absolute PRIORITY
Current Developments in Bankruptcies and Workouts to Keep You Ahead of the Curve
Cooley GODWARD KRONISH LLP
BANKRUPTCY AND RESTRUCTURING GROUP

Can Unsecured Creditors Recover Post-Petition Attorneys' Fees? *9th Circuit BAP Says Yes*

Prior to last year's United States Supreme Court decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.* ("*Travelers*"), the prevailing view among courts was that post-petition attorneys' fees incurred by unsecured creditors in connection with the litigation of their claims could not be recovered. The Supreme Court in *Travelers*, however, opened the issue for reconsideration among the lower courts by holding that the Bankruptcy Code contains no provision disallowing contract-based, unsecured claims for attorneys' fees incurred in connection with the litigation of such claims. The Supreme Court reasoned that section 502(b) of the Bankruptcy Code, which governs the allowance of claims, provides that a claim shall be allowed except to the extent that it falls within one or more of the section's nine enumerated exceptions – none of which call for the automatic disallowance of an unsecured creditor's claim for contract-based, post-petition attorneys' fees.

The Supreme Court did not definitively resolve the issue in *Travelers*, as it never reached the critical issue of whether section 506(b) of the Bankruptcy Code, which governs the scope of an allowed secured claim, implicitly disallows unsecured claims for

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Seller Beware:
Retention of Rights When You Sell Your Claim

Distressed debt trades on the secondary market generally using form transfer agreements standardized by the Loan Syndications and Trading Association ("LSTA"). To date, the terms and definitions found in LSTA documents have avoided scrutiny by the courts; however, last month, Chief Bankruptcy Judge Stuart Bernstein of the U.S. Bankruptcy Court for the Southern District of New York issued a memorandum decision and order that put the spotlight on LSTA documents and their scope in the bankruptcy context. At issue was the original creditor's right to assert a claim against the debtor after the claim had been sold. As discussed below, the answer lies in carefully reserving rights when claims are sold.

In *In re M. Fabrikant & Sons, Inc., Case No 06-12737 (Bankr. S.D.N.Y. Apr. 9, 2008)*, the debtors, one of the world's largest manufacturers and distributors of diamonds, in conjunction with the Official Committee of Unsecured Creditors (the "Committee") and Wilmington Trust Company, as collateral and administrative agent for a group of secured lenders (the "Current Lenders"), jointly proposed a plan of reorganization (the "Plan"). The assignors of the Current Lenders' claims (the "Original Lenders"), among others, objected to the Plan, on the grounds that the Plan did not account for certain reimbursement rights (the "Reimbursement Rights") to which

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from the editor

ADAM C. ROGOFF

Over the last several months, we have seen a proliferation of chapter 11 cases hitting all aspects of the marketplace —from mid-size to larger companies. Behind the public chapter 11 filings themselves are a myriad of distressed companies seeking to avoid a formal proceeding through out-of-court workouts. Unlike the recent past, the companies affected today cross a broad spectrum of industries—retailers, manufacturers, airlines, and hospitals and other health care providers. The perfect storm is upon us, as consumers have less disposable cash in the face of higher gas and utility prices, higher food prices, lower home equity, and a stock market that is anything but consistent.

So, in other words, it's a great time for the Spring edition of *Absolute Priority*…

This issue discusses alternatives to bankruptcy proceedings, ability to assert claims for legal fees post-bankruptcy, and other interesting case developments.

We have been very busy as a Firm in representing creditors' committees in many of today's well-known retail bankruptcy cases, representing Bayonne Medical Center as chapter 11 debtor in its case (which has successfully allowed the hospital's operations to survive while potentially providing a return for unsecured creditors—a virtually unheard of result for hospitals these days), and representing strategic and financial buyers of assets of distressed companies. But, we are never too busy to hear from you, our friends, and to keep you up to date on latest developments. You are, after all, our *Absolute Priority*…

Enjoy this latest issue and we look forward to hearing from you.•

Subordination Agreements

In re Dura Automotive Systems, Inc. et al. (Case No. 06-11202) (Bankr. D. Del. Dec. 7, 2007)

In this case, the Court analyzed what is commonly referred to as an "X-Clause"—a provision in a subordinated note that defines an exception to the basic subordination agreement that permits a distribution to the subordinated parties in certain circumstances. The Court held, among other things, that the X-Clause at issue did not relieve the subordinated note holders of their basic contractual promise to subordinate their right to payment or distribution from the debtors until after the debtors' senior note holders were paid in full.

The subordinated holders' had sought, among other things, a declaratory judgment that the X-Clause did not subordinate their right to receive payment or distribution from the debtors under a proposed plan which provided distributions through an equity-rights offering. The subordinated holders argued that the X-Clause at issue excepted "Permitted Junior Securities" (as defined in the subordinated note indenture) from their subordination promise even where the senior holders were not paid in full, and that the debtors' proposed equity offering constituted the distribution of "Permitted Junior Securities." The senior note holders moved for summary judgment on the grounds that the X-Clause did not affect the basic subordination promise inherent in the subordinated note indenture.

The Court's opinion is notable for several reasons. First, while observing that the X-Clause lacked "utter clarity," the Court nevertheless found that applicable New York law required the Court to consider the X-Clause within the overall purpose of the note indenture and not in isolation. Further, the Court accepted the proposition that an X-Clause is intended to create only a limited exception to the basic subordination promise and must be construed narrowly.

According to the Court, the subordinated note indenture as a whole supported the

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Transferree Liability

Farm Credit Leasing Services Corp. v. Ferguson Packaging Machinery Inc., Case No. 07-1900 (E.D. Pa. Dec. 3, 2007)

Good faith purchasers for value, beware. Your purchase (and subsequent sale) of equipment that you thought the seller was entitled to sell could subject you to liability if it turns out that, in fact, the seller was merely a lessee and the lessor decides to sue you (and not the lessee) for, among other things, conversion.

Last December, the federal district court for the Eastern District of Pennsylvania denied the defendant's motion to dismiss in *Farm Credit Leasing Services Corp. v. Ferguson Packaging Machinery Inc*. The plaintiff, Farm Credit Leasing Services Corp. ("Farm Credit') leased certain equipment to Le-Nature's f/k/a Global Beverage Systems, Inc. ("Le-Nature's") pursuant to a lease agreement. Sometime after July 2000, Le-Nature's sold the equipment to Ferguson Packaging Machinery Inc. ("Ferguson"). The sale occurred without Farm Credit's knowledge or consent, and in violation of the Lease Agreement. Furthermore, even though under the lease agreement, Farm Credit was the owner of the equipment, neither Le-Nature's nor Ferguson paid Farm Credit any consideration for the equipment.

Ferguson subsequently re-sold the equipment to a third party. Again, neither Ferguson nor the third party purchaser nor any other party paid Farm Credit any consideration for the sale of the equipment to the third party purchaser.

In 2006, Le-Nature's filed for chapter 11 protection, and, as a result, Farm Credit was prevented by the automatic stay from bringing an action against Le-Nature's for breach of contract. Farm Credit sued Ferguson for, *inter alia*, conversion. Farm Credit alleged three independent conversion claims:

1. Ferguson purchased the equipment, owned by Farm Credit, from Le-Nature's and exercised dominion and control over the equipment without the knowledge or consent of Farm Credit;

2. Ferguson sold the equipment to a third party, thus further depriving Farm Credit of its right to the equipment; and

3. Ferguson retained the proceeds from the sale of the equipment.

Given the "relatively low bar imposed by Rule 12(b)(6)"—*i.e.* motion to dismiss for failure to state a claim for which relief can be granted—the Court agreed that the elements of conversion were adequately pled and that the "bottom line" was that "Ferguson is liable to Farm Credit regardless of whether Ferguson purchased the [equipment] in good faith, and regardless of any claim against Le-Nature's."

The holding in *Farm Credit* is analogous to a decision rendered last August by Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York in *In re Enron Corp.*, Lead Case No. 01-16034, Adv. Proc. Nos. 05-01025, Nos. 06 Civ. 7828 (SAS), 07 Civ. 1957 (SAS) (Aug. 27, 2007). There, Judge Scheindlin entertained an interlocutory appeal, in which the issue was "whether equitable subordination under [section] 510(c) [of the Bankruptcy Code] and disallowance under [section] 502(d) [could] be applied, as a matter of law, to claims held by a transferee to the same extent they would be applied to the claims if they were still held by the transferor based on alleged acts or omissions on the part of the transferor."

Over the protests of several *amici curiae*, who "expressed great concern that the effect of [liability against good faith transferees would] wreak havoc in the markets for distressed debt," Judge Scheindlin ruled in favor of Enron—*i.e.* a good faith transferee's claim could be equitably subordinated or disallowed based purely on the improper conduct of the transferor. Judge Scheindlin, however, limited her holding to assignees, not purchasers, of claims. She based this distinction on a plain reading of the statutes, which argued for both equitable subordination and disallowance as personal disabilities of the *holders* of the claims and not characteristics of the claims themselves. As such, the inequitable conduct of the transferor could only be imputed to a good faith transferee if the claim was assigned to it and not purchased for value. Judge Scheindlin remanded to the bankruptcy court to determine whether the transfer at issue was a sale or assignment.

These two cases stand for the proposition that, regardless of your good faith intentions and lack of knowledge (despite due diligence) with regard to the purchase of goods or claims, you may become the target of a true owner or bankruptcy trustee, and you would therefore do well to account for this risk in your purchase agreement, in the form of a guaranty or indemnification provision. •

SUBORDINATION continued from page 2

conclusion that the subordinated holders were not expected to receive any payment or distribution from the debtors (a) until the senior holders were paid in full or (b) unless the senior holders consented to such distribution. As such, the Court rejected the subordinated holders' grammatically-based argument that the debtors' anticipated equity-rights offering constituted "Permitted Junior Securities."

The court's consideration of the issue is consistent with the expectations of the credit markets, and provides comfort to financial institutions investing in both senior and subordinated debt. •

In the News

Current Cooley Representations

***In re Lillian Vernon Corporation*, Case No. 08-10323 (Bankr. D. Del. 2008).** Lillian Vernon is a direct mail specialty catalog and online company specializing in gift, houseware, garden, Christmas and children's products. Within two months of filing its petition for relief, the Debtors' assets were completely liquidated, and the proceeds were largely used to satisfy the first priority secured debt. Cooley's Bankruptcy & Restructuring Group, represents the official committee of unsecured creditors.

***In re Sharper Image Corporation*, Case No. 08-10322 (Bankr. D. Del. 2008).** Known worldwide as a source of new and innovative products, such as its air-purification and its massage chair lines of products, The Sharper Image operated 184 stores in 38 states and the District of Columbia as of the date of its bankruptcy filing on February 19, 2008. Since that time, Cooley, as counsel for the official committee of unsecured creditors, has been actively engaged in all of the pressing issues of the case, including the controversial and highly publicized modified "gift card" program, which allowed customers to use their gift cards, but only on purchases priced at 200% of the value of the card. Cooley also played an instrumental role in facilitating the liquidation process for 96 of the Debtor's 184 stores (which process is still on-going), as well as persuading the Debtor to actively pursue a sale of the Company—whether it be as a going concern or liquidation.

***In re Wickes Holdings, LLC and Wickes Furniture Company, Inc.*, Case No. 08-10212 (Bankr. D. Del. 2008).** Once named a Top 25 Furniture Retail Leader by trade magazine Furniture Today, Wickes Furniture, as of the date of its filing,

Jury Trials and Proofs of Claim

***In re WorldCom, Inc.*, Case No. 02-13533, Adv. Proc. No. 04-04338 (Bankr. S.D.N.Y. Dec. 7, 2007)**

In December of last year, Judge Arthur J. Gonzalez issued a memorandum opinion related to a party's waiver of its right to jury trial in an adversary proceeding as a result of having filed a proof of claim in the bankruptcy case.

After oral argument on the issue, Judge Gonzalez issued an opinion that essentially reinforced the now oft-cited truism: if a creditor files a proof of claim in a bankruptcy case, he waives his right to a jury trial. Citing heavily from a triumvirate of Supreme Court cases—*Katchen v. Landy*, 382 U.S. 323 (1966), *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33 (1989) and *Langenkamp v. Culp*, 498 U.S. 42 (1990) (per curiam), reh'g denied, 498 U.S. 1043 (1991)—as well as the corollary Second Circuit case *Germain v. Conn. Nat'l Bank*, 988 F.2d 1323 (2d Cir. 1993), Judge Gonzalez ruled in favor of the Debtors and denied Communications Network International, Ltd.'s ("CNI") demand for jury trial on the grounds that (1) CNI waived its right to jury trial when it filed its proof of claim in the Debtors' bankruptcy case and (2) the Debtors' adversary proceeding was "inextricably intertwined" with the claims-allowance process, which itself was "integrally related to the equitable reordering of debtor-creditor and creditor-creditor relations."

Specifically, Judge Gonzalez held that both CNI's proof of claim and the Debtors' adversary proceeding complaint arose from a prepetition contractual dispute and action in Pennsylvania state court filed by the Debtors. After the Debtors filed for bankruptcy in 2002, CNI filed a timely proof of claim, reasserting its counterclaims from the Pennsylvania action. Subsequently, the Debtors initiated an adversary proceeding against CNI, objecting to the proof of claim and reasserting the issues in their Pennsylvania state court complaint. CNI answered in a timely manner and once again demanded a jury trial. On motions by the parties for judgment on the pleadings, Judge Gonzalez ruled partially in favor of the Debtors by dismissing CNI's claims. It denied the Debtors' motion, however, as to CNI's liability for unpaid services under the prepetition contract. In October 2007, the Debtors moved to strike CNI's demand for jury trial, to which CNI timely replied.

Notably, the Court rejected CNI's argument that because CNI's proof of claim was resolved prior to any trial on the merits of the Debtors' adversary proceeding, the adversary proceeding was separate and independent from the claims-allowance process. The Court deemed it "immaterial whether the creditor filed its proof of claim prior or subsequent to the commencement of the adversary proceeding or whether the jury trial demand preceded or followed the filing of the proof of claim." Additionally, "whether the proof of claim has been disallowed prior to the Court's determination of the jury trial demand" was held equally irrelevant. What *is* relevant, the Court stated, is the filing of the proof of claim, which necessarily "invokes the claims-allowance process and subjects the creditor to the equitable jurisdiction of the Court thereby waiving its right to a jury trial as to any issue that bears directly on the claims-allowance process."

Finally, the Court, in dicta, acknowledged that a creditor that filed a proof of claim could "retain" its right to a jury trial only by properly withdrawing its proof of claim. By this action, the previously filed proof of claim would be deemed a "legal nullity," as if it had never been filed, and therefore, the creditor, not subject to the equitable jurisdiction of the court, would be able to

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Lack of Standing

In re Refco Inc., Case No. 06-5786-bk(L) (2d Cir. Oct. 5, 2007)

Exactly who is a "party in interest" under section 1109(b) of the Bankruptcy Code with standing to appeal a bankruptcy court's approval of a settlement between a debtor and one of its creditors? According to the Second Circuit Court of Appeals, not investors of an individual creditor.

In this case, the Official Committee of Unsecured Creditors (the "Committee") filed an adversary proceeding against Sphinx SPC ("Sphinx"), a creditor, to recover what appeared to be a preferential transfer for approximately $312 million. The Committee and Sphinx ultimately settled the preference action for, among other things, $263 million (the "Settlement'). Several investors in Sphinx, who were essentially funding the Settlement, objected to the Settlement as "worse than losing" and the result of an "incestuous relationship" between the Debtors and Sphinx.

After hearing oral argument on the issue, the bankruptcy court approved the Settlement and held that the creditor's investors lacked standing to object because they were not a "party in interest" under § 1109(b) of the Bankruptcy Code. The court held as a matter of law that the Settlement affected the investors only indirectly. The court noted that reviewing the Settlement's fairness to the investors was outside its purview because such review "would entirely skew the task of a bankruptcy court and be extremely unfair to debtors and trustees in that it would force them, in essence, to continue negotiating and potentially litigating not only with the defendants that they're dealing with in litigation, but also parties who claim an interest in those defendants, which is simply inappropriate." The court stated that the only relevant inquiry in bankruptcy court is whether the debtor acted in good faith to ensure that the Settlement is favorable to the estate, and, in this case, there was no dispute that the Committee acted in the best interests of the estate.

On appeal, the district court affirmed the bankruptcy court's decision, finding, *inter alia*, that (1) the investors were "not directly and adversely affected pecuniarily by the challenged ruling of the Bankruptcy Court because they do not hold a direct interest in the Debtor" and therefore did not have standing to appeal the Settlement; (2) the investors were not a "party in interest" within the meaning of § 1109(b), because "a party must be a creditor or debtor to have standing to object" to a settlement, and the investors were neither; and (3) the bankruptcy court appropriately declined to evaluate the fairness of the Settlement from the perspective of the investors, because the bankruptcy court's only obligations in evaluating the Settlement were to the Debtors' estate, creditors, and shareholders.

On further appeal, the investors argued that the district court erred in dismissing their appeal of the bankruptcy court's order for lack of appellate standing, because, *inter alia*, (1) the approval of the Settlement would cost them tens of millions of dollars, thereby imposing upon them a direct, pecuniary harm sufficient to confer party-in-interest and appellate standing; and

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answer a debtor's adversary proceeding complaint without implicating the claims-allowance process.

This case, though not groundbreaking in its analysis or holding, serves as a powerful reminder of the strategic cost a creditor incurs in filing a proof of claim. Creditors with contract claims against debtors in bankruptcy would do well to carefully weigh the value of a jury trial against the need to file a proof of claim. •

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had 43 showrooms and 4 distribution centers in California, Illinois and Oregon and one cross dock operation in Nevada. Cooley, on behalf of the official committee of unsecured creditors, successfully negotiated a recovery for the sole benefit of general unsecured creditors (in a case where the first lien lender will likely not be paid in full) and successfully defended the validity of the carveout against the objection of the United States Trustee, who argued that the carveout violated the absolute priority rule under the Bankruptcy Code.

In re Domain, Inc., Case No. 08-10132 (Bankr. D. Del. 2008). As of the date of its filing on January 18, 2008, Domain Home operated a chain of 27 home furnishings stores across 7 states in the Northeastern and Mid-Atlantic regions of the U.S. Having unsuccessfully pursued a going concern buyer prior to filing for chapter 11 protection, Domain entered bankruptcy with a clear plan to liquidate substantially all of its assets within one month. As in most other retail chapter 11 cases, Cooley's Bankruptcy & Restructuring Group secured funds for distribution to unsecured creditors from the collateral of Wells Fargo, the senior secured lender, for the sole benefit of general unsecured creditors (including the right to control the pursuit of avoidance actions).

In re Bayonne Medical Center, Case No. 07-15195 (Bankr. D.N.J. 2007). Cooley's Bankruptcy & Restructuring Group, representing the debtor hospital in this chapter 11 case, overcame several financial and legal hurdles to successfully consummate a sale of substantially all of the Debtor's assets in February 2008 to a consortium of limited liability companies. After negotiating $8.5 million in bridge

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financing from the City of Bayonne and the State of New Jersey, Cooley attorneys sold the hospital for an aggregate purchase price of approximately $41 million—the proceeds of which were used to, among other things, pay off the DIP Lender. While the hospital continues to serve the Bayonne community under new ownership, Cooley is administering the wind-down of the Debtor's case. Cooley, and the other professionals, have been negotiating with the hospital's primary pre-petition secured lenders to facilitate a plan of liquidation that would allow for a small payout to pre-petition creditors, a remarkable achievement of insolvent hospitals.

***In re Harvey Electronics, Inc.*, Case No. 07-14051 (Bankr. S.D.N.Y. 2007)**. A retail provider of, among other things, custom installation of high quality audio, video and home theater equipment, Harvey Electronics operated 9 store locations in New Jersey, New York and Connecticut prior to its bankruptcy filing. In this case, Cooley's Bankruptcy & Restructuring Group, representing the official committee of unsecured creditors, successfully defeated the Debtor's request for DIP financing and obtained a ruling from the Court to convert the case. Immediately before the ruling and entry of the conversion order, however, Cooley's attorneys reached a deal with the secured lender to run a liquidation sale in chapter 11 and ultimately provide a modest return to unsecured creditors and Committee control over preferences (not to be pursued).

***In re PLVTZ, Inc. (dba Levitz Furniture)*, Case No. 07-13532 (Bankr. S.D.N.Y. 2007)**. In its third bankruptcy case in ten years, this well-known but struggling furniture company has nearly concluded the sale of substantially all of its assets through an orderly liquidation. In lieu of

Assignments for The Benefit of Creditors: Simple as ABC?

When a company is in financial trouble, the preference of the owners and management—and sometimes its creditors—is to restructure the enterprise's debt and, perhaps, business operations. This is one of the founding principles underlying Chapter 11—to preserve the going concern value for the estate. However, market and/or other economic forces may compel a different result and a business's value may be maximized through an orderly liquidation. A Chapter 11 (or Chapter 7) bankruptcy case is often used to effectuate an orderly wind-down and distribution scheme. Nonetheless, there are cost structures and risks inherent in a formal bankruptcy case and, at times, a non-bankruptcy corporate dissolution may be appropriate for a company with fewer creditors. This Alert examines another of the non-bankruptcy options, the assignment for the benefit of creditors, commonly known as an "ABC."

A Few Caveats. It is important to remember that determining which path an insolvent company should take depends on the specific facts and circumstances involved. There is no pre-determined rule for deciding whether the company should choose a Chapter 11 filing, out-of-court restructuring, or an ABC. Instead, as in many areas of the law and business, one size most definitely does not fit all for financially troubled companies. With those caveats in mind, here is one scenario sometimes seen when a venture-backed or other investor-funded company runs out of money.

One Scenario. After a number of rounds of investment, the investors of a privately held corporation have decided not to put in more money to fund the company's operations. The company will be out of cash within a few months and borrowing from the company's lender is no longer an option. The accounts payable list is growing (and aging) and some creditors have started to demand payment. A sale of the business may be possible, however, and a term sheet from a potential buyer is anticipated soon. The company's real property lease will expire in nine months, but it is possible that a buyer might want to take over the lease.

- A Chapter 11 bankruptcy filing is problematic because there is insufficient cash to fund operations going forward, no significant revenues are being generated, and debtor in possession financing seems highly unlikely unless the buyer itself would make a loan. In short, there are no readily available sources of funds to continue operating in bankruptcy (even with the payment of pre-petition claims and debt service being halted).
- The board prefers to avoid a Chapter 7 bankruptcy because it is concerned that a bankruptcy trustee, unfamiliar with the company's technology, would not be able to generate the best recovery for creditors.

The ABC Option. In many states, an option that may be available to companies in financial trouble is an assignment for the benefit of creditors (or "general assignment for the benefit of creditors" as it is sometimes called). *The ABC is an insolvency proceeding governed by state law rather than federal bankruptcy law*. The essence of an ABC is that the troubled company (the "assignor") assigns all of its assets to a third party (the "assignee") who will then wind up the business affairs of the company, sell its assets, and oversee a process for distributing the net proceeds to creditors.

California ABCs. For example, in California, where ABCs have been done for years, the primary governing law is found in

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California Code of Civil Procedure sections 493.010 to 493.060 and sections 1800 to 1802, among other provisions of California law. California Code of Civil Procedure section 1802 sets forth, in remarkably brief terms, the main procedural requirements for a company (or individual) making, and an assignee accepting, a general assignment for the benefit of creditors:

1802. (a) In any general assignment for the benefit of creditors, as defined in Section 493.010, the assignee shall, within 30 days after the assignment has been accepted in writing, give written notice of the assignment to the assignor's creditors, equityholders, and other parties in interest as set forth on the list provided by the assignor pursuant to subdivision (c).

(b) In the notice given pursuant to subdivision (a), the assignee shall establish a date by which creditors must file their claims to be able to share in the distribution of proceeds of the liquidation of the assignor's assets. That date shall be not less than 150 days and not greater than 180 days after the date of the first giving of the written notice to creditors and parties in interest.

(c) The assignor shall provide to the assignee at the time of the making of the assignment a list of creditors, equityholders, and other parties in interest, signed under penalty of perjury, which shall include the names, addresses, cities, states, and ZIP Codes for each person together with the amount of that person's anticipated claim in the assignment proceedings.

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Severance Not Executory

***In re Exide Technologies, Inc.* Case No. 02-11125 (KJC) (Bankr. D. Del. Dec. 5, 2007)**

In *Exide Technologies*, a senior vice president sought to compel the Debtor to assume his retirement and severance plan pursuant to the terms of its plan of reorganization. Under the employee's plan, the vice president was entitled to 10 annual payments in the amount of $57,500. The debtor stopped making such payments, however, after filing its bankruptcy petition.

The issue controlling the outcome of the vice president's motion was whether the retirement plan constituted an executory contract. In denying the vice president's motion, the court applied the *Countryman* test and ruled that the retirement plan was not an executory contract because the vice president did not owe any further duties to the debtor thereunder. Accordingly, the court concluded that the debtor could not assume the retirement plan pursuant to the plan of reorganization. •

Payment of Pre-Petition Claims

***In re Zenus Is Jewelry, Inc.*, Case No. 07-11245 (MWV) (Bankr. D.N.H. October 25, 2007),**

In *Zenus Is Jewelry*, the debtor sought to pay five of its prepetition unsecured creditors in return for an extension of credit from each of them. At trial, the debtor's president and sole shareholder testified that the prepetition payments were necessary in order for the debtor to obtain inventory for the Christmas season.

The debtor cited the "doctrine of necessity" as authority for its ability to pay certain prepetition unsecured creditors. The court denied the debtor's motion under the rationale that the "doctrine of necessity" should only be invoked in extraordinary circumstances. This decision highlights the difficulties facing debtors that seek approval of "critical vendor" motions in the wake of recent decisions in the *Kmart* and *CoServ* cases. •

IN THE NEWS continued

commencing litigation against the junior secured lender, Cooley's Bankruptcy & Restructuring Group negotiated a recovery of approximately $2 million, to be shared between the junior secured lender and the unsecured creditors.

***In re Princeton Ski Shops, Inc., et al.*, Case No. 07-26206 (Bankr. D.N.J. 2007)**. Based in Fairfield, New Jersey, Princeton Ski Shops operated a chain of retail stores that provided a comprehensive selection of ski equipment, snowboard gear and clothing, as well as a range of year-round outdoor gear, including equipment for kayaking, outdoor adventure travel, tennis, and inline skating. In the four months following the bankruptcy filing, the Debtors searched for possible sources of a cash infusion in order to potentially reorganize, but by the end of February 2008, it was clear that liquidation was the only viable option. Cooley, representing the official committee of unsecured creditors, facilitated the sale of the Debtors' merchandise to Gordon Brothers for approximately $2 million; the remaining assets (i.e. leases, IP) were recently sold at auction on April 16, 2008.

***In re Bombay Company, et al.*, Case No. 07-44084 (Bankr. N.D. Tex. 2007)**. Founded in 1975 as a mail order furniture company specializing in inexpensive reproductions of 18th and 19th Century English furniture, The Bombay Company eventually grew to become a standard-bearer in the high-end furniture retail market, at one time boasting annual sales of $596.4 million and net income of $9.7 million. Upon filing for bankruptcy, the Debtors notified the Court that they only had 20 days to hold an auction and have a sale hearing before their cash ran out. Judge Lynn was not pleased, and though ultimately that is what occurred,

IN THE NEWS continued

the Court tasked Cooley, representing the official committee of unsecured creditors, to conduct an investigation and determine why the Debtors filed when they did and whether they could have or should have filed at an earlier date.

***In re Hancock Fabrics, et al.*, Case No. 07-10353 (Bankr. D. Del. 2007)**. In what could prove to be a true retail bankruptcy reorganization – one that bucks the recent trend of chapter 11 liquidations – the Hancock Fabrics case is nearing the plan proposal and vote solicitation stage. Cooley's Bankruptcy & Restructuring Group, which represents the official committee of unsecured creditors, is optimistic that a plan very favorable to creditors will be filed by the end of April and the company could emerge from bankruptcy as a reorganized entity by the fall of this year.

CompUSA Out-of-Court Liquidation. Using December 7, 2007 as a "quasi-petition date," this retailer and reseller of consumer electronics, technology products and computer services is in the process of an orderly wind-down of operations and going-out-of-business sales. Cooley represents the Ad Hoc Creditors' Committee in this out-of-court liquidation, which contemplates an assignment of creditors' claims to Gordon Brothers (the purchaser of all of CompUSA's assets and liabilities) in exchange for a pro rata distribution from a trust established by the settlement agreement reached among CompUSA, Gordon Brothers, and the Committees (there is a separate Ad Hoc Landlords' Committee). Cooley attorneys anticipate a 35% to 40% payout to unsecured creditors with an initial distribution to occur by the end of April 2008. The size and timing of this distribution would not have been possible in a chapter 11 case,

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post-petition attorneys' fees. Section 506(b) allows, as part of a creditor's *oversecured* claim, reasonable attorneys' fees and costs incurred during the post-petition period.

Since the *Travelers* decision was issued in March 2007, two bankruptcy courts have offered conflicting opinions on whether an unsecured creditor may recoup contract-based, post-petition attorneys' fees. In May 2007, the Bankruptcy Court for the Northern District of California held that unsecured creditors could recover such attorneys' fees. *In re Qmect, Inc.*, Case No. 04-41044 (Bankr. N.D. Cal. May 17, 2007) ("*Qmect*"). In so holding, the *Qmect* Court rejected the debtor's argument that section 506(b) implicitly calls for the disallowance of such claims. The *Qmect* Court reasoned, *inter alia*, that if Congress had intended for the disallowance of unsecured claims for post-petition attorneys' fees, then it would have provided for such automatic disallowance in section 502(b) along with the other enumerated exceptions to allowance.

In July 2007, the Bankruptcy Court for the Middle District of Florida came to the opposite conclusion. *In re Electric Machinery Enterprises, Inc.*, Case No. 03-11047 (Bankr. M.D. Fla. July 6, 2007) ("*Electric Machinery*"). The *Electric Machinery* Court, relying heavily on the vast body of pre-*Travelers* case law disallowing such claims, concluded that unsecured creditors are not entitled to claims for contract-based, post-petition attorneys' fees. The *Electric Machinery* Court based its conclusion on four distinct legal and equitable concepts. First, the *Electric Machinery* Court explained that the plain language of section 506(b) evidences the congressional intent to create a limited exception (applicable only to oversecured claims) to the general rule set forth in section 502(b) that claims must be allowed in amounts as of the date of the filing of the petition. Second, the *Electric Machinery* Court reasoned that its conclusion is compelled by the Supreme Court's decision in *United Savings Ass'n v. Timbers*, 484 U.S. 364 (1988) ("*Timbers*"), which held that an undersecured creditor could not receive post-petition interest on the unsecured portion of its debt. Third, the *Electric Machinery* Court reasoned that the plain language of section 502(b), providing that the amount of an allowed claim shall be determined as of the date of the filing of the petition, dictates that the amount of an allowed claim (other than for an oversecured claim) must be determined without the inclusion of post-petition interest, attorneys' fees or costs. Finally, the *Electric Machinery* Court viewed its holding as consistent with the equitable principle of equality of treatment among similarly situated creditors, reasoning that to hold otherwise would favor certain unsecured creditors, including holders of contract claims under pre-petition agreements providing for payment of attorneys' fees, over other unsecured creditors with whom the debtor had no pre-petition contractual relationship (i.e., tort claimants and trade creditors).

In December 2007, the Ninth Circuit Bankruptcy Appellate Panel (the "BAP") became the first appellate court to address the issue in the post-*Travelers* context. *In re SNTL Corp., et al*, Case No. 06-1350 (9th Cir. BAP December 19, 2007) ("*SNTL*"). After carefully reviewing the decisions of the *Qmect* and *Electric Machinery* Courts, as well as the pre-*Travelers* case law, the BAP concluded that claims for contract-based, post-petition attorneys' fees cannot be disallowed solely because the creditor is unsecured. The BAP considered and expressly rejected each of the four justifications cited by the *Electric Machinery* Court in support of its holding. Like the *Qmect* Court, the BAP rejected the argument that section 506(b) implicitly preempts post-petition attorneys' fees for all but oversecured claims. With respect to section 502(b), the

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BAP reasoned that the requirement that the amount of an allowed claim be determined as of the petition date cannot be interpreted to categorically exclude payment of attorneys' fees on all but oversecured claims, in view of the Bankruptcy Code's broad definition of a "claim" as including any right to payment, whether or not such right is contingent and unliquidated. Additionally, the BAP deemed the *Timbers* holding inapplicable to the present issue, as such holding limits disallowance to unmatured interest without a similar prohibition against attorneys' fees. Finally, the BAP was unpersuaded by the *Electric Machinery* Court's equitable considerations, reasoning that it is improvident for courts to resolve public policy issues where the Bankruptcy Code itself provides the answer to the relevant question.

As the first post-*Travelers* appellate decision rendered on the issue, the *SNTL* decision can be expected to resonate among lower courts in the Ninth Circuit and beyond. Such expectations should be tempered, however, in light of the Supreme Court's decision to remand the *Travelers* case to the Court of Appeals for the Ninth Circuit. That case appears to have been fully briefed and the issuance of a decision can be expected in the near future. Importantly, any decision of the Ninth Circuit Court of Appeals on the issue would supersede the BAP's *SNTL* decision and become controlling authority in the Ninth Circuit. Although the ultimate outcome of the *Travelers* case will be controlling authority only in the Ninth Circuit, bankruptcy practitioners and creditors alike should expect that decision to influence all bankruptcy courts addressing the issue in the future. •

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the Original Lenders alleged they were entitled to payment, notwithstanding the assignment of their claims to the Current Lenders. The Court ultimately overruled the Original Lenders' objection, finding that, under a plain reading of the LSTA documents, the Original Lenders *had* assigned their Reimbursement Rights to the Current Lenders and therefore had no claim.

The Claim: The Final Cash Collateral Order and the Reimbursement Rights

By way of background, the issue arose under the Court's final cash collateral order, entered on December 18, 2006. In this order, the Original Lenders were granted, besides the usual adequate protection for the diminution in the value of their collateral, certain Reimbursement Rights, which were defined as follows:

> In addition to the fees, costs, charges and expenses authorized under the Pre-Petition Agreements, the Debtors shall pay in accordance with the procedures set forth in the following sentences, as allowed, post-petition administrative expenses entitled to the priority and security afforded to the Adequate Protection Claim, all of Collateral Agent's and *each Lender's reasonable (in all respects) attorneys' and other professionals' fees and reimbursable expenses* arising from or related to (a) this Order, including without limitation the negotiating, closing, documenting and obtaining of Court approval thereof, (b) all proceedings in connection with any Disposition (as such term is defined below), (c) all proceedings in connection with the interpretation, amendment, modification, enforcement, enforceability, validity or implementation of the Pre-Petition Agreements or this Order at any time, (d) all other matters and proceedings arising in or related to the Debtors' bankruptcy cases, and (e) all reasonable expenses, costs and charges in any way or respect arising in connection with the foregoing (collectively, the "Lender Expenses").

The Sale: Claim Transfers and the LSTA Definitions

The Original Lenders transferred their secured claims and security interests to the Current Lenders beginning shortly before the entry of the final cash collateral order through February 2007. The transfer agreements incorporated the Purchase and Sale Agreement for Distressed Trades, LSTA Standard Terms and Conditions (the "Standard Terms and Conditions") in form or in substance. The Standard Terms and Conditions provided that the "Seller irrevocably sells, transfers, assigns, grants and conveys the Transferred Rights to Buyer." The "Transferred Rights" included, among other things,

> any and all of Seller's right, title, and interest in, to and under the Loans and Commitments (if any) and, to the extent related thereto, the following (excluding, however, the Retained Interest, if any)…
>
> (e) all claims (including "claims" as defined in Bankruptcy Code Section 101(5)), suits, causes of action, and any other right of Seller…that is based upon, arises out of or is related to any of the foregoing, including, to the extent

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because the senior secured debt (held by Gordon Brothers) is approximately $310 million, and the estimated recovery from the liquidation is between $142 and $162 million. Unless Cooley could successfully equitably subordinate or recharacterize as equity the secured debt (which effort would undoubtedly be costly and long), unsecured creditors would likely receive nothing in such an endeavor.

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permitted to be assigned under applicable law, all claims (including contract claims, tort claims, malpractice claims,…) suits, causes of action, and any other right of Seller…against any attorney, accountant, financial advisor, or other Entity arising under or in connection with the Credit Documents or the transactions related thereto or contemplated thereby…

The Problem: The Adversary Proceeding

On October 1, 2007, the Committee initiated an adversary proceeding against the Original Lenders in an effort to (i) avoid the security interests that the Original Lenders transferred to the Current Lenders and (ii) recover the value of the transferred security interests for the benefit of the estates. The Original Lenders vigorously defended the Adversary Proceeding and, in the process, incurred substantial legal fees and expenses they claimed were covered by the Reimbursement Rights under the cash collateral order, which they maintained were not transferred to the New Lenders—after all, it was the Original Lenders who had been sued and were incurring the costs. The Original Lenders filed administrative expense priority claims to recover their actual attorneys' fees and expenses, plus estimated future fees and expenses, under the cash collateral order.

The Result: Beware What You Sell

In denying the Original Lenders' rights to reimbursement under the cash collateral order, the Court reasoned that the definition of the word "claim" found in the definition of "Transferred Rights" in the LSTA-based transfer agreements broadly encompassed the Original Lenders' Reimbursement Rights. The Court refuted several of the Original Lenders' arguments, including:

- "**'Claims' under the Bankruptcy Code are limited to pre-petition claims and the Reimbursement Rights arose post-petition.**" The Court rejected this argument as unfounded and cited several examples of sections in the Code where the word "claim" is specifically qualified to indicate whether it applies to pre- vs. post-petition claims. "[S]tatutes," the Court noted, "should not be interpreted in a manner that renders any word or provision superfluous."
- "**The Original Lenders could not have intended to transfer the Reimbursement Rights and leave themselves vulnerable to a lawsuit by the Committee.**" The Court pointed out that this argument ignored the fact that the Reimbursement Rights covered more than simply legal costs arising from litigation. Indeed, the Current Lenders (who had settled with the Committee) incurred substantial legal and other fees in monitoring their loans and collateral and joining as an active proponent in the Plan process, and the disclosure statement revealed that *they were reimbursed* pursuant to the final cash collateral order.
- "**The Reimbursement Rights were future rights at the time of the transfers and could therefore not be assigned under applicable non-bankruptcy law.**" The Court rejected this argument as an incomplete statement of the law. Only if the contract is *not in existence* will a purported assignment of a right be merely a promise to assign the right. In contrast, this case involved the absolute assignment of a definite right to reimbursement under the final cash collateral order.

Takeaway

The rights assigned under a standard LSTA-based transfer agreement are broad enough to apply to both contingent and post-petition claims, *unless specifically excluded*. Secured lenders who see themselves as potential targets of litigation would do well to secure carve-outs if they are intent on assigning their claims to third parties. Conversely, buyers of claims could be left exposed with no recourse if they lose the right to reimbursement (after all, the Current Lenders, who were actively pursuing the claim in the case, were sued too). And if the sellers and buyers both negotiate for a right to assert the reimbursement claim, the only potential loser is the estate (with additional claims being asserted) if the redundant claims are upheld. •

Collateral Valuation

In re Urban Communicators PCS Limited Partnership (Bankr. S.D.N.Y. 2007)

In *Urban Communicators*, the court ruled that the post-petition interest to which a creditor whose claim was secured by a license was entitled depended on the actual sale price obtained by the debtor's estate for the license. Section 506(b) of the Bankruptcy Code entitles oversecured creditors to seek post-petition interest. Section 506(a) states that the value of a secured claim is determined in light of both (i) the proposed distribution or use of the collateral; and (ii) the purpose of the valuation.

In determining the value of the secured creditor's collateral, the court followed two appellate court decisions that held that where a secured creditor's collateral was actually sold during the pendency of the case, and where the terms of the sale were fair and arrived at on an arm's length basis, the actual sale price should be used to measure the property's value, as contrasted to some earlier hypothetical valuation.

In so ruling, the court rejected the debtor's argument that the creditor had lost its secured status by reason of the prepetition drop in value of the licenses that comprised its collateral, and thus, was not entitled to post-petition interest. The Court noted that the value of the licenses had been restored prior to the bankruptcy filing, and the licenses had fetched prices sufficient to pay the secured creditor in full plus interest. •

Executory Contracts—Post-Petition Performance Does Not Affect Status

The Debtor's right to control the disposition of its executory contracts and unexpired leases is one of the considerable powers granted to the estate in a bankruptcy proceeding. The debtor has the right to assume (and assign) or reject its prepetition agreements, subject, of course, to complying with the Code requirements. Creditors, on the other hand, are often left waiting for the inevitable choice which all Debtors must make sooner or later – assume (and the creditor avoid the fate of other general unsecured creditors) or reject (and the creditor receives only a pro rata distribution of pennies on the dollar or, worse, nothing, for the deemed rejection-damage breach claim). Key to the decision and the debtor's right, however, is that the contract must be an "executory contract" (or unexpired lease). Contracts that terminated prior to the bankruptcy, for example, or for which one side has fully and completely performed, are not (typically) deemed executory. But, bankruptcy cases can last months or sometimes even years. When does the court measure a contract's "executoriness"? What happens if a contract was "executory" on the bankruptcy filing date, but subsequent actions affect its executory status? It depends. As discussed below, the Second Circuit recently held that a creditor's postpetition conduct cannot affect the executory nature of the contract.

In COR Route 5 Company, LLC v. The Penn Traffic Company (In re The Penn Traffic Company, et al.) (2nd Cir. Apr. 29, 2008), the debtor, Penn Traffic Company ("Penn Traffic"), sought to reject a supermarket construction, land sale and leaseback contract it had with an entity called COR Route 5 Company ("COR"). When Penn Traffic filed for bankruptcy protection, both it and COR had outstanding obligations. Namely, COR (i) owed Penn Traffic $3.5 million as reimbursement for construction costs and (ii) was required to deliver the lease to the supermarket to the debtor as part of the sale leaseback. Penn Traffic, meanwhile, was obligated to convey the supermarket parcel to COR (so that it could lease it back). Several months after Penn Traffic filed for bankruptcy, COR sought to tender the $3.5 million payment and the signed lease to Penn Traffic, pursuant to the then-executory contract. Penn Traffic declined to accept COR's tender and performance and, several months thereafter, moved, pursuant to section 365 of the Bankruptcy Code, to reject the contract, because the propery was worth more than the purchase price of $3.5 million.

To simplify the procedural background, Judge Adlai Hardin of the Bankruptcy Court for the Southern District of New York sided with COR and held that, although the contract was executory on the petition date, it was "rendered…non-executory and thus incapable of rejection" due to COR's post-petition tender of the payment and the lease. On appeal, the District Court reversed, stating emphatically "post-petition performance cannot alter the executoriness of a contract." COR appealed, and eventually, the Second Circuit Court of Appeals addressed the issue: "whether the non-debtor party to a contract that is executory at the time a bankruptcy case is commenced can, by post-petition tender or performance of its outstanding obligations under the contract, deprive the debtor party of the ability to exercise its statutory right to reject the contract as disadvantageous to the estate." The Second Circuit held very clearly that it cannot.

The Court's Rationale

After first running through the various standards to determine that the agreement was, in fact, an "executory contract" under section 365, the Court stated the fundamental principle that "[e]xecutoriness and the debtor's rights with respect to assumption or rejection of an executory contract are normally assessed as of the petition date" and not the date of the debtor's motion to assume or reject. Importantly, the Court distinguished those cases in which a contract was deemed to be no longer executory because (i) it expired by its own terms or (ii) the debtor itself took affirmative action under the contract that affected the outstanding performance obligations. [These are noteworthy exceptions that affect the Court's ultimate conclusion.]

Here, the Court explained, a non-debtor party to an executory contract, through unilateral action, was trying to prevent the debtor from exercising its statutory rights, and to allow such a result would undermine the plain language and policy of the Bankruptcy Code. As to the plain language, the Court noted that sections 365 and 1107 of the Bankruptcy Code expressly permit a chapter 11 debtor to move to assume or reject an executory contract at any time before the confirmation of a plan unless the court orders it to make an earlier determination. …The [Bankruptcy] Code does not condition the right to assume or reject on lack of prejudice to the non-debtor party, and the satisfaction of claims at less than their full non-bankruptcy value is common in bankruptcy proceedings, as is the disruption of non-debtors' expectations of profitable business arrangements.

As to the policy rationale underlying its holding, the Court reiterated the oft-cited truism that the debtor's rehabilitation and reorganization should be of paramount concern and consistent with that notion, section 365 "permits the trustee or debtor-in-possession, subject to the approval of the bankruptcy court, to go through the inventory of executory contracts of the debtor and decide which ones it would be beneficial to adhere to and which ones it would be beneficial to reject." The Court concluded:

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(2) the Sphinx directors breached their fiduciary duty by entering a fraudulent settlement, and therefore the funds at issue became the res of a constructive trust, of which the investors were the beneficiaries. Because the investors held a constructive trust over the money used to fund the Settlement, they had standing under the direct, pecuniary interest test.

The Second Circuit rejected the investors' arguments and affirmed the decisions of both the bankruptcy court and the district court. It began its analysis with the text of section 1109(b) of the Bankruptcy Code, which states that the term "party in interest includ[es] the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee." The court noted that the term "equity security holder" in the statute clearly refers to a *debtor's* equity security holder, which the investors could not claim to be. As to the Settlement, the court further noted that although Sphinx, as a party to the Settlement, clearly had standing to object to it, the standing of the Investors was a completely different issue.

Although the court sympathized with the investors' complaint that the Sphinx directors potentially violated their fiduciary duties by entering into the Settlement as not in the best interests of the investors, the court stated that that issue "was not for the bankruptcy court." "Bankruptcy courts," the court held, "are primarily courts of equity, but they are not empowered to address any equitable claim tangentially related to the bankruptcy proceeding. Bankruptcy court is a forum where creditors and debtors can settle their disputes *with each other*. Any internal dispute between a creditor and that creditor's investors belongs elsewhere."

The court quoted Chief Judge Lifland of the Bankruptcy Court for the Southern District of New York to reinforce this proposition:

> [I]t is important that a bankruptcy court is not too facile in granting applications for standing. Overly lenient standards may potentially overburden the reorganization process by allowing numerous parties to interject themselves into the case on every issue, thereby thwarting the goal of a speedy and efficient reorganization…. Granting peripheral parties status as parties in interest thwarts the traditional purpose of bankruptcy laws which is to provide reasonably expeditious rehabilitation of financially distressed debtors with a consequent distribution to creditors who have acted diligently.

Finally, the court advised that a bankruptcy court's obligation is to determine whether a settlement is in the best interests of the estate, not to ensure that the creditors' representatives are honoring their fiduciary duties. The Second Circuit agreed with the bankruptcy court that to permit the investors to lodge objections to the Settlement on the basis of their fiduciaries' appropriate approval would "entirely skew the task of [the] Bankruptcy Court," and that it would be "extremely unfair to debtors" to force them to negotiate not only with the legal representatives of creditors, but also with any interest holders of a creditor. •

Retail Bankruptcy Round-Up

The following cases are retail chapter 11 bankruptcies that were filed within the last 8 months. Cooley Godward Kronish represents the Creditors' Committee (both official and unofficial) in all but three of these cases (please see sidebar for summaries of current representations).

Case Name	Petition Date	Case Number	Bankruptcy Court
The Bombay Company	Sept. 17, 2007	07-44084	N.D. Tex. (Ft. Worth)
Princeton Ski Shops	Nov. 4, 2007	07-26206	D. N.J. (Newark)
PLVTZ, Inc. ("Levitz Furniture")	Nov. 8, 2007	07-13532	S.D.N.Y. (Manhattan)
CompUSA	Dec. 7, 2007*	N/A	N/A
Harvey Electronics	Dec. 28, 2007	07-14051	S.D.N.Y. (Manhattan)
Domain, Inc.	Jan. 18, 2008	08-10132	D. Del. (Wilmington)
Wickes Furniture	Feb. 3, 2008	08-10212	D. Del. (Wilmington)
Fortunoff	Feb. 4, 2008	08-10353	S.D.N.Y. (Manhattan)
The Sharper Image	Feb. 19, 2008	08-10322	D. Del. (Wilmington)
Lillian Vernon Corporation	Feb. 20, 2008	08-10323	D. Del. (Wilmington)
Hoop Holdings, LLC ("The Disney Store")	Mar. 26, 2008	08-10323	D. Del. (Wilmington)
Linens Holdings Co. ("Linens 'n Things")	May 2, 2008	08-10832	D. Del. (Wilmington)

* Because the CompUSA case is being conducted as an out-of-court liquidation, this date is the "Announcement Date" (i.e. the date that Gordon Brothers announced to creditors that CompUSA had been sold and was being liquidated). It serves as a quasi-petition date.

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As in many states, in California the company and the assignee enter into a formal "Assignment Agreement." The company must also provide the assignee with a list of creditors, equity holders, and other interested parties (names, addresses, and claim amounts). The assignee is required to give notice to creditors of the assignment, setting a bar date for filing claims with the assignee that is between five to six months later.

ABCs In Other States. Many other states have ABC statutes although in practice they have been used to varying degrees. For example, ABCs have been more common in California than in states on the East Coast, but important exceptions exist. Delaware corporations can generally avail themselves of Delaware's voluntary assignment statutes, and its procedures have both similarities and important differences from the approach taken in California. Unlike the California ABC process, in Delaware the Chancery Court retains a supervisory role during much of the ABC. For example, a Delaware assignee is required to file with the Chancery Court a complete inventory of the assets it has been assigned and, upon receipt of the inventory, the Chancery Court appoints two disinterested appraisers to evaluate the inventory. Once the appraisal is filed, the assignee is required to post a surety bond with a value equal to that of the appraised assets and, annually, the assignee is required to file an accounting of the assignee's activities. Other states where ABCs are more frequently used include Florida, Massachusetts, and Illinois.

Important Features Of ABCs. A full analysis of how ABCs function in a particular state and how one might affect a specific company requires legal advice from insolvency counsel. The following highlights some, but by no means all, of the key features of ABCs (and for illustration purposes only, we look at the California statute):

Court Filing Issue. In California, making an ABC does not require a public court filing. However, other states, such as Delaware and Michigan, do require a court filing to initiate or complete an ABC.

Select The Assignee. Unlike a Chapter 7 bankruptcy trustee, who is randomly appointed from those on an approved panel, a corporation making an assignment is generally able to choose the assignee. As with other professionals, particular assignees have a range of expertise and often take different approaches to management of an ABC. In selecting an assignee, companies should consider which assignee would be best able to liquidate the company's assets and address the company's specific circumstances.

No Automatic Stay. In many states, including California, an ABC does not give rise to an automatic stay like bankruptcy. However, Uniform Commercial Code section 9-309 gives an assignee a perfected lien, generally allowing assignees to block judgment creditors from attaching assets. With respect to creditors with perfected security interests, the lack of an automatic stay does mean that, unlike in a bankruptcy, absent an agreement by the secured lender or other secured creditor to work with the assignee, the lender will usually be able to foreclose on its collateral. As such, an ABC would not work for a company with a large and disparate creditor base and/or secured lenders who will not agree to work with the assignee.

Shareholder Approval. Most corporations require both board and *shareholder approval* for an ABC because it involves the transfer to the assignee of substantially all of the corporation's assets. This makes ABCs impractical for most publicly held corporations, since shareholder approval is not usually required for commencement of a bankruptcy case (i.e., only board approval is required).

Liquidator As Fiduciary. The assignee is a fiduciary to the creditors and is typically a professional liquidator. An ABC and bankruptcy option are similar in this regard as fiduciary duties are owed to creditors in both – whether the company is managed by a liquidator or a debtor in possession.

Assignee Fees. The fees charged by assignees often involve a substantial upfront payment and a percentage based on the assets liquidated. In comparison, a Chapter 7 trustee is entitled to reasonable compensation based upon a sliding sale, pursuant to Bankruptcy Code Section 326.

Event Of Default. The making of a general assignment for the benefit of creditors is typically a default under most contracts. Given the lack of an automatic stay in an ABC, contracts may be terminated upon the assignment under an *ipso facto* clause. This is one of the factors a company should consider in determining whether to pursue an ABC or a bankruptcy.

Claims. For creditors, an ABC process generally involves the submission to the assignee of a statement or other proof of claim by a stated deadline, which is similar to a bankruptcy process.

Employee Priority. Employee and other claim priorities are governed by state law and may involve different amounts than apply under the Bankruptcy Code. In California, for example, the employee wage and salary priority is $4,300, not the $10,950 amount currently in force under the Bankruptcy Code.

20 Day Goods. Generally, ABC statutes do not have a provision similar to that under Bankruptcy Code Section 503(b)(9), which gives an administrative claim priority to vendors who sold goods in the ordinary course of business to a debtor during the 20 days before a bankruptcy filing. As a result, these vendors may recover less in an ABC than in a bankruptcy case. In an ABC, vendors may assert reclamation rights under

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the Uniform Commercial Code and the absence of an automatic stay would allow vendors to reclaim goods, subject to the prior rights of a perfected secured creditor.

Landlord Claim. Unlike bankruptcy, there generally is no cap imposed on a landlord's claim for breach of a real property lease in an ABC. In California, an assignee is permitted to remain in the premises for up to 90 days after the assignment in exchange for paying rent but may not assign the lease without consent of the landlord. In contrast, a company in bankruptcy has up to 210 days (subject to additional time with landlord consent) to determine whether to assume or reject real property leases.

Sale Of Assets. In many states, including California, sales by the assignee of the company's assets are completed as a private transaction without approval of a court. However, unlike a bankruptcy Section 363 sale, *there is usually no ability to sell assets "free and clear" of liens and security interests without the consent or full payoff of lienholders. Likewise, leases or executory contracts cannot be assigned without required consents from the other contracting party*.

Avoidance Actions. Most states allow assignees to pursue preferences and fraudulent transfers. However, the U.S. Court of Appeals for the Ninth Circuit has held that the Bankruptcy Code pre-empts California's preference statute, California Code of Civil Procedure section 1800. Nevertheless, to date the California state courts have refused to follow the Ninth Circuit's decision and still permit assignees to sue for preferences in California state court. In February 2008, a Delaware state court followed the California state court decisions, refusing either to follow the Ninth Circuit position or to hold that the California preference statute was pre-empted by the Bankruptcy Code. The Delaware court was required to apply California's ABC preference statute because the avoidance action arose out of an earlier California ABC.

The Scenario Revisited. With this overview in mind, let us return to our company in distress.

- The prospect of a term sheet from a potential buyer may influence whether our hypothetical company should choose an ABC or another approach. Some buyers will refuse to purchase assets outside of a Chapter 11 bankruptcy or a Chapter 7 case. Others are comfortable with the ABC process and believe it provides an added level of protection from fraudulent transfer claims compared to purchasing the assets directly from the insolvent company. Depending on the value to be generated by a sale, these considerations may lead the company to select one approach over the other available options. One issue will the cooperation of secured lenders and contract parties (particularly where contracts require consent to assignment) with the sale process to allow the buyer to be comfortable that the sale can be concluded free and clear of liens and with all required contracts in full force.
- In states like California where no court approval is required for a sale, the ABC can also mean a much faster closing —often within a day or two of the ABC itself provided that the assignee has had time to perform due diligence on the sale and any alternatives—instead of the more typical 30-60 days required for bankruptcy court approval of a Section 363 sale. Given the speed at which they can be done, in the right situation an ABC can permit a "going concern" sale to be achieved.
- Importantly, as noted, secured creditors with liens against the assets to be sold will have to agree to cooperate with the assignee and will either need to be paid off through the sale or consent to release their liens pending resolution of their claims; forced "free and clear" sales generally are not possible in an ABC. For this reason, it may be important to discuss an ABC alternative with secured creditors sooner rather than later to obtain their cooperation with the sale process.
- If the buyer decides to take the real property lease, the landlord will need to consent to the lease assignment. Unlike bankruptcy, the ABC process generally cannot force a landlord or other third party to accept assignment of a lease or executory contract. The same consideration can apply to other contract and non-contract assets where, under the agreement or applicable law, consent is needed. Again, the company's ability to discuss an ABC with, and obtain consent from, the affected parties early in the process is an important factor in evaluating which insolvency options are available.
- If the buyer decides not to take the lease, or no sale occurs, the fact that only nine months remains on the lease means that this company would not benefit from bankruptcy's cap on landlord claims. If the company's lease had years remaining, and if the landlord were unwilling to agree to a lease termination approximating the result under bankruptcy's landlord claim cap, the company would need to consider whether a bankruptcy filing was necessary to avoid substantial dilution to other unsecured creditor claims that a large, uncapped landlord claim would produce in an ABC.
- If the potential buyer walks away, the assignee would be responsible for determining whether a sale of all or a part of the assets was still possible. In any event, assets would be liquidated by the assignee to the extent feasible and any proceeds would be distributed to creditors in order of their priority through the ABC's claims process.

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- While other options are available and should be explored, an ABC may make sense for this company depending upon the buyer's views, the value to creditors and other constituencies that a sale would produce, and a clear-eyed assessment of alternative insolvency methods.

Conclusion. When weighing all of the relevant issues, an insolvent company's management and board would be well-served to seek the advice of counsel and other insolvency professionals as early as possible in the process. The old song may say that ABC is as "easy as 1-2-3," but assessing whether an assignment for the benefit of creditors is best for an insolvent company involves the analysis of a myriad of complex factors. •

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However long this process may take, however onerous the dilemmas faced by the non-debtor party to an executory contract may be while the non-debtor awaits the debtor's decision, and whether or not the bankruptcy judge grants a motion by the non-debtor party to accelerate the debtor's timetable for making its election to assume or reject, the power to make that election is …that of the debtor alone.

Takeaway

The decision recognizes the estate's right to control the ultimate disposition of its assets, including its executory contracts. Importantly, it precludes a creditor from being permitted to take unilateral action that could change the character of the contract by rendering post-petition performance. Had the debtor performed, the Court's decision implies that the character of the contract could have been changed. But, the creditor may not do so. Interestingly, creditors are required to perform under contracts for so long as the debtor is performing or face attacks that their non-performance post-petition violates the automatic stay. This case, however, shows the dual nature of the stay, and estate's right to a "breathing spell". One the one hand, in general, creditors must perform post-petition under contracts; on the other hand, their performance, if rejected by the debtor, does not change the "executory" nature of the contract. However you analyze the duality, the balance of rights is clearly in favor of the debtor. •

Bankruptcy & Restructuring Event Calendar
Spring/Summer 2008 Cooley Godward Kronish Speaking Appearances

Event	Date/Location	Cooley Godward Kronish Participant/Topic
Cooley & Longacre Fund Management, LLC Co-Host a Symposium	May 6, 2008 (New York, NY)	Larry Gottlieb & Jay Indyke (Speakers: "Critical Legal Issues for Vendors in Recent Retail Bankruptcies")
National Credit Congress (NACM)	May 18, 2008 (Louisville, KY)	Jay Indyke (Speaker: "Critical Vendor Issues in an Economic Slowdown")
National Credit Congress (NACM)	May 21, 2008 (Louisville, KY)	Richard Kanowitz (Speaker: "Out of Court Workouts for Distressed Companies")
Bloomberg Finance L.P.	May 20, 2008 (Los Angeles, CA)	Cathy Hershcopf (Speaker: "Hot Topics in Chapter 11 Bankruptcies: Special Issues for Homebuilders and Current Topics for Retailers")
Super Return U.S. 2008	June 2-4, 2008	Larry Gottlieb (Moderator: "Harnessing Opportunities In Distressed: In An Era Of Rising Defaults, Where Are The Opportunities This Time Round?"
Creditntell	June 12, 2008 (webinar)	Larry Gottlieb & Jay Indyke (Speakers: "Understanding the Bankruptcy Process: Terminology and Trends")
National Credit Congress (NACM)	September 18, 2008 (Kansas City, KS)	Jay Indyke (Speaker: "Creditors Committees")

For more information on these appearances, please contact the Marketing Department at 212-479-6163.

Fire Drill

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