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IN THIS ISSUE

1 Taking the Gift Back: Second Circuit Alters Future Plan Negotiations by Striking Down the Use of Gifting Through a Chapter 11 Plan

3 Newsworthy

6 The U.K. Pensions Regulator–Will Its Powers Be Limited?

8 Calling All PRPs With Contribution Claims: Pay Up, or Steer Clear of Bankruptcy Court

11 *In re Washington Mutual, Inc.*: Delaware Bankruptcy Court Limits Debtors' Release of Third Parties

14 In Brief: District Court Affirms *Lehman Brothers* Safe-Harbor Setoff Ruling

15 Rumors of the Demise of Creditor Derivative Suits on Behalf of LLCs Not an Exaggeration

18 From the Top: Recent U.S. Supreme Court Ruling

19 The U.S. Federal Judiciary

TAKING THE GIFT BACK: SECOND CIRCUIT ALTERS FUTURE PLAN NEGOTIATIONS BY STRIKING DOWN THE USE OF GIFTING THROUGH A CHAPTER 11 PLAN

Scott J. Friedman and Ross S. Barr

Rehabilitating a debtor's business and maximizing the value of its estate for the benefit of its various stakeholders through the confirmation of a chapter 11 plan is the ultimate goal in most chapter 11 cases. Achievement of that goal, however, typically requires resolution of disagreements among various parties in interest regarding the composition of the chapter 11 plan and the form and manner of the distributions to be provided thereunder. While formulating and negotiating a chapter 11 plan, the debtor and other parties need to be cognizant of the requirements for plan confirmation, including, among others, those found in section 1129 of the Bankruptcy Code. In particular, where a chapter 11 plan purports to provide a class of unsecured creditors with a distribution worth less than the allowed amount of the creditors' claims, and that class of creditors votes against the plan, the "absolute priority rule," as codified in section 1129(b)(2)(B) of the Bankruptcy Code, dictates that no holder of any claim or interest which is junior to such class—typically, equity holders—shall "receive or retain under the plan on account of such junior claim or interest any property."

Notwithstanding the absolute priority rule, however, in order to foster plan confirmation or pursue other goals, a senior creditor, as part of a deal, may try to bypass

an intermediate class of creditors by providing, from value that absent the deal would have gone to the senior creditor, a "gift" distribution to a junior class that would not otherwise be entitled to anything under the plan. Although the United States Court of Appeals for the Third Circuit limited the use of gifting in that circuit in its 2005 ruling in *In re Armstrong World Indus., Inc.*, gifting retained viability as a tool to achieve certain goals within the Second Circuit. However, in *Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, the Second Circuit, among other rulings discussed below, recently rejected gifting as inconsistent with the absolute priority rule requirements for "cramdown" under section 1129(b)(2)(B) of the Bankruptcy Code.

CRAMDOWN AND THE ABSOLUTE PRIORITY RULE

Section 1129 of the Bankruptcy Code requires, among other things, that for a plan to be confirmable, each class of claims or interests must either accept the plan or not be "impaired." There is, however, an exception contained in section 1129 that a plan may be confirmed over the negative vote of an impaired class (*i.e.*, crammed down on that class) if all of the other plan requirements are satisfied and the plan is, among other things, "fair and equitable," with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. For a plan to be "fair and equitable," it must, with respect to a class of unsecured creditors, provide that either: (i) holders of claims in the rejecting class will receive value, as of the effective date, equal to the allowed amount of their claims; or (ii) holders of claims or interests in a junior class will not receive or retain any property under the plan on account of their claims or interests. The "fair and equitable" requirement as to unsecured creditors thus includes a form of the absolute priority rule.

GIFTING AROUND THE ABSOLUTE PRIORITY RULE

In the context of negotiating a chapter 11 plan, certain parties may determine that providing value to a junior class on account of its junior claims or interests, without paying the claims of an intermediate class in full, is advantageous. If such intermediate class accepts the plan, the absolute priority rule is inapplicable to that class. If, however, the intermediate class rejects the plan, the plan is not fair and equitable vis-à-vis that class and thus is unconfirmable.

In cases where such a distribution to junior classes is advantageous, but where an intermediate class rejects the plan, parties sometimes have sought to comply with the absolute priority rule by arguing that the value to be provided to the junior class is a "gift" from property that otherwise would be distributed to senior creditors, rather than a distribution on account of the claims or interests in the junior class. Under this theory, the rights of any intermediate creditors who received less than payment in full arguably are not affected because any distribution to the junior holders is merely a "gift" out of the senior creditor's distribution. Gifting, in this sense, provided parties with a powerful tool to accomplish a restructuring. The First Circuit's 1993 decision in *In re SPM Mfg. Corp.*, which allowed a secured creditor in a chapter 7 case to share a portion of its collateral with other creditors, provided some support for the gifting argument.

In *DBSD*, the Second Circuit ruled that a gift from a secured creditor to equity over the objection of a dissenting unsecured creditor class violated the absolute priority rule, thus significantly curtailing the gifting approach in the Second Circuit.

THE BANKRUPTCY AND DISTRICT COURT RULINGS

In *DBSD*, Sprint Nextel Corp. ("Sprint"), a litigation claimant that filed a claim against the debtor in the amount of $211 million (which was temporarily allowed for voting purposes in the amount of $2 million), objected to the plan of reorganization proposed by DBSD North America, Inc,. and its various subsidiaries (collectively, "DBSD"), arguing, among other things, that the plan violated the absolute priority rule. Under the plan, holders of unsecured claims, such as Sprint, would receive shares of reorganized DBSD estimated to be worth between 4 and 46 percent of their allowed claims, while DBSD's existing equity owner would also receive shares and warrants in the reorganized company. Sprint argued that because old equity received a distribution under the plan—in fact, the value to be distributed to old equity exceeded the value to be distributed to creditors by more than a factor of 20—the plan violated the absolute priority rule and could not be confirmed.

DBSD argued that this aspect of the plan was an acceptable gifting arrangement. Specifically, for equity to receive a distribution, the second lien holders, holding a lien on substantially all of the debtors' assets, made a gift to equity under the plan

NEWSWORTHY

Jones Day's Business Restructuring & Reorganization Practice was recognized as being among the finest worldwide in the field of Restructuring/Insolvency and Bankruptcy by *Chambers Global 2011*.

Corinne Ball (New York), ***David G. Heiman (Cleveland)***, ***Volker Kammel (Frankfurt)***, ***Michael Rutstein (London)***, ***Philip J. Hoser (Sydney)***, and ***Laurent Assaya (Paris)*** were designated "Leaders in their Field" in the area of Restructuring/Insolvency and Bankruptcy by *Chambers Global 2011*.

Paul D. Leake (New York), ***Corinne Ball (New York)***, ***David G. Heiman (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Philip J. Hoser (Sydney)***, ***Volker Kammel (Frankfurt)***, ***Richard L. Wynne (Los Angeles)***, and ***Peter J. Benvenutti (San Francisco)*** were recognized, recommended, or highly recommended in the Restructuring and Insolvency category in Practical Law Company's *Which lawyer? 2011*.

Jeffrey B. Ellman (Atlanta) and ***Al LaFiandra (Atlanta)*** were named "Georgia Super Lawyers" for 2011.

Brad B. Erens (Chicago) was named an "Illinois Super Lawyer" for 2011.

Gregory M. Gordon (Dallas) was recognized as being among *D* magazine's "Best Lawyers."

Daniel B. Prieto (Dallas) was designated a "Texas Rising Star" for 2011 in the field of Bankruptcy & Creditor/Debtor Rights by *Super Lawyers* magazine.

Bennett L. Spiegel (Los Angeles) and ***Richard L. Wynne (Los Angeles)*** were named "California Super Lawyers" for 2011.

Volker Kammel (Frankfurt), ***Sion Richards (London)***, and ***Laurent Assaya (Paris)*** were included in the 2011 edition of *Chambers Europe* in the field of Restructuring/Insolvency and Bankruptcy.

Philip J. Hoser (Sydney) was included in the 2011 edition of *Chambers Asia-Pacific* in the field of Restructuring/Insolvency and Bankruptcy.

An article written by ***Heather Lennox (New York and Cleveland)*** and ***Joseph M. Witalec (Columbus)*** entitled "An Overview of Chapter 9 of the Bankruptcy Code and Municipal Debt Adjustments" appeared in the February 1, 2011, edition of *Westlaw Business Currents*.

David G. Heiman (Cleveland) was named a "Client Service All-Star" for 2011 by The BTI Consulting Group.

An article written by ***Amy Edgy Ferber (Atlanta)***, ***Daniel M. Syphard (Cleveland)***, and ***Jennifer L. Seidman (Cleveland)*** entitled "Innovative Solutions in a Financial Crisis: *JP Morgan Chase Bank v. Charter Commun'cns Operating, LLC (In re Charter Commun'cns)*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009)" was published in the April 2011 edition of *The Banking Law Journal*.

An article written by ***Brad B. Erens (Chicago)*** and ***Timothy W. Hoffmann (Chicago)*** entitled "*In re Leslie Controls, Inc.*: The Delaware Bankruptcy Court Weighs In on the Common-Interest Doctrine" appeared in the April 2011 edition of *Pratt's Journal of Bankruptcy Law*.

An article written by ***Pedro A. Jimenez (New York)*** and ***Nicholas C. Kamphaus (New York)*** entitled "VA Bankruptcy Court Rules on New Value Defense and § 503(b)(9) Claim" appeared in the March 2011 edition of *The Bankruptcy Strategist*.

An article written by ***Brad B. Erens (Chicago)*** entitled "*In re Quigley Company, Inc.*: New York Bankruptcy Court Denies Confirmation of Proposed Chapter 11 Asbestos Plan" was published in the April 2011 edition of *Pratt's Journal of Bankruptcy Law*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "The Year in Bankruptcy—Part I" was published in the April 2011 edition of *Pratt's Journal of Bankruptcy Law.*

An article written by ***Pedro A. Jimenez (New York)*** and ***Mark G. Douglas (New York)*** entitled "Stays Without Borders in Chapter 15?" was published in the December 21, 2010, editions of *Bankruptcy Law360* and *International Trade Law360*.

from their distribution of the majority of the equity of the reorganized company, which was estimated to be valued at 51 to 73 percent of their allowed claims. In confirming the plan, the bankruptcy court agreed with the characterization of the recovery to equity as a gift from the second lien holders. The bankruptcy court held that the second lien holders were free to "voluntarily offer a portion of their recovered property to junior stakeholders." In addition, the court noted that gifting should be permissible "where, as here, the gift comes from secured creditors, there is no doubt as to their secured creditor status . . . and where the complaining creditor would get no more if the gift had not been made."

The district court affirmed.

DBSD undoubtedly will shift the dynamic in some chapter 11 plan negotiation processes in the Second Circuit and, in some cases, may render confirmation more difficult or expensive. In the single-debtor context, the ruling in particular may make it more difficult for equity holders to recover any property under a plan. But in the multiple-debtor context, its consequences may reach other types of constituencies as well.

THE SECOND CIRCUIT DECISION

The Second Circuit's full opinion addressed three issues: (i) Sprint's standing to appeal; (ii) whether the plan violated the absolute priority rule; and (iii) whether the bankruptcy court correctly "designated" (disallowed) the vote of Dish Network Corp. ("Dish"), an indirect competitor of DBSD.

As a preliminary matter, the Second Circuit determined that Sprint had standing to appeal even though, absent the gift, there would be no recovery for unsecured creditors and therefore the gift did not affect Sprint's recovery. The Second Circuit rejected the notion that a creditor lacks standing merely because its claim is out of the money. As the court noted, Sprint might do better by using its unsecured claim as leverage to increase its recovery if the reasons for the gift to equity were worth the cost to the second lien holders of obtaining the unsecured creditors' approval of the plan. For Sprint to have standing, the Second Circuit determined, the court need only determine that Sprint at the very least stood a reasonable chance of improving its position.

The Second Circuit then turned to gifting and the absolute priority rule. Citing the plain language of section 1129(b)(2)(B) and case law construing the absolute priority rule from its initial use in railroad reorganization cases in the 19th century to the present, the court held that because old equity received property—stock and warrants—under the plan on account of its interest, the bankruptcy court should not have confirmed the plan. Further, the court noted that additional reasons cited for the gift, including the shareholder's continued cooperation and assistance, did not justify what was, in its view, a clear violation of the absolute priority rule. In fact, the court believed that strict application of the absolute priority rule was mandated on the basis of two prior Supreme Court decisions indicating a preference for a strict reading of the rule—*Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship* and *Norwest Bank Worthington v. Ahlers*.

The Second Circuit distinguished its ruling from *SPM*. In *SPM*, the First Circuit held that nothing in the Bankruptcy Code barred secured creditors in a case converted from chapter 11 to chapter 7 from sharing with certain unsecured creditors, ahead of higher-priority unsecured creditors, proceeds they received from liquidating the debtor's assets where the amount of the secured lender's liens exceeded the debtor's value. The Second Circuit noted an important distinction between the two cases: *SPM* involved a chapter 7 liquidation, not chapter 11, and the absolute priority rule of section 1129(b)(2)(B) does not apply in chapter 7. The court also noted that in *SPM*, the secured creditor had obtained relief from the automatic stay to foreclose on the proceeds of the liquidation, such that those proceeds no longer constituted property of the estate but were property of the secured creditor, which could do with them what it pleased.

The Second Circuit also addressed certain policy arguments against strictly construing the absolute priority rule as a prohibition against gifting, including that: (i) gifting can be a powerful tool in encouraging an efficient and nonadversarial chapter 11 process; and (ii) enforcing the absolute priority rule, by contrast, may lead to holdout behavior. The court responded that strong policy arguments exist in support of strict construction as well. For example, it explained, because shareholders may retain substantial control over the chapter 11 process (as existing management or otherwise as a debtor in possession), a weakened absolute priority rule could allow for self-enrichment and other serious mischief between senior creditors and existing shareholders. Along those lines, the court found it telling that while the commission charged with reviewing the bankruptcy laws in the lead-up to the enactment of the Bankruptcy Code suggested loosening the absolute priority rule to allow greater participation by equity owners, and whereas Congress did in fact weaken the absolute priority rule in some ways, it did not create an exception for gifts of the type at issue in *DBSD*.

Importantly, because the distributions to old equity in *DBSD* were provided under the plan, the Second Circuit expressly declined to determine whether the Bankruptcy Code would allow the existing equity holder to receive the gift *outside the plan*.

Notably, the Second Circuit also affirmed an order of the bankruptcy court designating Dish's votes against the plan as having been cast in bad faith and thus disregarding Dish's vote for plan confirmation purposes. Dish, an indirect competitor of DBSD, purchased all of DBSD's first lien debt after the plan disclosure statement was released in an effort to control the plan process and eventually acquire some of DBSD's strategic assets. The Second Circuit held that, in rejecting the plan as proposed, Dish was not acting as a creditor seeking to maximize the return on its claims, but rather voting with an improper ulterior motive—the classic rationale for vote designation under section 1126(e) of the Bankruptcy Code.

CONCLUSION

DBSD undoubtedly will shift the dynamic in some chapter 11 plan negotiation processes in the Second Circuit and, in some cases, may render confirmation more difficult or expensive. In the single-debtor context, the ruling in particular may make it more difficult for equity holders to recover any property under a plan. But in the multiple-debtor context, its consequences may reach other types of constituencies as well. For example, if a dissenting unsecured class is not paid in full at the subsidiary level, what are the ramifications for the debtor's corporate structure? Will the court find that the absolute priority rule is not implicated where the debtor parent retains its equity in its debtor subsidiary even though the subsidiary's creditors do not receive payment in full under the plan because keeping the corporate structure intact is for convenience only? Or will the debtors be required to structure their plans around such a possibility or to rely on such other doctrines as the "new value" exception to the absolute priority rule?

Importantly, the Second Circuit limited its ruling to distributions under a plan. The court expressly declined to determine whether the second lien holders, after receiving a distribution under the plan, could in turn distribute a portion of that recovery to old equity outside the plan. A potential "gift" outside the plan raises many questions. For example, would the gift be permissible under *SPM*, or would it contravene the spirit of the absolute priority rule and therefore taint the plan? Even if permissible, how would the gift be implemented? Would it be based on a preconfirmation agreement between the parties? If not, what recourse would the prospective recipient have in the event the gift were not made? What are the disclosure obligations and considerations regarding such a gift? How would the gift be distributed, particularly if the junior class has disputed claims or interests, or numerous holders? What are the consequences for both the distributor and the recipient of the gift, particularly if the gift is in the form of noncash consideration?

By eliminating the ability to make class-skipping gifts pursuant to a plan, the *DBSD* ruling may change the plan negotiation process in some chapter 11 cases in the Second Circuit. As the Second Circuit noted, strict enforcement of the absolute priority rule would provide Sprint with additional leverage in negotiating for the value of the distribution to equity. As a result, intermediate classes may be able to obtain a greater recovery than they otherwise would receive if gifting under a plan were permissible in the Second Circuit.

In re Armstrong World Indus., Inc., 432 F.3d 507 (3d Cir. 2005).

In re DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part sub nom. Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 2010 WL 4925878 (2d Cir. Dec. 6, 2010), *opinion issued by* 2011 WL 350480 (2d Cir. Feb. 7, 2011).

In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993).

Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988).

THE U.K. PENSIONS REGULATOR—WILL ITS POWERS BE LIMITED?

Rosalind Connor and Paul Bromfield

Ever since the establishment of the U.K. Pensions Regulator (the "Regulator") by the U.K. Pensions Act 2004 (the "Act"), the Regulator's exercise of its authority has been of major importance to the U.K.'s restructuring and rescue business. The first judicial review of the Regulator's powers, however, hints that some of the procedures it has adopted may be curbed in the future.

THE PENSIONS REGULATOR AND THE RESTRUCTURING ENVIRONMENT

The increasingly large size of pension liabilities has made such liabilities central in any restructuring where there is a defined-benefit pension plan. Such a plan is usually the largest unsecured creditor by far, holding claims that in pure value often dwarf all other liabilities. The Regulator's powers to pierce the corporate veil and extend pension liabilities to group companies and shareholders have increased the importance of those liabilities and generally guarantee the Regulator a seat at the negotiating table.

The Regulator's powers include the authority to issue a contribution notice requiring a payment to the pension plan by any shareholder or director who omits to take action designed to reduce either pension plan obligations or the likelihood that such obligations will be paid in full. These powers are often relevant in a restructuring, particularly where existing shareholders plan to take the business and assets through a prepackaged administration (a "prepack"), leaving the pension plan behind in the insolvent shell company.

As a result, it is now common practice to seek clearance from the Regulator concerning the terms of a prepack and other business rescues. The Regulator's powers are set forth in the Act, but there is very little detail as to how the Regulator should reach its decisions, and as a result, the Regulator has been forced to develop its own processes and methods of analyzing cases brought before it. In particular, the Regulator expects the trustees of the pension plan to have been consulted beforehand and to agree to the terms

of the prepack; it also expects that some payment (referred to by the Regulator as "mitigation") will be made under the plan to reduce pensioner losses, together, in many cases, with an allocation to the plan trustees of an equity stake in the remaining business.

CRITICISM OF THE REGULATOR'S PROCEDURES

The first judicial review of the Regulator's powers in this regard indicates that the courts may be skeptical of the Regulator's procedures and that, in fact, the necessity of applying to the Regulator for approval of restructuring arrangements may be significantly curtailed.

The first contribution notice issued by the Regulator, on May 14, 2010, was against Michel van de Wiele NV ("VDW"), a Belgian company, following the insolvency of its subsidiary, Bonas UK Limited ("Bonas"), which had a defined-benefit pension plan in the U.K. VDW had owned Bonas for a number of years, and following a long period of losses, Bonas filed for a prepackaged administration, from which VDW bought the Bonas business and assets, leaving the pension plan behind.

VDW's appeal of the Regulator's decision to issue the contribution notice has been filed in the U.K. Upper Tribunal, and a full hearing is expected later this year. However, an application for a barring order—providing, effectively, that the Regulator's decision should be overturned without a full hearing—was heard in October 2010. The Upper Tribunal's judgment on that application was recently handed down. It examines in some detail the Regulator's exercise of its powers and suggests that the Regulator's procedures may need to be changed.

The particular criticism of VDW made by the Regulator, which gave rise to the contribution notice, was that VDW and Bonas failed to consult and negotiate with the plan trustees. The Regulator deduced that the failure to do so was an attempt to avoid having to make a payment to the pension plan, which the trustees and the Regulator would have demanded as part of the negotiation.

The Tribunal's ruling suggests that the Regulator, when arguing that VDW's actions reduced the payments to the plan, could not consider whether Bonas would have made a payment to the plan if VDW and Bonas had negotiated with the trustees or sought clearance from the Regulator. Effectively, the Tribunal determined, the act of failing to seek clearance was not relevant when considering whether to issue a contribution notice. The financial condition of Bonas was such that its insolvency was inevitable, and the pension plan, as an unsecured creditor, was not likely to obtain any payment.

A CHANGE TO THE REGULATORY ENVIRONMENT?

Although the Tribunal's ruling is just preliminary, it is a strong indication of the likely view of the court. If its ultimate judgment is decided along similar lines, the ruling may require a change in the Regulator's procedures. In particular, the Regulator's present focus on trustee consent and distributions of cash and equity to the pension plan may be revised. Applications for clearance in restructuring situations may become less common, particularly where the pension plan is unlikely to obtain any payment in the insolvency proceeding. Under the Tribunal's recent ruling, the Regulator would not have grounds in that circumstance to issue a contribution notice.

CALLING ALL PRPS WITH CONTRIBUTION CLAIMS: PAY UP, OR STEER CLEAR OF BANKRUPTCY COURT

Charles M. Oellermann and Mark G. Douglas

When a company that has been designated a responsible party for environmental cleanup costs files for bankruptcy protection, the ramifications of the filing are not limited to a determination of whether the remediation costs are dischargeable claims. Another important issue is the circumstances under which contribution claims asserted by parties coliable with the debtor will be allowed or disallowed in the bankruptcy case. This question was the subject of rulings handed down early in 2011 by the New York bankruptcy court presiding over the chapter 11 cases of Lyondell Chemical Co. and Chemtura Corp. In separate bench rulings, bankruptcy judge Robert E. Gerber held that environmental contribution claims remain contingent, and must be disallowed, until the coliable creditor actually pays for the cleanup or otherwise expends funds on account of the claim.

DISALLOWANCE OF CONTINGENT CLAIMS FOR CONTRIBUTION OR REIMBURSEMENT

Section 502(e)(1) of the Bankruptcy Code disallows certain contingent claims asserted by codebtors for contribution or reimbursement. It provides as follows:

> Notwithstanding subsections (a), (b), and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that—
>
> (A) such creditor's claim against the estate is disallowed;
>
> (B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution; or
>
> (C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title.

Pursuant to section 502(e)(2), claims for reimbursement or contribution that become fixed postpetition must be determined, and be allowed or disallowed, as if the contingency had been resolved prepetition.

The purpose of section 502(e) is to protect the bankruptcy estate against the risk of double payment on claims. Without it, a debtor could be liable to the primary creditor as well as coliable parties seeking contribution. According to its legislative history, section 502(e)(1) "adopts a policy that a surety's claim for reimbursement or contribution is entitled to no better status than the claims of the creditor assured by such surety." The legislative history further explains that:

> The combined effect of section 502(e)(1)(B) and 502(e)(2) is that a surety or codebtor is generally permitted a claim for reimbursement or contribution to the extent the surety or codebtor has paid the assured party at the time of allowance. Section 502(e)(1)(C) alternatively indicates that a claim for reimbursement or contribution of a surety or codebtor is disallowed to the extent the surety or codebtor requests subrogation under section 509 with respect to the rights of the assured party. Thus, the surety or codebtor has a choice; to the extent a claim for contribution or reimbursement would be advantageous, such as in the case where such a claim is secured, a surety or codebtor may opt for reimbursement or contribution under section 502(e). On the other hand, to the extent the claim for such surety or codebtor by way of subrogation is more advantageous, such as where such claim is secured, the surety may elect subrogation under section 509.

The Bankruptcy Code does not define the terms "contingent," "reimbursement," "contribution," or "subrogation" or the phrase "liable with the debtor." The definition of these terms for purposes of section 502(e) has been left to the courts, with sometimes inconsistent results. Courts generally look to applicable nonbankruptcy law for guidance (*e.g.*, state, federal statutory, or common law).

APPLICATION TO ENVIRONMENTAL REMEDIATION CLAIMS

In addition to claims arising from contractual codebtor relationships, section 502(e)(1)(B) disallows contingent reimbursement or contribution claims created by statute, including claims for contribution arising under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"). Congress enacted CERCLA more than 30 years ago to hold "potentially responsible parties" ("PRPs") liable for remediating pollution. CERCLA imposes liability for environmental cleanup costs, natural-resource damages, and certain other categories of recovery on PRPs, including the current "owner or operator" of a site contaminated with hazardous substances and any person who previously owned or operated a contaminated site at the time of a hazardous waste disposal. PRPs who fund remediation actions can seek contribution from other PRPs "during or following any civil action" instituted under CERCLA. In addition, CERCLA permits "private parties" (nongovernmental entities) to seek contribution after they settle their liability with the Environmental Protection Agency ("EPA") or a state in an administrative or judicially approved settlement. It also protects PRPs who have settled with the EPA from contribution claims by other PRPs.

Lyondell and *Chemtura* reinforce the principle that an environmental remediation contribution claim will remain contingent, and therefore subject to disallowance under section 502(e)(1)(B), if the claimant has not actually expended payment for the cleanup, provided, of course, that the other elements of section 502(e)(1)(B)—a claim for "reimbursement or contribution" and coliability of the debtor and the creditor—are satisfied.

If a PRP or another private party files a claim against a debtor's estate for remediation costs, the claim may be disallowed under section 502(e)(1). The circumstances under which disallowance is warranted—and, more particularly, whether an environmental remediation contribution and/or indemnification claim is "contingent"—were addressed in *Lyondell* and *Chemtura*.

LYONDELL AND *CHEMTURA*

The facts involved in the cases are substantially similar. Prior to filing for chapter 11 protection in New York, certain of the debtors as well as various other private parties were designated as PRPs for past and estimated future environmental remediation costs under CERCLA. The other private parties filed contribution claims against the debtors' estates for past and future estimated remediation costs. The debtors objected to the claims for *future* (but not past) cleanup costs, maintaining that such claims should be disallowed pursuant to section 502(e)(1)(B).

In *Lyondell*, one of the PRPs asserted that a claim is contingent only if it has not "accrued" under applicable law, regardless of whether the underlying remediation costs have actually been paid. Thus, the PRP argued, no part of its claim was contingent because its contribution claim against the debtors had accrued under CERCLA. Other PRPs relied on the Delaware bankruptcy court's 2007 ruling in *In re RNI Wind Down Corp.* for the proposition that their claims for future response costs were *unliquidated*, but not contingent. The debtors in both *Lyondell* and *Chemtura* argued that the Second Circuit Court of Appeals' 1991 ruling in *In re Chateaugay Corp.* constrained the court to conclude that contribution claims under CERCLA remain contingent unless and until remediation costs are actually paid by the claimant.

THE BANKRUPTCY COURT'S RULINGS

Judge Gerber declined to view *Chateaugay* as controlling authority for the proposition that a contribution claim is contingent until the claimant actually makes an expenditure. *Chateaugay*, Judge Gerber wrote, was "not a 502(e)(1)(B) case." He found it instructive, however, that in both *Chateaugay* and the Second Circuit's 2000 ruling in *In re Manville Forest Products Corp.*, "it was undisputed that the debtors faced some environmental liability, but the Second Circuit nevertheless described those claims as contingent because the scope, amount, and form of that liability was undetermined."

Nevertheless, Judge Gerber found compelling the reasoning articulated in other decisions applying section 502(e)(1)(B) in denying contribution claims on the basis of nonpayment by the claimant. According to Judge Gerber, the key inquiry is not whether liability has "accrued," but whether the coliable party has actually paid for the investigation and cleanup. Because the PRPs had not expended any amounts on future cleanup costs, the judge ruled that their contribution claims for future remediation costs remained both contingent and unliquidated. This approach, Judge Gerber reasoned, "advances not just bankruptcy policy, but environmental policy as well." Disallowance of such claims under the circumstances, he wrote, "advances CERCLA's policy goal of encouraging expeditious cleanup, because claimants are encouraged to remediate promptly by the threat of disallowance of claims that have not been fixed."

OUTLOOK

Lyondell and *Chemtura* do not represent a sea change in this area of bankruptcy law, even for Judge Gerber. The rulings are consistent with another 2010 ruling in *Chemtura*, where he determined that section 502(e)(1)(B) mandated disallowance of claims for contribution by downstream distributors of the debtor's allegedly defective products, because such claims depended on the success of the parties allegedly injured by those products on their tort claims against distributors and were not just unliquidated but contingent as well. Even so, *Lyondell* and *Chemtura* reinforce the principle that an environmental remediation contribution claim will remain contingent, and therefore subject to disallowance under section 502(e)(1)(B), if the claimant has not actually expended payment for the cleanup, provided, of course, that the other elements of section 502(e)(1)(B)—a claim for "reimbursement or contribution" and coliability of the debtor and the creditor—are satisfied.

In re Lyondell Chemical Co., 442 B.R. 236 (Bankr. S.D.N.Y. 2011).

In re Chemtura Corp., 2011 WL 109081 (Bankr. S.D.N.Y. Jan. 13, 2011).

In re RNI Wind Down Corp., 369 B.R. 174 (Bankr. D. Del. 2007).

In re Chateaugay Corp., 944 F.2d 997 (2d Cir. 1991).

In re Manville Forest Products Corp., 209 F.3d 125 (2d Cir. 2000).

In re Drexel Burnham Lambert Group, Inc., 148 B.R. 983 (Bankr. S.D.N.Y. 1992).

In re APCO Liquidating Trust, 370 B.R. 625 (Bankr. D. Del. 2007).

In re Alper Holdings USA, 2008 WL 4186333 (Bankr. S.D.N.Y. Sept. 10, 2008).

In re Wedtech Corp., 85 B.R. 285 (Bankr. S.D.N.Y. 1988).

Aetna Casualty & Surety Company v. Georgia Tubing Corp., 93 F.3d 56 (2d Cir. 1996).

In re Chemtura Corp., 436 B.R. 286 (Bankr. S.D.N.Y. 2010).

IN RE WASHINGTON MUTUAL, INC.: DELAWARE BANKRUPTCY COURT LIMITS DEBTORS' RELEASE OF THIRD PARTIES

Mark A. Cody

In a recent decision, Judge Mary F. Walrath of the United States Bankruptcy Court for the District of Delaware greatly limited debtors' ability to release parties under a chapter 11 plan in the bankruptcy cases of Washington Mutual, Inc. ("WMI"), and its debtor affiliates (together with WMI, the "Debtors"). In *In re Washington Mutual, Inc.*, Judge Walrath approved a global settlement agreement (the "Global Settlement") reached by the Federal Deposit Insurance Corporation ("FDIC") as receiver for Washington Mutual Bank ("WaMu Bank"); JPMorgan Chase Bank, N.A. ("JPMC"), as purchaser of the WaMu Bank assets in the fourth quarter of 2008; WMI; and certain other parties. The Global Settlement resolved litigation stemming from the failure of WaMu Bank in 2008 and the subsequent purchase of WaMu Bank's assets by JPMC and was the basis for the Debtors' Sixth Amended Joint Plan of Reorganization (the "Plan"). Despite finding that the Global Settlement was fair and reasonable, Judge Walrath denied confirmation of the Plan because she found the releases granted by the Debtors to certain parties under the Plan to be excessively broad and impermissible under applicable law.

BACKGROUND

On September 25, 2008, WaMu Bank's primary regulator, the Office of Thrift Supervision, seized WaMu Bank and appointed the FDIC receiver. The same day, the FDIC sold substantially all of WaMu Bank's assets to JPMC through a Purchase & Assumption Agreement (the "Purchase Agreement") under which JPMC obtained substantially all the assets of WaMu Bank for $1.88 billion in cash consideration and assumed more than $145 billion in deposit and other liabilities. The FDIC retained claims that WaMu Bank held against other third parties. On September 26, 2008 (the "Petition Date"), WaMu Bank's previous holding company owner WMI and certain of its affiliates filed for relief under chapter 11 of the Bankruptcy Code. Almost immediately thereafter, disputes arose among the Debtors, JPMC, and the FDIC regarding ownership of certain assets.

In the months following the sale of WaMu Bank and the Petition Date, each of the FDIC, JPMC, the Debtors, and various other noteholders and creditors initiated several adversary proceedings and declaratory-judgment actions related to either the failure of WaMu Bank or the Purchase Agreement. The Debtors brought an action in the U.S. District Court for the District of Columbia against the FDIC alleging the taking and conversion of the Debtors' property and the wrongful denial of proofs of claim filed with the FDIC in the WaMu Bank receivership. JPMC and certain noteholders subsequently intervened in the litigation. JPMC brought an adversary proceeding against the Debtors seeking a declaratory judgment that JPMC owned certain of the WaMu Bank's assets, including deposit accounts, tax refunds, and certain securities. The Debtors commenced a turnover action against JPMC seeking turnover of certain of WaMu Bank's deposit accounts and undertook an investigation under Rule 2004 of the Federal Rules of Bankruptcy Procedure into whether any viable business tort claims existed against JPMC. Lastly, two groups of unsecured noteholders of the Debtors initiated adversary proceedings against both the Debtors and JPMC, seeking a declaratory judgment that the noteholders owned certain securities and were entitled to the proceeds of certain litigation. In July 2010, the Delaware bankruptcy court appointed an examiner to review the claims asserted by the parties to help resolve many of the issues. The examiner submitted his report on November 1, 2010, and the parties thereafter negotiated and finalized the Global Settlement.

APPROVAL OF THE GLOBAL SETTLEMENT

The Global Settlement, which the Debtors intended to implement through the Plan, provides approximately $6.1 to $6.8 billion in funds to the Debtors' estates for distribution to creditors. Further, the Global Settlement and the Plan contain mutual releases by the Debtors, the FDIC, JPMC, and certain other parties, as well as injunctions against future claims.

Judge Walrath first analyzed the reasonableness of the Global Settlement and found that, on balance, with respect to much of the litigation resolved by the Global Settlement, the Debtors and other parties thereto may not have been able to fare better if they continued to litigate the various claims. Thus, with respect to the various claims and litigated matters, Judge Walrath approved the Global Settlement without

alteration or exception, finding it to be reasonable in light of the possible results of the pending litigation; difficulties in collection; complexity; expense and delay associated with continued litigation; and the best interests of creditors.

DENIAL OF PLAN CONFIRMATION AND REJECTION OF MUTUAL RELEASES

Under the Plan and the Global Settlement, the Debtors released JPMC, the FDIC, and WaMu Bank from claims held by the Debtors against those parties. The Debtors also released and waived claims against other parties to the Global Settlement and "Related Persons," including current and former officers and directors of the Debtors.

In reviewing and evaluating the releases granted by the Debtors under the Plan, Judge Walrath considered a multifactor test set forth in a Missouri bankruptcy court's 1994 ruling in *In re Master Mortgage Invest. Fund, Inc.*, which Judge Walrath had applied in her 1999 ruling in *In re Zenith Electronics Corp.* Under the *Master Mortgage* and *Zenith* test, Judge Walrath approved the Debtors' releases of the FDIC, JPMC, and WaMu Bank but disapproved the releases of claims against other third parties.

In *Master Mortgage*, the court outlined the following five factors that bankruptcy courts should consider when evaluating the release of claims against a nondebtor third party without the consent or agreement of the party deemed to be bound by such release:

(1) An identity of interest between the debtor and the third party, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate;

(2) Substantial contribution by the nondebtor of assets to the reorganization;

(3) The essential nature of the injunction to the reorganization to the extent that, without the injunction, there is little likelihood of success;

(4) An agreement by a substantial majority of creditors to support the injunction, specifically if the impacted class or classes "overwhelmingly" vote to accept the plan; and

(5) Provision in the plan for payment of all or substantially all of the claims of the class or classes affected by the injunction.

Ultimately, the court in *Master Mortgage* held that a release of, and injunction against, claims a creditor held against the debtors' nondebtor affiliate and plan supporter were appropriate. In *Zenith*, Judge Walrath applied the multifactor *Master Mortgage* test to releases granted by debtors to third parties, finding that the debtors' releases of third parties in that case satisfied the *Master Mortgage* test. With respect to third-party releases, however, the court found that a release of claims held by a third party against another third party was not appropriate under the plan without the affirmative agreement or consent of the creditor whose claim would be enjoined.

In *Washington Mutual*, Judge Walrath applied the *Master Mortgage* test to all releases granted by the Debtors. She found reasonable and approved the Debtors' releases of Plan supporters JPMC, the FDIC, and WaMu Bank. However, Judge Walrath concluded that the releases granted by the Debtors to settling noteholders, the official committee of unsecured creditors and its members, certain indenture trustees, and the liquidating trust and trustee under the Plan were not reasonable because, among other things, none of the parties contributed significantly to the reorganization; there was no identity of interest between the Debtors and such parties; and, in the case of the creditors' committee, its members did nothing more than fulfill their fiduciary duties and were otherwise covered by the Plan's exculpation provisions.

IMPACT OF *WASHINGTON MUTUAL*

While some circuits prohibit or significantly limit releases of claims held by a nondebtor third party against another nondebtor third party, a full release of claims held by a debtor against a nondebtor party is frequently approved in exchange for the nondebtor's support of the chapter 11 plan. Ordinarily, a nondebtor party will contribute to or otherwise support the debtor's plan and emergence from bankruptcy if the debtor grants it a full release from claims held by the debtor.

Similarly, it is customary for a debtor to release the official committee of unsecured creditors and its professionals in exchange for the committee's support for the debtor's plan and as part of the overall settlement set forth in the chapter 11 plan. For all such releases, a debtor must establish its determination in the exercise of its business judgment whether releasing claims under the chapter 11 plan will provide a greater benefit to the debtor's estate than the debtor would receive if it were to pursue such claims.

In *Washington Mutual*, the court applied the *Master Mortgage* test to releases granted by debtors to creditors who otherwise support a chapter 11 plan. As noted above, the *Master Mortgage* test originally was used to determine whether to approve plan provisions that release claims held by a creditor against a nondebtor without that creditor's consent. Thus, *Washington Mutual* expands the application of the *Master Mortgage* five-factor test to a *debtor's* decision to release certain parties under a plan.

Other bankruptcy courts, however, both in Delaware and elsewhere, have permitted debtors to release claims belonging to the debtor's estate if the release can be demonstrated to represent a valid exercise of the debtor's business judgment, is fair and reasonable, and is in the best interest of the debtor and its estate. By contrast, application of the *Master Mortgage* test to all releases granted by debtors would suggest substantially stricter scrutiny of such releases in the chapter 11 plan context.

Judge Walrath correctly stated that the Third Circuit has not articulated a test to determine whether releases by debtors are appropriate. As such, she indicated that she "continues to believe that the factors articulated in *Master Mortgage* form the foundation for such an analysis, with due consideration of other factors that may be relevant to [the] case." Other bankruptcy courts, however, both in Delaware and elsewhere, have permitted debtors to release claims belonging to the debtor's estate if the release can be demonstrated to represent a valid exercise of the debtor's business judgment, is fair and reasonable, and is in the best interest of the debtor and its estate. By contrast, application of the *Master Mortgage* test to all releases granted by debtors would suggest substantially stricter scrutiny of such releases in the context of the chapter 11 plan.

EPILOGUE

On February 8, 2011, the Debtors submitted a modified Sixth Amended Joint Plan of Reorganization substantially modifying the releases and injunctions granted to third parties contained therein to address the concerns of the bankruptcy court. The Debtors also moved for approval of a revised disclosure statement and for an order setting a new confirmation hearing for May 2, 2011, following a resolicitation of votes. Judge Walrath granted the motions on March 22, 2011, directing, however, that the Debtors explain in their revised disclosure statement what effect suspicions of insider trading could have on the $7 billion to be distributed under the modified Plan.

In re Washington Mutual, Inc., 2011 WL 57111 (Bankr. D. Del. Jan. 7, 2011).

In re Master Mortgage Invest. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994).

In re Zenith Electronics Corp., 241 B.R. 92 (Bankr. D. Del. 1999).

In re Aleris Intern., Inc., 2010 WL 3492664 (Bankr. D. Del. May 13, 2010).

In re Spansion, Inc., 426 B.R. 114 (Bankr. D. Del. 2010).

In re DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009).

David B. Shafer assisted in the preparation of this article.

IN BRIEF: DISTRICT COURT AFFIRMS *LEHMAN BROTHERS* SAFE-HARBOR SETOFF RULING

In the July/August 2010 edition of the *Business Restructuring Review*, we reported on an important ruling handed down by bankruptcy judge James M. Peck in the Lehman Brothers chapter 11 cases addressing the interaction between the Bankruptcy Code's general setoff rules (set forth in section 553) and the Code's safe harbors for financial contracts (found principally in sections 555, 556, and 559 through 562). In *In re Lehman Bros. Holdings, Inc.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010), Judge Peck held that, absent mutuality of obligation, funds on deposit with a bank are not protected by the safe-harbor provisions and cannot be used to set off an obligation allegedly owed by the debtor under a master swap agreement. "A contractual right to setoff under derivative contracts," Judge Peck wrote, "does not change well established law that conditions such a right on the existence of mutual obligations." According to the judge, "[M]utuality is baked into the very definition of setoff."

Among other things, Judge Peck found that: (a) the requisite mutuality did not exist under section 553(a) to permit the setoff of funds in the bank account because the derivatives claims against the debtor arose prepetition, whereas the obligation to the debtor (*i.e.*, the postpetition deposits in the bank account) arose postpetition; (b) the plain language of the safe-harbor provisions, as well as their legislative history, demonstrated that the provisions do not nullify the mutuality requirement of section 553(a); and (c) the administrative freeze of the accounts by the bank counterparty—Swedbank AB—violated the automatic stay.

The district court affirmed the ruling in all respects on January 26, 2011, for the most part without comment. *See In re Lehman Bros. Holdings Inc.*, 2011 WL 350280 (S.D.N.Y. Jan. 27, 2011). However, in its opinion, the district court specifically addressed Swedbank's argument on appeal that the legislative history supports its construction of the safe-harbor provisions. Surveying the legislative history, the court found no indication that the safe-harbor provisions displaced mutuality or functioned as an exception to section 553. Consequently, the court determined that the legislative history does not support Swedbank's position that the safe harbors permitted its attempted setoff against the debtor's postpetition assets, which were fortuitously deposited at Swedbank and which had no connection to the underlying swap agreements.

According to the court, a contrary rule would mean that a swap participant is entitled to a type of super-priority status that extends to all of its commercial transactions with the debtor, and Congress neither wrote nor intended to write such a rule. Together with the ruling in *In re SemCrude, L.P.*, 399 B.R. 388 (Bankr. D. Del. 2009), the decision would appear to make it more difficult to contract around the mutuality requirements of section 553, potentially prohibiting triangular setoffs in swap agreements. In a footnote, the district court wrote: "Similarly, Swedbank argues that the Safe Harbor Provisions permit parties to contract out of the requirements of the Bankruptcy Code, including out of the mutuality requirement. We note that there is a paucity of support for this argument, which runs counter to the fundamental purposes of the bankruptcy law."

RUMORS OF THE DEMISE OF CREDITOR DERIVATIVE SUITS ON BEHALF OF LLCS NOT AN EXAGGERATION

Nicholas C. Kamphaus

A decision recently handed down by the Delaware Chancery Court, *CML V, LLC v. Bax*, indicates that creditors of a limited liability company ("LLC") organized under Delaware law do not have standing to institute derivative suits against an LLC's management, even when the LLC is insolvent, unless the right is expressly set forth in the LLC's organizational documents or external agreements.

BACKGROUND

In April 2007, CML V, LLC ("CML"), loaned more than $25 million to JetDirect Aviation Holdings, LLC ("JetDirect"), a private jet management and charter company that, through subsidiaries, provided charter services, prepaid memberships for charter flights, aircraft management services, and maintenance and fuel services. The amount of the loan was later increased to more than $34 million. CML alleged that after this money was loaned, JetDirect's management approved four separate acquisitions despite lacking adequate information about JetDirect's finances and that JetDirect's working capital was insufficient to finance these acquisitions. In June 2007, JetDirect defaulted on CML's loan. According to a complaint later filed by CML, JetDirect then engaged in the liquidation of some of its assets. During this partial liquidation, some members of JetDirect's management allegedly caused various assets to be sold for inadequate consideration to entities controlled by members of management.

On the basis of these allegations, CML brought derivative actions asserting that certain officers, directors, and managers of JetDirect: (i) breached their duty of care by approving acquisitions after CML extended financing to JetDirect; (ii) acted in bad faith by failing to maintain and monitor an adequate internal control system and by concealing information from JetDirect's board; and (iii) breached their duty of loyalty when they benefited from the self-interested asset sales conducted during the partial liquidation of JetDirect's assets. CML also asserted a cause of action against JetDirect for breach of the loan agreement but conceded that the court would have jurisdiction over this claim only if CML had standing under one of the three derivative causes of action.

The defendants all moved to dismiss the derivative causes of action on the basis that CML, as a creditor of JetDirect, lacked standing to bring a derivative suit, because the Delaware Limited Liability Company Act (the "LLC Act") limits its standing for derivative suits to holders or assignees of LLC membership interests. CML argued that once an LLC becomes insolvent, the fiduciary duties of directors and officers run to the benefit of the LLC's creditors, rather than its members, and thus creditors have standing to bring derivative actions against an insolvent LLC.

RULING BY THE CHANCERY COURT

The Chancery Court held that under the plain meaning of the LLC Act, only members or assignees of LLC interests have standing to bring derivative actions. Thus, the court concluded, creditors of LLCs never have standing to bring derivative actions on behalf of the LLC. In so ruling, Vice Chancellor Laster noted that this rule is in stark contrast to the settled jurisprudence on creditor derivative standing with respect to corporations, but he nevertheless held that the plain meaning of the statute bound him to this result. Vice Chancellor Laster further noted that this same strict rule has already been applied to other "alternative entities" in Delaware. Finally, Vice Chancellor Laster noted that creditors of an LLC generally have the ability to protect themselves, both through their agreements with the LLC and through their insistence on the inclusion of creditor protections in the LLC agreement. Thus, he explained, this "plain meaning" interpretation of the LLC Act does not create an absurd result to the detriment of creditors.

Plain Meaning

The LLC Act contains an entire subchapter titled "Derivative Actions." The first section, section 18-1001, titled "Right to bring action," states as follows:

> A member or an assignee of a limited liability company interest may bring an action in the Court of Chancery in the right of a limited liability company to recover a judgment in its favor if managers or

> members with authority to do so have refused to bring the action or if an effort to cause those managers or members to bring the action is not likely to succeed.

The next section, section 18-1002, titled "Proper plaintiff," states as follows:

> In a derivative action, the plaintiff must be a member or an assignee of a limited liability company interest at the time of bringing the action and:
>
> (1) At the time of the transaction of which the plaintiff complains; or
>
> (2) The plaintiff's status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transaction.

The court noted that the only Delaware treatise to comment on the issue of creditor standing to bring a derivative suit on behalf of an LLC concludes that under the statute, a creditor is not a proper plaintiff. Additionally, a federal district court in Delaware, in an unpublished 2007 decision (*Magten Asset Mgmt. Corp. v. Paul Hastings Janofsky & Walker LLP*), interpreted a provision similar to section 18-1002 in the Montana limited liability company statute to preclude creditor standing for derivative suits. The court in *CML* explicitly agreed with the conclusions of these two authorities, holding that section 18-1002 contains "exclusive language."

A New Precedent

Vice Chancellor Laster openly acknowledged that his decision creates a difference in creditor derivative standing between Delaware LLCs and Delaware corporations and also marks a departure from the general understanding of most commentators.

The Delaware Supreme Court recently reaffirmed creditor derivative standing in the case of insolvent corporations in *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*. However, in *CML*, Vice Chancellor Laster contrasted the "exclusive language" of section 18-1002 with the "non exclusive language" of section 327 of the Delaware General Corporation Law, the only statute that deals with derivative actions on behalf of corporations. Section 327 states that:

> [i]n any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.

The court pointed out that section 327 purports to limit standing only for suits "instituted by a stockholder," leaving open the question of whether any other entities may bring derivative suits. Section 18-1002, by contrast, speaks of the requirements of a plaintiff "[i]n a derivative action."

CML represents an abrupt turn in the area of creditor derivative standing with respect to Delaware LLCs. However, the ruling also creates a simple, black-letter rule: creditors of Delaware LLCs must contract for any rights they desire when lending or extending credit to a Delaware LLC.

The court went on to acknowledge that, aside from the abovementioned treatise, commentators have universally assumed that creditors of insolvent LLCs generally do have derivative standing, and they have moved on to debate the extent to which an LLC agreement may limit creditors' rights in this regard. Additionally, two previous decisions of the Chancery Court assumed, in *dicta*, that derivative standing for creditors of insolvent LLCs exists. However, the *CML* court emphasized that these pronouncements were no more than *dicta* and that, while the overwhelming support in the scholarly community for creditor derivative standing has some persuasive value, it cannot overcome the plain meaning of the statute.

Origins of the Statute

In order to consider fully the intent of section 18-1002, the court examined the history of its language. Section 18-1002, like

much of the LLC Act, was modeled on a similar provision in the Delaware Limited Partnership Act (the "DLPA"). The provision in the DLPA was revised to its current version in 1982, on the basis of language in the Revised Uniform Limited Partnership Act (the "RULPA"), which was promulgated in 1976. The court found particularly instructive the facts that: (i) prior to this revision, the DLPA provision was substantially identical to section 327 of the Delaware General Corporation Law, failing to limit all derivative actions to equity interest holders; and (ii) although Delaware did not adopt the entirety of the RULPA, it did adopt the provision limiting derivative standing to limited partners and certain successors to their interests. Thus, the court concluded, the Delaware legislature had the opportunity to adopt a less restrictive statute on derivative standing but elected to adopt the exclusive language now found in section 18-1002.

"Nothing Absurd"

The court ended its analysis by rejecting CML's contention that section 18-1002, while not ambiguous on its face, leads to an absurd result. CML asserted that different derivative-standing rules for corporations and LLCs would result in indefensibly different treatment of creditors of LLCs and corporations, with corporate creditors being favored. Thus, CML asserted, section 18-1002 is ambiguous, despite any apparent facial clarity. The court disagreed strongly, holding that "there is nothing absurd about different legal principles applying to corporations and LLCs."

The court went on to hold that this plain-meaning interpretation of section 18-1002 does not conflict with the underlying purpose of the LLC Act. The act's guiding policy, according to section 18-1101(b), is to promote freedom of contract. The court outlined the various tools available to creditors of LLCs to protect their interests contractually, including: (i) section 18-101(7), which permits an LLC agreement to grant contractual rights to nonparties to the agreement; (ii) section 18-1101(c), which permits an LLC agreement to expand the duties of members and managers, including fiduciary duties; (iii) section 18-303(b), which permits personal guarantees of LLC obligations by members; (iv) section 18-805, which authorizes a creditor of a terminated LLC to seek appointment of a receiver; and (v) section 18-502(b), which allows a creditor to enforce a member's obligation under an LLC agreement to make a contribution or return a distribution, to the extent the creditor has relied on this obligation. Additionally, the court explained, creditors of insolvent LLCs are protected by state fraudulent-conveyance laws, as well as the avoidance provisions of the Bankruptcy Code, should the LLC file for bankruptcy protection.

CONCLUSION

CML represents an abrupt turn in the area of creditor derivative standing with respect to Delaware LLCs. However, the ruling also creates a simple, black-letter rule: creditors of Delaware LLCs must contract for any rights they desire when lending or extending credit to a Delaware LLC. In particular, a creditor of such an LLC should seek affirmative contractual rights and remedies with respect to LLC members and managers in connection with the operation of the LLC's business, as the creditor cannot rely on a derivative suit to protect its interests should the LLC become insolvent.

LLC agreements (in Delaware and elsewhere) sometimes provide that the directors of the LLC bear fiduciary duties identical to those of a director of a corporation under applicable law. We are left to speculate whether the *CML* court might have reached a different conclusion had this been the case in the JetDirect LLC agreement. In addition, the ruling's impact in the bankruptcy context, where prepetition causes of action become property of the estate and where it is not unusual for committees and even individual creditors to be given derivative standing to prosecute such actions, would appear to be limited at best. In fact, at least in Delaware, initiating an involuntary bankruptcy case as a means of pursuing LLC managers or directors for alleged fiduciary improprieties may be the preferred strategy.

CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. 2010).

Robert L. Symonds, Jr., & Matthew J. O'Toole, Symonds and O'Toole on Delaware Limited Liability Companies § 9.09, at 9-61 n.270 (2007).

Magten Asset Mgmt. Corp. v. Paul Hastings Janofsky & Walker LLP, 2007 WL 129003 (D. Del. Jan. 12, 2007).

North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

Vichi v. Koninklijke Philips Elecs. N.V., 2009 WL 4345724 (Del. Ch. Dec. 1, 2009).

Bren v. Capital Realty Grp. Senior Housing, Inc., 2004 WL 370214 (Del. Ch. Feb. 27, 2004).

FROM THE TOP: RECENT U.S. SUPREME COURT RULING

The U.S. Supreme Court's October 2010 Term (which extends from October 2010 to October 2011, although the Court hears argument only until June or July) 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 were included on the Court's docket for this Term. On January 11, 2011, the Court ruled in *Ransom v. FIA Card Services, N.A.*, 131 S. Ct. 716 (2011), that a chapter 13 debtor, in calculating his or her "projected disposable income" during the chapter 13 plan period, cannot 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 circuits were split 3-1 on this issue, which arises from ambiguities introduced into the relevant provisions of the Bankruptcy Code in 2005.

Writing for an 8-1 majority, Justice Kagan (in her first opinion) explained that, on the basis of the "text, context, and purpose" of the 2005 amendments, the IRS expense amount for transportation "ownership costs" is not "applicable" to a debtor who will not incur any such costs during his bankruptcy plan. The "ownership costs" category covers only loan and lease payments, Kagan noted, and because the debtor in this case owned his car free from any debt or obligation, she concluded that the debtor may not claim the allowance. Justice Antonin Scalia dissented from the majority opinion.

The Supreme Court's ruling in *Ransom* has already been applied retroactively to bar the vehicle-ownership deduction on vehicles owned free and clear in unconfirmed plans filed prior to the ruling. *See In re Willems*, 442 B.R. 918 (Bankr. E.D. 2011). In *Willems*, the bankruptcy court rejected the debtors' argument that the ruling should not be applied retroactively, explaining that the "general rule" is that when the Supreme Court applies a rule of federal law to the parties before it, that rule is the controlling interpretation of federal law and must be given retroactive effect in all cases "still open on direct review."

The other bankruptcy case on the Court's docket this Term is *Stern v. Marshall (In re Marshall)*, 600 F.3d 1037 (9th Cir.), *cert. granted*, 2010 WL 3053869 (Sept. 28, 2010). In that case, the Court will consider, among other things, whether Congress's intent in enacting 28 U.S.C. § 157(b)(2)(C) was contravened by 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. The Ninth Circuit's decision created a circuit split on the issue. The Court heard oral argument in the case on January 18, 2011.

THE U.S. FEDERAL JUDICIARY

U.S. federal courts have frequently been referred to as the "guardians of the Constitution." Under Article III of the Constitution, federal judges are appointed for life by the U.S. president with the approval of the Senate. They can be removed from office only through impeachment and conviction by Congress. The first bill considered by the U.S. Senate—the Judiciary Act of 1789—divided the U.S. into what eventually became 12 judicial "circuits." In addition, the court system is divided geographically into 94 "districts" throughout the U.S. Within each district is a single court of appeals, regional district courts, bankruptcy appellate panels (in some districts), and bankruptcy courts.

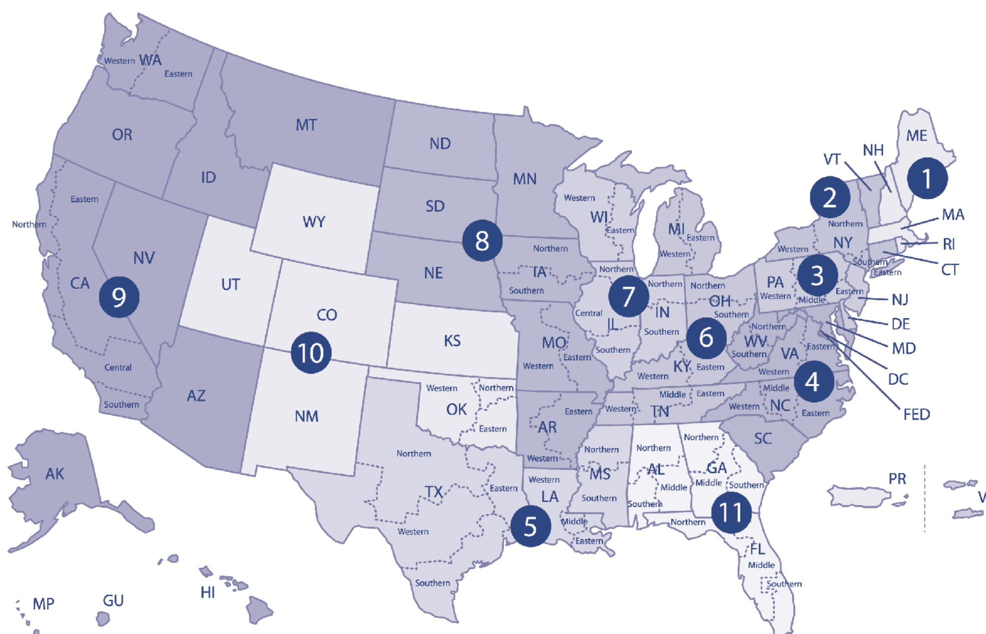
As stipulated by Article III of the Constitution, the Chief Justice and the eight associate Justices of the Supreme Court hear and decide cases involving important questions regarding the interpretation and fair application of the Constitution and federal law. A U.S. court of appeals sits in each of the 12 regional circuits. These circuit courts hear appeals of decisions of the district courts located within their respective circuits and appeals of decisions of federal regulatory agencies. Located in the District of Columbia, the Court of Appeals for the Federal Circuit has nationwide jurisdiction and hears specialized cases such as patent and international trade cases. The 94 district courts, located within the 12 regional circuits, hear nearly all cases involving federal civil and criminal laws. Decisions of the district courts are most commonly appealed to the district's court of appeals.

Bankruptcy courts are units of the federal district courts. Unlike that of other federal judges, the power of bankruptcy judges is derived principally from Article I of the Constitution, although bankruptcy judges serve as judicial officers of the district courts established under Article III. Bankruptcy judges are appointed for a term of 14 years (subject to extension or reappointment) by the federal circuit courts after considering the recommendations of the Judicial Conference of the U.S. Appeals from bankruptcy-court rulings are most commonly lodged either with the district court of which the bankruptcy court is a unit or with bankruptcy appellate panels, which presently exist in five circuits. Under certain circumstances, appeals from bankruptcy rulings may be made directly to the court of appeals.

Two special courts—the U.S. Court of International Trade and the U.S. Court of Federal Claims—have nationwide jurisdiction over special types of cases. Other special federal courts include the U.S. Court of Appeals for Veterans' Claims and the U.S. Court of Appeals for the Armed Forces.

Geographic Boundaries

of United States Courts of Appeals and United States District Courts



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