

Transfer Taxes—U.S. Supreme Court Rings Death Knell for Pre-Plan Sales Exemption

On June 16, 2008, the United States Supreme Court issued an opinion in the *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.* case, holding that the exemption from state stamp taxes under section 1146(a) of the Bankruptcy Code does not apply to asset sales under section 363 of the Bankruptcy Code that take place prior to the confirmation of a chapter 11 plan.

The *Piccadilly* case reached the Supreme Court on appeal from an Eleventh Circuit decision holding that the stamp-tax exemption may apply to pre-confirmation asset sales where there is a nexus between the pre-confirmation sale and the ability to consummate a chapter 11 plan.

The Supreme Court reversed the Eleventh Circuit's decision, holding that the plain and unambiguous language of section 1146(a) limits the scope of the tax exemption to post-confirmation transfers. Section 1146(a) of the Bankruptcy Code provides that "[t]he issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer *under a plan confirmed* under Section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax."

The *Piccadilly* decision is of significant importance in this post-BAPCPA restructur-

continued on page 10

Equitable Subordination of Insiders' Secured Claims Reversed by Fifth Circuit for Lack of Finding of Harm to Borrower

Increasingly, as companies face liquidity crunches, alternative sources of capital must be considered—including loans coupled with an equity component. These lending sources can range from existing owners ("insiders") providing loans to a company from third party lending sources (such as debt and equity funds) making loans to a company and, concurrently, taking an interest in the company's equity as "upside compensation" should the borrower's value increase. In these instances, an investor will be both a lender (secured or unsecured) and an equity holder. The mere presence of both interests is not, as recently reaffirmed by the Fifth Circuit, a basis to subordinate the debt claims of

the insider. According to the Fifth Circuit, something more is required for the remedy of equitable subordination.

In *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 2008 U.S. App. LEXIS 13140 (5th Cir. 2008), the Court of Appeals for the Fifth Circuit reversed the equitable subordination of the secured claims of a debtor's insiders. In that case, officers and directors of a debtor corporation made loans to the debtor during a prepetition liquidity crunch. The financial condition of the debtor, however, continued to deteriorate. During the subsequent bankruptcy, the insider lenders were removed as officers and resigned as directors, and the

continued on page 11

in this issue

From The Editor.....	2
Cooley Bankruptcy Chair Testifies to House Judiciary Committee.....	2
Chapter 15 Recognition Not So Easy.....	3
In the News.....	4
Application of the WARN Act's "Faltering Company" Exception.....	4
Debtor's Ability to Pursue Claims Post-Confirmation.....	5
BAP Casts Shadow Over 363(f) "Free and Clear" Sale Orders.....	6
Sharper Image Judge Approves "SPM" Trust.....	8
Bankruptcy Court Finds Section 502(d) Cannot Be Used to Disallow Section 503(b)(9) Admin Expenses.....	9
Retail Bankruptcy Round-Up.....	12
Ninth Circuit Reinforces the Enforceability of Collateral Surcharge Waiver.....	13
Reorganized Parmalat Has Liability For Securities Fraud Class Action Lawsuit.....	14
Debtor Still on Hook for Lease Damages.....	15
Event Calendar.....	16

This information is a general description of the law; it is not intended to provide legal advice nor is it intended to create an attorney-client relationship with Cooley Godward Kronish LLP. Before taking any action on this information you should seek professional counsel.

© 2008 Cooley Godward Kronish LLP, Five Palo Alto Square, 3000 El Camino Real, Palo Alto, CA, 94306. 650/843-5000. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward Kronish LLP as the author. All other rights reserved.

from the editor

ADAM C. ROGOFF

Noticed anything interesting in the marketplace these days? Bailouts, recessions, crashes and the like have predominated the news. "Bankruptcy" even reared its head as a discussion point between the candidates during the Vice Presidential debates recently. Whatever your views may be about the state of play, what is clear is that the National economy—and World economy—is going through a time of major contractions and sudden transitions. It's the game of musical chairs where someone swiped far more than one seat when the music paused. Whether or not you view the \$700 billion bailout as a savior to the marketplace, the constraints on liquidity and capital remain. Borrowers face less access to necessary cash to operate, let alone refinance their existing debt. Lenders, looking for an exit strategy, find themselves facing a lack of secondary (mezzanine) or replacement financing and now confront collateral values that may be stagnant or declining. Some companies, who have yet to face the need to restructure their portfolio interests or businesses in chapter 11 are now dealing with concepts that they have never dealt with before—the automatic stay, cram-down, adequate protection, etc. Whether or not you view chapter 11 as an efficient business tool necessary to preserve values, in this environment, businesses need to understand what can happen in Chapter 11—whether as the reorganizing borrower or the reluctant lender—if only to assess the alternatives outside of bankruptcy. The lender asked to restructure its maturing loan outside of bankruptcy needs to understand the consequences of a non-consensual modification of that debt through a cram-down in chapter 11, again if only to

continued on page 3

Cooley Bankruptcy Chair Testifies to House Judiciary Committee

On September 26, 2008, Lawrence Gottlieb, the Chair of the Bankruptcy & Restructuring Group at Cooley Godward Kronish LLP, testified before the Subcommittee on Commercial and Administrative Law of the United States House of Representatives Committee on the Judiciary. The subject of the hearing was "Lehman Brothers, Sharper Image, Bannigan's, and Beyond: Is Chapter 11 Bankruptcy Working?"

In his testimony, entitled "The Disappearance of Retail Reorganization In The Post-BAPCPA Era," he discussed the major impact the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") has had on retail reorganizations. He primarily testified that certain BAPCPA provisions that reduce a retailer's liquidity, have had a devastating effect on a retailer's ability to reorganize. Among his comments are the following:

BAPCPA has left retailers without adequate time and money to effectuate operational

initiatives and cost cutting measures needed to resuscitate their businesses. Retailers now enter the Chapter 11 arena with little choice but to narrowly tailor their strategy to ensure that their lenders are not deprived of the substantial benefits and protections conferred by section 363(b) of the Bankruptcy Code, which authorizes the use, sale or lease of estate property outside the ordinary course of business upon court approval. Section 363(b) offers the unique ability to cleanse the assets of a distressed company by permitting debtors to convey assets "free and clear," thereby maximizing value by removing the uncertainty of such stigmas as successor liability, fraudulent transfer claims and lien issues that often accompany asset purchases. Prepetition lenders, cognizant of this powerful liquidating tool and mindful of the numerous liquidity hurdles that the debtor must clear as a result of BAPCPA, have little

continued on page 8

absolute PRIORITY

Editor in ChiefAdam C. Rogoff
 Managing Editor.....Jeffrey L. Cohen
 Contributing Authors.....Seth Van Aalten
 Richelle Kalnit
 Michael Klein
 Brian Byun

Stay informed. To sign up for future issues of **Absolute Priority**, Cooley's quarterly newsletter on bankruptcy issues and developments, visit www.cooley.com/alert.

To keep informed on regular updates in the bankruptcy sector, you can check **In The (Red): The Business Bankruptcy Blog**, authored by Cooley Godward Kronish partner Robert Eisenbach. To read In The Red, visit: bankruptcy.cooley.com.

key attorney contacts

Lawrence C. Gottlieb.....212/479-6140
 lgottlieb@cooley.com
 James A. Beldner 212/479-6086
 jbeldner@cooley.com
 Robert Eisenbach 415/693-2094
 reisenbach@cooley.com
 Cathy Hershcopf.....212/479-6138
 chershcopf@cooley.com
 Jay R. Indyke 212/479-6080
 jindyke@cooley.com
 Richard S. Kanowitz212/479-6167
 rkanowitz@cooley.com
 J. Michael Kelly.....415/693-2076
 kellyjm@cooley.com
 Adam C. Rogoff212/479-6420
 aroff@cooley.com
 Ronald R. Sussman..... 212/479-6063
 rsussman@cooley.com

Chapter 15 Recognition Not So Easy, Even When Unopposed

In September of last year, Judge Burton R. Lifland of the United States Bankruptcy Court for the Southern District of New York issued a decision denying the petitions for recognition (*i.e.*, access to the U.S. Bankruptcy Courts) of winding-up proceedings pending in the Cayman Islands (the “Foreign Proceedings”) of two failed Bear Stearns Cos. hedge funds (the “Funds”). The joint official liquidators and duly authorized foreign representatives (the “Foreign Representatives”) appealed from the Bankruptcy Court’s decision. Although no party opposed the appeal, various *amici curiae* filed briefs in support of the Bankruptcy Court’s decision.

In a “must read” decision for any entity that seeks to have its foreign bankruptcy proceeding recognized by U.S. Bankruptcy Courts, Judge Robert W. Sweet of the United States District Court for the Southern District of New York affirmed the Bankruptcy Court’s decision and held that chapter 15 of the Bankruptcy Code is not available to the Funds. Noting the need for predictability and reliability, the District Court stated that a foreign proceeding should not be entitled to the benefits of the Bankruptcy Code unless the debtor has either its center of main interests (“COMI”) or an establishment in the country of the foreign proceeding, and the Funds did not meet either test.

After the sub-prime mortgage crisis resulted in margin calls the Funds were unable to meet, the Funds filed winding-up petitions in the Cayman Islands. The Foreign Representatives filed petitions in the Bankruptcy Court seeking recognition of the Foreign Proceedings as “foreign main proceedings” or, alternatively, as “foreign nonmain proceedings” under chapter 15. Chapter 15, added to the Bankruptcy Code as part of the 2005 amendments, entitles a company or court-appointed administrator to seek recognition of a foreign bankruptcy case as a foreign main proceeding (a pro-

ceeding pending in a country where the debtor’s COMI is located) or a foreign nonmain proceeding (a proceeding pending in a country where the debtor has an establishment, but not its COMI). A recognition determination is crucial because it affords the debtor various privileges under the Bankruptcy Code, arguably most importantly, the automatic stay.

In the decision below, the Bankruptcy Court denied recognition of the Foreign Proceedings. First, Judge Lifland found that the Foreign Proceedings are not “foreign main proceedings” because each of the Funds’ COMI was the United States, not the Cayman Islands. Second, Judge Lifland found that the Foreign Proceedings are not “foreign nonmain proceedings” because the Funds do not have an “establishment” (*i.e.*, “any place of operations where the debtor carries out a nontransitory economic activity”) in the Cayman Islands.

The District Court’s decision is a resounding affirmation of the decision below. With regard to whether the Foreign Proceedings are “foreign main proceedings,” the District Court found that, although there is a presumption that the COMI is the place of the Funds’ registered office (the Cayman Islands), such presumption was rebutted by other facts. Such facts include: the Funds had no employees or managers in the Cayman Islands, the investment manager for the Funds and the administrator that runs the Funds’ back office operations are located in the United States, the Funds’ books and records are located in the United States, and, prior to the commencement of the Foreign Proceedings, all of the Funds’ liquid assets were located in the United States. The District Court rejected the Foreign Representatives’ arguments that the Funds had “substantial connections” to the

continued on page 11

FROM THE EDITOR continued

evaluate fully the pros and cons of what prudent course to navigate.

This latest issue of Absolute Priority highlights some recent developments in bankruptcy law of interest to all parties in a case, whether borrower, lender or asset purchaser. Recent cases discuss the impact on asset sales, including the Supreme Court’s death knell for the exemption of pre-chapter 11 plan transfer taxes and the 9th Circuit BAP’s decision on the scope of sales “free and clear” of liens; cases impacting the rights of secured lenders, including cases on collateral surcharge and on equitable subordination; and cases affecting borrowers/debtors, including cases discussing WARN exposure, bars on post-confirmation litigation, and revived lease rejection claims. In short, the focus of this issue is varied because the issues affecting you are broad in scope.

Whatever new issues, opportunities or pitfalls that confront you in the coming months, Cooley’s nationally-renowned restructuring professionals stand ready to assist you, as we bring to your aid our knowledge of the issues—both legal and business—affecting borrowers, lenders, unsecured creditors, equity owners, and asset purchasers. •

In the News

Current Cooley Representations

***In re Hancock Fabrics et al.*, Case No. 07-10353 (Bankr. D. Del. 2007).** In what is now known as the first retailer to emerge successfully from bankruptcy as a reorganized entity since the 2005 amendments to the Bankruptcy Code, Hancock Fabrics exited bankruptcy in August, 2008 operating a core group of 270 stores in 37 states. Cooley, as counsel to the official committee of unsecured claims, successfully secured a cash payout for unsecured creditors equal to 104.93% of their claims pursuant to the Plan of Reorganization which had the support of both the creditors and equity committees.

***In re Goody's Family Clothing, Inc.*, Case No. 08-11133 (Bankr. D. Del. 2008).** As of May 31, 2008, Goody's, a retailer of moderately priced family apparel, operated 355 stores in 20 states primarily in the Southeastern United States. On October 6, 2008, less than 4 months after filing for chapter 11 protection, Goody's successfully confirmed its reorganization plan with more than 280 stores remaining in the retail chain. Cooley, as counsel for the official committee of unsecured creditors (and counsel to an ad hoc committee of trade vendors pre-bankruptcy filing), has been actively engaged in all aspects of this case including, primarily, negotiating the terms of the consensual plan of reorganization which enabled Goody's to become only the second major retailer to successfully reorganize since the 2005 amendments to the Bankruptcy Code.

***In re Steve & Barry's, Inc.*, Case No. 08-12579 (Bankr. S.D.N.Y. 2008).** Founded by Steven Shore and Barry Prevor at the University of Pennsylvania in 1985, Steve & Barry's became one of the

Application of the WARN Act's "Faltering Company" Exception Clarified in the Third Circuit

When a company liquidates or shuts down a meaningful portion of its operations, many issues arise, including claims of employees who do not get sufficient advance notice of a closing. Of course, often times, companies will not be able to provide advance notice. Nor may a company want to provide advance notice of a closing to employees and destabilize pre-closing business operations. A recent decision of the Court of Appeals for the Third Circuit clarified what must be demonstrated in order for a company to avail itself of the "faltering company" exception to the requirements of the federal Worker Adjustment and Retraining Notification Act (the "WARN Act")

In general, employers are covered by the WARN Act if they have 100 or more employees, not counting employees who have worked less than 6 months in the last 12 months and not counting employees who work an average of less than 20 hours a week. Private, for-profit employers and private, nonprofit employers are covered, as are public and quasi-public entities which operate in a commercial context and are separately organized from the regular government. Under the WARN Act, a covered employer must give notice if there is to be a mass layoff that results in an "employment loss" at the employment site during any 30-day period for 500 or more employees, or for 50-499 employees if they make up at least 33% of the employer's active workforce. The failure to comply with the WARN Act gives rise to potential civil actions by employees for damages in the form of back pay for each day of violation and benefits under any employee benefit plan which would have been covered under an employee benefit plan if the employment loss had not occurred.

The WARN Act provides an exception to the 60-day notice requirement when a "falter-

ing company" is confronted with a possible plant closing. This exception applies if the company can prove that (i) it is actively seeking capital at the time that the 60-day notice would have been required; (ii) it had a realistic opportunity to obtain the financing sought; (iii) the financing would have been sufficient, if obtained, to enable the employer to avoid or postpone the shutdown; and (iv) the employer reasonably and in good faith believed that sending the 60-day notice would have precluded it from obtaining the financing. In *In re APA Transport Corp. Consolidated Litigation*, (3d Cir., August 29, 2008) discussed several critical elements of the faltering company exception. First, the Third Circuit addressed whether the debtor and one of its non-debtor affiliates should be treated as a "single employer" for determining whether the debtor was faltering. The Court noted that the faltering company exception is not available if the debtor's related company had adequate capital to continue operations and the related companies were treated as a single employer.

The Court highlighted five factors to be considered in determining if related companies constitute a single employer under the WARN Act: (i) common ownership; (ii) common directors and/or officers; (iii) de facto exercise of control (i.e., one company was the decision maker for the employment practice that gave rise to the WARN Act litigation); (iv) unity of personnel policies emanating from a single source; and (v) dependency of operations, (i.e., interchangeability of employees or equipment or commingling of finances). The record before the court indicated that factors 1 and 2 supported a finding that the two entities were related companies, while factors 3, 4 and 5 militated against such a finding.

continued on page 12

Debtor's Ability to Pursue Claims Post-Confirmation Must Be Expressly Retained in Plan

The Fifth Circuit has recently confirmed the principle that “for a debtor to preserve a claim, the plan must expressly retain the right to pursue such actions” and such reservation must be “specific and unequivocal.” *In re United Operating, LLC*, 2008 WL 3306724, at * 2 (5th Cir. Aug. 12, 2008). This provides a burden on the estate to clearly preserve post-confirmation litigation claims—and an opportunity for defendants who should verify that such claims were properly preserved.

After Dynasty Oil and Gas (“Dynasty”) filed its chapter 11 petition, the court appointed Wildcat Energy, LLC (“Wildcat”) and its manager to operate Dynasty’s oil and gas wells. Wildcat was responsible for operations until confirmation of Dynasty’s chapter 11 plan (the “Plan”). The Plan authorized another creditor (the “Buyer”) to purchase all of Dynasty’s assets in exchange for a payment to Dynasty’s largest single creditor. The Fifth Circuit noted that “[t]hough Dynasty had been a debtor-in-possession, the Plan specified that Dynasty would not be revested with title to any estate assets at confirmation, because [Buyer] was purchasing substantially all of Dynasty’s assets.” *Id.* at * 1. Post-confirmation, Dynasty brought an action against Wildcat and others alleging common-law claims for, among other things, failing to complete necessary work on some wells and completing unnecessary work on other wells.

The Fifth Circuit stated that the case turned on “the [...] fundamental question of Dynasty’s standing” and held that Dynasty, as reorganized debtor, did not have standing to pursue claims based on pre-confirmation management of the estate’s assets. *Id.* at * 2. Specifically, the Court noted that “[a] debtor may preserve its standing to bring

[a post-confirmation action on a claim or interest belonging to the debtor or to the estate,] but only if the plan of reorganization expressly provides for the claim’s retention and enforcement by the debtor. After confirmation of a plan, the ability of the debtor to enforce a claim once held by the estate is limited to that which has been retained in the plan.” *Id.*

The Court found that neither the Plan’s blanket reservation of “any and all claims” arising under the Bankruptcy Code, nor its specific reservation of other types of claims, nor the bankruptcy court’s retention of jurisdiction over a given type of claim preserves a debtor’s standing to pursue the common-law claims brought by Dynasty. *See id.* at *3. The Fifth Circuit discussed the policy reason behind its decision—namely, that bankruptcy is “designed primarily to secure prompt, effective administration” of a debtor’s assets and liabilities, and that to do so, “a debtor must put its creditors on notice of any claim it wishes to pursue after confirmation.” *Id.* at * 2. Absent proper notice, creditors would be unable to determine how to vote on a plan.

This issue is not a new one and courts have varied on their views as to the degree of specificity required in a chapter 11 plan and/or accompanying disclosure statement to preserve post-confirmation litigation claims. Nonetheless, the case underscores that there is substantial risk associated with nonexistent or inadequate disclosure. Both debtors and creditors alike should be aware that unless a debtor makes an effective reservation of rights to pursue actions, a debtor has no standing post-confirmation to pursue claims owned by the estate pre-confirmation. •

IN THE NEWS *continued*

fastest-growing retailers in the U.S., opening hundreds of stores selling clothes under the names of Sarah Jessica Parker, Venus Williams and Stephon Marbury. As of July 9, 2008, Steve & Barry’s operated 276 stores in 39 states. Upon filing for bankruptcy in July of 2008, the company immediately put itself on the auction block. With the assistance of Cooley, acting as counsel for the official committee of unsecured creditors, the company was able to consummate a going concern sale of substantially all of its assets to BH S&B Holdings LLC, an affiliate of Bay Harbour Management, for a purchase price of \$163 million. As a result of the going concern sale, (i) the Debtors were provided with a greater return for their assets than liquidation value; (ii) landlords whose leases were assumed were provided with a tenant; (iii) the majority of employees remained employed; and (iv) the trade vendors were provided with a go-forward customer.

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. Despite its early attempts to reorganize the business or to alternatively sell the business as a going concern, Sharper Image, like most retailers in today’s current economic environment, was unable to achieve either initiative and liquidated its remaining assets, including its inventory and intellectual property, through an auction and sale that was

IN THE NEWS *continued*

approved by the Bankruptcy Court on May 30, 2008. Although Sharper Image will cease to exist as a retailer at the conclusion of its wind down process, the sale of its trade name and other intangible assets likely means that we will soon see Sharper Image branded products being sold through other retailers.

In re Mervyn's Holdings, LLC, et al., Case No. 05-11586 (Bankr. D. Del. 2008). Mervyn's, a chain of approximately 175 family friendly, promotional department stores predominantly located in the southwestern United States, filed for Chapter 11 protection on July 29, 2008. Although the company has implemented a number of strategic operational initiatives, including the immediate liquidation of 26 underperforming stores, and cost-cutting measures, the company continues to face a number of critical obstacles in its desired path towards reorganization. Cooley represents the official committee of unsecured creditors.

In re Boscov's, Inc. et al., Case No. 08-11637 (Bankr. D. Del. 2008). Boscov's Inc., through its operating subsidiary Boscov's Department Store, LLC and other debtor subsidiaries, owns and operates the nation's largest family-owned department store chain, with 39 locations across five states in the Mid Atlantic region generating approximately \$1 billion in sales on an annual basis as the date of its bankruptcy filing on August 12, 2008. Cooley, as counsel for the official committee of unsecured creditors, has been actively involved in all aspects of these cases, including investigating the series of prepetition events pursuant to which the debtors effectuated a leveraged recapitalization that enabled them to distribute \$185 million to its shareholders in the form of a repurchase

BAP Casts Shadow Over 363(f) "Free and Clear" Sale Orders—Especially For Lender's Credit Bid Under 363(k)

The primary objective of any buyer at a section 363 sale, whether one purchasing for cash or an existing secured creditor making a credit bid under section 363(k), is to obtain good title to the purchased assets free and clear of any liens, claims, or interests. However, a recent decision by the Bankruptcy Appellate Panel ("BAP") of the United States Court of Appeals for the Ninth Circuit is raising some doubt in this regard.

In *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 2008 Bankr. LEXIS 1934 (9th Cir. B.A.P. 2008), the BAP held that a senior secured creditor's credit bid, in an amount less than the aggregate value of all liens against the property in question, did not satisfy the requirements of section 363(f) and permit the sale to be "free and clear" of the existing junior liens on the property and reversed the bankruptcy court's order on appeal. The BAP held that the bankruptcy court erred in holding that the junior lienholder could be compelled to accept a money satisfaction of its interest, in less than the full amount, under section 363(f)(5) because the bankruptcy court failed to identify a "legal or equitable proceeding" wherein the junior lienholder could be compelled to take less than the full value of its secured claim. Had the bankruptcy court identified a "legal or equitable proceeding" which could compel the junior lienholder to take less than full value of its claim (i.e. state foreclosure proceeding), the Ninth Circuit might have affirmed the bankruptcy court ruling.

First, the BAP's decision that a sale will not be "free and clear" of junior liens is not that surprising, as it has generally been accepted that for a sale under section 363 in which the purchase price is less than the amount of liens against the property to be free and clear of liens, the secured

creditors must consent or one of the other exceptions under section 363(f) must be satisfied. Those other exceptions include a lien subject to "bona fide" dispute or a situation in which the lien holder can be forced to accept a cash payment in satisfaction of the lien. However, what is surprising about this decision is the holding that a credit bid by a senior secured creditor also cannot be made free and clear of junior liens, even though the senior secured creditor could have wiped out the junior liens through foreclosure under state law.

This ruling seems to leave secured creditors seeking to take title to their collateral with two main choices. First, the secured creditor may seek relief from the automatic stay to foreclose on its collateral, avoiding the section 363 sale and credit bid approach altogether. This may be the preferred path if (i) the debtor's assets cannot be sold for an amount greater than the senior secured creditor's claim, and (ii) a reorganization is not reasonably in prospect (the key factors in a bankruptcy court's decision whether to lift the stay). Second, the secured creditor may complete the credit bid through a chapter 11 plan of reorganization. However, some secured creditors may find the delay and expense involved in being a plan proponent problematic, as the secured creditor would take on the obligation to pay administrative expenses of the estate on the effective date of the reorganization plan, as well as satisfaction of all of the other requirements for confirming a plan. Of course, where the junior liens were consensual (i.e., not a statutory lien), the senior secured lender can alleviate the issues by a properly worded intercreditor agreement that precludes the junior creditor

continued on page 7

FREE AND CLEAR continued from page 6

from objecting to the senior lender's credit bid, even if the credit bid will wipe out the junior creditor's interest in the collateral.

Second, and perhaps more importantly, *the Clear Channel* decision exposes risks even for "good faith" purchasers in section 363 sales. Purchasers of assets under section 363 regularly seek a finding that they are a good faith purchaser because, pursuant to section 363(m), such a sale cannot be overturned on appeal. In *Clear Channel*, the BAP held that although the sale itself to the senior secured creditor could not be overturned on appeal, the protection of section 363(m) did not extend to the question of whether the sale was made "free and clear" of the junior liens. Rather, the BAP ruled that even in the absence of a stay pending appeal, the appellate court could reverse the "free and clear" determination because section 363(m) is expressly limited to sale orders under sections 363(b) and (c), which authorize the sale or lease of property, and does not extend to "free and clear" orders under Section 363(f). Accordingly, even though no stay pending appeal was obtained, the BAP concluded that relief could still be granted on the "free and clear" question by ordering that the junior lien remained attached to the property even after its sale.

These rulings raise issues about when a buyer of assets under section 363 should close on the sale. If a good faith purchaser for cash pays less than the "aggregate value of all liens" against the purchased assets, or if a question exists whether a lien or interest is really in "bona fide" dispute, then the "free and clear" aspect of the sale may be outside the protection of section 363(m) and an appeal by a secured creditor or other interest holder may not be moot. Buyers usually prefer to close a sale as soon as possible after entry of a bankruptcy court's order approving the sale, especially if the value of the assets are declining or the

debtor is running out of cash. However, a buyer that closes with an appeal threatened runs the risk of having the "free and clear" decision overturned months or even years later and the purchased assets suddenly subject to the debtor's liens.

While every sale objection or appeal will not raise these issues, if a serious objection to the "free and clear" aspect of the bankruptcy court's sale order has been made, and the objector is likely to appeal, the buyer should consider whether to wait until the later of (a) the passage of the 10-day appeal period, or (b) a final appellate decision affirming the bankruptcy court's denial of the objection, before agreeing to close the sale. Buyers may want to consider including provisions in the asset purchase agreement to permit this type of flexibility on when to close or to terminate the agreement if the closing is substantially delayed.

It is worth noting that, unlike a U.S. Court of Appeals, a BAP is made up of bankruptcy judges, not federal circuit judges. Accordingly, its decisions are not given the same precedential weight as other appellate court decisions. Moreover, BAP decisions generally are not binding on bankruptcy courts outside the Ninth Circuit. That said, some bankruptcy judges make a practice of following BAP decisions and the BAP's reasoning may influence other judges. Nonetheless, the *Clear Channel* decision has important implications for section 363 asset sales, as secured creditors intent on making a credit bid may now rethink that approach when junior liens are present. In addition, cash buyers may be more cautious on when to close a sale if disputes exist over whether the sale should be "free and clear" of existing liens and interests. It will be interesting to see how other courts, in the Ninth Circuit and beyond, react to the decision. •

IN THE NEWS continued

of a substantial majority of its outstanding stock from, as well as the debtors' efforts to sell substantially all of their assets as a going concern in the bankruptcy case.

In re Bayonne Medical Center, Case No. 07-15195 (Bankr. D. N.J. 2007).

Recently, Cooley professionals, working with the unsecured creditors' committee, obtained approval of a settlement with the primary secured creditors in the chapter 11 case of this important New Jersey hospital. The settlement resolved what could have been months, if not years, of extensive litigation over issues relating to collateral values and adequate protection. More importantly, the settlement sets the foundation for a chapter 11 plan for the debtor which would allow for a distribution to unsecured creditors—a rare result in hospital chapter 11 cases. Cooley has represented Bayonne Medical Center as chapter 11 debtor.

In re Bombay Company et al., Case No., 07-44084 (Bankr. N.D. Tex 2007).

Having represented the official committee of unsecured creditors during the pendency of these bankruptcy proceedings, Cooley now represents the Bombay Liquidation Trust, the successor entity of the Bombay Company which was created on the effective date of the confirmed Joint Plan of Liquidation (September 12, 2008). The Liquidation Trust holds approximately \$21 million in cash, a 25% interest in Bombay Brands (the entity that owns all of the intellectual property of Bombay) as well as certain avoidance actions that the Liquidation Trust intends to bring within the next 6-12 months. The Liquidation Trust projects distributions to unsecured creditors between 16-28%, with an initial distribution to all creditors this fall.

IN THE NEWS *continued*

In re Shoe Pavilion, Inc., Case No. 08-14939 (Bankr. C.D. Cal. 2008). Shoe Pavilion, Inc. and its wholly-owned affiliate, jointly operate as off-price footwear retailers with locations in the Western and Southwestern United States. Since the filing of these cases on July 14, 2008, Cooley has played an active role as counsel to the official committee of unsecured creditors, most recently in persuading the debtors to reach out to professional liquidators to conduct an orderly sale of their assets at 91 of their store locations. ■

COOLEY CHAIR TESTIFIES

continued from page 2

to gain by risking their collateral in pursuit of a reorganization process now widely perceived as hopeless.

Indeed, the constricted time frames and liquidity problems created and imposed by BAPCPA have effectively eliminated the need for existing lenders to provide any more financing than necessary to position the debtor to liquidate its assets in the first few months of the case. Today, the debtor is no longer “in possession” of its assets or its future upon the commencement of its Chapter 11 case. BAPCPA’s constrictive liquidity provisions and the enormous leverage handed to secured lenders as a result thereof have eliminated the ability of retailers to control the Chapter 11 process as a “debtor-in-possession.” Rather, the process is now controlled almost exclusively by prepetition lenders, who have essentially assumed the role of “creditor-in-possession.”

His testimony underscores how BAPCPA’s key changes have transformed Chapter 11 bankruptcy from a process by which retailers could reorganize into one where almost all face an early liquidation. ●

Sharper Image Judge Approves “SPM” Trust for General Unsecured Creditors

In an important decision issued on August 18, 2008, the United States Bankruptcy Court for the District of Delaware presiding over Sharper Image’s chapter 11 case approved a settlement between the Committee, represented by Cooley, and a joint venture (the “JV”) tabbed as the successful auction bidder for the sale of Sharper Image’s assets. The settlement memorialized the Committee’s agreement to withdraw its objection to the sale transaction in exchange for the JV’s agreement to create and fund a trust account, the proceeds of which would inure to the exclusive benefit of general unsecured creditors.

In April 2008, Sharper Image received authority from the Bankruptcy Court to auction its inventory and intellectual property and enter into a stalking horse agreement with the JV. On the eve of the auction, a dispute arose between Sharper Image and the JV concerning certain intellectual property rights that culminated in the JV’s decision to revoke its stalking horse bid. Sharper Image subsequently entered into a revised stalking horse agreement with the JV that contemplated a substantially lower purchase price. During the negotiation of the revised stalking horse agreement and following its execution, the Committee advised both Sharper Image and the JV that it was prepared to file an objection to the revised bid on the ground that the lower purchase price would yield no benefit to the estate insofar as it would substantially reduce, or quite possibly altogether eliminate, any distribution to general unsecured creditors.

At the conclusion of the auction, the revised stalking horse bid was deemed the highest and best offer for the assets and the Committee began its own negotiations with the JV to resolve its objection. The compromise ultimately reached between the Committee and the JV—which provided for a payment from the JV to a trust account established solely for the benefit of general

unsecured creditors—was memorialized in an agreement that was subsequently brought before the Bankruptcy Court for approval. The Office of the United States Trustee for the District of Delaware (the “UST”) filed an objection to the settlement motion, arguing that the settlement was improper, unfairly favored general unsecured creditors at the expense of other creditors, and violated the “absolute priority” rule. The Bankruptcy Court addressed and rejected each of the UST’s arguments in its memorandum decision.

The Bankruptcy Court began its analysis with the UST’s contention that the settlement violates the “absolute priority” rule of section 1129(b)(2)(B) of the Bankruptcy Code, which provides that “the holder of any claim or interest that is junior to the claims of [an impaired dissenting] class [of creditors under a plan] will not receive or retain under the plan on account of such junior claim or interest any property.” In other words, section 1129(b)(2)(B) prohibits confirmation of any plan that proposes to pay general unsecured creditors unless and until all senior creditors are paid in full. The UST argued that the Committee’s settlement violates this section of the Bankruptcy Code because the settlement proceeds would be paid only to general unsecured creditors, irrespective of whether administrative and unsecured priority creditors would ultimately be paid in full under a plan.

The Bankruptcy Court drew favorably upon a line of analogous case law cited by the Committee in support of the settlement. Beginning with the First Circuit’s seminal decision in the *In re SPM Manufacturing Corp.* case, bankruptcy courts have frequently been asked to address the propriety of collateral carve-outs (or “SPM carve-outs” as they have come to be known) to be provided by lenders to unsecured creditors

continued on page 9

Bankruptcy Court Finds Section 502(d) Cannot Be Used to Disallow Section 503(b)(9) Administrative Expenses

In a decision that may be the first reported decision, but certainly will not be the last on the issue, a bankruptcy court recently held that section 502(d) of the Bankruptcy Code may not be used to disallow an administrative expense under section 503(b)(9). In their bankruptcy cases in the Bankruptcy Court for the Eastern District of Michigan, Plastech Engineered Products, Inc. and its affiliated debtors (collectively, the “Debtors”) objected to motions of various entities asserting administrative expenses under section 503(b)(9) of the Bankruptcy Code based on the application of section 502(d). The parties to the dispute requested that the Court resolve the

“threshold legal issue of whether section 502(d) even applies to section 503(b)(9)”.

The following analysis leads to the issue. Section 503(b)(9) grants administrative expense priority for the value of goods received by a debtor within 20 days before the commencement of the case where such goods have been sold to the debtor in the ordinary course of its business. Sections 501 and 502 of the Bankruptcy Code address filing of proofs of claim or interests and allowing claims or interests, respectively. Section 502(d) requires that a court disallow claims under certain circumstances, including when a creditor has not repaid an avoidable transfer or turned over property of the estate. The issue arose because

the Debtors argued that the disallowance provision of section 502(d) is not limited to *claims* filed and otherwise allowed under section 502; rather, the Debtors argued that section 502(d) also applied to *administrative expenses* allowable under section 503, specifically, section 503(b)(9). As the Court stated, the Debtors argued that “it is one thing for Congress to expressly take certain prepetition claims and elevate their status [...] to administrative expenses, [...] [b]ut it does not follow that by doing so, Congress also intended to *sub silentio* take those same prepetition claims and insulate them from the requirement of section 502(d) that the claimant must first pay back any preferential transfers” before getting paid on its prepetition claims.

“SPM” TRUST continued from page 8

in exchange for creditors’ committee support on critical case issues such as financing and plan negotiation. Nearly every court to have considered the issue has concluded that *SPM* carve-outs do not violate the Bankruptcy Code because the funds to be provided by lenders to general unsecured creditors do not constitute property of the estate, but rather property of the lenders that would not otherwise be made available to any creditors. Relying upon the guidance of the *SPM* decision and its progeny, the Bankruptcy Court reasoned that while the funds to be set aside for Sharper Image’s general unsecured creditors would originate from the pockets of an asset purchaser, as opposed to the proceeds of a lender’s collateral in the traditional context, both scenarios contemplate a bargained-for exchange of non-estate property that does not violate the absolute priority rule.

The Bankruptcy Court next turned to the “fairness” of the settlement, including the UST’s assertion that the Committee had

breached its fiduciary obligations by negotiating a settlement designed to exclusively benefit general unsecured creditors. The Bankruptcy Court dismissed the UST’s argument concerning the scope of the Committee’s obligations, reasoning that the Committee is a fiduciary only for general unsecured creditors and not the debtor or the estate generally. Moreover, the Bankruptcy Court concluded that the settlement was fair, reasonable and in the best interests of estate for a variety of reasons, chief among them being Sharper Image’s critical financial need to consummate the sale transaction in a manner void of any delay.

The Bankruptcy Court’s approval of the Committee’s settlement is a critical victory for unsecured creditors, particularly in a chapter 11 environment where retailers have consistently struggled to maintain administrative solvency. Importantly, the UST has appealed the Bankruptcy Court’s decision and the parties will soon begin briefing the issue for the Delaware District Court. We will be sure to keep you posted on the status of this important issue in future editions. •

The Court began its analysis by discussing the consequences that flow from Congress’s decision, in adopting section 503(b)(9), of “depart[ing] significantly from pre-BAPCPA law by greatly expanding the expenses of administration of a bankruptcy estate.” These consequences include that a debtor who seeks to confirm a chapter 11 reorganization plan now has greater cash needs because of the requirement in section 1129(a)(9)(A) of the Bankruptcy Code that all administrative expenses be paid in full on the effective date of a plan. The Court also stated that section 503(b)(9) results in “significant differences in the treatment of prepetition debts of creditors who appear to be similarly situated”, noting that services provided in the 20 days prior to the petition date are not given different treatment, nor are goods provided outside of the ordinary course.

The Court continued by reviewing various decisions involving issues pertinent to section 503(b)(9) administrative expenses, but tangential to the issue faced by the Court. Noting that the precise issue in the case has not yet been addressed in any reported

continued on page 11

PICADILLY continued from page 1

ing environment, where reorganizations have been all but replaced by section 363 asset sales that effectively moot the plan process. Indeed, the facts at issue in the *Piccadilly* case closely resemble those found in nearly all recent pre-packaged chapter 11 filings. In that case, Piccadilly reached an agreement with a stalking-horse bidder for the sale of substantially all of its assets for \$54 million and, on the following day, filed a chapter 11 petition along with a motion seeking authority to effectuate a sale process pursuant to section 363 of the Bankruptcy Code. After a due diligence period and a public auction, the United States Bankruptcy Court for the Southern District of Florida approved a sale of Piccadilly's assets to the winning auction bidder for \$80 million. The order approving the sale provided that the transaction was exempt from the assessment of stamp taxes pursuant to section 1146(a) of the Bankruptcy Code. The sale closed shortly thereafter and Piccadilly filed a chapter 11 plan.

Piccadilly's plan was confirmed by the Bankruptcy Court for the Southern District of Florida over the Florida Department of Revenue's objection that the section 1146(a) exemption was improper because the sale was consummated prior to the confirmation of a chapter 11 plan. On appeal, both the District Court for the Southern District of Florida and the Eleventh Circuit affirmed the bankruptcy court's decision and held that the section 1146(a) exemption was proper because (i) the transfer was necessary to consummate the plan (because the proceeds of the sale were needed to fund the plan); (ii) the sale of substantially all of Piccadilly's assets contemplated the plan; and (iii) the sale and plan were so interwoven that one could not proceed without the other. In so holding, the Eleventh Circuit reasoned that to limit section 1146(a) to post-confirmation transfers would ignore the practical realities of the current chapter 11 landscape.

In a 7-2 decision, the Supreme Court reversed the Eleventh Circuit's decision and held that section 1146(a)'s exemption only applies to transfers "made pursuant to a Chapter 11 plan that has been confirmed." In reaching its decision, the Supreme Court rejected Piccadilly's argument that the language "under a plan confirmed" should be interpreted to mean "in accordance with a plan confirmed." Justice Thomas, writing for the majority, cautioned that federal courts "should proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed" and therefore concluded that the Supreme Court was obligated to construe section 1146(a) narrowly.

In a dissenting opinion joined by Justice Stevens, Justice Breyer endorsed a more liberal interpretation of section 1146(a) that would extend the exemption to transfers under a plan that "either already has been or subsequently is" confirmed. Justice Breyer criticized the majority view's inter-

pretation of section 1146(a) as imposing an unintended temporal limit on the exemption's availability and argued that it should "make[] no difference whether a transfer takes place before or after the plan is confirmed. In both instances the exemption puts in the hands of the creditors the estate money that would otherwise go to the State in the form of a stamp tax."

The *Piccadilly* decision, binding on all bankruptcy courts regardless of jurisdiction, is sure to resonate with potential sellers and purchasers of distressed assets in chapter 11 proceedings. The Supreme Court has made clear that, regardless of whether a plan has been formulated or even proposed, the section 1146(a) exemption will not apply unless the sale closes after a plan is confirmed. The consequences of this decision will have a direct impact upon net sale proceeds. Section 363 sales have been an important tool in selling some

continued on page 12

Retail Bankruptcy Round-Up

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

Case Name	Petition Date	Case Number	Bankruptcy Court
Bag 'n Baggage	May 4, 2008	08-32096	N.D. Tex. (Dallas)
Goody's Family Clothing	June 9, 2008	08-11133	D. Del. (Wilmington)
Whitehall Jewelers	June 23, 2008	08-11261	D. Del. (Wilmington)
Steve and Barry's	July 9, 2008	08-12579	S.D.N.Y. (Manhattan)
Shoe Pavilion	July 14, 2008	08-14939	C.D. Cal. (Los Angeles)
Mervyn's	July 29, 2008	08-11586	D. Del. (Wilmington)
Boscov's, Inc.	August 4, 2008	08-11637	D. Del. (Wilmington)
Marty's Shoes	September 12, 2008	08-12129	D. Del. (Wilmington)
BC Sports Collectibles	September 21, 2008	08-12170	D. Del. (Wilmington)

EQUITABLE SUBORDINATION

continued from page 1

creditors committee filed a complaint challenging the right of the insiders to be treated as secured creditors.

The bankruptcy court invoked equitable subordination, and effectively converted the insiders' secured claims to unsecured claims for the purpose of any distribution from the estate, finding that the insiders engaged in inequitable conduct and that their conduct conferred an unfair advantage on them. Specifically, the court found that the insiders' insistence on securing their contingent liabilities with the debtor's revenue stream as a condition of advancing funds to the company constituted inequitable conduct. The district court affirmed.

In reversing the lower court rulings, the Fifth Circuit set out the widely quoted three-prong test for equitable subordination set forth in *In re Mobile Steel Corp.*, 563 F.2d 692 (5th Cir. 1997): (i) the claimant must have engaged in inequitable conduct; (ii) the misconduct must have resulted in injury

to the creditors of the debtor or conferred an unfair advantage on the claimant; and (iii) equitable subordination must not be inconsistent with the Bankruptcy Code. The court also noted that the *Mobile Steel* decision added an additional requirement—a claim can be subordinated only to the extent necessary to offset the harm that the debtor or its creditors suffered as a result of the inequitable conduct. The lower courts made no findings in this regard, however, and the record did not support a finding that either the debtor or its creditors were harmed by the insider loan transactions. Accordingly, the Fifth Circuit reversed the subordination of the insiders' claims.

The *Wooley* decision underscores the high standard of proof required to successfully equitably subordinate secured claims under section 510 of the Bankruptcy Code, as a plaintiff must (i) satisfy the three-pronged test set forth in *Mobile Steel* and (ii) demonstrate that the debtor or its creditors were harmed as a result of the claimant's inequitable conduct. These factors remain highly fact-sensitive. •

502(d) AND 503(b)(9) continued from page 9

decision, the Court then examined various decisions which have examined the issue of whether section 502(d) generally applies to section 503(b) administrative claims, and found that cases have gone both ways on the issue.

Ultimately, the Court reached its decision that section 502(d) does not apply to section 503(b) generally, nor does it apply to section 503(b)(9), and relied on six grounds. First, the Court stated that it agreed with cases holding that the allowance of claims under section 502 is "entirely separate" from the allowance of administrative expenses under section 503. In so doing, the Court stated that section 502(d) applies to prepetition claims and only those postpetition claims that are covered by sections 501 and 502 of the Bankruptcy Code, and does not apply to administrative expenses under section 503. Second, the Court stated that when section 502(d) is examined within the larger framework of the Bankruptcy Code, "the better interpretation supports the argument" that section 502(d) does not apply to section 503(b)(9) expenses. Third, the Court stated that its interpretation permits the mandatory provisions of sections 502(d) and 503(b) to co-exist. Fourth, the Court stated that the "mere fact" that section 503(b)(9) expenses arise pre-petition "does not change the analysis." Fifth, the Court rejected the Debtors' attempt to treat section 503(b)(9) as a "special class" of prepetition claims, noting that the statute does not make such a distinction. Finally, the Court noted that Congress knew how to draft the statute differently, but chose not to do so.

This decision clearly represents a victory for creditors. However, it remains to be seen whether or not it will stand on appeal and how other bankruptcy courts will rule on the issue. •

CHAPTER 15 continued from page 3

Cayman Islands. The District Court also noted the fact that the recognition petition and the appeal were unopposed by any party (other than, in the case of the appeal, by the amici) was unavailing. The District Court also refused to consider the Funds' motivations for commencing the Foreign Proceedings, noting that "[w]hatever the motivation, the recognition result remains a factual issue appropriately determined by the [Bankruptcy Court]."

With regard to whether the Foreign Proceedings are "foreign nonmain proceedings," the District Court found that the Foreign Representatives did not meet their burden of showing the Funds' "establishment" in the Cayman Islands. The District Court noted that auditing activities and preparation of incorporation papers are not

"operations" or "economic activity," nor is review of insider transactions an "economic activity." The Court added that even if non-main recognition were available, it is limited to assets located in the nonmain jurisdiction, and the Funds had no assets in the Cayman Islands at the time of the filing.

Indeed, Judge Sweet underscored the importance of the issues before him, and his decision, by noting that "[t]he process by which the financial problems of insolvent hedge funds are resolved appears to be of transcendent importance to the investment community and perhaps even to the society at large." His decision should be carefully considered when hedge funds registered overseas (and with substantial overseas connections) seek to have foreign proceedings recognized by U.S. Bankruptcy Courts, as chapter 15 is not simply a "rubber stamp." •

WARN ACT continued from page 4

The court concluded that these facts could not support a finding that the two entities were a single employer. In so ruling, the Third Circuit clarified that a finding that two companies shared common ownership and common directors was not, in and of itself, to find that the companies constituted a single employer.

Next, the Court clarified what must be demonstrated to prove that a company was seeking additional financing. According to the court, the actions of the company occurring during the 60-day period must demonstrate *active* pursuit of financing. The court rejected the company's argument that a company may qualify for the faltering company defense irrespective of whether it was actively seeking capital at the time the notice was required, so long as it did not foresee the shutdown that occurred sixty days later. The court ruled that employers must demonstrate the timing and steps it took to secure financing.

The court's view of the exception places a degree of omniscience on employers to predict exactly when the company will shut down, and establishes that a company must take affirmative steps to seek additional financing in order to avail itself of the faltering company exception.

The decision is important since Delaware is within the Third Circuit. Given the large number of business bankruptcy cases commenced in Delaware and the fact that liquidation may be an inevitable consequence in these cases, it is important for the estate to carefully consider WARN liability in any closing scenario.

Late Breaking News: Delaware Bankruptcy Court Finds WARN Act Claim for Pre-Petition Termination to Constitute Unsecured Claim

On October 10, 2008, in *In re Powermate Holding*, Case No. 08-50559 (Bankr. D. Del. 2008) Judge Gross re-affirmed the

long-standing principle that claims arising from pre-petition employee terminations give rise to general unsecured claims, not administrative claims, notwithstanding the 2005 amendments to the Bankruptcy Code which created a possible administrative priority for backpay awarded by a judicial proceeding attributable to any period of time post-bankruptcy filing. In *Powermate*, the debtor discharged 260 employees just hours before the bankruptcy filing and Judge Gross found that damages awarded for WARN Act violations in connection with prepetition terminations constitute general unsecured claims. This decision underscores the importance of bankruptcy pre-planning for distressed companies.

States Have Recently Enacted Their Own Version of the WARN Act—New York State WARN Act to Go Into Effect on February 1, 2009

On August 5, 2008, New York Governor Paterson signed into law the New York State Worker Adjustment and Retraining Notification Act. Although the New York law is similar to the existing federal WARN Act, the state law is far more stringent in several critical respects:

- (i) The state law applies to employers with at least 50 full-time employees, whereas WARN applies to employers with at least 100 full-time employees.
- (ii) The state law requires at least 90 days advance notice of a covered mass layoff, relocation, or plant closing, whereas the WARN Act requires only 60 days advance written notice of a covered plant closing or mass layoff.
- (iii) The notice triggering job loss thresholds are lower under the state law. Notice is required under the state law when at least 25 full-time employees who represent at least 33% of the workforce (or 250 employees, regardless of workforce percentage) will suffer job loss due to a mass layoff, a plant closing, or a relocation (defined as the removal of all or substantially all of the commercial

or industrial operations of an employer to a location 50 miles or more away).

The WARN Act, on the other hand, does not contain provisions regarding relocations, and requires double the number of affected employees—50 full-time employees who represent at least 33% of the workforce (or 500 employees, regardless of workforce percentage) for a mass layoff, and 50 full-time employees for a plant closing—before the notice provisions are triggered.

(iv) Under the state law, notice must be provided to employees, any representative of the employees, the New York State Department of Labor, and the local workforce investment boards for the locality in which the mass layoff, reduction, or plant closing will occur. The WARN Act only requires notice to the employees or representative of employees and to the State or the entity designated by that State to respond. •

PICADILLY continued from page 10

or all of a debtor's assets in an efficient manner. Often times, the speed with which a debtor can proceed to consummate the sale directly enhances the purchase price received. As such, buyers may not be in a position to wait the extra 30-60 days, let alone subject themselves to confirmation risks extraneous to the sale, otherwise attendant to inclusion of the sale as part of a chapter 11 plan. It is possible that, if the transfer or similar taxes that were previously exempt are high enough, economics may warrant the parties seeking to include the sale in a plan, especially if the sale is of substantially all assets and there is no risk of deteriorating asset values. More likely, section 363 sales will continue as they have, outside of a plan, and either the buyer will pay the transfer tax or the estate will as an administrative claim. Since dollars are fungible, whether the buyer pays the tax (and lowers the purchase price) or the estate writes the check, it is logical to expect that the recovery to creditors will be the same—less. •

Ninth Circuit Reinforces the Enforceability of Collateral Surcharge Waiver—The Buck Stops with the Lender

Generally speaking, expenses incurred by a debtor in connection with the administration of a bankruptcy case are not chargeable to a secured creditor's collateral or claim and must be paid out of the estate's unencumbered assets, absent an express agreement to the contrary. Section 506(c) of the Bankruptcy Code codifies an exception to this general rule, recognizing that in certain instances a bankruptcy estate may be called upon to bear significant expense to dispose of its assets in a liquidation that primarily benefits the secured creditor. Under these facts, the secured creditor would receive a windfall under the general rule, as the estate would bear the expenses of disposing of its collateral which would have otherwise been incurred by the creditor had it foreclosed on the collateral.

Accordingly, section 506(c) enables a debtor to charge against a secured creditor's collateral the reasonable and necessary expenses of preserving and disposing of the creditor's property. Such costs and expenses must also directly benefit the secured creditor by preserving or increasing the value of the creditor's collateral. If an expense meets the requirements of section 506(c), the proceeds generated by the disposition of the collateral must be used first to pay the expense, and the remainder of the proceeds may be utilized to satisfy the claim of the secured creditor. In chapter 11 cases, debtors often waive their rights under section 506(c) in connection with the negotiation of a financing order early in a bankruptcy case in exchange for a secured creditor's agreement to pay certain "carve out" costs of administering a bankruptcy estate, such as professional fees incurred by a trustee, creditors committee or debtor in possession.

Because the cost of administering chapter 11 cases is difficult to predict at the outset of a case, the amount of the "carve out" must

be carefully negotiated by estate professionals in connection with a section 506(c) waiver to ensure that a debtor's estate will possess sufficient funds to avoid administrative insolvency. The consequences of what can happen when the debtor negotiates an inadequate carve out was recently illustrated by the ruling of the Ninth Circuit in *Weinstein, Eisen & Weiss v. Gill (In re Cooper Commons LLC)*, 512 F.3d 533 (9th Cir. 2008), where the court held that professional fees and expenses incurred by a chapter 11 debtor-in-possession over and above the amount of the carve out could not be charged to a lender's collateral due to the presence of a section 506(c) waiver in the final financing order.

In that case, chapter 11 debtor's counsel negotiated a \$50,000 carve-out with the debtor's pre and postpetition lender that included counsel's professional fees. The bankruptcy court subsequently ordered the appointment of a chapter 11 trustee, who negotiated a new postpetition financing agreement with the lender that included a much larger carve-out of \$890,000 for the fees and costs of the trustee and his professionals, among other things. Debtor's counsel, after recognizing that (i) the initial carve-out was insufficient to satisfy the fees it incurred before the appointment of the trustee; and (ii) the estate was administratively insolvent and could not pay its fees, unsuccessfully appealed the new financing order.

Two years later, as the chapter 11 cases dragged on, the trustee's fees mounted, it became apparent that the carve out negotiated by the chapter 11 trustee was inadequate. Accordingly, the lender agreed to fund an additional \$250,000 carve-out from its collateral. Debtor's counsel objected to the trustee's motion seeking court approval of the increased carve-out, arguing that the increased payments to the

trustee and his counsel unfairly prejudiced other administrative claimants of the estate. The bankruptcy court and the district court overruled the objection.

Debtor's counsel asserted that the lower court's rulings should be reversed because court approval of the arrangements between the trustee and the lender would open the door to side deals in other cases that would allow secured lenders and trustees to rearrange the priority scheme contemplated by the Bankruptcy Code to the detriment of other parties in interest. In concluding that debtor's counsel had no claim against the lender's collateral over and above the carve-out, the Ninth Circuit reinforced the validity of the section 506(c) waiver, stating that because the debtor's cash was subject to the lender's lien, the lender was free to specify the particular expenses it was willing to carve out from its collateral.

This ruling demonstrates the extent to which courts strictly enforce a section 506(c) waiver agreement negotiated at arms length, even if the result is that administrative claims cannot be paid in full and the confirmation of a chapter 11 plan is made impossible. This, in turn, leaves leverage with the secured creditors regarding costs to be paid by the estate using their collateral proceeds. In addition, for the estate, the Ninth Circuit's decision underscores the importance of negotiating a carve-out sufficient to satisfy the costs of administrative costs of the estate before granting a section 506(c) waiver. •

The Sins Of The Father Shall Be Visited Upon The Son: Reorganized Parmalat Has Liability For Securities Fraud Class Action Lawsuit Against Predecessor

On July 22, 2008, the Second Circuit Court of Appeals affirmed the order of the District Court for the Southern District of New York denying the motion by a reorganized debtor in bankruptcy abroad to enjoin actions brought against its predecessor in the United States.

Parmalat Finanziaria, S.p.A. (“Old Parmalat”), once the largest Italian food company and fourth largest in the EU, filed for bankruptcy protection in Italy in December 2003 in the wake of a fraud so huge, the debacle has since been dubbed “Europe’s Enron.” Dr. Enrico Bondi was appointed to serve as Extraordinary Commissioner of Old Parmalat’s bankruptcy estate, a role analogous to a Chapter 11 Trustee.

Almost immediately after Old Parmalat filed for bankruptcy in Italy, purchasers of Old Parmalat’s debt and equity securities (the “Securities Fraud Plaintiffs”) filed class action lawsuits in the United States (the “Securities Fraud Litigation”). In June 2004, pursuant to then section 304 of the Bankruptcy Code, Dr. Bondi petitioned the U.S. Bankruptcy Court for the Southern District of New York to enjoin actions against the Old Parmalat estate with respect to any property involved in its Italian bankruptcy proceedings. The bankruptcy court entered a preliminary injunction (the “304 Injunction”) and soon thereafter, Dr. Bondi (on behalf of Old Parmalat) went on the offensive in the U.S. courts, suing, among others, Old Parmalat’s accountants for malpractice.

Meanwhile, back in Italy, the court approved a restructuring plan under which the assets of the entities that comprised Old Parmalat were transferred to a newly formed entity called Parmalat, S.p.A. (“New Parmalat”), of which Dr. Bondi was the CEO. In marked contrast to bankruptcy norms in the U.S.,

New Parmalat assumed all of the legal liabilities of its predecessor companies. Thereafter, the district court allowed the Securities Fraud Plaintiffs to amend their complaint to join New Parmalat as a defendant in their class action lawsuit “as the successor to Old Parmalat.” New Parmalat moved to expand the existing 304 Injunction to include New Parmalat and protect it from direct claims brought by the Securities Fraud Plaintiffs (the “Expansion Motion”).

The Narrowing of the 304 Injunction

While the Expansion Motion was pending, the district court granted another motion—this one brought by corporate defendants of actions brought by Dr. Bondi, as well as by the Securities Fraud Plaintiffs—to *narrow* the 304 Injunction to permit those defendants to file third party contribution claims against New Parmalat based on Old Parmalat’s securities fraud (the “Narrowing Order”). The twist to the Narrowing Order, however, was that although one could liquidate its claim in the U.S., enforcement of any judgments would only be allowed in Italy. New Parmalat appealed the decision, and the Second Circuit affirmed.

The Denial of the Expansion Motion

While the appeal from the Narrowing Order was pending before the Second Circuit, the district court denied New Parmalat’s Expansion Motion on the same five grounds it used to justify the Narrowing Order, namely:

1. The economical and expeditious administration of the Old Parmalat estate would best be served by liquidating liability in the United States, where relevant facts were already being litigated in the Securities Fraud Litigation;
2. Comity would be served because, while plaintiffs would be allowed to liquidate

their claims in the United States, they would be enforced only in Italy, if at all;

3. The Narrowing Order did not unfairly advantage those making contribution claims, because such claims would be made in some forum in any event—if not in the U.S., then in Italy;

4. Dr. Bondi’s equitable claim to section 304 protection was weakened by his affirmative actions against Old Parmalat’s auditors and banks in the American courts rather than in Italy; and

5. Settlement would be facilitated by having all potentially liable parties before the district court.

Examining the above factors, the Second Circuit concluded:

- ▶ Whether the economical and expeditious administration of the Old Parmalat estate would *actually* best be served by liquidating liability in the United States depends on several factors, including (a) the high cost of litigation in the U.S.; (b) whether the Securities Fraud Plaintiffs would take their suit to an Italian court in the event they are precluded from continuing their action in the U.S.; and (c) the high cost of litigating this particular suit in Italy (i.e. Italian court would confront foreign legal and regulatory scheme, large number of documents in English and likely conflicting expert affidavits regarding American securities law, etc.). Given all of the above contingencies and more, the district court did not abuse its discretion in denying the Expansion Motion;
- ▶ “[T]o leave the enforcement (or not) of any [American] judgment against [New Parmalat] to the Italian courts [is] a sufficient measure of deference and comity”;

continued on page 16

Debtor Still on Hook for Lease Damages When Mitigating Lessee Defaults

If a debtor rejects an equipment lease, and the lessor is entitled to liquidated future rent damages under the lease, does the debtor's estate continue to be liable to the lessor for such damages if the lessor mitigates these damages by re-leasing the equipment and the new lessee defaults? In a recent decision, the Court of Appeals for the Sixth Circuit ruled "Yes."

In *Giant Eagle, Inc. v. Phar Mor, Inc.*, 528 F.3d 455 (6th Cir. 2008), the debtor rejected an equipment lease with Giant Eagle, who subsequently sought to mitigate the damages caused by debtor's breach by re-leasing the equipment. When the new lessee filed for bankruptcy, Giant Eagle asserted a claim in the debtor's bankruptcy for liquidated future rent damages due under the original lease.

The debtor alleged that it was no longer liable for such damages as a result of Giant Eagle's entry into the new lease. The bankruptcy court agreed, noting that allowing the new lessee's breach of the mitigating lease to revive the debtor's obligations to pay damages would (i) create uncertainty by forcing breaching debtors to wait anxiously for the duration of their lease term, fearing the mitigating lease might fail; (ii) force lessors to sue the original breaching lessee, even after mitigating, to protect themselves against a failed mitigating lease and the expiration of the statute of limitations; (iii) cause debtors to effectively become guarantors of mitigating leases; and (iv) cause the debtors to be worse off than they had been under the original lease. The district court affirmed.

The Sixth Circuit disagreed with the lower courts, and ruled that Giant Eagle was entitled to an allowed claim for future rent damages for payments due under the lease term, less the amount mitigated via payments from the post-rejection lessee that had defaulted under the new lease. The court addressed the "parade of hor-

ribles" raised by the bankruptcy court, and concluded that the lower court's concerns were either irrelevant or incorrect. In so doing, the Sixth Circuit emphasized that (i) the debtor became liable to Giant Eagle when it breached the lease, and did not become any less liable as a result of Giant Eagle's failed attempt at mitigation; and (ii) upon such a breach a lessor is entitled to recover the amount of its damages, regardless of the number of parties its pursues, until the applicable statute of limitations

expires. The court also observed that many of the concerns raised by the bankruptcy court could be addressed by the state legislature shortening the applicable statute of limitations.

This case underscores the consequences of the estate failing to obtain a final order fixing or expunging the lessor's initial rejection claim and otherwise protect against the resurfacing of a claim—as well as the opportunity for creditors to pursue damages under the right facts. •



Fire Drill

USE IN CASE OF RESTRUCTURING

Metromedia Fiber Network
Cooley restructured \$3.5 billion in debt for MFN which, unlike many bankrupt telecom companies, was successfully reorganized under Chapter 11.

Pacific Gas and Electric Company (PG&E)
Cooley represented PG&E, the largest public utility in California, in what was one of the longest and most complex cases in the history of U.S. Bankruptcy Courts.

Federated Department Stores
Cooley represented the official creditors committee of Allied Stores Corporation, one of the major debtors in the related Federated Stores Corporation Chapter 11 proceedings.

Cooley Godward Kronish, a national law firm for the converging worlds of high technology, high finance and high-stakes litigation. For more information, visit us at www.cooley.com

PALO ALTO | NEW YORK | SAN DIEGO | SAN FRANCISCO | RESTON, VA | BROOMFIELD, CO
WASHINGTON, DC | BOSTON | SEATTLE

Cooley
GODWARD KRONISH LLP

Prior results do not guarantee future outcome. © 2008 Cooley Godward Kronish LLP, Five Palo Alto Square, 3000 El Camino Real, Palo Alto, CA 94306. 650-943-5000.

PARMALAT continued from page 14

- ▶ The district court did not abuse its discretion by considering the increased potential for settlement if all American securities claims are consolidated before a single court;
- ▶ “[I]t is incrementally harder for Dr. Bondi to contend that it is a hardship for him to be where he has chosen to come.”

This decision obviously opens New Parmalat up to hundreds of millions of dollars of liability it would not otherwise be held accountable for. However, even if a judgment in favor of the Securities Fraud Plaintiffs is granted, such a judgment must

still be enforced by an Italian court, then, pursuant to the Italian restructuring plan, those judgment creditors would receive their pro rata share of New Parmalat stock as satisfaction for their claim. This would no doubt dilute the value of each individual share, but, as the Second Circuit stated, “there is no cognizable injustice to one claimholder in the satisfaction of claims properly presented by another.”

From a broader perspective, this decision, which does not rely so heavily on the explicit “successor liability” language in the restructuring plan but rather on an analysis

of the section 304 factors, could provide a model for future U.S. bankruptcy courts involved in Chapter 15 cases in deciding whether to expand the injunction against U.S. actions from the pre-petition debtor to include the post-confirmation reorganized debtor as well. •

Bankruptcy & Restructuring Event Calendar
Fall 2008 Cooley Godward Kronish Speaking Appearances

Event	Date/Location	Cooley Godward Kronish Participant/Topic
NACM – Kansas City Annual Conference	September 17-18, 2008	Jay Indyke (Speaker: “The Roles of Creditors’ Committees in Bankruptcies and Out of Court Workouts”)
National Conference of Bankruptcy Judges	September 24-27, 2008	Richard Kanowitz (Speaker: “Restructuring Healthcare Facilities Despite Medical Malpractice Liabilities”)
Intellectual Property Owners Association Annual Meeting	September 23, 2008	Robert Eisenbach (Speaker: “Bankruptcy; Taking a Security Interest in IP; Collecting Judgment on IP”)
NACM – East Coast Executive Session	September 24, 2008	Jeffrey Cohen (Speaker: “Insider Fraudulent Transfers”)
Distressed Retail Summit	October 15-17, 2008	Cathy Herscopf (Moderator: “Creditors’ Perspectives on Distressed Retail”) / Adam Rogoff (Speaker: “Planning for the Auction and Sale of the Retail Debtor’s Assets”)
AIRA 7th Annual Advanced Restructuring & Plan of Reorganization Conference	October 21, 2008	Jay Indyke (Speaker: “The New Retail Bankruptcies”)
CRF October Forum	October 21, 2008	Larry Gottlieb (Speaker: “What is different with this economic downturn with insolvencies? Is it the bankruptcy code, capital structures of company, hedge or private equity funds, etc.?”)
American Bankruptcy Institute / Delaware Views from the Bench	November 3, 2008	Jay Indyke (Speaker: “Views on Retailer Bankruptcies”)
NACM Eastern Regional Credit Conference	November 6, 2008	Jay Indyke (Speaker: “The Reality of the New Bankruptcy Law”)
VCF / TPMA Annual Conference	November 9-12, 2008	Larry Gottlieb (Speaker: “Rule Changes That Mean Moving at the Speed of Business”)
CMA Business Credit Services & CIC with NACM Oregon (Webinar)	November 20, 2008	Jay Indyke (Speaker: “Critical Issues in Retail Bankruptcies”)
Turnaround Management Association / The Deal: Distressed Debt Conference	January 21-23, 2009	Ronald Sussman (Speaker: “TBD”)

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