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Letter from the **Editor**

Dear Reader,

Our *Third Quarter Review* covers the latest and greatest developments in the restructuring world in the past quarter and follows hot on the heels of the *Inaugural Review* published in September to coincide with the fourth anniversary of the founding of the **Weil Bankruptcy Blog**.

And what a fascinating few months it's been: Judge Drain delivered a highly publicized bench ruling on the confirmation of Momentive Performance Materials' plan of reorganization on August 26, giving us a whole host of interesting issues to analyze on the treatment of senior secured debt. If you haven't read it already, please enjoy our in-depth series in the **Momentous Decision in *Momentive Performance Materials*** section of this *Third Quarter Review*, where we discuss Judge Drain's rulings on, among other things, cramdown, make - wholes, and contractual subordination.

We've also continued our market leading coverage of *Stern* and its progeny in our ***Stern* Files**. As we await the Supreme Court's decision in *Wellness Int'l Network v. Sharif*, the circuit courts have been providing convenient summaries of their split, and we've duly blogged about them on the Weil Bankruptcy Blog.

Valuation issues have made a strong comeback recently. Our ever-expanding **Slice of the Pie** section contains an interesting two-part series on the valuation questions coming out of *In re Genco Shipping & Trading Limited*, which should be particularly relevant to those of you involved in shipping restructuring cases, or simply those looking forward to their annual serving of pumpkin pie!

We have a section of this *Third Quarter Review* dedicated to interesting decisions that have come down on **Releases in Chapter 11 Plans**, as well as an analysis of recent decisions involving the Federal Deposit Insurance Corporation in our **The FDIC Goes to Court** section.

Lastly, don't forget to check out the **Best of the Rest** section of this *Third Quarter Review* to read interesting blog posts that weren't part of larger themes this quarter, but which are otherwise worthy of note.

As ever, I'd like to thank our dedicated Weil Bankruptcy Bloggers for their praiseworthy efforts, as well as my fellow Editorial Board members Ronit Berkovich and Elisa Lemmer for helping us keep the Weil Bankruptcy Blog on track, Lori Seavey for doing such a great job getting our posts online every day, and to *Third Quarter Review* Editorial Committee members David Griffiths and Kate Doorley for helping pull this edition together. Our next publication will be our *Annual Review*, a retrospective on an enthralling 2014.

Happy Thanksgiving!

Debra Dandeneau
Founding Editor

In This Issue:

Momentous Decision in *Momentive Performance Materials*

In This Section

Momentous Decision in *Momentive Performance Materials*: Cramdown of Secured Creditors – Part I

David Griffiths

On August 26, 2014, Judge Drain, of the Bankruptcy Court for the Southern District of New York, concluded the confirmation hearing in *Momentive Performance Materials* and issued several bench rulings on cramdown interest rates, the availability of a make-whole premium, third party releases, and the extent of the subordination of senior subordinated noteholders. This four-part Bankruptcy Blog series will examine Judge Drain's rulings in detail, with Part I of this series providing you with a primer on cramdown in the secured creditor context. Part II of this series will examine Judge Drain's cramdown decision in more detail. Part III will focus on the extent of the subordination of senior subordinated noteholders, and Part IV will explore both the "make-whole" aspects of Judge Drain's decision and third party releases.

What You Need To Know: Cramdown

One aspect of Judge Drain's decision may give debtors additional negotiating leverage in attempting to set terms for payment of secured claims under a plan. Judge Drain's bench ruling suggests that the allowed claim of a secured creditor may be satisfied by a long-dated replacement note with a below-market interest rate. This decision has the potential to positively affect exit financing needs for debtors and may even increase distributions to unsecured creditors in cases in which the allowed claims of secured creditors are deemed to have been fully satisfied.

Judge Drain's *Momentive* decision is unambiguous when it comes to its support for the "formula" approach in determining a cramdown interest rate for a secured creditor and in elucidating the guiding first principles that dictate how to calculate the applicable cramdown interest rate for a secured creditor's allowed claim in a chapter 11 case:

- First, a cramdown interest rate should not contain any profit or cost element, both being inconsistent with the present value approach for cramdown.
- Second, market testimony or evidence is only relevant when considering the proper risk premium to use in the formula approach.
- Third, the risk premium should not be used by creditors as a means of obtaining a market rate on their replacement notes.

The appropriate cramdown interest rate, therefore, is one that eliminates profit, eliminates fees, and compensates a secured creditor at an essentially riskless base rate, to be supplemented by a risk premium of between 1-3%, to account for a debtor's unique risks emerging from chapter 11.

Cram Session on Cramdown

Part II will delve into the details of what Judge Drain decided. Here, we will provide a quick primer on cramdown as it relates to secured creditors. Feel free to skip this part if you're already a restructuring demon.

A cramdown is the involuntary imposition by a bankruptcy court of a plan of reorganization on a class of creditors following a vote to reject a proposed plan or reorganization by that class.

The Bankruptcy Code differentiates between secured claims, unsecured claims, and equity interests when guiding a bankruptcy court to determine whether it can confirm a plan of reorganization despite the rejection of the plan by a class of claims or equity interests.

If one or more classes of secured claims or equity interests reject a proposed plan, and the plan satisfies the other applicable provisions of section 1129(a), section 1129(b) of the Bankruptcy Code permits confirmation of the plan so long as it does not "discriminate unfairly" and is "fair and equitable" with respect to each rejecting class.

A plan discriminates unfairly against a class of claims or equity interests where another class of equal or junior rank in priority receives greater value under the plan of reorganization than the class that has rejected the plan, without reasonable justification for the disparate treatment.

The test for determining whether a plan is "fair and equitable" to a rejecting class depends upon whether the class contains secured claims, unsecured claims, or equity interests. In this Bankruptcy Blog post, we will only look at the provisions that address what is fair and equitable to secured claims, as Judge Drain's decision in *Momentive* involved the claims of secured creditors. To put this in context, part of the cramdown controversy in *Momentive* revolved around whether the plan of reorganization that was proposed by the debtors provided secured noteholders with the full amount of their allowed claim. (The secured noteholders argued it didn't, and so was not fair and equitable.)

Section 1129(b)(2)(A) of the Bankruptcy Code provides three ways for treatment afforded to a class of secured creditors to be considered fair and equitable:

- First, if the debtor plans to retain the collateral securing the allowed claims, the plan may provide that a secured creditor (1) retains its liens in the assets securing its allowed claim (to the extent of its allowed claim) and (2) receives deferred cash payments with a present value totaling at least the value of the collateral securing its allowed claims (or the allowed amount of its claims if there is sufficient collateral). More about deferred cash payments shortly.
- Second, if the debtor plans to sell the collateral free and clear of the secured creditor's liens, the plan may provide for the secured creditor to credit bid its secured claim and (assuming the secured creditor is not the successful bidder), for the lien to attach to the proceeds of the sale up to the allowed amount of the secured claim.
- Third, the plan may provide the secured creditor with the "indubitable equivalent" of its allowed secured claim. This is the catch-all provision when the plan provides treatment that does not squarely comply with one of the first two options. Although this term is not defined in the Bankruptcy Code, the Supreme Court in *RadLAX*[1] made it clear that a plan proponent cannot use "indubitable equivalence" to do an end run around the other two tests.

Because *Momentive* involves the first type of cramdown and that is (at least in the post-*RadLAX* era) the test most subject to judicial interpretation, we will focus on the first test.

Present Value Calculations

The principle areas of dispute[2] under the first test revolve around how long a debtor can stretch repayments to a secured creditor and how the present value of the secured claim is determined. Because these were the two critical points in the cramdown discussion in *Momentive*, it is worth going into a more detailed explanation of these concepts.

When it comes to the length of time a debtor may stretch repayments, the seven years that Momentive proposed for first lien creditors, and the 7.5 years that it proposed for 1.5 lien creditors[3] is common, although shorter repayment periods are also frequently proposed, and debtors have been known to propose longer periods.

Section 1129(b)(2)(A)(i)(II) raises the issue of present value when it requires "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." It is an open question, though, whether that present value must be a calculation that determines the current market worth of a future sum of money or stream of cash flows given a specified rate of return, or whether the Bankruptcy Code permits something different.

A Quick Example

To explain how a present value calculation is performed, and why it is important, consider the following example: As a secured creditor, you have an allowed secured claim of $7 million, and more than enough collateral secures your claim. A debtor has a few options when determining what treatment to give your allowed secured claim under its chapter 11 plan. The first is to sell the collateral securing your claim, in which case you either would receive a replacement lien on the proceeds of the sale and then satisfy your claim in cash, or you would be entitled to

[1] *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (U.S. 2012); and our Bankruptcy Blog post *RadLAX: The Decision Is In—Supreme Court Rules That a Secured Lender Must Be Permitted To Credit Bid If Its Collateral Is Sold Pursuant To a Chapter 11 Plan* dated May 29, 2012.

[2] Of course, we are conveniently assuming that there is no dispute about the value of the secured creditor's collateral.

[3] The term "1.5 lien notes" is often used to refer to notes with second priority liens, junior to first lien notes, but where additional secured debt with subordinated liens that rank junior to the 1.5 lien notes exist.

credit bid and acquire your collateral. In theory, you could receive $7 million in cash or value from the debtor as soon as the debtor's chapter 11 plan of reorganization becomes effective. Alternatively, the debtor could decide to keep the collateral securing your claim because the debtor projects that, upon emergence from bankruptcy, its reorganized business will be able to handle paying you $1 million per year over seven years (total: $7 million) to satisfy your claim, and it needs that collateral to run its business.

As every aspiring lottery winner knows, if you have the choice between an equal sum of money now or later, the time value of money concept means that money is worth more today than in the future, so it's best to take the money and run (and reinvest it).

As a secured creditor, you are going to argue that, if you were given the money you are owed today, you could reinvest it at a market rate of, let's say 5%. In your view, if the debtor is going to pay you over seven years at a 5% interest rate, then it needs to pay you the equivalent of almost $10 million (well, $9,849,702.96 to be precise), so that the debtor has paid you in full on your allowed claim as required by the Bankruptcy Code.

Looking at it from the reverse angle, if you add up the payments the debtor will make each year to you over seven years (adding up to the $10 million number above), the appropriate discount rate to get your $7 million allowed secured claim is 5%.

From the debtor's perspective, the value of the interest rate or discount rate that is applied is of great concern: At 5%, its total payments will be $9,849,702.96 on a $7 million allowed secured claim over seven years. At 3%, the debtor will pay $8,609,117.06 over seven years, almost $1.25 million less.

You can see why, when the numbers are magnified to the levels of secured debt at issue in *Momentive* (approximately $1.25 billion), both debtors and secured creditors really care what the applicable cramdown interest rate will be on an allowed secured claim that is paid out over time.

Courts Weigh In

So how have courts determined what interest rate to apply? Unfortunately, the Bankruptcy Code does not provide guidance on the appropriate method to use to calculate a cramdown interest rate in the context of a secured creditor cramdown. Courts have therefore diverged on the appropriate method to use. In *Momentive*, Judge Drain considered the two main alternatives that have emerged over the years:

(1) the "formula" or "prime plus" approach, which takes a risk free rate then adjusts upwards for risk, and

(2) the coerced loan approach, which calculates the appropriate interest rate for the cramdown of a secured creditor by determining the interest rate that a secured creditor could obtain if it foreclosed on the collateral securing its claim and subsequently reinvested the proceeds into assets substantially similar to those of the debtor, and for a similar period, as proposed by the debtor's plan.

Other approaches also exist, such as the cost of funds approach[4] and the presumptive contract rate approach.[5] We'll focus more closely on the Supreme Court's chapter 13 *Till* approach because courts, Judge Drain included, have wrestled with how to apply *Till's* holding on interest rates in the context of chapter 11.

The *Till* Formula Approach

One of the leading decisions in this area is a Supreme Court case, *Till v. SCS Credit Corp.*[6] In *Till*, the Supreme Court determined — in the context of a chapter 13 case — that the "formula" approach was the most appropriate method to determine the discount (or interest) rate to apply to the cramdown of a secured creditor.

Although it was a chapter 13 case, *Till* has been instrumental in the attempt to harmonize the various approaches chapter 11 debtors take in their present value calculations for secured creditor cramdowns, towards the "formula" approach favored by this case. This is largely

[4] The cost of funds approach determines the cramdown interest rate based on the interest rate that a debtor would pay to borrow funds.

[5] The presumptive contract rate approach is a variation on the coerced loan approach, whereby a court will use the prepetition interest rate payable on the secured debt at issue as the cramdown interest rate, a rebuttable presumption that a debtor or secured creditor can challenge by persuasive evidence that an alternative rate is most appropriate.

[6] 541 U.S. 465 (2004).

due to the close similarity of the cramdown provisions provided for in section 1325(a)(5)(B)(iii) of the Bankruptcy Code, as well as the Supreme Court's statement in *Till* that Congress likely intended for the same approach to be taken when determining the appropriate interest rate under the various Bankruptcy Code provisions that require a net present value calculation.[7]

In short, the following summarizes the formula approach:

Prime Rate + Risk Factor = Cramdown Interest Rate

Let's look at this in more detail:

(1) Start with the prime rate, the lowest rate of interest at which money is lent by a financial institution to a commercial borrower, typically available only to the strongest borrowers in the market, then

(2) Add an additional amount to that prime rate number to account for the additional risk of lending to a debtor, usually 1%-3% but sometimes more, according to the Supreme Court in *Till*.

And voilà! You have your appropriate cramdown interest rate.

In *Till*, two joint chapter 13 debtors who owed a little under $5,000 to a lender on a used vehicle they owned could not reach agreement with their lender on the appropriate interest rate to pay the lender on the deferred monthly payments they proposed to make on its secured claim. The joint chapter 13 debtors proposed an interest rate of 9.5%. They calculated this rate by taking the prevailing prime rate and adding a 1.5% risk premium to account for the risk of them defaulting (as above, the "formula" approach). Their secured lender, on the other hand, contended that it should receive an interest rate of 21%. That rate was based on the rate of return the lender could earn if allowed to foreclose on the collateral securing the loan and then reinvest the proceeds of the sale of the collateral to borrowers in a similar distressed situation (as above, the "coerced loan" approach). The joint chapter 13 debtors sought to cram down their secured creditor using the 9.5% interest rate, and the $5,000 dispute made it all the way to the Supreme Court.

In a plurality opinion, the Supreme Court adopted the "formula" approach for chapter 13 cases, after having considered and then rejected alternative approaches as being too complicated, imposing too significant evidentiary costs, and misguided insofar as they sought to make a creditor whole, rather than ensure that a debtor's payments have the requisite present value to equal the secured creditor's allowed claim, up to the value of its interest in the collateral that secures its claim.

The Supreme Court left open the method for selecting the appropriate risk factor, though noted that the circumstances of the individual estate, the collateral and the nature of the security in the collateral and the duration and feasibility of the restructuring plan were all relevant inquiries. The Supreme Court also noted that other courts applying this formula approach had approved adjustments ranging from 1%-3%, though this range was not set in stone.

Of course, if the Supreme Court had fully and finally resolved the controversy in the chapter 11 context, then everyone would not be talking about *Momentive*. In the now famous footnote 14 to the opinion, the Supreme Court seemingly left the door open for other approaches in the chapter 11 context:

> This fact helps to explain why there is no readily apparent Chapter 13 cram down market rate of interest. Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. … Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

As you can see from this footnote, the Supreme Court drew a distinction between the lack of a free market for lenders to chapter 13 debtors in a cramdown context, to the general availability of financing in a chapter 11 case. Arguments have been raised, by debtors and commentators, that the reference to financing in a chapter 11 case is to debtor in possession (or DIP) financing, which may not be analogous to the type of financing at issue in a secured creditor cramdown context. Regardless, the

[7] 541 U.S. at 466.

footnote states that when choosing the appropriate cramdown interest rate in a chapter 11 context, it might make sense to ask what interest rate an efficient market would produce. This has subsequently led to courts in some chapter 11 cases to focus first on whether sufficient evidence is available to conclude that an efficient market exists, before moving to the formula approach, and has been seized upon as a basis for secured creditors to increase the yield on the deferred cash payments for their allowed secured claims.

How will Judge Drain deal with *Till* and footnote 14? In Part II, we look at the *Momentive* decision in more detail and find out.

Momentous Decision in *Momentive Performance Materials*: Cramdown of Secured Creditors – Part II

David Griffiths

On August 26, 2014, Judge Drain concluded the confirmation hearing in *Momentive Performance Materials* and issued several bench rulings on cramdown interest rates, the availability of a make-whole premium, third party releases, and the extent of the subordination of senior subordinated noteholders. This four-part Bankruptcy Blog series examines Judge Drain's rulings in detail, with Part I of this series having provided you with a primer on cramdown in the secured creditor context. Part II of this series, will examine Judge Drain's cramdown decision in more detail. Part III will focus on the extent of the subordination of senior subordinated noteholders, and Part IV will explore both the "make-whole" aspects of Judge Drain's decision and third party releases.

Judge Drain's Cramdown Holding: Interest Rate on Secured Debt May Be Below Market Even When Market Rate Determinants Exist

As we noted in Part I, one aspect of Judge Drain's decision may give debtors additional negotiating leverage in attempting to set terms for payment of secured claims under a plan. Judge Drain's bench ruling suggests that the allowed claim of a secured creditor may be satisfied by a long-dated replacement note with a below-market interest rate. This decision has the potential to positively affect exit financing needs for debtors and may even increase distributions to unsecured creditors in cases in which the allowed claims of secured creditors are deemed to have been fully satisfied.

Judge Drain's *Momentive* decision is unambiguous when it comes to its support for the "formula" approach in determining a cramdown interest rate for a secured creditor and in elucidating the guiding first principles that dictate how to calculate the applicable cramdown interest rate for a secured creditor's allowed claim in a chapter 11 case:

- First, a cramdown interest rate should not contain any profit or cost element, both being inconsistent with the present value approach for cramdown.
- Second, market testimony or evidence is only relevant when considering the proper risk premium to use in the formula approach.
- Third, the risk premium should not be used by creditors as a means of obtaining a market rate on their replacement notes.

The appropriate cramdown interest rate, therefore, is one that eliminates profit, eliminates fees, and compensates a secured creditor at an essentially riskless base rate, to be supplemented by a risk premium of between 1-3%, to account for a debtor's unique risks emerging from chapter 11.

Background

Momentive Performance Materials, a manufacturer of silicone and quartz products, filed for bankruptcy protection in the United States Bankruptcy Court for the Southern District of New York in April of 2014. Momentive filed its chapter 11 plan in May and revised its plan a number of times before its hotly contested confirmation hearing in August 26. As of December 31, 2013, Momentive had $4.1 billion of consolidated outstanding indebtedness. Momentive's primary classes of creditors under its plan are as follows:

Description	Estimated Amount of Claims in Class	Estimated Recovery
First Lien Notes[8]	$1.1 billion (not including accrued interest)	100%

[8] $1.1 billion of 8.875% First-Priority Senior Secured Notes due 2020.

Description	Estimated Amount of Claims in Class	Estimated Recovery
1.5 Lien Notes[9]	$250 million (not including accrued interest)	100%
Second Lien Notes[10]	$1.161 billion plus €133 million (not including accrued interest)	12.8% - 28.1%
Senior Sub Notes[11]	$382 million (not including accrued interest)	0%
PIK Notes[12]	$877 million	Less than 1%

Momentive's chapter 11 plan provided for its $1.1 billion first lien noteholders and $250 million 1.5 lien noteholders[13] to be paid in full, in cash, without payment of any "make-whole" premiums or unpaid principal and accrued interest. Consistent with the prepetition term sheet and restructuring support agreement that the debtors had negotiated with Apollo (Momentive's controlling shareholder and post-emergence equity owner) and the Ad Hoc Committee of Second Lien Noteholders, the plan also included a "deathtrap" provision for these senior noteholders: If the class of first lien notes or 1.5 lien notes voted to reject the plan, the rejecting class would receive replacement secured notes in a principal amount equal to its allowed secured claims, with an interest rate that Momentive considered sufficient on a present value basis to satisfy the cramdown requirements of the Bankruptcy Code. Notably, all parties agreed that the first lien and 1.5 lien notes were fully secured.

Holders of the first lien and 1.5 lien notes each voted as a class to reject confirmation of Momentive's proposed plan of reorganization. Momentive sought to cram down the plan over the objection of these two secured classes, and the indenture trustees for the secured noteholders objected to confirmation of the plan. Among other things, they argued that the plan was not fair and equitable because it did not satisfy the present value test required by section 1129(b)(2)(A)(i) of the Bankruptcy Code.

Controversy

Momentive argued that the rates proposed in the plan were sufficient to satisfy the cramdown requirements of section 1129(b)(2)(A)(ii) of the Bankruptcy Code, while the first and 1.5 lien noteholders argued for higher interest rates based on their view of what typical lenders would expect for new notes on a like for like basis. Momentive had previously obtained the Bankruptcy Court's authority to enter into a debtor in possession (DIP) financing facility, and the final DIP order authorized Momentive to enter into a commitment letter for a $1.0 billion exit financing facility with a term of seven years. If the first and 1.5 lien noteholders voted in favor of the plan, this exit facility, along with an equity infusion from Apollo and other investors, would provide Momentive with the liquidity to pay the allowed secured claims in cash. As Momentive had already obtained this binding assurance for exit financing, the senior secured creditors argued that evidence of what was a market rate was readily available and that the exit financing interest rate should be viewed as a proxy for the appropriate cramdown interest rate.

This dispute required the Court to undertake a present value calculation as to stream of cash flows being paid out by Momentive over seven years to the first lien noteholders and seven and a half years for the 1.5 lien noteholders.

As we saw in Part I of the Momentive Series, while this calculation is simple in practice, courts have developed varying ways of determining the appropriate cramdown interest rate, and Judge Drain' decision in the cramdown context focused heavily on which method was most appropriate, and why.

[9] $250 million of 10% Senior Secured Notes due 2020.

[10] Approximately $1.161 billion of 9% Second-Priority Springing Lien Notes due 2021 and €133 million 9.5% Second-Priority Springing Lien Notes due 2021.

[11] $382 million in aggregate principal amount of unsecured 11.5% Senior Subordinated Notes due 2016.

[12] Pay-in-Kind unsecured 11% Senior Discount Note, due June 4, 2017, with an original principal amount of $400 million. As of December 31, 2013, the aggregate principal amount outstanding on the PIK Note was $854 million.

[13] The term "1.5 lien notes" is often used to refer to notes with second priority liens, junior to first lien notes, but where additional secured debt with subordinated liens that rank junior to the 1.5 lien notes exist.

Turning to *Till*

Judge Drain's analysis of the appropriate method of calculating a cramdown interest rate focused on two significant chapter 13 cases, the Supreme Court's plurality opinion in *Till v. SCS Credit Corp*,[14] and the Second Circuit's decision in *In re Valenti*.[15] In *Valenti*, the Second Circuit adopted the "formula" approach in a chapter 13 case before the Supreme Court decided *Till*, and the Supreme Court cited favorably to *Valenti* in its *Till* decision. Even though they involved chapter 13 cases, *Till* and *Valenti* have been instrumental in leading courts in chapter 11 cases to move towards the "formula" approach applied in those cases. In his decision, Judge Drain concluded that both *Till* and *Valenti* quite clearly rejected the "forced loan" or "coerced loan"[16] alternatives that were proposed in those cases, and which were also proposed by the senior lenders in the *Momentive* case. As a result, Judge Drain refused to consider a market-based analysis of interest rates for similar loans available in the open market to establish the appropriate cramdown interest rate.[17]

Footnote Fencing: The Thrust

The indenture trustees for the first and 1.5 lien notes argued that section 1129(b)(2)(A)(ii) of the Bankruptcy Code requires the plan to provide for a rejecting class of secured creditors to receive a market interest rate on their replacement notes, particularly when the market rate is readily determinable. This reasoning echoes the approach taken by some courts[18] to determine a cramdown interest rate in a chapter 11 case and relies upon Footnote 14 from *Till*.[19]

In footnote 14 to the *Till* decision, the Supreme Court drew a distinction between the lack of a free market for lenders to chapter 13 debtors in a cramdown context and the general availability of financing in a chapter 11 case. The footnote states that when choosing the appropriate cramdown interest rate in a chapter 11 context, it might make sense to ask what interest rate an efficient market would produce. This has led some courts, such as the Sixth Circuit in *In re American Homepatient*,[20] to focus first on whether sufficient evidence is available to conclude that an efficient market exists, before moving to the coerced loan approach or the formula approach if it does not.

The indenture trustees supported their view that a market rate was the most appropriate cramdown interest rate for paying out their secured claims over time by referencing the loan commitment obtained by Momentive to support the cash-out option for the secured noteholders under Momentive's plan. This commitment provided for a higher interest rate than was being provided to the replacement secured notes, with the committed $1 billion first lien

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[14] *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

[15] *In re Valenti*, 105 F.3d 55 (2d Cir. 1997).

[16] The "forced loan" or "coerced loan" approach calculates the appropriate interest rate for the cramdown of a secured creditor by determining the interest rate that a secured creditor could obtain if it foreclosed on the collateral securing its claim and subsequently reinvested the proceeds into assets substantially similar to those of the debtor, and for a similar period, as proposed by the debtor's plan.

[17] *In re MPM Silicones, LLC, et al.*, Case No. 14-22503-RDD (Bankr. S.D.N.Y. Aug. 26, 2014) (Corrected and Modified Bench Ruling on Confirmation of Debtors' Joint Chapter 11 Plan of Reorganization for *Momentive Performance Materials* Inc. and its Affiliated Debtors, ECF No. 949, dated September 9, 2014, the "Transcript"), 69:17-25.

[18] Such as the Sixth Circuit in *In re American Homepatient, Inc.*, 420 F.3d 569 (6th Cir. 2005); other cases cited by Judge Drain that take this approach include *Mercury Capital Corp. v. Milford Connecticut Associates, L.P.*, 354 B.R. 1, 11-2 (D. Conn. 2006); *In re 20 Bayard Views LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011); and *In re Cantwell*, 336 B.R. 688, 692-93 (Bankr. D. N.J. 2006).

[19] Footnote 14 states: "This fact helps to explain why there is no readily apparent Chapter 13 cram down market rate of interest. Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession…. Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure." 541 U.S. at 477, n.14.

[20] *In re American Homepatient, Inc.*, 420 F.3d 569 (6th Cir. 2005).

backup takeout facility being priced, for example, at 5%, and with a seven year term.[21] Momentive's chapter 11 plan also proposed to stretch payment on the replacement first lien notes out over seven years, with a 3.60% interest rate as of August 26, 2014, based on a seven-year Treasury note rate plus 1.5 percent. Momentive planned a repayment schedule for the 1.5 lien notes of 7.5 years, with an interest rate of 4.09%.

Footnote Fencing: The Parry

Despite what Judge Drain referred to as "very clear guidance"[22] from *Till* with respect to the appropriate method for calculating cramdown interest rates in a secured creditor context, and the obligation and duty for the Bankruptcy Court for the Southern District of New York to follow the Second Circuit in *Valenti*, Judge Drain nevertheless recognized that some courts (in particular the Sixth Circuit in *In re American Homepatient*)[23] felt that *Till* was "not directly on all fours"[24] as a result of Footnote 14, and had continued to apply the coerced-loan approach unless no efficient market existed. Despite noting another court's conclusion that the efficient market analysis is almost, if not always a dead end,[25] this split led Judge Drain to engage in an extensive analysis of Footnote 14 and its implications, before ruling against the secured noteholders on their Footnote 14 related arguments.

Judge Drain noted that the Supreme Court in *Till* had expressly rejected market-based methodologies in favor of the "formula" approach for calculating a cramdown interest rate,[26] and that both *Till* and *Valenti* stated similar reasons for doing so: the objective of the cramdown interest rate is to put a creditor in the same economic position it would have been in had it received the value of its allowed claim immediately, and not in the same position that it would have been in had it arranged a new loan.[27] As a secured creditor's allowed claim does not include any degree of profit, the court in *Valenti* concluded that neither should a cramdown interest rate account for profit.[28]

The Court's decision points out that *Till* also distinguished cramdown interest rates from market rate loans, and that the Supreme Court in *Till* had ruled that a creditor who is paid on an allowed secured claim over time is not entitled to be put in to the same economic position than if that creditor had been allowed to foreclose on the collateral securing the allowed claim, and then loaned the proceeds in a new transaction.[29]

Consistent with *Till* and *Valenti*, Judge Drain concluded that the appropriate cramdown interest rate is one that eliminates profit, eliminates fees, and compensates a secured creditor at an essentially riskless base rate, to be supplemented by a risk premium of between 1-3%, to account for a debtor's unique risks emerging from chapter 11.

Judge Drain provided the following *Till* inspired guiding first principles that dictate how to calculate the applicable cramdown interest rate for a secured creditor's allowed claim in a chapter 11 case: first, a cramdown interest rate should not contain any profit or cost element, both being inconsistent with the present value approach for cramdown; second, market testimony or evidence is only relevant when considering the proper risk premium to use

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[21] LIBOR plus 4% with a 1% floor, or higher if an alternative base rate was used.

[22] Transcript at 74:5-6.

[23] *In re American Homepatient, Inc.*, 420 F.3d 569 (6th Cir. 2005).

[24] Transcript at 80:8.

[25] Transcript 81:4-5.

[26] The Supreme Court's plurality opinion in *Till* reads: "These considerations lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors—an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cram down loans." *See* 541 U.S. at 477 and Transcript at 70:6-22.

[27] *See* 105 F.3d at 63-4, Transcript at 71:9-16.

[28] 105 F.3d at 64, Transcript at 71:17-21.

[29] 541 U.S. at 476.

in the formula approach; and third, the risk premium should not be used by creditors as a means of obtaining a market rate on their replacement notes.

Footnote Fencing: The Riposte

Judge Drain addressed in detail the Footnote 14-related arguments raised by the secured noteholders. In his decision, Judge Drain stated that the only basis for a market cramdown interest rate based argument is Footnote 14 in *Till* because neither *Till* nor *Valenti* provides any other basis for the argument.[30] In Judge Drain's view, this is a "very slim reed indeed"[31] on which to argue for a market-based approach to cramdown interest, in contrast to the balance of the *Till* decision, which stands firmly in favor of the "formula" approach.

The *Momentive* court makes it clear that it views Footnote 14 was referring to, and deriving from, a specific statement in the *Till* decision, namely that a cramdown rate of interest need not ensure that creditors be ambivalent as to whether they foreclosed on collateral or were paid out on their secured claims over time.

The time value of money concept means that a creditor would clearly prefer to receive the value of its secured claim immediately, whether by foreclosure or immediate payment, so that it can then lend its proceeds out again. This is preferable to being forced to continue to lend to a debtor over time, through being paid out in installments on its secured loan at a rate that does not include any profit element. This preference to be paid out immediately, rather than lend to a debtor over time at no profit, explains why there is no readily apparent chapter 13 interest rate, because there is no readily apparent market of lenders that are willing to lend on any basis other than a market basis.

After finding that no market for involuntary loans exists, the Supreme Court in *Till* then contrasted this to the very active market for debtor in possession (or DIP) financing, where third parties willingly seek to lend money, and debtors willingly seek to borrow it, and questioned whether it might make sense in the chapter 11 context to ask what interest rate an efficient market would therefore produce.

[30] Transcript at 74:5-10.

[31] Transcript at 78:17-18.

Judge Drain found this inquiry to be unavailing, relying upon *Collier*[32] for the proposition that the only similarity between DIP financing and the loans imposed upon dissenting creditors at cramdown was that they both occurred during the pendency of a chapter 11 case.[33] Noting that no precedent supported the proposition that a DIP financing rate should be used as a proxy for a cramdown interest rate, and indeed no parties had ever argued for this, Judge Drain concluded that cramdown loans were more akin to exit loans, given that both occur at confirmation. For this reason, the Court considered it inappropriate to consider a DIP financing interest rate as a proxy for the rate at which a secured creditor should be paid over time on its allowed secured claim.

Judge Drain further buttressed his rejection of market interest related arguments by pointing out that Footnote 15[34] of the *Till* decision makes it clear that the Supreme Court disagrees with the use of a coerced loan approach (which, as we have seen, aims to set the cramdown interest rate at the level a creditor can obtain new loans of comparable duration and risk) in the chapter 13 context, and that in Footnote 18[35] of the *Till* decision, the Supreme Court considered the prime rate alone (with no adjustment whatsoever) to be an acceptable cramdown interest rate under the Bankruptcy Code, so long as a court could somehow be certain that a debtor would complete its plan of reorganization.

In his decision, Judge Drain echoed the Supreme Court's view in *Till* that each of the alternative approaches to calculating a cramdown interest rate is complicated, imposes significant evidentiary costs, and focuses on what he regards as the wrong objective — making the secured

[32] Transcript at 76; 4-25; COLLIER ON BANKRUPTCY, ¶ 1129.05(c)(i) (16th ed. 2014).

[33] Transcript at 76: 11-12.

[34] Footnote 15 states: "*See supra*,..., 158 L. Ed. 2d, at 796 (noting that the District Court's coerced loan approach aims to set the cram down interest rate at the level the creditor could obtain from new loans of comparable duration and risk)." 541 U.S. at 477 n.15.

[35] Footnote 18 states: "We note that, if the court could somehow be certain a debtor would complete his plan, the prime rate would be adequate to compensate any secured creditors forced to accept cram down loans." 541 U.S. at 477 n.18.

creditor whole, rather than ensuring that a debtor's deferred cash payments on an allowed secured claim have the required present value.

The court also rejected the notion that Momentive's exit loan commitment rates were relevant in considering the appropriate rate for a cramdown interest rate, finding that they included a profit element, which, regardless of how the exit loans were structured, failed to meet the *Till* and *Valenti* standards.

The court concluded its review of Footnote 14 arguments by holding that "Footnote 14 should not be read in a way contrary to *Till* and *Valenti*'s first principles,"[36] outlined above.

The Risk Premium

The indenture trustees for the first and 1.5 lien noteholders also objected to the risk premium that the debtors used to determine the appropriate cramdown interest rate — 1.5% above the Treasury rate for the first lien notes and 2% above the Treasury rate for the 1.5 lien notes.

Judge Drain ruled in favor of Momentive on this point, finding that the risk premium was appropriate in light of the circumstances of the estate, the nature of the security (both the collateral and the terms of the underlying agreements), the duration and feasibility of the reorganization plan, and the terms of the notes. The court further blessed the choice of the Treasury rate by the debtors as an appropriate base rate for longer-term debt, finding that the prime rate correlates more closely to the rate banks charge one another on overnight loans.

As to the appropriate risk premium, the Court questioned whether the 1-3% range in risk premiums applied in *Till* (which used the prime rate as the base rate) might not be higher if the Treasury rate had been used in that case. Judge Drain reasoned that the difference in interest rates between Treasury debt and debt issued by financial institutions to preferred clients at the prime rate could mostly be accounted for by risk. Treasury debt, because the U.S. government is the primary obligor, is considered to be largely risk free. Even the highest grade commercial borrowers have the potential for default, and Judge Drain considered that potential to be accounted for by the difference between the Treasury rate and the prime rate.

[36] Transcript 79:12-14.

This analysis led Judge Drain to the conclusion that, when Treasury debt is used as a base rate (as opposed to the prime rate), it was appropriate to augment that rate by an additional margin to compensate the lender for risk. Judge Drain then suggested that it would be appropriate for the first lien replacement note cramdown interest rate to be increased by an additional 0.5% and for the 1.5 lien replacement note cramdown interest rate to be increased by an additional 0.75%.

Below is a chart that sets out what was proposed by Momentive in its pre-confirmation plan, and what Judge Drain ultimately considered appropriate as cramdown treatment:

Creditor	Proposed Treatment	Court Proposed Treatment
$1.0 billion first lien notes	Seven-year Treasury note rate plus 1.5 percent, 3.60% as of August 26, 2014.	Seven-year Treasury note rate plus 2.0 percent, 4.1% as of August 26, 2014.
$250 million 1.5 lien notes	Imputed 7.5 year Treasury note rate (based on weighted averaging of the rates for seven-year and ten-year Treasury notes) plus 2 percent, 4.09%, as of August 26, 2014.	Imputed 7.5 year Treasury note rate (based on weighted averaging of the rates for seven-year and ten-year Treasury notes) plus 2.75%, 4.85% as of August 26, 2014.

Conclusion

The decision in *Momentive* provides both debtors and secured creditors clear guidance as to how Judge Drain views the calculation of the appropriate interest rate in a secured creditor cramdown situation. While the decision is not what the secured creditors in *Momentive* had hoped for, it does add to the body of case law applying the *Till* "formula" approach in this situation. Ultimately, the appropriate methodology for a cramdown interest rate is a value allocation tug-of-war between debtors, secured creditors and more junior creditors, and this decision affords additional weight to debtors in that battle. Coalescing around a common formula, no matter which it is, is ultimately beneficial to setting the expectations of all parties facing involved in distressed situations, and more certainty will assist in being able formulate and confirm plans of reorganization expeditiously.

Momentous Decision in *Momentive Performance Materials*: Subordination Is as Subordination Does

Charles Persons

As we began discussing in Parts I and II, on August 26, 2014, Judge Drain of the Bankruptcy Court for the Southern District of New York issued a momentous bench ruling in connection with the confirmation hearing of Momentive Performance Materials and its affiliates.[37] The decision grappled with a number of important topics in modern, complex chapter 11 bankruptcies. In Parts I and II of this series, we examined Judge Drain's analysis of secured party cramdown considerations in detail. In this entry, we turn to the topic of subordination. In Part IV, we will explore both the "make-whole" aspects of Judge Drain's decision and third party releases.

What You Need to Know: Subordination

As a preliminary matter, section 510(a) of the Bankruptcy Code serves as the basis for most subordination discussions in bankruptcy court — just as it did in *Momentive*. The provision simply enforces subordination agreements to the same extent they would be enforceable under nonbankruptcy law.

On its face, the section 510(a) appears to be aimed primarily at creditors, as subordination provisions are frequently found in intercreditor agreements or in entirely separate subordination agreements — documents to which the debtor likely is not a party. As Judge Drain noted in his ruling, though, the application of section 510(a) has a profound effect on debtors and their chapter 11 plans. Confirmation of a plan necessitates meeting the various requirements of section 1129, including section 1129(a)(1), a catch-all requiring a plan to comply with "the applicable provisions of this title." In short, even though a subordination fight appears at first blush to be a squabble solely among creditors, proper prioritization of debt in a plan requires the plan proponent to sort these subordination issues out.

The Subordination Provision in *Momentive*

Part II of this series generally described the classes and their proposed treatment under the plan and focused on the objections raised by the two most senior classes in the plan — the first lien claims and the 1.5 lien claims. The subordination fight in *Momentive* pitted two other classes of creditors against each other — the unsecured senior subordinated notes ("*Senior Sub Notes*") and the second-priority springing lien notes ("*Second Lien Notes*"). Momentive's plan proposed to give the Second Lien Notes a recovery of approximately 12.8-28%, but wiped out the Senior Sub Notes on the ground that the Senior Sub Notes were subordinated to the Second Lien Notes.

Not long after the chapter 11 filing, the Senior Sub Notes filed an adversary proceeding against the Debtors and the Second Lien Notes[38] seeking a declaration that their notes were not subordinated to the Second Lien Notes. Although the Second Lien Notes would have a senior right to any recovery on account of their liens (which were wholly underwater, and therefore, valueless), the Senior Sub Notes argued that, pursuant to the terms of the applicable indenture, any unsecured claims of the two classes should be *pari passu*.

As these disputes go, resolution depended upon an interpretation of the subordination provision in the indenture governing the Senior Sub Notes. That indenture, governed by New York law, provided that the Senior Sub Notes would be subordinated to "all existing and future Senior Indebtedness of the Company," and added that "only Indebtedness of the Company that is Senior Indebtedness of the Company shall rank senior to the [Senior Sub Notes] …."[39]

The adversary proceeding thus hinged on the definition of "Senior Indebtedness." The Senior Sub Notes indenture defined "Senior Indebtedness" as follows:

[37] *In re MPM Silicones, LLC*, Case No. 14-22503 (Bankr. S.D.N.Y. April 13, 2014) (RDD).

[38] *U.S. Bank N.A. v. Wilmington Savings Fund Society, FSB*, A.P. No. 14-08238 (RDD) (Bankr. S.D.N.Y. May 30, 2014).

[39] *Corrected and Modified Bench Ruling on Confirmation of Debtors' Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. and its Affiliated Debtors*, [*Momentive* Dkt. No. 949] (dated Sept. 9, 2014) (the "*Transcript*"), 11:16-17, 23-25.

> all Indebtedness ... unless the instrument creating or evidencing the same amount or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company or such Restricted Subsidiary, as applicable; [we will call this the "*Payment Subordination Provision*"] *provided however*, that Senior Indebtedness shall not include, as applicable:
>
> * * *
>
> (4) any Indebtedness or obligation of the Company or any Restricted Subsidiary that by its terms is *subordinate or junior in any respect* to any other Indebtedness or obligation of the Company or such Restricted Subsidiary, as applicable, including any Pari Passu Indebtedness [we will call this the "*Subordination Exception*"] ....[40]

The crux of the Adversary Proceeding turned upon the meaning of "junior in any respect." The holders of the Senior Sub Notes argued that, because the liens securing the Second Lien Notes were junior in priority to those of the first lien notes and the 1.5 lien notes, the Second Lien Notes were "junior in any respect to ... other Indebtedness," and, therefore, fell within the language of the Subordination Exception. The result of that would be that the Senior Sub Notes and the Second Lien Notes would be *pari passu* with respect to the unsecured claims of the Second Lien Notes. In a bit of unhelpful contractual circularity, the indenture for the Second Lien Notes (an agreement to which the holders of the Senior Sub Notes were not parties) provided that the Second Lien Notes were senior to any "Subordinated Indebtedness."

Court Holds That New York Law on Contract Interpretation Dictates That the Second Lien Notes Were Not Subordinated

Because the Bankruptcy Code holds that subordination agreements are only enforceable in bankruptcy to the extent they are enforceable under applicable nonbankruptcy law, Judge Drain began his decision with a primer on contract interpretation under New York law.

[40] *Id.* at 14:15-25; 16:1-6 (emphasis added).

These "well established" fundamental principles included the following concepts:

- The court should look to the language of an agreement that is complete, clear, and unambiguous on its face.[41]
- The subordination provision must be considered in the context of the entire agreement.[42]
- A contract should be construed as to give effect to all its provisions such that no part will be inoperative or superfluous.[43]

According to the court, these guiding principles of contract interpretation led to only one conclusion — the Subordination Exception was not intended to affect the Second Lien Notes' senior right to payment with respect to the Senior Sub Notes.

Looking first at the principle that the contract should be construed to give effect to all its provisions, Judge Drain noted that the Senior Sub Noteholders' interpretation of the Subordination Exception would "swallow up" the Payment Subordination Provision.[44] The court instead sided with Momentive's interpretation of the Subordination Exception, which it concluded gave meaning to the Subordination Exception only in situations where a separate subordination agreement, rather than the instrument itself, caused the subordination.[45]

The court also held that Momentive's interpretation tracked the plain terms of the Subordination Exception. The Subordination Exception, read strictly, said that Senior Indebtedness would not include Indebtedness "that by *its* terms is subordinate or junior" to any other Indebtedness. The indenture for the Second Lien Notes, which created the "Indebtedness," did not by *its* terms subordinate the Second Lien Notes to any other debt. On the contrary, only the *lien* securing the Second Lien Notes was subordinated as a matter of lien priority to another

[41] *J. D'Addario & Co., Inc. v. Embassy Indus., Inc.*, 20 N.Y. 3d 113, 118 (2012).

[42] *See, e.g.,* Barclays Capital, Inc. v. Giddens, 2014 U.S. App. LEXIS 15009, at *21 (2d Cir. Aug. 5, 2014).

[43] *See, e.g.*, LaSalle Bank N.A. v. Nomura Asset Capital Corp., 424 F.3d 195, 206 (2d Cir. 2005).

[44] Transcript, 18:22-24.

[45] *Id.* at 19:7-20.

lien. As Judge Drain reasoned, "liens secure debt and are not themselves debt," and thus they fall outside of the meaning of "Indebtedness."[46]

As a final theory, the Senior Sub Noteholders argued that, under Momentive's interpretation of the Senior Sub Notes Indenture, the debtors could theoretically continue to add priority notes ahead of the Senior Sub Notes by providing the new debt with illusory undersecured (in whole or in part) liens. Considering this possibility, the Senior Sub Noteholders argued that the Subordination Exception served an important "anti-layering" function.

The court, however, refused to buy the argument. Looking to the indenture for the Senior Sub Notes for context, Judge Drain pointed out that the indenture had no anti-layering provision or covenant, even though it contained plenty of other provisions about incurring additional debt.[47] Instead, the court pointed to the Senior Sub Noteholders' own evidence to support the argument that, "if one wants to exclude debt secured by a junior lien from the benefit of a subordination provision, [one should] do so in an anti-layering covenant."[48]

Conclusion

Decisions interpreting subordination agreements often serve as a reminder of the importance of using precise language, particularly when it comes to defining the relative rights of creditors in different agreements. *Momentive* is no exception. Although Judge Drain may have characterized his reading of the contractual provisions as having been based upon the "plain meaning" of the Subordination Provision and the Subordination Exception, potential ambiguity created by four words in a lengthy document — "junior in any respect" — opened the door to litigation.

[46] *Id.* at 23:13. To further support this point the court pointed out that the definition of "Indebtedness" in the Senior Sub Indenture included, "Indebtedness of another Person secured by a Lien," displaying a clear dichotomy between those two terms. *Id.* at 13:9-20.

[47] *Id.* at 21:11-25.

[48] *Id.* at 22:4-6.

Momentous Decision in *Momentive Performance Materials* Part IV: Make-Wholes and Third Party Releases

Jessica Liou

This is the final entry in our four-part series analyzing Judge Drain's widely read bench ruling issued on August 26, 2014 in connection with the confirmation hearing of *Momentive Performance Materials* and its affiliated debtors.[49] In Parts I and II, we discussed Judge Drain's conclusions regarding the appropriate calculation of cramdown interest rates for secured creditors. In Part III, we turned to his analysis of certain subordination provisions found in the indentures governing the Debtors' senior subordinated notes. In Part IV, we discuss Judge Drain's rulings regarding the parties' make-whole and third party release disputes.

What You Need to Know: Make-Wholes

Make-wholes have been a "trending" topic of late in the restructuring community. This is partly because it is difficult to find a consistent approach to the issue within the reported decisions. Therefore, even for those of us who have been closely following recent make-whole developments, a brief refresher on make-wholes is always helpful.

What are make-wholes? Make-wholes are contractual provisions found in indentures that typically permit a borrower to redeem or repay notes before maturity but require the borrower to pay a lump sum amount derived from a formula based on the net present value of future coupon payments that will not be paid as a result of early redemption or repayment. Make-wholes are usually available only during a "no-call" period, or a period of time specified in the indenture during which the borrower is prohibited from repaying the debt before maturity.

[49] Subsequent to issuing his original bench ruling, Judge Drain filed a *Corrected and Modified Bench Ruling on Confirmation of Debtors' Joint Chapter Plan of Reorganization for Momentive Performance Materials Inc. and its Affiliated Debtors*. *In re* MPM Silicones, LLC, Case No. 14-22503 (Bankr. S.D.N.Y. Sept. 9, 2014) (RDD) (Dkt. No. 979) (the "*Transcript*").

What is the purpose of make-wholes? The purpose of make-wholes is to determine the rights of the borrower and the creditor in the event repaying a debt before it matures becomes economically efficient for the borrower. From the creditor's perspective, a make-whole provides yield protection. When debt is redeemed before maturity or repaid upon default, a make-whole or prepayment provision requires the borrower to pay an amount above the principal and interest due on the debt to compensate the lender for economic loss suffered as a result of the redemption or repayment. From the borrower's perspective, a make-whole provides freedom to repay debt before maturity. Many jurisdictions, including New York, have adopted the "perfect tender in time" rule, which prohibits a borrower from repaying a loan before maturity in the absence of a specific contractual provision permitting early repayment.[50]

When are make-wholes payable in a bankruptcy case? Outside of bankruptcy, whether a creditor is entitled to a make-whole is determined purely by looking to the underlying contract that governs the debt. In other words, the analysis is rooted in state law. Once a borrower is in bankruptcy, however, the Bankruptcy Code adds a layer of complexity that has, at times, led to contradictory decisions on a constellation of bankruptcy-related issues.

While different courts have taken different approaches, a general framework for determining whether a make-whole provision is allowable in bankruptcy has emerged. Bankruptcy courts have generally engaged in two layers of analysis. The first layer of analysis requires analyzing the debt document under state law to determine whether the (i) make-whole has been triggered and (ii) if so, whether the entire claim is enforceable under state law. The second layer of analysis requires considering whether enforceable state law claims are allowable under federal bankruptcy law. The following are typical questions that a bankruptcy court might address in such an analysis:

- Does the debt document explicitly provide for a make-whole? If so, when exactly is the make-whole triggered?
- Does a bankruptcy filing automatically accelerate the debt under the debt documents?
- Does automatic acceleration upon a bankruptcy event of default cause the debt to mature on the petition date under the debt documents?
- Does a repayment or refinancing in bankruptcy qualify as a voluntary prepayment or redemption under the terms of the debt documents?
- Does the debt document include a no-call provision prohibiting early repayment of the debt?
- Can the creditor decelerate the debt postpetition?
- Would the claim for make-whole be disallowed as a claim for unmatured interest under section 502(b)(2) of the Bankruptcy Code?
- Would the claim for make-whole or prepayment premium be allowed as a secured claim under section 506(b) of the Bankruptcy Code?

As we will explore in greater detail below, Judge Drain's ruling in *Momentive* touches upon many of these questions.

The Make-Whole Dispute in *Momentive*

The indenture trustees for the holders of approximately $1.1 billion of First Lien Notes and $250 million of 1.5 Lien Notes (each discussed in greater detail in Parts I and II of this series) asserted that they were entitled to make-whole amounts under the terms of their respective indentures as a result of the repayment (in the form of the issuance of replacement notes) of the First Lien Notes and 1.5 Lien Notes before the original maturity date under the terms of the Debtors' plan. The trustees also argued that, barring such claim, they could assert a common law claim for damages as a result of the debtors' breach of the underlying debt documents or the "perfect tender" rule. Both indentures contained identical language with respect to the relevant provisions. As drafted, Momentive's chapter 11 plan did not contemplate a distribution on account of the make-whole claims asserted. Thus, if the bankruptcy court allowed the make-whole claim, the amount of replacement notes to be issued under the plan to the holders of the First Lien Notes and 1.5 Lien Notes

[50] *See* Transcript at 33-34, citing *U.S. Bank Nat'l Ass'n v. South Side House LLC*, 2012 Dist. LEXIS 10824, at *12-13 (E.D.N.Y. Jan. 30, 2012); *Northwestern Mutual Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831, 835 (N.Y. Sup. Ct. 2006). *See generally Charles & Kleinhaus, Prepayment Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537, 541 (Winter 2007) ("*Charles & Kleinhaus*") at 541 n.13.

would increase, giving them a larger distribution (approximately $200 million more) under the plan.

The court disagreed with the indenture trustees and ultimately held that they were not entitled to their make-whole claim, that the debtors did not owe damages for breach of a no-call provision or the perfect tender rule, and, lastly, that the indenture trustees were not permitted postpetition to decelerate the already accelerated debt.

The Debt Documents Do Not Explicitly Provide for a Make-Whole After the Automatic Acceleration of the First Lien and 1.5 Lien Debt

At the heart of the make-whole dispute sits the explicit language of the governing contract: in this case, the indentures and notes. As Judge Drain noted, when considering the allowance of a claim in a bankruptcy case, the bankruptcy court should first consider whether the claim would be valid under applicable nonbankruptcy law. Accordingly, Judge Drain devoted a large part of his ruling to unpacking the relevant provisions of the indentures and notes to determine whether they gave rise to a valid make-whole claim under New York state law.

Judge Drain first laid the foundation for his analysis by noting that the New York "perfect tender" rule prohibits early repayment of a loan unless a borrower and creditor contractually agree to provide the borrower a specific option under the contract to permit the borrower to prepay the debt in return for agreed-upon consideration that compensates the lender for the cessation of the stream of interest payments running to the original maturity date of the loan.

He also noted that it is "well-settled" that the common law rule in New York is that a lender forfeits its rights to consideration for early payment if the lender is the party affirmatively accelerating the balance of the debt. This rule, however, is subject to two main exceptions: when a debtor intentionally defaults to trigger acceleration and avoid the make-whole, which was not applicable to the debtors, and when the contract clearly and unambiguously requires payment of the make-whole in the event of acceleration of, or the establishment of a new maturity date for, the debt.[51]

In *Momentive*, the indentures provided for the automatic acceleration of the debt upon a bankruptcy event of default.[52] The court agreed with the debtors and Second Lien noteholders (who supported the Momentive plan) that, as a result of the automatic acceleration provision, the maturity date of the First Lien and 1.5 Lien debt had been contractually advanced. In other words, the First Lien and 1.5 Lien noteholders had bargained for the early repayment of the notes upon Momentive's bankruptcy and, therefore, forfeited their right to a prepayment premium, and the indentures lacked language that would otherwise "clearly and specifically" provide for the payment of the make-whole, notwithstanding the automatic acceleration.[53]

Judge Drain distinguished Judge Gerber's holding in *In re Chemtura Corp.*[54], which the indenture trustees attempted to use to support their make-whole claim. In *Chemtura*, Judge Gerber was not asked to decide the merits of the make-whole claims asserted, but only to evaluate whether a settlement of the make-whole claims under a chapter 11 plan fell below the lowest level in the range of reasonableness. There, Judge Gerber expressed that, in his opinion, the bondholders asserting a make-whole claim had the "substantially" better argument and the debtors opposing the make-whole claim had a weak argument where the indenture defined "Maturity Date" as a date certain and "Maturity" separately, and indicated

[51] *See* Transcript at 35, *citing U.S. Bank Nat'l Ass'n v. South Side House LLC*, 2012 Dist. LEXIS 10824, at *12-13; *Northwestern Mutual Life Ins. Co. v. Uniondale Realty Assocs.* 816 N.Y.S.2d at 836.

[52] Section 6.02 of the Indentures provided that "If an Event of Default specified in Section 6.01(f) or (g) with respect to MPM [which includes the debtors' bankruptcy] occurs, the principal of, premium, if any, and interest on all the Notes shall ipso facto become and be immediately due and payable without any declaration or other act on the part of the Trustee or any Holders."

[53] *See* Transcript at 37, 38-39, *citing In re Madison 92nd Street Assocs., LLC*, 472 B.R. 189, 195-96 (Bankr. S.D.N.Y. 2012); *In re LaGuardia Assocs. LLP*, 2012 Bankr. LEXIS 5612, at *11-13 (Bankr. E.D. Pa. Dec. 5, 2012); *In re Premiere Ent'mt Biloxi, LLC*, 445 B.R. 582, 627-28 (Bankr. S.D. Miss. 2010); *see also In re AMR Corp.*, 730 F.3d at 101 (noting that automatic acceleration provisions operate by the choice of the indenture trustee as much as of the debtor or issuer).

[54] 439 B.R. 561, 596-02 (Bankr. S.D.N.Y. 2010).

that a make-whole would be due upon early redemption of the debt before the "Maturity Date." Unlike *Chemtura*, Judge Drain noted that, in *Momentive*, there were no provisions within the indentures that stated explicitly that a make-whole would be due if the debt was repaid prior to its *original* maturity.[55]

Furthermore, Judge Drain dismissed the indenture trustees' arguments that language referencing lower case "prepayment premiums" found throughout the indenture was sufficiently clear to warrant entitlement to the make-whole. For example, section 6.02 of each of the indentures provides for the payment of a "premium, if any" upon the automatic acceleration of the debt. Judge Drain held that each of the references highlighted by the indenture trustees to "other rights" or "premiums, if any" to be paid upon a prepayment were not specific enough to give rise to a make-whole entitlement under New York law.

Lastly, the debtors and Second Lien noteholders argued that the repayment of the First Lien and 1.5 Lien debt under the terms of the Momentive chapter 11 plan did not constitute an elective or voluntary prepayment as contemplated by the indentures. Judge Drain noted that, under the terms of the debt documents, the debtors could elect to "redeem" under sections 3.02 and 3.03 of the indentures and paragraph 5 of the notes, but under section 1124 of the Bankruptcy Code, the debtors could choose to reinstate the First Lien and 1.5 Lien debt rather than pay with substitute consideration. Ultimately, however, Judge Drain restrained himself from further considering this particular argument in light of his agreement with the Debtors that the plain language of the Indentures failed to give rise to a valid make-whole claim.

No Claim for a Breach of the No-Call Arises Under the First Lien and 1.5 Lien Notes

Judge Drain turned next to the indenture trustees' alternative argument that they were entitled to a claim for damages as a result of the debtors' breach of the no-call provision found in the First Lien and 1.5 Lien notes. Paragraph 5 of the notes stated, "Except as set forth in the following two paragraphs, [which discuss the contractual make-wholes] the Note shall not be redeemable at the option of MPM prior to October 15, 2015." Siding again with the debtors and the Second Lien noteholders, Judge Drain held that this sentence was not a contractual no-call provision; instead, it was a framing device to introduce the notes' elective redemption provisions that provide for a make-whole under certain circumstances, which were not triggered here.

The indenture trustees also argued, however, that, under New York's "perfect tender" rule, which was contractually preserved by a general reservation of rights and remedies set forth in section 6.03 of the indentures, prepayment itself constituted a breach of that rule and entitled the First Lien and 1.5 Lien noteholders to a damages claim. Although Judge Drain acknowledged that New York law would, in fact, provide a claim for a breach of the "perfect tender" rule, the Bankruptcy Code would prohibit such a claim. First, Judge Drain noted that a prohibition on early repayment of debt is not specifically enforceable in bankruptcy.[56] Second, he reiterated that the debt documents did not explicitly provide for an additional premium to be paid post-acceleration. Accordingly, the claim could not be allowed under section 506(b), which allows oversecured creditors to recover fees and charges *under the parties' agreement* up to the value of their collateral.[57] Lastly, he concluded that a claim for breach of the "perfect tender" rule would be barred by section 502(b)(2)'s prohibition against claims for unmatured interest. Any damages for breach of the perfect tender rule or a no-call provision that does not provide for liquidated damages would be calculated by taking the difference between the present value of the interest to be paid under the First Lien and 1.5 Lien notes through their stated maturity and the present value of their interest under the replacement notes to be issued under the

[55] *See* Transcript at 39-41; *citing U.S. Bank Nat'l Ass'n v. South Side House, LLC*, 2012 U.S. Dist LEXIS, 10824, at *21-24; *LaGuardia Assocs., L.P.*, 2012 Bankr. LEXIS 5612, at *14-16; *see* Charles & Kleinhaus, 15 AM. BANKR. INST. L. REV. at 556.

[56] Transcript at 46, *citing HSBC Bank USA v. Calpine Corp.*, 2010 U.S. Dist. LEXIS 96792, at *11-14; Charles & Kleinhaus, 15 AM. BANKR. INST. L. REV. at 563-64.

[57] Section 506(b) provides "To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement…."

Debtors' plan, which difference would equate to unmatured interest.[58]

The Automatic Stay Bars Deceleration of the First Lien and 1.5 Lien Debt

Realizing that the Debtors' arguments against allowing the make-whole claims largely hinged on the automatic acceleration of the debt upon a bankruptcy event of default, the indenture trustees separately sought permission from the bankruptcy court to rescind the automatic acceleration of the notes. The indenture trustees made three arguments. First, the automatic stay does not apply to any rescission notice. Second, even if the automatic stay under section 362(a) of the Bankruptcy Code applied, rescission is excepted from the stay by section 555. Finally, they contended that even if the automatic stay applied, they should be granted relief.

Consistent with other similar cases, such as *AMR* and *Solutia*,[59] Judge Drain concluded that the automatic stay did bar the issuance of a rescission notice and the deceleration of the debt under sections 362(a)(3) and 362(a)(6). According to Judge Drain, the purpose of the rescission notice would be to "resurrect" the right to the make-whole claim by decelerating the debt, and the effect of rescission would be to increase the size of the indenture trustees' claims by approximately $200 million. This act thus constituted an act to control property of the estate by exercising a contract right to the estate's detriment and attempting to recover, by deceleration, a claim against the debtors.

The indenture trustees further attempted to argue that the automatic stay was not implicated because it affected solely the rights of third parties, as any additional distribution under the Momentive plan on the incremental make-whole claim would simply reduce distributions to the Second Lien holders and trade creditors. As such, this was simply an intercreditor dispute. Judge Drain quickly dismissed this argument, noting that a proper reading of section 362(a) did not impose the additional limitation that acts barred needed to provide economic value to the estate, and moreover, this argument ignored the applicability of section 362(a)(6).

In addition, the indenture trustees raised a novel argument, which was not previously raised in *AMR* or *Solutia*, that the sending of the rescission notice merely served to liquidate a securities contract as permitted by section 555 of the Bankruptcy Code.[60] Judge Drain, however, disagreed. He expressed serious doubts that the indentures qualified as "securities contracts" as defined in section 741(7)(A) of the Bankruptcy Code. The indentures were not contracts for the purchase, sale or loan of a security, but instead reflected the terms under which outstanding debt would be governed.[61] Furthermore, sending a notice of rescission would not, in Judge Drain's opinion, qualify as an act to liquidate the make-whole claim. It would, rather, constitute an act to increase the overall claims against the debtors by creating an altogether new and different claim.

Lastly, Judge Drain exercised his discretion and determined that relief from the stay was not warranted under these circumstances after application of the Second Circuit's *Sonnax* case.[62] Here, permitting the indenture trustees to send a rescission notice and decelerate the debt would significantly affect other creditors and the debtors' collective estate, potentially enhancing the claims of the First Lien and 1.5 Lien noteholders by hundreds of millions of dollars.

The Third Party Releases Dispute in Momentive

Before we conclude, we will take a moment to briefly discuss Judge Drain's ruling regarding the third party

[58] *See* Transcript at 48, *citing* Charles & Kleinhaus, 15 Am. Bankr. Inst. L. Rev. at 541-42, 580-81; *see also HSBC Bank USA v. Calpine Corp.*, 2010 U.S. Dist. LEXIS, at *14-21.

[59] *See* Transcript at 54, *citing In re AMR Corp.*, 730 F.3d at 102-03, 111-12; *see also In re Solutia Inc.*, 379 B.R. at 484-85.

[60] Section 555 provides, "The exercise of a contractual right of a stockbroker, financial institution, financial participant or securities clearing agency to cause the liquidation, termination or acceleration of a securities contract as defined in section 741 of this title, because of a condition of the kind specified in section 365(e) of this title, shall not be stayed, avoided or otherwise limited by operation of any provision of this title."

[61] *See* Transcript 57-58, *citing In re Qimonda Richmond, LLC*, 467 B.R. 318, 323 (Bankr. D. Del. 2012).

[62] *In re Sonnax Indus.*, 907 F.2d 1280, 1285-86 (2d Cir. 1990) (setting forth factors that may be relevant to a determination on a request to lift the automatic stay in such circumstances).

release provisions provided for under the Momentive plan. Only the indenture trustees for the First Lien and 1.5 Lien noteholders objected to the third party releases. The indenture trustees objected to the inclusion of third party releases for parties named or identified in state court lawsuits brought by the First Lien and 1.5 Lien indenture trustees to enforce the terms of an intercreditor agreement as against the Second Lien holders. In that litigation, the First Lien and 1.5 Lien holders alleged that the Second Lien noteholders' support of the Momentive plan and the plan's contemplated distribution of proceeds to the Second Lien noteholders before payment to the First and 1.5 Lien noteholders constituted a breach of the intercreditor agreement between the parties.

As a result of concerns Judge Drain expressed at the confirmation hearing, however, the debtors amended their releases to carve out the release of rights with respect to the intercreditor litigation. What remained of the third party releases, he upheld. Applying *Deutsche Bank AG v. Metromedia Fiber Networks, Inc.*[63] and the case law interpreting it in the Second Circuit, the court found that the third party releases satisfied the *Metromedia* test because the Second Lien holders who were covered by the releases were providing substantial consideration to the debtors under the *Momentive* plan. The released Second Lien noteholders had agreed to different treatment of their unsecured deficiency claim from the unsecured claims of trade creditors (who would be paid in full under the plan), were committing to backstop a $600 million equity investment under the plan and had consistently supported the debtors' reorganization efforts, starting with the execution of a prepetition plan support agreement. The court also found that the third party releases were an important part of the debtors' plan. Without the third party releases, there existed a "reasonable risk" that the Second Lien noteholders would withdraw their support of the plan, and the court found this risk was "especially significant" given all that the Second Lien noteholders had committed to do under the plan.

Conclusion

Judge Drain's rulings regarding the indenture trustees' make-whole claims are notable because they provide additional clarity in an otherwise murky area of law. Prior to *Momentive*, the core cases discussing make-wholes largely examined contractual provisions that either clearly entitled a party to a make-whole claim or clearly denied a party a make-whole claim. On the drafting spectrum, the indentures and notes at issue in *Momentive* clearly fell somewhere in between the two extremes. But exactly where it fell on the spectrum was a matter of rampant speculation. Particular attention was paid to the "premium, if any" language found in the automatic acceleration clauses of the debtors' indentures, as that specific language, or similar language, could be found in many modern indentures. Debates spawned regarding whether the use of lower case "premium" would be sufficiently clear to trigger entitlement to a make-whole as a matter of contract law, sides were taken, and bets were placed. Judge Drain's ruling — while not binding on other courts — provides yet another stake in the ground that telegraphs to creditors that their underlying contracts need to be more explicit regarding when they are entitled to a make-whole claim if they want to successfully seek allowance of such claim in bankruptcy. Furthermore, his denial of the indenture trustees' request to modify the automatic stay to allow deceleration of the First Lien and 1.5 Lien debt buttresses the existing case law that prohibits creditors from attempting to resurrect a make-whole claim post-acceleration where the contract language itself does not give rise to such a claim.

Momentive Postscript – Bankruptcy Rule 3018: Vote Changing on Chapter 11 Plans: You Can't Have Your Cake and Eat It, Too

David Griffiths

"Life is not about perfect information. Life is about choices, which is why you have elections."

Bankruptcy Blog readers could be forgiven for thinking that this quote was taken from the writings of a philosopher king from Plato's Utopian *Kallipolis*. Not so. In fact, no need for us to travel farther on Metro North than White Plains, where you will find the chambers of its author, Judge Drain of the United States Bankruptcy Court for the Southern District of New York, presiding over

[63] 416 F.3d 136, 141 (2d Cir. 2005).

the *Momentive Performance Materials*[64] case. We've been following *Momentive* for quite a while on the Bankruptcy Blog and recently covered the confirmation hearing in our four-part series. With a plethora of interesting issues coming out of this case, here's another one for you to consider: vote changing.

Background

A quick refresher on the pertinent facts of *Momentive* before we continue: Prior to Momentive Performance Materials filing for bankruptcy, its largest shareholder, Apollo Global Management, saw *inceptus finis* coming – in short, Momentive's moment had arrived. Anticipating the impending bankruptcy filing of its portfolio company, Apollo entered into a restructuring support agreement with some of the company's junior noteholders, which included a death-trap for its senior noteholders. The "fish-or-cut-bait" provision worked as follows: if senior noteholders voted in favor of the proposed plan of reorganization, their claims would be paid in full, in cash, once Momentive exited bankruptcy (though make whole claims and postpetition interest claims would be waived). If senior noteholders voted against the proposed plan of reorganization, they faced the risk of the plan being confirmed over the vote of dissenting classes, in which case secured claims would be paid out over seven years at a "cramdown" rate of interest. Cue: Showdown that would make Spartan King Leonidas of the Battle of Thermopylae fame proud, only instead of there being 300 soldiers, there are what seemed like 300 attorneys in Judge Drain's bankruptcy court.

The senior noteholders voted against the proposed plan of reorganization, lost a valiant fight for their make-whole payments and postpetition interest at *Momentive's* confirmation hearing, and the plan of reorganization was confirmed by Judge Drain notwithstanding their "no" votes. Instead of being paid in full, in cash on Momentive's exit from bankruptcy, they received seven year notes at a "*Till*" rate of interest. (If you don't know *Till*, suffice it to say that it is now a four-letter word in the bondholder world.)

So, in their own bid to make the best out of a bad situation, the senior noteholders tried to change their vote on the plan of reorganization. Instead of a "no," it was now a "yes, please".

The predicate for such a vote change is Federal Rule of Bankruptcy Procedure 3018 (*Acceptance or Rejection of Plan in a Chapter 9 Municipality or a Chapter 11 Reorganization Case*). Bankruptcy Rule 3018 provides, in pertinent part, "For cause shown, the court after notice and hearing may permit a creditor or equity security holder to change or withdraw an acceptance or rejection."

In short, Bankruptcy Rule 3018 requires a movant to show cause to allow a vote change, and "cause" in this context is not defined. It is, therefore, up to the bankruptcy court to determine what constitutes "cause" in the exercise of its discretion. Prior to the Federal Rules of Bankruptcy Procedure being amended in 1991, Bankruptcy Rule 3018(a) required that any motion to change or withdraw a vote had to be made before the deadline for voting had passed. This requirement was repealed in the current version of the rule without explanation, though "cause" is still required.

The senior noteholders argued that cause is a broad word that essentially means "any good reason or good basis" that would serve as a justification for allowing a vote to be changed. They also contended that allowing them to convert their classes of claims from rejecting to accepting classes under the plan would eliminate future litigation risk, uncertainty and costs; it would eliminate certain appeals to the confirmation order and would avoid litigation of stays pending appeal, as well as two separate intercreditor actions. They further argued that the court system and bankruptcy policy favors finalities, settlement and consensual plans, and that a vote change would further these objectives, therefore showing that "cause" existed to allow the vote change.

The senior noteholders also argued that the death trap in Momentive's plan of reorganization was more akin to an open-ended settlement offer, and that if the court granted the vote change motion, it would merely allow the senior noteholders to accept the offer that was on the table. In their view, the "death trap" provisions in the plan was an open ended offer, available up until the date that the plan

[64] Subsequent to issuing his original bench ruling, Judge Drain filed a *Corrected and Modified Bench Ruling on Confirmation of Debtors' Joint Chapter Plan of Reorganization for Momentive Performance Materials Inc. and its Affiliated Debtors. In re MPM Silicones, LLC*, Case No. 14-22503, 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y. Sept. 9, 2014) (Dkt. No. 979) (the "*Transcript*").

went effective. Bankruptcy Rule 3018, they said, required "cause," and this didn't necessarily mean that "cause" had to be a good thing for the debtors.

Analysis

Focusing first on the trading prices of the senior debt, Judge Drain speculated that the reason the senior noteholders' motion was before him was that the their bonds had traded down in light of the court's confirmation ruling and that, essentially, the senior noteholders were looking for a do-over:

> I mean, you would have had a lot more certainty, right, if 3,000 people who voted for Ralph Nader in Florida got the chance to change their vote, that might have objectively been a good thing, but that's not how elections go. They made the choice to vote for Ralph Nader.

Judge Drain viewed the relief being sought by the senior noteholders as paternalistic, requiring him to impose his views of what a proper settlement would be on all of the parties, something that he was unwilling to do, and that other parties would no doubt object to.

The Court further recognized that death-traps existed for a reason, with the following summing up Judge Drain's views succinctly,

> I mean, there's a reason it's called fish-or-cut-bait or death-trap. You either do it, or you die, or you win. You guys concluded that you wouldn't die, you would win, and maybe you will on appeal. It's possible. Maybe the bond prices will go up again. Should I let people change the vote every time bond prices go down? If the bond prices go up, are the seconds going to say I want to change my vote? It's just -- there's no end to it.

Judge Drain found that certain types of "cause" allowing for a vote change were obvious, such as a breakdown in communication at the voting entity for the creditor, a misreading of the terms of the plan or execution of the ballot by someone who did not have authority caught within a reasonable time by someone who did. Other forms of "cause" were not so obvious, and reported decisions in this area often deal with situations in which a vote change is tainted, often where the creditor believes the change in vote will benefit it. For instance, where a creditor has purchased a claim from a party who had voted one way on a plan, and then seeks to change the vote to enhance negotiation leverage against the debtor or another party, such vote changes are not permitted without the support of the plan proponent. If, however, such a vote change is supported by a plan proponent, courts will generally approve the vote change if it is furtherance of a consensual plan.

The court concluded that "fish-or-cut-bait" or "death trap" provisions have long been customary in chapter 11 plans, with a clear rationale: the saved the expense and uncertainty of a cramdown fight, which is in keeping with the Bankruptcy Code's overall policy of fostering consensual plans of reorganization. Judge Drain found that such provisions offer a choice to avoid the expense and more importantly the uncertainty of a contested cramdown hearing.

Ultimately, Judge Drain did not believe that the death trap offer in the plan was still open: if it were, the debtors would already have accepted it. The vote change was not an attempt at a consensual settlement, it was to undo a choice that had already been made and this wasn't sufficient to establish "cause." In the Court's view, because tactical or strategic changes in a vote after the voting deadline would sharply shift the balance towards a creditor that has obtained a blocking position in a case, or to one that has forced a cramdown fight and would negatively affect an otherwise orderly reorganization process, such relief should therefore be denied.

Conclusion

While the Bankruptcy Rules do allow for vote changes on chapter 11 plans, they don't allow parties to have it both ways. The popular English idiomatic proverb "you can't have your cake and eat it, too" might need to be slightly tweaked to sum up vote changes in the context of Bankruptcy Rule 3018 and Judge Drain's decision. Under Bankruptcy Rule 3018, you can't have your cake and eat it, too, unless your vote change has the approval of the plan proponent and the change is in furtherance of a consensual plan. In which case, bon appétit!

Stern Files

In this section:

- *The Ninth Circuit Waits for No One*
- *Back to School: Circuit Courts Provide "Cheat-Sheet" on Stern Consent Issues in Advance of the Supreme Court's Consideration of Wellness Int'l Network v. Sharif*

The Ninth Circuit Waits for No One

Kyle J. Ortiz and Doron Kenter

> "If ye continue in the faith grounded and settled, and be not moved away from the hope of [*EBIA v. Arkison*]. . ."
>
> – Colossians 1:23,
> King James version (as revised)

Earlier this year, we at the *Stern Files*[1] expressed our disappointment with the Supreme Court's limited decision in *Executive Benefits Insurance Agency v. Arkison*[2] and all of the questions it left unanswered (especially the question of whether the right to Article III adjudication of "*Stern* claims" could be waived with the parties' consent). But less than a month later, our sadness was transformed to joy when the Supreme Court granted certiorari in *Wellness Int'l Network v. Sharif*[3] and promised to revisit the "core" questions raised by *Stern v. Marshall* and its progeny.

While we all eagerly await the Supreme Court's thoughts on the consent question (or some other narrow decision based on a tangential point that manages to skirt the central questions for bankruptcy professionals), the Ninth Circuit once again saw fit to reiterate its position in a concise four page decision in *GBBY EWA Ltd. P'ship v. Finance Factors, Ltd.* (9th Cir. July 30, 2014). In that case, at the "eleventh hour," GBBY appealed from the district court's affirmance of the bankruptcy court's entry of a final order in a foreclosure action, arguing that the bankruptcy court lacked both (i) subject matter jurisdiction and (ii) authority to "decide [the] case in light of the Supreme Court's decision in *Stern*."

The Ninth Circuit found that the bankruptcy court had subject matter jurisdiction over the underlying action because it shared factually interdependent claims with an ancillary action brought before the bankruptcy court to enforce a settlement agreement that had been approved by the bankruptcy court. The Ninth Circuit, in an unpublished opinion but in no uncertain terms, decided to go further:

> [U]nlike subject matter jurisdiction, the guarantee of an Article III hearing is "subject to waiver" because the right "protect[s] primarily personal rather than structural, interests."

The Ninth Circuit went on to cite *Arkison* for the proposition that when the "allocation of authority between the bankruptcy courts and district courts" is in question, the issue of consent is dispositive," concluding that because the appellant had "consented to the bankruptcy court's authority to enter final orders or judgment, there was no constitutional infirmity in the bankruptcy court entertaining this action." The Ninth Circuit, apparently taking a cue from the Supreme Court, did not address whether this consent had to be express or could be implied.

Thus, as we await further guidance from the Supreme Court, the Ninth Circuit — which first gave us *Stern* (and later, *Arkison*) and which first created the circuit split[4] on the consent issue — has made it clear that even though it is the only circuit to have affirmatively stated that consent can cure the apparent constitutional infirmities raised by a bankruptcy court entering a final order on a *Stern* claim, it remains steadfast in its position in this regard. While we remain curious to see whether any other circuits will weigh in on these issues before the Supreme Court resolves these important open questions, it is refreshing to see that the circuit courts continue to devote meaningful attention to these central constitutional issues that affect so many of us in the bankruptcy arena. May it be so for the Supreme Court in *Wellness Int'l v. Sharif*.

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[1] *See The Stern Files* dated August 23, 2011 on the Weil Bankruptcy Blog.

[2] *See Breaking News: Unanimous Supreme Court Closes Statutory Gap, Leaves Other "Core" Stern Questions For Another Day* (*Executive Benefits Insurance Agency v. Arkison*) dated June 9, 2014 on the Weil Bankruptcy Blog.

[3] *See "Thank You, SCOTUS; It's About Time!": Supreme Court Grants Cert to Decide Meaningful Stern v. Marshall Questions* dated July 2, 2014 on the Weil Bankruptcy Blog.

[4] *See Stern Files: The Circuit that Originally Gave Us Stern Creates the First Stern Circuit Split* dated December 6, 2012 on the Weil Bankruptcy Blog.

Back to School: Circuit Courts Provide "Cheat-Sheet" on *Stern* Consent Issues in Advance of the Supreme Court's Consideration of *Wellness Int'l Network v. Sharif*

Kyle J. Ortiz and Doron Kenter

"Okay. Here we go. The short, short version."

– The Minister, *Spaceballs*

"I meant what I said and I said what I meant."

– *Horton Hatches the Egg*, Dr. Seuss

Remember CliffsNotes? (It's ok — you can admit it now.) Well, in the two months since the Supreme Court granted certiorari in *Wellness Int'l Network v. Sharif*[5] to (hopefully) address the question of whether parties can waive their "right" to have an Article III court adjudicate "*Stern* claims" (and, perhaps, non-core claims), two circuit courts of appeal have taken it upon themselves to save the uninitiated the trouble of the brief research required to find and read their earlier decisions giving rise to the still-extant circuit split. Last month, we reported on the Ninth Circuit's decision in *GBBY EWA Ltd., P'ship,* where that court reiterated its prior position[6] that the right to Article III adjudication can be waived by consent of the parties — whether that consent is expressly granted or simply implied by virtue of the parties' conduct. Now, in its own CliffsNotes-style memo to the Supreme Court, the Fifth Circuit Court of Appeals reminds us of its position (which it shares with the Sixth and Seventh Circuits) that the right to Article III adjudication is structural, and thus not capable of waiver — even if that waiver is express and undisputed.

Background

In *In re Galaz*,[7] the debtor had been a co-owner with her husband of 50% of Artist Rights Foundation, LLC (ARF), a company organized to collect royalties owed to a former funk band. After the couple divorced, the ex-husband allegedly transferred away the company's rights to collect those royalties to a third party company called "Segundo Suenos" without obtaining the consent of his ex-wife (then a 25% owner of the company, with no voting or management rights) or of their partner, Julian Jackson (who held the remaining 50% interest and the associated management rights). The debtor (*i.e.*, the ex-wife) then commenced an adversary proceeding in bankruptcy court against her ex-husband, his co-conspirator, and Segundo Suenos, asserting claims for breach of fiduciary duty and pursuant to sections 542, 544, and 548 of the Bankruptcy Code and pursuant to the Texas Uniform Fraudulent Transfer Act, alleging that her ex-husband fraudulently transferred her rights to the royalties away from their jointly-owned company. The defendants then commenced a third-party complaint against Julian, who, in turn, asserted counterclaims against the defendants.

Let's recap: Lisa, Raul, and Julian own ARF. Lisa and Raul get divorced. Raul transfers a 25% interest in ARF to Lisa, but the voting rights are not included. Raul and Alfredo transfer ARF's value to Segundo Suenos (without Julian's or Lisa's consent). Lisa files for bankruptcy and sues Raul, Alfredo, and Segundo Suenos. They, in turn, sue Julian. Julian sues them back. All of this takes place in Lisa's bankruptcy case.

After considering all of these claims, the bankruptcy court concluded that the transfer from ARF to Segundo Suenos constituted a fraudulent transfer under the Texas Uniform Fraudulent Transfer Act and entered a final judgment awarding the debtor damages. Raul and Segundo Suenos appealed to the district court, which affirmed. They then appealed to the Fifth Circuit, alleging, among other defenses, that the bankruptcy court lacked constitutional power to enter final judgment on the various claims

[5] *See* "*Thank You, SCOTUS; It's About Time!": Supreme Court Grants Cert to Decide Meaningful Stern v. Marshall Questions* dated July 2, 2014 on the Weil Bankruptcy Blog.

[6] *See Ninth Circuit Weighs In On Stern v. Marshall and Fraudulent Transfer Actions OR Stern v. Marshall (Yet Again): Are We All Just Making a Mountain Out of a Mole Hill?* dated December 5, 2012 and *Stern Files: The Circuit that Originally Gave Us Stern Creates the First Stern Circuit Split* dated December 6, 2012 on the Weil Bankruptcy Blog.

[7] *In re Galaz,* 765 F.3d 426 (5th Cir. 2014).

against them (including, but not limited to, Lisa's claims), in light of *Stern v. Marshall.*

Stern, at first glance, was not on point. The claims at issue were non-core "related to" claims instead of "core" claims (and were, therefore, not "*Stern* claims"). The district court, however, had affirmed the bankruptcy court's final judgment because it concluded that the defendants had impliedly consented to entry of a final judgment in the bankruptcy same. *Stern*, then, was relevant insofar as certain courts (including the Fifth Circuit) have held that certain infirmities in a bankruptcy court's ability to finally adjudicate a matter before it (whether they be core "*Stern* claims" or simply non-core claims) are not waiveable by the parties, even with their express consent to same.

Analysis

On appeal, the Fifth Circuit held that "the district court's consent rationale" was inconsistent with circuit precedent stemming from the Fifth Circuit's earlier *Frazin*[8] and *BP RE* decisions, which (relying on the Sixth Circuit's *Waldman* decision) held that "according to *Stern*, the parties' express or implied consent cannot cure the constitutional deficiency that results from circumventing, or diminishing, the Article III structural protections for the federal judiciary." The Fifth Circuit went on to note that the Supreme Court in *Executive Benefits v. Arkison*[9] had dodged the issue of whether consent can cure these constitutional infirmities, but noted that the Court had granted cert in *Sharif* to resolve that issue. Nonetheless, pending resolution of that issue, the Fifth Circuit stated that until "the Supreme Court decides [that issue], we are bound by controlling circuit precedent."*

The Fifth Circuit was then left with the question of how to deal with the case before it. Reverse? Dismiss? Remand? Showing great practicality, the Fifth Circuit stated that "[t]he failure of the consent rationale does not vitiate the lower courts' work altogether, however." Noting that even though the Supreme Court hadn't settled the consent issue in *Executive Benefits*, it had addressed the statutory gap question in holding that where bankruptcy courts lack final adjudicatory authority, they may still issue proposed findings of fact and conclusions of law for review by the district court. Accordingly, the Fifth Circuit elegantly remanded the matter back to the district court for "*de novo* review of the bankruptcy court's decision as recommended findings and conclusions." Although we won't weigh in on the merits of the actions in *Galaz*, we'd be surprised to see a vastly different outcome in that case in the end, notwithstanding the confusion and inefficiencies[10] that *Stern* and its progeny may have generated.

Now that the circuit courts have gotten everyone up to speed, it's on to the main event — *Sharif.*

*It should be noted that the bankruptcy court and the district court issued their opinions before the Fifth Circuit weighed in on the issues described herein, and therefore had not disregarded binding precedent in issuing their original decisions.

[8] *See Stern Files: Fifth Circuit Finally Weighs In and Holds Consent Cannot Cure Bankruptcy Court's Lack of Constitutional Authority* dated October 18, 2013 on the Weil Bankruptcy Blog.

[9] *See Breaking News: Unanimous Supreme Court Closes Statutory Gap, Leaves Other "Core" Stern Questions For Another Day* (*Executive Benefits Insurance Agency v. Arkison*) dated June 9, 2014 on the Weil Bankruptcy Blog.

[10] *See A Scatological Analysis of Bankruptcy Court Jurisdiction and Authority After Stern v. Marshall* dated August 1, 2012 on the Weil Bankruptcy Blog.

Slice of the Pie

In this section:

Genco: Dry Bulk Shipping Valuations No Longer Anchored to Discounted Cash Flow Method

Gabriel A. Morgan

Discounted cash flow analysis is a mainstay among the valuation methodologies used by restructuring professionals and bankruptcy courts to determine the enterprise value of a distressed business. Despite its prevalence, the United States Bankruptcy Court for the Southern District of New York recently concluded that the DCF method was inappropriate for the valuation of dry bulk shipping companies. *In re Genco Shipping & Trading Limited*.[1] Although the bankruptcy court merely applied existing law to the facts of the case, the decision in *Genco* could serve as precedent for the valuation of companies in other segments of the shipping industry, and other industries, that experience significant volatility in rates.

Genco and the Prepackaged Plan of Reorganization

Genco Shipping & Trading Limited is a leading provider of maritime transportation services for dry bulk cargoes such as iron ore, coal, grain, and steel products. Through its subsidiaries, Genco owns and operates a fleet of 53 vessels, which it contracts out to third-parties under fixed-rate or spot-market time charters.

In April 2014, Genco and certain of its affiliates commenced cases under chapter 11 of the Bankruptcy Code. It sought to implement a prepackaged plan of reorganization that would consensually restructure approximately $1.48 billion in secured and unsecured debt. The Genco plan had the following key features:

- Approximately $1.2 billion of secured debt would be converted into equity in the reorganized company.
- New capital, in the amount of $100 million, would be invested through a fully-backstopped rights offering.
- The maturities for two secured prepetition facilities would be extended.
- Allowed general unsecured claims would be reinstated and paid in the ordinary course of business.
- Existing equity holders would receive warrants for up to 6% of the equity in the reorganized company.

The plan garnered unanimous approval from Genco's secured lenders and holders of its unsecured convertible notes.

The Genco plan was premised on an enterprise valuation between $1.36 billion and $1.44 billion. The debtors derived this range of values from a "Net Asset Valuation" analysis, a methodology commonly applied to shipping companies in non-bankruptcy contexts. An upcoming post will examine the bankruptcy court's analysis of the NAV methodology in the bankruptcy context.

Equity Committee Contested Genco Plan Valuation

Less than three weeks into the bankruptcy, the U.S. Trustee appointed an equity committee, which was comprised of (i) Aurelius Capital Partners LP, (ii) Mohawk Capital LLC, and (iii) OZ Domestic Partners, LP (a/k/a Och Ziff).

The equity committee objected to confirmation of the Genco plan. It argued, among other things, that the debtors' enterprise value was actually between $1.54 billion and $1.91 billion. The equity committee argued that, because the debtors were solvent under its valuation, existing equity holders were entitled to greater recoveries than those provided under the Genco plan. The equity committee derived its range of values from a weighted average of its DCF, comparable company, precedent transaction, and NAV analyses, weighting each at 37.5%, 37.5%, 10%, and 15%, respectively.

Bankruptcy Court Rejected DCF Methodology for Dry Bulk Shippers

To determine whether Genco's enterprise value exceeded $1.48 billion, the amount at which existing equity holders would be entitled to any recovery, the bankruptcy court examined the testimony presented with respect to each of the four valuation methodologies. The bankruptcy court concluded that there were "many good reasons that the DCF method should not be applied here" and considered only the remaining three methodologies, ultimately

[1] 513 B.R. 233 (Bankr. S.D.N.Y. 2014).

determining that the debtors' value did not exceed $1.48 billion.

The bankruptcy court began its analysis of the DCF methodology by explaining it briefly, as follows:

> "A discounted cash flow analysis entails estimating the periodic cash flow that a company will generate over a discrete time period, determining the "terminal value" of the company at the end of the period, and discounting each of the cash flows and terminal value to determine the total value as of the relevant date."

Thus, even though a DCF analysis is a "traditional methodology," it is of limited use when based on projections of future cash flows that are unreliable or difficult to ascertain. The bankruptcy court found that accurate cash flow projections did not exist for Genco, and it observed that the parties agreed on this point. In fact, the equity committee's financial adviser testified that "shipping rates are volatile and the industry can be characterized as cyclical …." In addition, the equity committee's expert witness conceded that "[i]t is difficult to accurately forecast freight rates in drybulk shipping …. [and that] the drybulk market is dynamic and volatile."

Interestingly, the bankruptcy court concluded not just that accurate projections were unobtainable in the case of Genco, specifically, but also for dry bulk shippers, generally. The bankruptcy court observed that the DCF method is inappropriate for the dry bulk shipping market because it is volatile and highly fragmented, has low barriers to entry, and little differentiation exists among competitors, causing charter rates to fluctuate with supply and demand and making revenues unpredictable. The bankruptcy court further noted that its market-wide concerns were exacerbated in the case of Genco because Genco's long-term charters are set to expire by October 2014, leaving the company entirely exposed to market volatility through spot-rate charters.

Equity Committee's DCF Analysis Unpersuasive for Additional Reasons

Although the bankruptcy court found that "the volatility of the [dry bulk] industry is a sufficient basis by itself to reject a DCF analysis," it proceeded to identify a number of particular problems that made the equity committee's DCF analysis unpersuasive.

First, the bankruptcy court noted that the equity committee's heavy reliance on its DCF analysis was internally inconsistent because the assumptions about future industry performance underlying that analysis were based on reports from equity analysts, most of whom did not utilize the DCF method in reaching their conclusions. Second, in written materials presented to Och Ziff prior to the bankruptcy filing, the financial adviser to the equity committee noted that the DCF method was not commonly used to value companies in the shipping industry. The bankruptcy court also noted that, before being retained by the equity committee, the financial adviser to the equity committee prepared pitch materials for the debtors in which it estimated a shortfall in Genco's collateral value. The bankruptcy court made clear that it did not rely on this fact in reaching its decision, but mentioned it and other, similar statements that undermined the credibility of the testimony presented by the financial adviser to the equity committee. Third, the equity committee's argument that DCF analyses were used in fairness opinions issued in connection with certain maritime M&A transactions was not compelling because other evidence suggested that those transactions focused more on the NAV methodology for purposes of valuation, and there was conflicting testimony on the usefulness of fairness opinions in the context of a contested hearing on valuation. Finally, the bankruptcy court found that the testimony presented by the equity committee's expert witness regarding shipping rate forecasts was "unpersuasive and less credible than that" presented by the debtors' expert.

Lessons Learned

The prospective nature of the DCF method often allows parties to advocate for higher valuations on subjective and/or intangible grounds. The *Genco* decision is significant because it establishes a clear precedent rejecting the DCF method when determining the enterprise value of dry bulk shipping companies in bankruptcy. This precedent may reduce the leverage of parties, such as equity holders, that would benefit from a higher valuation of a dry bulk shipper.

The decision, however, will likely have farther-reaching consequences. Dry bulk is just one segment of the larger shipping industry, and many other segments share the characteristics that the bankruptcy court cited to support its conclusion that accurate projections were unobtainable. Similarly, shipping is not the only industry with notable volatility; other industries may soon become the next port of call for the *Genco* decision.

Genco: Future Earnings? That Was Then; This Is Now

Gabriel A. Morgan

Bankruptcy courts typically rely on three valuation methods to determine a debtor's enterprise value: comparable company analysis, precedent transaction analysis, and discounted cash flow analysis. As we previously reported, the United States Bankruptcy Court for the Southern District of New York recently concluded that the DCF method was inappropriate for the valuation of dry bulk shipping companies because rate volatility obscured future cash flows. *In re Genco Shipping & Trading Limited*.[2] In the same decision, the bankruptcy court accorded substantial weight to a fourth, asset-based method: Net Asset Valuation. As with its holding with respect to the DCF method, the bankruptcy court's decision to consider the NAV method could easily serve as precedent for the valuation of companies in other segments of the shipping industry, as well other industries that experience significant volatility in rates.

Background and Facts

Salient facts regarding Genco and the significant events in its bankruptcy case can be found in our July 24, 2014 post.

To recap, Genco had approximately $1.48 billion in claims to be paid in full before equity holders would recover anything under the absolute priority rule. Genco submitted a prepackaged plan of reorganization, which was premised on an enterprise valuation between $1.36 billion and $1.44 billion. Genco's secured lenders and holders of unsecured convertible notes unanimously approved the plan, but the equity committee objected to confirmation. The equity committee argued, among other things, that the debtors' enterprise value was actually between $1.54 billion and $1.91 billion.

Whereas the debtors' valuation relied entirely on the NAV analysis, the equity committee's valuation was the weighted average of its DCF, comparable company, precedent transaction, and NAV analyses. To determine whether Genco's enterprise value exceeded $1.48 billion, the bankruptcy court examined the testimony presented by both sides with respect to each of the four valuation methodologies. In the end, the bankruptcy court found that Genco's enterprise value did not exceed $1.48 billion, and, therefore, the debtors' plan did not give creditors a recovery greater than 100% of their claims and could be confirmed.

Debtors' Net Asset Value Analysis

The bankruptcy court described the NAV method as process of adding together the value of a company's assets. Here the bulk of the asset value was in the debtors' vessels, but they had other assets as well, such as equity stakes in other companies, service contracts, and cash on hand. To establish vessel values, the debtors turned to a variety of sources, including vessel appraisals from Marsoft and two unidentified shipbrokers, as well as VesselsValue, a recognized source of vessel value data. At trial, the debtors' expert on vessel valuation was from Maritime Strategies International, and he used three approaches in his overall assessment.

The first approach was "econometric modeling," in which the expert valued vessels "on the basis of their earning power, which changes depending on market fundamentals." The second approach was a "time series" analysis, in which the expert derived vessel values after considering benchmarks, such as price, earnings, and operating costs, for the applicable classes of dry bulk vessels as "measured at successive points in time to extract characteristics of the data." The third approach was a "last done" analysis, in which the expert considered recent sales and "market intelligence" on comparable vessels and made adjustments for the particular vessels in question. As part of his assessment, the debtors' expert made adjustments to vessel values for the length of time before special and immediate surveys and based on engine make and model, the country and shipyard in which the vessel was built, vessel design and/or configuration, and a vessel's desirability relative to similarly classed vessels. The debtors' expert concluded that the aggregate "charter free market value" for Genco's fleet was $1.21 billion.

On top of that, the debtors' financial advisor then added the following:

[2] 513 B.R. 233 (Bankr. S.D.N.Y. 2014).

- $40 million for net working capital,
- $98 million for equity stakes in other companies,
- $40 million for service contracts, and
- $4 million for other fixed assets.

In the end, the debtors' NAV analysis produced an enterprise value between $1.36 billion and $1.44 billion, leaving equity holders out of the money.

Bankruptcy Court Adopts Net Asset Value Methodology for Dry Bulk Shippers

The equity committee did not challenge the substance of the debtors' NAV analysis. Rather, it argued that the debtors' asset-based methodology undervalued Genco as a going concern because it did not "fully account for all the tangible and intangible value of Genco's corporate franchise, experienced management team, and future cash flows, which are the hallmarks of true going-concern enterprise valuation derived from traditional methodologies …."

The bankruptcy court agreed that the NAV method should not be the "exclusive basis" for establishing the Genco's enterprise value. It disagreed, however, with the equity committee's "dismissive attitude" toward the NAV method (only 15% of its weighted average) and concluded that NAV was not only an appropriate method under the circumstances but deserved "substantial weight" due the nature of dry bulk shipping. Specifically, the bankruptcy court cited the debtors' testimony and the treatise *Maritime Economics* to find that the dry bulk market "is competitive, highly fragmented, and has low barriers to entry" and resembles the perfect competition model developed in classical economics. Because "companies keep investing until marginal cost equals price and in the long term marginal cost is the cost of capital," the bankruptcy court concluded that the asset-based NAV method was "highly probative."

The bankruptcy court further observed that the handful of comparable transactions identified by the parties corroborated the bankruptcy court's conclusion because the indicative values in those transactions were "at or very near NAV."

Lessons Learned

The bankruptcy court's decision to accord substantial weight to the NAV method is particularly interesting in light of its decision to reject the DCF method because both methods rely on projections of future cash flows. The DCF method projected the future cash flows from operation of the debtors' vessels and discounted those amounts to obtain a present value. The NAV method added together market values for the debtors' vessels, which values are a function of expected future cash flows from operation of each vessel. Indeed, each of the three NAV "approaches" utilized by the debtors' expert on vessel values considered the earning power of the debtors' vessels.

The bankruptcy court appears to address the discrepancy by adopting the debtors' explanation that the NAV method is "based on independent appraisals that incorporate an impartial assessment of the broadest, most concrete consensus regarding future earnings." Yet, it does not explain how the "concrete consensus regarding future earnings" for the NAV analysis affected its determination that "[n]o accurate projections exist in this case" for the DCF analysis and its conclusion that the "volatility of the [dry bulk] industry is a sufficient basis by itself to reject a DCF analysis." If rate volatility truly undermined the ability to project future earnings, vessel values based on market consensus regarding future earnings should also be inaccurate.

The bankruptcy court's decision is also significant because it may extend well beyond the original context. As with its rejection of the DCF method for dry bulk shippers, the bankruptcy court's decision turns on particular features of the dry bulk shipping market that can be observed both in other shipping segments as well as other industries. Thus, the *Genco* decision may offer precedent, or at least instruction, on the use of asset-based valuation methods, which will guide parties that would benefit from the lower enterprise values those methods generally produce.

In Assessing Solvency, Beware the Unknown Unknowns

Kyle J. Ortiz

Donald Rumsfeld might sum up a recent decision[3] by Judge Isgur out of the United States Bankruptcy Court for

[3] *Williams v. Wu (In re TTC Plaza Ltd. P'ship)*, 2014 WL 3057555 (Bankr. S.D. Tex. July 7, 2014).

the Southern District of Texas as follows: "We also know there are known unknowns; that it to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know." Little did we know that this sentiment could be applied to evaluating a company's solvency in the context of a fraudulent transfer analysis.

In *TTC Plaza,* the chapter 7 trustee commenced an adversary proceeding alleging that certain prepetition transfers made by the debtor in March 2011 were fraudulent under section 24.006(a) of the Texas Business and Commerce Code.[4] Judge Isgur held a trial on the threshold issue of whether the debtor was insolvent at the time of the March 2011 transfers. The definition of insolvency under Texas law is that "[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation." This definition closely mirrors the Bankruptcy Code's definition in section 101(32) of the Bankruptcy Code, which defines insolvency as a "financial condition such that the sum of [the] entity's debts is greater than all of [its] property, at a fair valuation."

Judge Isgur summarized the Fifth Circuit standard for assessing fair value as being determined "by estimating what the debtor's assets would realize if [the assets] were sold in a prudent manner" under the "market conditions" present on "the date of the challenged transfer." Although the debtor's March 2011 balance sheet showed the debtor's assets exceeded its liabilities, the chapter 7 trustee argued, and Judge Isgur ultimately agreed, that the assets listed on the March 2011 balance sheet were overvalued and that the debtor was actually insolvent at the time of the transfers. In addition to a number of receivables on the March 2011 balance sheet that the chapter 7 trustee was able to demonstrate the debtor had no real prospect of collecting, the chapter 7 trustee pointed to the eventual postpetition April 2012 sales price for the debtor's primary asset, a piece of real property, to argue that the value of the property as listed on the debtor's March 2011 balance sheet should be reduced for purposes of the solvency determination. Although the eventual buyer of the property was originally willing to purchase the property at an amount near the value listed on the debtor's March 2011 balance sheet, the sales price ended up being reduced after a neighbor refused to grant the buyer ingress/egress rights over its land to permit access to the property from a second road. Lack of access from a second road required the buyer to reduce the scope of its planned project for the property and forced the chapter 7 trustee to lower the sales price.

In determining the proper valuation to give to the property for purposes of the insolvency question, Judge Isgur held that "[t]he best evidence of the fair market value of the property as of March 2011 [was] … the purchase price obtained for the property in 2012." Even though the ingress/egress problem was not discovered until the property was sold, Judge Isgur found it appropriate to use the 2012 sales price (which factored in the ingress/egress problem) to determine the March 2011 value of the property, because the ingress/egress problem nonetheless existed at the time of the transfers. Judge Isgur went on to note that the defendant did not present any evidence to demonstrate that the chapter 7 trustee obtained less than fair market value from the sale of the property or that any changes to the real estate market occurred between March 2011 and April 2012 "that would have affected the fair market value of the property."

At first glance (but as we shall see, only at first glance), Judge Isgur's willingness to use hindsight to consider facts unknown to the debtor and the transferees at the time of the allegedly fraudulent transfers appears to be a departure from the standard in certain other districts. For instance, in *Iridium Operating,*[5] Judge Peck rejected the use of hindsight in "valuing a company's pre-bankruptcy assets." In *Iridium*, Judge Peck held that the market value of a startup company (that had yet to commence commercial operation) as determined by the value of its publicly traded securities at the time of certain allegedly fraudulent transfers was the best indicator of value. Judge Peck refused to use hindsight to factor into the

[4] (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

[5] *Iridium Operating LLC v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

valuation the fact that once the startup company commenced operations, it was an immediate commercial failure that never turned a profit and quickly fell into chapter 11. Judge Peck held that the market value as determined contemporaneously with the allegedly fraudulent transfers was the best indicator of value even if it turned out to "be an unreliable indicator of future fair market value" in hindsight.

Although one judge seemingly was willing to use hindsight and the other was not, Judge Peck and Judge Isgur's decisions, upon closer examination, are actually complementary. The following passage from Judge Peck's *Iridium* opinion demonstrates how the two decisions may be reconciled:

> When determining the value of a company's assets prepetition, it is not improper hindsight for a court to attribute "current circumstances" which may be more correctly defined as "current awareness" or "current discovery" of the existence of a previous set of circumstances. Such value, however, must be determined as of the time of the alleged transfer and not at what assets turned out to be worth at some time after the bankruptcy intervened.

The key distinction is between facts used to make a valuation that turned out to be wrong and facts that were present at the time of the transfers but were left out of an earlier valuation because they were unknown. In *Iridium*, Judge Peck relied upon a contemporaneous market valuation that reflected the value of the company as determined by the market with full knowledge of the factors that ultimately led to Iridium's demise. Market participants were aware of the factors when determining the value of Iridium, but didn't fully appreciate how fatal those factors were to the future business prospects of Iridium. In *TTC Plaza*, on the other hand, the valuation on the March 2011 balance sheet did not account for the ingress/egress problem at all even though the problem existed (albeit unknown to the parties to the transfers) at the time of the transfers.

Thus, when reading the two cases together, a hindsight rule begins to take shape. It is inappropriate to use hindsight to second guess a valuation made with full information even if such valuation turns out to be overly optimistic about future prospects (we might consider these the known unknowns). It is appropriate to use hindsight, however, when a fact that results in a lower valuation of the property and existed at the time of the transfer, but was not factored into the valuation because it was unknown to the debtor, is later uncovered (these are the unknown unknowns). Put simply, courts are unwilling to second guess valuations made with full information, but are willing to factor in newly introduced information that was left out of a valuation even if it was unknown to the parties at the time of the transfer.

Thus, when conducting a solvency analysis in connection with evaluating fraudulent transfer risk, as Rumsfeld famously cautioned, it's not necessarily the "known unknowns" that you need to worry about, but the "unknown unknowns."

Releases in Chapter 11 Plans

In this section:

The Fourth Circuit Provides a Useful Roadmap for Debtors Seeking Third-Party Releases

Christopher Hopkins

The inclusion of third-party releases in plan of reorganization can be a particularly contentious aspect of the plan confirmation process. Debtors seeking such releases typically face opposition from affected creditors and scrutiny from bankruptcy courts[1] that consider such releases prone to abuse. As the Fourth Circuit's recent decision in *National Heritage Foundation, Inc. v. Highbourne Foundation*[2] makes clear, courts will not simply "rubber stamp" third-party releases absent creditor consent unless the debtor is able to prove that the unique circumstances of the case justify the release. Even in jurisdictions where third-party releases may be enforced in appropriate circumstances, many courts only grant releases "cautiously and infrequently."

Background

National Heritage Foundation is a public non-profit charity that administers and maintains donor advised funds. In 2009, National filed for chapter 11 protection after a state court entered a multimillion dollar judgment against it. Following a contentious plan confirmation process, the bankruptcy court approved the debtor's plan of reorganization. The plan included a third-party release releasing claims against the debtor, the creditor's committee, and any officer, director, or employee of the debtor or the committee. Following confirmation of the debtor's plan, certain creditors affected by the releases challenged the bankruptcy court's approval of the plan on the ground that the release provision was invalid. The creditor's appeal was remanded back to the bankruptcy court by the Fourth Circuit after the district court affirmed the bankruptcy court's confirmation of the plan on the ground that the bankruptcy court failed to make sufficient factual findings to support approval of the release. On remand, the bankruptcy court (with a new bankruptcy judge) reversed and declared the release unenforceable. This time, National appealed, and after the district court affirmed the bankruptcy court's ruling, National found itself before the Fourth Circuit for the second time.

The *Dow* Factors: Justifying Third-Party Releases

The Fourth Circuit adopted the seven-factor test set out by the Sixth Circuit in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*[3] (which is a test comprised of six substantive factors and one non-substantive factor)[4] to determine whether National had adequately proved the appropriateness of the third-party release provision in the plan. The court applied the six substantive *Dow* factors to the facts of the case and concluded that National had failed to meet its burden. Because the court's decision addressed the applicable standards related to each *Dow* factor and applied the facts of the case to each of this six substantive factors, *National Heritage* provides a useful road map for debtors seeking approval of third-party releases.

1. Whether the debtor and the third-party share a unity of interest

Courts generally look to whether there is an indemnity or guarantee relationship between the debtor and the third-party. Where such relationships exist, courts reason that third-party releases may be appropriate because a suit against the third-party may operate in effect as a suit against the debtor by virtue of the indemnity or guaranty. Here, the court concluded that National had adequately

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[1] *Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142 (2d Cir. 2005).

[2] No. 13-1608, 2014 WL 2900933 (4th Cir. Jun. 27, 2014).

[3] 280 F.3d 648, 658 (6th Cir. 2008).

[4] The six substantive *Dow* factors are: (i) whether the debtor and the third-party share an identity of interest, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor; (ii) whether the third-party has contributed substantial assets to the reorganization; (iii) whether the injunction is essential to reorganization such that the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (iv) whether the impacted class, or classes, has overwhelmingly voted to accept the plan; (v) whether the plan provides a mechanism to pay for all, or substantially all, of the class or classes, affected by the injunction; and (vi) whether the plan provides an opportunity for those claimants who choose not to settle to recover in full. The seventh, non-substantive factor is whether the bankruptcy court made a record of specific factual findings that support its conclusion.

proved this factor by demonstrating that, under its by-laws, it was obligated to advance legal expenses and indemnify its officers and directors. The court reasoned that such an expansive indemnity obligation was enough to satisfy the first *Dow* factor. This would be the only *Dow* factor that National successfully proved weighed in favor of the release.

2. Whether the third-party has contributed substantial assets to the reorganization

This factor requires the debtor to prove that the released parties made a substantial, cognizable, and valid contribution of assets to the debtor as part of its reorganization. National attempted to meet its burden under this factor by asserting that its directors and officers had made a substantial contribution to the reorganization by promising to continue serving at National. The court rejected this argument, finding that National's directors and officers continued serving National because they were either paid or had a fiduciary duty to do so. Further, National offered no evidence supporting its assertion that its officers and directors actually promised to stay. Accordingly, the court concluded that the released parties had not provided meaningful consideration to National in exchange for the release.

3. Whether the release is essential to the debtor's reorganization

National not only failed to prove that it met this factor, but it also included provisions in its plan that "cemented" the court's belief that the release was not essential to its reorganization. The court stated that the relevant inquiry concerning this factor is whether the debtor's reorganization "hinges on the debtor being free and clear from indirect suits against parties who would have indemnity or contribution claims against the debtor." National failed to provide convincing evidence regarding the number of likely claims, the nature of such claims, and their potential merit, and other evidence provided by National was simply too vague to substantiate the risk of litigation. National's plan also included severability provision that provided that National's plan would remain in effect "should any provision in this Plan be determined to be unenforceable." The court reasoned that if the release was truly essential to the debtor's plan, National would not have made it subject to a severability provision.

4. Whether the creditors affected by the release have overwhelmingly voted in favor of the plan

The releases in National's plan primarily affected National's donor-investors. The Fourth Circuit was faced with an interesting dilemma. Because National's donors were not considered an impaired class under the plan, the donors were deemed to accept the plan without voting. National argued that the bankruptcy court was entitled to presume the donors' support of the releases because their claims were unimpaired. The Fourth Circuit disagreed, reasoning that although there is "some uncertainty regarding whether an unimpaired class's presumed support for a reorganization plan is sufficient to satisfy this *Dow* factor," National could have implemented a procedure providing each creditor the right to vote on the release irrespective of the creditor's class's right to vote on the plan. Because the affected creditors had no opportunity to accept or reject the plan — and thereby the release — the court refused to find that the equities tipped in National's favor.

5. Whether the debtor's plan of reorganization provides a mechanism to consider and pay substantially all claims of the affected creditors

National failed to establish that this factor justified the releases for two reasons: (i) National's plan failed to provide any mechanism for the payment of untimely and other claims not resolved through National's bankruptcy, and (ii) National failed to present evidence that the notice it provided to affected creditors adequately protected their interests. As a general matter, courts will usually find that a debtor has met its burden under this *Dow* factor where the debtor's plan provides for the "channeling" of released claims to a settlement fund or some other mechanism that prevents the release from effectively extinguishing the affected creditors' claims. The absence of such a mechanism from National's plan weighed against the grant of the release because the plan lacked an important safeguard: "a second chance for even late claims to recover."

Further, the court noted that National's course of conduct in dealing with the affected creditors did not constitute a bona fide effort to ensure the consideration of nearly all of the affected creditor's claims in the bankruptcy proceedings. National did not encourage the affected creditors to participate in the bankruptcy process. Instead, National's disclosure statement told the affected creditors that National would object to any filed claims and that the affected creditors had no right to vote on or reject the debtor's plan. Under such circumstances, the court refused to find that National had established that this factor weighed in favor of the release because National neither encouraged the affected creditors' participation in the bankruptcy process nor provided a mechanism to ensure such their claims were not extinguished by the release.

6. Whether the plan provides an opportunity for those who chose not to settle to recover in full

After noting that the proper analysis under this *Dow* factor largely overlaps with that of the fifth factor, the court reiterated the importance of National's failure to provide any mechanism to pay the affected creditors' claims outside of the bankruptcy proceedings. Further, noting National's inability to prove five of the six *Dow* factors weighed in favor of the release, the court reiterated the bankruptcy court's finding that the "very purpose of the Release Provision is to preclude any recovery from third party sources outside of the plan."

The Fourth Circuit ultimately concluded that, although a debtor need not demonstrate that every *Dow* factor is met, National had failed to tip the scales in its favor. Importantly, the court also noted that its ruling was rooted in National's "failure of proof rather than circumstances alone," suggesting that if National had provided adequate factual support for its claims that the circumstances warranted the third-party release, the court might have approved the release.

Conclusions

National Heritage is an instructive case for debtors seeking third-party releases. Where the inclusion of a third-party release in a plan has been challenged, debtors should be prepared to present specific and substantial evidence establishing the necessity of the third-party release; unsubstantiated assertions are not enough to pass muster. In addition, debtors should be mindful of the reasons the court ruled against National, which included the severability provision in the plan, National's failure to solicit the approval of the affected creditors with respect to the third-party release, and National's failure to provide a mechanism to prevent the release from effectively extinguishing the affected creditors' claims (especially given National's lack of bona fide effort to deal with the affected creditors' claims in the bankruptcy proceedings). Had any or all of these facts been different, then, perhaps, the releases may have been upheld.

Release Me! Release Me!: S.D.N.Y Bankruptcy Court Upholds Certain Non-Consensual Non-Debtor Releases Granted By Unimpaired Creditors and Equity Holders

Frank Grese

One topic we regularly write about on the Bankruptcy Blog is releases — especially third-party releases. The topic of third-party releases is often controversial, and circuits disagree about the extent to which they are permissible, if at all. In a recent memorandum opinion confirming the chapter 11 plan of drybulk shipper Genco Shipping and its debtor affiliates, the Honorable Sean Lane of the United States Bankruptcy Court for the Southern District of New York in *In re Genco Shipping & Trading Limited, et. al.* waded into the controversy by considering the appropriateness of third-party releases — and non-consensual ones at that.

Background

The Genco plan provided for certain standard releases and exculpations, including releases granted by the debtors and exculpation for released parties, which were not opposed by any party in interest. In addition, the plan included non-debtor releases granted by certain non-debtor third parties, including, among other parties, parties holding unimpaired claims and equity interests, who were deemed to accept the plan and, thus, not entitled to vote on the plan. Among the non-debtor parties to be released under the plan were the prepetition agent and lenders under the debtors' three credit facilities, convertible noteholders and their indenture trustee, and parties agreeing to backstop the debtors' rights offering. The U.S. Trustee and the official committee for equity holders objected to such third-party releases. The U.S. Trustee objected to the extent holders of claims did not affirmatively consent to these releases and argued that a release granted solely because a party was deemed unimpaired under a plan violated section 1124(1) of the Bankruptcy Code (which sets forth the conditions under which a class of claims is impaired) because by requiring that an unimpaired holder of a claim or interest grant a release, the holder is, in effect, relinquishing certain legal rights and, therefore, is not in fact "impaired." The equity committee objected on the grounds that equity holders were not given the opportunity to vote, the releases were non-consensual, and otherwise failed to satisfy the requirements under Second Circuit law. In particular, the equity committee argued that no mechanism was established to allow an equity holder to exercise a right to opt-out of the releases.

In support of the releases, the debtors noted that no party, including the equity committee or the U.S. Trustee, identified any actual third-party claim that was being released by the parties that were not entitled to vote. With respect to unimpaired creditors, the debtors said that it would be difficult to imagine what possible remaining claims they could have when they were being paid in full under the plan. As to equity holders, the debtors hypothesized that the only claim an equity holder might have would be against directors and officers or certain creditors, but, they noted, such claims were almost certain to be estate causes of action being released by the debtors, without regard to third-party releases. In addition, the debtors noted that the third-party releases under the plan were being granted "to the fullest extent permissible under applicable law" and that courts in the S.D.N.Y. have found this qualification acceptable and have held that a plan is confirmable with such a qualification even if it provides for impermissible, non-consensual third-party releases. The debtors also characterized the binding of unimpaired creditors who did not vote on the plan as an unremarkable feature of any non-consensual third-party release and cited certain S.D.N.Y. cases approving similar treatment. Finally, the debtors dismissed the U.S. Trustee's "novel" section 1124 argument as irrelevant arguing that section 1124 applies to a class of claims or interests *against the debtor* as opposed to claims against third parties.

Analysis

After considering the arguments, the court concluded that the non-consensual third-party releases were permissible so long as the Second Circuit standard set forth in *Metromedia* was satisfied. The *Metromedia* standard looks to (i) whether the releases are important to a debtor's plan; (ii) the claims are channeled to a settlement fund rather than extinguished; (iii) the enjoined claims would indirectly impact the debtor's reorganization by way of indemnity or contribution; (iv) the released party provides substantial contribution; or (v) whether the plan otherwise provides for full payment of the enjoined claims. The Second Circuit has stated that the *Metromedia* standard is not a matter of factors or prongs, but, instead, requires a finding of unique circumstances. The court agreed in part with the U.S. Trustee that just because a party's claim or interest is classified under a plan as unimpaired does not mean that the party should automatically be deemed to have granted a release when the *Metromedia* standard is not met. The court then proceeded to analyze the releases under the *Metromedia* standard.

First, the court approved all consensual releases under the plan — *i.e.*, by parties that expressly consented to grant the releases or were deemed to have done so through their ability to "check the box" on the plan's voting ballots. The court noted that this includes those who voted in favor of the plan and those who voted to reject the plan but failed to opt out from granting the release provisions. Second, the court approved all third-party releases for claims that would trigger indemnification or contribution claims against the debtors, explaining that the purpose of such releases is to align with indemnification obligations of the debtors that existed before the filing of the bankruptcy such as indemnification obligations under employment agreements, bylaws, or loan agreements. The court, however, refused to extend its ruling to indemnification obligations that arose out of plan negotiations or negotiations surrounding the restructuring support agreement executed by the debtors, the vast majority of their secured creditors, and holders of unsecured convertible notes. The court reasoned that granting such releases would allow parties to create indemnification obligations simply to gain the protection of a third-party release and quoted case law reaching a similar conclusion on the grounds that the law would be turned on its head if parties could require a third-party release as a condition to a restructuring agreement or plan and circumvent the general rule that non-debtor third-party releases are proper only in rare cases. Third, the court approved third-party releases as to those parties who provided substantial consideration to the reorganization by (i) agreeing to forego consideration to which they would otherwise be entitled and providing a distribution of warrants to existing equity holders; (ii) providing new value to the debtors by agreeing to backstop a rights offering; or (iii) agreeing to receive equity in exchange for debt. The court found that these concessions are "precisely the types of circumstances and 'give-ups' that meet the requirements of *Metromedia*, in return for which it is appropriate to grant the [third-party releases]," and are important to implementation of the plan.

Conclusion

Genco's ruling — that a plan can require holders of unimpaired claims or equity interests to grant a release to non-debtors even when such parties were not entitled to vote on the plan and did not otherwise consent to, or have an opportunity to opt-out of, granting such a release — is noteworthy because it was presented to the court as a novel issue that no prior case law had addressed. Another noteworthy aspect of the ruling is the court's refusal to approve third party-releases that arose only out of a restructuring support agreement or plan negotiations.

The court's ruling on third-party releases is not the only significant aspect of the *Genco* confirmation opinion — there were also noteworthy conclusions on valuation, including the court's conclusion that the discounted cash flow methodology is not appropriate in the drybulk shipping context.

Indecent Disclosure: How the Failure to Disclose a Third-Party Release Led to Its Undoing

Adam M. Lavine

As a result of the sheer number of legal and factual issues involved in many chapter 11 cases, bankruptcy judges can sometimes find themselves as captives of the parties; they may not appreciate the significance of an issue or a provision buried in a longer document unless it is properly presented. Thus, it is imperative that counsel flag the key issues for the court. Failure to do so risks severe consequences for parties in interest, as exemplified by *In re Lower Bucks Hospital*.[5]

In *Lower Bucks*, the Third Circuit (in an opinion by Judge Ambro) denied approval of a third-party release contained in a chapter 11 plan, in large part because such release was not properly disclosed to creditors or the court at the appropriate time. As we previously reported, the lower courts in this case, the District Court for the Eastern District of Pennsylvania and the Bankruptcy Court for the Eastern District of Pennsylvania, likewise relied on the parties' failure to disclose properly the third-party release as a basis for denying their approval.[6]

Background

In *Lower Bucks*, an indenture trustee filed a $26 million secured claim on behalf of certain bondholders. The debtor disputed the priority of the claim, arguing that the indenture trustee had failed to properly perfect its security interest. Ultimately, the indenture trustee and the debtor reached a settlement that granted the bondholders secured status in exchange for a reduction of the claim from $26 million to $8.15 million.

The settlement agreement included releases between the signatories (the debtor and the indenture trustee) as well as a release of all bondholder claims against the indenture trustee — *i.e.*, a non-consensual third-party release. The settlement agreement was approved by the bankruptcy court at a hearing pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure.

The third-party release was also built into the debtor's plan of reorganization. Critically, however, the third-party release was referenced only once in the plan (on page 42 of 47) and only once in the disclosure statement (on page 55 of 62). The release was not emphasized in any way, whether through bold-face type, italics, or underlining. Further, neither counsel for the debtor nor counsel for the indenture trustee referenced the third-party release at the

[5] No. 13-1311, 2014 WL 2981215 (3d Cir. July 3, 2014).

[6] *See NO WALLFLOWERS HERE: Bankruptcy Court Holds That Disclosure Statement Containing Third Party Release in Favor of Indenture Trustee Must Specifically and CONSPICUOUSLY Inform Bondholders of Release* dated June 22, 2012 and *The Latest on Third Party Releases* dated January 15, 2013 on the Weil Bankruptcy Blog.

Rule 9019 hearing or at the disclosure statement hearing. Accordingly, the court was unaware of the third-party release when it approved of the settlement agreement and later the disclosure statement.

After the disclosure statement was approved, a bondholder objected to the proposed plan, arguing that the third-party release was impermissible and not properly disclosed. At the confirmation hearing, the parties agreed to sever provisionally the third-party release from the plan and hold a separate hearing on the propriety of such release after confirmation. The bankruptcy court confirmed the plan but subsequently denied approval of the third-party release.

The Third Circuit's Decision

In *Lower Bucks*, the Third Circuit decision addressed three issues: (1) was the third-party release adequately disclosed in the disclosure statement, (2) could the bankruptcy court revisit its initial approval of the disclosure statement, and (3) was the denial of the third-party release appropriate?

With respect to the first issue, the Third Circuit held that the bankruptcy court did not abuse its discretion in finding that the disclosure statement did not contain "adequate information" with respect to the third-party release as required by section 1125 of the Bankruptcy Code. In support of this holding, the Third Circuit noted that the debtor had violated Rule 3016(c) of the Federal Rules of Bankruptcy Procedure, which requires that "[i]f a plan provides for an injunction … , the plan and disclosure statement shall describe in specific and conspicuous language (bold, italic, or underlined texts) all acts to be enjoined …." In addition, the Third Circuit observed that the release was "omitted from numerous sections of the disclosure statement where it was arguably relevant" and that "in both presentation and placement, the documents sent to the Bondholders did not differentiate the Third-Party Release from any of the other information provided. …"

With respect to whether the bankruptcy court could revisit its initial approval of the disclosure statement, the Third Circuit held that it could under Rule 9024 of the Federal Rules of Bankruptcy Procedure, which incorporates Rule 60(b) of the Federal Rules of Civil Procedure. Rule 60(b) allows courts to reconsider earlier orders in the case of "mistake, inadvertence, surprise, … excusable neglect," or "any other reason that justifies relief." According to the Third Circuit, once the bankruptcy court learned of the third-party release after its approval of the disclosure statement, Rule 60(b) permitted the bankruptcy court to revisit that decision. The Third Circuit reasoned that "any other rule would encourage debtors to obscure information in their disclosure statement."

Finally, when considering whether the bankruptcy court was correct to withhold approval of the third-party release, the Third Circuit applied the standard it had crafted in *In re Continental Airlines*.[7] Under this standard, some small subset of non-consensual third-party releases might be confirmable where the release is both necessary to the plan of confirmation [sic] and given in exchange for fair consideration. … [T]he hallmarks of a permissible non-consensual third-party release [are] fairness, necessity to the reorganization, and specific factual findings to support these conclusions.

Applying the *Continental Airlines* standard, the Third Circuit held that the third-party release of claims against the indenture trustee could not be approved. In support of this holding, the Third Circuit reasoned that if the bankruptcy judge was not aware of the third-party release, "it seems highly unlikely that a typical Bondholder was." Thus, absent adequate disclosure of the release to bondholders, it was impossible for the court to conclude that the release was exchanged for adequate consideration or was otherwise fair to the relevant parties.

The Takeaway

The main takeaway from *Lower Bucks* should be obvious. Just in case it isn't, the Third Circuit made sure to spell it out in a concluding paragraph seemingly directed at bankruptcy practitioners:

Key terms of a plan of confirmation, particularly those that release a non-debtor from claims by creditors, must be adequately disclosed. Failure to do so in a clear and conspicuous manner risks excision of the release from the plan. That is what occurred here, and thus we affirm.

[7] 203 F.3d 203 (3d Cir. 2000).

Let's Call the Whole Thing Off: What Happens If the Bankruptcy Code Says Yes, But the Debtor's Governance Documents Say No?

Christopher Hopkins

As a general matter, governance provisions in a chapter 11 debtor's organizational documents continue to apply postpetition.[8] But what if those governance provisions prevent the debtor from engaging in an act expressly authorized by the Bankruptcy Code? This issue was recently addressed by the United States Bankruptcy Court for the Southern District of Florida in *In re DocAssist, LLC*,[9] where the court held that a debtor-LLC could not obtain postpetition financing pursuant to section 364 of the Bankruptcy Code without first obtaining the approval of a supermajority of its members as required by its operating agreement.

In re DocAssist, LLC

The dispute in *DocAssist*, though addressed in the bankruptcy context, was essentially a two-party governance dispute. Formed as a Florida LLC, the debtor's members consisted of two factions: the majority members, which owned a 64.16% equity interest in DocAssist, and the minority members, which owned the remaining 33.84%. The majority members were also the debtor's primary prepetition lenders, providing nearly $3.8 million in capital through a number of unsecured loans. Prepetition, the majority had tried to effect certain amendments to the debtor's operating agreement in an effort to extinguish the minority members' interest in the LLC, which were subsequently invalidated in state court. Unwilling to concede defeat, however, the majority members caused the debtor to file a prepackaged chapter 11 plan in the Bankruptcy Court in an attempt to wipe out the minority members' interest through a plan of reorganization.

The majority members' proposed plan would extinguish all existing equity interests in the debtor and convert all prepetition loans into all of the equity of the reorganized LLC. Because the majority members were the debtor's primary prepetition lenders, the restructuring would leave the majority members with the overwhelming majority of the reorganized LLC's equity, effectively wiping out the minority members' interest. In addition, the plan provided that one of the majority members would provide $100,000 in postpetition financing pursuant to section 364 of the Bankruptcy Code. Shortly after the petition date, the minority members objected to the entirety of the debtor's plan, including the postpetition financing, and asked the court to dismiss the debtor's chapter 11 case.

Although the court ultimately abstained from the case on the ground that the debtor's chapter 11 case amounted to a "naked attempt to avoid the governance determinations by the State Court," and, therefore, there was "no economic need or purpose for [the debtor] to be in [c]hapter 11," the court took particular issue with the debtor's proposed postpetition financing. Pursuant to the debtor's operating agreement, certain "Major Decisions" required the supermajority approval of 66.67% of the members' equity interests, and the incurrence of any debt over $25,000 constituted a "Major Decision." Absent the consent of the minority members, therefore, the majority members could not cause the debtor to incur more than $25,000 in postpetition financing if the operating agreement remained in effect postpetition.

The majority members argued that the governance provisions of DocAssist's operating agreement ceased to apply upon the commencement of its chapter 11 case and that it was free to incur postpetition financing in any amount subject only to its own business judgment and the review and approval of the bankruptcy court. The court gave this argument short shrift, however, concluding that it was "nonsense" to suggest that a chapter 11 debtor was free to act in a manner inconsistent with its governing documents. Although the court's decision was likely influenced in view of the majority members' intentions in commencing the debtor's bankruptcy case, the court did not limit its holding to cases where the controlling shareholder or majority member engages in misconduct. Rather, the court reasoned that because the supermajority requirement was enforceable under Florida law, and no provision of the Bankruptcy Code provides a different result, the debtor remained bound by the

[8] *Official Bondholders Comm. v. Chase Manhattan Bank (In re Marvel Entm't Grp., Inc.)*, 209 B.R. 832 (D. Del. 1997).

[9] Case No. 14-27625 (JKO), 2014 WL 3955062 (Bankr. S.D. Fla. Aug. 8, 2014).

governance provisions of its operating agreement postpetition.

Conclusions

Given the unique circumstances surrounding the dispute in *DocAssist*, it remains to be seen whether the court would reach a similar conclusion in a legitimate chapter 11 case. Although the court's reasoning in *DocAssist* did not depend on a finding of misconduct by the controlling party, the court was clearly agitated by the majority members' thinly veiled attempt to exploit the chapter 11 process to circumvent the state court proceedings that frustrated their previous attempt to extinguish the minority members' interest. Nonetheless, the court's holding may have troubling implications for debtors whose organizational documents contain similar restrictions to those at issue in *DocAssist.* For example, could the minority members have used their effective blocking position to prevent the debtor from obtaining any postpetition financing in excess of $25,000 in order to force a liquidation of the LLC? The opinion in *DocAssist* seems to say "yes," suggesting that holders of a minority interest in a debtor could use governance provisions in a debtor's operating agreement to effectively hijack the chapter 11 process by simply withholding their consent, even where the debtor's proposed action (such as obtaining postpetition financing pursuant to section 364) is expressly authorized by the Bankruptcy Code.

The FDIC Goes to Court

In this section:

How to Overcome Your Fear of "Commitment" If You Are a Bank Holding Company

Maurice Horwitz

When a bank holding company files a chapter 11 case, a key factor to the success of the case will be whether the debtor previously made any commitment to a federal depository institution regulatory agency, such as the FDIC, to maintain the capital of the debtor's bank subsidiary. This is because section 365(o) of the Bankruptcy Code provides that the debtor is *deemed* to have assumed such obligations, and any claim for subsequent breach of these obligations is entitled to priority under section 507(a)(9) of the Bankruptcy Code. The FDIC often demands that the debtor honor these commitments, and the viability of the chapter 11 case may depend on the debtor's ability to either meet its obligations or pay the priority claim. Otherwise, the debtor needs to successfully challenge the FDIC's claim for breach. In evaluating these challenges, courts often focus on whether the debtor is found to have made a "commitment" at all, but a recent decision by the United States Bankruptcy Court for the District of New Mexico highlights yet another potential challenge: whether the commitment was breached. Although the case, *In re First State Bancorporation*,[1] is a chapter 7 case, the chapter 7 trustee's ability to raise this challenge could easily be applied in the chapter 11 cases of other bank holding companies.

Background

In *First State*, the FDIC, as the receiver for First Community Bank, Taos, New Mexico, filed a priority claim in the chapter 7 case of the bank's parent, First State Bancorporation, asserting an unsecured priority claim under section 507(a)(9) of the Bankruptcy Code in the amount of $63,821,000 based on an alleged commitment to maintain the capital of the bank. The chapter 7 trustee commenced an adversary proceeding against the FDIC seeking, in part, to expunge the claim on the grounds that, among other things, none of the documents that the FDIC relied upon in support of its claim obligated the debtor to infuse its own capital to restore the capital of the bank. Instead, the debtor had committed to assist the bank by agreeing to take affirmative steps to try and retire $100 million in debt and raise in excess of $200 million in third party capital.

In opposing the FDIC's motion to dismiss, the trustee cited several cases in support of her argument, including *In re Colonial BancGroup, Inc.*, about which we have previously written,[2] in which the Bankruptcy Court for the Middle District of Alabama found no commitment "to maintain the net worth of the Bank or to infuse additional capital as necessary …." The court in *First State* noted, however, that "nothing in 11 U.S.C. § 365(o) or 11 U.S.C. § 507(a)(9) requires 'a commitment to 'infuse equity capital' in order to constitute a commitment to maintain the capital of an FDIC-insured bank." Instead, the court said, "section 507(a)(9) gives priority status to 'any commitment' to maintain an insured depository institution's capital." The court concluded that based on the documents relied upon by the FDIC, the debtor had made a commitment to maintain the capital of the bank, even if it had not specifically promised to make an equity infusion, because the debtor had agreed to take affirmative steps to raise third party capital.

Concluding that the debtor made "a commitment" did not end the court's inquiry, because "to sustain a claim based on a commitment to maintain the capital, [the debtor] must have breached that commitment." As the trustee stated in her complaint, the debtor had "struggled to close a deal with third party investors to adequately capitalize the bank," and "engaging an investment banking firm, which brought in 13 investor groups for a potential whole bank purchase, each of which declined to go forward, as well as 8 private equity firms that performed diligence on a private placement transaction." Ultimately, one investor came forward with a qualifying proposal, but the FDIC "preferred a whole bank purchase by another bidder with whom it had been negotiating a purchase and assumption agreement." In light of these facts, the court found that the trustee's allegations sufficiently stated a claim that

[1] *Bloom v. FDIC (In re First State Bancorporation)*, Adv. No. 13-1033-J, 2014 WL 3051312, slip op. (Bankr. D.N.M. July 3, 2014).

[2] *See Colonial Bancgroup Appellate Court Finds FDIC Entitled to Setoff Rights for Deposits at Failed Bank Subsidiary* dated January 24, 2012 on the Weil Bankruptcy Blog.

the debtor did not, in fact, breach its commitment to maintain the capital of the bank.

Conclusion

Among other things, *First State* adds another item to the pre-bankruptcy diligence checklist for a financially distressed bank holding company. As a preliminary matter, any commitment to maintain the capital of a bank subsidiary should be carefully considered, even if it is not a commitment to contribute capital. Whatever that commitment is, consideration should be given to whether that commitment has been breached, and if it has not been breached, whether the time and means exist to satisfy those commitments. The debtor in *First Street* may not have had the resources to save its own bank subsidiary, but the court found it, nevertheless, took adequate measures prior to the bankruptcy to satisfy its pre-bankruptcy commitments and, potentially, defend against a claim for breach from the FDIC.

Following the Eleventh Circuit, Sixth Circuit Sides with FDIC in Latest Tax Refund Dispute

Maurice Horwitz

In the world of bank holding company bankruptcies, often a dispute arises between the parent company and the FDIC (as receiver for parent's failed bank subsidiary) over the ownership of the tax refunds issued to the bank's consolidated group pursuant to a consolidated tax return. Generally, ownership of the refund turns on whether the parties had a debtor-creditor relationship (in which case, the parent owns the refund, and the subsidiary merely has a claim in the parent's chapter 11 case) or an agency/trust relationship (in which case, the subsidiary owns the refund, which must be turned over by the parent). The FDIC has lost many of these battles when there was a tax sharing agreement (TSA) in place, because bankruptcy courts have tended to construe these agreements as creating a debtor-creditor relationship between the parent and the bank subsidiary. As we reported,[3] the Eleventh Circuit in *In re BankUnited Financial Corp.*[4] sided with the FDIC after determining that, upon closer scrutiny, the TSA was silent with respect to ownership of the refund. This month, the Sixth Circuit issued a similar decision, adding to the growing body of case law on this topic and giving the FDIC some grist for the mill in future disputes.

The *AmFin Financial* Case

In *FDIC v. AmFin Financial Corp.*,[5] the parent company was a party to a TSA with its consolidated tax group, which included an insured depository institution. After the parent filed for chapter 11 in November of 2009, the federal Office of Thrift Supervision closed the subsidiary bank and placed it into FDIC receivership. The parent later filed a consolidated 2008 tax return on behalf of the group, showing a total net operating loss ("NOL") of $805 million, $767 million of which was attributed to the bank's losses. Ultimately, the IRS issued a refund of approximately $194 million, and the FDIC filed a complaint in the United States District Court for the Northern District of Ohio, seeking a declaratory judgment that the bank owned the refund. The parent made the argument to the district court that any refund formed part of parent's bankruptcy estate. The FDIC, on the other hand, asserted that approximately $170 million of the refund belonged to the bank because that portion resulted solely from NOLs attributable to the bank's losses in the prior year — a fact that the holding company did not dispute. The FDIC also sought to offer extrinsic evidence to support its argument that the parties had intended to create an agency or trust relationship under Ohio law.

Finding the TSA integrated and unambiguous, the district court held in favor of the parent without considering any of the extrinsic evidence proffered by the bank about the parties' intent. Basing its analysis on the decision of the bankruptcy court in *Spiegel v. FDIC (In re IndyMac BanCorp),*[6] the district court found that the TSA's use of terms such as "reimbursement" and "payment" established a debtor-creditor relationship between the

[3] *See Eleventh Circuit: Tax Refunds Due Pursuant to a Tax Sharing Agreement Are Not Property of the Filer's Estate* dated September 10, 2013 on the Weil Bankruptcy Blog.

[4] *Zucker v. FDIC (In re BankUnited Fin. Corp.)* 727 F.3d 1100 (11th Cir. 2013).

[5] *FDIC v. AmFin Fin. Corp.*, 757 F.3d 530 (6th Cir. 2014).

[6] *Spiegel v. FDIC (In re IndyMac Bancorp.)*, No. 2:08-bk-21752-BB, 2012 WL 1037481 (Bankr. C.D. Cal. Mar. 29, 2012) (report and recommendation), *aff'd*, 554 F. App'x 668 (9th Cir. 2014).

parent its subsidiaries as to tax refunds, thereby justifying an award of the refund to the parent's bankruptcy estate.

On appeal, like the Eleventh Circuit in *In re BankUnited Financial Corp*, the Sixth Circuit read the TSA more closely and concluded that in fact, the TSA was silent as to who owned the tax refunds issued to the parent. The agreement allocated tax liability among members of the group, required members to pay their shares, and permitted members to use other members' NOLs to reduce their tax liability; but none of the agreement's provisions addressed the disposition or ownership of tax refunds. The Sixth Circuit also distinguished *IndyMac BanCorp*, noting that the TSA in that case "expressly stated the circumstances under which the parent corporation would disburse refunds to the group and gave the parent corporation discretion as to whether to distribute refunds at all." Other cases relied upon by the holding company were also distinguishable because the TSAs in those cases "include language directly addressing the distribution of refunds," while the TSA before the Sixth Circuit did not.

Finally, the Sixth Circuit invoked the recent decision of the Eleventh Circuit in *In re BankUnited Financial Corp.* In that case, the bankruptcy court held, much like the district court in *AmFin Financial Corp*, that "the TSA's use of terms such as 'payables' and 'receivables' evidenced the parties' unambiguous intent that a bank's parent company would retain tax refunds generated by the bank with only a debtor's obligation to repay the bank." The Eleventh Circuit reversed, rejecting the bankruptcy court's "terminology-based rationale" and finding that the TSA did not unambiguously confer ownership of the refund to the parent company. The Sixth Circuit found the case before it to be on all fours with *In re BankUnited Financial Corp.*: "Just so here: The TSA says nothing about tax refunds received by [the parent] on behalf of the group and includes no protections for the putative creditor, as one would expect if the parties intended a debtor-creditor relationship." The Sixth Circuit reversed and remanded for the district court to consider whether, instead of a debtor-creditor relationship, an agency or trust relationship was created under Ohio law.

Conclusion

In reversing the district court, the Sixth Circuit in *AmFin Financial Corp.* joins the Eleventh Circuit in challenging the approach that some bankruptcy courts have taken in their consideration of TSAs. More importantly, these decisions send a strong signal to consolidated tax groups in any industry that they should review their tax allocation agreements to ensure that the agreements achieve the desired objectives of the group. In the case of bank groups, to the extent that their TSAs are reviewed in the wake of *In re BankUnited Financial Corp.* and *AmFin Financial Corp.*, it can be expected that the FDIC may seek to ensure that these agreements provide for an agency relationship between the holding company and its subsidiary bank with respect to tax refunds.

Can the FDIC Assert Direct As Well As Derivative Claims of Stockholders of Failed Banks? The Seventh Circuit Says "No (But Maybe They Should)"

Kyle J. Ortiz

In *Levin v. Miller*,[7] a recent decision out of the Seventh Circuit, Judge Easterbrook clarified the types of claims that the Federal Deposit Insurance Corporation (FDIC) may assert under section 1821(d)(2)(A)(i) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 after it takes over a failed bank. Section 1821(d)(2)(A)(i) grants the FDIC "all rights, titles, powers, and privileges of the insured depository institution, *and of any stockholder*, member, accountholder, depositor, officer, or director of such institution with respect to the institution and the assets of the institution" (emphasis added). Judge Easterbrook, consistent with the FDIC's own interpretation, held that section 1821(d)(2)(A)(i) applies only to derivative stockholder claims. The most interesting part of the decision, however, was Judge Hamilton's concurrence. In his concurrence, Judge Hamilton strongly advocated — on public policy grounds — for a broader interpretation of section 1821(d)(2)(A)(i) that encompasses direct claims by stockholders against a failed bank in addition to derivative claims.

Background

In *Levin v. Miller*, the trustee of a bank holding company, which filed for bankruptcy following the FDIC's takeover of its two subsidiary banks, brought an action alleging

[7] *Levin v. Miller*, 763 F.3d 667 (7th Cir. 2014).

several claims against certain directors and officers of the holding company. These directors and officers also were directors and officers at the banks. The FDIC intervened and asserted that most of the trustee's claims belonged to the FDIC under section 1821(d)(2)(A)(i) and any assets collected by the trustee from the directors and officers would no longer be available to satisfy any claims the FDIC may have against the directors and officers. Certain of the trustee's claims alleged that the directors and officers breached their fiduciary duties to the holding company by not implementing sufficient financial controls that would have protected the holding company from errors the directors and officers made in their roles at the banks. Another claim alleged that the directors and officers allowed the holding company to pay dividends that left the holding company undercapitalized when the financial crisis struck in 2008. The final claim asserted that the directors and officers breached their duties of care and loyalty by giving in to pressure by the FDIC to have the holding company infuse new capital into the banks, prior to the FDIC's takeover of the banks, when the directors and officers should have known doing so was "throwing good money after bad."

Judge Easterbrook's Opinion

Judge Easterbrook held that the claims asserting breaches of fiduciary duties were derivative claims because they related to actions taken by the directors and officers in their roles at the banks which caused the value of the holding company's shares in the banks to dramatically decline. The claims asserting undercapitalization and a breach of the duties of care and loyalty, on the other hand, related to acts that allegedly injured the holding company in its own right as opposed to injuring it through causing a decline in the value of its shares in the banks. Thus, these claims were more properly classified as direct claims against the officers and directors.

Judge Easterbrook, in determining which of the various claims brought by the trustee more properly belonged to the FDIC, asked the parties at oral arguments whether section 1821(d)(2)(A)(i) should be "understood not simply to allocate claims between the FDIC and other entities, but to transfer to the FDIC *all* claims held by any stockholder of a failed bank — even claims that … do not depend on an injury to the failed bank." None of the parties advocated for such an interpretation, and thus, noting that section 1821(d)(2)(A)(i) transfers only those stockholder claims "with respect to … the assets of the institution" to the FDIC, Judge Easterbrook held that section 1821(d)(2)(A)(i) should be understood to transfer to the FDIC only those stockholder claims that investors would, but for 1821(d)(2)(A)(i), "pursue derivatively on behalf of the failed bank." Judge Easterbrook also noted that no federal court has read the statute to include *all* claims held by stockholders of a failed bank and that the FDIC's own reading of the statute is that section 1821(d)(2)(A)(i) applies only to derivative claims. Judge Easterbrook also postulated that transferring direct claims to the FDIC might raise questions as to "whether [the holding company] and similarly situated stockholders would be entitled to compensation for a taking" under the Takings Clause of the Fifth Amendment. However, because Judge Easterbrook held that section 1821(d)(2)(A)(i) applied only to derivative claims, he did not have to grapple with that question. As the concurrence made evident, however, if Judge Hamilton ever gets his way, judges may have to tackle that question in the future.

Judge Hamilton's Concurrence

In his impassioned concurrence/lobbying effort, Judge Hamilton (although agreeing with Judge Easterbrook's decision based on current law and the FDIC's interpretation of the statute) strongly advocated — on public policy grounds — for section 1821(d)(2)(A)(i) to be interpreted more broadly to include not just derivative claims of stockholders, but also direct claims. Judge Hamilton was disturbed that holding companies like the holding company could use "the direct/derivative dichotomy … in ways that could allow those who ran the banks into the ground to take for themselves some of the modest sums available (particularly with regard to director and officer liability insurance proceeds) to reimburse the FDIC for a portion of the socialized losses they inflicted." Judge Hamilton stated that to the extent such a "result is not contrary to federal law, it should be."

Judge Hamilton went on to note that there are several ways to achieve a "more just result." One possible solution would be for the FDIC to modify its interpretation of the ambiguous language of section 1821(d)(2)(A)(i) to encompass direct claims. Judge Hamilton believes the FDIC has room to modify its interpretation because "the statutory language is not precise and could be interpreted, for sound policy reasons, more broadly." For instance, Judge Hamilton noted that section 1821(d)(2)(A)(i) would grant the FDIC derivative stockholder claims even if it did not include any reference to stockholders because such claims are encompassed in the FDIC's right to step into the shoes of a failed depository institution. Thus, the inclusion of *stockholder* could be construed as granting something broader than derivative claims because those are already captured in the statute by virtue of the FDIC assuming all rights and privileges of a failed depository institution. Judge Hamilton conceded that a reinterpretation by the FDIC would require courts to uphold the broader interpretation and that the broader interpretation, as Judge Easterbrook noted in the opinion, might raise Fifth Amendment takings concerns. Thus, Judge Hamilton stated that an "even better" solution would be for Congress to amend the statute to clarify that it applies to direct stockholder claims. Judge Hamilton stated that such a statutory fix "would surely withstand any challenges by parties like [the holding company] under the Takings Clause of the Fifth Amendment."

Under the current statute, and the FDIC's interpretation of the same, the FDIC's powers under section 1821(d)(2)(A)(i) are limited to derivative stockholder claims, but as Judge Hamilton points out, the statute doesn't necessarily require such limiting. It will be interesting to see if Judge Hamilton's statements will open the door to a broader interpretation of the statute by the FDIC in the future.

Circuit Court Round Up

In this section:

Practice Pointers from the Second Circuit: A Prohibited Power Grab Can Be "Taxing"

Erika del Nido

Introduction

We bring you the sequel to our previous four-part series on *United States v. Bond*[1] — the tale of three related telecommunications corporations (which we will refer to as the "PT-1 debtors") whose chapter 11 cases spawned a series of tax-related disputes. Now, the Second Circuit[2] has weighed in, and its decision serves as an important reminder to drafters of chapter 11 plans that a plan cannot bestow powers on parties that the Bankruptcy Code does not.

Background

After the PT-1 debtors commenced their chapter 11 cases, they filed their tax returns and reported payment in full. The United States government then asserted an administrative expense claim for interest and penalties against the PT-1 debtors. Prior to resolution of the government's claim, the United States Bankruptcy Court for the Eastern District of New York confirmed the PT-1 debtors' joint chapter 11 plan. The plan created a liquidating trust designed to pay unsecured creditors from its assets, including "all rights in and to any tax refunds due to the Debtors for tax years ending prior to January 1, 2005." Edward P. Bond was appointed as trustee of the liquidating trust. Notably, no chapter 11 trustee ever had been appointed, and the PT-1 debtors operated as debtors in possession. After confirmation, the liquidating trustee filed a claim for a federal income tax refund in the bankruptcy court and subsequently filed the same request with the IRS.

Procedural History

In the dispute between the liquidating trustee and the government, the bankruptcy court granted the liquidating trustee a complete victory — the court dismissed the government's claims, denied the government's request for setoff and recoupment rights because a plan provision extinguished them, rejected the government's argument that sovereign immunity barred the liquidating trustee's request for a refund, and awarded the liquidating trustee a $3.8 million refund plus interest.

On appeal to the United States District Court for the Eastern District of New York, the government argued that, due to sovereign immunity, the bankruptcy court lacked jurisdiction over the refund claim, and the government could not be bound by the provisions of the plan barring setoff and recoupment. The district court affirmed the award of the refund to the liquidating trustee, but reversed with respect to the setoff rights.

Both the government and the liquidating trustee appealed to the Second Circuit. The liquidating trustee argued that the government lacked setoff rights, and the government argued that the liquidating trustee was not entitled to the tax refund. After some procedural maneuvering, the sole issue before the Second Circuit on appeal was whether the bankruptcy court had jurisdiction to adjudicate the tax refund claim asserted against the IRS by the liquidating trustee.

The Second Circuit Opinion

The Second Circuit noted that section 106(a)(1) of the Bankruptcy Code provides that sovereign immunity is abrogated as to section 505 of the Bankruptcy Code, which grants jurisdiction to bankruptcy courts to adjudicate tax disputes. Absent such a statutory waiver of sovereign immunity, courts lack jurisdiction to adjudicate actions brought against the United States. Pursuant to section 505(a)(2)(B) of the Bankruptcy Code, however, one of the conditions that must be fulfilled before the bankruptcy court has jurisdiction to determine tax refunds is that the "trustee" must properly request the tax refund from the government. The Second Circuit held that this condition was not satisfied because the liquidating trustee was not a "trustee," as such term is used in the Bankruptcy Code, for three reasons. First, section 1104(a) of the Bankruptcy Code provides that a trustee must be appointed "before confirmation of a plan," and the

[1] *See* Weil Bankruptcy Blog, Four Part Series, *"Auditing" an EDNY Decision with a Plethora of Tax Issues (Part One)* on April 15, 2013, *Part Two* on May 7, 2013, *Part Three* on May 14, 2013, and *Part Four* on May 21, 2013 on the Weil Bankruptcy Blog.

[2] *United States v. Bond*, 762 F.3d 255 (2d Cir. 2014).

liquidating trustee was appointed pursuant to the plan and after confirmation. Second, section 1123(b)(3) of the Bankruptcy Code "makes clear" that a "debtor," "trustee," and appointed "representative of the estate" are different parties. Third, the Bankruptcy Code establishes the powers of a trustee or debtor in possession, whereas a liquidating trustee's powers are established by the confirmed chapter 11 plan.

Strictly construing section 505(a)(2)(B) of the Bankruptcy Code, the Second Circuit found that, although the bankruptcy court had authority to confirm a plan that assigned the refund claim to a liquidating trust and that appointed the liquidating trustee, the bankruptcy court lacked jurisdiction to *adjudicate* such claim unless a bankruptcy trustee (or a debtor in possession) first filed a refund claim with the IRS. The bankruptcy court cannot expand its own jurisdiction through provisions in a chapter 11 plan of reorganization. The Second Circuit summarized its rationale as follows: "Thus the jurisdiction of the bankruptcy court is premised on the action of an entity that draws its authority directly from the Code itself (*i.e.*, a debtor or bankruptcy trustee), rather than on the action of an entity (such as the Liquidating Trustee) whose authority derives from a Chapter 11 plan over which a bankruptcy court has full control, and the Congress none."

The Second Circuit noted that its decision did not leave the liquidating trustee without a remedy. Although the PT-1 debtors, as debtors in possession, could have filed a claim for a refund with the IRS prior to confirmation (which did not occur), the liquidating trustee, in the ordinary course, may still pursue the claim directly in federal district court.

Conclusion

The Second Circuit's opinion in *Bond* offers two practice tips to drafters of chapter 11 plans. First, plan provisions must be consistent with the Bankruptcy Code. Drafters cannot use a plan to accomplish something for which statutory authority is lacking. Second, debtors in possession should mind the clock because certain tasks (such as requesting an IRS refund) that might be easily accomplished pre-confirmation may become more complicated or even foreclosed post-confirmation.

Delaware Bankruptcy Court Weighs in on Subsequent New Value Circuit Split

Andriana Georgallas

Judge Christopher Sontchi of the United States Bankruptcy Court for the District of Delaware has now weighed in on a hotly debated circuit court split. The issue of whether, under section 547(c)(4) of the Bankruptcy Code, a recovery on a preferential transfer may be reduced by subsequent new value — regardless of whether it was "paid" or "unpaid" prior to the petition date — has remained unresolved among the circuits and within the Third Circuit for years. In the recent case *Miller v. JNJ Logistics LLC (In re Proliance Int'l, Inc.)*,[3] Judge Sontchi found that, at least by inference, previous decisions of the Delaware bankruptcy court adopted the subsequent advance approach to this issue. That is, a party's preference exposure may be reduced by both paid and unpaid subsequent new value. Applying this approach, Judge Sontchi held that the defendant in Proliance was entitled to full credit for all subsequent new value it provided to the debtors, even though it received payment for some of such value.

Background

Prior to the petition date, JNJ Logistics LLC, the defendant, provided freight transport services for auto parts to the debtors. Although the debtors paid $222,045.11 on account of certain JNJ prepetition invoices, JNJ invoices in the amount of $49,366.28 remained opened and unpaid as of the petition date. The trustee sought the return of $548,035.66 in preferential transfers made to JNJ in the 90-day window prior to the petition date. The parties agreed that JNJ had a subsequent new value defense to the preference claims in the amount of $49,366.28 on account of invoices that remained open and unpaid as of the petition date, but the parties disagreed about whether JNJ had a subsequent new value defense to the preference claims in the amount of $222,045.11 on account of invoices that had been paid by the debtor as of the petition date.

[3] 514 B.R. 426 (Bankr. D. Del. 2014).

The Subsequent New Value Defense and the Circuit Split

Section 547(c)(4)(B) provides as follows:

> The trustee may not avoid under this section a transfer ... to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor ... on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor.

Interestingly, courts are split on the interpretation and application of the double negative in section 547(c)(4)(B). Prior to the enactment of the Bankruptcy Code, section 547(c)(4)(B)'s predecessor, section 60(c) of the Bankruptcy Act of 1898,[4] limited the use of new value to the "amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy." Subsequently, courts established the so-called "net result rule" whereby the courts simply totaled the preferential payments and the subsequent advances by the creditor during the preference period and offset them against each other. When Congress did not include this language in section 547(c)(4)(B), courts adopted two different approaches: the "remains unpaid" approach and the "subsequent advance" approach.

The Remains Unpaid Approach

The courts that take the "remains unpaid" approach hold that the double negative in section 547(c)(4)(B) should be read to mean that, in order to be used as a defense to a preference claim, value must remain unpaid at the end of the preference period. Why? Courts adopting the remains unpaid approach argue that the extension of new value under section 547(c)(4) is merely meant to return the preference to the estate. "The creditors have not been harmed [and] the estate has not been diminished, because new inventory has been supplied."[5] Where a debtor pays a subsequent advance (or the creditor retains a security interest in the advance), the preference is not returned, and the estate is not benefited. Accordingly, the remains unpaid approach puts the debtor on a C.O.D. basis — as if the creditor is being paid in advance of shipments rather than for antecedent debts. According to the *Proliance* court, the remains unpaid approach provides that "new value that has been paid by the debtor prior to the petition date is not eligible for offset under section 547(c)(4) because paid new value does not represent the return of a preferential transfer to the estate."

The Subsequent Advance Approach

Other courts take the "subsequent advance" approach, holding that section 547(c)(4)(B) does not require that new value remain unpaid at the end of the preference period. Specifically, such courts hold that the "net result rule [under 60(c)] was modified [with the insertion of 'otherwise'] so that new value could only be used to set off preferences received earlier."[6] Accordingly, the only way for a creditor-supplier to have a defense to a preference is to continue supplying additional new value after receiving each preference. At bottom, subsequent advance supporters find that the subsequent new value defense was intended to except from avoidance revolving credit relationships.[7] Moreover, the word "otherwise" refers to transfers that are avoidable under section 547(c)(4), not transfers that are avoidable under other sections of the Bankruptcy Code. This encourages trade creditors to continue dealing with troubled businesses and is designed to treat fairly creditors who have replenished the estate after having received a preference. Otherwise, a creditor who continues to extend credit to the debtor in reliance on prior payments is only increasing its bankruptcy loss.

Remains unpaid supporters have argued that the subsequent advance approach "may give lip service to the statutory goal of encouraging continued dealings with distressed businesses, but it does so at the cost of tipping

[4] Bankruptcy Act of 1898, Ch. 541, § 60(c), 30 Stat. 544 (1898).

[5] *Proliance*, No. 09-12278 (CSS), Adv. Proc. No. 11-52514 (CSS), at 10 (quoting *Begier v. Airtech Services, Inc. (In re Am. Int'l Airways, Inc.)*, 56 B.R. 551, 554-55 (Bankr. E.D. Pa. 1986)).

[6] *Id. Boyd v. The Water Doctor (In re Check Reporting Servs., Inc.)*, 140 B.R. 425, 437 (Bankr. W.D. Mich. 1992) (internal quotation marks omitted).

[7] *See Id.* at 15 (citing *Laker v. Vallette (In re Toyota of Jefferson)*, 14 F.3d 1088, 1091 (5th Cir. 1994)).

the statutory balance of economic considerations over to the creditor-supplier's side."[8]

Application of Both Approaches

In *Proliance*, Judge Sontchi provided the following chart to illustrate a defendant's preference exposure under both the remains unpaid and subsequent advance approach:

Date	Preference Payment	New Value	Remains Unpaid Approach Preference Exposure	Subsequent Advance Approach Preference Exposure
1/1	$1,000		$1,000	$1,000
1/5		$1,000		$0
1/10	$1,000		$2,000	$1,000
1/15		$2,000		($1,000)
1/30	$3,000		$5,000	$2,000
2/5		$1,000		$1,000
2/10	$1,500		$6,500	$2,500
2/15		$1,000		$1,500
Total	$6,500	$5,000		
Results			$5,500	$1,500

The Parties' Positions

JNJ argued that its preference exposure should be reduced by its subsequent new value defense under the "subsequent advance" approach, which would reduce JNJ's preference by both paid and unpaid invoices. The trustee argued that the court should adopt the "remains unpaid" approach and only reduce JNJ's preference exposure by the amount of unpaid invoices.

Trustee's "Remains Unpaid" Approach	
Alleged Preference:	$548,035.66
Undisputed SNV Defense for Unpaid Invoices:	($49,366.28)
Total Preference Exposure:	**$498,669.38**

[8] *Id.* at 11 (quoting *Iannocone v. Klement Sausage Co., Inc. (In re Hancock-Nelson Mercantile Co.)*, 122 B.R. 1006 (Bankr. D. Minn 1991)).

JNJ's "Subsequent Advance" Approach	
Alleged Preference:	$548,035.66
Undisputed SNV Defense for Unpaid Invoices:	($49,366.28)
Disputed SNV Defense for Paid Invoices:	($222,045.11)
Total Preference Exposure:	**$276,624.27**

Judge Sontchi Adopts the Subsequent Advance Approach

After sifting through several decisions on both sides of the split, Judge Sontchi noted that, to date, the Third Circuit has not weighed in on this dispute. In reliance on the Delaware bankruptcy court's statements in *In re Sierra Concrete Design*[9] and *In re Vaso Active Pharmaceuticals, Inc.*[10], Judge Sontchi held that the rulings in such cases have, at least by inference, adopted the subsequent advance approach.

In *Sierra*, the Delaware bankruptcy court held that "in order to invoke successfully the subsequent new value defense in [the Third Circuit] the creditor must establish two elements: (1) after receiving the preferential transfer, the creditor must have advanced 'new value' to the debtor on an unsecured basis; and (2) the debtor must not have fully compensated the creditor for 'new value' as of the date that it filed its bankruptcy petition." The *Sierra* Court explained that

> [t]he statute's language is difficult to decipher containing, among other things, a double negative. Nonetheless, it correctly invokes the underlying economic principle — the creditor made subsequent shipment of goods only because the debtor was paying for the earlier shipments. Thus, one *should and does look* at the net result — the extent to which the creditor was preferred, taking account of the new value the creditor extended to the debtor after repayment on old loans.

In adopting this approach, the *Sierra* Court also noted that the defense is not available to give a creditor a "credit" for new value in excess of its preference exposure. This

[9] 463 B.R. 302, 307 (Bankr. D. Del 2012).

[10] 500 B.R. 384 (Bankr. D. Del. 2103).

ruling was reiterated by the Delaware bankruptcy court in *Vaso*.

In *Proliance*, Judge Sontchi found that, although *Sierra* and *Vaso* did not explicitly adopt the subsequent advance approach, the essence of their holdings provided, at least by inference, that the court had adopted the subsequent advance approach. Applying such rulings in *Proliance*, JNJ was entitled to a full credit for all subsequent new value it provided to the debtors, including paid and unpaid invoices. Thus, the court reduced JNJ's preference exposure by $271,411.39.

Although the jurisdictional split on the new value defense continues, Judge Sontchi, in adopting the tests set forth in *Sierra* and *Vaso*, has provided some clarity on this issue for cases within Delaware. Only time will tell, though, when the Third Circuit will crystalize its position on section 547(c)(4)(B). Until then, creditors rejoice. The creditor-friendly *Proliance* test appears to be the persuasive rule in Delaware for now.

The Pain that Comes Along with Walking a Mile in Your Own Shoes … Circuits Refuse to Allow Reorganized Debtors to "Step in the Shoes" of Debtors in Possession as Subrogees

Jessica Diab

> Walk a mile in my shoes
> Walk a mile in my shoes
> Yeah, before you abuse, criticize and accuse
> Walk a mile in my shoes
>
> – Elvis Presley, "Walk a Mile in My Shoes"

> Walk a mile in these Louboutins
> But they don't wear these *%!# where I'm from
> I'm not hating, I'm just telling you
> I'm tryna let you know what the %#!* that I've been through
>
> – Iggy Azalea, "Work"

Whether blue suede or Louboutins, people have been asked to "walk a mile in my shoes" as a means of seeking empathy from others. Unfortunately, as recently noted by the Second Circuit and Tenth Circuit, debtors are stuck in their own shoes and must live with the consequences of their conduct.[11] In two decisions arising from the Asarco chapter 11 case, the Second and Tenth Circuits simultaneously considered whether Asarco, a reorganized debtor, could seek contribution from other potentially responsible parties under the Comprehensive Environmental Response, Compensation, and Liability Act ("*CERCLA*")[12] more than three years after the court approved settlements of certain environmental cleanup claims brought against Asarco by various governmental entities and agencies. These decisions also considered whether, postconfirmation, a reorganized debtor may assert claims on the grounds that it is subrogated to the rights of the debtor in possession.[13] In both cases, the circuit courts held that the claims for contribution were time-barred and that, based on the terms of the debtor's plan, the reorganized entity was not a separate legal entity from the debtor in possession and therefore, could not "step in the shoes" of the debtor in possession as a subrogee.

Background

In August 2005, Asarco, a mining, smelting, and refining company, filed for chapter 11 protection in the United States Bankruptcy Court for the Southern District of Texas. Asarco's filing was precipitated by massive asbestos and environmental liabilities. Among others, various United States agencies (including the EPA), the State of Washington, and the Port of Everett, filed claims for the cost of resolving the environmental damage caused by Asarco's release of hazardous substances at the various sites owned or operated by Asarco. These

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[11] *Asarco LLC v. Goodwin et al.*, 756 F.3d 191 (2d Cir. 2014) and *Asarco LLC v. Union Pacific Railroad Co.*, 755 F.3d 1183 (10th Cir. 2014).

[12] 42 U.S.C. §§ 9601-9675.

[13] The Second Circuit also considered whether a debtor can assert a claim for contribution against the estate of the original wrongdoer. This issue was not considered by the Tenth Circuit where all the defendants to that appeal were alive. For the purposes of the Second Circuit's analysis on the issues discussed herein, the court assumed that a claim for contribution could proceed against the estate of a wrongdoer who shared in the debtor's liability.

proofs of claim asserted liability under, among other things, CERCLA, which imposes liability for cleanup costs on a variety of potentially responsible persons ("*PRPs*"), including the owners or operators of hazardous waste sites. Under CERCLA, a PRP that has been sued and then settles through either an administrative or judicially approved settlement may seek contribution from other PRPs.[14]

As part of its chapter 11 bankruptcy, Asarco reached settlements with the governmental entities that had asserted environmental cleanup claims against it. The bankruptcy court approved the settlement agreements, which granted each claimant a prepetition, general unsecured claim against Asarco's estate. The plan provided that all environmental unsecured claims, including the settled claims, would be paid in full on the effective date.

After emerging from chapter 11, the reorganized Asarco pursued its right under CERCLA to require other PRPs to reimburse it for those parties' fair share of the environmental damages. The reorganized Asarco filed complaints in New York and Colorado seeking, among other things, contribution, directly and on a subrogation theory, contending that it was entitled to assert a contribution claim as a subrogee of itself, as debtor in possession. Each complaint was filed more than three years after the settlement agreement was approved by the bankruptcy court, but within three years of the effective date. In response, the PRPs argued that the action should be dismissed because the contribution claims were time-barred, and the reorganized entity could not establish that it was a subrogee of itself as debtor in possession.

Issue 1: The Contribution Claims

Pursuant to CERCLA, the statute of limitations for a direct claim of contribution is three years after the date of entry of a judicially approved settlement. The issue on appeal before both circuits was whether "entry of a judicially approved settlement" referred to the date upon which the bankruptcy court approved the settlement agreements, which, in each case, was outside the three-year period, or some later date such as the date the upon which the claimants received payments under the plan or the bankruptcy court entered the confirmation order.

The reorganized Asarco argued that the bankruptcy court's order approving the settlement did not constitute a final judicially approved settlement because the approval was preliminary and subject to a confirmed and effective plan. According to the reorganized Asarco, the most logical triggering event for the statute of limitations was the chapter 11 plan's effective date because it was only upon the judicial confirmation of the plan and the effective date that the contribution amounts were finally determined. Both circuit courts rejected these arguments. The plain language of CERCLA states that the statute of limitations begins on the "date of … entry of a judicially approved settlement" and does not make any reference to the date of payment. According to the circuit courts, each settlement resolved Asarco's liability to that claimant and was effective once approved by the bankruptcy court. The Second Circuit also noted that, from a policy perspective, the statute of limitations should accrue from the date on which the bankruptcy court approves a settlement because a reorganization plan could take several years, and tying the statute of limitations to that date would do nothing to ensure the principal purpose of the limitations period in this setting, namely, "ensuring that the responsible parties get to the bargaining-and-clean-up table sooner rather than later."

Issue 2: The Subrogation Claims

The reorganized Asarco also asserted that it was entitled to contribution as a subrogee of the debtor in possession. Subrogation refers to the substitution of one party for another whose debt the party pays, entitling the paying party to the rights and remedies that otherwise would belong to the debtor. As noted by the Second Circuit, subrogation exists where one person is allowed to "stand in the shoes of another" and assert that person's rights against a third party. A person's payment of his own debt, however, does not entitle the person to subrogation. Under CERCLA, the statute of limitations for claims based on rights subrogated by reason of payment of a claim is three years from the date of payment. On these facts, Asarco's claim for contribution as a subrogee, if successfully established, would not have been time-barred.

To establish that it was a subrogee of the Asarco debtor in possession's right to contribution, the reorganized Asarco,

[14] 42 U.S.C. § 9613(f).

which paid the settled amounts pursuant to the plan, needed to establish that it was a separate legal entity from the debtor in possession. In an effort to do so, Asarco argued that, from a pure bankruptcy law perspective, once a plan becomes effective, the "debtor" ceases to exist, and the reorganized entity is a new entity not subject to the jurisdiction of the bankruptcy court. In addition, Asarco argued that the plan itself provided that the reorganized entity was a separate legal entity by stating that the reorganized Asarco would not be "responsible for any successor or transferee liability of any kind or character."

The circuit courts, however, found that other provisions of the plan suggested the contrary. In particular, the circuit courts pointed to provisions in the plan providing that the reorganized Asarco would be vested with (1) all the estate property and assets of the debtor Asarco and (2) any and all claims and causes of actions that were owned by the debtor Asarco or its estate as of the effective date, including claims against other PRPs for environmental contribution. Both circuit courts held that these plan provisions confirmed that the debtor in possession was not a separate legal from the Asarco that emerged from bankruptcy. Accordingly, the reorganized Asarco was "still wearing its own shoes; it agreed to pay and paid its own debts" and was not entitled to a claim for contribution based on a theory of subrogation.

Conclusion

These two cases focus primarily on a debtor's right to seek contribution under CERCLA. Unsurprisingly, many debtors who seek contribution will do so under the common law theory of contribution or a statutory scheme other than the CERCLA. Nonetheless, this case serves as a friendly reminder to debtors, especially those who file for bankruptcy as a result of ensuing litigation, to consider whether they have potential claims for contribution, under CERCLA or otherwise, and when the statute of limitations begins to run on such claims. As these two decisions point out, failure to do so might require the debtor to embark on a long, lonely, and expensive walk in its own [insert uncomfortable footwear brand here]!

Pass the Buck: Fourth Circuit Preserves the Mere Conduit Defense

Eric D. Kasenetz

Banks, insurance brokers, and other agents can breathe a sigh of relief as the Fourth Circuit enabled the "mere conduit" defense to survive another day. The Fourth Circuit has long recognized[15] the proposition that an avoidable transfer cannot be recovered, pursuant to section 550(a)(1) of the Bankruptcy Code, from a transferee who acted as a "mere conduit" for another party having the direct business relationship with the debtor. In *Guttman v. Construction Program Group (In re Railworks Corporation)*,[16] this recovery defense was put to the test.

The Alleged Preferential Transfers

Railworks Corporation, a national provider of rail systems services, filed a voluntary chapter 11 petition in 2001. Prepetition, Railworks maintained insurance coverage through TIG Insurance Company. Rather than paying premiums to TIG directly, Railworks paid Construction Program Group — the managing general underwriter for TIG — which then forwarded the payments, less commissions, to TIG.

CPG and TIG were parties to a General Agency Agreement, pursuant to which CPG was obligated to collect, receive, and account for the premiums related to the Railworks insurance policies. The agreement consisted of, among other provisions, the following terms: (i) CPG was liable to TIG for payment of the premiums attributable to the policies, regardless of whether the premiums had been collected; (ii) premiums collected by CPG were property of TIG and to be held in trust for TIG; and (iii) TIG was obligated to pay to CPG commissions, which CPG could deduct from the collected premiums.

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15 *See, e.g.*, *Lowry v. Sec. Pac. Bus. Credit, Inc. (In re Columbia Data Prods., Inc.)*, 892 F.2d 26, 28 (4th Cir. 1989) ("[A] party cannot be an initial transferee if he is a mere conduit for the party who had a direct business relationship with the debtor.")

16 *Guttman v. Construction Program Group (In re Railworks Corporation)*, 760 F.3d 398 (4th Cir. 2014).

Within the 90 days leading up to the filing of Railworks' chapter 11 petition, Railworks transferred four premium payments totaling approximately $2 million to CPG. CPG forwarded the premiums, less commissions, to TIG.

The Chapter 11 Litigation Trustee, appointed pursuant to Railworks' confirmed plan of reorganization, sought to avoid Railworks' payments to CPG as preferential transfers pursuant to section 547 of the Bankruptcy Code and collect the payments from CPG under section 550(a)(1). Section 550(a)(1) permits recovery of an avoided transfer from *either* the initial transferee *or* the entity for whose benefit the transfer was made.

Decisions of the Lower Courts

The United States Bankruptcy Court for the District of Maryland rejected the Litigation Trustee's argument that the payments could be recovered from CPG under section 550(a)(1). The bankruptcy court determined that CPG was not an initial transferee because CPG never had "legal dominion and control" over the transfers. In other words, CPG was a "mere conduit" that never had an "unrestricted right to use the transferred property" for its own purposes. For this reason and several others, the bankruptcy court granted CPG's motion for summary judgment.

The Litigation Trustee appealed to the United States District Court for the District of Maryland. The district court agreed with the Litigation Trustee, holding that, for purposes of recovery under section 550, CPG occupied a "dual status" as both a "mere conduit" *and* as one for whose benefit the transfers occurred. The district court explained that CPG benefitted from the transfers because CPG's contingent liability — the obligations to pay premiums to TIG regardless of whether they were collected from Railworks — was extinguished when CPG received the payments and remitted them to TIG. The district court vacated the bankruptcy court's decision and remanded for further proceedings.

The Fourth Circuit's Opinion

CPG appealed to the Fourth Circuit. On appeal, the parties agreed that CPG was a "mere conduit" and thus not an "initial transferee" under the first prong of section 550(a)(1). As such, the dispute before the Fourth Circuit focused on whether, notwithstanding CPG's status as a "mere conduit," CPG also could be considered an entity for whose benefit the transfers were made, in accordance with the second prong of section 550(a)(1).

The Fourth Circuit disagreed with the "dual status" proposition that the Litigation Trustee had proposed and that the district court had applied. The Fourth Circuit concluded that, just as a mere conduit cannot be an initial transferee for the purposes of avoidance recovery, so too a mere conduit cannot be "one for whose benefit the transfer was made."

According to the Fourth Circuit, CPG was indisputably a "mere conduit" that did not have a legal right to use the payments as it pleased. If, as the Fourth Circuit explained, the court were to adopt the Litigation Trustee's reasoning — that a contingent liability was extinguished upon Railworks' payment to CPG — a conduit would *always* be contingently liable to the principal or beneficiary, and thus a conduit would *always* be an entity for whose benefit a transfer was made. "This is so," according to the Fourth Circuit, "because a conduit, by definition, has an obligation to pass the funds on to a third party, and, if he fails to pass the funds to the third party, he is liable for those funds." Simply put, the Fourth Circuit was "unwilling" to "eviscerate the conduit defense."

Because CPG was a "mere conduit" for the premium payments from Railworks to TIG, and, according to the Fourth Circuit, a party cannot be both a mere conduit and an entity for whose benefit a transfer was made, the Litigation Trustee was unable to recover the payments from CPG under section 550(a)(1).

Conclusion

It appears that the Litigation Trustee's argument, *i.e.*, a conduit benefitted through extinguishment of a contingent liability, did not sit well with the Fourth Circuit. Interestingly, the Fourth Circuit perceived the "mere conduit" defense as a given and never questioned its continued validity in light of the Litigation Trustee's contingent liability argument.

Perhaps the Litigation Trustee should not have conceded on appeal that CPG was a "mere conduit." Pursuant to its agreement with TIG, CPG arguably had taken on the credit risk of collecting the receivables from Railworks and, therefore, was the party with the true economic interest in the payments. Such a position may have offered the Fourth Circuit an option to rule in favor of the Litigation Trustee without putting the "mere conduit" defense at risk of "evisceration." In any event, thanks to the principle of *stare decisis*, the "mere conduit" defense lives to see another day.

Flexibility on Finality: Over Dissent, First Circuit Splits from Majority in Holding that Orders Denying Relief from Stay Are Not Always Final

Debra McElligott

The First Circuit contributed to a circuit split regarding jurisdiction in its recent decision in *Pinpoint IT Services, LLC v. Rivera (In re Atlas IT Export Corp.)*[17]. In this case, the court considered whether orders denying relief from the automatic stay are final and appealable as a matter of right. Over a dissent, and contrary to the decision of seven of the eight circuits that have considered the question, the court held that such orders are not final unless they have definitively decided a discrete, fully-developed issue that is unreviewable in another forum.

Dueling Lawsuits

Pinpoint, a Virginia company, and Atlas, a Puerto Rican company, had a prepetition contract that became the subject of two simultaneous federal court actions prior to Atlas's bankruptcy. Pinpoint sued Atlas for breach of contract in the United States District Court for the Eastern District of Virginia. Atlas, a Puerto Rican company, moved to change venue to the United States District Court for the District of Puerto Rico and then sued Pinpoint in that court before the Virginia judge could rule on the motion. Atlas then filed for chapter 7 protection in the United States Bankruptcy Court for the District of Puerto Rico, and the bankruptcy court granted the debtor a modification of the automatic stay that allowed only the Puerto Rico action to go forward. Pinpoint ultimately sought a modification of the stay in the bankruptcy court, arguing that the stay was preventing the Eastern District of Virginia from applying the common-law "first-filed" rule. Generally, the "first-filed" rule requires that, where two district courts have jurisdiction over the same controversy, the court with the "first-filed" action has the first chance to decide the case.

[17] 761 F.3d 177 (1st Cir. 2014).

The bankruptcy court denied Pinpoint's motion to lift the stay for failure to show cause, after which Pinpoint appealed to the Bankruptcy Appellate Panel in the First Circuit. The Bankruptcy Appellate Panel dismissed the appeal for lack of jurisdiction, concluding that the order did not amount to a final decision from which Pinpoint could appeal as a matter of right. The panel reasoned that the order only decided that Pinpoint could not presently proceed in the Eastern District of Virginia, not that it was prevented from "trying to prove its case, or from arguing the 'first-to-file rule,'" in the District of Puerto Rico. Pinpoint then appealed to the First Circuit.

A Flexible Approach to Finality

The First Circuit considered Pinpoint's argument that the court had jurisdiction under 28 U.S.C. § 158(d)(1), which allows federal courts to review appeals from "final decisions, judgments, orders, and decrees" by the Bankruptcy Appellate Panel. The court thus examined whether the Bankruptcy Appellate Panel's dismissal of Pinpoint's appeal amounted to a "final order" within the language of the statute and noted that the answer depended on whether the bankruptcy court's order denying Pinpoint stay relief constituted a "final order."

Primarily, the court noted that, although federal court actions are generally treated as a "single judicial unit" from which one appeal can be made, the length and complexity of bankruptcy cases allows for a "flexible approach to finality."[18] In bankruptcy, "final" does not refer only to the last order entered in the case, but to any order that decides all the issues "of a 'discrete dispute within a larger case.'"[19] The First Circuit chose to depart from the rule accepted by the majority of circuits,[20] which is that all orders denying stay relief are final and appealable as of right. In doing so, the court contributed to the circuit split initiated by the Third Circuit in *In re West Electronics, Inc.*,[21] which drew a distinction between

[18] *In re Parque Forestal, Inc.*, 949 F.2d 504 (1st Cir. 1991).

[19] *Tringali v. Hathaway Mach. Co.*, 796 F.2d 553 (1st Cir. 1986) (Breyer, J.)

[20] The United States Courts of Appeals for the Second, Fourth, Fifth, Eighth, Ninth, Tenth, and Eleventh Circuits consider all orders denying stay relief final and appealable as a matter of right.

[21] 852 F.2d 79 (3d Cir. 1988).

orders "'conclusively' deciding the contested issue" and those demonstrating signs of *nonfinality* — for example, orders denying stay relief because of ongoing discovery or further required research. The First Circuit adopted the *West* court's "fact-specific, case-by-case style of analysis" and the viewpoint that orders that do not decide a discrete, fully-developed issue are not final.

Policy Concerns

The court also examined policy justifications underlying the majority rule that all orders denying motions for relief from stay are final. Among these was the argument that the automatic stay is "like an injunction, and so is final and appealable." The court noted that the operation of the automatic stay is the default position in a bankruptcy, and that Congress has already decided the "balance of equities" (one of the four elements for a preliminary injunction) by automatically imposing it upon a debtor's filing. The court also explained that judicial economy will be served by a rule that does *not* allow all denials of stay relief to be appealed, as parties would have to consider the finality of their order rather than "reflexively appeal."

Application and Dissent

Applying its rule, the First Circuit held that the bankruptcy court's order denying relief from stay was not final. The court dismissed Pinpoint's arguments to the contrary, finding that the underlying dispute related to venue and the first-filed rule, which the bankruptcy court avoided addressing by expressly stating that both could be litigated in the District of Puerto Rico action. Because the order did not resolve that dispute, it was not final.

The court issued its opinion over Judge Kayatta's dissent. The judge noted the value of uniformity in the context of bankruptcy and highlighted not only that the Third Circuit has "never encountered an order that fell within the exception it hypothesized" in *West*, but also that the majority did not point to any appeal "that would have been precluded or rendered less difficult" by their rule. He also explained that the purpose of the finality rule was judicial economy and that an "ad hoc, case sensitive approach" to deciding jurisdiction over orders denying relief from stay would not serve this purpose.

Implications

The First Circuit's decision in this case stands alone in the realm of jurisdiction over orders denying stay relief. Not only does it depart from the decision of seven of the eight circuits that have considered the question, but it goes farther than the Third Circuit's decision in *West*, which merely proposed an example of an order that would not be final. It will be interesting to see whether the First Circuit's departure from the majority rule will create efficiency by lessening the number of appeals (perhaps at the price of a simple, "blanket rule"), or whether it will create confusion and delay by requiring an analysis of whether an order is final before it can be appealed.

I Hear Nothing, I See Nothing, I Know Nothing: Third Circuit Says Transferee's Knowledge Not Relevant to Establishing Fraudulent Transfer Claims

Katherine N. Doorley

The extent of a transferee's knowledge in the context of fraudulent transfer claims under the Bankruptcy Code has been a frequent topic of discussion on the Weil Bankruptcy Blog. For example, we have examined the knowledge[22] required to establish a transferee's "good faith" defense under section 548(c) of the Bankruptcy Code. Now, the United States Court of Appeals for the Third Circuit in *SB Liquidation Trust v. Preferred Bank*[23] has provided more food for thought when it comes to the issue of a transferee's knowledge, concluding that it is not necessary to plead the transferee's knowledge of the fraudulent transfer to maintain a cause of action under section 548(a)(1) of the Bankruptcy Code.

Background

In *SB Liquidation Trust*, prepetition, debtor Syntax-Brillian Corporation and Preferred Bank entered into a loan agreement and credit agreement, the proceeds of which were used by Syntax to acquire inventory from Taiwan Kolin Company. The loan agreement between Syntax and Preferred Bank was amended on a number of occasions. As it happened, several of Syntax's officers and directors

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[22] *See I Didn't Know, I Swear! Section 548(c)'s Good-Faith Defense to Fraudulent Transfer Actions* dated March 18, 2014 on the Weil Bankruptcy Blog.

[23] 573 F. App'x. 154 (3d Cir. 2014).

were also officers and directors of Kolin. Subsequently, the debtor sought bankruptcy protection in the United States Bankruptcy Court for the District of Delaware. The SB Liquidation Trust was established pursuant to the debtor's liquidation plan, which transferred control over all of the debtor's assets and causes of action to the Liquidation Trust. The Syntax-Brillian Liquidation Trust initiated an adversary proceeding against Preferred Bank under section 548(a) of the Bankruptcy Code and the corresponding provisions of the Delaware Code, attempting to avoid and recover alleged fraudulent transfers in the form of payments made by the debtor to Preferred Bank pursuant to the loan agreements. In its complaint, the Liquidation Trust alleged that several of Syntax's officers and directors engaged in "a series of fraudulent activities" that led to the debtor's insolvency and that such fraud was made possible through the involvement of Preferred Bank. The Liquidation Trust asserted that the debtor entered into financing with Preferred in order to "siphon" money to Kolin, Kolin overcharged Syntax for inventory, and that, as a result, the proceeds of Syntax's sales of the inventory were insufficient to repay the debt to Preferred Bank. The Liquidation Trust further asserted that Preferred Bank was aware that Kolin priced its products above market, which would eventually make it impossible for the debtor to remain in business. At bottom, the crux of the complaint was that the financing, coupled with the purposeful overcharging, constituted a fraudulent transfer by the debtor under section 548(a)(1), and that Preferred Bank had culpable knowledge of the underlying scheme to defraud.

Legal Analysis

Section 548(a)(1) of the Bankruptcy Code provides that "[t]he trustee may avoid any transfer … of an interest of the debtor in property, or any obligation … incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition if the debtor voluntarily or involuntarily (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became … indebted …."

The bankruptcy court analyzed the fraudulent transfer claims against Preferred Bank using the "collapsing" doctrine. The collapsing doctrine provides that a court may "collapse" several apparently innocuous transactions for purposes of fraudulent transfer analysis and consider the economic reality of the transactions together.

The bankruptcy court dismissed the claims at the pleading stage, concluding that the Liquidation Trust was required to show that Preferred Bank had knowledge of the alleged fraudulent acts and that the complaint had failed to allege facts from which such knowledge could be inferred. On direct appeal, the Third Circuit vacated the bankruptcy court's dismissal.

As the Third Circuit noted, some courts applying the collapsing doctrine have required proof of knowledge of the fraudulent scheme on the part of both the debtor and the transferee. Adopting that interpretation, the bankruptcy court found that the transfers in question could not be collapsed because the Liquidation Trust failed to sufficiently allege that Preferred Bank had knowledge of the alleged scheme. The court stated that, without collapsing the transactions, the Liquidation Trust's claims necessarily failed.

On appeal, the Third Circuit disagreed with the bankruptcy court's interpretation and noted that Bankruptcy Code was "clear and unambiguous" that obligations are avoidable if the debtor incurred the obligations "with actual intent to hinder, delay or defraud" the debtor's creditors. The Third Circuit noted that neither the Bankruptcy Code nor Delaware law refers to the intent of the transferee as being relevant to a determination of whether a specific transaction is fraudulent and avoidable, and, therefore, the transactions could be avoided without needing to resort to the collapsing doctrine. The Third Circuit concluded that the Liquidation Trust should not have been required to establish that Preferred Bank had knowledge of the debtor's fraudulent intent to maintain a fraudulent transfer action. Accordingly, the Third Circuit vacated the bankruptcy court's dismissal of the actual fraud claims against Preferred Bank.

Conclusion

Parties bringing fraudulent transfer actions under section 548(a)(1) in the Third Circuit may breathe a little easier knowing that the bar has not been raised — they do not need to establish the transferee's knowledge of the fraudulent transfer to avoid a fraudulent transfer. That said, a transferee's knowledge continues to be a factor in determining that the transferee acted in good faith.

Best of the Rest

In this section:

The Reach of the Automatic Stay: One Court Reminds Us that Extending the Automatic Stay to Non-Debtors Is "Extraordinary Relief"

Nelly Almeida

If you ask the average person (a non-bankruptcy lawyer, that is) what they know about bankruptcy, chances are they will reference the Bankruptcy Code's "automatic stay" provisions in their answer. That is because, the automatic stay, which is found in section 362(a) of the Bankruptcy Code, is considered one of the most fundamental tenets of bankruptcy law. The filing of a bankruptcy petition triggers the protections of the automatic stay — staying, among other things, "the commencement or continuation … of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title."

The requirement that an action must be against the debtor is generally strictly construed. Nonetheless, bankruptcy courts have relied upon section 105(a) of the Bankruptcy Code, which permits bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate" to carry out the provisions of the Bankruptcy Code, to extend the protections of the automatic stay to non-debtors. This extension creates a whole new set of questions pertaining to when the protections of the automatic stay are available to non-debtors.

The Fourth Circuit provided some guidance on the issue in *A.H. Robins Co. v. Piccinin*,[1] where it articulated the "unusual circumstances" test for extending the automatic stay to non-debtors — often cited to provide the protections of the automatic stay to the debtor's officers and directors. According to *A.H. Robins Co. v. Piccinin*, "unusual circumstances" exist when "there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will effect be a judgment or finding against the debtor."

[1] 788 F.2d 994, 999 (4th Cir. 1986).

In addition to the "unusual circumstances" test, some courts have followed the test articulated in *Queenie Ltd. v. Nygard Int'l*,[2] where the Second Circuit found that the automatic stay can apply to non-debtors if a claim against the non-debtor will have "an immediate adverse economic consequence for the debtor's estate." As we previously wrote,[3] in *In re Residential Capital, LLC*,[4] the Second Circuit reaffirmed the decision in *Queenie Ltd. v. Nygard Int'l* and clarified that the decision "should not be interpreted as being limited to wholly-owned subsidiaries of a chapter 11 debtor."

Although various courts that have used the tests set out in *A.H. Robins and Queenie Ltd. v. Nygard Int'l*, the reach of those tests remains unclear. The subjective nature of the tests in those cases leave much to the discretion of a bankruptcy court — making it difficult for parties to predict when the automatic stay will be applied to protect non-debtors.

SDNY 19 Mad Park, LLC

For now, it appears that the question of whether the automatic stay will be extended to non-debtors continues to be a subjective one. In Judge Gropper's recent decision in *In re SDNY 19 Mad Park, LLC*,[5] the debtor, SDNY 19 Mad Park, LLC, filed a motion seeking entry of an order extending the automatic stay to Antonio Magliulo, a member and manager of the debtor, with respect to two lawsuits filed against the debtor and Magliulo. The first lawsuit was brought by employees who alleged that the debtor failed to comply with New York Labor Laws (NYLL) and the Fair Labor Standards Act (FSLA) by, among other things, failing to pay tips and alleged overtime to the employees/plaintiffs. The second action was brought by a former employee alleging malicious prosecution.

Magliulo's management of the debtor's business was governed by an operating agreement that contained exculpation and indemnification provisions. The debtor argued the lawsuits should be stayed as against Magliulo

[2] 321 F. 3d 282, 287 (2d Cir. 2003).

[3] *See Second Circuit: Automatic Stay May Apply to Non-Debtor Parent and Affiliate* dated July 31, 2013 on the Weil Bankruptcy Blog.

[4] 529 F. App'x. 69 (2d Cir. 2013).

[5] No. 14-11055 (ALG), 2014 WL 4473873, slip op. (Bankr. S.D.N.Y. Sept. 11, 2014).

because (i) allowing the lawsuits to proceed would have binding *res judicata* effect on the claims against the debtor's estate, (ii) there was an absolute identity of interest between the debtor and Magliulo, such that allowing the actions to proceed would cause irreparable harm to the debtor's estate, and (iii) Magliulo's exculpation and indemnification rights would also result in binding claims against the debtor's estate. The employees countered that any indemnification provisions pertaining to the NYLL and FLSA claims were unenforceable (per state law) and that there was a strong likelihood that indemnification would be denied because of the intentional/willful nature of Magliulo's claim (per the carve out in the indemnification provision).

After noting that some courts have extended the automatic stay to non-debtors pursuant to section 105 of the Bankruptcy Code, Judge Gropper noted that a motion staying an action against a debtor's principal is "extraordinary relief." He explained that the mere possibility that Magliulo has indemnification rights against the debtor "does not tip the balance in favor of a stay." In support of his decision, Judge Gropper noted that there is conflicting law on a defendant's right to indemnification against a judgment in a case under the NYLL and the FLSA. Moreover, Judge Gropper stated that the purpose of extending the stay to non-debtors is to "suspend actions that pose a serious threat to a corporate debtor's reorganization efforts." In this case, the debtor failed to show that any indemnification rights Magliulo had against the debtor should result in a stay of actions against him. The possibility of the offensive use of estoppel was not enough as there was "nothing in the record to indicate that Magliulo's defense of [the litigation] would not be as vigorous as if the Debtor remained a defendant." Accordingly, Judge Gropper found that the debtor had not shown that extending the stay to the debtor's management was warranted.

Conclusion

Although automatic stay protections can be extended to non-debtor entities under certain circumstances, *In re SDNY 19 Mad Park, LLC* reminds us that such extension continues to be an extraordinary exercise of a bankruptcy court's equitable discretion. The particular circumstances of a case have to be sufficiently "unusual" to merit such an expansion. Debtors seeking to extend the automatic stay to non-debtors will have to show that such "extraordinary" relief is warranted.

Double Dipping? Section 503(b)(9) and the New Value Defense to Preference Liability

Debora Hoehne

The 2005 Amendments to the Bankruptcy Code ushered in section 503(b)(9) of the Bankruptcy Code, which grants trade creditors an administrative expense[6] for goods sold to the debtor in the ordinary course of the debtor's business and that the debtor received within 20 days prior to the commencement date. Trade creditors also may face preference litigation for payments they received prior to the petition date, but may be able to reduce or eliminate their preference exposure by asserting a "new value" defense under section 547(c)(4) of the Bankruptcy Code (one of the more frequently raised defenses to preference liability). To reduce or eliminate preference liability under a new value defense, the creditor must have given unsecured new value to the debtor by selling goods or providing services on credit terms after the alleged preference payment but prior to the petition date. If these conditions are met, the creditor can subtract the value of those goods from the preference amount.

The overlap of these two Bankruptcy Code provisions gives rise to an interesting question: Can a creditor that holds an administrative expense under section 503(b)(9) of the Bankruptcy Code predicate a new value defense to an alleged preferential transfer under section 547(c)(4)(B) of the Bankruptcy Code on the same goods shipped 20 days before the commencement date? The Bankruptcy Court for the Eastern District of Virginia has been clarifying the law in this area, including most recently in *Siegel v. Sony Electronics, Inc. (In re Circuit City Stores, Inc.)*,[7] which provides guidance to trade creditors on this question.

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[6] In order for a debtor to confirm a plan of reorganization, section 503(b)(9) administrative expenses must be paid in full, unless the creditor accepts alternative treatment.

[7] 515 B.R. 302 (Bankr. E.D. Va. 2014).

Background

Before it went out of business, Circuit City was a national electronic retailer operating in over 700 stores throughout the United States and Puerto Rico. In late 2008, Circuit City sought bankruptcy protection in the United States Bankruptcy Court for the Eastern District of Virginia. Though it continued to operate its business in the ordinary course following the petition, by early 2009, the bankruptcy court had authorized Circuit City to conduct going out of business sales at all of its retail locations. In the fall of 2010, the going out of business sales having been completed, Circuit City's plan of liquidation was confirmed. The plan established a liquidating trust to, among other things, liquidate Circuit City's assets and distribute them to its creditors. Alfred Siegel was appointed as trustee for the liquidating trust.

As part of his efforts to liquidate Circuit City's estates, the liquidating trustee commenced numerous preference actions — one of which was brought against Sony Electronics, Inc. Prepetition, Sony and Circuit City had entered into a "Dealer Agreement" under which Sony sold goods to Circuit City and Circuit City received various funding incentives. Among other claims the liquidating trust asserted against Sony was a preference claim relating to a check made by Circuit City to Sony seven days before the petition date.

Sony asserted a number of defenses to the preference claim. Among them, Sony asked the court to find that the value of goods it delivered to Circuit City during the 20 days immediately prior to the commencement of Circuit City's bankruptcy case could be used both to recover under section 503(b)(9) and to assert a new value defense under section 547(c)(4). Section 547(c)(4) excepts from preference liability transfers to or for the benefit of a creditor to the extent that, after such transfer, the creditor gave "new value" to or for the benefit of the debtor that, generally speaking, was unsecured and for which the debtor did not make an "otherwise unavoidable transfer."

Analysis

The court's analysis centered on whether the debtor made an avoidable transfer to or for the benefit of a creditor on account of the new value it received from such creditor. The court concluded that, because the payment of a 503(b)(9) administrative expense is an "otherwise unavoidable transfer" under 547(c)(4)(B), the recipient of such payment is not entitled to utilize the value of those same goods as the basis for a new value defense.

The bankruptcy court relied on its recent decision (in a slightly different context) in preference litigation involving *Mitsubishi Digital Electronics America, Inc.*,[8] in which Mitsubishi tried to utilize the same goods delivered 20 days before Circuit City's bankruptcy filing to recover an administrative expense and assert a new value defense in preference litigation. There, the bankruptcy court found that Mitsubishi could not include the goods that were the basis for its section 503(b)(9) claim, which was fully funded by a reserve account, in its preference defense. The court's reasoning turned on the fact that the court had approved the postpetition establishment of the reserve fund for allowed 503(b)(9) claims, and so postpetition payment of Mitsubishi's allowed section 503(b)(9) claim was authorized by the court and under the Bankruptcy Code, and was an "otherwise unavoidable transfer."

Notwithstanding this precedent, Sony had urged the bankruptcy court to reconsider its ruling in *Mitsubishi* in light of the Third Circuit Court of Appeals' decision in *Friedman's Liquidating Trust v. Roth Staffing Cos. (In re Friedman's, Inc.)*.[9] The bankruptcy court noted that in *Friedman's*, the Third Circuit held that postpetition transfers made pursuant to a prepetition wage order did not affect the calculation of that creditor's new value defense under section 547(c)(4). This was because the Third Circuit determined that section 547(c)(4)(B) was only meant to encompass "otherwise unavoidable *prepetition* transfers." The court also noted that the Third Circuit left open the question of whether assertion of a reclamation claim should reduce a new value defense, and so the bankruptcy court was not persuaded that the holding in *Friedman's* should extend to section 503(b)(9) claims. As a result, the bankruptcy court did not reconsider its holding in *Mitsubishi* in order to allow Sony to use its section 503(b)(9) claim as new value for

[8] *Circuit City Stores, Inc. v. Mitsubishi Digital. Elecs. Am., Inc. (In re Circuit City Stores)*, Adv. No. 10-03068-KRH, 2010 WL 4956022, slip op. (Bankr. E.D. Va. Dec. 1, 2010).

[9] 738 F.3d 547 (3d Cir. 2013).

purposes of section 547(c)(4), as to do so would permit Sony a "double recovery" (full payment on its section 503(b)(9) claim and reducing its preference exposure) "based on the same goods that underlie its single claim."

Takeaway

Case law on this topic remains unresolved. The Bankruptcy Court for the Northern District of Georgia,[10] like the Bankruptcy Court for the Eastern District of Virginia, has rejected a trade creditor's attempt to assert a section 503(b)(9) claim as part of a new value defense to preference liability where the section 503(b)(9) claim at issue was fully funded or paid postpetition. However, the Bankruptcy Court for the Middle District of Tennessee[11] has held that goods within the scope of section 503(b)(9) can form part of a new value defense to preference allegations. At the heart of the debate is whether or not a postpetition payment will disqualify the new value defense, or if the reduction to new value has to be on account of payment received prior to the commencement date.

The bottom line is that trade creditors evaluating their ability to assert a defense to preference liability should consider whether they can demonstrate that the new value extended to the debtor after the alleged preference was *not* repaid with an otherwise unavoidable transfer, which debtors and trustees may argue excludes postpetition payments under a critical vendor order or section 503(b)(9).

The Interplay Between Section 502(d) of the Bankruptcy Code and SIPA's Requirement of "Prompt" Return of Customer Funds

Andrea C. Saavedra

Canons of statutory construction are used frequently to resolve ambiguities in the Bankruptcy Code. In a recent decision[12] arising out of the Madoff liquidation, Judge Rakoff of the Southern District of New York had to implement more than a few to creatively resolve a potential conflict between the Bankruptcy Code and the Securities Investor Protection Act (SIPA). He also had to take a practical, yet expansive, view of what the word "prompt" can mean when managing the untangling of one of the largest financial frauds in American history.

The Facts

Certain customers had filed net equity claims with the Madoff SIPA trustee. In other words, they asserted that they had received *less* in withdrawals from their Madoff securities accounts than they initially invested and were seeking compensation for the remainder of their principal. The Madoff SIPA trustee, however, sought disallowance of their claims pursuant to section 502(d) of the Bankruptcy Code, which, in short, permits disallowance of an entity's claim if it is the recipient or subsequent transferee of estate property that is subject to the claw back provisions[13] of the Bankruptcy Code, unless the creditor has already returned the property to the estate or paid any amounts due. In other words, until the customers returned their withdrawals (again, even though these amounts were less than the principal that they had deposited), the Madoff SIPA trustee refused to pay them either a statutory permissible advance or any interim distribution. The customers moved to dismiss the trustee's disallowance actions, arguing: (i) section 502(d) was inapplicable to their net equity claims as they were filed pursuant to SIPA's claim allowance provisions, instead of those of the Bankruptcy Code; (ii) the trustee's position was incompatible with multiple provisions of SIPA which, in short, required "prompt" return or payment of customer funds; (iii) under the *expression unius est exclusio alterius* (or "expression of one implies exclusion of another") canon of statutory construction, the absence of a specific exception to the payment of net equity claims and advances on account of section 502(d)'s requirement of the return of avoided transfers prior to allowance should not be read into SIPA; and (iv) that it would be inequitable to disallow their net equity claims given that they withdrew less than they had deposited.

[10] *In re TI Acquisition, LLC*, 429 B.R. 377 (Bankr. N.D. Ga. 2010).

[11] *In re Commissary Operations, Inc.*, 421 B.R. 873 (Bankr. M.D. Tenn. 2010).

[12] *SIPC v. Bernard L. Madoff Inv. Sec. LLC*, 513 B.R. 437 (S.D.N.Y. 2014).

[13] *See* sections 547, 548 and 550 of the Bankruptcy Code.

The Law

Judge Rakoff found that the alleged conflict between the statutes was "purely a question of statutory interpretation" and began his analysis with the assumption that, absent any indication to the contrary, he was required to read SIPA's provisions *in pari materia* (or "in the same matter") with those of the Bankruptcy Code to determine how the customers' net equity claims should be treated.

He disposed of the customers' first argument in two quick steps. First, he determined that the SIPA claims allowance process was more akin to the prepetition claims allowance process incorporated into chapter 5 of the Bankruptcy Code. Next, because chapter 5 of the Bankruptcy Code is made generally applicable to SIPA, he concluded that he would have to find an inconsistency or conflict in order to grant defendants' dismissal motion.

However, he could not find such an inconsistency. First, Judge Rakoff did not read SIPA's requirement of "prompt" payment of net equity claims to be incompatible with the temporary disallowance provisions of section 502(d) given that the adjudication and payment of avoidance claims could affect the final calculation of a given customer's net equity. He found that section 502(d) was an "ordering" provision, which reflected the underlying "logic that the estate should receive property due to it before a liable creditor of the estate may obtain payment on its own claims." He further found that it would be inequitable to allow customers "who effectively owe money to their fellow customers to be permitted to retain those funds and at the same time receive payments from the estate," especially where it seemed unlikely that net equity claims would be satisfied in full. Indeed, Judge Rakoff found that other provisions of SIPA supported this equitable rationale, such as the trustee's right to delay return of customer securities if a customer otherwise owes a debt to the estate.

Further, as to the defendants' *expressio unius* argument, Judge Rakoff concluded that it applied "poorly" to the provisions at issue, as there was no statutory list of exceptions to prompt payment that would result in exclusion of section 502(d) from their ranks. While the court was not unsympathetic to the defendants' final argument that permitting temporary disallowance, in some sense, permits a double-penalty on account of their customer withdrawals (first, against their net equity calculation, and second, as the basis for disallowance), he concluded that he could not "override" the statutory scheme to on the basis of such alleged inequities. He further noted that, to the extent any setoff argument was appropriately raised and preserved, the parties could raise them in the adjudication of the avoidance actions.

The Takeaway

The decision reinforces the importance of understanding the interplay between SIPA and the Bankruptcy Code. It also reminds customers that while SIPA is meant to protect their investment, it does so equitably. Where fraud is involved, even individuals who did not make a profit and may not have known of the fraud, should not anticipate the "prompt" return of their securities or cash investments within a few months — or even a few years.

Court Denies Administrative Priority Status to Seller Whose Goods Were Not Received By the Debtor

Elisa Lemmer

Since it burst onto the Bankruptcy Code scene in 2005 with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), section 503(b)(9) of the Bankruptcy Code, which affords a creditor administrative priority for the value of goods the debtor received within 20 days prior to its bankruptcy filing, has been the subject of many bankruptcy decisions. The express language of section 503(b)(9) has come under heavy scrutiny, with much of the litigation surrounding section 503(b)(9) focusing on what constitutes a "good." You can read about whether electricity, for example, is a "good" on the Weil Bankruptcy Blog.[14]

[14] *See It's Electric! Boogie Woogie Woogie (But It's Not a Good)— Delaware Bankruptcy Court S(l)ides With Courts Ruling That Electricity Not a "Good" for Purposes of Section 503(b)(9) of the Bankruptcy Code* dated November 6, 2013, *Are Utilities Unfairly Protected Under the Bankruptcy Code?* dated December 6, 2013, *"Call Me [a Good,] Maybe,"* dated October 22, 2013, and *Is Electricity a "Good"? Montana Bankruptcy Court Says Yes!* dated January 30, 2013 on the Weil Bankruptcy Blog.

In re World Imports,[15] issued by the United States Bankruptcy Court for the Eastern District of Pennsylvania last week, again examines the express language of section 503(b)(9) but, this time, from an entirely different context. *In re World Imports* discusses, among other things, what it means, under section 503(b)(9), for a debtor to have "received" goods.

Background

In *In re World Imports,* creditor Sunrise Furniture Co. Ltd. sought payment of administrative expenses relating to goods it sold to the debtor within 20 days prior to the debtor's bankruptcy filing. Specifically, section 503(b)(9) of the Bankruptcy Code provides, "After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including — (9) the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of the debtor's business." To establish entitlement to administrative priority, the claimant must show that: (1) it sold goods to the debtor, (2) the goods were sold in the ordinary course of the debtor's business, and (3) the goods were received by the debtor within 20 days prior to the bankruptcy filing.

Though the debtor and Sunrise agreed that the goods at issue were sold in the ordinary course of business and were, in fact, "goods" under the meaning of section 503(b)(9), they disagreed as to whether the debtor had "received" the goods as contemplated by the statute. This is because Sunrise had "drop-shipped" (*i.e.,* delivered directly) the items at issue to the debtor's customers. The debtor contended that a drop-shipment is not "received" by the retail merchant, so Sunrise's drop-shipments to the debtor's customers could not qualify for administrative priority treatment under section 503(b)(9).

To support its position, the debtor argued that every case to consider the issue had held that section 503(b)(9) applies only when the debtor has *physically* received the goods. By contrast, Sunrise argued that, under the Uniform Commercial Code, receipt of goods by a buyer includes receipt of such goods by the buyer's representative or subpurchaser. Sunrise also cited to a trade journal article espousing the opinion that drop-shipped goods should be deemed received by the debtor for purposes of section 503(b)(9).

Analysis

Apparently unconvinced by the characterizations in the Uniform Commercial Code and the opinion piece in the trade journal, the court concluded, without expressly stating it, that the term "received," essentially, implies physical receipt. Justifying its conclusion, the court relied upon two of the four cases cited by the debtor in its pleadings. The court noted that the Bankruptcy Court for the Eastern District of Michigan[16] had considered a similar issue and rejected the seller's argument that, where goods are delivered to the debtor's customer, the debtor need not actually receive the goods in order for the creditor to claim administrative priority. The Michigan court had relied on the express language of section 503(b)(9) requiring receipt and did not expand the definition beyond the more traditional meaning of the word.

The court next cited to a decision issued by the United States District Court for the District of New Hampshire.[17] There, the New Hampshire district court had undertaken a more thorough analysis of the term "receipt." Observing that the word "received," as it is used in section 503(b)(9), is not defined in the statute or elsewhere in the Bankruptcy Code, the New Hampshire court stated that Congress added section 503(b)(9) to supplement the remedies available to reclamation sellers under section 546(c) and that Congress had not actually intended to "create a new and expansive creditor class entitled to a unique priority." The *World Imports* court quoted the New Hampshire decision in noting that reading section 503(b)(9) narrowly "would likely enhance prospects for successful reorganization, while respecting creditor equality principles" and "the larger the potential cash reserve needed,…the less likely a debtor will reorganize." In this context, the New Hampshire district court concluded that the phrase "received by the debtor" in section 503(b)(9) necessarily meant "possessed by the debtor, either actually or constructively" and concluded

[15] No. 13-15929-SR, 2014 WL 4452764 (Bankr. E.D. Pa. Sept. 10, 2014).

[16] *In re Plastech Engineered Products*, 2008 Bankr. LEXIS 3130 (Bankr. E.D. Mich. Oct. 7, 2008).

[17] *Ningbo Chenglu Paper Products Mf'g Co., Ltd. v. Momenta, Inc. (In re Momenta Inc.)*, 2012 WL 3765151 (D.N.H. Aug. 29, 2012).

that a drop-shipment does not constitute "even constructive possession" for purposes of section 503(b)(9). Persuaded by the reasoning of the New Hampshire District Court, the court in *World Imports* held, without any additional analysis, that the goods delivered by Sunrise via drop-shipment were not actually received by the Debtor and could not qualify for administrative priority.

Conclusion

It's probably true that, in commercial trade, bankruptcy is not always at the forefront of merchants' minds. The efficient scenario in which a purchaser requests that the seller deliver the items directly to the purchaser's customers and "eliminate the middle man" is likely a common one. But, as the *World Imports* decision suggests, a seller's agreement to deliver goods directly to the ultimate purchaser may have economic consequences for the seller if the purchaser files for bankruptcy protection within the 20-day period in which the goods are delivered and the court finds the customer's receipt of the goods directly from the seller necessarily means the debtor did not receive the goods under section 503(b)(9).

A Dispute Over a Dispute: Recent Bankruptcy Court Decision Dismisses Involuntary Chapter 7 Petition Due to Bona Fide Disputes

Matthew P. Goren

Creditors contemplating the bold step of commencing an involuntary bankruptcy case against a putative debtor may wish to consider a recent decision of the Bankruptcy Court for the District of Minnesota, *In re American Resource & Energy, LLC*,[18] where the court dismissed an involuntary chapter 7 petition by summary judgment motion after determining that (a) each of the three petitioning creditors failed to qualify under section 303(b)(1) of the Bankruptcy Code to file a bankruptcy petition as a "bona fide dispute" existed with respect to each of their putative claims when they filed the petition that commenced the case and (b) with the disqualification of those parties as petitioners, the joinder of a fourth creditor to the petition post-filing did not satisfy the debt threshold of section 303(b)(2) to allow that party to maintain the petition even if the putative debtor had fewer than twelve creditors in all. For want of a qualified petitioning creditor holding claims in a sufficient amount against the putative debtor, the petition, and the case as a whole, was dismissed.

Background

The case against American Resources & Energy, LLC ("ARE") was commenced on January 24, 2014, by the filing of an involuntary petition for relief under chapter 7 of the Bankruptcy Code. Three named parties asserted the status of petitioning creditors in connection with the petition. In its answer to the petition, ARE asserted, among other things, that: (i) one or all of the petitioners were ineligible to join in the involuntary petition against ARE, (ii) none of the claims referenced in the involuntary petition had become due, and (iii) as a result of some or all of the claims reference in the involuntary petition being subject to a bona fide dispute, the petitioners did not meet the requirements of section 303(b)(1) of the Bankruptcy Code. Some months after the commencement of the case, petitioners' counsel filed an amended petition that purported to join a fourth party as a petitioning creditor.

The court went through a detailed examination of the events leading up to the commencement of the chapter 7 case, including a discussion of ARE's complicated and convoluted corporate structure. ARE's business was the design and sale of wind turbine towers, foundations, and raising systems. Prior to the commencement of the case, a struggle arose for dominance over the entire ARE-related enterprise. The disputes among the various parties in ARE's ownership structure centered on the capitalization, ownership and control of ARE and its affiliated entities. The parties even disputed which among them was rightfully the majority shareholder of ARE.

The turmoil eventually led to the commencement of at least two actions against ARE in state court, which remained pending when the bankruptcy was commenced. Two of the petitioners were ARE's opponents in the lawsuits, with each having commenced a separate action against ARE on different theories of liability. The first of the lawsuits had been fully briefed, with counterclaims asserted by ARE, but a judgment had yet to be rendered, while the second had been removed to state district court following a judgment against ARE and the other

[18] 513 B.R. 371 (Bankr. D. Minn. 2014).

defendant in a lower court. The lawsuits constituted the sole bases for the claims asserted by two of the petitioners in the involuntary petition. With respect to the third petitioner, which asserted a claim on a business loan, no litigation was pending at the time of the filing of the petition; however, a controversy existed over the identity of the third petitioner (the name of the entity identified on the petition differed materially from the entity identified with the transfer) as well as to the nature of the asserted claim (*i.e.*, whether the funds constituted a loan, an equity contribution or whether a transfer occurred at all).

The court identified the threshold issue before it: whether the petitioners' claims "were not contingent as to liability or the subject of a bona fide dispute as to liability or amount, as 11 U.S.C. § 303(b)(1) requires of petitioning creditors in an involuntary case." In a footnote, the court characterized this issue as "a dispute over the separate existence of a dispute." The court directed the parties to put the threshold issue before the court early and, given the posture of ARE's existing controversies with all three petitioners and the "extrinsic, preexisting, formulized articulation of factual and legal positions" set forth in pleadings filed in the prepetition lawsuits, the court determined that a motion for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure was the appropriate vehicle for this determination.

Analysis

Section 303 governs the procedures for the commencement of an involuntary bankruptcy case under the Bankruptcy Code. Pursuant to section 303(b)(1), an involuntary case may be commenced by three or more entities, each of which holds a claim that is neither contingent nor "the subject of a bona fide dispute as to liability or amount," and such noncontingent, undisputed claims aggregate to at least $15,325 more than the value of any liens on the property securing such claims. If there are fewer than twelve such holders, an involuntary case may be commenced by one or more of such parties that hold claims of at least $15,325 in the aggregate pursuant to section 303(b)(2). According to the court, the constraints of section 303(b) exist to require "a certain level of solidity in a creditor's claim, something akin to a coherent well-based case for a right to payment enforceable under non-bankruptcy law, before the creditor may seek the powerful, collective remedy of bankruptcy against its debtor." If there is, however, a contest over a putative debtor's liability that is "worthy of a fight under generally-applicable law," the putative debtor may not be forced into bankruptcy at the instance of the claimholder.

The Bankruptcy Code does not define "bona fide dispute," leaving the meaning of the term to judicial determination. According to the court, the relevant factors for that determination include the posture of the parties; the nature and gravity of their contentions with each other, factual and legal; and the non-bankruptcy law that governs their disputes.

Vehicle for Determination

As both sides had professed a desire for broad discovery, the court first addressed why it believed it could dispose of the threshold issue by summary judgment rather than holding a full evidentiary hearing. This determination began with an examination of the Eighth Circuit's decision in *In re Rimell*, 946 F.2d 1363 (8th Cir. 1991), where the Court of Appeals previously observed that "the determination as to whether a dispute is bona fide will often depend…upon an assessment of witnesses' credibilities and other factual considerations…."

Based in large part on the *Rimell* court's use of the word "often" as opposed to "always," the *ARE* court found that *Rimell* did not categorically require the taking of evidence on an assertion of bona fide dispute. The court explained that *Rimell's* articulation "puts primacy on the legal viability of petitioning creditors' claims and putative debtors' defenses against them, under the facts advanced in support of them." The court reasoned that where such claims were already in suit under a plausibly-pled statement of facts, *Rimell* did not require the analysis on bona fide dispute to go to an actual resolution of the pleaded issues on their merits. The court went on to state that a determination under section 303(b)(1) need go only to "the *existence* of a dispute from the putative debtor as to its liability on the claim or the claim's amount, and then whether the debtor has an objective basis in *asserted* fact or law for its disputation. As to the factual dimension of resistance, this is satisfied when facts are pled or framed *plausibly* to support a defense. When it comes to the objective character of legal positions, it is satisfied where they are pled *colorably* against the petitioning creditor."

The court established a two-step analysis for resolving an involuntary petition on summary judgment. First, a court must determine if there is a genuine dispute of material fact (*i.e.*, a triable issue as to a fact necessary to satisfy an essential element of the claim or defense in question). Second, if there is no genuine dispute of material fact, the court must determine if the governing law dictates judgment for the movant on the uncontroverted facts.

Petitioners' Claims

As ARE denied it had any liability on the claims of all three petitioners, it was obvious to the court that disputes existed with respect to the petitioning claims. From there, the court moved to an examination of whether ARE's resistance to the claims was "bona fide." The court found that this issue could also easily be decided based on the record at bar.

The court, which was clearly concerned about the potential for abuse with involuntary petitions, held that the claims of all three petitioners lacked "the solidity, the prima facie sheen of enforceability and consequent recovery, that § 303(b)(1) requires to qualify as a petitioning creditor in involuntary bankruptcy." With respect to the first petitioner's claim, the court examined the answer and other submissions filed in connection with its lawsuit and determined that ARE's fact allegations, set forth in plausible fashion, colorably supported a defense and, therefore, the claim was clearly subject to bona fide dispute. The court found that the second petitioner's claim was subject to bona fide dispute as its removal to district court entitled the defendants to a trial *de novo* and, therefore, the claim remained unresolved by any judicial determination. With respect to the third petitioner, the court found that the serious questions as to the identity of the real party in interest to the alleged transaction as well as to the nature of the questioned funds infusion constituted bona fide dispute.

Finally, the court found that the addition of the fourth petitioner that purported to join the petition post-filing could not save the petition. Even if ARE had less than twelve creditors holding noncontingent, undisputed claims, the debt held by the joining creditor, which totaled only $12,605, did not meet the current debt threshold under section 303(b)(2) and, therefore, the case had to be dismissed.

Conclusion

The threat of an involuntary bankruptcy is a useful, albeit extreme, remedy available to creditors that can be used to exert pressure on a putative debtor and foster a consensual resolution. Creditors considering such an action, however, should take a careful look at the underlying claims that will be used as a basis for the involuntary petition to be sure the claims are reasonably solid and not in dispute, as petitioning creditors may not have the benefit of a full evidentiary hearing in bankruptcy to defend the quality and validity of their petitioning claims.

Unfinished Business: And The Winner Is …

Sunny Singh

In a unanimous decision,[19] the New York Court of Appeals stuck a dagger through the heart of bankruptcy estates of failed law firms as it declared that profits earned on matters that former partners of the failed firm take with them to their new employers are not property of the former firm. Those profits belong to the new firm that provides the legal services.

The recent failures and bankruptcies of some of the largest law firms in the country have given rise to substantial litigation. One type of litigation arising out of law firm failures has been the pursuit of profits earned on "unfinished business" that originated with the failed law firm. The theory is premised on a 1984 California appellate court decision — *Jewel v. Boxer*[20] — that held, absent an agreement to the contrary, profits derived from work begun by former partners of dissolved law firms are partnership assets that must be finished for the benefit of the dissolved partnership. Based on *Jewel*, trustees and other representatives of failed law firms have argued that, upon a bankruptcy filing, work pending at the time of dissolution of the failed law firm and the profits thereon constitute property of the failed law firm's bankruptcy estate under section 541 of the Bankruptcy Code. As a result, many law firms that hired former partners from failed firms have been sued for turnover of profits realized on "unfinished business" for the benefit of the failed law firm's creditors.

[19] *In re Thelen LLP*, 24 N.Y.3d 16 (N.Y. 2014).

[20] 156 Cal. App. 3d 171 (Cal. Ct. App. 1984).

The issue was presented to the New York Court of Appeals in connection with the bankruptcy cases of Thelen LLP and Coudert Brothers LLP. In October 2008, the partners of Thelen voted to dissolve the firm. In connection with the dissolution, the Thelen partners executed an "Unfinished Business Waiver" (also known as a "Jewel Waiver") pursuant to which the Thelen partners, on behalf of themselves and the partnership, waived any right to profits from work that Thelen partners took with them to new law firms. Following Thelen's bankruptcy filing, Thelen's chapter 7 trustee commenced an adversary proceeding against Seyfarth Shaw LLP, which hired 11 former Thelen partners. The Thelen trustee argued that because there was no consideration paid to Thelen's estate for the Jewel Waiver, the waiver was an unenforceable fraudulent conveyance and the pending hourly matters and profits thereon were still property of Thelen's bankruptcy estate. The District Court for the Southern District of New York held that the unfinished business doctrine does not apply under New York law to a dissolving law firm's pending hourly fee matters.

The decision was in conflict with another decision by the District Court for the Southern District of New York issued just four months earlier in the Coudert Brothers bankruptcy. Coudert Brothers dissolved in August 2005. After Coudert's failure, many Coudert partners were hired by several other firms and took with them work that had originated while they were with the Coudert firm. In September 2013, Coudert's bankruptcy administrator commenced 13 adversary proceedings against some of the firms that hired former Coudert partners asserting *Jewel* or unfinished business claims. In one of those lawsuits, the district court granted summary judgment for Coudert holding that hourly fee matters were presumed to be property of the partnership on its dissolution date.

The conflicting decisions were appealed to the Second Circuit, which certified the question of whether the "unfinished business doctrine" was valid under New York law to the New York Court of Appeals. The New York Court of Appeals rejected the *Jewel* claims. The court held that a law firm does not own a client or an engagement and, as a result, a former law firm is not entitled to be paid for services that are rendered by another law firm. In its analysis, the court considered the role of Partnership Law, in particular, the Revised Uniform Partnership Act which has been enacted in every state except Louisiana. The court found that "Partnership Law does not define property; rather, it supplies default rules for how a partnership upon dissolution divides property as elsewhere defined in state law."[21] The court then concluded, in New York, given the unqualified right of clients to terminate the attorney-client relationship at any time, "no law firm has a property interest in future hourly legal services …."[22] The former law firm only has the right to be paid compensation for legal services already provided.

The court's decision was also guided by public policy considerations and principles governing the attorney-client relationship and the Rules of Professional Conduct. In the court's view, allowing a former law firm and its partners to profit from work it did not perform would create an unjust windfall. In addition, the Coudert and Thelen trustees conceded that there was no basis for the failed law firms to recover amounts on account of a former partner who left the firm before its dissolution. This distinction would encourage partners to jump ship from a struggling law firm sooner rather than later, thereby making it more difficult for a struggling firm to try to restore its financial condition. In contrast, attorneys who stick around too long may no longer be able to represent their clients when they move to a new employer, "a major inconvenience for the clients and a practical restriction on a client's right to choose counsel."[23] Attorneys may also find it more difficult to secure a position at a new law firm. In sum, the court concluded that the trustees' position "conflicts with New York's strong public policy encouraging client choice, and concomitantly, attorney mobility."[24]

Many commentators have stated that the court's decision is likely to put an end to *Jewel* litigation in New York (and perhaps elsewhere). In the spirit of the World Cup, score new law firms, one, failed law firms, nil.

[21] *Id.* at *9.

[22] *Id.* at *10.

[23] *Id.* at *16.

[24] *Id.* at *16-17.

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