JONES DAY

RECENT DEVELOPMENTS IN BANKRUPTCY AND RESTRUCTURING

VOLUME 11 ▪ NO. 4 ▪ JULY/AUGUST 2012

BUSINESS RESTRUCTURING REVIEW

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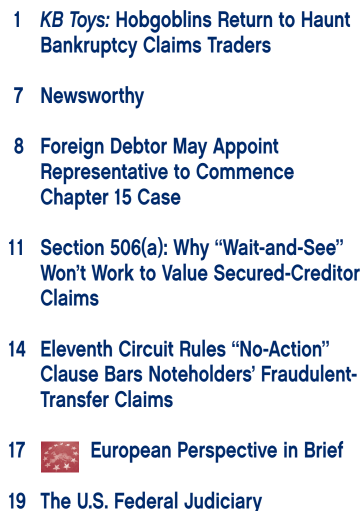

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KB TOYS: HOBGOBLINS RETURN TO HAUNT BANKRUPTCY CLAIMS TRADERS

Charles M. Oellermann and Mark G. Douglas

Participants in the multibillion-dollar market for distressed claims and securities have had ample reason to keep a watchful eye on developments in the bankruptcy courts during the last decade. That vigil appeared to have been over five years ago, after a federal district court ruled in the Enron chapter 11 cases that sold claims are generally not subject to equitable subordination or disallowance on the basis of the seller's misconduct or receipt of a voidable transfer. A ruling recently handed down by a Delaware bankruptcy court, however, has reignited the debate. In *In re KB Toys, Inc.*, 470 B.R. 331 (Bankr. D. Del. 2012), the court, rejecting as unworkable any distinction between a sale and an assignment of a claim, held that several transferred trade claims should be disallowed under section 502(d) of the Bankruptcy Code because the transferors received voidable preferences. As expected, the ruling was appealed immediately.

ALLOWANCE AND DISALLOWANCE OF CLAIMS IN BANKRUPTCY

Section 502 of the Bankruptcy Code sets forth procedures governing the allowance or disallowance of a "claim or interest" in a bankruptcy case. Section 502(a) provides that a claim or interest, proof of which is filed with the court, "is deemed allowed," unless a party in interest objects. Under section 502(b), the bankruptcy court is

obligated to resolve any objection in accordance with delineated criteria by ruling to allow or disallow the claim (in whole or in part). Section 502(c) directs the court in certain circumstances to estimate for the purpose of allowance certain contingent or unliquidated claims and any right to payment arising from an equitable remedy for breach of performance.

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

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

As noted by the Fifth Circuit Court of Appeals in *In re Davis*, 889 F.2d 658 (5th Cir. 1989), "The legislative history and policy behind Section 502(d) illustrates that the section is intended to have the coercive effect of insuring compliance with judicial orders." Similarly, 5 Collier on Bankruptcy ¶ 502.05[2][a], at pp. 502–58 (16th ed. 2012), explains that the purpose of the provision is "to promote the pro-rata sharing of the bankruptcy estate among all creditors and the coercion of the payment of judgments obtained by the trustee."

CLAIMS TRADING

The market for "distressed" debt is thriving and largely unregulated. The market has grown so much in size and scope that claims trading has become commonplace in nearly every major chapter 11 case. Sophisticated players in the market are aware of most of the risks associated with acquiring discounted debt but generally focus on the enforceability of the obligation in question and its probable payout or value in terms of bargaining leverage. These risks can often be assessed with reasonable accuracy by examining the underlying documentation, applicable nonbankruptcy law, the obligor's financial condition, and its prospects for satisfying its obligations in whole or in part. Other types of risk may be harder to quantify. For this reason, most claim-transfer agreements include a blanket indemnification clause designed to compensate the transferee if a traded claim proves to be unenforceable in whole or in part.

That eventuality, in addition to other risks associated with claims trading, has been brought into sharper focus during the last decade due to a series of controversial court rulings. Some of these decisions address the disallowance of a traded claim under section 502(d) because the original holder of the claim was the recipient of a voidable transfer. At issue in rulings construing the provision is the meaning of the phrase "any claim of any entity."

THE STORY THUS FAR

Although its precursors were lurking in the background, the bankruptcy claims-trading debate with respect to section 502(d) began in earnest during 2005 and 2006, after controversial rulings by the bankruptcy court overseeing the chapter 11 cases of failed energy broker Enron Corporation and its affiliates had traders scrambling for cover due to the potential for acquired claims to be equitably subordinated or disallowed on the basis of the seller's misconduct. *See Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 2005 WL 3873893 (Bankr. S.D.N.Y. Nov. 28, 2005); *Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (collectively, "*Enron I*"). The decisions had players in the distressed-securities market rushing to limit their exposure by building stronger indemnification clauses into claims-transfer agreements.

The rulings' "buyer beware" approach, moreover, was greeted by a storm of criticism from lenders and traders alike, including the Loan Syndications and Trading Association; the Securities Industry Association; the International Swaps and Derivatives Association, Inc.; and the Bond Market Association. According to these groups, if *caveat emptor* is the prevailing rule of law, claims held by a bona fide purchaser can be equitably subordinated even though it may

be impossible for the acquiror to know, despite having conducted rigorous due diligence, that it was buying loans from a "bad actor."

The partial sigh of relief collectively exhaled by claims traders in the wake of the district court's ruling in *Enron II* has now been supplanted by the same sort of chagrin with which traders greeted *Enron I*. Even so, the story is far from over. ASM immediately appealed the ruling in *KB Toys*, so we can expect the Delaware district court to weigh in on the issue in the relatively near future. In the meantime, one unhappy ramification of *KB Toys* for traders is that courts in New York and Delaware now have different rules regarding the application of section 502(d) to traded claims. What impact the competing regimes will have on bankruptcy claims trading in those venues remains to be seen.

Although it garnered the most attention, *Enron I* was not the first decision to address the disallowance of assigned claims under section 502(d) of the Bankruptcy Code or its predecessor. The Eighth Circuit Court of Appeals confronted the issue more than a century ago in *Swarts v. Siegel*, 117 F. 13 (8th Cir. 1902), disallowing an assigned claim under section 57g of the Bankruptcy Act of 1898 because the original holder had received a preference, and remarking that "[t]he disqualification of a claim for allowance created by a preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred to another, until the preference is surrendered."

More recently, a New York bankruptcy court reached the same conclusion under the current statute in *In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003), characterizing the attempted destruction of a section 502(d) claim defense by means of assignment of the claim as "a pernicious result" and observing that "[t]he assignment should not, and does not, affect the debtor's rights vis a vis the claim; it is incumbent, instead, on prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments."

The defendants in *Enron I* had relied on an unpublished opinion issued by a Texas district court in *Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc. (In re Wood & Locker, Inc.)*, 1988 U.S. Dist. LEXIS 19501 (D. Tex. 1988), as support for the proposition that a claim in the hands of a transferee can be disallowed only if the transferee is subject to avoidance liability. In that case, the creditors' committee commenced preference litigation against a creditor who had assigned its claim to a bank. The bank was permitted to intervene in the avoidance action and later commenced a separate adversary proceeding seeking a declaratory judgment that it was not subject to preference liability under sections 547 and 550, and that its assigned claim could not be disallowed under section 502(d), and thus it was entitled to receive distributions under the debtor's chapter 11 plan. The bankruptcy court granted summary judgment in the bank's favor on these issues.

On appeal, the district court explained that, under the former Bankruptcy Act, a creditor had the option of: (i) retaining a preference and forgoing any distribution from the estate; or (ii) seeking recovery from the estate by filing a proof of claim. The trustee could "bring[] the creditor within the bankruptcy court's summary jurisdiction" and invoke section 57g as a defense only in the latter case. "Such is not the case under the modern Code," the district court observed, emphasizing that "the analytical tool to unlock the mysteries of Sec. 502(d) is to examine the enumerated sections to determine whether the transferee has liability. Where there is no liability under those sections, Sec. 502(d) is not triggered."

The severity of the cautionary tale writ large in the bankruptcy court's *Enron* decisions was ultimately ameliorated on appeal in 2007. District judge Shira A. Scheindlin vacated *Enron I* in *Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"), holding that "equitable subordination under section 510(c) and disallowance under section 502(d) [of the Bankruptcy Code] are personal disabilities that are not fixed as of the petition date and do not inhere in the claim." The key determination, she explained, is whether the claim transfer is in the form of an outright sale or merely an assignment. If a claimant purchases its claim, as opposed to taking it by assignment, operation of law, or subrogation, Judge Scheindlin explained, "assignment law principles have no application with respect to personal disabilities of claim-

ants . . . [and] purchasers are protected from being subject to the personal disabilities of their sellers." This distinction, she observed, is "particularly imperative" in the distressed-debt market, where sellers are frequently anonymous and buyers have no way of knowing whether the seller (or any preceding transferee) has engaged in misconduct or received an avoidable transfer. According to Judge Scheindlin, it is unclear how such "unknowable risk" could be priced by the market. By contrast, she explained, parties to true assignments can readily contract around the risk of subordination or disallowance by means of indemnification clauses drafted to protect the assignee. Despite Judge Scheindlin's holding, the ordeal (and the uncertainty it spawned) left a bad taste in the mouths of market participants.

The next significant development in the bankruptcy claims-trading saga was the subject of a ruling handed down by the Second Circuit Court of Appeals in September 2009. Addressing the matter before it as an issue of first impression, the court held in *ASM Capital, LP v. Ames Department Stores, Inc. (In re Ames Dept. Stores, Inc.)*, 582 F.3d 422 (2d Cir. 2009), that section 502(d) does not mandate disallowance, either temporarily or otherwise, of administrative claims acquired from entities that allegedly received voidable transfers.

Although the ruling was a positive development for claims traders, the Second Circuit skirted the $64,000 question on claim transfers; in view of its conclusion, the court stated that:

> we find it unnecessary to reach [the claim purchaser's] alternative argument that, even if section 502(d) did extend to administrative expenses under section 503(b), it could be invoked only against the recipient of the alleged preferential transfer and not against a subsequent holder of a claim that originated with the alleged transferee.

Thus, traders were left to speculate whether the Second Circuit, like the district court in *Enron II*, would have drawn any distinction between assigned and purchased claims in this context.

The latest salvo in the bankruptcy claims-trading fireworks in the context of section 502(d) was discharged by the Delaware bankruptcy court in *KB Toys*.

KB TOYS

KB Toys, Inc., and various related entities (collectively, the "Debtors") sought chapter 11 protection in January 2004 in Delaware. On August 18, 2005, the bankruptcy court confirmed a liquidating chapter 11 plan for the Debtors. Among other things, the plan established the "KBTI Trust" for the purpose of realizing the value of the Debtors' assets, including causes of action, for the benefit of creditors. The trustee commenced litigation against certain trade creditors between 2006 and 2008, seeking to avoid as preferential transfers various payments made by the Debtors during the 90 days prior to their chapter 11 filings.

Nine of those preference recipients (the "Original Holders") sold their claims (the "Sold Claims") postpetition to ASM Capital, LP, and ASM Capital II, LLP (collectively, "ASM"). ASM purchased some of the claims prior to confirmation of the Debtors' plan, acquiring others after confirmation. Some of the "assignment agreements" contained indemnification clauses, while others did not.

The court entered default or summary judgments against all of the Original Holders in the preference actions. Except for one claim that it acquired after the trustee obtained a default judgment, ASM purchased all of the claims from the Original Holders before the trustee commenced the preference litigation. The trustee sought an order disallowing the Sold Claims pursuant to section 502(d).

THE BANKRUPTCY COURT'S RULING

Bankruptcy judge Kevin J. Carey sustained the trustee's objections to the Sold Claims. The judge squarely framed the issue before him as "whether the purchaser of a trade claim holds the purchased claim subject to the same rights and disabilities, and is subject to Bankruptcy Code § 502(d) challenge, as is the original holder of the claim." More specifically, he explained, at issue is the meaning of the phrase "any claim of any entity" in section 502(d).

According to the trustee, because the provision states "claim" rather than "claimant," section 502(d) should be interpreted to mean that "a disability accompanies the claim through its journey into the hands of others." In accordance with *Enron II*, the trustee argued, the claims transferred to ASM were

assignments and should therefore be disallowed. The trustee also contended that because KB Toys' chapter 11 filings gave ASM constructive, if not actual, knowledge of the preferential transfers to the Original Holders, such knowledge was evidence that ASM did not purchase the Sold Claims in good faith, and the Sold Claims should therefore be disallowed.

ASM countered that "any claim of any entity" means only the "claimant," such that any disability "rests with the original claimant." According to *Enron II*, ASM argued, the Sold Claims should not be disallowed because the claims were transferred by means of *sales* rather than *assignments*. ASM argued that the parties' intention to "sell" the claims outweighed the fact that each of the transfer documents was entitled an "Assignment Agreement" and referred to the parties as "assignor" and "assignee." Although "assignment" and "sale" are often used interchangeably in claim-transfer agreements, ASM contended, claim transfers are always "sales."

Acknowledging that there is a disagreement as to the meaning of section 502(d), Judge Carey ruled in favor of ASM, observing that:

> I agree with the analysis and conclusions of the courts in *Metiom* and *Enron I* . . . : the plain language, legislative history, and decisional law support the view that a claim in the hands of a transferee has the same rights and disabilities as the claim had in the hands of the original claimant. Disabilities attach to and travel with the claim.

The judge examined the legislative provenance of section 502(d), explaining that the provision's predecessor—section 57g of the Bankruptcy Act—required disallowance of a particular "claim," indicating that "disabilities travel with claims." He also examined relevant case law, including *Swarts*; subsequent decisions holding that a claim assignee stands in the shoes of, and is subject to the same defenses that can be raised against, an assignor; *Metiom*; *Enron I*; and *Enron II*.

In determining whether a traded claim is subject to disallowance under section 502(d), Judge Carey distanced his ruling from the district court's rationale in *Enron II* that distinguished between sales and assignments. "The terms 'assignment' and 'sale' are not easily distinguishable," he wrote, and although the Bankruptcy Code defines neither term, the definition of "transfer" in section 101(54)(D) arguably includes both assignments and sales. Moreover, Judge Carey emphasized, "In this context, use of any distinction between the two terms has been widely criticized."

Judge Carey also took issue with the *Enron II* court's determination that burdening the transferee of a claim with a disability imposed on a claim by the transferor would disrupt the distressed-debt markets:

> Buyers of debt, in the Court's experience, are highly sophisticated entities fully capable of performing due diligence before any acquisition. However, even without *any* due diligence, today's claim purchasers are aware of the ever-present possibility of avoidance actions based on preference liability or fraudulent conveyances. Under the circumstances now before me, the assertion that subjecting transferred claims to § 502(d) disallowance would cause disruption in the claims trading market is a hobgoblin without a house to haunt.

According to Judge Carey, in their chapter 11 schedules and statements, the Debtors put ASM and all other potential buyers of trade claims on constructive, if not actual, notice of potential avoidance claims against the Original Holders. ASM, he wrote, "could have discovered the potential for disallowance with very little due diligence and factored the potential for disallowance into the price it paid for the trade claims." The fact that ASM used indemnity clauses in some of the assignment contracts, the judge explained, indicated that ASM "had sufficient understanding and leverage to negotiate for such provisions," and in cases where it elected not to do so, "ASM may have other remedies or chose to bear the risk." According to Judge Carey, allowing claims under these circumstances—in other words, evading a section 502(d) challenge—would make the estate the claim purchaser's insurer, "providing the claim purchaser and the seller with a benefit for which neither paid."

Finally, Judge Carey rejected ASM's argument that the Sold Claims should not be disallowed because ASM purchased the claims in "good faith," and section 502(d) expressly incorporates the good-faith-purchaser defense set forth in section

550(b) of the Bankruptcy Code. In doing so, he agreed with the court's reasoning in *Enron I*, remarking that:

> A purchaser of claims in a bankruptcy is well aware (or should be aware) that it is entering an arena in which claims are allowed and disallowed in accordance with the provisions of the Bankruptcy Code and the decisional law interpreting those provisions. Under such conditions, a claims purchaser is not entitled to the protections of a good faith purchaser.

OUTLOOK

The partial sigh of relief collectively exhaled by claims traders in the wake of the district court's ruling in *Enron II* has now been supplanted by the same sort of chagrin with which traders greeted *Enron I*. Even so, the story is far from over. ASM immediately appealed the ruling in *KB Toys*, so we can expect the Delaware district court to weigh in on the issue in the relatively near future. In the meantime, one unhappy ramification of *KB Toys* for traders is that courts in New York and Delaware now have different rules regarding the application of section 502(d) to traded claims. What impact the competing regimes will have on bankruptcy claims trading in those venues remains to be seen. To be sure, however, traders will likely pay greater attention to the indemnity provisions in claim-transfer agreements in an effort to limit their exposure.

Notably, the *KB Toys* court was careful to limit its ruling to "trade claims." In a footnote, Judge Carey wrote:

> The claims before me in this matter are trade claims purchased from the original holders of such claims. I make no determination about whether the same result should ensue in circumstances involving other types of transferred claims. It seems that the drafters of the Bankruptcy Rules also recognized when public markets might be affected. For example, publicly traded note, bond and debenture claims are excluded from the disclosure requirements of Fed. R. Bankr. P. 3001(e), presumably to facilitate trading of public securities.

The viability of the *KB Toys* approach in cases involving securities or claims other than trade claims is not clear. In dicta, the court in *Enron I* suggested that the same rule should apply to transferred claims based upon bonds or notes because "the post-petition purchaser of such debt instruments either knows or should know that the issuer of these securities is a debtor, so the prices of these transfers would reflect the attendant risks that the claims [might be disallowed]." Even so, the court did not hazard an opinion on whether a different rule would apply if a note or bond is traded before the debtor files for bankruptcy, when the purchaser has less reason to be aware of anything other than the possibility that the obligor may file a bankruptcy case.

Rulings addressing section 502(d) were not the only notable developments of interest to claims traders during the recent past. For example, in *In re M. Fabrikant & Sons, Inc.*, 385 B.R. 87 (Bankr. S.D.N.Y. 2008), a New York bankruptcy court took a hard look for the first time at the standard transfer forms and definitions contained in nearly every bank-loan transfer agreement, ruling that a seller's reimbursement rights were transferred along with the debt. The ruling indicated that the rights assigned to a buyer using the standard transfer forms are broad and include contingent (and even postpetition) claims. The decision also fortified the conventional wisdom that transfer documents should be drafted carefully to spell out explicitly which rights, claims, and interests are not included in the sale.

In *B-Line, LLC v. Wingerter (In re Wingerter)*, 594 F.3d 931 (6th Cir. 2010), the Sixth Circuit reversed lower-court rulings sanctioning a company engaged in the business of buying and selling consumer bankruptcy claims for failing to make "a reasonable pre-filing inquiry" to ascertain whether an acquired claim was bona fide. Had the Sixth Circuit ruled otherwise, claims traders (principally in consumer cases) faced the unwelcome prospect of increased costs associated with ensuring that each proof of claim is supported by actual documentation, rather than information more easily accessible from electronic databases, and an inability to rely on industry-standard warranties of a claim's validity by intermediate sellers.

NEWSWORTHY

On July 2, ***David G. Heiman (Cleveland)*** and ***Corinne Ball (New York)*** were among nearly 130 corporate-restructuring professionals asked by the American Bankruptcy Institute's commission studying the reform of chapter 11 of the Bankruptcy Code to serve on one of 13 advisory committees to examine chapter 11 issues. The newly created ABI commission held its first public meeting April 19 in Washington, D.C., to study the reform of chapter 11. The work of the commission is expected to take two years.

Corinne Ball (New York), ***Paul D. Leake (New York)***, ***David G. Heiman (Cleveland)***, ***Brad B. Erens (Chicago)***, ***Heather Lennox (Cleveland and New York)***, ***Charles M. Oellermann (Columbus)***, ***Gregory M. Gordon (Dallas)***, ***Bennett L. Spiegel (Los Angeles)***, ***Richard L. Wynne (Los Angeles)***, ***Bruce Bennett (Los Angeles)***, ***James O. Johnston (Los Angeles)***, ***Sidney P. Levinson (Los Angeles)***, ***Peter J. Benvenutti (San Francisco)***, ***Tobias S. Keller (San Francisco)***, ***Kevyn D. Orr (Washington)***, ***Carl E. Black (Cleveland)***, and ***Thomas A. Howley (Houston)*** were designated "Leaders in their Field" in the area of Restructuring/Insolvency and Bankruptcy by *Chambers USA* 2012.

An article written by ***Jeffrey B. Ellman (Atlanta)*** and ***Brett J. Berlin (Atlanta)*** entitled "Bankruptcy Code Preemption of State Law" was published in the June 2012 edition of the *Norton Bankruptcy Law Adviser*.

Kevin D. Lyles (Columbus—Health Care) and ***Heather Lennox (Cleveland and New York)*** were quoted in an article entitled "Healthcare in Flux: Distressed Investors Eye Fallout from Reform" in the June 15, 2012, edition of *LCD Distressed Weekly*.

Thomas A. Howley (Houston) was recently elected president of the Bankruptcy Law Section of the State Bar of Texas for 2012–2013. The Bankruptcy Law Section is the leading organization in Texas for professionals involved in workouts, restructurings, and bankruptcy cases.

Lori Sinanyan (Los Angeles) participated in a panel discussion on July 12 entitled "Ins and Outs of a Sales Process in Bankruptcy—How to Maximize Value and Who Is Really in Control of the Process?" at the 4th Annual Turnaround Management Association Western Regional Conference in Santa Barbara, California.

Justin F. Carroll (New York) was included among the "Best LGBT Lawyers Under 40" for 2012 by the National LGBT Bar Association.

FOREIGN DEBTOR MAY APPOINT REPRESENTATIVE TO COMMENCE CHAPTER 15 CASE

Pedro A. Jimenez and Mark G. Douglas

As the seventh anniversary of the enactment of chapter 15 of the Bankruptcy Code draws near, the volume of chapter 15 cases commenced in U.S. bankruptcy courts on behalf of foreign debtors has increased rapidly. During that period, there has also (understandably) been a marked uptick in litigation concerning various aspects of the comparatively new legislative regime governing cross-border bankruptcy cases patterned on the Model Law on Cross-Border Insolvency. One such issue was the subject of a ruling recently handed down by a Texas district court. In *In re Vitro, S.A.B. de C.V.*, 470 B.R. 408 (N.D. Tex. 2012), the district court affirmed a bankruptcy court's decision that an individual appointed by the foreign debtor could serve as the debtor's "foreign representative" under chapter 15 of the Bankruptcy Code and is thus authorized to commence a chapter 15 case on the foreign debtor's behalf.

RECOGNITION UNDER CHAPTER 15

Under chapter 15, the "foreign representative" of a foreign debtor may file a petition in a U.S. bankruptcy court seeking "recognition" of a "foreign proceeding." "Foreign representative" is defined in section 101(24) of the Bankruptcy Code as "a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such proceeding."

"Foreign proceeding" is defined by section 101(23) of the Bankruptcy Code as:

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

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

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

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

In *Vitro*, the district court carefully examined section 101(24)'s definition of "foreign representative" to ascertain the meaning of the phrase "authorized in a foreign proceeding."

VITRO

Vitro, S.A.B. de C.V. ("Vitro"), is a Mexican holding company whose subsidiaries jointly constitute one of the largest glass manufacturers in the world. At a board meeting in October 2010, Vitro appointed Alejandro Sanchez-Mujica as its "foreign representative" in connection with an anticipated bankruptcy filing. In December 2010, Vitro filed in Mexico a voluntary petition for reorganization pursuant to Mexico's *Ley de Concursos Mercantiles* (the "Mexican Business Reorganization Act"). Sanchez-Mujica later filed a petition in the U.S. bankruptcy court in New York seeking recognition of Vitro's Mexican bankruptcy proceeding under chapter 15 and an injunction preventing the continuation of litigation commenced in New York against Vitro's nondebtor guarantors

and affiliates. The venue of Vitro's chapter 15 case was subsequently moved to Texas so that it could be administered with other related proceedings.

Vitro appears to be the first published ruling on whether a foreign debtor's representative must be court-appointed to qualify as a "foreign representative" under chapter 15. Even so, the decision is consistent with other rulings that have interpreted "foreign proceeding" to encompass extra-judicial winding-up or insolvency proceedings. It also reinforces the notion that chapter 15 was designed to be flexible in providing assistance to accredited representatives of foreign debtors with assets located in the U.S.

An ad hoc group of Vitro noteholders objected to Vitro's chapter 15 petition, primarily because Sanchez-Mujica could not be a "foreign representative" since he was not permitted to leave Mexico. Vitro responded by appointing Javier Arechavaleta Santos as its "co-foreign representative" in connection with the Mexican and U.S. bankruptcy proceedings. After the U.S. bankruptcy court entered an order on July 21, 2011, recognizing the Mexican bankruptcy proceeding under chapter 15 as a foreign main proceeding (and expressly ruling that Vitro could appoint its own "foreign representative" as a predicate to the application for recognition under section 1517 of the Bankruptcy Code), the noteholders appealed.

THE DISTRICT COURT'S RULING

The noteholders argued that the U.S. bankruptcy court's recognition of the Mexican bankruptcy proceeding under chapter 15 was improper because, having never been formally appointed by the Mexican court, Sanchez-Mujica and Santos could not be Vitro's foreign representatives within the meaning of section 101(24) of the Bankruptcy Code.

The district court disagreed with the noteholders' characterization of the phrase "foreign proceeding" in section 101(24) as "express and unambiguous" in restricting qualified "foreign representatives" to individuals or entities that are directly authorized by a foreign court to act in that capacity. According to the court, "[I]t is reasonable to understand the phrase 'authorized in a foreign proceeding' more broadly, *i.e.*, to mean authorized *in the context of* a foreign bankruptcy proceeding."

Given the "apparent uncertainty" regarding the meaning of section 101(24), the district court looked to sources other than the statutory language, including relevant case law, to determine its meaning. The court acknowledged that case law on this issue is sparse, although, it wrote, "every case cited by the parties suggests that a debtor is allowed to appoint its own foreign representative." In fact, the court explained, U.S. bankruptcy courts have granted recognition of *concurso* proceedings "every single time they have been asked to do so by a petitioner who was appointed by the Mexican debtor, without exception."

In particular, the court found the reasoning articulated in an unpublished ruling, *In re Compania Mexicana de Aviacion, S.A. de C.V.*, No. 14182 (MG) (Bankr. S.D.N.Y. Nov. 8, 2010), to be persuasive. In *Compania Mexicana*, bankruptcy judge Martin Glenn ruled that the board of directors of a Mexican corporation could authorize a person to act as the corporation's foreign representative in a chapter 15 case. Judge Glenn based his decision on the fact that, under the Mexican Business Reorganization Act, the debtor is allowed to continue to manage its affairs during a bankruptcy proceeding, akin to a chapter 11 "debtor in possession" under U.S. bankruptcy law. Because the debtor in a Mexican bankruptcy proceeding is essentially a debtor in possession, Judge Glenn held that the debtor may authorize its own foreign representative under section 101(24).

The district court in *Vitro* agreed. According to the court, because: (i) section 101(24) refers to, among other things, persons or entities "authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs," and (ii) a debtor in a commercial Mexican bankruptcy proceeding is essentially a debtor in possession, Vitro's foreign representatives need not have been formally approved by the Mexican bankruptcy court to qualify in that capacity for purposes of recognition of Vitro's bankruptcy proceeding under chapter 15.

The district court rejected the noteholders' argument that the Mexican Business Reorganization Act prohibits a debtor in possession like Vitro from appointing its own foreign representative. Even if this were so (and the court expressed some doubt on this point in light of the evidence), the court explained, "the matter of whether Sanchez-Mujica and Arechavaleta are proper foreign representatives is a matter of United States—not Mexican—law." Finally, the district court concluded that any error that may have been committed by the bankruptcy court in taking judicial notice of materials from other bankruptcy cases was harmless.

OUTLOOK

Vitro appears to be the first published ruling on whether a foreign debtor's representative must be court-appointed to qualify as a "foreign representative" under chapter 15. Even so, the decision is consistent with other rulings that have interpreted "foreign proceeding" to encompass extra-judicial winding-up or insolvency proceedings. It also reinforces the notion that chapter 15 was designed to be flexible in providing assistance to accredited representatives of foreign debtors with assets located in the U.S. That bedrock of chapter 15 jurisprudence is especially relevant here. If the position advanced by the noteholders had been accepted by the district court, the corresponding implication would be that a Mexican company could not seek chapter 15 relief until such time as the Mexican courts had accepted the bankruptcy petition and appointed a person to act as the foreign representative. Since that process normally takes months under the Mexican Business Reorganization Act, a Mexican debtor would be unable to protect its U.S.-based assets and interests during that time, a result that would undermine the prospects for a successful reorganization in Mexico and would be squarely at odds with the purpose behind the enactment of chapter 15.

Chapter 15 continues to evolve rapidly, and *Vitro* is far from the only notable chapter 15 ruling handed down thus far in 2012—even in the same chapter 15 case. Six weeks after the district court issued its decision in *Vitro*, the bankruptcy court overseeing Vitro's chapter 15 case ruled in *In re Vitro S.A.B. de C.V.*, 2012 WL 2138112 (Bankr. N.D. Tex. June 13, 2012), that releases of nondebtor affiliates included in Vitro's Mexican reorganization plan were unenforceable as being contrary to U.S. public policy, opening the door for bondholders seeking to collect on $1.2 billion in debt for which the nondebtors were jointly liable as guarantors or direct obligors.

The June 13 *Vitro* decision, which has been appealed directly to the Fifth Circuit, would appear to be contrary to a New York bankruptcy court's decision in *In re Metcalfe & Mansfield Alternative Investments*, 421 B.R. 685 (Bankr. S.D.N.Y. 2012). In *Metcalfe*, the court, by way of "additional assistance" in a chapter 15 case involving a Canadian debtor, enforced a Canadian court's order confirming a restructuring plan that contained nondebtor releases and injunctions, even though it was uncertain whether a U.S. court would have approved the releases and injunctions in a case under chapter 7 or 11 of the Bankruptcy Code. The bankruptcy court reasoned that such uncertainty was of little consequence in the case before it, which involved not the propriety of nondebtor injunctions and releases in a plenary bankruptcy case, but rather a request to enforce a foreign judgment in a chapter 15 case. The court concluded that "principles of enforcement of foreign judgments and comity in chapter 15 cases strongly counsel approval of enforcement in the United States of the third-party non-debtor release and injunction provisions included in the Canadian Orders, even if those provisions could not be entered in a plenary chapter 11 case."

The June 13 *Vitro* decision is also at odds with the U.S. district court's ruling in *CT Investment v. Carbonell and Grupo Costamex*, 2012 WL 92359 (S.D.N.Y. Jan. 11, 2012), in which the court, in extending comity to an order issued by a Mexican court overseeing the *concurso* of Cozumel Caribe S.A. de C.V., rejected the argument that an order issued by the Mexican court staying all collection actions during the pendency of the Mexican bankruptcy proceeding, including any actions against nondebtor affiliates to enforce a guaranty, violated U.S. public policy. The court concluded that extension of the stay to a nondebtor guarantor under the terms of the order was not "manifestly contrary" to U.S. public policy, in light of, among other things, several U.S. bankruptcy-court rulings extending the bankruptcy stay, under appropriate circumstances, to nondebtor parties in order to assist in and maintain the integrity of the administration of a debtor's bankruptcy case.

A version of this article will be published in the September 2012 edition of *The Bankruptcy Strategist*. It has been printed here with permission.

SECTION 506(a): WHY "WAIT-AND-SEE" WON'T WORK TO VALUE SECURED-CREDITOR CLAIMS

Lauren M. Buonome and Mark G. Douglas

Section 506(a) of the Bankruptcy Code contemplates bifurcation of a debtor's obligation to a secured creditor into secured and unsecured claims, depending on the value of the collateral securing the debt. The term "value," however, is not defined in the Bankruptcy Code, and bankruptcy courts vary in their approaches to the meaning of the term. In *In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012), the Court of Appeals for the Third Circuit ruled that, in a chapter 11 reorganization, the term "value," as applied to section 506(a), should mean the fair market value of collateral as of plan confirmation. In so ruling, the court of appeals rejected the market-based, or "wait-and-see," approach recommended by a group of secured creditors, whose subordinated claims would be rendered unsecured unless the court included projected revenues from the debtor's chapter 11 plan in the valuation analysis. Applying the fair-market-value approach to calculate the amount of a creditor's secured claim, the Third Circuit held, does not constitute impermissible lien stripping. In addition, the court of appeals adopted a burden-shifting approach to the question of who bears the burden of demonstrating value.

VALUATION OF COLLATERAL UNDER SECTION 506

The Bankruptcy Code classifies a debtor's obligations in terms of "claims" rather than "debts." This means that a creditor who is owed money on the basis of a prebankruptcy transaction is generally treated under the statute as the holder of either an unsecured prepetition claim or a secured prepetition claim.

Whether a claim is secured or unsecured is determined in accordance with section 506(a) of the Bankruptcy Code. Section 506(a)(1) provides that a secured creditor's claim is "a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim." The provision goes on to mandate that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."

The extent to which a claim is secured, therefore, turns on the valuation of the collateral. Section 506(a) is silent, however, as to the valuation method that a court should employ. As noted by the Third Circuit in *Heritage Highgate*, the legislative history of section 506(a) suggests that Congress's silence on this point was intentional, to enable bankruptcy courts to "choose the standard that best fits the circumstances of a particular case." Even so, the court wrote, the valuation method should be employed in light of the proposed disposition or use of the collateral, language that is "of paramount importance to the valuation question."

Neither section 506(a) nor the Federal Rules of Bankruptcy Procedure allocate the burden of proof as to the value of secured claims. In the absence of any express direction, courts have developed divergent approaches to the issue.

HERITAGE HIGHGATE

Heritage Highgate, Inc., and Heritage Twin-Ponds II, L.P. (jointly, "Heritage"), are the developers of a residential real estate project (the "Project") in Pennsylvania. To fund the Project, Heritage obtained financing from a group of banks (the "Banks") and later a group of private individuals and entities known as Cornerstone Investors ("Cornerstone"). Loans from both the Banks and Cornerstone were secured with liens on nearly all of Heritage's assets, initially at equal priority, although Cornerstone later agreed to subordinate its claims in a series of intercreditor agreements.

Heritage sought chapter 11 protection in Pennsylvania on January 20, 2009. Shortly afterward, Heritage filed a proposed chapter 11 plan providing that it would complete the Project and make payments to creditors with the resulting revenue, based on a set of projections.

A dispute arose during the chapter 11 case regarding Heritage's use of cash collateral generated by the Project. At a contested hearing on the matter, Heritage provided an appraisal of the Project's fair market value. The bankruptcy court accepted the appraisal, conducted by an independent company in February 2009, which valued the Project at $15 million, an amount exceeding the total amount of debt secured by the property ($12 million owed to the Banks and $1.2 million owed to Cornerstone).

In September 2009, Heritage's official committee of unsecured creditors (the "Committee") challenged the Project's value in a motion to value and determine the extent of Cornerstone's secured claims. The Committee argued that, because Heritage sold certain lots attached to the Project after the appraisal had been performed, the value of the Project should be reduced to approximately $9.54 million, a value less than the amount of the Banks' secured claim. On the basis of this lower valuation, the Committee maintained, Cornerstone's claims against Heritage were wholly unsecured and its secured claims should be valued at zero.

In *Heritage Highgate*, the Third Circuit clarified that, in the chapter 11 reorganization context, collateral must be assigned its fair market value as of the confirmation date in determining the amount of a creditor's secured claim under section 506(a).

Cornerstone countered that its claims were secured because, in assigning a value to the Project, the court should factor in the revenue from the Project's completion anticipated in Heritage's chapter 11 plan. According to Cornerstone, if the property, when sold, would generate sufficient dollars to pay its secured claims in full, its claims should reflect that value. Because Heritage would continue to develop and sell lots during the plan's life, Cornerstone argued, the extent to which its claims are secured should similarly be calculated over time. This market-based, or "wait-and-see," approach, Cornerstone maintained, would fulfill the plain language of section 506(a), which directs the court to value property "in light of . . . [its] proposed disposition or use." Cornerstone also argued that excluding the expected revenue from the Project's completion in valuing the property would constitute impermissible "lien stripping."

The bankruptcy court confirmed Heritage's chapter 11 plan in March 2010. The following month, the court ruled in favor of the Committee on the motion to value Cornerstone's secured claims at zero. The district court affirmed on appeal, concluding that, in the context before it, fair market value was the appropriate collateral-valuation standard to apply pursuant to section 506(a). Both the bankruptcy and district courts reasoned that the Project's revenue projections were intended as a kind of budget to prove the feasibility of the reorganization plan but were not relevant to the analysis of collateral value for purposes of determining the amount of Cornerstone's secured claim under section 506(a). Moreover, the district court declined to extend to a chapter 11 reorganization case the U.S. Supreme Court's holding in *Dewsnup v. Timm*, 502 U.S. 410 (1992), which prohibits lien stripping in a chapter 7 liquidation case by depriving a secured creditor of its right to "[a]ny increase over the judicially determined valuation during bankruptcy." Cornerstone appealed.

THE THIRD CIRCUIT'S RULING

A three-judge panel of the Third Circuit affirmed, ruling that the proper valuation standard to apply in this context pursuant to section 506(a) was fair market value as of the confirmation date of the chapter 11 plan, rather than the wait-and-see approach proffered by Cornerstone. In addition, the court held permissible any "lien stripping" resulting from a determination that the value of the Project was insufficient to render Cornerstone's claim secured, declining to extend the holding in *Dewsnup* to the chapter 11 reorganization context. Finally, the Third Circuit established a burden-shifting framework to govern valuation claims pursuant to section 506(a).

The Meaning of "Value"

Acknowledging the importance of valuing collateral in light of its "proposed disposition or use," the Third Circuit viewed the requirement differently than Cornerstone. The court drew an analogy to *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), in which the U.S. Supreme Court held that valuation in a chapter 13 cramdown scenario should be based on the collateral's replacement value, defined as "the cost the debtor would incur to obtain a like asset for the same 'proposed use,' " rather than a "hypothetical foreclosure sale." Similarly, in a chapter 11 reorganization, the Third Circuit explained, the collateral's proposed use is intended to generate income with which to pay off creditors. Thus, the court concluded, the collateral's fair market value, which is "consistent with" the meaning of "replacement value" in *Rash*, is "most respectful of the property's anticipated use."

The Third Circuit ruled that the lower courts properly concluded that the fair market value of the Project as of the confirmation date controlled whether Cornerstone's claims were secured or not. Because the confirmed plan of reorganization called for Heritage to retain ownership of the Project in order to complete its development, the court wrote, "[t]he discounted fair market value of the property as of the confirmation date . . . best approximated just how secure the liens held by creditors—namely, the [Banks and Cornerstone]—were at the relevant point in [Heritage's] bankruptcy."

The Third Circuit emphasized that Cornerstone's proposed wait-and-see valuation model has never been used, and for good reason:

> A wait-and-see approach would in effect do away with bankruptcy courts' obligation to determine value under § 506(a). . . . That result is at odds with the Bankruptcy Code. In § 506(a), Congress expressly provided for the division of allowed claims supported by liens into secured and unsecured portions during the reorganization, before the plan's success or failure is clear. The fact that its "proposed disposition or use" should be factored into the valuation does not mean that the time as of which property is valued is to be postponed or altered.

Heritage's projections, the Third Circuit explained, were offered as support for the feasibility of its chapter 11 plan, not to determine the extent of secured claims. Moreover, in order to be realized, the projections would entail the expenditure of Heritage's time and resources, which, the court noted, "should not be credited to the secured creditor at confirmation." According to the Third Circuit, valuations should be "based upon realistic measures of present worth," not on speculative projections.

Lien Stripping and Chapter 11

The Third Circuit declined to extend *Dewsnup*'s lien-stripping prohibition to chapter 11 cases. In *Dewsnup*, the court of appeals explained, the U.S. Supreme Court held that when the value of a chapter 7 debtor's property increases from the time of judicial valuation to the time of the foreclosure sale, "the creditor's lien stays with the real property until the foreclosure." Following a majority of courts, the Third Circuit acknowledged that, although this rationale makes sense in a chapter 7 case, where the encumbered property will be liquidated, a chapter 11 reorganization is different. Reorganizations, the court noted, necessarily involve the continued and productive use of the retained property, which can and should entail future profits.

According to the Third Circuit, to prohibit lien stripping in the chapter 11 context would render many of the reorganization provisions in the Bankruptcy Code meaningless or nonsensical. After *Dewsnup*, the court explained, Congress amended the Bankruptcy Code to expressly allow for the modification of most rights of secured creditors in what the court perceived as "explicit approval of lien stripping in Chapter 11 bankruptcies."

Burden-Shifting Framework

Clarifying the "divergent formulations" that have developed for valuing collateral under section 506(a), the Third Circuit adopted a burden-shifting framework for parties challenging the valuation of a secured claim. That is, the party filing the motion to determine the value and extent of a secured claim bears the initial burden of production and must present enough evidence to overcome the presumed validity of the secured creditor's claim.

In the case before it, the Third Circuit ruled, the Committee provided sufficient evidence that "the Project's fair market value, together with the value of other collateral held by [Heritage], was less than the [Banks'] secured claim." Furthermore, the court concluded, the submission of an appraisal of the collateral's fair market value that was completed "in light of the property's 'proposed disposition or use' " and also accepted by Cornerstone, was sufficient to meet the Committee's burden.

However, the Third Circuit determined that the ultimate burden of persuasion rested with Cornerstone, as the allegedly secured creditor. The court held that Cornerstone failed to meet that burden, having declined to retain its own appraiser and instead opting, as part of its wait-and-see approach, to rely on the appraisal proffered as part of Heritage's plan-feasibility projections.

OUTLOOK

The need to value collateral arises in many different contexts during a bankruptcy case, and valuation methodologies can vary widely, depending upon, among other things, the nature of the case (e.g., a chapter 11 reorganization or a liquidation under chapter 7 or chapter 11) and the purpose of the valuation. In addition, the timing of any valuation is critical, and collateral may be valued differently at different times during the course of a bankruptcy case. In *Heritage Highgate*, the Third Circuit clarified that, in the context of chapter 11 reorganization, collateral must be assigned its fair market value as of the confirmation date in determining the amount of a creditor's secured claim under section 506(a). The Third Circuit's burden-shifting approach to establishing value under section 506(a) is instructive, although it remains to be seen whether other courts will adopt it. Finally, the Third Circuit's refusal to extend *Dewsnup*'s lien-stripping prohibition to chapter 11 cases is consistent with the majority view on this issue.

ELEVENTH CIRCUIT RULES "NO-ACTION" CLAUSE BARS NOTEHOLDERS' FRAUDULENT-TRANSFER CLAIMS

Dan T. Moss

In *Akanthos Capital Mgmt., LLC v. CompuCredit Holdings Corp.*, 677 F.3d 1286 (11th Cir. 2012), the U.S. Court of Appeals for the Eleventh Circuit reversed a district-court decision and dismissed claims brought by noteholders under Georgia's Uniform Fraudulent Transfers Act ("UFTA") to avoid allegedly fraudulent transfers made by the issuing company. The primary issue confronting the Eleventh Circuit involved the circumstances under which a "no-action" clause in a bond indenture precludes noteholders from taking legal action against a debt issuer. In enforcing the terms of the no-action clause to bar noteholders from bringing UFTA claims, the Eleventh Circuit refused to deviate from legal precedent that generally discourages efforts to circumvent the provisions of a contract and refused to alter the terms of an agreement in cases not involving an indenture trustee's demonstrated conflict of interest.

WHAT IS A NO-ACTION CLAUSE?

When companies issue notes or bonds, an "indenture" is sometimes created to govern the terms of the debt instrument. The indenture stipulates the terms of the contract between bondholders and the issuer company, including the time period of repayment and the rate of interest. A "no-action" clause is a common provision in an indenture. The clause establishes when and how creditors can take legal action against the issuer. No-action clauses guard against superfluous suits by an individual bondholder or a small bondholder group that may not share the interests of other bondholders. Most important, these clauses commonly require bondholders to seek action through an intermediary—usually an indenture trustee.

Some bondholder suits fall outside the scope of the no-action clause altogether, whereas others satisfy certain limited exceptions. Exceptions vary among indentures, although most indentures share a core set of prerequisites to bondholder action, which may include: (i) nonpayment of principal

or interest; (ii) a minimum threshold of bondholders who collectively seek a remedy (usually 25 percent or more); and (iii) failure by the indenture trustee to take action. The indenture trustee's conflict of interest may also serve as justification for bondholders to take action. Outside of these exceptions, bondholders are generally obligated to take collective action through the indenture trustee.

AKANTHOS CAPITAL

CompuCredit Holdings Corporation ("CompuCredit") is a financial-services provider operating in the subprime-lending market. In 2005, CompuCredit issued approximately $387 million in convertible notes, $230 million of which were scheduled to be repurchased in May 2012 in accordance with the terms of the indenture. Akanthos Capital Mgmt., LLC, and certain other hedge funds (the "noteholders") hold a majority of the principal amount of the notes.

The no-action clause in the indenture, which is governed by New York law, provides in relevant part as follows:

> A Securityholder may not pursue any remedy with respect to this Indenture or the Securities, except in case of a Default due to the non-payment of the principal amount of the Securities, any accrued and unpaid Interest, any accrued and unpaid Contingent Interest, if any, or any accrued and unpaid Liquidated Damages, if any, unless:
>
> (a) the Holder gives to the Trustee written notice stating that a Default is continuing;
>
> (b) the Holders of at least 25% in aggregate principal amount of the Securities at the time outstanding make a written request to the Trustee to pursue the remedy;
>
> (c) such Holder or Holders offer reasonable security or indemnity to the Trustee against any costs, liability or expense;
>
> (d) the Trustee does not comply with the request within 60 days after receipt of such notice and offer of security or indemnity; and
>
> (e) the Holders of a majority in aggregate principal amount of the Securities at the time outstanding do not give the Trustee a direction inconsistent with the request during such 60-day period.

In November 2009, CompuCredit publicly reported that it would likely be unable to honor its repurchase obligation under the indenture, due to poor financial performance and substantially decreased asset value. CompuCredit further announced that it planned to spin off the company's profitable microloan business (its only profitable division). The following month, the company announced its intention to pay a cash dividend of $24 million—the first dividend CompuCredit had ever paid—to its shareholders in less than 60 days.

No-action clauses are a common feature of indentures and other agreements governing debt instruments. In *Akanthos Capital*, the Eleventh Circuit determined that such clauses "must be given a consistent, uniform interpretation" to preclude noteholder suits that fall outside the express terms of the delineated exceptions. The ruling demonstrates that investors would be well advised to review indentures and other governing agreements carefully, recognizing that courts' broad interpretation of the scope of no-action clauses may restrict their individual efforts to pursue causes of action against the issuer.

In December 2009, the noteholders sued CompuCredit and its officers, directors, and principal shareholders in federal district court in Georgia, alleging that CompuCredit's payment of the dividend violated Georgia's UFTA as a transfer made with the intent to hinder, delay, or defraud creditors. The noteholders argued, among other things, that CompuCredit's financial reporting artificially depressed the market value of the notes (as well as the repurchase price) and that the company's plan to spin off its profitable microloan business to benefit insiders would reduce CompuCredit's ability to pay the notes. All of the defendants moved to dismiss the complaint.

THE DISTRICT COURT'S DECISION

The district court denied the defendants' motion to dismiss. The court explained that the no-action clause in the indenture did not preclude the noteholders' suit under the UFTA because: (i) the noteholders asserted "extra-contractual" claims exempt from the no-action clause; (ii) the noteholders collectively held a majority of the notes; and (ii) CompuCredit made it impossible to comply with the 60-day notice requirement by announcing that it would pay a dividend to shareholders less than 60 days prior to the payment. Under these circumstances, the court concluded, the noteholders did not have to rely, as a prerequisite to taking action, on the exceptions expressly delineated in the no-action clause.

In April 2011, the district court certified the following question to the Eleventh Circuit as part of an interlocutory appeal of its ruling: "Under New York Law, may noteholders sue under Georgia's Uniform Fraudulent Transfer Act where the noteholders have not complied with the conditions precedent to filing suit specified in the 'no-action clause' in the trust indentures governing the notes?"

THE ELEVENTH CIRCUIT'S RULING

A three-judge panel of the Eleventh Circuit reversed. In doing so, the court of appeals rejected the "extra-contractual" fraudulent-transfer-claim exception relied on by the district court, concluding that the noteholders relinquished to the indenture trustee their right to sue upon agreeing to be bound by the contract. Citing *Feldbaum v. McCrory Corp.*, 1992 WL 119095 (Del. Ch. June 2, 1992), the Eleventh Circuit explained that the no-action clause bars all actions regarding the indenture or the notes, subject only to the exceptions set forth therein. In addition, the court wrote, "Courts applying New York law have consistently held . . . that no-action clauses bar fraudulent conveyance claims." Because the noteholders did not argue that there was any trustee conflict of interest (an exception that has been recognized by New York courts), the Eleventh Circuit explained, there is no reason to deviate from the consistent legal framework applied to indentures.

The Eleventh Circuit also rejected the noteholders' claim that their actions were legitimate because they held a majority of the principal amount of the notes. Acknowledging that no-action clauses are meant to protect against suits brought by a handful of investors, the court was not convinced that the noteholders' majority-ownership interest alleviates the clear-exception requirements of the indenture. Instead, the Eleventh Circuit concluded, the best way to interpret the indenture is by reviewing its clear, unambiguous language, which does not authorize noteholder action solely on the basis of majority ownership.

The Eleventh Circuit did not consider the timing of the dividend announcement and payment relevant. Although a notice of less than 60 days prevented the noteholders from relying on the trustee-demand exception, the court explained, the dividend payment complied with the terms of the trust indenture, which required only 20 days' notice of a dividend payment.

CASE IMPLICATIONS

No-action clauses are a common feature of indentures and other agreements governing debt instruments. In *Akanthos Capital*, the Eleventh Circuit determined that such clauses "must be given a consistent, uniform interpretation" to preclude noteholder suits that fall outside the express terms of the delineated exceptions. The ruling demonstrates that investors would be well advised to review indentures and other governing agreements carefully, recognizing that courts' broad interpretation of the scope of no-action clauses may restrict their individual efforts to pursue causes of action against the issuer.

Europe has struggled mightily during the last several years to triage a long series of critical blows to the economies of the 27 countries that comprise the European Union as well as the collective viability of eurozone economies. Here we provide a snapshot of some recent developments relating to insolvency and restructuring in the EU.

Italy—Italian law decree No. 83 of 22 June 2012 (the "Decree") has introduced significant amendments to several provisions contained in the Italian Insolvency Act, governing, among others, the following major pre-insolvency restructuring proceedings: (a) the debt-restructuring agreement (*accordo di ristrutturazione dei debiti*) pursuant to Article 182-*bis* ("Art. 182-*bis* Agreement"); and (b) the arrangement with creditors (*concordato preventivo*) pursuant to Article 160 ("Arrangement with Creditors"). With respect to such restructuring proceedings, the Decree provides for the following main amendments: (i) faster, easier access to an Arrangement with Creditors that was reformed along the lines of the key principles underlying the chapter 11 process in the U.S. Bankruptcy Code; (ii) a new form of Arrangement with Creditors aimed at ensuring the continuity of an insolvent debtor as a going concern (*concordato con continuità aziendale*); (iii) enhanced protection of new financing granted in connection with restructuring proceedings; and (iv) certain amendments to provisions regulating the repayment of non-consenting creditors under an Art. 182-*bis* Agreement.

The UK—On 1 May 2012, the Chancery Division of the English High Court handed down its ruling in *Re JT Frith Ltd (Young v Kenneth)* [2012] EWHC 196 (Ch), concerning the ability of a secured lender to share indirectly in funds set aside for unsecured creditors. Section 176A (2) of the Insolvency Act 1986 provides that in cases where a floating charge has been granted over all of a company's assets, the liquidator, administrator or receiver must make a "prescribed part" of the company's net assets available for the benefit of unsecured creditors. A secured creditor may share in the "prescribed part" only if it: (i) releases its security; and (ii) shares as an unsecured creditor.

In *Frith*, a junior secured creditor of a company in liquidation was held to have effectively surrendered its security interest by submitting both a deed of release and proof of debt stating that it held no security in the company. As a result, it was allowed to participate in the "prescribed part". The significance of the case is that the junior secured creditor was also party to an intercreditor agreement with a senior secured creditor which contained a subordination clause requiring the junior lender to turn over any recoveries received from the debtor to the senior lender until the latter had been repaid in full. The result was that the senior secured lender was able to benefit indirectly from the prescribed part, even though it had already relied on its security and was therefore unable to participate in the prescribed part directly. This outcome was upheld by the court, as the intercreditor agreement was seen as a separate contractual matter between the junior and senior lenders and did not therefore undermine Section 176A (2).

This case is significant. Where senior and junior creditors hold separate security, senior creditors may now require the junior creditor, as part of the turnover provisions in any intercreditor agreement, to give up its security and prove as an unsecured creditor in order to allow the senior creditor to benefit indirectly from the prescribed part. It is not clear whether a court would take the same stance the *Frith* court did if the security were shared and the senior creditors had already made a secured recovery, or where the same entity also holds senior debt, while claiming to be unsecured vis-à-vis the junior debt. Nonetheless, we can expect to see senior creditors finding more creative ways to get money out of the prescribed-part pot.

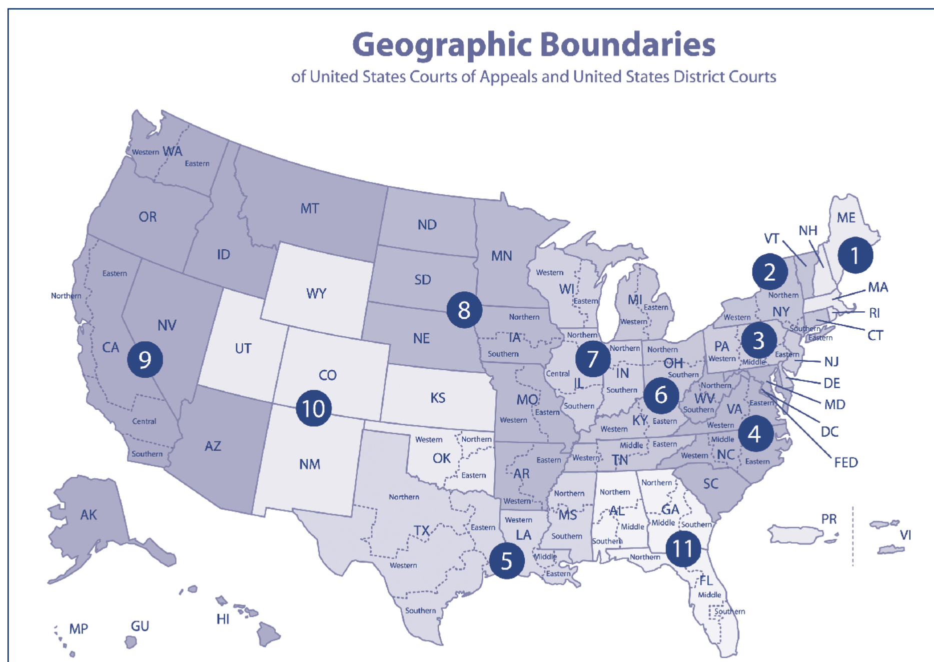
THE U.S. FEDERAL JUDICIARY

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 United States. 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.



BUSINESS RESTRUCTURING REVIEW

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

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