Recent Developments in Bankruptcy and Restructuring
Volume 14 | No. 3 | May–June 2015

BUSINESS RESTRUCTURING REVIEW

DASHED EXPECTATIONS: DELAWARE COURT RULES MAKE-WHOLE PREMIUM NOT PAYABLE UPON EARLY REPAYMENT OF BOND DEBT IN BANKRUPTCY

Jonathan M. Fisher and Mark G. Douglas

Whether a provision in a bond indenture or loan agreement obligating a borrower to pay a "make-whole" premium is enforceable in bankruptcy has been the subject of heated debate in recent years. A Delaware bankruptcy court recently weighed in on the issue in *Del. Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 527 B.R. 178 (Bankr. D. Del. 2015).

Aligning itself with a number of New York bankruptcy courts, the *Energy Future* court granted partial summary judgment to the debtor-borrower. The court ruled that, although the debtor repaid the bonds prior to maturity, a make-whole premium was not payable under the plain terms of the bond indenture because automatic acceleration of the debt triggered by the debtor's chapter 11 filing was not a "voluntary" repayment. However, the court reserved judgment on the indenture trustee's request for relief from the automatic stay to revive the make-whole premium claim by decelerating the bonds, as permitted under the terms of the indenture.

ENFORCEABILITY OF MAKE-WHOLE PREMIUMS IN BANKRUPTCY

Restrictions on a borrower's ability to prepay secured debt are a common feature of bond indentures and credit agreements. Lenders often incorporate "no-call" provisions to prevent borrowers from refinancing or retiring debt prior to maturity. Alternatively, a loan agreement may allow prepayment at the borrower's option, but only upon payment of a "make-whole" premium. The purpose of such a provision is to compensate the lender for the loss of the remaining stream of interest payments it would otherwise have received had the borrower paid the debt through maturity.

Bankruptcy courts almost uniformly refuse to enforce no-call provisions against debtors, allowing debtors to repay outstanding debt despite such provisions. *See, e.g., HSBC Bank USA, N.A. v. Calpine Corp.*, No. 07 Civ. 3088, 2010 U.S. Dist.

IN THIS ISSUE

1 Dashed Expectations: Delaware Court Rules Make-Whole Premium Not Payable Upon Early Repayment of Bond Debt in Bankruptcy

5 Newsworthy

6 No Decision From Eighth Circuit on Validity of Ponzi Scheme Presumption

9 From the Top in Brief

11 Credit Bidding Alert: Fifth Circuit Rules That Inaction Results in Waiver of Right to Credit Bid

14 Trademark Licensees Beware: The Hypothetical Test Lives On in the Third Circuit

18 Legislative Update—International Edition

19 Sovereign Debt Update

LEXIS 96792, at *17 (S.D.N.Y. Sept. 14, 2010); *In re Vest Assocs.*, 217 B.R. 696, 698 (Bankr. S.D.N.Y. 1998); *Cont'l Sec. Corp. v. Shenandoah Nursing Home P'ship*, 188 B.R. 205, 213 (W.D. Va. 1995). Further, the majority of courts have disallowed a lender's claim for payment of a make-whole premium when the premium is not explicitly payable in the event of acceleration. Such courts find that acceleration due to the debtor's bankruptcy filing, and any subsequent repayment of the debt during the bankruptcy case as part of a chapter 11 plan or otherwise, is not voluntary and therefore does not trigger any make-whole premium obligations. *See*, *e.g.*, *Bank of New York Mellon v. GC Merchandise Mart, LLC (In re Denver Merchandise Mart, Inc.)*, 740 F.3d 1052, 1059 (5th Cir. 2014); *U.S. Bank Trust Nat'l Assoc. v. Am. Airlines, Inc. (In re AMR Corp.)*, 730 F.3d 88, 105 (2d Cir. 2013); *In re MPM Silicones, LLC*, 2014 BL 250360 (Bankr. S.D.N.Y. Sept. 9, 2014) (memorializing bench ruling of Aug. 26, 2014), *aff'd U.S. Bank National Association v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*, 2015 BL 131356 (S.D.N.Y. May 4, 2015); *Premier Entm't Biloxi, LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entm't Biloxi, LLC)*, 445 B.R. 582, 627–28 (Bankr. S.D. Miss. 2010); *In re Solutia Inc.*, 379 B.R. 473, 488 (Bankr. S.D.N.Y. 2007); *but see In re School Specialty, Inc.*, No. 13-10125, 2013 Bankr. LEXIS 1897, at *19 (Bankr. D. Del. Apr. 22, 2013) (allowing claim for make-whole premium under New York law where loan agreement specifically provided for make-whole premium in event of "either prepayment or acceleration" and make-whole premium was not plainly disproportionate to lender's probable loss).

The courts are divided on the alternative argument sometimes made that a lender should be entitled to contract damages (apart from a make-whole premium) for "dashed expectations" when its outstanding debt has been paid prior to its original maturity. *See*, *e.g.*, *Calpine*, 2010 U.S. Dist. LEXIS 96792, at *18 (noteholders were not entitled to expectation damages because notes did not provide for payment of premiums upon acceleration and claims for expectation damages violated prohibition against unmatured interest under section 502(b)(2)); *Premier Entm't Biloxi*, 445 B.R. at 631 (although lenders were not entitled to secured claim for make-whole damages because indenture required prepayment penalties only if debtor repaid loan prior to maturity, and maturity was automatically accelerated due to bankruptcy filing, lenders were entitled to unsecured claim for dashed expectations).

The bankruptcy court in *Energy Future* recently added to this growing body of jurisprudence.

ENERGY FUTURE

Known as TXU Corp. until 2007, when it was acquired in what was then the largest leveraged buyout ever, Texas-based Energy Future Holdings Corp. and its subsidiaries (collectively, "Energy Future") filed for chapter 11 protection in the District of Delaware on April 29, 2014, to implement a restructuring that would split the company and eliminate more than $26 billion in debt.

Energy Future's pre-bankruptcy capital structure included $4 billion of first-lien notes divided into two separate tranches bearing different interest rates and maturities. Both issuances of first-lien notes included identical make-whole provisions designed to protect the noteholders from early redemption. In particular, the indenture governing each tranche of notes, in specifying what constitutes an "Optional Redemption," stated that "at any time prior to December 1, 2015, the Issuer may redeem all or a part of the Notes at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium." The "Applicable Premium" was defined as an amount equal to the greater of: (i) 1 percent of the principal amount of the notes; and (ii) the excess, if any, of the present value of the notes' redemption price and the required interest payments to maturity over the outstanding principal amount of the notes.

The indenture also stated that an "Event of Default" occurs when Energy Future "commences proceedings to be adjudicated bankrupt or insolvent." If such an Event of Default should occur, the indenture provided that "all outstanding Notes shall be due and payable immediately without further action or notice." In the event of acceleration, the indenture gave the indenture trustee a qualified right to effectively decelerate the first-lien notes upon the request of the holders of at least a majority in principal amount of the notes.

On the bankruptcy petition date, Energy Future filed a restructuring support and lockup agreement that documented a broad settlement reached among Energy Future and various creditors. This "global settlement" included a settlement between Energy Future and some of the first-lien noteholders that was to be implemented by means of a postpetition tender offer. The tender offer proposed a "roll-up"—an exchange of existing first-lien notes for new notes bearing a lower interest rate to be issued under a $5.4 billion debtor-in-possession financing facility.

In exchange for new notes valued at 105 percent of outstanding principal and 101 percent of accrued interest, participating noteholders would agree to release their make-whole premium claims. Of Energy Future's two tranches of first-lien debt, 97 percent of one tranche and 34 percent of the other tranche accepted the tender offer. Nonsettling noteholders retained the right to litigate the validity of their make-whole premium claims.

On the basis of these results, the bankruptcy court approved the settlement with accepting first-lien noteholders on June 6, 2014. That order was later upheld on appeal in *Del. Trust Co. v. Energy Future Intermediate Holding Co. LLC (In re Energy Future Holdings Corp.)*, 527 B.R. 157 (D. Del. 2015). Prior to the bankruptcy court's approval of the settlement, the indenture trustee for the tranche of first-lien notes that had not overwhelmingly accepted the tender offer filed an adversary proceeding seeking, among other things, a determination that the nonsettling noteholders were entitled to a secured claim for a make-whole premium in the amount of approximately $660 million.

Viewed as a whole, the rulings in *Energy Future*, *Calpine*, *Premier Entm't*, *MPM Silicones*, and *Solutia* send a clear message: In Delaware and New York, a bond indenture or other governing instrument must expressly and unequivocally provide that repayment is not permitted prior to the maturity date and that a make-whole premium is payable upon an automatic acceleration of the notes caused by a bankruptcy default.

The bankruptcy court later bifurcated the adversary proceeding into two phases. In the first phase, it considered: (i) whether Energy Future was liable for the make-whole premium or other damages for breach of the no-call provision in the note indenture; and (ii) whether Energy Future intentionally defaulted on the notes in order to avoid paying the make-whole premium or other damages. The court assumed for purposes of this phase of the litigation that Energy Future was solvent and able to pay all creditor claims in full. The indenture trustee and Energy Future cross-moved for summary judgment on these issues.

THE BANKRUPTCY COURT'S RULING

The court granted Energy Future's motion for summary judgment in part and denied the trustee's motion in its entirety. Initially, the court ruled that the plain language of the indenture governing the first-lien notes did not require payment of a make-whole premium following acceleration due to a default caused by the commencement of a "proceeding to be adjudicated bankrupt or insolvent." The court explained that the indenture provision, specifying the consequences of an event of default triggered by a bankruptcy filing, did not include any reference to "anything that would support the Trustee's position that the Applicable Premium is owed upon a bankruptcy event of default and acceleration." The court agreed with the approach applied in *Calpine, Premier Entm't, MPM Silicones,* and *Solutia*, ruling that "the acceleration provision in the Indenture does not include clear and unambiguous language that a make-whole premium (here, the 'Applicable Premium') is due upon the repayment of the Notes following a bankruptcy acceleration."

In so ruling, the court focused on the distinction between "redemption" and "acceleration." Under the indenture, "Optional Redemption . . . is an act separate and apart from automatic acceleration." The court agreed with Energy Future that the make-whole premium was due only upon an Optional Redemption and that repayment following acceleration did not constitute an Optional Redemption. It found that the Optional Redemption provision contemplated a voluntary action by Energy Future, noting that, under New York law (which governed the indenture), "a borrower's repayment after acceleration is not considered voluntary."

The court rejected the indenture trustee's contention that Energy Future should be liable for the make-whole premium because its bankruptcy filing was an intentional default specifically designed to skirt such liability. According to the court, the indenture did not provide that the make-whole premium would be owed if Energy Future intentionally defaulted. Moreover, the court explained, although Energy Future had made no secret of its plans to use the default caused by the bankruptcy filing to refinance the first-lien notes without having to pay the Applicable Premium, "that is not enough to counter the overwhelming evidence that [Energy Future] filed for bankruptcy because [it] was facing a severe liquidity crisis."

However, the court agreed with the indenture trustee that it has a qualified right under the indenture to rescind the automatic acceleration which took place upon Energy Future's bankruptcy filing. If the rescission were to be effective retroactively (i.e., prior to the June 2014 repayment date), the court explained, Energy

Future's repayment of the first-lien notes would in fact constitute an Optional Redemption, and the make-whole premium would be payable. Although the trustee could not rescind the acceleration without violating the automatic stay, the court ruled that there was a material issue of fact as to whether "cause" existed to lift the stay. It accordingly denied Energy Future's motion for summary judgment on this issue, stating that a trial must be held to consider the indenture trustee's ability to decelerate the first-lien notes retroactively.

POSTSCRIPT

Five weeks after the bankruptcy court handed down its ruling in *Energy Future*, the U.S. District Court for the Southern District of New York affirmed the bankruptcy court's rulings in *MPM Silicones* regarding make-whole premiums, subordination provisions in an intercreditor agreement, and the appropriate rate of interest to be paid to secured creditors under a cramdown chapter 11 plan. *See U.S. Bank National Association v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*, 2015 BL 131356 (S.D.N.Y. May 4, 2015). In affirming the bankruptcy court's order denying the payment of a make-whole premium to senior noteholders, the district court wrote that "[n]either the 2012 Indentures nor the Senior Lien Notes themselves clearly and unambiguously provide that the Senior Lien Noteholders are entitled to a make-whole payment in the event of an acceleration of debt caused by the voluntary commencement of a bankruptcy case."

OUTLOOK

Viewed as a whole, the rulings in *Energy Future*, *Calpine*, *Premier Entm't*, *MPM Silicones*, and *Solutia* send a clear message: In Delaware and New York, a bond indenture or other governing instrument must expressly and unequivocally provide that repayment is not permitted prior to the maturity date and that a make-whole premium is payable upon an automatic acceleration of the notes caused by a bankruptcy default. If such express and unequivocal provisions were included in the *Energy Future* bond indentures, the nonsettling first-lien noteholders would not have been forced to rely on the uncertain prospect that the court might grant relief from the stay to permit deceleration of the notes. It remains to be seen whether this alternative strategy to collect the make-whole premium will succeed.

The message borne by all of these cases is that careful attention must be paid to drafting indenture documents. Interestingly, in addition to the inadequacy of the make-whole premium language in the bond indenture in *Energy Future*, it bears noting that the indenture provided that an event of default would occur if the company was "adjudicated bankrupt or insolvent." Such outmoded language (which hearkens back to bankruptcy practice prior to the enactment of the Bankruptcy Code in 1978) suggests that at least parts of the indenture had not been updated to account for more recent developments in law and practice. In the absence of careful drafting, the enforceability of make-whole premiums in bankruptcy will continue to be fertile territory for litigation. Investors in distressed debt would be well advised to consider this prospect.

NEWSWORTHY

On March 31, 2015, the U.S. Bankruptcy Court for the District of Delaware approved the sale of more than 1,740 RadioShack stores to an affiliate of hedge fund Standard General LP, preserving some 7,500 jobs and paving the way for the pared-down company to remain in business as an electronics retailer. The Jones Day team representing RadioShack was led by ***Gregory M. Gordon (Dallas)*** and included Business Restructuring & Reorganization Practice members ***Dan B. Prieto (Dallas)***, ***Thomas A. Howley (Houston)***, ***Paul M. Green (Houston)***, ***Amanda Suzuki (Dallas)***, and ***Jonathan M. Fisher (Dallas)***.

The American Lawyer has chosen ***Bruce Bennett (Los Angeles)***, ***David G. Heiman (Cleveland)***, and ***Heather Lennox (New York and Cleveland)*** as "Dealmakers of the Year" for 2015 for their role in leading a team of approximately 100 Firm lawyers advising the City of Detroit in connection with its historic chapter 9 bankruptcy and plan of adjustment, the largest and most complex municipal bankruptcy in U.S. history.

Ben Larkin (London), ***Juan Ferré (Madrid)***, and ***Laurent Assaya (Paris)*** have been recommended as "Leaders in their Field" by *Chambers Europe* 2015 in the practice area of Restructuring/Insolvency.

David G. Heiman (Cleveland), ***Bruce Bennett (Los Angeles)***, and ***Heather Lennox (New York and Cleveland)*** were featured in the "Dealmakers and Their Deals" section of the April 2015 issue of *The American Lawyer*.

Volker Kammel (Frankfurt) and ***Olaf Benning (Munich)*** have been recommended in the field of "Insolvency and restructuring—Restructuring" in *The Legal 500 Europe, Middle East and Africa* 2015.

On April 23, ***Jeffrey B. Ellman (Atlanta)*** and ***Daniel J. Merrett (Atlanta)*** participated in a presentation at Jones Day's Atlanta Office, entitled "The Decline and Rebirth of Detroit," to members of the restructuring community.

On May 5, 2015, Jones Day hosted the 2015 Turnaround Management Association ("TMA") Network of Women ("NOW") Summit in New York City. ***Amy Edgy Ferber (Atlanta)*** led the event as the global cochair of TMA NOW, and ***Heather Lennox (New York and Cleveland)*** moderated a panel discussion entitled "The Women of Detroit."

Sidney P. Levinson (Los Angeles), ***Brad B. Erens (Chicago)***, ***Heather Lennox (New York and Cleveland)***, ***Jeffrey B. Ellman (Atlanta)***, ***Carl E. Black (Cleveland)***, ***Bennett L. Spiegel (Los Angeles)***, ***Thomas A. Howley (Houston)***, ***Corinne Ball (New York)***, ***Paul D. Leake (New York)***, ***Bruce Bennett (Los Angeles)***, ***David G. Heiman (Cleveland)***, ***Charles M. Oellermann (Columbus)***, ***Gregory M. Gordon (Dallas)***, ***Richard L. Wynne (Los Angeles)***, and ***James O. Johnston (Los Angeles)*** were designated "Leaders in their Field" in the area of Bankruptcy/Restructuring by *Chambers USA* 2015.

Kevyn D. Orr (Washington) and ***Dan T. Moss (Washington)*** made a presentation on March 19 at Cornell Law School regarding the landmark chapter 9 bankruptcy of the City of Detroit.

Heather Lennox (New York and Cleveland) was selected as a 2015 "Woman of Note" by *Crain's Cleveland Business*.

Ben Larkin (London), ***Laurent Assaya (Paris)***, ***Juan Ferré (Madrid)***, ***David G. Heiman (Cleveland)***, ***Sion Richards (London)***, ***Paul D. Leake (New York)***, ***Bruce Bennett (Los Angeles)***, ***Heather Lennox (New York and Cleveland)***, ***Corinne Ball (New York)***, and ***Richard L. Wynne (Los Angeles)*** have been recommended in the area of Restructuring/Insolvency or Bankruptcy/Restructuring by *Chambers Global* 2015.

Scott J. Greenberg (New York) was profiled as a "Rising Star" in the field of bankruptcy in the April 2, 2015, issue of *Law360*.

On May 14, ***Paul D. Leake (New York)*** served as a panelist on a "Bankruptcy Litigation Panel" discussing fraudulent transfers, automatic stay litigation, aiding and abetting claims, and post-*Stern v. Marshall* consent to jurisdiction cases at the 17th Annual New York City Bankruptcy Conference, sponsored by the American Bankruptcy Institute.

An article featuring "Bankruptcy Examiner" ***Paul D. Leake (New York)*** appeared in the "Bankruptcy Beat" column of the April 9, 2015, edition of *The Wall Street Journal*.

An article written by ***Jane Rue Wittstein (New York)*** and ***Mark G. Douglas (New York)*** entitled "Foreign Representative Lacks Standing to Assert State-Law Avoidance Claims in Chapter 15 Case" was reprinted in the April 2015 *INSOL International News Update.*

NO DECISION FROM EIGHTH CIRCUIT ON VALIDITY OF PONZI SCHEME PRESUMPTION

Dan T. Moss

In *Ritchie Capital Mgmt., LLC v. Stoebner*, 779 F.3d 857 (8th Cir. 2015), the U.S. Court of Appeals for the Eighth Circuit affirmed a bankruptcy court's decision that transfers of trademark patents were avoidable under section 548(a)(1)(A) of the Bankruptcy Code and Minnesota state law because they were made with the intent to defraud creditors. On a motion for summary judgment, the bankruptcy court had determined that transfers effected as part of a massive, multibillion-dollar Ponzi scheme satisfied both the "Ponzi scheme presumption" of fraud and the more general "badges of fraud" analysis. On appeal, the Eighth Circuit affirmed the rulings below on the basis of the badges of fraud analysis. The court did not find it necessary to address the validity of the Ponzi scheme presumption, writing that "[w]e . . . draw no conclusions as to the validity or future applicability of the Ponzi scheme presumption in the Eighth Circuit."

AVOIDANCE POWERS AND PROVING FRAUDULENT INTENT

Section 548(a)(1) of the Bankruptcy Code authorizes a trustee or debtor-in-possession ("DIP") to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor within the two years preceding a bankruptcy filing if: (i) the transfer was made, or the obligation was incurred, "with actual intent to hinder, delay, or defraud" any creditor; or (ii) the debtor received "less than a reasonably equivalent value in exchange for such transfer or obligation" and was, after the transfer, insolvent, undercapitalized, or unable to pay its debts as such debts matured.

Transfers or obligations may also be avoided under analogous state laws by operation of section 544(b)(1) of the Bankruptcy Code, which empowers a trustee or DIP to "avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim" against the debtor. Examples of such laws are the versions of the Uniform Fraudulent Transfer Act ("UFTA") and the Uniform Fraudulent Conveyance Act ("UFCA") adopted by most states. Like section 548(a)(1), both the UFTA and the UFCA provide for the avoidance of intentionally and constructively fraudulent transfers or obligations.

Proving actual intent to defraud under either section 548 or state law can be difficult. Many courts therefore permit plaintiffs to rely on "badges of fraud," a concept developed and applied by English courts since the reign of Queen Elizabeth I, to support a case for avoidance based on actual intent to hinder, delay, or defraud creditors. In general terms, badges of fraud are "circumstances so commonly associated with fraudulent transfers that their presence gives rise to an inference of intent." *In re Sharp Intern. Corp.*, 403 F.3d 43, 56 (2d Cir. 2005). While there is no exhaustive catalog of badges of fraud, courts typically look for, among other things, "a close relationship between the parties to the alleged fraudulent transaction; a questionable transfer not in the usual course of business, inadequacy of consideration; . . . and retention of control of the property by the transferor after the conveyance." *Id.* (internal citations omitted); *see also HBE Leasing Corp. v. Frank*, 48 F.3d 623, 639 (2d Cir. 1995) ("Actual fraudulent intent . . . may be inferred from the circumstances surrounding the transaction, including the relationship among the parties and the secrecy, haste, or unusualness of the transaction"). Once the trustee or DIP establishes the existence of several badges of fraud, the trustee or DIP is entitled to a presumption of fraudulent intent. The burden then shifts to the transferee "to prove some legitimate supervening purpose for the transfers at issue." *Kelly v. Armstrong*, 141 F.3d 799, 802 (8th Cir. 1998) (citation omitted).

> *Ritchie Capital* may be a disappointment for those hoping that the Eighth Circuit would rule on the legitimacy of the Ponzi scheme presumption in the context of fraudulent transfer litigation. Even so, the court did not reject the validity of the presumption, and the court's flexible approach to establishing fraudulent intent leaves open the possibility that it might be receptive to the concept in a future case which does not involve the application of Minnesota law.

With respect to Ponzi schemes, several courts have decided that "transfers made in furtherance of the scheme are presumed to have been made with the intent to defraud for purposes of recovering the payments under § 548(a)." *Perkins v. Haines*, 661 F.3d 623, 626 (11th Cir. 2011); *accord Wing v. Dockstader*, 2012 BL 140244 (10th Cir. 2012); *Donell v. Kowell*, 533 F.3d 762 (9th Cir.

2008); *Warfield v. Byron*, 436 F.3d 551 (5th Cir. 2006); *see also In re DBSI, Inc.*, 476 B.R. 413, 422 (Bankr. D. Del. 2012) (" 'all payments made by a debtor in furtherance of a Ponzi scheme are made with actual fraudulent intent' ") (citation omitted). To trigger this presumption, a plaintiff must establish that a Ponzi scheme exists and that the transfers were made in furtherance of the scheme. *See In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1 (S.D.N.Y. 2007).

The Eighth Circuit had an opportunity to address these issues in *Ritchie Capital*.

BACKGROUND

Ritchie Capital involved one of many disputes related to the multibillion-dollar Ponzi scheme perpetrated by Thomas Petters ("Petters"), founder of Petters Group Worldwide ("PGW"). In this case, Petters, as the sole board member of PGW, directed PGW in 2005 to purchase Polaroid Holding Company ("Polaroid"), successor to the once iconic photographic technology pioneer. Petters thus became the 100 percent beneficial owner of Polaroid, an otherwise legitimate, independent, stand-alone business. After PGW acquired Polaroid, Petters became the sole member and chairman of the Polaroid board. Polaroid's business operations continued after the acquisition without substantial change.

Approximately three years later, however, Petters' companies—including Polaroid—began to experience financial difficulties. To alleviate these problems, between February 2008 and May 2008, Petters obtained loans from various hedge funds affiliated with Ritchie Capital Management, LLC (collectively, "Ritchie") totaling approximately $160 million. Some of these funds were used to pay debts of PGW and Polaroid. Polaroid was never a signatory to any of these loans, and although some of the funds were used to repay some of Polaroid's debts, none of the proceeds from these loans went directly to Polaroid.

Petters was unable to service the loans. By September 2008, all the loans were past due, and Ritchie demanded collateral. In response, Petters proposed a Trademark Security Agreement ("TSA") whereby Ritchie would be granted liens on several Polaroid trademarks. Polaroid's CEO objected, claiming that the agreement would inhibit her ability to secure new capital for the company (the TSA's terms did allow Polaroid to obtain first-priority secured financing for up to $75 million, but this was not disclosed to the CEO). Notwithstanding this objection, Petters executed the TSA on Polaroid's behalf on September 19, 2008.

Five days later, the Federal Bureau of Investigation raided Petters' office and home, suspecting his involvement in a massive fraud. Shortly afterward, Ritchie accelerated the amounts due on all outstanding loans. Polaroid filed for chapter 11 protection on December 18, 2008, in the District of Minnesota. Petters was later convicted of mail fraud, wire fraud, and money laundering and was sentenced to 50 years in prison.

Polaroid commenced an adversary proceeding in February 2009 against Ritchie, alleging that the TSA was unenforceable because, among other things, the obligations created under the agreement were avoidable under section 548(a)(1)(A) of the Bankruptcy Code and Minnesota's version of the UFTA because they were both actually and constructively fraudulent. A bankruptcy trustee was substituted as the plaintiff in the litigation after Polaroid's chapter 11 case was converted to a chapter 7 liquidation in August 2009.

The bankruptcy court bifurcated the litigation to consider the actual and constructive fraud claims separately. In the first phase, the court considered a motion for partial summary judgment on the trustee's actual fraudulent transfer claims.

To establish fraudulent intent, the trustee relied on both the Ponzi scheme presumption and the traditional badges of fraud analysis. The bankruptcy court granted the trustee's partial summary judgment motion in part and denied it in part. *See Stoebner v. Ritchie Capital Mgmt., LLC*, 472 B.R. 22 (Bankr. D. Minn. 2012). The court granted the motion on the issue of actual fraud, to which the court applied both the Ponzi scheme presumption and the badges of fraud analysis.

The bankruptcy court considered Petters' "overarching level of control," concluding that, under either theory, Ritchie's liens resulted from actual fraudulent transfers and were therefore avoidable. Explaining that while the presumption of fraudulent intent could be rebutted by "probative, significant evidence that the transferor-debtor lacked the intent to take the transferred value away from contemporaneous or future creditors," the court ruled that Ritchie failed to meet the burden of production necessary to demonstrate nonfraudulent intent.

The bankruptcy court found that the following badges of fraud established actual intent: (1) the lack of reasonably equivalent value given in exchange for the transfer; (2) concealment of the transfer; (3) litigation or the threat of litigation by the transferee in the absence of the transfer; (4) the transfer of "substantially all" of the transferor's assets; and (5) orchestration of the transfer by the sole person in common control.

Ritchie appealed to the U.S. District Court for the District of Minnesota. Noting that the Eighth Circuit has not yet ruled on the application of the Ponzi scheme presumption to alleged fraudulent transfers, the district court affirmed the bankruptcy court's application of the Ponzi scheme presumption but expressly declined to address the badges of fraud analysis. *See Ritchie Capital Mgmt., L.L.C. v. Stoebner*, 2014 BL 420623 (D. Minn. Jan. 6, 2014). Ritchie then appealed to the Eighth Circuit.

THE EIGHTH CIRCUIT'S RULING

A three-judge panel of the Eighth Circuit affirmed. At the outset of its discussion, the court explained that many courts have looked to badges of fraud in determining whether a transfer was made with intent to hinder, delay, or defraud creditors under section 548(a) of the Bankruptcy Code and that Minnesota's codification of the UFTA contains "a lengthy list" of factors or badges of fraud which a court may consider in deciding this issue. It further noted that many courts confronted with circumstances amounting to a Ponzi scheme, including courts in the Fifth, Sixth, Ninth, Tenth, and Eleventh Circuits, have bypassed the badges of fraud analysis and applied the Ponzi scheme presumption.

However, the Eighth Circuit panel emphasized, the Eighth Circuit has not yet ruled on the Ponzi scheme presumption, and the Minnesota Supreme Court recently rejected the presumption in *Finn v. Allied Bank*, 2015 BL 40772, *8 (Minn. Feb. 18, 2015). In *Finn*, the Minnesota Supreme Court wrote that "there is no statutory justification for relieving the Receiver of its burden of proving . . . fraudulent intent [which must] . . . be determined in light of the facts and circumstances of each case."

The Eighth Circuit panel concluded, however, that it need not take a position on this issue, noting merely that "[w]e thus draw no conclusions as to the validity or future applicability of the Ponzi scheme presumption in the Eighth Circuit."

Instead, the court affirmed the rulings below on the basis of its *de novo* review and approval of most of the bankruptcy court's badges of fraud analysis under Minnesota law. Among other things, the Eighth Circuit panel determined that:

- In a case where multiple entities are involved, it is important to precisely identify whose intent is relevant to the consideration of fraudulent intent. Here, the Eighth Circuit focused on the intent of Polaroid, as directed and orchestrated by Petters.
- Polaroid's trademarks were encumbered without any real benefit to Polaroid, which was not a party to the Ritchie loan agreements. Thus, the "lack of reasonably equivalent value" badge of fraud was present.
- At the time the TSA was executed, Petters' Ponzi scheme was in a precarious financial position. Petters also was aware that Polaroid was in the zone of insolvency, given its inability to satisfy vendor payments. Although the liens granted by Polaroid to Ritchie were not granted to an insider per se, they were granted to Ritchie for the benefit of an insider, Petters. Thus, the "transfer for the benefit of an insider" badge of fraud was present.
- It was undisputed that Polaroid had serious financial difficulties before the TSA was executed, which worsened afterward. Citing cases that look to unmanageable indebtedness in addition to insolvency, the Eighth Circuit panel found that the "insolvency of the debtor" badge of fraud was present.
- Petters directed Polaroid to grant liens to Ritchie despite knowing that Polaroid's CEO feared that those liens would inhibit Polaroid's ability to raise much-needed capital. The Eighth Circuit found this relevant to discerning fraudulent intent irrespective of whether the CEO was aware of the new first-lien capital carve-out in the TSA.

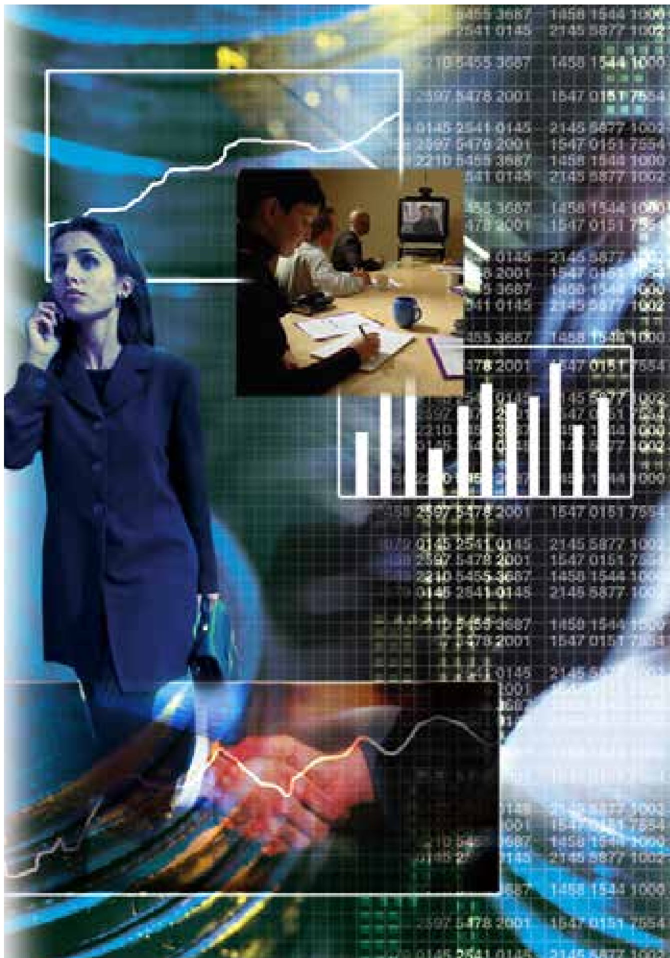
On the basis of the existence of these badges of fraud, the Eighth Circuit found no fault with the bankruptcy court's conclusion that Polaroid, controlled solely by Petters, was presumed to have acted with the actual intent to defraud creditors when it granted liens to Ritchie under the TSA. The Eighth Circuit rejected Ritchie's argument that all the badges of fraud under Minnesota law were not established. According to the court,

"[T]he law does not require the trustee to prove *all* of the badges [because] [o]nce a trustee establishes a confluence of *several* badges of fraud, the trustee is entitled to the presumption of fraudulent intent" (citations omitted).

However, this did not end the inquiry. Instead, it "merely shifted the burden to Ritchie to prove it took the liens in good faith and for value." The Eighth Circuit agreed with the bankruptcy court that Ritchie failed to satisfy this burden—a ruling, moreover, which Ritchie did not appeal.

TAKEAWAY

Ritchie Capital may be a disappointment for those hoping that the Eighth Circuit would rule on the legitimacy of the Ponzi scheme presumption in the context of fraudulent transfer litigation. Even so, the court did not reject the validity of the presumption, and the court's flexible approach to establishing fraudulent intent leaves open the possibility that it might be receptive to the concept in a future case which does not involve the application of Minnesota law.



FROM THE TOP IN BRIEF

On May 4, 2015, the U.S. Supreme Court handed down its first 2015 ruling in a case involving an issue of bankruptcy law. In *Bullard v. Blue Hills Bank*, No. 14-116, 2015 BL 129010, _____ S. Ct. _____ (May 4, 2015), the court reviewed a ruling by the First Circuit Court of Appeals that an order of a bankruptcy appellate panel affirming a bankruptcy court's denial of confirmation of a chapter 13 plan is not a final order and therefore is not appealable under 28 U.S.C. § 158(d), so long as the debtor remains free to propose an amended plan. *See Bullard v. Hyde Park Sav. Bank (In re Bullard)*, 752 F.3d 483 (1st Cir. 2014), *cert. granted*, No. 14-116, 2014 BL 349325 (Dec. 12, 2014). The Second, Sixth, Eighth, Ninth, and Tenth Circuits had also held that such an order is not final so long as the debtor may still propose another plan. The Third, Fourth, and Fifth Circuits had adopted the minority approach that such an order can be final.

The Supreme Court affirmed the First Circuit's ruling, resolving the circuit split in favor of the majority approach. Writing for a unanimous court, Chief Justice Roberts explained that the finality rules in bankruptcy are different from those that apply in ordinary federal litigation because bankruptcy cases typically involve many discrete disputes within the larger case. For this reason, Congress has provided that orders in a bankruptcy case may be appealed immediately if they finally dispose of such a discrete dispute.

Confirmation of a chapter 13 plan, Justice Roberts reasoned, is immediately appealable because it "alters the status quo[,] . . . fixes the rights and obligations of the parties . . . and has preclusive effect." The consequences are similarly significant, he explained, when confirmation is denied and the case is dismissed because dismissal "dooms the possibility of a discharge and the other benefits available to a debtor under Chapter 13."

By contrast, according to Justice Roberts, denial of confirmation with leave to amend the chapter 13 plan "changes little" and " '[f]inal' does not describe this state of affairs." The conclusion that an order denying confirmation of such a plan with leave to amend is not final is bolstered by 28 U.S.C. § 157(b)(2)(L), which lists "confirmations of plans" as a "core" proceeding but does not contain any reference to confirmation denials.

A rule against immediate appeal of an order denying plan confirmation, Justice Roberts noted, avoids delays and

inefficiencies arising from multiple time- and resource-consuming appeals—"precisely the reason for a rule of finality." It also promotes cooperation among debtors, trustees, and creditors in developing a confirmable plan as promptly as possible.

Justice Roberts wrote that "debtors may often view, in good faith or bad, the prospect of appeals as important leverage in dealing with creditors." He also stated that "[t]hese concerns are heightened if the same rule applies in Chapter 11," where business debtors "are more likely to have the resources to appeal and may do so on narrow issues."

Finally, Justice Roberts downplayed the argument that, if orders denying plan confirmation are not final and immediately appealable, "there will be no effective means of obtaining appellate review of the denied proposal." According to Justice Roberts, bankruptcy courts, like trial courts in ordinary litigation, rule correctly most of the time, and "even when they may slip, many of their errors . . . will not be of a sort that justifies the costs entailed by a system of universal immediate appeals."

In addition, Justice Roberts explained that there are several mechanisms for interlocutory review of an order denying confirmation of a chapter 13 plan, including the following: (i) a district court or bankruptcy appellate panel may grant leave to hear the appeal under 28 U.S.C. § 158(a)(3), and if the debtor loses on appeal, the district court or bankruptcy appellate panel may certify the interlocutory appeal to the court of appeals under 28 U.S.C. § 1292(b); (ii) under 28 U.S.C. § 158(d)(2), a bankruptcy court may certify an appeal directly to the court of appeals, which then has discretion to hear the matter. According to Justice Roberts, "While discretionary review mechanisms such as these do not provide relief in every case, they serve as useful safety valves for promptly correcting serious errors and addressing important legal questions" (internal quotation marks and citation omitted).

The Supreme Court handed down its second bankruptcy ruling in 2015 on May 18. In *Harris v. Viegelahn*, No. 14-400, 2015 BL 152138 (May 18, 2015), the court considered whether undistributed funds held by a chapter 13 trustee must be distributed to creditors or revert to the debtor, a question that has divided courts for 30 years. The appeal stems from a Fifth Circuit decision holding that wages earned by the debtor after filing for chapter 13, but held by the trustee at the time the debtor's case is converted to a chapter 7 liquidation, must be distributed to creditors rather than returned to the debtor, on the basis of considerations of equity and policy. *See Viegelahn v. Harris (In re Harris)*, 757 F.3d 468 (5th Cir. 2014), *cert. granted*, 135 S. Ct. 782 (Dec. 12, 2015). The Fifth Circuit's decision created a split with the Third Circuit's ruling in *In re Michael*, 699 F.3d 305 (3d Cir. 2012).

Writing for a unanimous court, Justice Ruth Bader Ginsburg explained that, in a chapter 13 case, postpetition wages are property of the estate under section 1322(a)(1) of the Bankruptcy Code and may be collected by the chapter 13 trustee for distribution to creditors under a chapter 13 plan. By contrast, in a chapter 7 case, such earnings are not estate property, but belong to the debtor.

Justice Ginsburg further explained that, prior to 1994, courts were divided on the disposition of a debtor's undistributed postpetition wages following conversion of a case from chapter 13 to chapter 7. To address these concerns, Congress added section 348(f) to the Bankruptcy Code in 1994. Section 348(f)(1)(A) provides that, in a case converted from chapter 13, the property of the chapter 7 estate consists of the property of the estate, as of the petition date, which remains in the debtor's possession or control. Thus, a debtor's postpetition earnings and acquisitions generally do not become part of the chapter 7 estate. However, section 348(f)(2) contains an exception for bad-faith conversions. It provides that "[i]f the debtor converts a case [initially filed] under chapter 13 . . . in bad faith, the property of the estate in the converted case shall consist of the property of the estate *as of the date of conversion*" (emphasis added).

On the basis of this statutory framework, Justice Ginsburg concluded that, in the absence of bad faith, postpetition wages must be returned to the debtor:

> Bad-faith conversions apart, we find nothing in the Code denying debtors funds that would have been theirs had the case proceeded under Chapter 7 from the start. In sum, §348(f) does not say, expressly: On conversion, accumulated wages go to the debtor. But that is the most sensible reading of what Congress did provide.

In reversing the Fifth Circuit's ruling, Justice Ginsburg downplayed the Fifth Circuit's concern that debtors would receive a "windfall" if they could reclaim accumulated wages from a chapter 13 trustee upon conversion. "We do not regard as a 'windfall,' " she wrote, "a debtor's receipt of a fraction of the wages he earned and would have kept had he filed under Chapter 7 in the first place."

CREDIT BIDDING ALERT: FIFTH CIRCUIT RULES THAT INACTION RESULTS IN WAIVER OF RIGHT TO CREDIT BID

Charles M. Oellermann and Mark G. Douglas

Even after the U.S. Supreme Court in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012), pronounced in no uncertain terms that a secured creditor must be given the right to "credit bid" its claim in a bankruptcy sale of its collateral, the controversy over restrictions on credit bidding continues in the courts. A ruling recently handed down by the Fifth Circuit Court of Appeals has added a new wrinkle to the debate. In *Baker Hughes Oilfield Operations, Inc. v. Morton (In re R.L. Adkins Corp.)*, 2015 BL 116996 (5th Cir. Apr. 23, 2015), the Fifth Circuit held that an undersecured creditor which elected to have its claim treated as fully secured under section 1111(b) of the Bankruptcy Code, yet failed to obtain a pre-confirmation ruling on the election or to object to confirmation of a plan providing for the sale of its collateral under section 363(b), was not impermissibly stripped of the right to credit bid its secured claim in connection with the sale.

CREDIT BIDDING UNDER THE BANKRUPTCY CODE

Section 363(k) of the Bankruptcy Code provides that a creditor with a lien on assets to be sold outside the ordinary course of business under section 363(b) may "credit bid" its secured claim at the sale, "unless the court for cause orders otherwise." A credit bid is an offset of a secured claim against the property's purchase price. The U.S. Supreme Court explained in *RadLAX*, 132 S. Ct. at 2070 n.2, that "[t]he ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price" and "[i]t enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan."

The Supreme Court ruled in *RadLAX* that, pursuant to section 1129(b)(2)(A)(ii) of the Bankruptcy Code, although the right to credit bid is not absolute, a nonconsensual, or "cram down," chapter 11 plan providing for the sale of encumbered property free and clear of a creditor's lien cannot be confirmed without affording the creditor the right to credit bid for the property.

In the aftermath of *RadLAX*, the debate shifted largely to the circumstances that constitute "cause" under section 363(k) to prohibit or limit a secured creditor's right to credit bid its claim. For example, in *In re Fisker Automotive Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014), *leave to app. denied*, 2014 BL 33749 (D. Del. Feb. 7, 2014), *cert. denied*, 2014 BL 37766 (D. Del. Feb. 12, 2014), the court limited the amount of a credit bid to the discounted purchase price actually paid to purchase the debt because, among other things, the court concluded that an unrestricted credit bid would chill bidding.

In *In re The Free Lance-Star Publishing Co.*, 512 B.R. 798 (Bankr. E.D. Va.), *leave to appeal denied sub nom. DSP Acquisition, LLC v. Free Lance-Star Publishing Co.*, 512 B.R. 808 (E.D. Va. 2014), the court found "cause" under section 363(k) to limit a credit bid by an entity that purchased $39 million in face amount of debt with the intention of acquiring ownership of the debtor's assets. The court limited the credit bid because: (i) the creditor's liens on a portion of the assets to be sold had been improperly perfected; (ii) the creditor engaged in inequitable conduct by forcing the debtor into bankruptcy and an expedited section 363 sale process in pursuing an obvious identified "loan to own" strategy; and (iii) the creditor actively frustrated the competitive bidding process and attempted to depress the sale price of the assets.

Finally, the court in *In re Charles Street African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass. 2014), denied in part a chapter 11 debtor's motion to limit a credit bid on the basis that the secured creditor's claims were subject to bona fide dispute. In that case, the debtor had filed counterclaims against the creditor that, by way of setoff, could have reduced the amount of the claims to zero. In finding that "cause" was lacking under section 363(k), the court explained that: (i) despite the debtor's counterclaims, which did not relate to the validity of the secured creditor's claims or liens, the claims were "allowed" (a designation that the debtor did not dispute); and (ii) the entire amount of the claims was not likely to be used in a credit bid for the assets.

PROTECTION OF UNDERSECURED CREDITORS PURSUANT TO SECTION 1111(b)

Section 1111(b)(1) of the Bankruptcy Code provides that a secured claim will be treated as a recourse claim even if the creditor does not actually have recourse to the debtor by contract or under applicable state law, unless: (i) the creditor (or the class of which the creditor is a part) makes an election to have its claim treated as fully secured under section 1111(b)(2); or

(ii) the creditor does not have recourse and the property securing its lien "is sold under section 363 of [the Bankruptcy Code] or is to be sold under the plan." Thus, absent a section 1111(b) election or a sale of collateral, an undersecured nonrecourse creditor will have a secured claim to the extent of the value of its collateral and an unsecured claim for any deficiency.

The section 1111(b) election is intended to protect a secured creditor against the possibility that the debtor can realize a windfall if collateral, not being sold by the debtor, is assigned a low value (due to depressed market conditions or valuation error) and the creditor's secured claim is stripped down to that low value.

However, section 1111(b)(1)(B) provides that the election is not available if, among other things, the creditor has recourse against the debtor and the collateral "is sold under section 363 of [the Bankruptcy Code] or is to be sold under [a chapter 11] plan." The exception for collateral that is sold is premised upon the idea that protection against low valuation is not necessary when the market determines the value of the collateral. Moreover, creditors do not need the protections of section 1111(b) if the collateral is sold because they have the right under section 363(k) to credit bid at the sale.

In *Adkins*, the Fifth Circuit considered whether a materialman's lien creditor that elected to have its claim treated as fully secured under section 1111(b)(2) was impermissibly denied the right to credit bid its claim in connection with the sale of its collateral under a nonconsensual chapter 11 plan.

ADKINS

Baker Hughes Oilfield Operations, Inc. ("Baker Hughes") and certain other oil and gas service companies filed an involuntary chapter 7 petition against Sweetwater, Texas-based drilling company R.L. Adkins Corp. ("Adkins") in the Northern District of Texas in July 2011. The case was converted to chapter 11 one month afterward. The court later appointed a chapter 11 trustee to administer Adkins' estate.

Potential purchaser Scott Oils, Inc. ("Scott") proposed a chapter 11 plan for Adkins at the end of 2012 under which Adkins, "pursuant to Bankruptcy Code Section 363," would sell its mineral properties to Scott in a private bulk sale for $3.4 million. The plan recognized that Baker Hughes had a lien on four mineral leases and one well as security for claims aggregating approximately $320,000, but that Baker Hughes' claims were secured only to the extent of $39,000 because the property was of insufficient value and other creditors had more senior liens on the collateral.

On March 4, 2013, Baker Hughes filed an election with the court under section 1111(b) to have its claims treated as fully secured. Scott filed a response on March 28 in which it stated that section 1111(b)(1)(B)(ii) precludes such an election where the collateral is sold under section 363 or is to be sold under a chapter 11 plan.

The bankruptcy court confirmed the chapter 11 plan on May 13, 2013, after several days of confirmation hearings. Baker Hughes cast a ballot rejecting the plan. However, Baker Hughes did not otherwise participate in any way in the confirmation proceedings, nor did it appeal the confirmation order.

On July 3, 2013, the bankruptcy court issued an order denying Baker Hughes' election of fully secured status under section 1111(b). In its order invalidating Baker Hughes' election because the collateral securing its claims was sold "pursuant to § 363 of the Bankruptcy Code," the court stated:

> Baker Hughes . . . construe[s] the Plan's failure to specifically reference [its] right[] to make [a] credit bid[] to somehow validate [its] § 1111(b) election[] and thus require payment of [its] allowed claim[] in full. The Court does not so construe the Plan's effect under the circumstances here. Baker Hughes . . . did make an election; [it] elected not to credit bid. [It] held such right under § 363 of the Bankruptcy Code, not under § 1111(b) of the Bankruptcy Code.

The U.S. District Court for the Northern District of Texas affirmed that ruling, and Baker Hughes appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

The Fifth Circuit affirmed the rulings below. In the majority opinion, the court rejected Baker Hughes' argument that either the section 1111(b) election should have been approved or Baker Hughes should have been given the chance to credit bid.

According to the majority, Baker Hughes "never sought a credit bid" and "[a]ny uncertainty Baker Hughes had about the meaning of the Plan, and whether it had been denied the right to credit bid, could have been easily resolved at the hearing on

confirmation or by objection or even appeal." Because the plan provided for the sale under section 363 of property securing Baker Hughes' claim, the court held that the lower courts had properly denied the section 1111(b) election.

Adkins is an unusual case, but it does not appear to represent a significant development in bankruptcy jurisprudence concerning a secured creditor's right to credit bid its claim in a sale of collateral under section 363 or a chapter 11 plan. The message borne by the ruling is a cautionary missive regarding the consequences of a creditor's failure to participate in the bankruptcy process.

In a concurring opinion, circuit judge Judith H. Jones wrote that "[t]he argument that Baker Hughes waived its § 1111(b) election by failing to pursue it at the confirmation hearing is persuasive." However, she continued, "[t]he majority unwisely steps beyond this narrow holding . . . when they appear to conclude that the bulk sale of the debtor's assets, which occurred outside a public auction and included multiple assets burdened by multiple liens, nevertheless protected a secured creditor's right to credit bid."

According to Judge Jones, merely because the plan and confirmation order "perfunctorily incant[ed]" section 363 does not mean that the creditor's right to credit bid was adequately protected. Section 1111(b), she explained, "offers no guidance as to what constitutes a sale 'under § 363' or 'under the plan.' " Judge Jones then detailed several hypothetical situations in which a debtor's assets could be sold in a single blanket sale transaction that could make it difficult for creditors with liens on discrete assets to exercise their credit bidding rights.

Judge Jones delineated three points to "assure proper development of the creditors' statutory protections": (i) the court must rule on a timely asserted section 1111(b) election prior to a plan confirmation hearing; (ii) a secured creditor should be allowed to make a section 1111(b) election if the terms of a sale are "found wanting in protection of its credit bid rights"; and (iii) "mindful that *RadLAX* as well as § 363(k) mandate the availability of credit bidding," the court should order "transparent, broadly publicized auction[s] of debtors' assets that test the market for valuations as well as secured creditors' sincerity about credit bidding."

OUTLOOK

Adkins is an unusual case, but it does not appear to represent a significant development in bankruptcy jurisprudence concerning a secured creditor's right to credit bid its claim in a sale of collateral under section 363 or a chapter 11 plan. The message borne by the ruling is a cautionary missive regarding the consequences of a creditor's failure to participate in the bankruptcy process. By neglecting to file a specific objection to (or to appeal) confirmation of a plan that provided for the sale of its collateral, the creditor in *Adkins* was deemed to have waived its right to credit bid. Presumably, Baker Hughes elected not to object on this basis because it had no intention of submitting a credit bid—had it done so, Baker Hughes would have been obligated to pay off more senior liens on the collateral in connection with credit bidding its debt.

The more interesting aspects of *Adkins* arguably lie in the concurring opinion. Judge Jones made much of the bankruptcy court's failure to issue a ruling on the validity of Baker Hughes' section 1111(b) election before confirming Adkins' chapter 11 plan. However, the court's failure to make such a straightforward ruling is somewhat surprising. Because the plan proposed for Adkins contemplated the sale of Baker Hughes' collateral, section 1111(b) expressly barred Baker Hughes from making an election.

Judge Jones criticized the majority for implying that "attaching the statutory labels to a debtor's proposed collateral sale is enough to deprive a recourse secured creditor like Baker Hughes of the § 1111(b) election." After positing various scenarios in which a secured creditor's credit bidding right might be abridged, she wrote that "§ 1111(b) itself offers no guidance as to what constitutes a sale 'under § 363' or 'under the plan.' " She concluded that "[a]ll of these [scenarios] could contradict the mutually reinforcing goals of §§ 363(k), 1111(b) and 1129(b)(2)(A) to protect secured creditors from the risk of erroneous judicial property valuations."

Although this approach might have some logical appeal as a policy matter, it is not required by the express terms of section 1111(b). The election exception set forth in the provision does not mandate that a secured creditor's right to credit bid be realistic or efficacious under the circumstances. It requires only that the collateral be sold under section 363(b) or a plan.

TRADEMARK LICENSEES BEWARE: THE HYPOTHETICAL TEST LIVES ON IN THE THIRD CIRCUIT

Christopher M. Healey and Mark G. Douglas

Trademark licensees that file for bankruptcy protection face uncertainty concerning their ability to continue using trademarks that are crucial to their businesses. Some of this stems from an unsettled issue in the courts as to whether a licensee can assume a trademark license without the licensor's consent. In *In re Trump Entertainment Resorts, Inc.*, 2015 BL 44152 (Bankr. D. Del. Feb. 20, 2015), a Delaware bankruptcy court reaffirmed that the ongoing controversy surrounding the "actual" versus "hypothetical" test for assumption of a trademark license has not abated. Applying the hypothetical test, the court granted a trademark licensor's motion for relief from the automatic stay to pursue termination of the license agreement because the license could not be assumed or assigned by the debtor under sections 365(c)(1) and 365(f)(1) of the Bankruptcy Code.

LIMITATIONS ON THE ABILITY TO ASSUME OR ASSIGN CERTAIN CONTRACTS AND LEASES IN BANKRUPTCY

Section 365(a) of the Bankruptcy Code allows a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to assume or reject most kinds of executory contracts and unexpired leases. This broad power, however, is limited with respect to certain kinds of contracts. For example, section 365(c)(1)(A) of the Bankruptcy Code provides that a trustee or DIP may not "assume or assign" an executory contract or unexpired lease if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession" and such party does not consent to assumption or assignment.

Courts have applied this provision to a wide variety of contracts. Among these are personal service contracts, including employment agreements; contracts with the United States government, which cannot be freely assigned under federal law; certain kinds of franchise agreements; and licenses of intellectual property, which generally cannot be assigned without consent under federal intellectual property law. Thus, many debtors (especially those in the technology industry) find that their rights with respect to certain executory contracts are significantly limited.

THE STATUTORY MUDDLE

Section 365(c)(1) prevents a trustee or DIP from assigning a contract without the nondebtor's consent if applicable law prevents the contract from being assigned outside bankruptcy without consent. Section 365(c)(1), however, uses the distinctive phrase "assume or assign," as opposed to "assume *and* assign," which would seem to mean that a trustee or DIP cannot even assume such a contract and agree to perform under it, even if the trustee or DIP has no intention of assigning the contract to a third party.

Some courts construe the "assume or assign" language to mean that the statutory proscription applies to a trustee or DIP who seeks either: (i) to assume and render performance under the agreement; or (ii) to assume the agreement and assign it to a third party. Under this literal interpretation, the court posits a hypothetical question: Could the debtor assign the contract to a third party under applicable nonbankruptcy law? If the answer is no, the trustee or DIP may neither assume nor assign the contract. This approach is commonly referred to as the "hypothetical test." The Third, Fourth, Ninth, and Eleventh Circuits have adopted this approach. *See In re West Elecs. Inc.*, 852 F.2d 79 (3d Cir. 1988); *Resort Computer Corp. v. Sunterra Corp (In re Sunterra Corp.)*, 361 F.3d 257 (4th Cir. 2004); *Perlman v. Catapult Entm't, Inc. (In re Catapult Entm't, Inc.)*, 165 F.3d 747 (9th Cir. 1999); *City of Jamestown, Tenn. v. James Cable Partners, L.P. (In re James Cable Partners, L.P.)*, 27 F.3d 534 (11th Cir. 1994).

Other courts, having determined that the phrase "may not assume or assign" should be read to mean "may not assume *and* assign," apply the statutory proscription only when the trustee or DIP actually intends to assign the contract to a third party. This approach is commonly referred to as the "actual test." Its adherents include the First Circuit and the vast majority of lower courts considering the issue. *See Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), *abrogated by Hardemon v. City of Boston*, 1998 WL 148382 (1st Cir. Apr. 6, 1998), *superseded by* 144 F.3d 24 (1st Cir. 1998); *Summit Inv. & Dev. Corp. v. Leroux (In re Leroux)*, 69 F.3d 608 (1st Cir. 1995); *In re Jacobsen*, 465 B.R. 102 (Bankr. N.D. Miss. 2011) (citing and listing cases). In addition, the Fifth Circuit has applied the actual test in construing section 365(e)(2)—the Bankruptcy Code's exception to the prohibition against enforcement of "*ipso facto*" clauses that act to terminate or modify a contract as a consequence of a bankruptcy filing. *See Bonneville Power Admin. v. Mirant Corp. (In re Mirant Corp.)*, 440 F.3d 238 (5th Cir. 2006).

In *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005), the court adopted a slightly different test predicated upon the legal distinctions between the debtor and the DIP, on the one hand, and the bankruptcy trustee, on the other. The court reasoned that the term "trustee" in section 365(c)(1) should not automatically be read (as it is in many other provisions "as a matter of simple logic and common sense") to be synonymous with the term "debtor-in-possession." Instead, the proscription of assumption and assignment is limited to situations where a trustee, rather than a DIP, seeks to assume an executory contract. Under the *Footstar* approach, the DIP would be permitted to assume the contract because, unlike a bankruptcy trustee, the DIP is not "an entity other than" itself; nevertheless, the DIP would be precluded from assigning a qualifying contract because assignment would force the nondebtor contracting party to accept performance from or render performance to an entity other than the debtor. In contrast, under *Footstar*, a trustee would be permitted neither to assume nor to assign such a contract.

Depending on the contracts involved, whether a bankruptcy court applies the hypothetical test or the actual test can profoundly impact a DIP's ability to stay in business. Application of the hypothetical test can prevent a DIP from continuing to exercise its rights under a nonassignable contract, such as a patent, copyright, or trademark license, which generally cannot be assigned without the licensor's consent. Without such contracts, some DIPs may be incapable of reorganizing under chapter 11. In *Trump Entertainment*, the bankruptcy court considered section 365(c)(1) in the context of a trademark licensor's motion for relief from the automatic stay to continue state court litigation in which the licensor was seeking to terminate a trademark license agreement with the debtor.

TRUMP ENTERTAINMENT

In 2010, Donald and Ivanka Trump entered into a perpetual trademark license agreement with Trump Entertainment Resorts, Inc., and its affiliates (collectively, "TER") that granted TER a royalty-free license to use the Trumps' names, likenesses, and other marks in connection with the operation of three hotel casinos located in Atlantic City. The Trumps subsequently assigned their rights under the agreement to Trump AC Casino Marks, LLC ("Trump AC").

The license agreement required Trump AC's prior written consent to any assignment by TER. On the same day that TER executed the license agreement, the Trumps, TER, and one of TER's secured lenders entered into a Consent Agreement whereby Trump AC (as the Trumps' assignee) agreed that TER's rights under the license agreement could be assigned to the lender "upon and following the enforcement" by the lender of its rights under its credit agreement with TER.

On August 5, 2014, Trump AC sued TER in state court, seeking to terminate the license agreement due to TER's alleged breach of the agreement. That action was stayed when TER filed for chapter 11 protection in the District of Delaware on September 9, 2014. TER later proposed a chapter 11 plan pursuant to which the secured lender's claims would be exchanged for equity in a reorganized entity recapitalized to continue the business of TER's one remaining operating casino, the Trump Taj Mahal Casino Resort. The plan also contemplated assumption of the trademark license agreement.

On September 24, 2014, Trump AC filed a motion for relief from the automatic stay to proceed with the state court action to terminate the license agreement.

THE BANKRUPTCY COURT'S RULING

At the outset of its analysis, the court explained that, in accordance with *Izzarelli v. Rexene Prods. Co. (In re Rexene Prods. Co.)*, 141 B.R. 574 (Bankr. D. Del. 1992), Delaware bankruptcy courts typically apply a balancing test in assessing whether "cause" to lift the stay exists under section 362(d) of the Bankruptcy Code to allow pending nonbankruptcy litigation to continue. Under this three-pronged test, the court considers:

(1) Whether continuation of the nonbankruptcy litigation will cause great prejudice to either the estate or the debtor;

(2) Whether any hardship to the nondebtor arising from continuation of the stay considerably outweighs the hardship to the debtor; and

(3) The probability that the nondebtor will prevail on the merits.

The court found that Trump AC failed to demonstrate that any significant hardship would result from maintenance of the stay. It also found that continuation of the state court litigation "would impose a substantial burden on [TER's] reorganization efforts." The court therefore concluded that Trump AC was not

entitled to relief from the automatic stay under the traditional *Rexene* analysis.

Trump Entertainment indicates that the hypothetical test is alive and well in the Third Circuit and that a trademark licensee may not be able to retain its rights under an executory license agreement, even if it has no intention of assigning the agreement. These issues create uncertainty for licensees considering a bankruptcy filing in any district in the Third Circuit.

The court noted, however, that "cause" under section 362(d)(1) "is a flexible concept and not confined solely to the *Rexene* factors." In particular, the court agreed with Trump AC's position that, in accordance with the Third Circuit's ruling in *West Electronics*, "cause" to modify the stay existed because the trademark license agreement was not assignable absent Trump AC's consent and thus could not be assumed or assigned by TER under section 365(c)(1). In *West Electronics*, the Third Circuit ruled that, where an executory contract is subject to the limitation on assumption or assignment set forth in section 365(c)(1), the nondebtor contracting party is entitled to relief from the automatic stay to seek termination of the contract.

In *Trump Entertainment*, the bankruptcy court explained that, pursuant to the binding precedent in *West Electronics*, courts in the Third Circuit are obligated to apply the hypothetical test to determine whether a contract can be assumed. Thus, the court concluded, a DIP may not assume an executory contract over the nondebtor's objection if applicable law would bar assignment to a hypothetical third party, "*even where the [DIP] has no intention of assigning the contract in question to any such third party*" (quoting *Catapult*, 165 F.3d at 750).

Nonetheless, the court cautioned that section 365(c)(1) must be read in conjunction with section 365(f)(1), which provides that:

> *Except as provided in subsections (b) and (c) of this section*, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or *in applicable law*, that prohibits or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection (emphasis added).

Thus, the general rule in section 365(f)(1) invalidating anti-assignment clauses in contracts or leases as well as overriding nonbankruptcy laws that prohibit assignment is expressly subject to any alternative rule provided in section 365(b) or 365(c). As discussed, section 365(c)(1) provides that a contract may not be assumed or assigned if assignment is prohibited by applicable nonbankruptcy law.

According to the *Trump Entertainment* court, the inconsistency between these provisions has been "persuasively reconciled" by a number of courts, including the Sixth and Ninth Circuits. In particular, in *In re Magness*, 972 F.2d 689 (6th Cir. 1992), the Sixth Circuit found that sections 365(c)(1) and 365(f)(1) do not conflict because "each subsection recognized an 'applicable law' of markedly different scope." As described by the Ninth Circuit in *Catapult*, section 365(f)(1) broadly provides that a law which "prohibits, restricts, or conditions the assignment" of an executory contract is trumped by section 365(f)(1). Section 365(c)(1), on the other hand, "states a carefully crafted exception to the broad rule—where applicable law does not merely recite a general ban on assignment, but instead more specifically 'excuses a party . . . from accepting performance from or rendering performance to an entity' different from the one with which the party originally contracted, the applicable law prevails over subsection (f)(1)." *Catapult*, 165 F.3d at 752.

Finding this reasoning persuasive, the bankruptcy court in *Trump Entertainment* concluded that, for section 365(c)(1) to apply, the applicable law must *specifically* provide that the nondebtor contract party "is excused from accepting performance from a third party under circumstances where it is clear from the statute that the identity of the contracting party is crucial to the contract" (citing *In re ANC Rental Corp.*, 277 B.R. 226, 236 (Bankr. D. Del. 2002)).

Initially, the bankruptcy court determined that the "applicable law" in this context is federal trademark law. Under trademark law, the bankruptcy court noted, "the substantial weight of authority" indicates that trademark licenses are not assignable in the absence of some kind of express authorization by the licensor, such as a clause in the license agreement itself (citing *In re XMH Corp.*, 647

F.3d 690 (7th Cir. 2011); *Miller v. Glenn Miller Prods., Inc.*, 454 F.3d 975 (9th Cir. 2006)). Even so, the bankruptcy court explained that it is not sufficient alone to recognize a general ban on assignment under applicable nonbankruptcy law—the court must determine *why* the law in question bans assignment.

Federal trademark law generally bans assignment of trademark licenses without the licensor's consent because trademarks are meant to identify a good or service of a particular, consistent quality, making the identity of licensees crucial to licensors. Although the parties to a license agreement are free to contract around this general rule, the court in *Trump Entertainment* found no indication that the Trumps (and by extension Trump AC) and TER intended to do so in the trademark license agreement.

Moreover, the court found that notwithstanding the Consent Agreement, Trump AC did not consent to assignment of the trademark because the consent provided was effective only with respect to an "isolated assignee" in the context of a state enforcement action that was unlikely to occur once the bankruptcy case was commenced. Therefore, the bankruptcy court ruled that the hypothetical test under section 365(c)(1) was satisfied and, accordingly, under *West Electronics*, that Trump AC was entitled to relief from the automatic stay.

OUTLOOK

Recent rulings from courts in the Third Circuit concerning the treatment of trademark licenses in bankruptcy are a decidedly mixed bag. On the one hand, the court in *In re Crumbs Bake Shop, Inc.*, 522 B.R. 766 (Bankr. D.N.J. 2014), held that trademark licensees are entitled to the protections of section 365(n) of the Bankruptcy Code, even though the Bankruptcy Code does not include "trademarks" in the definition of "intellectual property." Furthermore, on the basis of circuit judge Thomas L. Ambro's concurring opinion in *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), the Third Circuit may be receptive to this approach, which would be a positive development for trademark licensees. On the other hand, *Trump Entertainment* indicates that the hypothetical test is alive and well in the Third Circuit and that a trademark licensee may not be able to retain its rights under an executory license agreement, even if it has no intention of assigning the agreement. These issues create uncertainty for licensees considering a bankruptcy filing in any district in the Third Circuit.

Lawmakers had an opportunity to end this uncertainty when Congress amended the Bankruptcy Code in 2005, yet they failed to do so. The U.S. Supreme Court similarly declined the opportunity to resolve the circuit split over the "hypothetical test" versus the "actual test" in 2009, when it denied certiorari in *N.C.P. Marketing Group, Inc. v. BG Star Productions, Inc.*, 556 U.S. 1145 (2009) (concluding that the division in the courts over the interpretation of section 365(c)(1) is "an important one to resolve" but that the case in question was "not the most suitable case for our resolution of the conflict").

The final report issued on December 8, 2014, by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 recommended that the Bankruptcy Code be amended in several respects to address these issues. First, the Commission recommended that trademarks, service marks, and trade names be included in the Bankruptcy Code's definition of "intellectual property." The Commission also recommended that a trustee or DIP should be able to assume an intellectual property license notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. Finally, the Commission recommended that a trustee or DIP should be able to assign an intellectual property license to a single assignee in accordance with section 365(f), notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. However, if a trustee or DIP were seeking to assign an intellectual property license to a competitor of the nondebtor licensor, the court could deny the assignment if it were to determine that the harm to the nondebtor licensor resulting from the proposed assignment would significantly outweigh the benefit to the estate derived from the assignment.

It remains to be seen whether Congress will take action to implement these recommendations.

REVISED RUSSIAN BANKRUPTCY REGULATIONS

On March 24, 2015, the Russian government enacted new bankruptcy procedures, including amendments to rules governing insolvency cases that involve tax debts. Decree No. 265 implements reforms authorized by Order No. 1358-r of July 24, 2014. Among other things, the decree permits greater interaction between the Russian Federal Tax Service ("FTS") and other federal and municipal agencies in insolvency cases where the FTS acts as the government's representative with respect to claims for taxes, fees, and customs duties. Decree No. 265 also allows for a greater exchange of information (electronic and otherwise) between the FTS and other federal and municipal agencies.

The full text of Decree No. 265 is available in Russian at: http://government.ru/media/files/6wNvf6li18g.pdf.

NEW POLISH RESTRUCTURING LAW

On April 9, 2015, Poland's National Assembly (*Zgromadzenie Narodowe*) adopted a new Restructuring Law, with the goal of introducing an effective mechanism to restructure a debtor-company's business and prevent liquidation. The Restructuring Law, which is expected to become effective on June 1, 2015 (with certain exceptions) after it is approved by Polish president Bronisław Komorowski: (i) makes the existing Bankruptcy and Reorganization Law applicable to liquidation proceedings only; (ii) establishes new rules and procedures governing restructuring proceedings; and (iii) includes various regulations implementing the changes. The new Restructuring Law was patterned on the European and U.S. examples that have proved to be most effective (e.g., chapter 11 of the U.S. Bankruptcy Code, the English scheme of arrangement, and the French *sauvegarde* proceeding).

Under the new law, financially distressed companies that would previously have been liquidated will now have the opportunity to restructure in either an arrangement proceeding pursuant to a plan approved by creditors or a rehabilitation proceeding. The restructuring plan option is a streamlined proceeding whereby a debtor, cooperating with a plan supervisor, discloses its assets and liabilities, specifies how it will treat creditor claims, and solicits creditor approval of the plan. The court's role is limited to approving or rejecting any plan approved by creditors.

A debtor unable to obtain creditor approval of a plan may resort to a court-supervised rehabilitation proceeding. Among other things, such proceedings give the debtor, under the supervision of a court-appointed administrator, the ability to reject unfavorable contracts, reduce its workforce, and sell redundant assets.

SOVEREIGN DEBT UPDATE

The long-running dispute over the payment of Argentina's sovereign debt, on which the South American nation defaulted for the second time in July 2014, continues to be particularly active.

On April 6, 2015, Argentina appealed a March 12, 2015, order of the U.S. District Court for the Southern District of New York that blocked Citibank, N.A. ("Citibank") from processing scheduled interest payments on $2.3 billion of Argentine-law governed bonds issued as part of 2005 and 2010 debt restructurings. Argentina's appeal claims that the order improperly extended a 2012 injunction which barred Argentina from making interest payments on restructured bonds without also paying amounts owed to holdout bondholders. However, on March 20, 2015, U.S. district judge Thomas Griesa approved a stipulation between Argentina's holdout bondholders and Citibank that conditionally authorized Citibank's Argentine branch to make interest payments scheduled for March 31 and June 30 on the Argentine-law bonds. The judge also authorized Citibank to exit its custody business in Argentina.

On April 7, 2015, Argentina asked Judge Griesa to hear a group of eight class actions filed by certain holders of the country's defaulted debt separately from the lawsuits brought by hedge fund holdouts who acquired their bonds at a discount after Argentina defaulted on its debt in 2001. Argentina asked Judge Griesa to deny a request by the non-hedge fund classes to consider their cases along with dozens of what are referred to in the bond dispute as "me-too cases." Both bondholder groups are seeking the benefit of Judge Griesa's 2012 rulings blocking Argentina from paying holders of its restructured debt until it pays $1.7 billion owed to the hedge fund holdouts.

On April 7, 2015, the U.S. Court of Appeals for the Second Circuit dismissed an appeal by Argentina of Judge Griesa's October 3, 2014, order holding the South American nation in contempt for violating his 2012 injunction preventing the country from making payments on restructured bonds without making corresponding payments to holdout bondholders. A two-judge Second Circuit panel dismissed the appeal for lack of jurisdiction, writing that "[w]e conclude that a final order has not been issued by the district court . . . and the collateral order doctrine does not apply to this appeal."

Argentina's Economy Minister, Axel Kicillof, announced on April 8, 2015, that the Argentine government will seek an injunction against Citibank in local Argentine courts for its role in the March 20, 2015, agreement between Citibank and holdout bondholders to permit certain one-time payments on Argentine-law bonds, enabling Citibank to wind down its operations in Argentina without violating U.S. district judge Griesa's orders. Kicillof, however, provided few details with respect to either the nature of the charges or the court in which the government will pursue its case.

On April 20, 2015, Argentina announced that, in an effort to evade U.S. restrictions on its market access, Argentina would issue $500 million of a new series of "BONAR 2024" bonds paying an interest rate of 8.75 percent and maturing in nine years. On April 22, 2015, Judge Griesa ruled that the holdout bondholders suing Argentina are entitled to disclosure of the details of the BONAR 2024 bond offering. Judge Griesa held that the hedge fund holdouts can seek documents from Argentina and banks subscribing to the offering, including Deutsche Bank AG and Banco Bilbao Vizcaya Argentaria, S.A., related to the April 21, 2015, $1.4 billion bond sale to determine whether any assets exist in the United States which could satisfy billions of dollars in unpaid judgments against Argentina.

BUSINESS RESTRUCTURING REVIEW

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

Executive Editor: Charles M. Oellermann
Managing Editor: Mark G. Douglas

If you would like to receive a complimentary subscription to *Business Restructuring Review*, send your name and address to:

Jones Day
222 East 41st Street
New York, New York 10017-6702
Attn.: Mark G. Douglas, Esq.

Alternatively, you may call (212) 326-3847 or contact us by email at mgdouglas@jonesday.com.

Business Restructuring Review provides general information that should not be viewed or utilized as legal advice to be applied to fact-specific situations.

JONES DAY HAS OFFICES IN:

ALKHOBAR
AMSTERDAM
ATLANTA
BEIJING
BOSTON
BRUSSELS
CHICAGO
CLEVELAND
COLUMBUS
DALLAS
DUBAI
DÜSSELDORF
FRANKFURT
HONG KONG
HOUSTON
INDIA
IRVINE
JEDDAH
LONDON
LOS ANGELES
MADRID
MEXICO CITY
MIAMI
MILAN
MOSCOW
MUNICH
NEW YORK
PARIS
PERTH
PITTSBURGH
RIYADH
SAN DIEGO
SAN FRANCISCO
SÃO PAULO
SHANGHAI
SILICON VALLEY
SINGAPORE
SYDNEY
TAIPEI
TOKYO
WASHINGTON

© Jones Day 2015. All rights reserved.