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PRIORITY
Current Developments in Bankruptcies and Workouts
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Cooley LLP

BANKRUPTCY AND RESTRUCTURING GROUP

WaMu Court Rejects Bankruptcy Plan Due to Overly Broad Releases

The United States Bankruptcy Court for the District of Delaware recently denied confirmation of the chapter 11 plan proposed by Washington Mutual, Inc. and its affiliated debtor—even though it found that a global settlement among the major parties embodied by the plan was fair and reasonable—because the plan's releases of third parties were unacceptably broad and unfairly prejudiced the debtors' creditors. The Court's decision serves as a reminder to both debtors and creditors that the scope of plan releases will be closely scrutinized, and overreaching in this regard can spell doom for plan confirmation and send plan proponents back to the drawing board.

Washington Mutual Bank ("WMB"), one of the highest profile casualties of the recent financial crisis, was once one of the nation's largest savings and loan associations, with over 2,200 branches holding $188.3 billion in deposits. Beginning in 2007, revenues and earnings decreased, causing the asset portfolio of Washington Mutual, Inc. ("WMI"), WMB's parent holding company, to precipitously decline in value. By September 2008 ratings agencies had downgraded both WMB and WMI's credit ratings, sparking a stunning $16 billion run on WMB's deposits by the end of September, 2008.

As a result of these developments, the Office of Thrift Supervision, WMB's primary regulator, seized WMB and appointed the Federal Deposit Insurance Corporation (the "FDIC") as a receiver, marking the largest bank failure in the nation's history. That

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Lehman Brothers Court Compels Bank of America's Return of $500 Million Following Improper Unilateral Setoff

As the economic crisis unfolded during the summer of 2008, Bank of America ("BofA"), one of Lehman Brothers' principal clearing banks with respect to the numerous securities transactions handled by Lehman each business day, became uneasy about the deteriorating financial condition of the venerable investment bank.

In August 2008, just weeks before Lehman Brothers filed for chapter 11 protection, BofA required Lehman Brothers to post $500 million in a secured interest-bearing cash collateral account to protect BofA from potentially significant losses arising from intra-day overdrafts that routinely appeared in Lehman's demand deposit accounts at various time during the banking day. Notwithstanding BofA's preoccupation with potential intra-day overdrafts, BofA's actual exposure to Lehman in this regard was negligible at the time Lehman filed its bankruptcy in September 2008. But instead of releasing the funds in the cash collateral account to Lehman following the bankruptcy filing, BofA unilaterally offset the $500 million against amounts allegedly owed by Lehman in connection with the parties' non-commercial banking relationship. Importantly, BofA did not seek

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from the editor

JEFFREY L. COHEN

As our country continues to climb from the historic valleys of the post-Lehman recession, the bankruptcy courts continue to face the daunting challenge of administering the most complex financial institution bankruptcies of our time. In just the few months that followed our previous publication in October of last year, the SDNY and Delaware bankruptcy courts, presiding over the *Lehman Brothers* and *Washington Mutual* bankruptcies respectively, have issued decisions of critical importance concerning creditor setoff rights, third-party plan releases and the enforceability of make-whole and no-call loan agreement provisions.

So, in other words, it's a great time for the Spring 2011 edition of *Absolute Priority*

This issue also discusses the Delaware Chancery Court's recent answer to the long-standing question of whether creditors of insolvent Delaware limited liability companies enjoy derivative standing to bring breach of fiduciary duty actions against managers of such companies. In addition, this issue reports on recent bankruptcy court decisions considering exceptions to a debtor's WARN Act liability, the ordinary course of business defense to preference claim liability, the propriety of lease security deposit setoffs and the questionable validity of some of the more onerous provisions of postpetition financing agreements that are frequently demanded by lenders. This issue also ponders whether the Bankruptcy Code provides a statutory predicate for the important remedy of substantive consolidation.

As always, the Cooley bankruptcy group has been busy representing creditors' committees in most of today's prominent

Creditors of Insolvent Delaware LLCs Lack Standing To Bring Breach of Fiduciary Duty Cause of Action

Filling a hole in Delaware law left by the landmark 2007 decision of *N. Am. Catholic Educ. Programming, Inc. v. Gheewalla, et al. (Gheewalla)*, 930 A.2d 92 (Del. 2007), in which the Delaware Supreme Court held that creditors could derivatively sue a director of an insolvent Delaware *corporation* for breach of fiduciary duty, the Delaware Chancery Court recently refused to extend this holding to managers of an insolvent Delaware *limited liability company*.

In *CML V LLC v. Bax, et al.*, C.A. No 5373-VCL (Del. Ch. Nov. 3, 2010), the Delaware Chancery Court considered the merits of a derivative breach of fiduciary duty action commenced by CML, a lender of debtor JetDirect Aviation Holdings, LLC (JetDirect), against certain of JetDirect's managers. JetDirect is a private jet management and charter company, which undertook an aggressive expansion strategy that resulted in a highly leveraged balance sheet. CML alleged that JetDirect's management breached their duties of care and loyalty to JetDirect's creditors by, among other things, negotiating sales of JetDirect's assets to entities under their control at a time when JetDirect was insolvent.

The Court recognized that in the aftermath of the *Gheewalla* decision, many have assumed that creditor derivative standing exists to bring claims on behalf of an insolvent LLC. The Court explained, however, that this is not the case. Based on the plain language of the Delaware Limited Liability Company Act (the LLC Act), creditors of an insolvent LLC do not have standing to bring derivative claims against management. While the Court acknowledged that the LLC Act provides a statutory right to bring a derivative action, section 18-1001 of the LLC Act requires that the plaintiff bringing such action be "a member or an

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SDNY Bankruptcy Court Addresses Inconsistent Treatment of Lenders' Make-Whole and No-Call Claims in Bankruptcy

A recent decision issued by the Bankruptcy Court for the Southern District of New York in the *In re Chemtura Corporation, et al.*, 2010 WL 4272727 (Bankr. S.D.N.Y. Oct. 21, 2010) case adds to the murky case law on the treatment of claims for "make-whole" amounts and damages for breaches of "no-call" provisions in debt instruments. In *Chemtura*, the proposed plan of reorganization embodied a settlement pursuant to which bondholders were to receive substantial value on account of claims for damages related to the early repayment of prepetition debt. These claims were based on alleged breaches by the debtors of certain no-call and make-whole provisions in the agreements that governed the prepetition bonds.

A no-call provision typically prohibits the borrower from prepaying a loan or imposes a fee in the event of prepayment. Make-whole provisions generally provide a set formula for the calculation of prepayment damages based upon the estimated amount of interest the lender would expect to receive if the loan were to be repaid on the maturity date. Many loan agreements containing make-whole and no-call provisions also provide that the debt is to be automatically accelerated in the event the borrower files for bankruptcy. However, these loan agreements are frequently silent on the issue of whether the make-whole amount governs the lender's damages in the event the loan is automatically accelerated as a result of the bankruptcy filing. In other words, the loan agreements do not specify whether the filing of a bankruptcy case by the borrower entitles the lender to receive the liquidated damages provided for in the make-whole provision or whether it requires the lender to prove actual damages for breach of the no-call provision.

The bond indentures at issue in *Chemtura* provided for the automatic acceleration of the loan in the event of a bankruptcy filing, but did not specify how the acceleration would impact the make-whole and no-call provisions in the indenture. In evaluating the proposed settlement in *Chemtura*, Judge Gerber analyzed several recent, conflicting decisions handed down by SDNY Bankruptcy Court judges. In *In re Calpine Corp.*, 376 B.R. 392 (Bankr. S.D.N.Y. 2007), Judge Lifland held that no-call provisions in a bond indenture supported unsecured claims for damages resulting from the debtors' breach in an amount calculated according to the make-whole formula contained in the indenture agreement—even though the make-whole provision was, by its own terms, inapplicable to repayment made by the debtors' prior to a specific date, which had not yet occurred when the loan was accelerated and repaid.

Judge Gerber's *Chemtura* opinion also contains a discussion of a decision authored by another SDNY bankruptcy judge, Judge Beatty, in the *In re Solutia Inc.*, 379 B.R. 473 (Bankr. S.D.N.Y. 2007) case. In *Solutia*, Judge Beatty rejected bondholders' claims for damages under a make-whole provision because the indenture lacked any specific provision requiring the debtor's payment of a premium upon the automatic acceleration of the indebtedness in the event of a bankruptcy filing. According to Judge Beatty, the sophisticated and well-represented bondholders conceded their expected future income stream in exchange for the automatic acceleration of all indebtedness in the event of a bankruptcy filing.

At the time the settlement with the *Chemtura* bondholders was negotiated, it was unclear whether courts would follow the reasoning of *Solutia* or *Calpine*. Prior to Judge Gerber's *Chemtura* decision, however, the District Court for the Southern District of New York

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retail bankruptcy cases, debtors attempting to restructure their businesses in chapter 11 and strategic and financial buyers of distressed assets. Nevertheless, we are never too busy to keep you up to date on the latest developments in the bankruptcy world. You are, after all, our *Absolute Priority* …

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

In the News

Current Cooley Representations

***In re Lehr Construction Corp.*, Case No. 11-10723 (Bankr. S.D.N.Y. 2011)** On February 21, 2011, Lehr Construction Corp. filed a voluntary petition for chapter 11 bankruptcy protection. Lehr specializes in interior construction and serves clients throughout the New York metropolitan area. Cooley represents the debtor in connection with its bankruptcy case and is assisting the debtor with the completion of its current construction projects. The debtor anticipates completing all of its outstanding construction obligations whereupon Cooley will assist the debtor with an orderly wind-down of the debtor's operations.

***In re Robb & Stucky Limited LLLP*, Case No. 11-02801 (Bankr. M.D. Fla. 2011)** Robb & Stucky, a market leading retailer of high end furniture that operates 24 locations in Florida, Texas, Arizona and Nevada, commenced a chapter 11 proceeding on February 18, 2011. The debtor filed a motion to sell substantially all of its assets pursuant to an expedited sale process. Cooley, as counsel to the official committee of unsecured creditors, is playing an integral role in the marketing

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of the company's assets and implementing creative strategies to generate value for general unsecured creditors. An auction for substantially all of Robb & Stucky's assets is currently scheduled for March 7, 2011.

***In re Blockbuster Inc., et al.*, Case No. 10-14997 (Bankr. S.D.N.Y. 2010)** Cooley represents the official committee of unsecured creditors of Blockbuster, the first national video sale and rental retailer that operated approximately 3,000 retail stores throughout the United States prior to its bankruptcy filing. Since the outset of the cases, Cooley has pursued a number of value maximizing strategies for the benefit of unsecured creditors, including negotiating certain key concessions from the DIP lenders and conducting an investigation of the senior noteholders' liens and claims and the prepetition conduct of Blockbuster and its management. In March 2011, the Court approved a sale process that is likely to keep open a significant number of stores, while insulating unsecured creditors from preference liability.

***In re Appleseeds Intermediate Holdings LLC, et al. d/b/a Orchard Brands*, Case No. 11-10160 (Bankr. D. Del. 2011)** Cooley represents the official committee of unsecured creditors of Orchard Brands, a leading, multi-channel marketer of apparel and home products focused on serving the needs of the market segment of women and men over the age of 55. On the first day of the cases, the debtors filed a "pre-negotiated" plan and disclosure statement, as well as motions for approval of DIP financing and other "first day" relief The committee successfully negotiated a global resolution with the debtors and their lenders, among other things, the prospect of a recovery for general unsecured creditors from certain potential

Is There a Statutory Predicate for Substantive Consolidation?

The Bankruptcy Code does not explicitly address whether courts may substantively consolidate a bankruptcy estate's assets and liabilities with those of a separate debtor or non-debtor entity. Nonetheless, many courts consider substantive consolidation to be a remedy that is available to creditors and trustees under the Bankruptcy Code. *See, e.g., In re Augie/Restivo Baking Ltd*, 860 F.2d 515 (2d Cir. 1988); *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005). These courts often cite section 105(a) of the Code, which empowers bankruptcy courts to issue "any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code, as the basis for such authority, and characterize substantive consolidation as a remedy based in common law and principles of equity. *See Owens Corning*, 419 F.3d at 205) ("Substantive consolidation, a construct of federal common law, emanates from equity.").

A recent decision of the Bankruptcy Court for the Western District of Michigan challenges the conventional wisdom of the common law premise. In *In re Cyberco Holdings, Inc.*, 2010 Bankr. LEXIS 2111 (Bankr. W.D. Mich. July 2, 2010), Judge Jeffrey R. Hughes issued a thoughtful opinion concluding that, notwithstanding many courts' expressing views to the contrary, there is a statutory basis for substantive consolidation in the Bankruptcy Code.

Procedural Background of the Cyberco Cases

The chapter 7 cases of Cyberco Holdings, Inc. and its affiliate Teleservices Group, Inc. arose from the fraudulent activities of Barton Watson, the debtors' principal. As explained by the court, Watson's scheme involved seeking out banks, leasing companies, and other similar institutions for advances under the pretext that Cyberco needed cash to acquire computer equipment for a growing business. However, Cyberco never acquired any of the equipment. Watson represented to his financiers that Teleservices was Cyberco's supplier of the computer equipment based upon those representations. The finance companies forwarded funds directly to Teleservices, and Watson then had Teleservices issued phony invoices to evidence the equipment transactions. *Id.* at *10.

Teleservices then transferred the funds it received from the financial institutions back to Cyberco, who used the money to, among other things, pay the high salaries of Watson and others perpetuating the fraud. *Id.* at *13. Those transfers were made through accounts that Cyberco had opened at Huntington National Bank, who had provided Cyberco with a $13 million line of credit, and were facilitated by various cash management services that Huntington Bank provided. Huntington Bank's relationship with Cyberco ultimately soured, and on the eve of the fraud's discovery by the FBI, Cyberco used funds generated by the fraud to reduce the bank's exposure to Cyberco from $12.6 million to $600,000. *Id.* at *14.

Subsequently, creditors of Cyberco commenced an involuntary chapter 7 proceeding and a receiver was appointed for Teleservices, who filed a chapter 7 petition for the company one month later. The trustees for both estates pursued avoidance actions against Huntington Bank. The trustee for Cyberco contended that the bank had received substantial preferential transfers in connection with the indebtedness owed to it by Cyberco, and the trustee for Teleservices asserted that Huntington Bank was liable for fraudulent transfers it received directly from Teleservices and as a subsequent transferee of transfers made by Teleservices to Cyberco. *Id.* at *4. In response to the commencement of these adver-

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Bankruptcy Court Applies WARN Act Exceptions To Insulate Debtor From Employee Liability

In *In re FF Acquisition Corp., d/b/a Flexible-Flyer*, 423 B.R. 502 (Bankr. N.D. Miss. 2010), the Bankruptcy Court for the Northern District of Mississippi recently dismissed claims against Flexible Flyer under the Worker Adjustment and Retaining Notification Act (the WARN Act) in a decision that will surely affect the way future debtors defend against claims brought under the WARN Act.

Flexible Flyer manufactured swing sets, hobby horses and other products which it sold to retailers. Prior to its bankruptcy filing, Flexible Flyer met its operating capital needs through a factoring arrangement with CIT Group Commercial Systems, LLC (CIT), pursuant to which CIT purchased Flexible Flyer's accounts receivable and advanced Flexible Flyer 80% of the amount of those receivables. When the CIT factoring arrangement was insufficient to meet Flexible Flyer's capital needs, Flexible Flyer received capital infusions from Cerberus Capital Management Corporation (Cerberus), its parent corporation.

Until September 2005, Cerberus had never refused to extend capital to Flexible Flyer. Approximately two to three weeks prior to Flexible Flyer's chapter 11 filing, CIT reduced the advance rate on receivables from 80% to 50% and, immediately prior to the filing, to zero. Likewise, Cerberus refused to infuse additional capital. On September 9, 2005, Flexible Flyer filed a voluntary petition for relief under chapter 11, ceased doing business and issued a notice to employees pursuant to the WARN Act. Flexible Flyer's former employees filed claims against the company in the bankruptcy case seeking damages under the WARN Act totaling $659,736.41, as well as fees and costs.

The WARN Act provides that an employer may be liable for up to 60 days' back pay and benefits to certain employees who do not receive 60 days advance notice of a plant closing or mass layoff. However, there are exceptions to the notice requirement, two of which the Court analyzed in detail. First, the "unforeseen business circumstances" exception to the WARN Act's notice requirements may apply when (i) the circumstances leading to the layoffs were unforeseeable and (ii) the layoffs were caused by those circumstances. The plaintiffs asserted that the cessation of Flexible Flyer's operations was foreseeable because the company experienced various operational problems in 2005, including, among other things, an increasing deficit and the deferral of certain large purchase orders. Flexible Flyer's CFO denied that any of the foregoing actually caused the shutdown, and the Court agreed. Namely, the CFO stated that CIT's reduction in the advance rate to zero was the unforeseen circumstance that primarily caused the shutdown. Moreover, the CFO indicated that Cerberus's refusal to supply additional capital was completely unforeseeable based on past experience.

Although the Court found that "the unforeseen business circumstances exception is by far the most compelling", it also found that the "faltering company" exception to the WARN Act's notice requirement applied under the circumstances. Under this exception, the employer must show that (i) it was actively seeking capital at the time the 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 it to avoid or postpone the shutdown and (iv) it reasonably and in good faith believed the notice would have precluded it from obtaining financing. 60 C.F.R. § 639.9(a). The Court found that Flexible Flyer had adequate financing in place coupled with the potential 'back-up' support from its parent Cerberus, and that the CFO had no reason to believe either was in jeopardy

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causes of action and a waiver of preference actions against trade creditors.

***In re Ultimate Acquisition Partners, LP, et al.*, Case No. 11-10245 (Bankr. D. Del. 2011)** Cooley is counsel to the creditors' committee of Ultimate Electronics, a leading retailer of high-end home entertainment and consumer electronics. By the time the committee was formed, the Debtors had already announced their plans to liquidate inventory and wind-down the business through store closing sales. Cooley immediately objected to the proposed sale and was in Court just two days after the committee's formation to prosecute the committee's sale objection to, among other things, the fees proposed to be paid to the liquidators. After a lengthy sale hearing, the committee persuaded the liquidators to reduce their fees by approximately $1 million. Cooley will now turn its attention to assisting the debtors in winding down their operations.

***In re Goldcoast Liquidating, LLC, et al. f/k/a Claim Jumper Restaurants*, Case No. 10-12819 (Bankr. D. Del. 2010)** Claim Jumper restaurants operated 45 western-style full-service restaurants primarily in the western United States, Wisconsin and Illinois. The debtors filed their chapter 11 cases with a "stalking horse" agreement which would have provided no return to unsecured creditors and approximately $24.5 million in cash to the estates. With the assistance of the creditors' committee, an auction was conducted which resulted in the successful bid of an affiliate of Landry's Restaurants at more than double the amount of the stalking horse bid, providing, among other things, $48.3 million in cash to the estates and the assumption of up to $23.3 million in assumed liabilities. Unsecured creditors will share in the substantial upside

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resulting from the auction process and the debtors and creditors' committee are currently preparing a plan of liquidation.

***In re OTC Holdings Corporation, et al.*, Case No. 10-12636 (Bankr. D. Del. 2010)** Oriental Trading Company, the largest direct marketer of party supplies, novelties, toys and children's arts and crafts in the United States, commenced a chapter 11 proceeding in August 2010. At the outset of the cases, the company had already negotiated a restructuring support agreement and plan term sheet with its first lien secured lenders that provided general unsecured creditors with a *de minimis* recovery. Cooley, on behalf of the official committee of unsecured creditors, immediately commenced negotiations with the first lien lenders, who ultimately agreed to provide holders of allowed general unsecured claims with a cash distribution. Total recoveries by general unsecured creditors under the plan, which went effective in February 2011, are anticipated to range from 6.5% to 21%.

***In re UBI Liquidating Corp., et al. f/k/a/ Urban Brands*, Case No. 10-13005 (Bankr. D. Del. 2010)** Urban Brands Inc., the parent of the Ashley Stewart chain, filed for chapter 11 protection in September 2010. On the petition date, Ashley Stewart, which caters to plus-size urban women and had approximately 210 stores in cities including New York and Los Angeles, was poised to sell all of its assets through an expedited sale process. Upon its selection as counsel to the official committee of unsecured creditors, Cooley played an integral role in the sale process by attracting potential bidders, actively participating in the robust auction of the company's assets, and negotiating the sale of the company on terms that provided significant additional value to creditors than

Debtor's Voluntary Change In Payment Terms Still Impacts Creditor's Ordinary Course Defense To Preference Avoidance

Section 547 of the Bankruptcy Code permits the trustee or a debtor-in-possession to avoid and recover certain "preferential" transfers of property from the debtor to a creditor within the 90 day period prior to the debtor's bankruptcy filing. The intent of the statute is to discourage unusual actions from being taken by the debtor or the creditor during the period of instability just prior to a company's bankruptcy filing. In following, the Bankruptcy Code provides certain defenses to preferences designed to encourage creditors to continue doing business with troubled companies. One of the more critical defenses to preferences is the so-called ordinary course of business defense. Pursuant to this defense, a preferential transfer is not avoidable to the extent the transfer is in payment of a debt incurred by the debtor in the ordinary course of business between the debtor and the creditor and such transfer was (i) made in the ordinary course of business of the debtor and the transferee or (ii) made according to ordinary business terms.

In evaluating whether the ordinary course of business defense will insulate a transfer from avoidance, bankruptcy courts frequently consider: (1) the length of time the parties were engaged in the type of transaction at issue, (2) whether the amount or form of tender differed from past practices, (3) whether the debtor or creditor engaged in any unusual collection or payment activity, and (4) whether the creditor took advantage of the debtor's deteriorating financial condition. In *Valley Petroleum, LLC v. Garrow Oil Corporation (In re Valley Petroleum, LLC)*, 53 B.R. 138 (Bankr. E.D. Wis. 2010), the Eastern District of Wisconsin recently addressed the issue of whether a debtor's decision to accelerate payment terms without provocation by the creditor would harm the creditor's ability to successfully establish an ordinary course of business defense.

In *Valley Petroleum*, the prepetition agreement between the debtor and a supplier provided that the debtor's payment for fuel was due 10 days after delivery. A portion of the running balance would first be collected through the debtor's assignment of credit card receivables to the supplier and the balance owed would then be paid after the supplier requested an electronic fund transfer from the debtor's bank account. In June 2009, the supplier's request for an electronic payment was denied. Shortly thereafter, the debtor began making advance payments to the supplier by cashier's check through the time of the debtor's bankruptcy filing.

The supplier conceded at trial that each of the statutory elements of an avoidable preference were present with respect to the subject transfers, but argued that the transfers were (a) contemporaneous exchanges for new value given to the debtor and (b) made in the ordinary course of business. Although the Court accepted the supplier's new value defense with respect to the advance payments, it rejected the supplier's ordinary course defense.

Neither party disputed that the debt was incurred in the ordinary course of business between the parties for delivery of fuel. Rather, the dispute concerned the manner in which payment was made by the debtor. The debtor argued that its decision to accelerate payment terms was the result of the supplier's insistence upon receiving improved payment terms during the debtor's slide into bankruptcy. In contrast, the supplier argued that the acceleration of payment terms was a voluntary decision made by the debtor. The Court reasoned

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Lease Security Deposit Properly Setoff Against Landlord's Prepetition—Not Postpetition - Claim

In *In re Telligenix Corp.*, 436 B.R. 211 (Bankr. M.D. Fl. 2010), the Bankruptcy Court for the Middle District of Florida rejected Telligenix Corporation's "novel" argument that a landlord's administrative claim for unpaid, postpetition rent should be treated as a prepetition claim subject to setoff under section 553(a) of the Bankruptcy Code.

Telligenix filed for bankruptcy on October 8, 2009. Soon thereafter, the company rejected an unexpired real property lease, leaving the landlord with an undisputed prepetition damage claim in the amount of $2,436,628.00 and an administrative claim in the amount of $284,052.22 for approximately three months of unpaid postpetition rent. While the size of this administrative claim likely rendered Telligenix administratively insolvent, the Debtor tried to keep the hope of a successful reorganization alive by asking the Court to offset its $1.5 million security deposit against the landlord's administrative claim rather than its prepetition damage claim. Well aware of the debtors' solvency concerns, the Court still refused to permit the offset against the landlord's administrative claim.

From the Court's perspective, its decision boiled down to the simple question of whether the landlord's administrative claim for postpetition rent could be considered a prepetition claim for purposes of setoff under section 553(a) of the Bankruptcy Code. Telligenix argued that a claim for rent under the lease, whether accruing before or after the petition date, is a prepetition claim because the lease is a prepetition contract. The Court rejected this argument, finding that Telligenix failed to cite any case concluding that postpetition rent due under a prepetition lease automatically gives rise to a prepetition claim, particularly in view of the substantial case law granting administrative expense priority to claims for postpetition rent under prepetition leases under sections 365 and 503 of the Bankruptcy Code. What matters, the Court explained, is when the act giving rise to the claim was performed (i.e., the debtors' non-payment postpetition). Because the debtors' occupied and benefitted from the premises postpetition, the claim was administrative in nature and therefore could not be offset by the debtors' prepetition security deposit pursuant to section 553(a) of the Bankruptcy Code. •

Indiana Bankruptcy Court Vetoes Onerous DIP Facility

On October 19, 2010, Indiana Bankruptcy Judge Terry L. Myers did something that bankruptcy judges are often reluctant to do: he refused to approve a proposed debtor in possession financing facility. While the circumstances of the case are unique—particularly the fact that the financing facility was proposed months after the bankruptcy filing—Judge Myers' decision in *In re Tamarack Resort*, Case No. 09-03911-TLM (Bankr. D. Ind. October 19, 2010) is noteworthy because the terms of the proposed financing facility, while onerous, are not uncommon.

Tamarack Resort is composed of a ski facility, a golf course, numerous residential developments, a conference facility, and various commercial and retail facilities. The Resort has been under construction for years and remains only partially complete. In 2006, Tamarack obtained a $250 million dollar loan from a syndicate of lenders represented by Credit Suisse. Two years later, Credit Suisse commenced an action in Idaho state court to foreclose on the property, appoint a receiver and determine the priority of various liens. While the state action was proceeding, an involuntary chapter 7 petition was filed against Tamarack. The bankruptcy court ruled that

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that proposed at the outset of the case. The successful bidder ultimately agreed to continue operating Ashley Stewart stores at over 180 locations, and it is anticipated that the distribution of sale proceeds will yield a meaningful distribution to unsecured creditors.

***In re The Kasden Fuel Company*, Case No. 10-21973 (Bankr. D. Conn. 2011)** In February 2011, the Office of the United States Trustee for Region 2 appointed Cooley bankruptcy partner James A. Beldner as chapter 11 trustee for The Kasden Fuel Company, a 100-year-old full service energy company specializing in heating and cooling homes and businesses throughout Connecticut. Mr. Beldner has retained Cooley to represent him in the company's bankruptcy proceedings. After stabilizing the company's operations and obtaining the Court's authority to use cash collateral, Cooley will assist Mr. Beldner in selling the company pursuant to a plan.

Representation of Ad Hoc Group of Tort Claimants of Long Island College Hospital Cooley was recently retained by an ad hoc group of tort claimants of Long Island College Hospital in connection with state court proceedings related to the hospital's well-publicized proposed merger with SUNY Downstate Medical Center.

***In re Fortunoff Holdings, LLC and Fortunoff Card Company, LLC*, Case No. 09-10497 (Bankr. S.D.N.Y. 2009)** Cooley is special litigation counsel to Ian Gazes, Esq., the chapter 7 trustee of jewelry and home furnishing retailer Fortunoff Holdings LLC and Fortunoff Card Company. Cooley is currently investigating potential causes of action that may be asserted on behalf of the debtors' estates against the debtors' former officers and directors as a result of the

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company's bankruptcy and subsequent liquidation in early 2009. It is anticipated that Rule 2004 examinations of the company's former officers and directors will be conducted shortly.

Preference Defense and Mediation Engagements Cooley represents Graphic Communications, Logitech and D&H Distributing as defendants in preference actions brought by the liquidating trustee in the Circuit City Stores bankruptcy case. The preference actions are currently in the mediation stage. Separately, Eric Haber currently serves as the mediator in numerous preference actions brought in the Quebecor, BearingPoint and Pope & Talbot bankruptcy cases.

Intellectual Property Purchase Engagements Cooley recently represented media and entertainment company NECA, Inc. in connection with its purchase of the Hollywood Video, Movie Gallery, and Game Crazy brands from the bankruptcy estate of Movie Gallery, Inc. In addition, Cooley advised Authentic Brands Group, a newly-formed brand development and licensing company, in connection with raising $250 million in equity capital from Leonard Green & Partners for investment in distressed brands. Since that time, Cooley has assisted Authentic Brands in its purchase of three of the premier brands in the ultimate fighting and mixed martial arts industry: Tapout, Silver Star Casting and Sinister Brand.

***In re Mervyn's Holdings, LLC, et al.*, Case No. 08-11586 (Bankr. D. Del. 2008)** Mervyn's, a chain of approximately 175 family-friendly, promotional department stores predominantly located in California and the southwestern United States, filed for chapter 11 protection in July 2008 and subsequently liquidated its assets. Cooley represents the official

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same day, in a highly controversial decision, the FDIC sold substantially all of WMB's assets to JP Morgan Chase ("JPMC"). Under the terms of the sale, JPMC paid $1.88 billion for WMB's assets and assumed more than $145 billion in deposit and other liabilities. The FDIC retained claims that WMB held against others.

One day later, on September 26, 2008, WMI and its affiliate Washington Mutual Investment Corporation (collectively, the "Debtors") filed chapter 11 petitions in the United States Bankruptcy Court for the District of Delaware. Not surprisingly, disputes immediately arose among WMI, the FDIC and JPMC, among others, regarding the ownership of certain assets, including WMB's deposit accounts. On March 12, 2010, WMI, JPMC and the FDIC announced that they had reached a global settlement (the "Settlement") of all issues regarding the disputed assets, and a term sheet reflecting the Settlement was incorporated into a liquidating plan (the "Plan"). A number of parties that were dissatisfied with aspects of the Settlement objected to the Plan, including the official committee of equity security holders, the Office of the United States Trustee (the "UST") and several groups of holders of WMB securities (collectively, the "Plan Objectors").

All of the Plan Objectors other than the UST objected to the releases granted by the Debtors on behalf of the estates on the grounds that the Settlement was unreasonable because it conceded ownership of certain assets to JPMC and released substantial claims of the estates for no value before the Debtors had adequately investigated the value of the claims. *See In re Washington Mutual, Inc., et al.*, Case No. 08-12229, 2011 WL 57111 at *5 (Bankr, D. Del. January 7, 2011). In so doing, the Plan Objectors complained that the Settlement only provided returns for the Debtors' creditors, asserting that the Debtors had ignored their fiduciary duty to shareholders. *Washington Mutual*, 2011 WL at *5.

The Court analyzed whether the Settlement was in the best interests of the estates under the well-established factors established by *Myers v. Martin (In re Martin)*, 91 F.3d 389, 393 (3d Cir. 1996), which include (i) the probability of success in litigation; (ii) the likely difficulties in collection; (iii) the complexity, expense and delay of the issues involved; and (iv) the paramount interest of the creditors. *Id*. at *7. The Court concluded that it was unlikely that the Debtors could have improved on the return they received in the Settlement by litigating the matters further. Moreover, because the dollars at risk were "enormous" and each individual disputed claim involved "a multiplicity of issues raising complex arguments about the intersection of bankruptcy law and the regulation of banks," the Court determined that the case was "precisely the type of multi-faceted litigation that cries out for settlement" and deemed the Settlement fair and reasonable. *Id*. at *23.

This, however, did not end the Court's analysis of the releases included in the Settlement. Under the Plan, the Debtors sought to release all claims against "Released Parties", which included WMB, JPMC, the FDIC, noteholders that were party to the Settlement, the official committee of unsecured creditors and each of its members, professionals retained by the Debtors and the creditors committee, the indenture trustees for each of the tranches of the Debtors' debt and the liquidating trust and trustee established by the Plan and all of their affiliates.

The proponents of the Plan argued that the releases were an integral part of the Settlement and must be approved if the Court ruled that the Settlement as a whole was reasonable. In assessing the releases, the Court applied the guidance set forth in

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WAMU COURT REJECTS BANKRUPTCY PLAN continued from page 8

In re Zenith Elecs., 241 B.R. 92 (Bankr. D. Del. 1999), in which the Court indentified five factors that are relevant to determining whether a debtor's release of a non-debtor is appropriate:

1) An identity of interest between the debtor and non-debtor such that a suit against the non-debtor will deplete estate resources;
2) A substantial contribution to the plan by the non-debtor;
3) The necessity of the release to the reorganization;
4) The overwhelming acceptance of the plan and release by creditors and interest holders; and
5) The payment of substantially all of the claims of the creditors and interest holders under the plan.

Id. at *24. After considering these factors, the Court concluded that the releases granted by the Debtors to WMB, JPMC and the FDIC were reasonable. Of particular importance to the Court was the identity of interest between these parties and the fact that JPMC and/or the FDIC may be viewed as a successor to WMI and WMB for the purposes of ongoing litigation related to the seizure of WMB's assets. The Court also ruled that JPMC and the FDIC had made substantial contributions to the Plan by waiving the sizable claims they had asserted against the Debtors' estates, which the Debtors estimated to be worth $54 billion.

The Court was not persuaded, however, that the releases granted to the other parties were warranted. With respect to the liquidating trust and trustee, the Court noted that these parties did not yet exist and could not have done anything for which a release was necessary. As for the creditors committee and its members, the Court concluded that while exculpations for postpetition actions were appropriate, the proposed releases were overreaching because there was no evidence that the creditors' committee had done anything other than fulfill its fiduciary duties to the estates. *Id*. at *26. The Court also struck down the releases of the settling noteholders because "the only contribution made by them was their participation in the settlement negotiations." *Id*. The Court also found no valid reason to approve releases of the Debtors' directors and officers and estate professionals. While the Court acknowledged that there was an identity of interest between the Debtors and these parties, the Court concluded that the releases proposed to be granted to them were either unnecessary, duplicative or excessive in light of the exculpations granted to them in the Plan relative to their postpetition activities.

The Court was even more critical of the third-party releases proposed by the Plan. As originally drafted, the Plan contained a release of all Released Parties by non-debtor third parties who were creditors or shareholders of the Debtors, except for claims arising from gross negligence and willful misconduct. Notably, the Plan provided that even third parties that had either failed to return a Plan ballot or elected to "opt out" of the releases by checking a box on their ballot would be bound by the releases. The Plan Objectors argued that the third party releases were improper as a matter of law because they were not consensual. *Id*. at *30. In response, the Debtors agreed to modify the Plan to provide that no releases would be granted by any entity that opted out of the release, but that such entity would not be entitled to a distribution under the Plan. The Court began its analysis of the third party releases by observing that such releases were the exception, not the rule and subject to a high standard of review. *Id*. at *30. (citing *In re Gillman v. Continental Airlines (In re Continental*

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committee of unsecured creditors in its pursuit of a complex $1.2 billion litigation related to the 2004 acquisition of Mervyn's from Target Corporation by various private equity firms, which stripped Mervyn's retail operations from its valuable real estate pursuant to an "opco/propco" structure.

***In re St. Vincent Catholic Medical Centers of New York*, Case Nos. 05-14945 (Bankr. S.D.N.Y 2005) and 10-11963 (Bankr. S.D.N.Y. 2010)** After representing the tort claimants' committee in St. Vincent's first bankruptcy case, Cooley represents the monitor of medical malpractice trusts in St. Vincent's second bankruptcy case, which were established to pay medical malpractice claims pursuant to the plan of reorganization confirmed in the first bankruptcy case. Cooley was instrumental in achieving significant value for the debtors' "Staff House" residential apartment building in Manhattan, upon which the trusts have a second lien, and is currently involved in the sale of St. Vincent's Westchester hospital, upon which the trusts also have a lien.

***In re Crabtree & Evelyn, Ltd.*, Case No. 09-14267 (Bankr. S.D.N.Y. 2009)** At the beginning of 2010, Crabtree emerged from bankruptcy as one of the handful of retailers to have successfully reorganized since the 2005 amendments to the Bankruptcy Code. During the bankruptcy case, Cooley assisted the debtor in the closure of 35 unprofitable retail locations. In addition, Cooley formulated the debtor's plan of reorganization, which reorganized the debtor around a smaller retail platform, and proposed a consensual plan through negotiations with the creditors' committee and the debtor's other constituents. Cooley has assisted the reorganized debtor with all post-confirmation issues, including claims analysis.

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***In re Trade Secret, Inc., et al.*, Case No. 10-12153 (Bankr. D. Del. 2010)** Trade Secret, an operator of approximately 600 retail and salon locations that sells hair care and beauty products and provides hair care services, commenced a chapter 11 proceeding in June 2010. As counsel to the official committee of unsecured creditors, Cooley obtained a firm commitment from the Debtor's former owner and the purchaser of Trade Secret's assets out of bankruptcy to infuse $2 million of much needed equity into the company as part of the sale, ensuring the continuation of the company as a viable going concern.

***In re Mount Diablo Young Men's Christian Association*, Case No. 10-44367 (Bankr. N.D. Cal. 2010)** The debtor filed its chapter 11 case in April 2010 and immediately sought bankruptcy court approval of the sale of its main operating facilities and certain after-school day care programs to another YMCA in the area. As counsel to the official committee of unsecured creditors, Cooley advised the committee regarding the sale of the debtor's operating facilities, worked to maximize the value of the debtor's primary remaining asset, approximately 12 acres of partially developed, and negotiated changes to the now confirmed plan of liquidation. Cooley is continuing to advise the post-confirmation committee in overseeing the implementation of the plan.

***In re Michael Anthony Management, Inc. (d/b/a Sierra Snowboard)*, Case No 10-55755 (Bankr. N.D. Cal. 2010)** Sierra Snowboard is one of the largest online retailers of winter sporting goods, apparel and accessories. Sierra filed for chapter 11 bankruptcy protection in June 2009 in the Northern District of California. Sierra ultimately sold its assets as a going concern to one of its competitors, Active

LEHMAN – IMPROPER SETOFF continued from page 1

the prior approval of the bankruptcy court before taking this action and Lehman challenged the unauthorized setoff as a violation of the automatic stay. In a strongly worded opinion that will undoubtedly serve as a cautionary tale for parties contemplating unilateral setoff against a chapter 11 debtor, Judge Peck of the United States Bankruptcy Court for the Southern District of New York ruled that the setoff was improper, ordered BofA to return the $500 million and scheduled further proceedings to determine whether sanctions against BofA were warranted under the circumstances.

BofA's prepetition relationship with Lehman Brothers was exceedingly complex, and involved the transfer and reconciliation of vast sums of cash on a daily basis. The Court's decision noted that, in the ordinary course of dealing between the parties, temporary overdrafts would appear within Lehman Brothers' accounts with BofA as a natural consequence of Lehman's large-scale brokerage and investment banking transactions. *See Bank of America, N.A. v. Lehman Brothers Holdings, Inc. (In re Lehman Brothers Holdings, Inc. et al.*), 2010 Bankr. LEXIS 3867 (Bankr. S.D.N.Y. November 16, 2010). BofA customarily disregarded such negative balances as an accommodation to Lehman Brothers, under the expectation that there would be a positive cash balance in the accounts when they were reconciled at the end of each day. In essence, by honoring Lehman's checks at times when no funds were on deposit to cover advances, BofA extended short-term unsecured credit to Lehman pending clearance of deposits at the end of the day.

BofA's willingness to continue this practice began to waver in July 2008 as a result of a $650 million overnight overdraft that appeared in one of Lehman's accounts. That event, led BofA to seek additional protection from Lehman Brothers to reduce its risk of loss from future intra-day overdrafts. Using the considerable leverage that it possessed as Lehman's primary clearing bank, BofA initially requested that Lehman post $1 billion to a secured cash collateral account in exchange for BofA's agreement to continue to honor the overdrafts. Lehman agreed to post $500 million to a secured cash collateral account controlled by BofA. In the security agreement governing the cash collateral account, the parties narrowly defined the term "indebtedness" to include only those debts of Lehman which related to overdrafts.

Addressing Lehman Brothers' challenge of BofA's setoff, the Court first noted that the Bankruptcy Code does not provide an independent right of setoff. Rather, section 553 incorporates any setoff right that may exist under applicable state law as long as the setoff complies with the following prerequisites: (i) the amount owed by the debtor must be a prepetition debt; (ii) the debtor's claim against the creditor must also be prepetition; and (iii) the debtor's claim against the creditor and the debt owed to the creditor must be mutual. Although the decision to permit setoff is within the sound discretion of the bankruptcy court, courts have long held that principles of equity favor the right of setoff as a means to avoid a multiplicity of lawsuits and inefficient use of judicial resources.

The Court considered whether BofA was entitled to setoff the funds in the cash collateral account in the manner in which it did under New York law, which the parties agreed would apply to any dispute arising under the security agreement. Under New York law, while funds within a special purpose account are not subject to setoff, funds within a general deposit account are subject to setoff. *Id.* at *31-32 (citing *In re Applied Logic Corp.*, 576 F.2d 952, 958 (2d Cir. 1978) (stating that "a bank cannot exercise a set-off against a deposit which

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is known by it to be dedicated to a special use[.]"). The Court noted that a strong presumption exists under New York law that a deposit account like the cash collateral account established by Lehman Brothers is a general account and not a special purpose account. In order to overcome this presumption, the Court required Lehman Brothers to present evidence sufficient to demonstrate that the parties intended to create the cash collateral account for a specific purpose. Citing the restrictive definition of "indebtedness" in the security agreement and the undisputed evidence that the parties had explicitly agreed that the cash collateral account was pledged for the sole purpose of providing BofA with overdraft protection (as opposed to providing BofA with a general security interest), the Court reasoned that the parties mutually intended for the cash collateral account to be a special purpose account securing only Lehman's overdraft obligations to BofA. Because the setoff exercised by BofA concerned Lehman debts that were wholly unrelated to overdrafts, the Court concluded that BofA's setoff was improper.

The Court further ruled that BofA's seizure and setoff of the $500 million violated the automatic stay triggered by Lehman's chapter 11 filing. Upon the filing of a bankruptcy petition, section 362(a) of the Bankruptcy Code stays, among other things, any and all acts taken to realize the value of collateral given by the debtor. When a creditor fails to obtain leave of the court and then seeks retroactive approval of a setoff that had been undertaken while the automatic stay is in effect, the creditor must prove the validity of the setoff and justify its failure to move for relief from the stay before it had exercised its setoff rights. *See id.* at *62 (citing *Shugrue v. Chem. Bank., Inc. (In re Ionospehere Clubs. Inc.)*, 177 B.R. 198, 206 (Bankr. S.D.N.Y. 1995).

BofA argued that it did not violate the automatic stay because its actions fell within one of the "safe harbor" exceptions set forth in section 362(b) of the Bankruptcy Code. Specifically, BofA relied on section 362(b)(17), which insulates "the exercise by a swap participant or financial participant of any contractual right…under any security agreement…forming a part of or related to any swap agreement" from the ambit of the automatic stay. 11 U.S.C. § 362(b)(17). BofA reasoned that this exception permits creditors to exercise setoff rights under *any* contract with a debtor, provided that the creditor and debtor are also parties to a swap agreement or other derivatives contract. The Court noted that BofA's interpretation of section 362(b)(17) is unsupported by any authority and is contradicted by the legislative history of the Code section, which expressly limits the scope of the exception to rights (including setoff rights) arising *directly* under derivative contracts. The Court scheduled further proceedings to determine whether sanctions against BofA were warranted under the circumstances, and the parties are presently negotiating a briefing and scheduling order to govern such proceedings.

The Court punctuated its ruling with some harsh words for BofA, stating that it was "astonishing that [BofA] would make the premeditated tactical decision to deliberately seize the collateral without first moving the Court for stay relief." *Id.* at *70. The Court's ruling serves as a stark reminder that creditors who exercise self-help remedies in the face of the automatic stay do so at their own peril. As Judge Peck notes, "lenders and other counterparties must be obedient to the bankruptcy law as it is written and should exercise great care in determining the applicability of any claimed exception to the automatic stay[.]" *Id.* at *71. Indeed, banks and other entities considering whether to unilaterally exercise

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Boarder Corporation, in a transaction that will yield substantial value to unsecured creditors. Sierra is currently in the process of drafting a plan of liquidation and winding down its bankruptcy estate.

***In re Lower Bucks Hospital, et al.*, Case No. 10-10239 (Bankr. E.D. Pa. 2010)**
Lower Bucks Hospital is a 183-bed acute care hospital and ambulatory surgical facility located on a 36-acre campus in Bristol, Pennsylvania. Cooley is representing Eric Huebscher, the Court-appointed patient care ombudsman, in the chapter 11 case. In connection therewith, Cooley has advised Mr. Huebscher regarding the noticing and preparation of his interim reports to the Court, and ensured that the content and dissemination of the reports complies with applicable federal rules.

***In re Pacific Metro, LLC (f/k/a The Thomas Kinkade Company, LLC)*, Case No. 10-55788 (Bankr. N.D. Cal, 2010)**
Pacific Metro, LLC (formerly known as The Thomas Kinkade Company, LLC), which commenced chapter 11 proceedings in June 2010, produces, distributes and sells works of art incorporating images licensed to the debtor by the artist Thomas Kinkade. Cooley, on behalf of the official committee of unsecured creditors, investigated and identified potential affirmative claims involving prepetition transactions between the debtor and its non-debtor affiliates, has begun negotiating a plan of reorganization.

***In re Alfred J.R. Villalobos, et al.*, Case No 10-52248 (Bankr. D. Nev. 2010)**
In May 2010, the State of California, commenced a civil enforcement action against Alfred J.R. Villalobos and one of his companies. Thereafter, a state court issued a temporary restraining order and appointed a receiver to administer the assets of Mr. Villalobos and one of his

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companies. As a result, Mr. Villalobos and three of his companies filed voluntary chapter 11 petitions in the Bankruptcy Court for the District of Nevada. As co-counsel to the debtors, Cooley is assisting the debtors in complex and contentious litigation concerning the appointment of a chapter 11 trustee and other issues arising in the bankruptcy cases, including a motion by the State of California for relief from the automatic stay to continue to pursue the civil enforcement action, which motion was denied by the Bankruptcy Court and is now on appeal.

***In re Eddie Bauer Holdings, Inc., et al.*, Case No. 09-12099 (Bankr. D. Del. 2009)** Cooley represented the official committee of unsecured creditors of Eddie Bauer, an internationally recognized retailer that operated approximately 370 retail and outlet stores throughout the United States and Canada prior to its bankruptcy filing. In June 2009, Eddie Bauer was sold as a going concern to Golden Gate Capital, a San Francisco private equity firm, for $286 million plus the assumption of hundreds of millions of dollars in liabilities. The sale kept open 336 of Eddie Bauer's 370 stores. Cooley currently represents the liquidating trustee appointed under the confirmed chapter 11 plan in connection with the wind down of the estate and the claims reconciliation process.

***In re Ritz Camera Centers, Inc.*, Case No. 09-10617 (Bankr. D. Del. 2009)** As counsel to the official committee of unsecured creditors in the Ritz Camera Centers bankruptcy, Cooley actively negotiated a sale of substantially all of Ritz's assets to RCI Acquisition, LLC. Prior to the sale and partial liquidation, Ritz Camera was considered America's largest camera store chain with more than 1,000 store locations spread across

CREDITORS LACK STANDING

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assignee" of the LLC. The Court contrasted this with section 327 of the Delaware General Corporation Law, which provides that stockholders of corporations can sue derivatively, but not to the exclusion of other potential plaintiffs.

The Court also considered comparable provisions of the Delaware Limited Partnership Act (the LP Act) and the origins of LLC and limited partnership standing provisions. The Court found that the LP Act, upon which the LLC Act is modeled, provides that only limited partners can bring derivative actions against limited partnerships. The Court likewise concluded that the origins of the LLC Act suggest an intent to confer derivative standing exclusively to members or assignees of LLCs.

Finally, the Court addressed CML's argument that a plain meaning interpretation of the LLC Act generates an absurd distinction between insolvent corporations, where creditors can sue derivatively, and insolvent LLCs, where they cannot. The Court disagreed, reasoning that there is nothing absurd about different legal principles applying to corporations and LLCs. The Court further recognized that the LLC Act itself offers creditors certain protections, including the potential for members to be held personally liability for obligations of the LLC under certain circumstances. Moreover, an LLC creditor may seek appointment of a receiver and may possess a statutory right to enforce a member's obligation to contribute to the LLC.

The *CML* decision clarifies that unlike creditors of Delaware corporations, creditors of Delaware LLCs are statutorily barred from prosecuting breach of fiduciary duty claims against members or managers of such companies. Creditors of LLCs should be mindful of this decision and the need to affirmatively protect themselves when transacting with limited liability companies. •

LEHMAN – IMPROPER SETOFF

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setoff rights against property of the estate should tread with extreme caution. The prudent course of action is to first seek and obtain the prior approval of a bankruptcy court. BofA did not heed this approach, and its decision to act without court authority based on a novel and untested interpretation of the Bankruptcy Code may ultimately result in the levy of significant sanctions by the Court. •

ORDINARY COURSE DEFENSE

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that the identity of the party who instigates an acceleration in payment terms is irrelevant because the ordinary course of business analysis is not limited to the creditor's actions, but also implicates the circumstances surrounding the debtor's actions. The Court concluded that the relationship between the parties changed after the supplier's electronic fund request was refused and the advance payments began.

The *Valley Petroleum* decision is a useful reminder to creditors that any change in payment terms during the 90 days preceding a debtor's bankruptcy filing—including changes that are not made at the creditor's behest—will be carefully scrutinized by bankruptcy courts when analyzing an ordinary course of business defense to preference avoidance. •

SUBSTANTIVE CONSOLIDATION

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sary proceedings, Huntington Bank requested that the estates of Cyberco and Teleservices be consolidated into a single estate, hoping that the result would be a reduction in what the trustees could claim it must return in connection with the avoidance actions.

A Statutory Predicate for Substantive Consolidation

In addressing the bank's motion, Judge Hughes reviewed the development of substantive consolidation jurisprudence during the period prior to the enactment of the Bankruptcy Code, discussing at length the seminal pre-Code cases of *Sampsell v. Imperial Paper & Color Corp.*,313 U.S. 215 (1941), *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845 (2d Cir. 1966), *Maggio v. Zeitz*, 333 U.S. 56 (1947), *Fish v. East*, 114 F.2d 177 (10th Cir. 1940) and *Stone v. Eacho (In re Tip Top Tailors*, 127 F.2d 284 (4th Cir. 1942) among others. Judge Hughes noted that, like the Bankruptcy Code, the Bankruptcy Act of 1898 vested title to all of the bankrupt's property in the trustee. However, unlike the Bankruptcy Code, the Act also included property that the debtor had fraudulently transferred to third parties prepetition in its definition of property of the estate. The pre-Code substantive consolidation decisions revealed to the court that the exercise of combining another entity's assets with those of the bankruptcy estate's through a turnover proceeding was a generally accepted and "appropriate 'judicial innovation' under the Act to accomplish the intended consolidation." *Id.* at *46. (citations omitted).

The court's recognition of the essence of this pre-Code practice was significant because the concept of turnover is not a "judicial innovation" under the modern-day Bankruptcy Code. Indeed, section 542(a) of the Code provides, in part, that "an entity, other than a custodian, in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363…shall deliver to the trustee, or account for, such property or the value of such property[.]" 11 U.S.C. § 542(a). Accordingly, Judge Hughes concluded, in stark contrast to the general view of modern courts regarding substantive consolidation, that the plain meaning of section 542 is informed by the pre-Code substantive consolidation decisions, and provides a statutory predicate for the doctrine under the Bankruptcy Code. In so doing, the court characterized the consolidation of distinct entities as a continuation of the pre-Code court's exercise of its summary jurisdiction in turnover actions over all property of the estate, regardless of whether such property was held by the debtor or a distinct and separate corporate entity. The court noted that this result was far superior to reliance on equitable principles for the availability of the substantive consolidation remedy, which it remarked "flies in the face of the oft repeated admonition that 'whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code.'". *Id.* at *51 (citing *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988) among other cases).

The Court then observed that while section 542 provided a basis for how and when a targeted entity's assets could become part of a bankruptcy estate, that section did not address the related question of what is to be done with the creditors of the targeted entity, and noted that equity suggested that some provision be made for these creditors. The court found a source for such relief in section 502(j) of the Bankruptcy Code, which in pertinent part, provides that a claim that has been allowed or disallowed "may be reconsidered for cause. A reconsidered claim maybe allowed or disallowed according to the equities of the case[.]"

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45 states. As a result of the sale, RCI continued operating approximately 400 stores across the United States. The committee then became a co-proponent of a confirmed plan of liquidation, pursuant to which Cooley was appointed counsel to the plan oversight committee and the plan trustee. Cooley is currently assisting the Trustee in liquidating the remaining assets of the estate in order to fund a distribution to general unsecured creditors.

***In re Filene's Basement, Inc., et al.*, Case No. 09-11525 (Bankr. D. Del. 2009)** As counsel to the post-effective date committee, Cooley continues to oversee the reconciliation of claims and distribution of the proceeds from the sale of substantially all of the assets of Filene's to Syms Corp. and Vornado Realty Trust. Buoyed by a 3-day auction which produced a sale price of approximately $63 million—a figure almost 300% higher than the stalking horse bid—distributions to general unsecured creditors are on course to exceed 75% of their allowed claim.

***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. Cooley's investigation of the leveraged recapitalization of Boscov's resulted in a Court-approved settlement, which enhanced the recovery for unsecured creditors. The debtors' plan was confirmed in September 2009, and the liquidating trustee has commenced the claims reconciliation process with an eye towards making an initial distribution to unsecured creditors by the middle of 2011.

***In re Gottschalk's, Inc.*, Case No. 09-10157 (Bankr. D. Del. 2009)** Founded in 1904, Gottschalk's, Inc. operated 50

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full-line department stores and three specialty stores in six western states. Cooley, on behalf of the creditors' committee, played a key role in maximizing value for unsecured creditors by negotiating a stalking horse asset purchase agreement for the sale of the debtor's inventory, fostering a robust auction for the conduct of going out of business sales, negotiating agreements for the sale of Gottschalk's lease portfolio and owned real property, and developing the terms of a plan of liquidation that will ensure a meaningful distribution to unsecured creditors. The debtor's plan of liquidation was filed in early December 2009, and is likely to become effective in February 2011.

***In re G.I. Joe's Holding Corp., et al.*, Case No. 09-10713 (Bankr. D. Del. 2009)** Cooley represents the official committee of unsecured creditors of G.I. Joe's Inc., a sporting goods retailer which operated 31 stores in Washington, Oregon and Idaho prior to its chapter 11 filing in March 2009 and subsequent liquidation. G.I. Joe's filed its chapter 11 case with substantial first and second lien secured debt that will not be paid in full from the proceeds of the company's store closing and intellectual property sales. Nevertheless, the committee was successful in achieving a significant "carve out" from the secured lenders' collateral among other concessions made at the outset of the case. In March 2011, the court approved a structured dismissal of the case providing for a distribution to unsecured creditors while insulating them from potential preference liability.

***Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities, LLC*, Adv. Proc. No. 08-1789 (Bankr. S.D.N.Y. 2008)** Cooley has provided ongoing legal advice to various foreign institutions regarding potential

MAKE-WHOLE AND NO-CALL PROVISIONS continued from page 3

decided an appeal of *Calpine* and refused to allow the unsecured "dashed expectation" claims awarded to bondholders by the bankruptcy court. *HSBC Bank USA, Nat'l Ass'n v. Calpine Corp.*, No. 07-civ-3088 (GBD), 2010 WL 3835200 (S.D.N.Y. Sept. 15, 2010). The District Court reasoned that no-call provisions are unenforceable in bankruptcy and refused to allow the bondholders' unsecured claims. In deciding *Chemtura*, Judge Gerber considered all of the cases discussed above, but was not bound by any of them in making his decision. Judge Gerber was merely tasked with determining whether the settlement before him was reasonable. After considering the applicable cases, Judge Gerber approved the settlement, which provided value to the bondholders for damages stemming from breach of the no-call provisions.

The importance of the *Chemtura* opinion goes well beyond mere settlement approval because it sets forth what Judge Gerber believes to be the proper analysis for determinations on claims involving make-whole or no-call provisions under the Bankruptcy Code. According to Judge Gerber, a two-step analysis is necessary. First, the bond indenture provisions must be analyzed under applicable non-bankruptcy law to determine whether they were breached and, if so, how the damages should be calculated. Judge Gerber indicates that this analysis could result in a court disregarding a contractual make-whole payment formula if the court deems it to amount to a penalty inconsistent with applicable state law. Second, and most importantly, bankruptcy law must be applied to determine whether claims for damages should be allowed at all. For Judge Gerber, a distinction should be made between solvent and insolvent debtors when enforcing no-call and make-whole provisions. When the debtor is solvent, as was the case in *Chemtura* and *Calpine*, issues relating to fairness among creditors no longer apply—that is all of the creditors, including the claims of general unsecured creditors will be paid in full.

The *Chemtura* opinion leaves open an important question: whether claims concerning no-call and make-whole provisions are allowable in the more common chapter 11 cases where the debtor is *insolvent*. In *Chemtura*, Judge Gerber expressed the view that prepayment damage claims triggered by early payment in bankruptcy may amount to unmatured interest, for which claims are not allowed pursuant to section 502(b)(2) of the Bankruptcy Code. Judge Gerber admits that the cases are split on this issue, but explains that he might be inclined to side with the minority of cases which hold that make-whole premiums and damages for breaches of a no-call provisions are proxies for unmatured interest that must be disallowed under the Bankruptcy Code. Where the debtor is insolvent, allowance of prepayment penalty claims comes at the direct expense of other creditors in the case —an outcome which Judge Gerber appears to find objectionable. It remains to be seen whether Judge Gerber's reasoning will persuade other bankruptcy judges to view make-whole and no-call claims through a more equitable prism. •

WARN ACT EXCEPTIONS cont. from page 5

or would be insufficient to satisfy Flexible Flyer's capital needs.

Relying heavily on the testimony of Flexible Flyer's CFO, the Court concluded that had the company actually provided termination notice in accordance with the WARN Act, it would have irreparably harmed its future prospects—the precise result which the WARN exceptions were created to avoid. It remains to be seen whether other courts will endorse the rationale of this decision or continue the more traditional approach of applying the WARN exceptions only in the rarest instances. •

DIP FACILITY DENIED continued from page 7

Tamarack should remain in bankruptcy, and the case was ultimately converted into a reorganization under chapter 11. At first, Tamarack maintained limited operations at the Resort by using a small portion of the lenders' cash collateral. After months of unsuccessful efforts to sell itself, Tamarack sought court approval of a $2 million dollar DIP loan to be provided by an investment group represented by Credit Suisse.

Two facets of the proposed DIP facility drew the Court's ire. First, the proposal provided adequate protection to Credit Suisse in the form of a replacement lien and superpriority claim, while providing no such protection to the other prepetition lenders. Second, the proposal set a very strict, and in the Court's opinion, unrealistic, sale timeline. Specifically, while the loan would not mature for six months, Credit Suisse would be empowered to call a default under the proposed DIP facility if Tamarack failed to have sale procedures approved by the Court within 30 days of the Court's approval of the DIP facility.

In order for a court to approve a priming lien such as the one sought by Credit Suisse to secure the proposed DIP facility, the court must find that the debtor (i) could not obtain credit without priming the prepetition lenders and (ii) that there is adequate protection for the lienholders who are being primed by the postpetition facility. The Court concluded that neither requirement was met. The Court concluded that Tamarack did not meet its burden of proving that it made a sufficient effort to find financing on superior terms, and found that Tamarack failed to provide any evidence that the other prepetition lenders would be protected to the same extent as if the DIP loan was not made. At the core of the decision was the Court's belief that the terms of the proposed DIP facility preordained a default by Tamarack that would inequitably augment Credit Suisse's collateral position at the expense of the other prepetition lenders.

For a variety of reasons, this case may well be a one-off decision. In most cases, DIP facilities are proposed at the very outset of the case, at which time the bankruptcy court is provided with little time and information to process the various interests at stake in the case. Bankruptcy courts are often reluctant to test the debtor's judgment that the company will not survive without the financing and employees will lose their jobs. These consequences did not phase the *Tamarack* Court, who did not consider the proposed DIP facility until months into the case and, only three months following its decision to deny the facility, dismissed the bankruptcy case, leaving the resolution of Tamarack to state court proceedings. Nonetheless, the *Tamarack* case is a notable example of judicial scrutiny over some of the more traditionally onerous provisions of postpetition financing agreements. •

IN THE NEWS continued

claims by the trustee appointed in the Madoff Ponzi scheme litigation, and potential claims related to certain "feeder funds" that were invested in Madoff funds. Cooley has advised its clients with respect to a wide variety of substantive and procedural aspects of U.S. bankruptcy and other laws.

Bankruptcy & Restructuring Event Calendar
Spring 2011 Speaking Appearances

Event	Date/Location	Cooley Participant/Topic
19th Annual Hon. Conrad B. Duberstein Gala Awards Banquet	March 7, 2011 (New York, NY)	Jay Indyke, Jim Beldner, Cathy Hershcopf
Credit Research Foundation's Credits and Accounts Receivable Forum	March 7-9, 2011 (San Diego, CA)	Larry Gottlieb, Jeffrey Cohen
Turnaround Management Association Spring Conference	April 28, 2011 (Chicago, IL)	Jay Indyke (Speaker: "Restructuring Trends: Turnarounds at the Onset of Recovery.")
American Bankruptcy Institute's Spring Meeting	March 31-April 3, 2011 (National Harbor, MD)	Jeffrey Cohen (Speaker: "Is Social Networking Good Marketing and Is the Power of the Internet Changing How to Chase Committees?")
23rd Annual California Bankruptcy Forum Insolvency Conference	May 20-22, 2011 (San Francisco, CA)	Keith McDaniels (Speaker: "Protecting Your Firm From Preference Exposure on Pre-Petition Payments")

WAMU COURT REJECTS BANKRUPTCY PLAN continued from page 9

Airlines), 203 F.3d 203, 212 (3d Cir. 2000) (stating that non-consensual releases by a non-debtor of other non-debtor third parties are to be granted only in extraordinary circumstances) and *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136 (2d Cir. 2005) (ruling that such releases should be approved only in truly unusual cases, and only after the trial court makes detailed findings that the release itself is important to the success of the plan of reorganization)). The Court further noted that, under controlling precedent, it lacked the authority to grant a third party release absent the third party's consent. *Id.* (citing cases).

As an initial matter, the Court concluded that the modifications to the Plan release language made by the Debtors in response to the objections were ineffective because the third party releases were not modified in the Settlement itself, and the Plan provided that the Settlement controlled in the event of a conflict between the Plan and the Settlement. Accordingly, the Court ruled that Plan must be modified to provide that the Plan language controlled in the event of any conflict with the terms of the Settlement. The Court then turned to the Debtors' modification of the "opt out" mechanism proposed by the Debtors, and concluded that it was insufficient to support the release. The Court was particularly troubled by the Debtors' effort to enforce the releases against those who had not voted on the Plan, as it found that the failure to return a ballot was not a sufficient manifestation of consent to a third party release. Therefore, the Court concluded that the third party releases were effective only with respect to those who affirmatively consented by voting in favor of the Plan and not opting out of the releases. *Id.* at *33. Finally, and consistent with its ruling with respect to the debtor releases, the Court concluded that there was no basis for third party releases of the directors and officers, even if the release was limited to postpetition conduct, because the only contribution made by them was the negotiation of the Settlement and Plan, actions required of them as fiduciaries. *Id.* at *32.

On February 8, 2011, the Debtors submitted an amended plan that, among other things, scaled back the broad releases that compelled the Court to deny confirmation of the Plan. While the Debtors may ultimately obtain confirmation of the revised plan, the Court's ruling serves as a reminder that overreaching releases can be fatal to a successful plan confirmation. Parties that become actively involved in a bankruptcy proceeding, including a debtor's officers and directors, members of the statutory committees and estate professionals, should not take for granted that they will receive the protection of sweeping releases once all disputed issues in a case are resolved. Even in instances where the releases are an important component of the settlement that forms the basis of the plan itself and provides the source of the distributions proposed to be made to creditors thereunder, the Court will closely scrutinize the consideration provided by the releases party, and will likely deny confirmation if releases are granted to parties that did not make a substantial contribution to the debtor's reorganization or seek to bind third parties without their affirmative consent. •

SUBSTANTIVE CONSOLIDATION continued from page 13

11 U.S.C. § 502(j). The court opined that equitable principles would permit a creditor of a non-debtor entity to assert a claim in a bankruptcy whenever there has been a seizure by the bankruptcy estate of the assets of the entity against whom the creditor originally possessed a claim.

Does Cyberco Expand or Restrict the Applicability of Substantive Consolidation?

By concluding that the doctrine of substantive consolidation is nothing more than a modern iteration of the pre-Code practice of courts exercising their summary jurisdiction over all "estate" property through turnover proceedings, the *Cyberco* decision is a significant and noteworthy addition to contemporary substantive consolidation jurisprudence. However, the impact of this decision on the availability of the remedy in future cases is uncertain. At first glance, it appears that by relying on Code provisions instead of on amorphous equitable principles as a basis for substantive consolidation, the *Cyberco* decision will further legitimize the doctrine and lead to an increase of consolidations in future cases. To the contrary, the Court's application of its analysis to the facts in *Cyberco* demonstrates that the decision may actually represent a severe restriction on the availability of the substantive consolidation remedy going forward.

Indeed, Judge Hughes ultimately ruled that Huntington Bank was without standing to seek consolidation of the Cyberco and Teleservices estates because, under section 542 of the Code, only the trustee of the estate, as opposed to a creditor of the debtor, may initiate an action for turnover of estate assets. *Cyberco*, 2010 Bankr. LEXIS at *82-*83 (citing cases). Thus, under *Cyberco*, substantive consolidation may not be an available remedy to creditors in all chapter 11 cases in which the debtor is continuing to manage its affairs and operate its business as a debtor in possession. This holding, if followed, may result in *fewer*, not more, substantive consolidations, as it bars creditors from utilizing the doctrine to bring assets into an estate that may have been secreted prepetition by a debtor-in-possession to one of its non-debtor affiliates. •