

# BUSINESS RESTRUCTURING REVIEW

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## RIGHTS OFFERINGS IN BANKRUPTCY: MORE THAN NEW CAPITAL

*Daniel P. Winikka and Paul M. Green*

Over the past decade, rights offerings have become a valuable and frequently used source of exit financing for chapter 11 debtors. The increased use of rights offerings is, in part, a result of the increased participation of nontraditional, sophisticated lenders in the bankruptcy process. Rights offerings are often beneficial to all parties involved. The debtor can obtain access to new capital without resorting to secured financing, and creditors or prebankruptcy equity security holders can preserve their investments in the debtor and obtain enhanced recoveries by investing at a discount to the perceived value of the reorganized company. Moreover, a successful rights offering can provide a signal to the market that there is healthy optimism about the success of the reorganized company.

In addition to providing reorganized debtors with access to new capital, rights offerings are increasingly being used as a tool to effectuate other agendas in a bankruptcy case, including the resolution of valuation disputes and allocating control of the new company.

### THE BASICS OF RIGHTS OFFERINGS

In bankruptcy, a rights offering allows a debtor to offer creditors or equity security holders the right to purchase equity in the postemergence company, usually at a healthy discount to the assumed value of the reorganized enterprise. The class of creditors or equity security holders solicited for participation is generally offered the right to purchase its pro rata share (*i.e.*, the same percentage that its current holdings represent) of the equity available under the offering. Rights offerings typically involve a solicitation of the eligible creditors or equity security holders either

in connection with solicitation of the reorganization plan or following confirmation of a plan, but prior to consummation of the plan and emergence from bankruptcy. Because the new equity typically is sold at a discount to assumed value, the parties often have a strong incentive to participate in the offering to avoid dilution, provided that they believe the offering price does in fact represent a discount to the value of the reorganized entity.

To guarantee that the reorganized debtor's capital needs are met, rights offerings are usually backstopped by a third party that agrees to purchase any unsubscribed shares. Because the debtor's plan of reorganization is normally premised upon raising the financing contemplated by the rights offering, obtaining a backstop commitment is typically critical to establish the feasibility of the plan at confirmation and to avoid the possibility of a substantial loss of time and expense soliciting and confirming a plan that is thereafter never consummated because sufficient funds have not been raised. Because there is always the inherent risk that the backstop party could be required to purchase a much larger number of unsubscribed shares than the party desires, backstop parties typically require payment of a backstop fee, often ranging from 3 to 7 percent of the total offering. The backstop party will also typically want assurance, through an "over-allotment right" or otherwise, that it will have the opportunity to purchase a certain minimum number of shares. To ensure its protection, the backstop party will require that, prior to proceeding with any solicitation of the rights offering, the debtor seek court approval of the backstop agreement, including the backstop fee. The backstop party can often end up with a controlling, or at least very influential, equity block. To obtain the most favorable terms, debtors often shop the backstop right, sometimes through an informal auction process.

One of the most heavily negotiated terms of the backstop agreement will be a "material adverse change" provision. Often there are months between the time the backstop agreement is signed and the consummation of the rights offering, and it can be challenging to define, and reach agreement on, what unexpected adverse developments might permit the backstop party to terminate the backstop commitment.

A rights offering may include "oversubscription" or over-allotment rights. Oversubscription rights allow existing creditors or equity holders to purchase more than their pro rata shares if unsubscribed securities are available, while over-allotment rights permit holders to purchase additional securities even when the offering is fully subscribed. The use of oversubscription/over-allotment rights in connection with backstop rights provides debtors with substantial flexibility in the offering process, facilitating the debtor's ability to achieve the optimal capital and ownership structure upon emergence from bankruptcy.

#### **SECURITIES-LAW EXEMPTION**

Another benefit of rights offerings in bankruptcy is the potential to exempt the new securities from registration with the Securities and Exchange Commission ("SEC"). Registration is typically lengthy and expensive, but Bankruptcy Code section 1145 permits a debtor to issue securities in the reorganized company without registration if certain conditions are met. To rely on the securities-law exemption under section 1145(a)(1), the new offering of securities must be issued: (i) under a plan of reorganization; (ii) by the debtor, an affiliate of the debtor, or a successor to the debtor; and (iii) in exchange for claims against or interests in the debtor, or "principally" in exchange for such claims or interests and partly for cash or property. Section 1145(a)(2) also provides an exemption for offerings of securities through warrants, options, rights to subscribe, or conversion privileges when the original security is issued in compliance with section 1145(a)(1).

To qualify for the exemption when securities are exchanged for cash or property in addition to claims or interests, the debtor in possession must be careful to ensure that the transaction does not appear to be primarily an effort to raise fresh capital—in other words, the claims or interests exchanged for the right to participate, not the new money raised, must be the central aspect of the rights offering. Under the statute, the exemption is unavailable if the amount of cash or property given by a claimant transforms the transaction into something other than securities issued "principally in exchange" for the claims or interests, sometimes referred to as the "principally/partly" test. This test raises the question: How much cash or property is too much in a section 1145(a) transaction?

The text of section 1145, “principally in exchange,” could be read to require simply that the exchange of property and cash be less than the amount of the surrendered claim or interest. SEC no-action letters, however, have suggested that “principally in exchange” may require a lower ratio of cash to claim or interest value. For instance, in *Bennett Petroleum Corporation*, the SEC agreed that the exemption applied to a plan of reorganization where the debtor exchanged new preferred stock for old common stock plus cash. The exchange was structured to provide a cash amount equal to 75 percent of the value of the interests being surrendered (e.g., cash of \$75 million compared to old stock tendered with a value of \$100 million).

Similarly, in *Jet Florida System, Inc.*, the SEC requested further information regarding a plan under which the unsecured creditors received new common stock and subscription rights, among other things, in exchange for their claims. The SEC agreed to take no enforcement action with respect to the application of the exemption after the debtor established that the value of the claims exchanged by the creditors was substantially greater than the \$2.40 subscription price. As in *Bennett Petroleum*, the ratio of cash value to the value of claims exchanged for the new securities was approximately 75 percent. The SEC no-action letters appear to provide a safe harbor at 75 percent for meeting the principally/partly test; however, a rights offering could have a ratio of more than 75 percent (e.g., \$95 million in cash raised compared to stock surrendered with a value of \$100 million) and still potentially satisfy the requirements of section 1145.

Section 1145, by its own terms, does not exempt transfers to underwriters. As a result, shares purchased by the backstop party are typically not exempt from registration under section 1145. Thus, to issue new securities to the backstop, the debtor usually relies on a private-placement exemption. Additionally, if the backstop seeks to sell its shares to the public at some point in the future, the backstop may separately require the reorganized company to go through the registration process after the offering has been completed.

## USE OF RIGHTS OFFERINGS IN RECENT CASES AND RELATED ISSUES

Among other uses, rights offerings can be an effective tool for junior creditors or equity security holders to bolster their position on valuation by demonstrating a willingness and financial commitment to invest new money premised on a higher valuation—i.e., put their money where their mouths are.

For instance, a proposed rights offering backed by certain equity holders was utilized in the GSI Group, Inc., case: (i) to convince the debtors to abandon a plan negotiated with certain noteholders and premised on a lower valuation; and (ii) ultimately to reach a consensual plan on much more favorable terms for equity holders. In GSI Group, Inc., the debtors commenced their chapter 11 cases with a prenegotiated plan supported by the holders of the debtors’ \$210 million in unsecured notes. The prenegotiated plan contemplated that the noteholders would receive \$95 million in new notes and approximately 80 percent of the equity in the reorganized entity and that existing shareholders would receive approximately 20 percent of the new equity. Following several weeks of litigation over valuation and the debtors’ subsequently proposed modifications to the plan to improve the treatment of equity holders, the equity committee proposed an alternative plan premised on a rights offering with a higher enterprise value than the plan the debtors and noteholders were seeking to cram down. The rights offering under the alternative plan was to be backstopped by one of the shareholders on the committee, and the alternative plan proposed to pay down a substantial portion of the notes in cash and reinstate the balance of the notes. Initially, the parties could not come to an agreement on a consensual plan because a subgroup of noteholders wanted a share of the upside in the reorganized company, as opposed to cash and new notes, and there was a fundamental disagreement over the enterprise value of the reorganized entity and thus the value of the new equity to be distributed under the plan.

Ultimately, the valuation dispute was resolved through the creative use of the backstop right coupled with a potential overallotment right. Under the consensual plan, the noteholders agreed to backstop the offering and the equity committee agreed that the noteholders would have the right to

purchase a certain minimum amount of the new equity—even if the offering was fully subscribed. Because it was anticipated that a portion of the existing equity holders would elect not to participate in the offering, much of the allotment guaranteed to the backstopping noteholders was expected to come from equity holders that elected not to participate in the offering. Following the completion of the rights offering under the plan, existing equity holders retained approximately 86 percent of the stock in the reorganized company, and the noteholders received, among other things, the cash proceeds from the rights offering and new secured notes. As anticipated, the guaranteed minimum equity for the noteholders was fulfilled in part from existing equity holders that chose not to participate, reducing the dilution of the participating equity holders that believed the shares were worth substantially more than the subscription/conversion price.

Because participation in a rights offering is often viewed as a valuable right, issues have arisen in recent cases over the ability to participate, including whether similarly situated creditors or shareholders are receiving equal treatment under a plan.

For instance, in the chapter 11 case of Dana Corp., the debtor reached agreements with its unions and with a financial sponsor for exit financing. Under those agreements, the financial sponsor would backstop a rights offering for new preferred stock that would include, among other things, consent rights for certain transactions. To make its corporate governance manageable, Dana needed to limit the ultimate number of new preferred stockholders. In addition, to reach the desired result and provide assurance that the preferred stock offering would not be materially undersubscribed, the financial sponsor negotiated to limit participation in the offering to sophisticated parties, which would provide greater certainty of participation. To effectuate this plan, Dana developed certain objective criteria for claimants eligible for participation, including a requirement that they hold claims aggregating a certain minimum amount. Ineligible creditors and the creditors' committee objected on the basis that the participation right was valuable and was being provided on account of the eligible creditors' claims, thereby resulting in unequal treatment of unsecured creditors. Dana contended, among other things, that the creditors purchasing the pre-

ferred stock were not receiving that right on account of their claims and that the smaller ineligible creditors were likely to benefit in any event because larger holders were likely to seek to buy smaller claims at a premium if they wanted to participate. The issue was eventually settled through the provision of an additional settlement fund in which ineligible creditors would have the right to share under certain circumstances, and Dana raised new capital through an offering without creating an unworkable governance structure for the reorganized company.

A similar issue regarding the ability to participate arose in the chapter 11 case of Visteon Corp. In Visteon, the debtors proposed a plan that contemplated, among other things, a \$950 million rights offering to unsecured noteholders, which was oversubscribed by more than \$110 million, and a \$300 million direct-purchase commitment from certain noteholders. An ad hoc group of shareholders (representing about 20 percent of the outstanding shares) objected to plan confirmation on the basis that unsecured creditors were receiving more than 100 percent on their claims based on the value of the equity being distributed and thereby setting up a complex valuation dispute at confirmation. To resolve the objection and avoid the cost and delay of the valuation trial, the debtors proposed to reimburse the ad hoc shareholder group for the professional fees the group had incurred. In addition, to further entice the ad hoc group to drop its objection and vote in favor of the plan, the noteholders agreed to permit the shareholders in the group to participate to a very limited degree in the direct-commitment portion of the rights offering. No other shareholders were given this right to participate. Because the equity class as a whole would not have voted in favor of the plan without the support of the ad hoc group, the settlement avoided cramdown and the valuation trial.

The U.S. Trustee and certain shareholders objected to the plan and settlement on the basis that (i) the settlement amounted to a purchase of the ad hoc group's votes; and (ii) the plan did not provide equity holders equal treatment as required under section 1123(a)(4) of the Bankruptcy Code because the ad hoc group was receiving different and more favorable treatment than other similarly situated shareholders. The debtors argued that the participation right was not

part of the plan treatment, but rather an agreement by the investor noteholders to share a portion of their equity purchase commitment to avoid what might otherwise be an expensive valuation dispute that could result in a material delay, potentially putting the investor noteholders' equity at risk. The court overruled the objections.

Rights offerings were successfully used to effectuate confirmation of a plan in each of these cases. Rights offerings can also be used, however, to disadvantage certain parties. For instance, investment funds may have internal restrictions that prevent them from investing additional funds in a rights offering. To the extent that part of the real value given in exchange for a claim or interest is the right to participate in the offering, such parties can be diluted to their disadvantage. Rights offerings could be proposed as leverage against such parties in the context of restructuring negotiations.

## CONCLUSION

Over the past few years, rights offerings have become an increasingly important tool for reorganizing debtors. Because of their inherent flexibility and value, rights offerings can be used to resolve disputes and benefit certain parties over others, in addition to raising new money for the reorganized company. Practitioners should be aware that offerings can be used both offensively and defensively, and they should remain cognizant of the increased creative use of the rights-offering process to best protect the client's position.

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*Bennett Petroleum Corporation*, SEC No-Action Letter, 1983 WL 28907 (Dec. 27, 1983).

*Jet Florida System, Inc.*, SEC No-Action Letter, 1987 WL 107448 (Jan. 12, 1987).

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## ***IN RE LESLIE CONTROLS, INC.: THE DELAWARE BANKRUPTCY COURT WEIGHS IN ON THE COMMON-INTEREST DOCTRINE***

*Brad B. Erens and Timothy W. Hoffmann*

The "common interest" doctrine allows attorneys representing different clients with aligned legal interests to share information and documents without waiving the work-product doctrine or attorney-client privilege. Issues involving the common-interest doctrine often arise during the course of a business restructuring, because restructurings tend to involve various constituencies, including the company, the official committee of unsecured creditors, secured debt holders, other creditors, and equity holders whose legal interests may be aligned at any one time. As a result, restructuring scenarios often produce strange bedfellows, as what would otherwise appear to be competing factions work together to build a consensus on how to proceed with a restructuring.

*In re Leslie Controls, Inc.* is the latest decision from the Delaware bankruptcy court addressing the common-interest doctrine. In *Leslie*, the court determined that the common-interest doctrine protected certain prepetition communications and documents relating to insurance coverage for potential asbestos liabilities that counsel to chapter 11 debtor Leslie Controls, Inc., shared with counsel to an ad hoc committee of asbestos plaintiffs and counsel to a proposed future-claims representative during the course of restructuring negotiations. The negotiations eventually culminated in a bankruptcy filing and the submission of a consensual plan of reorganization.

## THE COMMON-INTEREST DOCTRINE

The common-interest doctrine applies only to documents or communications that are otherwise protected from discovery under the attorney-client privilege or work-product doctrine. As such, rather than establishing an independent basis to prevent discovery of communications or documents, the common-interest doctrine expands the attorney-client privilege and work-product doctrine to allow parties represented by separate attorneys to share communications and documents without losing the protections afforded by the

attorney-client privilege or work-product doctrine. To demonstrate successfully that the common-interest doctrine applies to a communication or document, three elements must be satisfied:

- (1) the communication was made by separate parties in the course of a matter of common interest;
- (2) the communication was designed to further that effort; and
- (3) the privilege has not otherwise been waived.

As noted by a California bankruptcy court in its 1997 ruling in *In re Mortgage & Realty Trust*, with respect to the first element, the parties must show that “at least a substantially similar legal interest” exists, but complete agreement or accord among the parties is unnecessary. “The privilege applies where the interests of the parties are not identical, and it applies even where the parties’ interests are adverse in substantial respects.” In fact, the common-interest doctrine may apply between codefendants even if a lawsuit appears likely between them sometime in the future. When the parties’ interests diverge, however, the common-interest doctrine will not apply to communications involving those matters as to which the parties fail to possess a common interest.

To satisfy the second element, the parties must demonstrate that the purpose of the communication at issue was to further the common interest shared among the parties. Stated otherwise, the existence of a theoretical common interest is not sufficient; parties must affirmatively demonstrate a collective cooperation in the development of a shared legal strategy.

Finally, the third element requires the parties not to have otherwise waived the attorney-client privilege or protections afforded under the work-product doctrine.

### **LESLIE CONTROLS**

*Leslie Controls* involved a discovery dispute between certain insurance companies and the debtor, a manufacturer of industrial water heaters, control systems, and regulators based in Tampa, Florida. The insurance companies provided insurance coverage for various asbestos liabilities of the debtor. Those asbestos liabilities ultimately led the debtor to file for chapter 11 protection in Delaware in July 2010.

Prior to filing for bankruptcy, the debtor engaged in negotiations with an ad hoc committee of asbestos plaintiffs and a proposed future claimants’ representative regarding a potential plan of reorganization. During the course of these negotiations, the debtor shared various documents with the ad hoc committee and the proposed future-claims representative, including a memorandum prepared by the debtor’s insurance coverage lawyers. The memorandum addressed how various legal positions taken by the insurance companies would impact creditor recoveries under a plan of reorganization. The sharing of the memorandum, other documents, and communications occurred, in part, prior to the time that the debtor, the ad hoc committee, and the proposed future-claims representative reached an agreement on the terms of a chapter 11 plan.

The debtor asserted that the memorandum and other documents and communications among itself, the ad hoc committee, and the proposed future-claims representative were protected from discovery under the common-interest doctrine. The bankruptcy court agreed with the debtor.

Before issuing its opinion, the court conducted an *in camera* review of the memorandum, related documents, and other communications and concluded that the items were all subject to either the attorney-client privilege or the work-product doctrine. Accordingly, the sole remaining issue involved whether the debtor’s sharing of the documents and other communications caused a waiver of the privilege or whether the documents and communications remained protected from discovery under the common-interest doctrine.

In its analysis of the common-interest doctrine, the court first determined that the debtor, the ad hoc committee, and the proposed future-claims representative all shared a common *legal* interest, disagreeing with the insurance companies’ argument that the parties shared, at most, a common commercial interest, which may be insufficient to assert a privilege under the common-interest doctrine. In making this determination, the court noted that a party asserting the common-interest doctrine must provide evidence that a legal interest is implicated. The debtor, the ad hoc committee, and the proposed future-claims representative, the court observed, shared an interest in “preserving and maximizing

# NEWSWORTHY

An article written by **Corinne Ball (New York)** entitled “The Chrysler Bankruptcy: In Defense of the Auto Industry Bailout” appeared in the October 1, 2010, issue of *Butterworths Corporation Law Bulletin*.

**Gregory M. Gordon (Dallas)** has been selected to become a fellow in the American College of Bankruptcy. The induction ceremony will take place in March.

An article written by **Brad B. Erens (Chicago)** and **Timothy W. Hoffmann (Chicago)** entitled “Are the Claims of Convertible Debt Holders at Risk in Bankruptcy?” was published in the October 2010 edition of *Pratt’s Journal of Bankruptcy Law*.

**Craig F. Simon (Dallas)** sat on a panel on November 10 at the Wharton Club of Dallas Fort Worth discussing corporate bankruptcy and restructuring.

An article written by **Michael Rutstein (London)** and **Linton Bloomberg (London)** entitled “A Wind Blows Through an English Brothel” was published in the August 2010 issue of *Corporate Rescue and Insolvency*.

**Lori Sinanyan (Los Angeles)** was honored as “Woman Lawyer of the Year” by the Armenian American Chamber of Commerce.

the insurance proceeds available to pay asbestos claims.” According to the court, this was an inherently legal interest, because it involved an analysis of the insurance policies and related documents, in addition to insurance, contract, and bankruptcy law.

The bankruptcy court next turned to the question of whether the debtor, the ad hoc committee, and the proposed future-claims representative shared a common interest. The insurance companies asserted that the parties could not have shared a common interest prior to reaching an agreement on a chapter 11 plan structure. The insurance companies buttressed this argument by stating that during the course of negotiations, the sole interest of the ad hoc committee and the proposed future-claims representative was to maximize recoveries for their respective creditor constituencies, and therefore their interests were diametrically opposed.

The bankruptcy court noted that the insurance companies’ position on this point would essentially create a per se rule that parties engaged in negotiations could never share a common interest. Although the court acknowledged that some case law exists to support this position, it explained that other case law, including the Third Circuit’s 2007 ruling in *In re Teleglobe Comm. Corp.*, which involved the negotiation of a merger agreement, supports a contrary conclusion.

After concluding that a case-by-case approach is appropriate for assessing the issue, the *Leslie* court determined that the debtor, the ad hoc committee, and the proposed future-claims representative shared the requisite common interest. In reaching this conclusion, the court cited to a New Jersey district court’s 2008 ruling in *Louisiana Municipal Police Employees Retirement System v. Sealed Air Corp.*, a case that addressed whether parties shared a common interest in the context of a class-action lawsuit for alleged violations of

securities laws. The focus of the litigation in *Sealed Air* was the solvency of chemical conglomerate W.R. Grace & Co. at the time it engaged in a major corporate transaction with Sealed Air Corporation (“SAC”). The plaintiff sought the production of documents relating to potential asbestos liabilities that the companies shared between themselves while negotiating the transaction. SAC asserted that the documents were privileged and subject to the common-interest doctrine. The district court agreed with this position, stating that “the fact that the parties were on adverse sides of a business deal . . . does not compel the conclusion that the parties did not share a common legal interest.”

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*Leslie Controls* provides parties participating in plan negotiations some reassurance that sharing documents during the course of such negotiations will not make the materials subject to discovery in later litigation.

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Following the court’s analysis in *Sealed Air*, the *Leslie* court concluded that although the debtor, the ad hoc committee, and the proposed future-claims representative had conflicting interests in attempting to maximize their respective constituencies’ recoveries, they shared with the debtor a common interest in maximizing the collective pool of assets, including any insurance proceeds. As such, the court concluded, the necessary common interest existed among the parties.

## CONCLUSION

Debtors and their respective creditor constituencies often engage in negotiations prior to and during a chapter 11 case in an attempt to achieve a consensual restructuring. Equally common is litigation over the confirmation of a chapter 11 plan. Therefore, the ability of debtors and their various creditor constituencies to share information during plan negotiations without losing the protections afforded by the attorney-client privilege or work-product doctrine in subsequent litigation is an important issue. In this regard, *Leslie Controls* provides parties participating in plan negotiations some reassurance that sharing documents during the course of such negotiations will not make the materials subject to discovery in later litigation.

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*In re Leslie Controls, Inc.*, 437 B.R. 493 (Bankr. D. Del. 2010).

*In re Mortgage & Realty Trust*, 212 B.R. 649 (Bankr. C.D. Cal. 1997).

*In re Rivastigmine Patent Litig.*, 2005 WL 2319005 (S.D.N.Y. Sept. 22, 2005).

*In re Teleglobe Comm. Corp.*, 493 F.3d 345 (3d. Cir. 2007).

*Louisiana Municipal Police Employees Retirement System v. Sealed Air Corp.*, 253 F.R.D. 300 (D.N.J. 2008).



## TEXAS RANGERS: A BIG CHANGE-UP ON IMPAIRMENT?

Erica M. Ryland and Mark G. Douglas

The concept of “impairment” of a claim under a chapter 11 plan for the purpose of determining whether the claimant has the right to vote on the plan has evolved since the Bankruptcy Code was first enacted in 1978. A noteworthy step in that development was the subject of a ruling handed down earlier this year by the bankruptcy court overseeing the whirlwind chapter 11 case of Major League Baseball's Texas Rangers. In *In re Texas Rangers Baseball Partners*, the court held that, in order to render a secured creditor's claim “unimpaired,” a chapter 11 plan need not honor all of the creditor's contractual rights, so long as the creditor retains the right to sue the debtor for breach of the contract.

### VOTING RIGHTS AND IMPAIRMENT OF CLAIMS

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 those who receive nothing under a plan are deemed to reject it; in neither instance are they entitled to vote on the chapter 11 plan.

Section 1124 of the Bankruptcy Code provides that a class of claims or interests is impaired under a chapter 11 plan unless the plan either: (1) “leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest;” or (2) notwithstanding any contractual right to accelerated payment, reinstates the original maturity date of the obligation, cures outstanding defaults (with certain exceptions), compensates the claimant or interest holder for damages suffered in reasonably relying on the default provision, and otherwise leaves unaltered the legal, equitable, or contractual rights of the claimant or interest

holder. The plan itself must be the source of the impairment. If a creditor's legal rights or remedies are altered by operation of a provision in the Bankruptcy Code (e.g., the statutory cap on a landlord's claim for damages resulting from the rejection of a lease) rather than the plan, its claim will be deemed unimpaired.

Section 1124 originally included a third option for rendering a claim unimpaired under a chapter 11 plan: by providing the claimant with cash equal to the allowed amount of its claim. This option was removed by the Bankruptcy Reform Act of 1994. The amendment expressly overruled a New Jersey bankruptcy court's 1994 decision in *In re New Valley Corp.* In *New Valley*, the court ruled that unsecured creditors of a solvent debtor that are to be paid in full in cash under a chapter 11 plan are unimpaired even though the plan does not provide for the payment of postpetition interest on their claims. The 1994 amendment permits creditors that are not to receive postpetition interest under a plan to vote against the plan. Assuming that the class of creditors rejects the plan, it can be confirmed only if the plan satisfies the “cramdown” standards in section 1129(b). Also, because their claims are impaired, these creditors are entitled to the protection of the “best interests of creditors” test in section 1129(a)(7), which requires that they receive or retain at least as much under a chapter 11 plan as they would receive in a hypothetical chapter 7 liquidation of the debtor. Since the 1994 amendment, most courts considering the issue have held that payment in full in cash with postpetition interest at an appropriate rate constitutes unimpairment under section 1124(1).

Whether or not a claim is impaired, therefore, will determine voting rights, and 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 that lack the same negotiating power. In some cases, the accumulation of claims and voting power can even be an effective means of gaining control of a company in chapter 11.

As demonstrated by the bankruptcy court's ruling in *Texas Rangers*, the impairment question may also have a significant impact on whether the debtor or its assets can be sold as part of an overall chapter 11 restructuring and exit strategy.

### **TEXAS RANGERS**

Until this year, the Texas Rangers enjoyed the dubious distinction of being one of only three Major League Baseball franchises to have never played in the World Series. On May 24, 2010, the club also became one of only three Major League Baseball teams to file for bankruptcy protection (joining the Baltimore Orioles and the Chicago Cubs, which filed for chapter 11 protection in 1993 and 2009, respectively). The ensuing bankruptcy courtroom drama captivated the U.S. media (sports, financial, and otherwise) during the three months following the filing. It finally culminated on August 5, 2010, when the bankruptcy court approved an auction sale of the ball club for \$590 million (\$380 million in cash and the remainder in assumed liabilities) to Rangers Baseball Express LLC ("Express"), a consortium headed by Pittsburgh sports lawyer Chuck Greenberg and Rangers team president Nolan Ryan. Express prevailed over the competing bid of Radical Baseball LLC, a group formed by Houston businessman Jim Crane (who had unsuccessfully attempted to buy the Houston Astros) and Dallas Mavericks owner Mark Cuban (who had unsuccessfully attempted to buy the Chicago Cubs). The fireworks along the way, however, included a controversial development in bankruptcy jurisprudence regarding the concept of impairment under section 1124(1) of the Bankruptcy Code.

Texas Rangers Baseball Partners (the "debtor") was a Texas general partnership of which Rangers Equity Holdings GP, LLC ("REHGP"), was a 1 percent general partner and Rangers Equity Holdings, L.P. ("REHLP" and, together with REHGP, the "Rangers Equity Owners"), was a 99 percent general partner. The Rangers Equity Owners are indirect subsidiaries of HSG Sports Group, LLC ("HSG"), which, through other subsidiaries, has interests in other professional sports franchises. HSG is largely owned and controlled by prominent Texas entrepreneur Thomas O. Hicks ("Hicks"), who acquired the debtor in 1998.

HSG is indebted to a consortium of banks (the "lenders") for \$525 million. The debtor guaranteed \$75 million of that obligation on a secured basis under a pledge and security agree-

ment. The debtor was never profitable after being acquired by Hicks, who determined in 2008 to sell the ball club to avoid additional losses. He eventually identified Express as a potential purchaser, at a purchase price of approximately \$463 million.

HSG defaulted on the loans in March 2009. In the meantime, the debtor entered into loan agreements with the Office of the Commissioner of Baseball ("COB") to cover operating shortfalls. The debtor borrowed a total of \$20 million from COB. The loan agreements gave COB certain rights regarding any anticipated sale of the debtor. In addition, the Major League Constitution (the "MLC"), which governs Major League Baseball franchises, limits any club's discretion in selecting a prospective purchaser. COB took the position that the MLC and its prepetition loan agreements with the debtor barred any sale of the debtor without the approval of COB and the requisite percentage of owners of other Major League Baseball franchises.

The lenders also claimed the right to pass on any sale of the debtor under the pledge and security agreement, which expressly gave the agent bank: (i) the power to control the equity interests of the Rangers Equity Owners following a default; and (ii) approval rights as to any sale of the debtor. Exercising these rights, the lenders declined to approve the sale of the debtor to Express, claiming that potential purchasers existed that would pay more for the debtor than the \$463 million offered by Express. The COB had preliminarily approved the sale to Express, but the transaction still had to be approved by a vote of 75 percent of the Major League Baseball owners.

Faced with an impasse, the debtor filed for chapter 11 protection on May 24, 2010, in Fort Worth, Texas. On the petition date, it also filed a "prepackaged" chapter 11 plan to consummate the sale transaction with Express. The plan provided that the lenders were to be paid \$75 million "in full satisfaction" of their secured claims under the pledge and security agreement. It stated that the lenders' claims were unimpaired under section 1124(1) of the Bankruptcy Code, such that the lenders were not entitled to vote on the plan.

The lenders argued that, due to HSG's default, no sale of the debtor could be agreed to by the Rangers Equity Owners

without their acquiescence. They also contended that payment under the plan of the capped guarantee amount of \$75 million would not equate to unimpaired treatment under section 1124(1). To render their claims unimpaired, the lenders claimed, the debtor was required to comply with all of the terms of the pledge and security agreement, including the agent bank's right to veto a sale in the event of a default.

### THE BANKRUPTCY COURT'S RULING

For the typical unsecured creditor, the bankruptcy court explained, compliance with section 1124(1) requires only that the creditor receive full payment of its claim on the effective date of the plan plus interest—precisely as if a judgment on the debt were “entered immediately following the plan's effective date.” However, the court noted, the lenders in this case had rights *vis-à-vis* the debtor, which, as part of the HSG family of entities, assumed obligations to the lenders in addition to guaranteeing up to \$75 million of HSG's debt. “In order for the Lenders to be unimpaired,” the court wrote, “their treatment under a plan must recognize and preserve those rights.”

Even so, the court concluded that section 1124(1) does not require the plan to grant the lenders an effective veto right over any proposed sale. First, the court explained, unlike section 1124(2), which demands a cure of defaults, section 1124(1) is “prospective,” requiring merely that an unimpaired creditor be able to exercise all of its rights *vis-à-vis* the debtor after the effective date:

Under the Plan . . . , the sale of the Rangers will occur on the effective date. . . . Thereafter, the Lenders, if treated under section 1124(1), must be able to exercise their rights under their loan documents *vis-à-vis* Debtor (though those rights may have lost much of their usefulness) and other members of the HSG family.

As the sale of the Rangers will have been consummated at that point, however, the Lenders' rights under the Pledge Agreement will not affect the sale. As would be the case with a breach outside of bankruptcy, except to the extent the Code excuses such a breach as a matter of law, if the Lenders are

damaged by the actions of Debtor or the Rangers Equity Owners or their parents through a pre-effective date failure to honor the Lenders' rights under [the loan documents] . . . , they may assert in this court a claim against Debtor for their damages or pursue its affiliates in an appropriate forum.

The court explained that, if the veto powers of the lenders were deemed “interests” in property within the meaning of section 363(f) or (h) of the Bankruptcy Code, “the court might conclude that unimpairment requires recognition of those rights in connection with any transaction consummated pursuant to the Plan.” However, it emphasized, because the trustee could sell the debtor's assets under section 363(b) without complying with those veto rights and “without protecting the Lenders as to such provisions under section 363(f) or (h), the court concludes that a failure to honor those provisions in the Plan or the . . . [asset purchase agreement] does not alone amount to impairment.”

Next, the court reasoned, rules of statutory construction support its conclusion that section 1124(1) does not require the lenders' veto rights to be honored. According to the court, the fact that, unlike in section 1124(1), Congress expressly provided in section 1124(2) that unimpaired treatment must include a cure of defaults indicates that “the intent of legislators was that unimpaired treatment under [section 1124(1)] . . . would include . . . allowing the class so treated to pursue remedies not otherwise in conflict with the Code, the plan, or bankruptcy court orders for defaults existing as of the effective date.”

Third, the court noted, permitting the agent bank to exercise its veto power would give the lenders “a degree of control over the conduct of this case that is inconsistent with the Code and contrary to public policy.” A sale of the debtor, the court emphasized, whether under section 363 or a plan, is a transaction undertaken by the debtor in possession in its role as a fiduciary. It would be “inconsistent with the authority and responsibility conferred on that fiduciary by law,” the court wrote, “to give effect to a contractual provision that would frustrate its performance of its fiduciary duties.”

Fourth, the court explained, in order for the agent bank to exercise its veto rights prior to confirmation, it would need to obtain relief from the automatic stay. To construe section 1124(1) as permitting the lenders to invoke those rights prior to the effective date of the plan, the court observed, “would be tantamount to requiring . . . allowing enforcement by a creditor of its ‘legal, equitable, and contractual rights’ prior to confirmation of the plan by the court and the binding effectiveness of the creditor’s plan treatment.”

Finally, the court wrote, if the lenders were allowed to block a sale by exercising their veto rights, the debtor, “a solvent entity, notwithstanding payment in full of all of its monetary obligations, could only confirm a plan that was acceptable to the Lenders or through cramdown by artificial impairment of another class of creditors.” According to the court, it would be “inconsistent with public policy to construe the Code in a fashion that encourages debtors to deal with creditors by artificial impairment when such creditors could otherwise be left unimpaired.”

The court ultimately ruled that, in order for the plan to be confirmed without the lenders’ acceptance, or absent compliance with the cramdown requirements of section 1129(b), “the treatment of the Lenders must be modified to allow them to exercise their rights under the loan documents following the effective date.”

The bankruptcy court approved procedures to govern an auction of the ball club shortly afterward. Express was the prevailing bidder but ended up paying \$130 million more for the debtor than its original \$463 million offer. After approving the sale, the court confirmed the debtor’s chapter 11 plan on August 23. The court found that only the classes of equity (consisting of the interests of REHLP and REHGP) were impaired by the plan. Thus, even though the lenders were not permitted to exercise their sale-veto rights, their claim under the pledge and security agreement was deemed unimpaired.

## OUTLOOK

The court’s analysis and conclusions concerning this issue leave a number of important questions unresolved. For example, according to the court, any claim for damages that

the lenders might have for breach of the pledge and security agreement can be prosecuted against the debtor in the bankruptcy court or against the Rangers Equity Owners in an appropriate forum. This claim could be a prepetition claim (because it arises under a prepetition contract), a postpetition claim (as the breach did not occur until approval of the sale), or a claim against the reorganized debtor.

The court did not offer any guidance on this issue. It may have believed that any such claim—regardless of its legal character from a bankruptcy perspective—is meritless. The court observed in a footnote that “[t]he court does not mean to imply that it believes that the Lenders have such a claim.” The debtor’s chapter 11 plan ignores it altogether. Neither the plan, its accompanying disclosure statement, nor the order confirming the plan discusses the possibility (as part of the feasibility of the plan or otherwise) that the lenders might be awarded a substantial judgment on such a damages claim.

The court’s observations concerning the possibility that the lenders’ claim might be impaired if their veto powers were deemed “interests” within the meaning of section 363(f) or (h) are also curious. Sections 363(f) and (h) address, respectively, sales “free and clear of any interest in such property of an entity other than the estate” and sales of an “interest” of a co-owner in property jointly owned by the debtor. It is difficult to determine how the lenders’ sale-veto power would qualify as an “interest” under either of these provisions. Moreover, the idea that the trustee could sell the debtor’s assets under section 363(b) “without protecting the Lenders as to such provisions under section 363(f) or (h)” flatly contradicts the express language of those provisions as well as accepted practice and case law.

The court’s ruling would appear to have been motivated partially by its perception that the lenders were using the veto rights as leverage to hold up the sale process and extract more value than the \$75 million to which they were entitled because they realized that REHGP and REHLP were empty pockets. Regardless, on the issue of impairment under section 1124(1), *Texas Rangers* raises more questions than it answers.

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*In re Texas Rangers Baseball Partners*, 434 B.R. 393 (Bankr. N.D. Tex. 2010).

*In re Texas Rangers Baseball Partners*, 2010 WL 3377594 (Bankr. N.D. Tex. Aug. 23, 2010).

*In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1984).

*Solow Building Co. v. PPI Enters. (U.S.), Inc. (In re PPI Enters. (U.S.), Inc.)*, 324 F.3d 197 (3d Cir. 2003).

*In re Pilgrim's Pride Corp.*, No. 08-45664 (Bankr. N.D. Tex. Dec. 10, 2009) (order confirming chapter 11 plan with findings of fact and conclusions of law).

*In re South Canaan Cellular Investments, Inc.*, 427 B.R. 44 (Bankr. E.D. Pa. 2010).

*In re G-I Holdings, Inc.*, 420 B.R. 216 (Bankr. D.N.J. 2009).

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## ***IN RE QUIGLEY COMPANY, INC.: NEW YORK BANKRUPTCY COURT DENIES CONFIRMATION OF PROPOSED CHAPTER 11 ASBESTOS PLAN***

*Brad B. Erens*

The early 2000s witnessed a wave of chapter 11 filings by entities with liability for asbestos personal-injury claims. The large number of filings was matched by the variety of legal strategies that companies pursued to address their asbestos liabilities in chapter 11. The chapter 11 case of Quigley Company, Inc. ("Quigley"), was one of the last large asbestos cases to file in the 2000s and represents one of the more interesting strategies for dealing with asbestos liabilities in chapter 11. The bankruptcy court for the Southern District of New York, however, recently struck down this strategy and denied confirmation of the debtor's proposed chapter 11 plan.

### **THE QUIGLEY ASBESTOS STRATEGY**

Founded in the early part of the 20th century, Quigley manufactured various products throughout its history, including certain products that contained asbestos. The company was acquired by Pfizer, Inc. (the "Parent"), in 1968, and the transfer of its assets out of the company in the early 1990s made it essentially a nonoperating shell company for more than a decade. By the time it filed for chapter 11 in September 2004, Quigley had faced approximately 411,000 asbestos personal-injury claims, of which about 212,000 were pending or threatened. The Parent was also a defendant in approximately 280,000 of the actions that had been filed against Quigley, in most cases simply because it was Quigley's parent company.

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*Quigley serves as a reminder that courts may closely scrutinize the chapter 11 plans of distressed subsidiaries if the plan is perceived to have been formulated by, and for the primary benefit of, the parent company.*

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Prior to 2003, the Parent typically settled asbestos claims against Quigley and procured a release for itself in connection with such settlements for little or no additional consideration. During 2003, with Quigley's insurance diminishing

and litigation increasing, the Parent adjusted its approach. The Parent undertook to settle its own derivative liability for asbestos claims against Quigley and made its settlement payments contingent upon confirmation of a chapter 11 plan for Quigley that protected the Parent from all future derivative liability under section 524(g) of the Bankruptcy Code.

Section 524(g) establishes a procedure for dealing with future personal-injury asbestos claims against a chapter 11 debtor. The procedure entails the creation of a trust to pay future claims and the issuance of an injunction to prevent future claimants from suing the debtor and, under certain circumstances, other entities. All claims based upon asbestos-related injuries are channeled to the trust. The statute contains detailed requirements governing the nature and scope of any injunction issued under section 524(g) in connection with the confirmation of a chapter 11 plan under which a trust is established to deal with asbestos claims.

The Parent's new approach culminated in the execution of global settlement agreements (the "Settlement Agreements") with a variety of asbestos plaintiff firms representing about 175,000 clients, primarily in August 2004. The aggregate amount of the settlements was approximately \$500 million. The Parent agreed to pay 50 percent of the settlement amount on the earlier of December 1, 2005, and confirmation of Quigley's chapter 11 plan. The second 50 percent was also due at confirmation. However, if Quigley solicited votes on its chapter 11 plan prior to December 1, 2005, and asbestos claimants did not provide the necessary voting support for the plan, the second payment was eliminated. The Settlement Agreements settled the Parent's liability, but not Quigley's. The settling asbestos claimants, however, agreed that under Quigley's chapter 11 plan they would receive only 10 percent of the payment that they otherwise would be due from the asbestos trust created by such plan.

When Quigley, after filing for chapter 11 protection in New York on September 3, 2004, later solicited votes for its chapter 11 plan, the settling asbestos claimants provided the necessary votes to confirm the plan. However, three law firms that had not executed Settlement Agreements objected. These firms argued that the plan had been proposed in bad faith and that votes of the settling claimants should not be counted on the basis that the Parent had acquired such

votes in connection with the Settlement Agreements. These firms also asserted that the plan should not be confirmed for a variety of other reasons, as discussed below.

### **BANKRUPTCY COURT DENIES CONFIRMATION OF THE QUIGLEY PLAN**

The bankruptcy court agreed with the nonsettling firms and denied confirmation of the Quigley plan. The court found that the chapter 11 case was a Quigley bankruptcy "only in name." According to the court, the Parent had arranged the proceedings to protect itself from derivative liability for asbestos claims against Quigley and only incidentally to reorganize Quigley. Further, the court found that the Parent had acquired the votes it needed to confirm the Quigley plan through the Settlement Agreements and that, as such, those votes had not been procured in good faith. The court concluded that the asbestos claimants voted for the plan to obtain their payments for settling the Parent's liability under the Settlement Agreements, rather than as creditors of Quigley. Therefore, the court ruled both that the plan was not proposed in good faith, as required by section 1129(a)(3) of the Bankruptcy Code, and that the votes of the settling claimants should not be counted, as not having been procured in good faith under section 1126(e). This caused the plan to fail.

The bankruptcy court also denied confirmation on a variety of other grounds. Section 524(g) of the Bankruptcy Code provides that a court can issue an injunction under a chapter 11 plan protecting a "third party," such as the Parent, from future derivative liability for asbestos claims against a debtor if the injunction is "fair and equitable" in light of contributions to the plan made by or on behalf of the third party. The court found that for such an injunction to be "fair and equitable," the contributions must have some equivalence to the estimated liability enjoined. After a lengthy financial analysis, the court determined that the present value of the Parent's contribution was approximately \$216 million but that it was being protected from a liability with a present value of approximately \$613 million. In the court's view, therefore, the proposed injunction under the Quigley plan to protect the Parent was not "fair and equitable."

The bankruptcy court also concluded that the Quigley plan violated the Bankruptcy Code's "best interest of credi-

tors” test and the prohibition against disparate treatment of similar claims. Under the best-interests test, which is set forth in section 1129(a)(7), each impaired creditor under a plan that does not vote for the plan must receive or retain under the plan at least as much as it would receive in a hypothetical chapter 7 liquidation of the debtor. Since the nonsettling asbestos claimants were required under the plan to release the Parent from its derivative liability, the court found that such creditors would fare better in chapter 7, where they would not be enjoined from pursuing the Parent on their claims. Similarly, the court found that nonsettling claimants were being treated differently from settling claimants. Settling claimants had already released the Parent under the Settlement Agreements, whereas nonsettling claimants had not. As such, the court determined that nonsettling claimants were giving up additional consideration in exchange for the same distributions as settling claimants and thus were being treated differently.

Finally, the court concluded that the Quigley plan was not “feasible,” as required by section 1129(a)(11). That section provides that the court must find that “confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor,” except as proposed in the plan. Prior to its bankruptcy filing, Quigley had been a nonoperating entity. However, before the petition date, the Parent transferred to Quigley the operations that were being used to settle asbestos claims against the Parent and Quigley. This was done to satisfy the “ongoing business requirement” of section 524(g) of the Bankruptcy Code, and the court agreed that such requirement was satisfied. Under the Quigley plan, the Parent also agreed to pay Quigley \$5 million per year for five years to continue to process asbestos claims for the Parent. Quigley would also perform claims-handling work for the asbestos trust created under its chapter 11 plan, although such work could be terminated by the trust after five years.

Given these facts, the court found that Quigley would remain a viable, operating entity for five years. According to the court, however, Quigley did not demonstrate that it would have a viable business thereafter. Therefore, the court found that its plan did not meet the feasibility requirement of section 1129(a)(11) of the Bankruptcy Code.

## LESSONS

The bankruptcy court’s decision in *Quigley* struck down a unique strategy pursued in asbestos bankruptcy cases. However, chapter 11 cases for distressed subsidiaries of parent companies are not unique, and *Quigley* serves as a reminder that courts may closely scrutinize the chapter 11 plans of such subsidiaries if the plan is perceived to have been formulated by, and for the primary benefit of, the parent company. The feasibility holding of the court also may have general applicability. Case law is sparse regarding the length of time that a debtor must demonstrate it will be able to operate for it to meet the feasibility requirement of the Bankruptcy Code. *Quigley* provides one court’s view on that issue, at least in the unique circumstances of the case.

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*In re Quigley Co., Inc.*, 437 B.R. 102 (Bankr. S.D.N.Y. 2010).

## FORUM SHOPPING, PORTABLE COMI, AND THE LESSONS OF *WIND HELLAS*

Michael Rutstein and Linton Bloomberg

No two recessions are the same. The current recession is the first one since the effective date of the EC Regulation on Insolvency Proceedings (the “Insolvency Regulation”). It offers the potentially exciting and dramatic ability for an individual or company facing financial disaster to open up an atlas and take a good, hard look at a map of Europe, then rush to the country where the debtor can best restructure or where it is best for the debtor to declare bankruptcy or enter into a formal insolvency procedure. In legal terms, this occurs by a process known as “center of main interests migration,” or “COMI migration.” One recent example of COMI migration occurred in the *Wind Hellas* case, which attracted a great deal of colorful press coverage involving accusations that England had become a “brothel for bankrupts.” In this article, we examine the reasons for COMI migration, how it was achieved in the *Wind Hellas* case, whether England is in fact a bankruptcy brothel and, if so, whether being so is a bad thing.

COMI migration is one example of “forum shopping.” The wealthy have long taken their pick of where they live, pay their taxes, and divorce. U.S. companies have long favored incorporating in Delaware even though they may do no business there. In a similar vein, England has been a popular venue for bringing libel actions and (according to English restructuring professionals) offers an ideal environment in which to restructure a company due to its respected body of insolvency legislation and associated case law, its trusted and impartial judiciary, its developed rescue culture, and the depth and breadth of its restructuring experience and expertise. Compared to many nations, England is arguably both a creditor- and debtor-friendly country for those seeking to restructure their financial liabilities, even if they have had little connection with the country before. *Wind Hellas* certainly shared this view.

### **WIND HELLAS**

Wind Hellas is one of Greece’s largest telecom groups, with more than 5 million customers, 400 stores in Greece, and revenue exceeding €1 billion a year. In the summer of 2009, a Luxembourg-registered entity, Hellas Telecommunications (Luxembourg) II S.C.A (“HTL”), which held the group assets (comprising shares in operating companies), migrated its COMI (but not its registered office) from Luxembourg to London. (HTL was a hybrid between a company and a partnership that has no equivalent under English law.) Three months later, it applied to the English court for an administration order (the purpose of the administration being a better realization of assets for creditors than would be achieved by a liquidation). In a short judgment delivered on November 26, 2009, but not published until considerably afterward, the court held that HTL had successfully moved its COMI to England and could therefore make use of the U.K. administration procedure as a “main” insolvency proceeding for the purposes of the Insolvency Regulation. This in turn enabled HTL (acting through its court-appointed administrators) to effect a prepackaged sale of its assets that was later approved by the court.

HTL’s COMI migration may seem a curious decision in the midst of its financial problems. It is unlikely that the decision to migrate was made with an aim toward benefiting HTL’s business or streamlining operations. In fact, the move appears to have been clearly contrived with the sole motive of effecting an efficient and expeditious sale (by means of an English prepackaged administration) of the group assets to the successful bidder (which was part of the *Wind Hellas* group) following a marketing exercise. Presumably, this option was not available in either Luxembourg or Greece. It should come as no surprise that the English court expressed no concerns as to whether genuine commercial or business reasons existed for moving the COMI. There is, after all, nothing in the Insolvency Regulation limiting the reasons that a debtor may elect to move its COMI, nor is there any prohibition on moving a COMI purely for the purpose of entering into a more favorable insolvency procedure than would otherwise be available.



## THE INSOLVENCY REGULATION

The Insolvency Regulation came into force throughout the European Union (other than Denmark) on May 31, 2002. COMI, one of the key concepts of the Insolvency Regulation, is conferred on all “legal persons” (e.g., corporations, as opposed to “natural persons”). The geographical location of a debtor’s COMI is important because it will govern where the debtor’s main insolvency proceedings in the EU must be filed. If the debtor is a company, regardless of where the debtor is incorporated, it must commence a main insolvency proceeding in the EU Member State where the debtor’s COMI is located.

Unfortunately (and surprisingly), there is no complete definition of “COMI” within the Insolvency Regulation itself. Guidance, however, can be found in Recital 13 of the Regulation, which provides that “the [COMI] should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.” Further assistance is found in Article 3(1) of the Insolvency Regulation, which provides that “the place of the registered office shall be presumed to be the [COMI], in the absence of proof to the contrary.”

## REBUTTABLE PRESUMPTION

Since the Insolvency Regulation came into force, there have been a number of reported cases on COMI migration relating to the “proof to the contrary” that is required to rebut the presumption that the COMI is where the registered office is located. Similarly, there have been examples where a registered office has been moved but the COMI has not.

German auto parts maker Schefenacker moved its COMI as the first step in its chosen restructuring process, which involved a nonconsensual restructuring of bondholder debt by way of a debt-for-equity swap implemented by an English company voluntary arrangement, or “CVA” (the CVA being less cumbersome and providing greater certainty of result than an “*Insolvenzplan*” under German law). Schefenacker’s automotive supply group consisted of a German holding company with subsidiaries in various jurisdictions, including England, the U.S., Australia, and Germany. The German holding company decided that its best interests from a restructuring perspective would be to move ownership of its assets and liabilities to a new English hold-

ing company (using procedures available under German law). The company was then able to enter into an English CVA. Applying German law, the holding company’s place of incorporation was successfully relocated, and the German court, on the basis of the movement of assets and liabilities to England, was satisfied that the company had moved its COMI there. However, as demonstrated by another case involving a German company—*Hans Brochier Holdings Ltd. v. Exner*—simply moving the jurisdiction of a company’s incorporation through German law procedures is not, by itself, sufficient to move a company’s COMI.

## COMMAND AND CONTROL ALONE IS NOT ENOUGH

The tests used to establish COMI in a country different from the one where the debtor’s registered office is located have had a somewhat turbulent history. Until quite recently, the “command and control” test was applied by courts in many countries in Europe, including England. Under this test, it was often sufficient to base COMI in the country where the group parent was located on the basis that the parent determined the overall strategy of the group and many group functions were conducted in the parent’s home country (e.g., IT services, human resources, treasury and finance functions, corporate branding, and purchasing functions).

Since 2006, however, the command and control test has been placed on the back burner, following a ruling by the European Court of Justice in *Eurofood IFSC Limited*, where the court stated that command and control by a parent in one country is not enough on its own to establish that the COMI of the parent’s subsidiaries is the same as the parent’s. The *Eurofood* court stressed the need for COMI to be ascertainable by third parties. Following extensive review of a number of decisions of the courts in England, in the U.S., and throughout Europe, the English Court of Appeal recently applied *Eurofood* in *In Re Stanford International Bank Limited (in liquidation)*, where the controversy concerned whether an Antiguan-incorporated bank had its COMI in the U.S. rather than in Antigua. On the evidence, the court found that the bank’s COMI was in Antigua. Further, the court held that COMI is to be determined by information about the debtor in the public domain that a typical third party would learn as a result of its dealings with the debtor in the ordinary course of business. Matters that could be

established only on inquiry, the court held, should be ruled out. Although *Stanford* was decided under the Cross-Border Insolvency Regulations 2006 rather than the Insolvency Regulation, both statutes use COMI as a basis for recognition of foreign insolvency procedures.

A decision earlier this year by the English High Court, Chancery Division, in *Kaupthing Capital Partners Master LP Inc.*, is a further example of a court applying the principles articulated in *Stanford*. *Kaupthing*, a special-purpose vehicle that, alongside other group companies and its ultimate parent company, formed part of an investment fund administered by an English-registered limited partnership, had its registered office in the Bailiwick of Guernsey in the Channel Islands, but its day-to-day activities, including the performance of its administrative and business functions, were carried out in London. The appointment of administrators for *Kaupthing* was challenged on the basis that the company's COMI was in Guernsey, and therefore it could not be subject to administration under English law.

The court held that the presumption that COMI is where the registered office is located can be rebutted only by factors that are both objective and ascertainable by third parties (*i.e.*, those that conduct business with the company). Simply looking at where head-office functions are carried out, the court emphasized, is insufficient. According to the court, in determining what is ascertainable by third parties, reference should be made to what third parties could find out in the public domain and what they could learn in the ordinary course of business (similar to the approach in *Stanford*). Information ascertainable only by investors (or industry insiders) should not be taken into account in assessing COMI.

### THE COURT'S RULING IN HELLAS

Let us go back to HTL. How did HTL manage successfully to move its COMI and how did it do so, bearing in mind its size, in just three months? In addition to and concurrent with moving its head office, the company also:

- Informed creditors of the change of address to London;
- Made a press announcement that its activities were moving to London;
- Opened a London bank account;

- Registered under the Companies Act as a foreign company; and
- Appointed U.K. resident individuals directors of the English company that had become HTL's general partner.

However, HTL retained its registered office in Luxembourg, occupied no more than relatively modest premises in London (certainly not befitting the parent company of a group with €1 billion in revenue), retained a bank account in Luxembourg, and may have remained liable to pay tax in Luxembourg.

The court's approach in determining COMI was in line with *Eurofood* and *Stanford*. It found that the presumption that HTL's COMI was in Luxembourg was rebutted and that the company's COMI was in England on the basis of objective and ascertainable facts. It is interesting to note that the court deemed one factor to be the most significant. The judge wrote:

The purpose of the COMI is to enable creditors in particular to know where the company is and where it may deal with the company. Therefore it seems to me that one of the most important features of the evidence . . . is that all negotiations between the company and its creditors have taken place in London.

The case, therefore, is consistent with the German Insolvency Court's 2008 decision in *The PIN Group*, which held that the COMI of a Luxembourg group company was in Germany because all of the group's financial-restructuring negotiations took place in Germany. Following *Hellas*, the importance that English courts will place on the location of negotiations with creditors is evident. Foreign directors trying to establish an English COMI for their companies would be well advised to establish a significant presence in England (both personally and commercially) at the earliest opportunity.

### USE OR ABUSE OF FORUM SHOPPING

It is in no way unique to corporate restructurings that well-advised clients will seek to place themselves in the best possible position. Whether by setting up a tax-efficient corporate structure or keeping parts of corporate structures insolvency-

remote, clients will try to seek an advantage in whatever way they can. COMI migration is no different, although it is understandable why certain creditors may feel aggrieved.

Central to the concept of COMI is the idea that it would be unfair to local creditors for a debtor to be able to avail itself of an insolvency regime in a jurisdiction other than that which is reasonably ascertainable by the creditor. But the fact that a company can change its COMI in a relatively short time frame may be perceived as rendering this protection redundant. An unsecured creditor may decide to enter into a debtor-creditor relationship on the basis of many factors, among them the creditor's awareness of its rights under applicable law if the debtor becomes subject to an insolvency procedure. The possibility that the debtor may later move its COMI to a different jurisdiction injects an additional (and perhaps unfair) element of uncertainty into the creditor's calculus of potential exposure.

### PREPACKAGED ADMINISTRATION SALES

It is not just the issues relating to COMI that make *Hellas* significant. A notable goal of the migration of the debtor's COMI to England was the facilitation of a prepackaged sale of the company's main asset—its shares in the operating telecom company—to a new group company, leaving behind subordinated lenders with nearly €1.5 billion in debt owed by a company with no assets. The court specifically acknowledged significant concerns in relation to the use (or misuse) of prepackaged transactions. These concerns prompted the Association of Business Recovery Professionals (also known as “R3”) to issue a new Statement of Insolvency Practice 16 (E&W) on Pre-Packaged Sales in Administrations (“SIP 16”), which became effective on January 1, 2009. SIP 16 requires insolvency practitioners to provide transparency to creditors about prepackaged sales and establishes short time frames for the provision of such information.

In *Hellas*, the court held that the guidance provided by SIP 16 had met with compliance, and it expressly authorized the administrators to proceed with the prepack on the basis of the court's finding that there was no realistic alternative to realizing better value for creditors. Although prepacks are not new, the judgment is one of the few occasions on which the English court has expressly given support to a specific prepack strategy.

### CONCLUSION

There has been much criticism from nonlegal sources in relation to both key aspects of *Hellas*. Aggrieved creditors are incensed that a debtor can blatantly “play the rules” and move its COMI for the purpose of gaining what they perceive to be an unfair advantage. Additionally, prepacks have garnered more bad publicity, which was probably inevitable, given the size of the business in question and the volume of the debt left behind. Administrators are required to act in the best interests of creditors generally, and in circumstances where the court has considered the prepack strategy and approved it, no creditor can successfully challenge the administrator's conduct. It does seem a fair bet to say that forum shopping will continue to play a central role in cross-border insolvencies, as commerce and industry continue to become more globalized. However, whether England is in fact a “brothel for bankruptcy” remains to be seen.

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*Hans Brochier Holdings Ltd. v. Exner* [2007] BCC 127.

*Eurofood IFSC Limited* (Case C-341/04).

*In Re Stanford International Bank Ltd (in liquidation)*, 2010 EWCA Civ 137.

*Kaupthing Capital Partners Master LP Inc.* Ch D (Proudman J) 31.3.2010.

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## TRADEMARK-LICENSEE LIMBO IN BANKRUPTCY CONTINUES

Christopher M. Healey

A debtor's decision to assume or reject an executory contract is typically given deferential treatment by bankruptcy courts under a "business judgment" standard. Certain types of nondebtor parties to such contracts, however, have been afforded special protections. For example, in 1988, Congress added section 365(n) to the Bankruptcy Code, granting some intellectual property licensees the right to continued use of licensed property, notwithstanding a debtor's rejection of the underlying license agreement. A ruling recently handed down by the Third Circuit Court of Appeals in *In re Exide Technologies* highlights an issue that has received some attention but remains unresolved: how are the rights of trademark licensees affected by a debtor's rejection of a trademark-licensing agreement?

### LUBRIZOL AND BANKRUPTCY CODE SECTION 365(n)

In 1985, the Fourth Circuit Court of Appeals in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.* held that a debtor could reject an executory agreement pursuant to which it had licensed its intellectual property, and upon rejection, the licensee lost the right to use that intellectual property. Despite recognizing the "chilling effect" its holding might have on intellectual property ("IP") licensing agreements, the court saw no way around the plain language of the Bankruptcy Code as it existed at that time: the licensing agreement was an executory contract, the debtor rejected the executory contract, and it was "clear that the purpose of [section 365] is to provide only a damages remedy for the non-bankrupt party."

In direct response to *Lubrizol*, Congress added section 365(n) to the Bankruptcy Code to protect the rights of many (but not all) IP licensees. Section 365(n) gives such licensees two options when a debtor rejects an executory license agreement: the licensee may either (i) treat the agreement as terminated (as in *Lubrizol*) and assert a claim for rejection damages; or (ii) retain the right to use the IP (with certain limitations). The legislative history of section 365(n) reveals

that Congress intended to "make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to Section 365 in the event of the licensor's bankruptcy." But the story does not end there. "Intellectual property," as defined in the Bankruptcy Code, covers only certain types of intellectual property.

### THE BANKRUPTCY CODE'S DEFINITION OF "INTELLECTUAL PROPERTY"

Section 101(35A) of the Bankruptcy Code defines "intellectual property" to mean:

- (A) trade secret;
- (B) invention, process, design, or plant protected under title 35;
- (C) patent application;
- (D) plant variety;
- (E) work of authorship protected under title 17; or
- (F) mask work protected under chapter 9 of title 17;

to the extent protected by applicable nonbankruptcy law.

Notably, trademarks, trade names, and service marks are not included in the definition of "intellectual property." Thus, the protections afforded IP licensees under section 365(n) do not apply to trademark licensees. Since section 365(n) was added to the Bankruptcy Code, courts have struggled to determine the proper treatment of trademark licenses in bankruptcy. Many questions remain largely unanswered, at both the bankruptcy-court and appellate-court levels. For example, do trademark licensees lose the right to use their trademarks when a debtor-licensor rejects the licensing agreement, consistent with *Lubrizol*? Do bankruptcy courts have the authority to balance the interests of the licensee with those of the debtor in determining whether to allow the debtor to reject the license agreement in the first instance? Might trademark licensees be entitled to the same protection afforded holders of other IP licenses, notwithstanding a lack of explicit statutory authority?

The Third Circuit's recent decision in *Exide Technologies* highlights the uncertainty faced by trademark licensees when a debtor seeks to reject a trademark-licensing agreement.

## EXIDE TECHNOLOGIES

Prior to filing for chapter 11 protection in 2002 in Delaware, Exide Technologies, Inc. (“Exide”), one of the world’s largest producers, distributors, and recyclers of lead-acid batteries, licensed its “Exide” trademark to EnerSys Delaware Inc. (“EnerSys”) for use in the industrial-battery business. Exide, however, wanted to continue to use the Exide mark outside the industrial-battery business. To accommodate the needs of both parties, Exide granted EnerSys a perpetual, exclusive, royalty-free license to use the Exide trademark in the industrial-battery business. This arrangement was satisfactory to both parties for nearly a decade.

However, Exide expressed a desire in 2000 to reenter the North American industrial-battery market. Exide made several attempts to regain its trademark from EnerSys, but EnerSys rebuffed the attempts. For the next two years, Exide, which offered industrial batteries under a different brand, was forced to compete directly against EnerSys, which was selling batteries under the Exide name.

After it filed for bankruptcy in 2002, Exide sought court approval to reject the license agreement. The bankruptcy court held that the trademark license was executory and that upon Exide’s rejection of the agreement, the rights of EnerSys to use Exide’s trademarks were terminated. The district court affirmed on appeal.

## THE THIRD CIRCUIT’S DECISION

A three-judge panel of the Third Circuit Court of Appeals reversed. The court concluded that the agreement was not executory because EnerSys had materially completed its performance under the contract, and only those contracts as to which there remain material unperformed obligations by both sides are executory. Thus, the court ruled, the agreement could not be assumed or rejected at all. As a consequence, however, the Third Circuit never addressed whether rejection of the agreement (had it been found to be executory) would have terminated the right of EnerSys to use Exide’s trademarks.

In a separate concurring opinion, circuit judge Thomas L. Ambro took issue with the bankruptcy court’s conclusion that rejection of a trademark-licensing agreement terminates the

licensee’s right to use the debtor’s trademark. Courts have long recognized, Judge Ambro explained, that rejection of an executory contract is not synonymous with termination of that contract. Rejection, he wrote, “is a breach of the executory contract,” not “avoidance, rescission, or termination.” According to the judge, even if a debtor may reject a trademark-licensing agreement, it does not necessarily follow that such a breach terminates the licensee’s right to use the licensed trademarks.

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Congress’s failure to include trademarks under Bankruptcy Code section 365(n) adds to the uncertainty faced by trademark licensees. Until Congress makes a statutory pronouncement or the courts come to a consensus, the uncertain state of play for trademark licensees will continue.

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In concluding that the rights of trademark licensees are unprotected in bankruptcy, the bankruptcy court reasoned that “Congress certainly could have included trademarks within the scope of § 365(n) . . . but saw fit not to protect them.” On that basis, and consistent with *Lubrizol*, it ruled that a trademark license is terminated upon rejection, leaving the licensee with, at most, a claim for damages. As Judge Ambro emphasized, however, the legislative history of section 365(n) calls into question this negative inference. Congress was aware that 365(n) does not explicitly protect trademarks. However, according to the legislative history, the reason for the omission was simply that Congress found it needed “more extensive study” to determine the proper treatment of trademark licenses. Rather than make a decision based on inadequate information, Congress elected “to postpone congressional action in this area and to allow the development of equitable treatment of [trademark licenses] by bankruptcy courts.”

According to Judge Ambro, Congress’s decision to leave treatment of trademark licenses to the courts signals nothing more than Congress’s inability, at the time, to devote enough time to consideration of trademarks in the bankruptcy context; no negative inference should be drawn by the failure to include trademarks in the Bankruptcy Code’s definition of “intellectual property.” As Judge Ambro concluded, “[I]t is

simply more freight than negative inference will bear to read rejection of a trademark license to effect the same result as termination of that license.”

Despite the passage of significant time since Congress added section 365(n) to the Bankruptcy Code, bankruptcy courts have rarely accepted Congress's invitation to develop an equitable treatment of trademark licenses in bankruptcy, and among the reported decisions on this topic, there is no clear consensus. A majority of courts have followed *Lubrizol* and concluded that trademark licensees do not have the right to continued use of a debtor-licensor's trademarks after rejection. Consistent with the *Exide* bankruptcy court's holding, these courts have inferred that the exclusion of trademarks from the Code's definition of "intellectual property" can only lead to the conclusion that trademark licensees lose their rights upon the debtor's rejection of the license agreement.

Other courts, consistent with Judge Ambro's concurring opinion in *Exide*, have held that rejection of a trademark-licensing agreement does not necessarily deprive a nondebtor-licensee of the right to use the trademark. For example, the bankruptcy court in *In re Matusalem* balanced the benefits of rejection to the debtor and the harm to be caused to the licensee, holding that the licensee was entitled to continued use of the debtor's trademarks. Likewise, Judge Ambro's decision focuses on the legislative history of section 365(n) and bankruptcy courts' inherent authority to consider the equities.

*Lubrizol* is binding only on courts within the Fourth Circuit, and it did not involve a trademark-licensing agreement. It is therefore not a foregone conclusion that other courts will follow *Lubrizol* with respect to the rejection of trademark-licensing agreements. Judge Ambro specifically declined to do so: "Rather than reasoning from negative inference to apply another Circuit's holding to this dispute, the Court here should have used, I believe, their equitable powers to give *Exide* a fresh start without stripping [the licensee] of its fairly procured trademark rights."

#### LOOKING AHEAD

Congress could easily settle the dispute by adding trademarks to the Bankruptcy Code's definition of "intellectual property" or by clarifying that a trademark licensee loses its rights when a

license agreement is rejected. But for one reason or another, it has declined to do so, and there remains no definitive authority on an issue that is significant to trademark licensees.

In many instances, an entity's business relies heavily, if not exclusively, on its ability to use intellectual property—its own intellectual property and the intellectual property it has licensed from others. At the very least, Congress recognized the importance of intellectual property when it added section 365(n) to the Bankruptcy Code, giving parties to certain IP licenses protections not afforded to other creditors. It may well be that there are substantive differences between trademarks and, for example, patents and copyrights, which warrant the exclusion of trademarks from the Bankruptcy Code's definition of "intellectual property." But the legislative history of section 365(n) suggests that courts may have some discretion regarding the proper treatment of trademark licenses as opposed to other "intellectual property."

Judge Ambro's concurring opinion is not binding on lower courts in the Third Circuit or elsewhere. It highlights, however, an issue that remains unresolved after more than 20 years. Parties in interest realistically can expect a certain amount of uncertainty regarding their rights and responsibilities in a bankruptcy case. Congress's failure to include trademarks under Bankruptcy Code section 365(n) adds to the uncertainty faced by trademark licensees. Until Congress makes a statutory pronouncement or the courts come to a consensus, the uncertain state of play for trademark licensees will continue.

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*In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).

*Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985).

*In re Old Carco LLC*, 406 B.R. 180 (Bankr. S.D.N.Y. 2009).

*In re HQ Global Holdings, Inc.*, 290 B.R. 507 (Bankr. D. Del. 2003).

*In re Centura Software Corp.*, 281 B.R. 660 (Bankr. N.D. Cal. 2002).

*In re Matusalem*, 158 B.R. 514 (Bankr. S.D. Fla. 1993).

## BANKRUPTCY TRUSTEE MAY SELL STATE-LAW AVOIDANCE CLAIMS

*George R. Howard*

In *In re Moore*, the Fifth Circuit Court of Appeals recently addressed two issues that have created a split of authority among the federal circuits: (i) whether a trustee in bankruptcy may sell causes of action that arise from the trustee's avoidance powers under section 544(b) of the Bankruptcy Code; and (ii) whether the proposed settlement of an avoidance action should be scrutinized under section 363(b) as well as Rule 9019 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") because a creditor offered to purchase the claim for more than the proposed settlement amount.

### THE TRUSTEE'S AVOIDANCE POWERS

Among the powers conferred upon a bankruptcy trustee or chapter 11 debtor in possession ("DIP") under the Bankruptcy Code is the ability to avoid asset transfers that are either actually or constructively fraudulent. Section 548 of the Bankruptcy Code provides in part that the trustee can avoid any transfer made, or obligation incurred, by the debtor in the two years preceding a bankruptcy filing if it is effected with the "actual intent to hinder, delay, or defraud" creditors. Section 548 also authorizes avoidance of certain transfers made or obligations incurred in the absence of intent as constructive fraudulent transfers.

Transfers may also be avoided under applicable state law by operation of section 544(b) of the Bankruptcy Code. Section 544(b) allows a DIP or trustee to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" against the debtor. The primary advantage of this provision over section 548 is that a two-year reach-back period from the petition date applies to actions brought under section 548. By contrast, many state fraudulent-conveyance laws (in most jurisdictions, a version of the Uniform Fraudulent Transfer Act) provide for a longer statutory reach-back period.

### COMPROMISE AND SETTLEMENT IN BANKRUPTCY

Bankruptcy Rule 9019 provides a framework for bankruptcy-court review of settlements of claims or causes of action in a bankruptcy case. It provides in part that "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." The purpose of the rule is to allow the trustee or DIP, subject to court review, to avoid the expenses and burdens associated with litigating sharply contested and dubious claims. Rule 9019 is silent, however, on the standard the court should apply in determining whether to approve a proposed settlement. The courts have devised a number of different tests designed to gauge the reasonableness and fairness of settlements proffered by a bankruptcy trustee or DIP.

### MOORE

In *In re Moore*, the chapter 7 trustee filed a motion for approval of a settlement of an adversary proceeding commenced against the debtor, his wife, and two affiliated companies that were allegedly alter egos of the debtor (collectively, the "defendants") by a prepetition judgment creditor of the debtor, The Cadle Company ("Cadle"). Cadle had sued the defendants in state court in 2005, attempting to collect the judgment and asserting claims of reverse veil piercing, fraudulent conveyance, and constructive trust. After the debtor filed a chapter 7 case in Texas in 2006, Cadle removed the state-court claims, which became part of the debtor's bankruptcy estate, to the bankruptcy court, where the litigation continued as an adversary proceeding with the trustee substituted as plaintiff. Cadle, however, continued to fund the litigation due to the absence of sufficient estate assets.

Upon learning of the proposed settlement, Cadle filed an objection and offered to purchase the causes of action from the trustee for an amount slightly greater than the proposed settlement offer. After concluding that, as a matter of law, the claims could not be sold, the bankruptcy court approved the proposed settlement as being fair and reasonable and in the best interests of the estate pursuant to Bankruptcy Rule 9019. The district court affirmed on appeal.

## THE FIFTH CIRCUIT'S DECISION

Cadle appealed to the Fifth Circuit. A three-judge panel of the court ruled that both the reverse veil-piercing and fraudulent-conveyance claims were property of the estate that could be sold, and it therefore reversed the bankruptcy court's ruling and remanded the case below for further proceedings. In addition, the Fifth Circuit ordered the bankruptcy court to consider the propriety of an auction and section 363 sale procedures in light of Cadle's offer to purchase the claims, as well as the propriety of the settlement of the claims under Bankruptcy Rule 9019.

### Section 544(b) Claims Can Be Sold

With respect to whether the claims could be sold, the Fifth Circuit began its analysis by considering whether the reverse veil-piercing and fraudulent-conveyance claims were property of the debtor's estate. Previous cases under Texas state law, the court explained, have established that both veil-piercing and reverse veil-piercing claims are property of a debtor's bankruptcy estate under section 541 of the Bankruptcy Code, rather than assets of individual creditors. By contrast, the Fifth Circuit explained that there is conflicting authority under its own precedent as to whether state-law fraudulent-transfer claims may be property of a debtor's estate under section 541.

The Fifth Circuit panel emphasized that deeming a claim belonging exclusively to a creditor prior to the commencement of a bankruptcy case property of the debtor's estate would conflict with the general rule that a cause of action is part of a debtor's estate only if the debtor could have prosecuted the action immediately prior to filing for bankruptcy. The court proceeded to analyze whether a fraudulent-transfer claim may become property of a debtor's estate pursuant to section 544(b) and, if so, whether such a cause of action may be sold.

As noted, section 544(b) generally provides that a bankruptcy trustee may prosecute under applicable nonbankruptcy law avoidance claims of creditors holding allowable unsecured claims against the estate. Thus, the Fifth Circuit panel remarked, "[t]he right to recoup a fraudulent conveyance, which outside of bankruptcy may be invoked by a creditor, is property of the estate that only a trustee or debtor in possession may pursue once bankruptcy is under way."

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The Fifth Circuit's ruling in *Moore* adds another chapter to the continuing controversy regarding a bankruptcy trustee's ability to sell estate claims and the standards that should be applied by bankruptcy courts in assessing proposed compromises designed to augment the pool of assets in the bankruptcy estate available for distribution to creditors.

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There is, however, a split of authority on whether a trustee or DIP may sell a state-law fraudulent-transfer action back to a creditor after the commencement of a bankruptcy case. On the one hand, the Ninth Circuit held in *In re P.R.T.C., Inc.* in 1999 that such actions can be sold or transferred. On the other, the Third Circuit ruled in *In re Cybergenics Corp.* the following year that the power to avoid a debtor's prepetition transfers and obligations to maximize the value of the bankruptcy estate for the benefit of creditors pursuant to section 544 of the Bankruptcy Code "neither shift[s] ownership of the fraudulent transfer action to the debtor in possession, nor [constitutes] a debtor's assets" and therefore cannot be sold or transferred.

The Fifth Circuit followed the Ninth Circuit's approach. The court reasoned that fraudulent-transfer claims are property of the estate under section 541(a)(1) or, in the alternative, become property of the estate pursuant to section 544(b) and may therefore be sold pursuant to section 363(b) of the Bankruptcy Code, which authorizes the trustee DIP to sell estate assets outside the ordinary course of business, after notice and a hearing. According to the Fifth Circuit panel, the ability to sell fraudulent-transfer claims is generally consistent with: (i) the ability of a trustee or DIP in section 1123(b)(3)(B) to transfer the right to exercise avoidance powers under a chapter 11 plan; (ii) the right of a single creditor to prosecute an avoidance action on behalf of the estate after court approval under the principle of "derivative standing"; and (iii) the reimbursement of creditors for successfully pursuing, at their own risk and expense, a transfer avoidance action for the benefit of the estate pursuant to section 503(b)(3)(B).



### Settlement Subject to Scrutiny Under Section 363(b)

Whether a proposed settlement of estate claims should be analyzed as a sale transaction under section 363(b) is likewise subject to a split of authority. In 1998, for example, the First Circuit concluded (without analysis) in *In re Healthco Int'l Inc.* that a settlement should not be subjected to scrutiny as a sale, whereas the Third Circuit and a Ninth Circuit bankruptcy appellate panel ruled to the contrary in *In re Martin* and *In re Mickey Thompson Entm't Group, Inc.*, respectively.

In *Moore*, the Fifth Circuit panel determined that subjecting a proposed settlement to scrutiny under section 363(b) and Bankruptcy Rule 6004 (delineating procedural requirements for a proposed use, sale, or lease of estate property) as well as Bankruptcy Rule 9019 is the better-reasoned approach. According to the court, although the decision to implement formal sale/auction procedures when considering a settlement of claims should remain in the discretion of the bankruptcy court, under the specific facts of *Moore*, the offer from the debtor's major creditor to purchase claims for a higher amount than the proposed settlement "obligated the bankruptcy court to consider whether an auction and § 363 sale were appropriate." The bankruptcy court's failure to do so, the Fifth Circuit panel observed, meant that "the true value of the claims [remained] undetermined" and was an abuse of discretion.

However, the court limited the scope of its ruling to "causes of action that [the trustee] has inherited from creditors under § 544(b)—causes of action that exist independent of the bankruptcy proceeding." It expressly declined to address "the broader question [of] whether a trustee may sell all chapter 5 avoidance powers, such as the power to avoid preferences under § 547 or to avoid fraudulent transfers under § 548."

### OUTLOOK

The Fifth Circuit's ruling in *Moore* adds another chapter to the continuing controversy regarding a bankruptcy trustee's ability to sell estate claims and the standards that should be applied by bankruptcy courts in assessing proposed compromises designed to augment the pool of assets in the bankruptcy estate available for distribution to creditors. At its most basic level, the ruling adopts a practical approach to a common problem in many bankruptcy cases—a shortage of estate assets to bankroll litigation that may represent the only realistic chance for creditor recoveries. In cases where the estate cannot bear the costs of prosecuting colorable claims, the only alternative may be a sale of the claims to generate cash.

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*Cadle Co. v. Mims (In re Moore)*, 608 F.3d 253 (5th Cir. 2010).

*Ducker Spradling & Metzger v. Baum Trust (In re P.R.T.C., Inc.)*, 177 F.3d 774 (9th Cir. 1999).

*Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery (In re Cybergenics Corp.)*, 226 F.3d 237 (3d Cir. 2000).

*Hicks, Muse & Co., Inc. v. Brandt (In re Healthco Int'l Inc.)*, 136 F.3d 45 (1st Cir. 1998).

*Myers v. Martin (In re Martin)*, 91 F.3d 389 (3d Cir. 1996).

*Goodwin v. Mickey Thompson Entm't Group, Inc. (In re Mickey Thompson Entm't Group, Inc.)*, 292 B.R. 415 (Bankr. 9th Cir. 2003).

## RULE 2019 UPDATE

In the July/August 2010 edition of the *Business Restructuring Review* (Vol. 9, No. 4), we reported on significant changes to Rule 2019 of the Federal Rules of Bankruptcy Procedure ("Rule 2019") recommended by the Advisory Committee on Bankruptcy Rules (the "Rules Committee"). In its present form, Rule 2019 contains various disclosure requirements that must be complied with by "every entity or committee representing more than one creditor or equity security holder" in a chapter 9 or 11 case (except for official committees appointed under section 1102 or 1114 of the Bankruptcy Code).

Whether these disclosure requirements apply to ad hoc, or informal, creditor groups has been the subject of vigorous dispute in the bankruptcy courts during the last three years, with courts lining up on both sides of the divide in roughly equal numbers. Amendments to Rule 2019 originally proposed by the Rules Committee would have increased the scope of required disclosures by ad hoc committees, including information regarding each committee member's "disclosable economic interest," a term defined to mean "any claim, interest, pledge, lien, option, participation, derivative instrument, or any other right or derivative right that grants the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest." Under the initial recommendation, the bankruptcy court would also have been given the authority to order the disclosure of amounts paid for claims or interests.

The Rules Committee's final recommendation for changes to Rule 2019 (issued May 27, 2010), however, retreated from the "precipice of full pricing disclosure." Instead, the recommendation adopts substantially all of the changes lobbied for by trading-industry watchdogs, such as the Loan Syndications and Trading Association and the Securities Industry and Financial Markets Association, which have been actively seeking to repeal or alter Rule 2019 since 2007. Among other things, the amended rule (as compared to the Rules Committee's initial recommendation) would: (i) remove any absolute requirement to disclose the price paid for a bankruptcy claim or reveal the claimant's disclosable economic interest; (ii) delete any requirement to disclose

the acquisition date of the claimant's disclosable economic interest, except in rare cases where an unofficial group or committee claims to represent any entity other than its members (and even then, only the quarter and the year must be reported); and (iii) eliminate the authority of the court to order disclosure of the purchase price paid for a disclosable economic interest.

Although the Rules Committee has unanimously recommended that these changes be approved, the recommended revisions to Rule 2019 must be approved by the Standing Committee on Rules of Practice and Procedure, the Judicial Conference, and the U.S. Supreme Court before they become effective. At present, such approval is anticipated so that revised Rule 2019 will become effective as of December 1, 2011.

In the meantime, the debate concerning Rule 2019's application to ad hoc committees continues in the nation's bankruptcy courts. On September 15, 2010, an Ohio bankruptcy court made yet another contribution to the Rule 2019 jurisprudence. In *In re Milacron, Inc.*, an ad hoc group of a chapter 11 debtor-corporation's noteholders consisting of distressed debt and hedge funds sought derivative authority to prosecute various causes of action against the company's officers and directors on behalf of the bankruptcy estate. One of the defendants sought an order of the bankruptcy court directing the noteholders, pursuant to Rule 2019, to disclose their economic interest in the derivative claims as part of the required showing that the claims against the defendants were colorable.

Relying on a Pennsylvania bankruptcy court's 2010 ruling in *In re Philadelphia Newspapers, LLC*, the noteholders contended that Rule 2019 does not apply to them because they are neither an "entity" nor a "committee," and they do not "represent more than one creditor or equity security holder." The bankruptcy court acknowledged that the decision supports the noteholders' position but explained that it is not binding and, on the basis of decisions to the contrary issued by other courts, observed that "the courts that have gone before us offer no clear path." The court ultimately granted the defendant's Rule 2019 motion, holding that: (i) the language used by the noteholders in their response to the motion indicated that they were acting as "an entity representing

more than one creditor,” a conclusion bolstered by the Rules Committee’s recommendations for changes to Rule 2019; and (ii) given the context of their request for derivative standing to prosecute estate claims, the noteholders will have to “identify their members with more transparency” in order to demonstrate that they have colorable claims and that the debtor’s refusal to bring such claims is unjustified. According to the court, unlike in *Philadelphia Newspapers*, where the group of lenders may not have been considered an “entity” because they were only “steering” a bankruptcy case, Milacron’s noteholders “are plaintiffs intending to bring a lawsuit,” and full disclosure of their identities “is warranted and not prejudicial.” This conclusion is further supported, the bankruptcy court wrote, “by the general proposition that the Bankruptcy Court is a public place.”

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*In re Northwest Airlines Corp.*, 363 B.R. 701 (Bankr. S.D.N.Y. 2007).

*In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007).

*In re Washington Mutual, Inc.*, 419 B.R. 271 (Bankr. D. Del. 2009).

*In re Premier Int’l Holdings, Inc.*, 423 B.R. 58 (Bankr. D. Del. 2010).

*In re Accuride Corp.*, Case No. 09-13449 (Bankr. D. Del. Jan. 20, 2010).

*In re Philadelphia Newspapers, LLC*, 422 B.R. 553 (Bankr. E.D. Pa. 2010).

*In re Milacron, Inc.*, 436 B.R. 515 (Bankr. S.D. Ohio 2010).

## FROM THE TOP

The U.S. Supreme Court’s October 2010 Term officially got underway on October 4, three days after Elena Kagan was formally sworn in as the Court’s 112th Justice and one of three female Justices sitting on the Court.

Only two bankruptcy-related cases are on the Court’s docket for this Term. On the opening day of the Term, the Court heard oral argument on the first of these cases—*Ransom v. MBNA*. In *Ransom*, the Court will consider whether, in calculating a chapter 13 debtor’s “projected disposable income” during the chapter 13 plan period, the debtor can deduct automobile “ownership costs” specified in charts produced by the Internal Revenue Service (the “IRS”) even though the debtor’s vehicle is completely paid for. The IRS’s National Standards and Local Standards are charts contained in the IRS’s *Financial Analysis Handbook* that are used to determine a taxpayer’s ability to pay his or her taxes. The ownership chart is a national table, while the operating-costs chart is a local one. The U.S. Court of Appeals for the Ninth Circuit ruled that the bankruptcy court may not allow such deductions. The circuits are split 3-1 on this issue, which arises from ambiguities introduced into the relevant provisions of the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The Fifth, Seventh, and Eighth Circuits have ruled that the deduction may be taken.

The other bankruptcy case on the Court’s docket this Term is *Stern v. Marshall*. In that case, the Court will consider, among other things, whether a ruling of the Ninth Circuit Court of Appeals that Congress cannot constitutionally authorize non-Article III bankruptcy judges to enter final judgments on all compulsory counterclaims to proofs of claim contravenes Congress’s intent in enacting 28 U.S.C. § 157(b)(2)(C)(2). The Ninth Circuit’s decision created a circuit split on the issue. Oral argument has not yet been scheduled for the case.

The Supreme Court declined to review 14 bankruptcy-related cases on the opening day of the October Term. Among these were:

- *Apex Oil Co. v. United States*, 579 F.3d 734 (7th Cir. 2009). The case concerns a ruling by the Seventh Circuit that an obligation imposed on a company by an injunction issued

under the authority of the Resource Conservation and Recovery Act to clean up a contaminated site is not a dischargeable “claim” in bankruptcy.

- *Hinkle Oil & Gas Inc. v. Bowles Rice McDavid Graff & Love LLP*, 2010 WL 55538 (4th Cir. Jan. 5, 2010). The Fourth Circuit ruled that the district court properly dismissed an oil and gas well development company’s lawsuit against attorneys whose then-recently organized company submitted a bid for certain assets of a bankruptcy debtor while another member of their law firm was representing the development company in its attempt to acquire the same assets.
- *Chase Manhattan Bank USA NA v. Taxel*, 594 F.3d 1073 (9th Cir. 2010). The Ninth Circuit ruled that a bankruptcy trustee’s “strong arm powers” under section 544(a)(3) permit the trustee to disregard a lender’s unrecorded security interest in the debtor’s real property, even though the debtor disclosed the lender’s interest in schedules that were electronically filed simultaneously with the debtor’s electronic bankruptcy petition.
- *W.R. Grace & Co. v. Chakarian*, 591 F.3d 164 (3d Cir. 2010). The Third Circuit held that a bankruptcy court properly declined to grant a debtor’s motion to expand the scope of a preliminary injunction—enjoining litigation by Montana residents against the debtor and its nondebtor affiliates whose purported asbestos liability derived from the debtor’s alleged liability—to encompass lawsuits against Montana itself by the same residents, who alleged that the state was negligent in failing to warn them of the risks of asbestos from a nearby mine operated by the debtor.

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*Ransom v. MBNA (In re Ransom)*, 577 F.3d 1026 (9th Cir. 2009), cert. granted, 130 S. Ct. 2097 (2010).

*eCast Settlement Corp. v. Washburn (In re Washburn)*, 579 F.3d 934 (8th Cir. 2009).

*Tate v. Bolen (In re Tate)*, 571 F.3d 423 (5th Cir. 2009).

*Ross-Tousey v. Neary (In re Ross-Tousey)*, 549 F.3d 1148 (7th Cir. 2008).

*Marshall v. Stern (In re Marshall)*, 600 F.3d 1037 (9th Cir.), cert. granted, 2010 WL 3053869 (Sept. 28, 2010).

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## BUSINESS RESTRUCTURING REVIEW

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