

# BANKRUPTCY BULLETIN

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## Section 365(c)(1) Does Not Prohibit Debtor In Possession From Assuming Contract That Is Not Being Assigned

Jessica L. Fink

The question of whether section 365(c)(1) of the Bankruptcy Code prohibits a debtor in possession from assuming, but not assigning, a non-assignable contract continues to confront the courts. In *In re Footstar, Inc.*, the United States Bankruptcy Court for the Southern District of New York held that while the Bankruptcy Code limits a trustee's ability in bankruptcy to assume or assign executory contracts that are not assignable under applicable law, section 365(c)(1) does not as a matter of law bar a debtor or debtor in possession from assuming such a contract.

### Section 365(c)(1) of the Bankruptcy Code

As a general rule, section 365 of the Bankruptcy Code gives a trustee or debtor in possession authority to assume or to assume and then assign the debtor's executory contracts. While the Bankruptcy Code does not define "executory contract," one widely accepted definition is a contract under which the obligations of both the debtor and the other party to the contract are so far unperformed that the failure of either party to complete performance would constitute a material breach excusing the performance of the other. Generally, under section 365(f)(1), a contract that by its terms or under applicable law is not assignable nonetheless may be assigned to another party with one major exception: under section 365(c)(1), a "trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, 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, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and such party does not consent to such assumption or assignment." This provision is typically implicated in cases where the identity of the performing party is critical to the underlying contract, such as personal service contracts.

Section 365(c)(1) prohibits a trustee from assuming or assigning a non-assignable contract. There is a split in authority as to whether a debtor (as opposed to the trustee) may assume, but not assign, a non-assignable contract. The crux of the dispute is an issue of statutory interpretation — whether the prohibition on assumption or assignment applies to the debtor in possession.

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Some courts, including the United States Court of Appeals for the First Circuit and a majority of lower courts, have concluded that section 365(c)(1) of the Bankruptcy Code permits assumption where the debtor in possession in fact does not intend to assign the contract. In so holding, these courts apply the so-called “actual test,” which considers the facts of the case to determine whether the nondebtor party would actually be forced to accept performance from someone other than the party with whom it originally contracted and whether the debtor intends to continue its performance under the contract and not assign it to a third party. Under this approach, the court does not prohibit the debtor from assuming an executory contract if the debtor intends to continue its perfor-

mance under the contract and not assign it to a third party. Application of this test upholds the general goal of the Bankruptcy Code of promoting rehabilitation, and avoids the absurd result of penalizing debtors just because they file for bankruptcy.

Other courts, including the United States Court of Appeals for the Third, Fourth, Ninth and Eleventh Circuit have rejected the “actual test” and applied the so-called “hypothetical test” to preclude a debtor in possession from assuming a non-assignable contract. These courts purport to rely on a literal interpretation of the statute’s “plain language” to prohibit assumption or assignment and do not consider whether a non-assignable contract will actually be assigned or whether Congress intended the limita-

tion to apply to a debtor in possession. Instead, courts that have adopted the “hypothetical” test hold that the statute precludes the debtor’s *assumption or assignment* of an executory contract without the nondebtor’s consent if applicable law would preclude *assignment* to a third party — whether or not the debtor actually intends to assign the contract. This approach bars a debtor from *assuming* a non-assignable contract even if it has no intention of *assigning* the contract to a third party.

## Factual Background

The debtors, a footwear company that operated through two business segments, filed 2,529 chapter 11 cases in early March 2004 that were procedurally consolidated. The company sold the athletic footwear and apparel business during the chapter 11 case. The debtors’ remaining business segment is discount and family footwear. Approximately 95% or more of the debtors’ revenues of this business segment are generated from sales of family footwear in stores operated by Kmart Corporation (“Kmart”).

In connection with this business, the debtors are parties to certain agreements, including a Master Agreement and individual Sub-Agreements with Kmart pursuant to which the debtors operate footwear departments in particular Kmart stores. The debtors moved to assume the agreements and Kmart objected on the grounds, among others, that section 365(c)(1) precluded their assumption by the debtors. The debtors argued that assumption of the agreements is critical to the debtors’ ability to reorganize and would allow the debtors to confirm a plan providing for a 100% recovery to unsecured creditors with

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equity unaltered. The debtors also argued that the master agreements were not personal agreements under section 365(c)(1). The court reserved decision on that issue.

## The Bankruptcy Court's Decision

The *Footstar* court agreed with the outcome of courts following the actual test, but used a different analysis. The *Footstar* court held that section 365(c)(1), by its plain language, only applies to prohibit trustees, and not debtors in possession, from assuming or assigning non-assignable contracts. The court found “[t]he key word is ‘trustee’ and held that ‘[t]o construe ‘trustee’ in Section 365(c)(1) to mean ‘debtors’ or ‘debtors in possession’ would defy the ‘plain meaning’ of the statute as written by Congress.” Therefore, because a trustee had not been appointed in *Footstar*, section 365(c)(1) did not preclude assumption of the agreements. In so concluding, the court reasoned that by reading the statute in this manner, effect can be given to the plain meaning of the statute while also reaching a conclusion that is harmonious with the objective of section 365(c)(1) and the overall objectives of the Bankruptcy Code. In effect, the *Footstar* court adopted the outcome reached by the courts that have adopted the “actual test.”

In rationalizing its holding, the court in *Footstar* found that the Bankruptcy Code does not define “trustee” as synonymous with “debtor” or “debtor in possession” and that the two terms are often invested with different meanings. Under the Bankruptcy Code, the debtor remains in possession unless a trustee is appointed by an order of the bankruptcy court under section 1104. If

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## Speculative Right to Payment Under Critical Vendor Order Is Invalid Defense Against Preference Liability

Robert J. Lemons

In *Zenith Industrial Corp. v. Longwood Elastomers, Inc. (In re Zenith Industrial Corp.)*, the United States Bankruptcy Court for the District of Delaware held that a debtor's vendor could not defend an action by the debtor to avoid pursuant to section 547 of the Bankruptcy Code payments made prepetition by the debtor to the vendor on the basis that the vendor would have been a “critical vendor” under an order authorizing the debtor to make certain payments of prepetition claims to its critical vendors had the vendor not been paid prepetition within the preference period.

### Section 547 of the Bankruptcy Code

Section 547 of the Bankruptcy Code allows a debtor in possession to avoid (and then recover “for the benefit of the estate” pursuant to section 550 of the Bankruptcy Code) “preferences,” which are defined as transfers of property, including payments, made to or for the benefit of a creditor on account of an antecedent debt while the debtor was insolvent in the 90 days prior to the commencement of the debtor's chapter 11 case (one year for insiders) and that allow the creditor to recover more than it would in a hypothetical chapter 7 liquidation of the debtor.

### Background

On March 12, 2002, Zenith Industrial Corporation (“Zenith”), a supplier

of materials used by automotive equipment manufacturers, filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code.

Two days after the commencement of Zenith's chapter 11 case, the bankruptcy court entered an order authorizing, but not requiring Zenith, in its discretion and using its business judgment, to make payments of prepetition claims up to an aggregate amount of \$1,000,000 to certain unidentified essential vendors of goods and services to Zenith.

On March 10, 2004, Zenith commenced an action against Longwood Elastomers, Inc. (“Longwood”), a supplier of goods used in the production of Zenith's products, seeking to avoid, as preferential payments pursuant to section 547 of the Bankruptcy Code, prepetition payments made by Zenith to Longwood in the amount \$1,317,587. Longwood asserted a number of defenses, including that a payment of \$506,035 made by Zenith to Longwood on the eve of Zenith's chapter 11 case was not a preferential payment because Longwood was a critical vendor and such payment was protected by the bankruptcy court's order authorizing critical vendor payments. Zenith moved to strike this defense (a procedure used to object to a legally insufficient defense).

## The Bankruptcy Court's Decision

Faced with Longwood's "critical vendor" defense, the bankruptcy court considered the effect of the critical vendor payment order on prepetition payments made to an allegedly critical vendor. Longwood argued that if it had not received the allegedly preferential prepetition payment, it would have been a critical vendor and the prepetition payment would have been made to Longwood postpetition under the auspices of the critical vendor payment order. Under Longwood's theory, Longwood would not receive more than it would receive in a hypothetical chapter 7 case of Zenith, and, therefore, the prepetition payment did not meet all of the criteria for a preferential payment.

Longwood cited two primary cases to support its argument. In the first case, *Kimmelman v. Port Authority of New York & New Jersey (In re Kiwi International Air Lines, Inc.)*, prepetition payments to landlords of a debtor were held not to be preferential transfers because the debtor assigned the leases as part of an asset sale, thus triggering a requirement under section 365 of the Bankruptcy Code that the debtor pay all amounts due under the leases upon assignment. Accordingly, the court held that payments were "not recoverable as preferences because, had the creditors not received the payments pre-petition, they would have received amounts reflecting those sums, in any event, when the Bankruptcy Court approved the cures of the assumed agreements." In the second case, *Official Committee of Unsecured Creditors v. Medical Mutual of Ohio (In re Primary Health Systems, Inc.)*, payments to an administrator of the debtor's employee benefits plan were

held not to be preferential transfers because the court had entered an order generally approving the payment of prepetition claims for wages and benefits. In this instance, the payments could not be avoided as preferences because they were made pursuant to and after entry of an order of the court.

"[T]he court noted that the critical vendor order at issue in Longwood did not identify the beneficiaries of the order and Longwood could not be a beneficiary of the order since it had been paid prepetition."

The bankruptcy court in *Zenith*, however, distinguished both the *Kiwi* and *Primary Health Systems* cases from the facts in *Longwood*. First, the bankruptcy court noted that *Kiwi* was inapposite because payments to Zenith's critical vendors were discretionary, whereas the cure payments made by the debtor in *Kiwi* to its landlords were mandatory upon assignment of their leases. Moreover, the court noted that the critical vendor order at issue in *Longwood* did not identify the beneficiaries of the order and Longwood could not be a beneficiary of the order since it had been paid prepetition.

The bankruptcy court also distinguished *Primary Health Systems* and concluded it "to be inapplicable to

whether a preference action is barred by the entry of a critical vendor order that may implicate the preference action defendant." Moreover, the court noted how the bankruptcy judge from the *Primary Health Systems* case subsequently acknowledged that the entry of a critical vendor order does not foreclose preference liability. Unlike the order in *Primary Health Systems* which authorized payment of a claim that would have been afforded priority under section 507 of the Bankruptcy Code if it had not been paid pursuant to such order, Longwood's prepetition payment would only have resulted in a general unsecured claim if it had not been paid. Accordingly, the recipient of the prepetition payment in *Primary Health Systems*, as a priority claimant, would have been paid ahead of general unsecured creditors in a chapter 7 liquidation of the debtor and did not involve a situation where one unsecured creditor was being preferred over another.

The bankruptcy court next noted that approval of a critical vendor payment motion is discretionary and based on the specific facts of each case. The court concluded that even if Longwood could prove that Zenith considered Longwood's goods and services critical to its survival, and that Zenith intended to pay Longwood under the critical vendor order absent the \$506,035 prepetition payment, Longwood could not prove that the bankruptcy court would have approved the critical vendor motion. The bankruptcy court found it speculative that no party in interest would object, including the debtor's secured lender or the United States Trustee, to a motion based on very different facts from the one approved by

the court. If the payment to Longwood was added to the critical vendor motion, it would have resulted in a 50% increase to the maximum amount of payments authorized by the critical vendor payment order. The court concluded that the United States Trustee, Zenith's prepetition secured lenders or the bankruptcy court itself might have objected to a critical vendor order seeking authorization to make payments of up to approximately \$1.5 million, especially with a payment of \$506,035 to one creditor.

Ultimately, the bankruptcy court granted Zenith's motion to strike Longwood's critical vendor defense because the court found the defense legally insufficient to prevent recovery of the preference.

## Conclusion

The decision in *Zenith* stands for the proposition that at least in the District of Delaware, a creditor who received a prepetition payment immediately prior to a debtor's commencement of a chapter 11 case, who might otherwise have been paid postpetition pursuant to a critical vendor order, may be required pursuant to a preference action to turn over to the debtor's estate the payment it received prepetition. Whether the critical vendor defense remains a viable defense in other jurisdictions remains to be seen.

*Zenith Indus. Corp. v. Longwood Elastomers, Inc.* (In re *Zenith Indus. Corp.*), 319 B.R. 810 (Bankr. D. Del. 2005).

*Kimmelman v. Port Auth. of N.Y. & N.J.* (In re *Kiwi Int'l Air Lines, Inc.*), 344 F.3d 311 (3d Cir. 2003).

*Official Comm. of Unsecured Creditors v. Med. Mut. of Ohio* (In re *Primary Health Sys., Inc.*), 275 B.R. 709 (Bankr. D. Del. 2002).

## Seventh Circuit Rules That Punitive Damages Claims Allowed in Bankruptcy But May Be Equitably Subordinated

Andrew Kamensky

The United States Court of Appeals for the Seventh Circuit, in *In re A.G. Financial Service Center, Inc.*, recently examined a creditor's ability to pursue a prepetition claim for punitive damages against a chapter 11 debtor. The Seventh Circuit held that there is no federal law prohibiting creditors from seeking allowance of a punitive damages claim in a chapter 11 bankruptcy case. The Seventh Circuit ruled that creditors are entitled to pursue punitive damages against a debtor if state law allows punitive awards against insolvent parties. The Seventh Circuit concluded, however, that although a bankruptcy court cannot categorically disallow a claim for punitive damages if such a claim is available under state law, a bankruptcy judge may exercise discretion and equitably subordinate any punitive damages award to other allowed claims against the debtor's estate.

### Punitive Damages Claims in Chapter 11 Cases

Many courts have struggled with how to deal with punitive damages claims in chapter 11 bankruptcies. The Bankruptcy Code does not address whether punitive damages claims shall be disallowed in chapter 11 cases. Because the amount of punitive damages claims in a chapter 11 case often constitutes a significant portion of the total claims against a debtor, numerous bankruptcy courts

have disallowed these claims in chapter 11 cases. These bankruptcy courts have used their broad equitable powers to disallow punitive damages claims, reasoning that (i) punitive damages claims frustrate a debtor's ability to reorganize, (ii) punitive damages claims punish innocent creditors for the debtor's wrongdoing by reducing their recovery, and (iii) the punitive and deterrent purposes of punitive damages are not served in bankruptcy. Other bankruptcy courts have concluded that the disallowance of punitive damages claims in chapter 11 cases is no longer a viable means of handling punitive damages claims in chapter 11 cases, reasoning that (i) disallowance of punitive damages claims can unfairly deprive some creditors of their right to receive payment for compensatory claims against the debtor, (ii) disallowance can be inequitable, and (iii) a punitive damages claim that would have been paid under chapter 7 as a fourth priority claim cannot be disallowed in chapter 11. Prior to the *A.G. Financial Service Center* decision, only one court of appeals addressed this issue. The United States Court of Appeals for the Eleventh Circuit held that punitive damages claims are not available in bankruptcy.

### Factual Background

A.G. Financial Service Center Inc. ("A.G.") issued private-label credit cards to over 280,000 borrowers,

which consumers used to purchase goods and services from single merchants. Some of A.G.'s merchants were distributors of satellite television systems. Many borrowers complained that they had been misled about the terms of credit or the costs of satellite television. A.G. experienced high delinquency rates and approximately 500 cardholders sued the company.

One lawsuit in Mississippi against A.G. resulted in a \$167 million judgment, almost all of it comprised of punitive damages. A.G. responded by filing a petition for chapter 11 relief. Other than \$2 million in cash, A.G.'s principal asset was a tort claim against its corporate parent based on the legal theory that the parent had induced A.G. to mislead the consumer cardholders.

To settle A.G.'s claim, the non-debtor parent company offered a global settlement to satisfy all of A.G.'s debts in full except for punitive damages awards. Almost all of A.G.'s actual and contingent creditors agreed to accept specified sums from the parent. To the non-settling creditors, A.G. offered a choice between \$5,500 cash (less any unpaid balance on the account) and an opportunity to prove actual damages in court. Wanting to maintain the ability to pursue punitive damages, eight cardholders objected to these options, three of which filed claims in the chapter 11 case.

A.G. filed a plan of reorganization with the bankruptcy court. The plan of reorganization provided for payment in full for all claims other than punitive damages claims. The plan categorically disallowed all punitive damages claims. The plan also included a release of the parent in exchange for the cash settlement with A.G. and an injunction forbidding A.G.'s creditors from suing the parent.

The bankruptcy court confirmed A.G.'s plan of reorganization over the objection of five creditors who argued that the rejection of all punitive damages claims and the injunction against the debtor's parent were unwarranted. The

**“[T]he Seventh Circuit ruled that if state law deems punitive damages unavailable against an insolvent defendant, bankruptcy courts should enforce the prohibition if the defendant files for bankruptcy.”**

district court upheld the plan on appeal, ruling that punitive damages are unavailable in bankruptcy proceedings. The objecting cardholders then appealed to the United States Court of Appeals for the Seventh Circuit, arguing that the plan provisions categorically denying punitive damages claims were impermissible and asked the court to reverse and direct the bankruptcy court to allow them jury trials to collect punitive damages.

## The Seventh Circuit's Decision

The Seventh Circuit considered the issue of whether the cardholders were entitled to pursue punitive damages. The Seventh Circuit observed that both the bankruptcy court and the district court summarily concluded that punitive damages are unavailable in bankruptcy proceedings because their award would be unfair to other creditors. The Seventh

Circuit noted that neither court attempted to identify any Bankruptcy Code provision supporting categorical disallowance of punitive damages claims. The court stated that “[b]ankruptcy law enforces non-bankruptcy entitlements, unless they are modified according to the Code.” Accordingly, the Seventh Circuit reasoned that the lower courts lacked authority to alter state law, or depart from the Bankruptcy Code, to implement their own views of wise policy.

In considering whether punitive damages are available in bankruptcy, the Seventh Circuit noted one appellate decision from the Eleventh Circuit which upheld a bankruptcy court decision striking a creditor's claim for punitive damages. In *Novak v. Callahan (In re GAC Corp.)*, the Eleventh Circuit held that the purposes of punitive damages, to punish and deter the tortfeasor, are not served in bankruptcy. In a single paragraph, the Eleventh Circuit ruled that allowance of punitive damages claims in bankruptcy is inequitable because innocent creditors would be forced to pay for the debtor's wrongdoing. The Eleventh Circuit concluded that future wrongful conduct will not be deterred when the punitive damages are paid from the wrongdoer's estate rather than from his own pocket.

The Seventh Circuit also looked to *United States v. Noland*, a United States Supreme Court decision, to determine whether punitive damages are available in bankruptcy. In *Noland*, the Supreme Court held a bankruptcy court may not use its equitable power to subordinate tax penalty claims on a categorical basis in derogation of Congress's scheme of priorities. Moreover, the Supreme Court strongly implied that case-by-case administration of the Bankruptcy Code's

authority for equitable subordination of claims is the proper way to deal with all punitive financial claims.

Relying on *Noland*, the Seventh Circuit ruled that if state law deems punitive damages unavailable against an insolvent defendant, bankruptcy courts should enforce the prohibition if the defendant files for bankruptcy. The Seventh Circuit concluded, however, if punitive damages claims against insolvent parties are allowed under state law, there is no federal law prohibiting punitive damages against a debtor “though whether a punitive award should be subordinated to other claims is open to independent consideration under the terms of the Bankruptcy Code.” Nevertheless, the Seventh Circuit affirmed confirmation of A.G.’s plan of reorganization in part because the district court judge made it clear that any punitive awards would be equitably subordinated to all other claims. Moreover, the Seventh Circuit observed that appellants adduced no facts or circumstances that supported a right to punitive damages. Indeed, appellants failed to allege any facts concerning A.G.’s purported misconduct and failed to identify the governing state law. The Seventh Circuit concluded that any claim against A.G.’s parent company was settled and released and there was no claim for the creditors to pursue individually.

## Conclusion

The court’s holding in *A.G. Financial Service Center* is significant because the Seventh Circuit, unlike the Eleventh Circuit, is the first court of appeals to conclude that there is no federal bar against punitive damages claims in chapter 11 cases. Although debtors in the Seventh Circuit may no longer categori-

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## Success Fee of Creditors Committee’s Financial Advisor Must Be Paid from Recovery of Committee’s Constituents

*Nila Williams*

In *Official Committee of Unsecured Creditors v. Farmland Industries, Inc.* (*In re Farmland Industries, Inc.*), the United States Court of Appeals for the Eighth Circuit held that where there are two statutory committees representing competing classes of creditors, the success fee paid to the unsecured creditors committee’s financial advisor must be paid out of the amount recovered by the committee’s members.

### The Retention and Payment of Professionals by Statutory Committees

Section 328(a) of the Bankruptcy Code permits a creditors committee appointed pursuant to section 1102 of the Bankruptcy Code to employ a professional person “on any reasonable terms and conditions of employment,” provided that the committee obtains court approval to do so. Section 330 of the Bankruptcy Code governs the compensation of retained professionals and pursuant to section 330(a)(4)(A)(ii), a court may not allow compensation of a professional retained pursuant to section 328 if the services provided were not “reasonably likely to benefit the debtor’s estate” or “necessary to the administration of the case.” Compensation awarded pursuant to section 330 qualifies as an allowed administrative expense under section 503(b)(2) of the Bankruptcy Code.

### Factual Background

Farmland Industries and its affiliated debtors filed for chapter 11 relief. The United States Trustee in the chapter 11 cases appointed two creditors committees to represent the two large groups of unsecured creditors with competing claims — the Official Committee of Unsecured Creditors to represent trade creditors (the “Unsecured Creditors Committee”) and the Official Committee of Bondholders to represent bondholders (the “Bondholders Committee”). Each committee retained a separate financial advisor — the Bondholders Committee retained Ernst & Young Corporate Finance (“Ernst & Young”) and the Unsecured Creditors Committee retained Houlihan Lokey Howard & Zukin Financial Advisors (“Houlihan Lokey”). Both committees agreed to pay their respective financial advisor a flat monthly fee plus a “success fee” based on the recovery received by the members of their respective committee. The agreement between the Bondholders Committee and Ernst & Young provided that any success fee to be paid to Ernst and Young was to be paid from the bondholders’ recovery. The agreement between the Unsecured Creditors Committee and Houlihan Lokey, however, provided that Houlihan Lokey’s transaction or success fee would be a general administrative expense to be paid by all creditors out of the general funds of the debtors’ estates.

Upon objections by both the debtors and the Bondholders Committee, the bankruptcy court approved the retention of Houlihan Lokey, but found that because “Houlihan Lokey was engaged to work specifically for the benefit of the trade creditors,” any success fee should be paid out of the trade creditors’ recovery, rather than out of the general funds of the debtors’ estates.

On appeal by the Unsecured Creditors Committee, the bankruptcy appellate panel found that the bankruptcy court did not abuse its discretion in finding that Houlihan Lokey’s success fee should be paid out of the trade creditors’ recovery and affirmed the bankruptcy court’s decision on the grounds that (i) Houlihan Lokey was working for the benefit of the trade creditors, (ii) Houlihan Lokey’s success fee was negotiated by the Unsecured Creditors Committee, and (iii) the bondholders should not have to pay additional contingent fees beyond the success fee to be paid to their financial advisor, Ernst & Young. The Unsecured Creditors Committee appealed the decision arguing that the bankruptcy court’s decision was based on clearly erroneous findings of fact.

## The Eighth Circuit’s Decision

The Unsecured Creditors Committee argued that “the bankruptcy court’s order was based on clearly erroneous findings of fact because there was insufficient evidence that (a) Houlihan Lokey was working solely for the benefit of the trade creditors, and (b) the fee agreement between the Bondholders Committee and Ernst & Young ‘is fairer and more equitable to all creditors.’” The Eighth Circuit concluded these arguments were meritless.

The Unsecured Creditors Committee also argued that because sections 330 and 503 of the Bankruptcy Code require that Houlihan Lokey’s services benefit the estates, all payments for those services should come from the estates’ general funds. The committee further argued that not paying Houlihan Lokey’s transaction

**“[I]n a case where there is a single committee that retains a single financial advisor, the corresponding administrative expense claims are typically paid out of the debtor’s general funds.”**

fee from the estates’ general funds would violate the priority granted to administrative expenses under the Bankruptcy Code. The Eighth Circuit disagreed, finding that neither section 330 nor section 503 identifies the specific source from which professionals must be paid. The court noted that, in a case where there is a single committee that retains a single financial advisor, the corresponding administrative expense claims are typically paid out of the debtor’s general funds. However, such practice merely represents “a sensible way to proceed,” rather than a statutory mandate. Where, as in the instant case, there are multiple committees that have retained separate advisors, the Eighth Circuit concluded that section 330(a)(4)(A)(ii) does not prohibit “the court from providing at the outset that the contingent portion of each advisor’s fees will be paid out of the creditors’ recovery that was enhanced by that advi-

sor’s services.” The court further held that proceeding in this manner is consistent with the authority granted to the court in section 328(a) to approve the employment of a professional on “any reasonable terms and conditions of employment” and clearly within the court’s discretion.

Finally, the Eighth Circuit found that the priority requirements of section 507 of the Bankruptcy Code were satisfied. The court noted that Houlihan Lokey would only be entitled to a transaction fee if the debtors have sufficient funds to pay the claims of trade creditors in full. According to the court, the priority requirements of section 507 provide that “administrative claims must be paid in their entirety before lower priority claims may be paid. [Section 507] does not mean that the amounts to be paid to lower priority claimants may not be *calculated* before the administrative expense claims are *paid*.”

## Conclusion

The *Farmland Industries* court established that, at least in the Eighth Circuit, where there are competing classes of unsecured creditors, the success fee charged by a financial advisor should be paid out of the recovery obtained by the creditors who benefited from the services of that financial advisor, rather than out of the general funds of the debtor’s estate. It remains to be seen whether, when confronted with a similar situation, other courts will adopt the same approach.

*Official Comm. of Unsecured Creditors v. Farmland Indus., Inc. (In re Farmland Indus., Inc.)*, 397 F.3d 647 (8th Cir. 2005).

## Punitive Damages Claims May Be Equitably Subordinated

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cally disallow punitive damages claims in a chapter 11 plan, bankruptcy courts may still have the ability and discretion to

equitably subordinate such claims to foster a successful restructuring. It remains to be seen whether other courts of appeal will reach the same conclusion as the Seventh Circuit or follow the Eleventh Circuit in concluding that punitive damages are unavailable in bankruptcy.

*In re A.G. Fin. Serv. Ctr., Inc.*, 395 F.3d 410 (7th Cir. 2005).

*United States v. Noland*, 517 U.S. 535 (1996).

*Novak v. Callahan (In re GAC Corp.)*, 681 F.2d 1295 (11th Cir. 1982).

## 365(c)(1) Does Not Prohibit Assumption

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a trustee is appointed, a statutory transfer is effected that transfers or assigns the debtor's property, including its contractual relationships, from the debtor to the trustee. The court noted that section 1107(a) grants to the debtor in possession "all the rights . . . and powers . . . of a trustee," "[s]ubject to any limitations of a trustee . . . ." As further noted by the court, many decisions have held that, consistent with section 1107(a), various statutory limitations of the powers of a chapter 11 trustee apply equally to debtors in possession. In these instances, the court concluded there is no basis to distinguish between a trustee and debtor in possession.

In distinguishing 365(c)(1), the *Footstar* court found that unlike in other statutory provisions, the limitation under section 365(c)(1) is different. The limitation under section 365(c)(1) is to uphold the right under applicable law of a contract counterparty to refuse acceptance from or to render performance to an entity other than the entity with whom they have contracted. A chapter 11 trustee is a different entity than the original counterparty, while the debtor in pos-

session is not. Further, the *Footstar* court found that if "debtor in possession" were merely substituted for "trustee" in section 365(c)(1), the statute would not make sense, as it would read, in pertinent part, "the *debtor in possession* may not assume . . . any contract if . . . applicable law excuses [the counterparty] . . . from accepting performance from or rendering performance to an entity *other than the debtor in possession* . . . ."

The court further concluded that the limitation in section 365(c)(1) — to protect a counterparty to a contract from being forced to accept performance from an entity other than the debtor — is not implicated when the debtor seeks to assume, but not assign, the contract. According to the *Footstar* court, this interpretation of section 365(c)(1) gives effect to all of the words in the statute, while avoiding the consequence of the "hypothetical test" under which a debtor may lose the benefit of a contract solely because it sought bankruptcy relief.

Finally, the court reviewed the legislative history of section 365(c)(1) in support of its conclusion that section 365(c)(1) was not meant to prohibit a debtor in possession from assuming a contract to which it would have had the benefit of had it not filed for protection under chapter 11. Under the court's interpretation of section 365(c)(1) of the

Bankruptcy Code, "a debtor in possession *can* assume because by the limitation's express terms it can have no consequence or effect as to a debtor in possession, which is *not* 'an entity other than' itself."

## Conclusion

The court's conclusion in *Footstar*, that a debtor is not barred from assuming a contract under section 365(c)(1), even if such contract is not assignable, is consistent with the conclusion reached by a majority of the courts under the actual test. However, the court avoided the pitfalls in the analysis employed by other courts that have reached the same conclusion, *i.e.*, that the "or" in 365(c)(1) does not really mean "or." It remains to be seen whether other courts, particularly circuit courts, will adopt the view of the court in *Footstar*, with respect to section 365(c)(1) in particular and in general, with respect to the rights of debtors and trustees.

Kmart has filed a motion for reargument on the bankruptcy court's decision. We will keep you advised of any further developments.

*In re Footstar, Inc.*, Case No. 04-22350 (ASH) (Bankr. S.D.N.Y. Feb. 16, 2005).

Weil, Gotshal & Manges LLP represents the debtors in this chapter 11 case.

## Legislative Update

### Senate Passes Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

On February 28, 2005, the United States Senate began consideration of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. The Senate passed the bill on March 10, 2005 and it is expected that the United States House of Representatives will introduce the Senate's bill. Once introduced, a House Judiciary Committee Report will be written on the bill and a report is expected to be filed on or around April 4, 2005. Assuming the House of Representatives acts quickly and passes the bill, President Bush will then have 10 days to sign into law the bill that is presented to him. It is possible that President Bush will sign the bill by the end of April 2005. Once signed, the bill will take effect 180 days after enactment. The amendments to the Bankruptcy Code made by the bill shall not apply to cases already commenced under the Bankruptcy Code before the effective date of the bill, except as otherwise provided in the bill.

While the bill is widely known for its "means test" on debtors which limits an individual debtor's access to chapter 7 of the Bankruptcy Code if the individual has sufficient income to repay a portion of his debts, there are many important provisions relevant to business bankruptcies.

First, as reported in last month's issue of the *Bankruptcy Bulletin*, Republican Senator John Cornyn (R-Tex.) planned to offer an amendment that would change the current venue rules

in bankruptcy. Senator Cornyn has now announced that he no longer plans to offer the venue amendment at this time. Under Senator Cornyn's proposed amendment, corporate debtors would have been required to file their bankruptcy cases where their principal place of business or principal assets are located. Corporate debtors would no longer be able to use their state of incorporation as a basis for filing their cases in jurisdictions other than where their principal place of business or principal assets are located. In addition, corporate debtors would be unable to forum shop for a venue in a favorable jurisdiction by first filing a subsidiary to create a venue for the parent company.

While the venue amendment is no longer an issue, provisions relating to exclusivity and unexpired leases will amend the current provisions of the Bankruptcy Code on these issues. Under the Senate bill, the right of a debtor in possession to obtain an extension of the exclusive period for filing and obtaining acceptance of a plan is limited to 18 and 20 months, respectively. Under current law, there is no limit to the extensions of exclusivity that the court, in its discretion, may grant for cause. In addition, under the Senate bill, an unexpired lease of nonresidential real property shall be deemed rejected if it is not assumed or rejected by the earlier of 120 days after the order for relief or the date an order confirming a plan is entered. Moreover, the court may extend this 120-day period for 90 days upon motion of the trustee or lessor for cause. If, however, a court grants the 90-day extension, a court may only grant a subsequent exten-

sion upon the prior written consent of each lessor. Under current law, a court, for cause, may grant a debtor unlimited extensions of time to assume or reject an unexpired lease of nonresidential real property.

One additional amendment of particular interest, proposed by Democratic Senator Edward Kennedy (D-Mass.), relating to limitations on retention bonuses and severance payments to employees of debtors in chapter 11 cases, has been approved by the Senate Judiciary Committee and is now part of the legislation passed by the Senate. Under Senator Kennedy's amendment, a bankruptcy court would only be able to allow a retention bonus if the employee "has a bona fide job offer from another business at the same or greater rate of compensation" and the employee provides services that "are essential to the survival of the business." The amendment places further limitations on the amount a debtor could pay in such bonuses. With respect to severance payments, the amendment would prohibit the allowance of a severance payment unless "the payment is part of a program that is generally applicable to all full-time employees." As with the retention bonuses, the amendment seeks to limit the amount of any severance payments.

We will keep you advised of all further developments on this legislation and expect to provide a more detailed summary of the key provisions of the bill once signed by President Bush.

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Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, 109th Cong. (2005).