for the limited purpose of protecting a foreign debtor's U.S. assets from creditor collection efforts by means of injunctive relief granted by a U.S. bankruptcy court and, in some cases, for the purpose of repatriating such assets or their proceeds abroad for administration in the debtor's foreign bankruptcy case. In deciding whether to grant injunctive, turnover, or other appropriate relief under former section 304, a U.S. bankruptcy court was obliged to consider "what will best assure an economical and expeditious administration" of the foreign debtor's estate, consistent with a number of factors, including comity.

Comity continues to play a prominent role in chapter 15, which is patterned on the Model Law on Cross-Border

Insolvency. The Model Law is a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. To date, it has been adopted in 18 nations or territories. The stated purpose of chapter 15 is "to incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency" consistent with objectives that include cooperation between U.S. and non-U.S. courts and related functionaries.

To effectuate that goal, if a U.S. court "recognizes" a foreign "main" or "nonmain" proceeding under chapter 15, it is authorized under section 1507 to provide "additional assistance" to a foreign representative. This can include injunctive relief or authority to distribute the proceeds of all or part of the debtor's U.S. assets, provided the court concludes, "consistent with the principles of comity," that such assistance will reasonably ensure, among other things, the just treatment of creditors and other stakeholders, the protection of U.S. creditors against prejudice in pursuing their claims in the foreign proceeding, and the prevention of fraudulent or preferential disposition of property. In addition, if the bankruptcy court enters an order of recognition under chapter 15, section 1509 provides that any other U.S. court "shall grant comity or cooperation to the foreign representative."

Applying principles of comity to strike a fair balance between the competing interests of creditors under conflicting laws is a difficult undertaking. The bankruptcy court in *Lehman Brothers* was recently called upon to do so.

LEHMAN BROTHERS

In one of the myriad legal disputes arising from the mammoth bankruptcy of investment bank holding company Lehman Brothers Holdings, Inc. ("LBHI"), a New York bankruptcy court refused to grant comity to the English courts concerning the interpretation of a contract that contained an English choice-of-law provision. One of LBHI's subsidiaries, Lehman Brothers Special Financing, Inc. ("LBSF"), had entered into certain swap agreements with various special-purpose entities (the "SPEs"), which had in turn issued credit-linked notes to various noteholders. After LBHI filed for chapter 11 protection in September 2009, two English courts ruled that a provision in related transaction documents that altered the priority of payments from the SPEs to favor noteholders over LBSF, effective upon LBHI's bankruptcy filing, was valid and enforceable under English law. The English courts did not address whether the "flip clauses" were valid and enforceable under U.S. law. U.S. bankruptcy judge James M. Peck refused to enforce the rulings notwithstanding principles of comity, concluding, among other things, that the priority shift triggered by parent company LBHI's chapter 11 filing was an unenforceable *ipso facto* clause under U.S. law.

The Transactions

The relevant transactions, known as the "Dante Program," provided for the creation of synthetic interests in certain reference entities through the creation of credit-linked notes. All of the relevant agreements contained choice-of-law provisions that they were to be governed by English law. The SPEs issued the notes, using the proceeds to buy certain highly rated collateral (the "Collateral"). The Collateral was then transferred to a trustee, the Bank of New York ("BNY"). On the other side of the transaction, LBSF entered into swap agreements with the SPEs, such that LBSF was obligated to remit to BNY periodic payments that would be used, along with the returns from the Collateral, to fund distributions on the notes.

Both LBSF's payment obligations under the swap agreements and noteholder distributions were affected by the occurrence or nonoccurrence of certain credit events with respect to the reference entities, with the purpose that a default by any of the reference entities would decrease the amount owed by LBSF and the amount distributed on account of the notes. Thus, the risk of default by the reference entities was borne by the noteholders, not LBSF. In addition, defaults by reference entities entitled LBSF to certain payments to be funded by liquidation of the Collateral.

Rights to proceeds from the Collateral were specified in detail in the Principal Trust Deed and the Supplemental Trust Deed (collectively, the "Trust Deeds"), which initially conferred the highest priority of payment for obligations owed to LBSF, so that LBSF would recover proceeds due to defaults by reference entities before the noteholders would receive the proceeds from any excess Collateral. However, under certain circumstances, including a bankruptcy filing by LBSF or LBHI,

or nonpayment by LBSF of any amounts due under the swap agreements, the Trust Deeds provided for a change in payment priority, such that the noteholders would receive payment from the proceeds of the Collateral prior to LBSF.

The Lehman Bankruptcy Filings

LBHI filed for chapter 11 protection in New York on September 15, 2008. Shortly thereafter, LBSF ceased making payments under any of the relevant swap agreements. On October 3, 2008, LBSF filed for bankruptcy protection in the same court. At the time, due to defaults by various reference entities, LBSF was owed substantial sums under the relevant swap agreements.

The U.K. Litigation

Two noteholders filed litigation in English court against BNY seeking a judgment that, due to the bankruptcy filing by LBHI and nonpayment under the swap agreements by LBSF, the noteholders had priority of distribution of the Collateral proceeds pursuant to the Trust Deeds. LBSF intervened in the English proceeding and counterclaimed for a stay of the litigation. As a defense to the noteholders' claim that they had priority of distribution under the Trust Deeds, LBSF raised the "anti-deprivation principle," a doctrine of English insolvency law akin to the prohibition on enforcement of *ipso facto* clauses under U.S. bankruptcy law.

The High Court of Justice, Chancery Division, ruled in favor of the noteholders. It found that LBHI was a "credit support provider" under the agreements and that the bankruptcy filing of such an entity constituted an event of default under the Trust Deeds. The court concluded that the anti-deprivation principle did not apply in the case before it, ruling that the priority of payment shifted from LBSF to the noteholders as of September 15, 2008, when LBHI filed for bankruptcy protection. In addition, the English court held, an "early termination payment" provided for in the notes calculated in favor of LBSF would be subordinated to noteholder distributions. The court then adjourned further proceedings on the matter to allow the parties time to confer and to allow cooperation between the U.S. bankruptcy court and the English courts with respect to the matter. LBSF appealed the ruling to the English Court of Appeal, which affirmed the decision below on November 6, 2009.

The U.S. Bankruptcy Court's Decision

LBSF commenced an adversary proceeding in the U.S. bankruptcy court seeking a declaratory judgment that the change in payment priority under the Trust Deeds in favor of the noteholders was an unenforceable *ipso facto* clause under sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code. LBSF also sought a declaratory judgment that any action undertaken to alter payment priority under the Trust Deeds violated the automatic stay. LBSF sought summary judgment on both claims.

After determining that all of the agreements in question were executory contracts, the court considered whether the point at which the payment priorities shifted in favor of the noteholders was the date LBHI filed for bankruptcy or some time afterward. The court acknowledged that the English courts had construed the relevant documents to effectuate the shift as of LBHI's petition date. However, the bankruptcy court declined to defer to this determination, explaining that it is "not obliged to recognize a judgment rendered by a foreign court, but instead may choose to give *res judicata* effect on the basis of comity."

Metcalfe & Mansfield and *Lehman Brothers* are interesting case studies on comity in cross-border bankruptcy cases involving significant differences in law among nations that are otherwise generally perceived as having a common legal heritage. Where such conflicts of law are manifest, the U.S. bankruptcy court is obligated to balance the strong interests in applying local law to a given dispute against the important international principle of deference to the duly sanctioned resolutions of foreign states and their judicial institutions.

Comity is generally not extended to foreign proceedings, the court emphasized, "when doing so would be contrary to the policies or prejudicial to the interests of the United States." The U.S., Judge Peck wrote, "has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law, particularly . . . where the relevant provisions of

the Bankruptcy Code provide far greater protections than are available under applicable provisions of foreign law."

The bankruptcy court construed the relevant agreements to require "certain affirmative acts to be taken prior to the effectiveness of any modification of payment priority or method of calculation of the Early Termination Payment." Among other things, these acts included payment of amounts due under the Trust Deeds "in connection with the realisation or enforcement of the [Collateral]," as a condition precedent to the priority shift. In fact, the court noted, many of the actions required to effectuate the priority shift either occurred after LBSF filed for bankruptcy protection or had not yet occurred. As such, the court concluded that there was no *automatic* shifting of payment priorities under the agreements and, further, that "the relevant date for purposes of testing whether any shifting of priorities occurred under the Transaction Documents is the LBSF Petition Date." According to the court, "LBSF held a valuable property interest in the Transaction Documents as of the LBSF Petition Date and, therefore, such interest is entitled to protection as part of the bankruptcy estate."

However, the court further held that if the "relevant date" was instead the LBHI petition date, the prohibition on enforcement of *ipso facto* clauses in sections 365(e)(1) and 541(c)(1)(B) would nonetheless invalidate any shifting in payment priorities. According to the court, in prohibiting modification of a debtor's rights solely because of a provision in an agreement conditioned upon "the commencement of a case under this title," the language of sections 365(e)(1) and 541(c)(1)(B) "is not limited to the commencement of a case *by or against the debtor*" (emphasis added). Such limiting language, the court explained, was considered but rejected by lawmakers when they enacted the provisions. The absence of "precise limiting language," the court reasoned, leaves open the possibility that the provisions can be read to invalidate *ipso facto* clauses that are triggered by a bankruptcy filing by or against an entity *other than the debtor* that is party to the contract. The court recognized that attempting to define the kinds of relationships that would qualify for extended *ipso facto* protection is akin to opening the proverbial can of worms:

> The Court recognizes the potential for future disputes over the interpretation of this language but declines here to make any broad pronouncements, interpret the language in the abstract or to expand on the various relationships between or among debtor entities that would make it appropriate for one debtor to invoke *ipso facto* protection due to the filing of another affiliated member of a corporate family. The description of the kind of relationship that is sufficient to trigger such protections affecting the rights of contracting parties is best left to a case-by-case determination. With this principle of restraint in mind, the Court will apply the language of these sections of the Bankruptcy Code to the situation presented by the sequential filings of the LBHI and LBSF bankruptcy cases and confine its conclusions to the Debtors' business structure and circumstances.

Explaining that LBHI, LBSF, and their debtor affiliates "are perhaps the most complex and multi-faceted business ventures ever to seek the protection of chapter 11," the bankruptcy court emphasized that their various corporate entities comprise an "integrated enterprise" and, as a general matter, "the financial condition of one affiliate affects the others." The closeness of these relationships, the court emphasized, warranted extending the *ipso facto* protections triggered by the parent company's bankruptcy filing to its affiliates, even though they did not seek chapter 11 protection until some time later:

> Under these circumstances, the first filing at the holding company level of the corporate structure has significance, especially in the context of the *ipso facto* provisions that speak in terms of the commencement of "a" case under this title. Regardless of how this language may be interpreted in other settings, the Court is convinced that the chapter 11 cases of LBHI and its affiliates is a singular event for purposes of interpreting this *ipso facto* language. Nothing in this decision is intended to impact issues of substantive consolidation, the importance of each of the separate petition dates for purposes of allowing claims against each of the debtors or any other legal determination that may relate to the date of commencement of a case. However, for purposes of applying the *ipso facto* provisions of 365(e)(1) and 541(c)(1)(B),

> what happened on September 15, 2008 was a bankruptcy filing that precipitated subsequent related events. LBHI commenced a case that entitled LBSF, consistent with the statutory language, fairly read, to claim the protections of the *ipso facto* provisions of the Bankruptcy Code because its ultimate corporate parent and credit support provider, at a time of extraordinary panic in the global markets, had filed a case under the Bankruptcy Code.

The bankruptcy court also ruled that the priority-shift provision was not saved by the "safe harbor" in section 560 of the Bankruptcy Code for swap agreements, because the provisions were clearly not part of (or even referred to in) the swap agreements between LBSF and the SPEs, and the provisions did not relate to "the liquidation, termination, or acceleration" of a swap agreement. Finally, the court rejected BNY's argument that the priority-shift provision was nothing more than a subordination agreement that would be enforceable under applicable nonbankruptcy law, observing that "BNY cannot overcome the shifting nature of the subordination that is being activated by reason of a bankruptcy filing."

OUTLOOK

Metcalfe & Mansfield and *Lehman Brothers* are interesting case studies on comity in cross-border bankruptcy cases involving significant differences in law among nations that are otherwise generally perceived as having a common legal heritage. Where such conflicts of law are manifest, the U.S. bankruptcy court is obligated to balance the strong interests in applying local law to a given dispute against the important international principle of deference to the duly sanctioned resolutions of foreign states and their judicial institutions.

The fact that the bankruptcy courts in *Metcalfe & Mansfield* and *Lehman Brothers* reached different conclusions is a testament to the difficulty of striking the proper balance under the circumstances of any given case. In *Lehman Brothers*, Judge Peck respectfully declined to defer to the English courts because deference would have had ramifications that were diametrically opposed to important provisions in U.S. bankruptcy law designed to prevent forfeiture of a debtor's rights. Judge Glenn reached a different conclusion in *Metcalfe & Mansfield*. Given the present state of uncertainty in U.S. law concerning the circumstances under which third-party releases and injunctions are valid and enforceable on jurisdictional grounds, Judge Glenn's decision to enforce the Canadian courts' orders is not surprising.

Finally, the U.S. bankruptcy-law implications of *Lehman Brothers* beyond the ruling's application of principles of comity will doubtless be fodder for discussion and dispute for some time.

In re Metcalfe & Mansfield Alternative Investments, 421 B.R. 685 (Bankr. S.D.N.Y. 2010).

Lehman Brothers Special Financing, Inc. v. BNY Corporate Trustee Services, Ltd. (In re Lehman Brothers Holdings, Inc.), 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

Hilton v. Guyot, 159 U.S. 113 (1895).

A CLAIM BY ANY OTHER NAME: COURT DISALLOWS 503(b)(9) CLAIMS UNDER SECTION 502(d)

Daniel J. Merrett and Mark G. Douglas

A new administrative-expense priority was added to the Bankruptcy Code as part of the 2005 bankruptcy reforms for claims based upon the value of goods received by a debtor from vendors in the ordinary course of business within 20 days of filing for bankruptcy. A dispute has arisen in the courts as to whether such "20-day claims" under section 503(b)(9) of the Bankruptcy Code are subject to disallowance (temporary or otherwise) under section 502(d) if the vendor is alleged to have been the recipient of a preference or other avoidable transfer. In a recent ruling in *In re Circuit City Stores, Inc.*, a Virginia bankruptcy court disagreed with a number of other courts in holding that 20-day claims held by avoidable transfer recipients must be disallowed under section 502(d), pending the return of prepetition payments that are the subject of avoidance litigation.

SECTIONS 502(d) AND 503(b)(9) OF THE BANKRUPTCY CODE

Section 502(d) provides a tool for bankruptcy trustees or chapter 11 debtors in possession to deal with creditors who have possession of estate property on the bankruptcy petition date or are the recipients of pre- or post-bankruptcy asset transfers that can be avoided because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) provides as follows:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

The purpose of the provision is to promote the pro rata distribution of the bankruptcy estate's assets among all creditors and to coerce payment of judgments obtained by the trustee.

Section 503(b) of the Bankruptcy Code provides a nonexclusive list of nine categories of expenses that are entitled to administrative-expense status and consequent priority in any distribution to unsecured creditors under section 507(a)(2) of the Bankruptcy Code. In relevant part, section 503(b) provides that:

> After notice and a hearing, there shall be allowed, administrative expenses . . . including . . . (9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

Section 503(b)(9) was added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The provision gives added protection to a debtor's prepetition trade creditors over and above the potential availability of a traditional reclamation claim under section 546(c). Certain characteristics of 20-day claims differentiate them from other claims entitled to administrative status under section 503(b). Most of the administrative-expense categories enumerated in section 503(b), for example, represent postpetition liabilities, yet 20-day claims are, by their nature, prepetition claims. Also, among the categories of claims in section 503(b) that by their terms contemplate prepetition liabilities, only 20-day claims have wide application in most voluntary chapter 11 cases.

PRIOR APPLICATION OF SECTION 502(d) TO ADMINISTRATIVE EXPENSES

Although some courts have held to the contrary, the majority of decisions addressing the interplay between sections 502(d) and 503(b) of the Bankruptcy Code have concluded that administrative expenses cannot be disallowed under section 502(d). The reasoning of these cases was exemplified by the United States Court of Appeals for the Second Circuit in its 2009 ruling in *ASM Capital, LP v. Ames Department Stores, Inc.* In *Ames*, an investor in distressed debt that had acquired almost $400,000 in postpetition

administrative-expense claims under section 503(b)(1)(A) of the Bankruptcy Code appealed a ruling denying its request for an order directing immediate payment of the administrative expenses, pending repayment of funds that were allegedly transferred preferentially by the debtor to the creditor that originally held the debt.

The Second Circuit vacated the ruling and remanded the matter to the bankruptcy court, holding that section 503(b) administrative expenses may not be disallowed under section 502(d). Acknowledging that section 502(d) provides for the temporary disallowance only of certain "claims," the court of appeals addressed at the outset whether administrative expenses under section 503(b) are "claims" at all. The court recognized that the Bankruptcy Code's definition of the term "claim," found in section 101(5), does not distinguish between prepetition and postpetition rights to payment and appears to encompass administrative-expense liabilities. Nevertheless, focusing on the Bankruptcy Code's definition of "creditor," which is limited to holders of prepetition claims (and certain postpetition claims deemed to be prepetition claims), and distinctions between claims and administrative expenses drawn elsewhere in the Bankruptcy Code, notably in section 348(d) (addressing the impact of conversion of a case), the Second Circuit determined that administrative expenses are not claims of the type that may be disallowed by section 502(d).

According to the *Ames* court, "[T]he express exclusion of administrative expense claims from section 348(d), and the exclusion of administrative claim holders from the definition of 'creditor,' lend 'support to the view that administrative expense claims are claims that are separate and apart from pre-petition, or deemed pre-petition, creditor claims.' " In conjunction with section 501, the court explained, section 502 provides a procedure for the allowance of claims that is "entirely separate from the procedure for allowance of administrative expenses under section 503." Accordingly, the court concluded that the administrative-expense claims could not be disallowed under section 502(d).

In several other recent cases, courts have applied analysis similar to that articulated in *Ames* in concluding that neither 20-day claims nor other administrative-expense claims can be disallowed under section 502(d). In its 2008 decision in *In re Plastech Engineered Products, Inc.*, for example, a Michigan bankruptcy court agreed that the allowance-of-claims provisions under section 502 apply only to claims filed under section 501, and thus, they are entirely separate from the provisions governing allowance of administrative expenses under section 503. The court stated that "[t]he fact that [20-day claims] happen to be a kind of administrative expense that is comprised of pre-petition obligations does not detract from the analysis" of the line of cases holding that administrative expenses are not subject to disallowance under section 502(d).

In 2009, in *Southern Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC)*, a Georgia bankruptcy court came to a similar conclusion. The court was concerned, however, by the possibility that immediate payment of the 20-day claim held by the recipient of an avoidable transfer might prejudice the rights of other creditors in the event that, for example, the transferee was unable to satisfy any judgment eventually entered in favor of the debtor in the avoidance action. Accordingly, despite holding that section 502(d) was no barrier to allowance of the creditor's 20-day claim, the court ordered payment of the administrative expense to be delayed pending resolution of the debtor's avoidance proceeding.

THE RULING IN *CIRCUIT CITY*

In *Circuit City*, the debtors filed omnibus objections to certain 20-day claims on grounds that each claim was subject to temporary disallowance under section 502(d) of the Bankruptcy Code up to the amount potentially recoverable in a preference action. A large number of claimants filed responses, arguing, among other things, that 20-day claims cannot be disallowed under section 502(d).

Citing Fourth Circuit precedent in *Durham v. SMI Industries*, in which it was held that section 502(d) could not be employed to bar the assertion of the affirmative defense of prepetition setoff, the bankruptcy court agreed with *Ames* that section 502(d) can be used to disallow only those claims that are filed under section 501(a). With respect to 20-day claims in particular, however, the court's analysis diverged from that of *Plastech* and *TI Acquisition* because, according to the court

in *Circuit City*, 20-day claims, "unlike other [section] 503(b) administrative expenses, must be filed under [section] 501(a) of the Bankruptcy Code."

The *Circuit City* court quoted Rule 3002(a) of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules"), which mandates, with certain exceptions not applicable here, that "[a]n unsecured creditor . . . must file a proof of claim . . . for the claim . . . to be allowed," and Bankruptcy Rule 3003(c), which requires that "[a]ny creditor . . . whose claim . . . is not scheduled or [is] scheduled as disputed, contingent, or unliquidated shall file a proof of claim." As in *Ames*, the bankruptcy court also invoked the Bankruptcy Code's definition of "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief." In this case, however, the court noted that the holder of a 20-day claim appears to fit squarely within the definition of "creditor" and, in fact, each of the implicated claimants had filed a proof of claim under section 501 with respect to their 20-day claims.

The court disagreed with *Plastech* insofar as it "ignored the fact that nothing in the Bankruptcy Code makes [sections] 501, 502 and 503 mutually exclusive." Given its determination that holders of 20-day claims are "creditors," the *Circuit City* court reasoned that Bankruptcy Rules 3002(a) and 3003(c) render the allowance of 20-day claims a two-stage process, implicating both sections 502 and 503. According to the court, because 20-day claims must be filed under section 501, and a request for payment of such claims must be made under section 503, they may be disallowed under section 502(d). Echoing the policy concerns raised in *TI Acquisition*, the court added that its conclusion is supported by the bankruptcy goals of equitable distribution and efficiency because temporarily disallowing 20-day claims held by an entity that is a defendant in avoidance litigation "and holding [such claims] in abeyance until the preference litigation takes place would allow this Court to adjudicate these issues together and ensure that Claimants do not receive windfalls to the detriment of other creditors."

Finally, in ruling that a 20-day claim should be temporarily disallowed pending the resolution of preference litigation, the bankruptcy court in *Circuit City* observed that temporary disallowance of the claim until the preference litigation is resolved "would allow this Court to adjudicate these issues together and ensure that Claimants do not receive windfalls to the detriment of other creditors." The court characterized a preference defendant's recourse to the "new value" defense after receiving payments postpetition from the estate as a "windfall" or "double recovery." This statement suggests the court's view that postpetition payments could preclude recourse to the subsequent new-value-preference defense under section 547(c)(4).

The distinction between *Circuit City* and its predecessors, in terms of practical impact, may rest on the difference between temporary disallowance and delayed payment of 20-day claims.

Section 547(c)(4) shields from avoidance as a preference any transfer to the extent to which "after such transfer, such creditor gave new value to or for the benefit of the debtor" that is "not secured by an otherwise unavoidable security interest" and "on account of which the debtor did not make an otherwise unavoidable transfer" to or for the benefit of the creditor. The court acknowledged that "[t]here is no controlling case law in this jurisdiction on the issue of whether creditors may assert a claim under § 503(b)(9) for goods sold to the debtor and use those same goods as the basis for asserting a new value defense under § 547(c)(4)." Its observations in *dicta* concerning the new-value defense are arguably contrary to the view taken on this issue by some other courts, which have read section 547(c)(4) to mean that a postpetition payment under section 503(b)(9) does not constitute a transfer by the *debtor* and consequently should not be considered an "otherwise unavoidable" transfer that renders the subsequent new-value defense inapplicable. The court's statements in *dicta* regarding this defense are also seemingly at odds with the only other decision addressing the effect that payment of a 20-day claim has on the creditor's ability to invoke the new-value defense. In *In re Commissary Operations, Inc.*, a Tennessee bankruptcy court ruled in January 2010 that "[t]he possibility that a debtor may pay a creditor's § 503(b)(9) claim does not negate the value represented by the claim that the creditor provided to the debtor."

OUTLOOK

In practical terms, the holding in *Circuit City* may not represent a sea change in the fortunes of 20-day claimants, even though the court expressly disagreed with, and held contrary to, earlier decisions addressing the application of section 502(d) to 20-day claims. Prior to *Circuit City*, even some courts taking the opposite position expressed concern that the premature payment of 20-day claims would prejudice the rights of other creditors in the event the debtor was unable to recover a judgment obtained against the claimant in the avoidance action. This concern, for example, led the *TI Acquisition* court to exercise its power to deny immediate payment of the 20-day claim at issue, despite holding that the claim could not be disallowed temporarily under section 502(d). Accordingly, the distinction between *Circuit City* and its predecessors, in terms of practical impact, may rest on the difference between temporary disallowance and delayed payment of 20-day claims.

The U.S. Supreme Court recently had an opportunity to weigh in on this issue but declined to do so when it denied a petition for a writ of certiorari in the *Ames* case on February 22, 2010. The debtor's petition cited the split between the Second Circuit in *Ames* and the Eighth Circuit's 1973 decision in *In re Colonial Services Co.*, where the court ruled that section 57g of the Bankruptcy Act of 1898 (a predecessor of section 502(d)) mandates disallowance of an administrative claim asserted by a preference defendant until "surrender of the preference" to the estate. The debtor also asserted that "[the] issue arises in virtually every chapter 11 case and continues to spawn confusion and diverse opinions from multiple lower courts." That confusion persists.

In re Circuit City Stores, Inc., 426 B.R. 560 (Bankr. E.D. Va. 2010).

ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Department Stores, Inc.), 582 F.3d 422 (2d Cir. 2009), *cert. denied*, 130 S. Ct. 1527 (2010).

Durham v. SMI Industries Corp., 882 F.2d 881 (4th Cir. 1989).

In re Plastech Engineered Products, Inc., 394 B.R. 147 (Bankr. E.D. Mich. 2008).

Southern Polymer, Inc. v. TI Acquisition, LLC (In re TI Acquisition, LLC), 410 B.R. 742 (Bankr. N.D. Ga. 2009).

In re Colonial Services Co., 480 F.2d 747 (8th Cir. 1973).

Commissary Operations v. DOT Foods, Inc. (In re Commissary Operations, Inc.), 421 B.R. 873 (Bankr. M.D. Tenn. 2010).

FROM THE TOP, IN BRIEF: 2010 U.S. SUPREME COURT BANKRUPTCY RULINGS

Mark G. Douglas

Thus far in 2010, the U.S. Supreme Court has handed down two decisions involving issues of bankruptcy law. In the first bankruptcy ruling, the court reversed a decision of the Eighth Circuit Court of Appeals, holding on March 8 in *Milavetz, Gallop & Milavetz, P.A. v. U.S.* that bankruptcy lawyers must advertise themselves as "debt-relief agencies." In doing so, the court upheld the constitutionality of provisions added to the Bankruptcy Code in 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act. Among the new provisions are: (i) section 526(a)(4) of the Bankruptcy Code, which provides, among other things, that a "debt-relief agency" shall not "advise an assisted person or prospective assisted person to incur more debt in contemplation of such person filing a case under this title"; and (ii) requirements in sections 527 and 528 that any debt-relief agency must specifically describe itself as such in advertising. The lawyers in *Milavetz* argued that these rules should not apply to bankruptcy lawyers, but if they do apply, they unconstitutionally prohibit bankruptcy lawyers from advising clients to take on more debt before bankruptcy, even when the advice would otherwise be legal and proper. The Eighth Circuit had ruled that section 526 violates the First Amendment by preventing "attorneys from fulfilling their duty to clients to give them appropriate and beneficial advice."

The Supreme Court, which agreed to hear the case to resolve a split in the circuits on the issue, readily concluded that bankruptcy lawyers are "debt-relief agencies" and therefore subject to the prescriptions and restrictions in sections 526 through 528. Writing for the court, Justice Sonia M. Sotomayor remarked that "the statutory text clearly indicates that attorneys are debt relief agencies when they provide qualifying services to assisted persons." Nevertheless, because the case involved commercial speech, the court ruled that the disclosure provisions are subject to less exacting scrutiny. Justice Sotomayor explained that the provisions prohibit lawyers only from giving advice "designed to manipulate the protections of the bankruptcy system." Advice about new debt, she wrote, is prohibited "when the impelling reason for the advice is the anticipation of bankruptcy." In other words, the "incur more debt" prohibition applies only to advice that an attorney might give to a debtor to engage in the abusive practice of loading up on debt before filing for bankruptcy. In a footnote, Justice Sotomayor wrote that the law would not apply in situations when an attorney and his or her bankruptcy client were merely aware of the possibility of bankruptcy. Instead, she said, the law "proscribes only advice to incur more debt that is principally motivated by that likelihood" and thus is not overly broad.

Six other justices joined in Justice Sotomayor's opinion. Justices Antonin Scalia and Clarence Thomas concurred with the result but filed separate opinions detailing what they perceived to be flaws in the reasoning of the majority.

On March 23, a unanimous court ruled in *United Student Aid Funds Inc. v. Espinosa* that under Federal Rule of Civil Procedure 60(b)(4), a student loan provider was not entitled to relief from a bankruptcy-court order confirming a chapter 13 plan that discharged the debtor's student loan debt even though the bankruptcy court made no finding of "undue hardship" in an adversary proceeding, as required by section 523(a)(8) of the Bankruptcy Code and Federal Rule of Bankruptcy Procedure 7001(6). In affirming a ruling by the Ninth Circuit Court of Appeals, Justice Clarence Thomas, writing for the court, concluded that although the bankruptcy court's failure to find undue hardship was a legal error, given the Bankruptcy Code's clear and self-executing requirement for an undue-hardship determination, the confirmation order is enforceable and binding on the lender because it had actual notice of the error and failed to object or timely appeal.

However, Justice Thomas wrote, the Ninth Circuit went too far when it overruled cases stating that bankruptcy courts must confirm a plan proposing the discharge of a student loan debt without a determination of undue hardship in an adversary proceeding unless the creditor timely raises a specific objection. To comply with section 523(a)(8), he explained, bankruptcy courts must make an "independent determination of undue hardship before a plan is confirmed, even if the creditor fails to object or appear in an adversary proceeding." The court acknowledged the potential for "bad-faith litigation tactics" but observed that "expanding the availability of relief under Rule 60(b)(4) is not an appropriate prophylaxis." Penalties under various provisions governing attorney

conduct, Justice Thomas remarked, should deter attempts to discharge student loan debt without the undue-hardship finding Congress required.

In certain other bankruptcy-related developments in the Supreme Court this year, the court denied certiorari on February 22 in *Ames Dept. Stores, Inc. v. ASM Capital, L.P.*, where it was asked to review a ruling by the Second Circuit Court of Appeals that section 502(d) of the Bankruptcy Code does not mandate disallowance of an administrative claim under section 503(b)(9) held by a creditor that had allegedly received a preferential transfer.

On April 19, the court granted certiorari in *Ransom v. MBNA*, where it will consider whether an above-median-income chapter 13 debtor may deduct from his projected disposable income, which would otherwise be available to unsecured creditors under a plan, an "ownership cost" for a vehicle the debtor owns free and clear. The Ninth Circuit ruled in August 2009 that, based upon its interpretation of section 707(b)(2)(A)(ii)(I), the deduction may not be taken when there is no debt on the auto. The federal courts of appeal are split on the issue, and the Supreme Court decided to take the case to resolve the circuit split. The case will be heard in the Supreme Court Term that begins in October.

Milavetz, Gallop & Milavetz, P.A. v. U.S., 130 S. Ct. 1324 (2010).

United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367 (2010).

In re Ames Dept. Stores, Inc., 582 F.3d 422 (2d Cir. 2009), *cert. denied sub nom. Ames Dept. Stores, Inc. v. ASM Capital, L.P.*, 130 S. Ct. 1527 (2010).

Ransom v. MBNA (In re Ransom), 577 F.3d 1026 (9th Cir. 2009), *cert. granted*, 2010 WL 333672 (Apr. 19, 2010).

CHAPTER 15 DEBUT IN THE CIRCUITS

Mark G. Douglas

April 17, 2010, marked the four-and-one-half-year anniversary of the effective date of chapter 15 of the Bankruptcy Code, which was enacted as part of the comprehensive bankruptcy reforms implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Governing cross-border bankruptcy and insolvency cases, chapter 15 is patterned after the Model Law on Cross-Border Insolvency (the "Model Law"), a framework of legal principles formulated by the United Nations Commission on International Trade Law in 1997 to deal with the rapidly expanding volume of international insolvency cases. The Model Law has now been adopted in one form or another by 18 nations or territories.

The jurisprudence of chapter 15 has evolved rapidly since 2005, as courts have transitioned in relatively short order from considering the theoretical implications of a new legislative regime governing cross-border bankruptcy and insolvency cases to confronting the new law's real-world applications. Until 2010, however, cases involving the interpretation of chapter 15's provisions had risen no higher in the appellate hierarchy than the federal district courts. That changed in March 2010, when the Fifth Circuit handed down its highly anticipated ruling in *Fogerty v. Petroquest Resources, Inc. (In re Condor Insurance Limited).* In that case, Mississippi bankruptcy and district courts held that unless the representative of a foreign debtor seeking to avoid pre-bankruptcy asset transfers *under either U.S. or foreign law* first commences a case under chapter 7 or 11 of the U.S. Bankruptcy Code, a bankruptcy court lacks subject-matter jurisdiction to adjudicate the avoidance action. The Fifth Circuit reversed on appeal, ruling that "[a]s Chapter 15 was intended to facilitate cooperation between U.S. courts and foreign bankruptcy proceedings, we read section 1521(a)(7) in that light and hold that a court has authority to permit relief under foreign avoidance law under the section."

PROCEDURES AND RELIEF UNDER CHAPTER 15

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

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

Because more than one bankruptcy or insolvency proceeding may be pending against the same foreign debtor in different countries, chapter 15 contemplates recognition in the U.S. of both a "main" proceeding—a case pending in the country that contains the debtor's "center of main interests"—and "nonmain" proceedings, which may have been commenced in countries where the debtor merely has an "establishment."

Upon recognition of a foreign "main" proceeding, certain provisions of the Bankruptcy Code automatically come into force, while others may be deployed in the bankruptcy court's discretion by way of "additional assistance" to the foreign representative. Among these are the automatic stay (or an equivalent injunction) preventing creditor collection efforts with respect to the debtor or its assets located in the U.S. (section 362, subject to certain enumerated exceptions); the right of any entity asserting an interest in the debtor's U.S. assets to "adequate protection" of that interest (section 361); the power to avoid unauthorized postrecognition asset transfers (section 549); and restrictions on the debtor's ability to use, sell, or lease its U.S. property outside the ordinary course of its business (section 363). In contrast, if the foreign proceeding is recognized as a "nonmain" proceeding, then the bankruptcy court may, but is not required to, grant a broad range of provisional and other relief designed to preserve the foreign debtor's assets or otherwise provide assistance to a main proceeding pending elsewhere.

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

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

Condor Insurance represents the debut of chapter 15 in the circuit courts of appeal. Other decisions at the circuit level are likely in the near future as disputed issues regarding application and interpretation of the chapter's provisions percolate upward through the appellate process.

This limitation is spelled out in sections 1521 and 1523 of the Bankruptcy Code. Section 1521(a)(7) provides that upon recognition of a foreign proceeding, the court may grant "any appropriate relief," including "additional relief that may be available to a trustee, *except for relief available under sections 522, 544, 545, 547, 548, 550, and 724(a).*" Section 1523 authorizes the bankruptcy court to order relief necessary to avoid acts that are "detrimental to creditors," providing that upon recognition of a foreign proceeding, a foreign representative has "standing in a case concerning the debtor pending *under another chapter of this title* to initiate actions under sections 522, 544, 545, 547, 548, 550, 553, and 724(a)." The referenced provisions of the Bankruptcy Code pertain generally to a bankruptcy trustee's powers to avoid prebankruptcy transfers that are either preferential or fraudulent.

The legislative history of sections 1521 and 1523 provides as follows:

> [Section 1521] follows article 21 of the Model Law, with detailed changes to conform to United States law. The exceptions in subsection (a)(7) relate to avoiding powers. The foreign representative's status as to such powers is governed by section 1523 below.

*   *   *   *

> [Section 1523] follows article 23 of the Model Law, with wording to fit it within procedure under this title. It confers standing on a recognized foreign representative to assert an avoidance action but only in a pending case under another chapter of this title. The Model Law is not clear about whether it would grant standing in a recognized foreign proceeding if no full case were pending. This limitation reflects concerns raised by the United States delegation during the UNCITRAL debates that a simple grant of standing to bring avoidance actions neglects to address very difficult choice of law and forum issues. This limited grant of standing in section 1523 does not create or establish any legal right of avoidance nor does it create or imply any legal rules with respect to the choice of applicable law as to the avoidance of any transfer of obligation. The courts will determine the nature and extent of any such action and what national law may be applicable to such action.

H.R. Rep. 109-31(I), at 178–79 (2005) (footnotes omitted). In *Condor Insurance*, the courts considered whether sections 1521 and 1523 preclude a foreign representative in a chapter 15 proceeding from seeking to avoid transfers *under non-U.S. law* without first commencing a chapter 7 or 11 case with respect to the debtor.

CONDOR INSURANCE

Condor Insurance, Limited ("Condor"), is a corporation organized under the laws of the Federation of St. Kitts and Nevis that formerly operated an insurance and surety bond business. Condor became the subject of a winding-up petition under Nevis law in 2007. The company's court-appointed liquidators filed a petition the following year in the U.S. for recognition of the Nevis winding-up proceeding under chapter 15. After the Mississippi bankruptcy court entered an order recognizing the winding-up as a foreign main proceeding under chapter 15, the liquidators commenced an adversary proceeding in the bankruptcy court seeking to avoid transfers aggregating more than $313 million to Condor affiliates and principals. The defendants moved to dismiss, claiming that the bankruptcy court lacked jurisdiction to grant the relief requested. The bankruptcy court agreed.

On appeal to the district court, the liquidators argued that the language of sections 1521 and 1523 clearly indicates that foreign representatives are prohibited from utilizing certain sections of the U.S. Bankruptcy Code to avoid transfers but are not precluded from relying on foreign law to do so. The district court concluded that "the plain language of the statutes does not specifically address the use of avoidance powers under foreign law." Even so, the court emphasized, "the choice of law that is to be applied to a lawsuit is determined by a court having jurisdiction over the case, and the parties are not permitted to choose whatever law they wish when filing a lawsuit."

According to the district court, section 1521 speaks to the "types of powers and relief" that are available to a foreign representative, and lawmakers arguably referred to specific provisions of the Bankruptcy Code merely "to specify the types of powers that foreign representatives do not have." Given its conclusion that the express language of the provisions is ambiguous, the district court examined their legislative history. On the basis of that inquiry, the court concluded that sections 1521(a)(7) and 1523 "are intended to exclude all of the avoidance powers specified, under either United States or foreign law, unless a Chapter 7 or 11 bankruptcy proceeding is instituted." A contrary determination, the court explained, "would conflict with Congress' expressed desire that courts make the choice of law determination in a full bankruptcy proceeding." It accordingly affirmed the ruling below.

THE FIFTH CIRCUIT'S RULING

The Fifth Circuit reversed on appeal. Addressing the interpretation of chapter 15 as a matter of first impression in the federal circuit courts of appeal, the Fifth Circuit examined the language of sections 1521 and 1523 as well as the legislative provenance of chapter 15 as a progeny of the Model Law. The avoidance-power exceptions to "any appropriate relief" delineated in section 1521(a)(7), the court of appeals explained, do not exist in the Model Law, and "[w]hile it is plain that relief under the listed sections is excluded, the statute is silent regarding proceedings that apply foreign law, including any rights of avoidance such law may offer." In accordance with traditional rules of statutory construction, the Fifth Circuit wrote, exceptions beyond the U.S. avoidance powers expressly included in the provision "are not to be implied." According to the court, "If Congress wished to

bar all avoidance actions whatever their source, it could have stated so; it did not."

Chapter 15's stated purpose—"to incorporate the Model Law . . . so as to provide effective mechanisms for dealing with cases of cross-border insolvency"—and its overall structure, the Fifth Circuit observed, "strongly suggest" that section 1521(a)(7) does not exclude avoidance actions under foreign law:

> The structure of Chapter 15 provides authority to the district court to assist foreign representatives once a foreign proceeding has been recognized by the district court. Neither text nor structure suggests additional exceptions to available relief. Though the language does not explicitly address the use of foreign avoidance law, it suggests a broad reading of the powers granted to the district court in order to advance the goals of comity to foreign jurisdictions. And this silence is loud given the history of the statute including the efforts of the United States to create processes for transnational businesses in extremis.

The court of appeals rejected the argument that permitting the application of foreign avoidance law in a chapter 15 case would allow foreign representatives to "section-shop" by commencing a chapter 15 case when they seek to use foreign law or by filing a chapter 7 or 11 case when they seek to use U.S. avoidance law. According to the Fifth Circuit, conflicts-of-law issues are inherent in cross-border bankruptcy cases and were considered carefully by the drafters of the Model Law and chapter 15:

> UNCITRAL's Working Group on Insolvency Law examined three potential approaches to the question of which law a recognizing court should apply. The first approach would allow the recognizing court to apply its own law. This was favored by some countries concerned with the potential lack of familiarity with foreign law by recognizing courts. The second approach would apply the law of the main proceeding. This approach was favored by some as it "would lead to a more consistent, harmonized result, in view of divergences among national insolvency laws" and would help "avoid abetting debtors seeking to conceal assets behind another law that might provide a haven for those assets." A third approach was to permit the recognizing court to apply either the law of the main proceeding or its own law—a solution which might "provide flexibility needed to limit insulation of assets from insolvency proceedings." However this approach drew concern that it might raise the potential that a foreign representative "would be enabled to exercise more powers than those that would be available to the representative under the law of the appointing jurisdiction."
>
> The final provision did not accept any of these three approaches in full. Rather, the Model Law permitted the recognizing court to grant any appropriate relief and granted standing to the foreign representatives to bring avoidance actions under the law of the recognizing state. This purposefully left open the question of which law the court should apply—in deference to the choice of law concerns raised by the United States.
>
> The drafters of Chapter 15, responsive to the concerns raised at the UNCITRAL debates, confined actions based on U.S. avoidance law to full Chapter 7 and 11 bankruptcy proceedings—where the court would also decide the law to be applied to the distribution of the estate. The application of foreign avoidance law in a Chapter 15 ancillary proceeding raises fewer choice of law concerns as the court is not required to create a separate bankruptcy estate. It accepts the helpful marriage of avoidance and distribution whether the proceeding is ancillary applying foreign law or a full proceeding applying domestic law—a marriage that avoids the more difficult depecage rules of conflict law presented by avoidance and distribution decisions governed by different sources of law.
>
> It is no happenstance that this solution also addresses the concern that foreign representatives would bring an ancillary action simply to gain access to avoidance powers not provided by the law of the foreign proceeding. Access to foreign law offers no opportunity to gain the powers of

> avoidance provided by the U.S. Bankruptcy Code when there is no such power offered by the foreign state—at least not without filing a full bankruptcy case under the Code—and deference to comity does not invite forum shopping.

Its conclusion that Congress did not intend to preclude application of foreign avoidance law in chapter 15 cases, the Fifth Circuit emphasized, is supported by the practice in "ancillary proceedings" commenced under chapter 15's predecessor—section 304 of the Bankruptcy Code. For example, a New York bankruptcy court in 1987 in *In re Metzler* rejected earlier authority suggesting that bankruptcy courts had discretion to authorize the utilization of U.S.-law avoidance powers in a section 304 proceeding. However, the court ruled that only avoidance actions relying upon foreign law were permitted under section 304, in keeping with the limited role of U.S. courts in providing assistance to the administration of foreign bankruptcy proceedings. In *Condor Insurance*, the Fifth Circuit determined that, in enacting chapter 15, "Congress essentially made explicit *In re Metzler*'s articulation of the bar on access to avoidance powers created by the U.S. [Bankruptcy] Code by foreign representatives in ancillary proceedings."

Finally, the Fifth Circuit concluded that access to foreign avoidance laws in a chapter 15 case does not offend important policy considerations affecting domestic and global commerce:

> [T]he application of foreign law under Chapter 15 of the Bankruptcy Code implicates none of the salient concerns driving reliance by United States Courts upon the law of foreign nations in defining domestic norms. Providing access to domestic federal courts to proceedings ancillary to foreign main proceedings springs from distinct impulses of providing protection to domestic business and its creditors as they develop foreign markets. Settled expectations of the rules that will govern their efforts on distant shores is an important ingredient to the risk calculations of lenders and corporate management. In short, Chapter 15 is a congressional implementation of efforts to achieve the cooperative relationships with other countries essential to this objective. The hubris attending growth of the country's share of international commerce rests on a nourishing of its exceptionalism not its diminishment.

OUTLOOK

Condor Insurance is indicative of the kinds of challenges faced by U.S. courts in fleshing out the details of a relatively new and untested legislative framework. The ruling may also illustrate that despite the many years devoted by lawmakers, restructuring professionals, and international law experts to the arduous task of devising a workable framework of rules applying to cross-border bankruptcy cases, questions linger regarding how the rules are supposed to work. As noted, *Condor Insurance* represents the debut of chapter 15 in the circuit courts of appeal. Other decisions at the circuit level are likely in the near future as disputed issues regarding application and interpretation of the chapter's provisions percolate upward through the appellate process.

Condor Insurance does not represent the first instance that a U.S. court has been asked to decide whether a foreign representative in a chapter 15 proceeding can seek to avoid transfers under non-U.S. law. In *In re Loy*, a Virginia bankruptcy court ruled in 2008 that a foreign representative could not sell the debtor's real property free and clear of a lien that was purportedly void or voidable under English law and section 549 of the Bankruptcy Code because the lien was recorded after the property became part of the debtor's bankruptcy estate. The court acknowledged that relief under the Bankruptcy Code's prebankruptcy transfer avoidance and recovery provisions can be granted only if the debtor is the subject of a case under another chapter of the Bankruptcy Code, while relief under section 549 regarding postbankruptcy transfers can be granted in a chapter 15 proceeding. Even so, the *Loy* court ruled that avoidance under section 549 (regardless of the underlying substantive law) cannot be granted in the context of a motion under section 363(f) to sell property free and clear because the Bankruptcy Code requires that such relief be sought in an adversary proceeding.

Finally, *Condor Insurance* is not alone among the recent significant developments in the evolving chapter 15 jurisprudence. Another breaking development was the subject of a ruling handed down in March 2010 by a Pennsylvania

bankruptcy court. In *In re RHTC Liquidating Co.*, an involuntary chapter 7 petition was filed in the U.S. against a U.S.-incorporated company that, together with its Canadian parent corporation, was a debtor in a Canadian bankruptcy proceeding. The involuntary case was filed by U.S. creditors shortly after the Canadian proceeding had been recognized under chapter 15 by a U.S. bankruptcy court.

The bankruptcy court denied the foreign representative's motion to dismiss the chapter 7 case under section 305(a)(2) of the Bankruptcy Code, which provides that the court may dismiss or suspend all proceedings in a chapter 15 case if "the purposes of chapter 15 . . . would be best served by such dismissal or suspension." The court concluded that the representative failed to satisfy its burden of showing that dismissal of the parallel involuntary chapter 7 petition, which had been filed by creditors holding roughly 85 percent of the U.S. subsidiary's unsecured debt, would best serve the purposes of chapter 15. Dismissal, the court explained, was not necessarily warranted on grounds of comity because: (i) it was unclear what interest Canada had in applying Canadian insolvency law to a U.S. company, given that funds to be distributed to creditors were derived primarily from the sale of assets located in the U.S.; (ii) dismissal did not appear to further the purpose of providing legal certainty, as creditors or investors dealing with the company in the U.S., where most of the company's assets and operations were located even though its headquarters were in Canada, would presumably anticipate that any liquidation of the company would also occur in the U.S.; and (iii) the petitioning U.S. creditors raised concerns about whether their interests were being adequately protected in the Canadian proceedings. *RHTC Liquidating* is one of the first rulings to address "abstention" under section 305(a)(2), which was enacted as part of the 2005 U.S. bankruptcy reforms specifically to govern chapter 15 cases.

Fogerty v. Petroquest Resources, Inc. (In re Condor Insurance Limited), 601 F.3d 319 (5th Cir. 2010), *reversing Fogerty v. Condor Guaranty, Inc. (In re Condor Insurance Limited (In Official Liquidation))*, 411 B.R. 314 (S.D. Miss. 2009).

In re Metzler, 78 B.R. 674 (Bankr. S.D.N.Y. 1987).

In re Loy, 2008 WL 906503 (Bankr. E.D. Va. Apr. 3, 2008).

In re RHTC Liquidating Co., 424 B.R. 714 (Bankr. W.D. Pa. 2010).

CONTRACT LAW UPDATE: IS AN EXECUTED TERM SHEET A BINDING CONTRACT OR AN UNENFORCEABLE "AGREEMENT TO AGREE"?

Mark G. Douglas

Whether an executed term sheet detailing the terms of a loan represents a binding agreement to lend or merely an unenforceable "agreement to agree" was the subject of an important ruling handed down by the Appellate Division of the New York State Supreme Court in February 2010. In *Amcan Holdings, Inc. v. Canadian Imperial Bank of Commerce*, the court held that a financing term sheet expressly providing that binding terms will be established only upon the completion of definitive loan documentation does not create an enforceable agreement to lend.

In 2001, Amcan Holdings, Inc. ("Amcan"), approached Canadian Imperial Bank of Commerce ("CIBC") to obtain financing in the form of a revolving line of credit and a term loan for the purpose of acquiring another company and refinancing existing debt. The parties negotiated and later executed a "Summary of Terms and Conditions" outlining the proposed terms of the loans (the "term sheet"). The term sheet contained a highlighted box at the top of the first page stating that "[t]he Credit Facilities will only be established upon completion of definitive loan documentation, including a credit agreement . . . which will contain the terms and conditions set out in this Summary in addition to such other representations . . . and other terms and conditions . . . as CIBC may reasonably require."

The executed term sheet contained specific details regarding a number of items, including, among other things, the identity of the borrowers, the amount of funding to be provided under each credit line, amortization and interest rates, fees, security, a proposed closing date, and definitions of key terms. Under the subheading "Conditions Precedent" in the term sheet were set forth terms "[u]sual and customary for transactions of this type," such as "Initial Funding" and the "Execution and delivery of an acceptable formal loan agreement and security . . . documentation, which embodies the terms and conditions contained in this Summary."

The term sheet also provided for payment of a $500,000 fee to CIBC, with $50,000 payable upon acceptance of the first draft summary, $150,000 payable upon acceptance of the executed term sheet, and $300,000 payable upon the closing of the financing transaction. Amcan paid the first two

installments, which were not refunded by CIBC when the deal later terminated. The term sheet did not expressly provide that CIBC was obligated to negotiate in good faith to enter into definitive loan documentation.

Prior to the execution of the final credit agreement and other loan documentation, CIBC discovered that Amcan had failed to disclose that it had been enjoined from pledging certain stock as collateral for the loans—a condition precedent to closing the transaction. CIBC also alleged that Amcan's principal failed to disclose that he had been held in contempt for violating the injunction on two separate occasions. CIBC broke off negotiations and the deal was never consummated.

Amcan sued CIBC six years later, asserting causes of action for breach of contract based on the bank's failure to close the loan, breach of the obligation of good faith and fair dealing, and fraud. CIBC moved to dismiss, arguing that the executed term sheet was not a binding agreement but a mere "agreement to agree" and that it had not acted arbitrarily in breaking off negotiations after discovering Amcan's disclosure failures. The New York State Supreme Court denied the motion to dismiss the breach-of-contract claim, ruling that the circumstances presented at what was then a preliminary stage of the proceedings did not permit a determination as to whether the term sheet was a binding agreement or merely an agreement to agree. The court, however, granted the lender's dismissal motion with respect to the remaining claims.

The Appellate Division affirmed the ruling on appeal, with certain important modifications. Addressing whether the term sheet represented an enforceable contract, the court focused on the parties' intent to be bound (*i.e.*, whether there was a "meeting of the minds" regarding the material terms of the transaction). It found that no such intent existed:

> Here, both the [draft term sheet and the term sheet] clearly state the credit facilities "will only be established upon completion of definitive loan documentation," which would contain not only the terms and conditions in those documents but also such "other terms and conditions . . . as CIBC may reasonably require." Although the [term sheet] was detailed in its terms, it was clearly dependent on a future definitive agreement, including a credit agreement. At no point did the parties explicitly state that they intended to be bound by the [term sheet] pending the final Credit Agreement, nor did they waive the finalization of such agreement . . . .
>
> The parties disagree on whether the [draft term sheet and the term sheet] fall into a Type I (fully negotiated) or Type II (terms still to be negotiated) preliminary agreement, commonly used in federal cases addressing the issue of whether a particular document is an enforceable agreement or merely an agreement to agree . . . . However, our Court of Appeals recently rejected the Federal Type I/Type II classifications as too rigid, holding that in determining whether the document in a given case is an enforceable contract or an agreement to agree, the question should be asked in terms of "whether the agreement contemplated the negotiation of later agreements and if the consummation of those agreements was a precondition to a party's performance" . . . .
>
> Here, the [term sheet] made a number of references to future definitive documentation, starting with the box on page one of the [term sheet]. The fact that the [term sheet] was extensive and contained specific information regarding many of the terms to be contained in the ultimate loan documents and credit agreements does not change the fact that defendants clearly expressed an intent not to be bound until those documents were actually executed.

Amcan Holdings, Inc. v. Canadian Imperial Bank of Commerce, 894 N.Y.S.2d 47 (N.Y. App. Div. 2010).

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