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Cooley LLP

Current Developments in Bankruptcies and Workouts to Keep You Ahead of the Curve
from the Cooley Bankruptcy And Restructuring Group

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from the editor

JEFFREY L. COHEN

Bankruptcy courts continue to define and redefine the rights of creditors in chapter 11 cases, whether at the plan stage or in the prosecution of estate causes of action as illustrated by the recent decisions discussed in this issue. In just the few months that followed our previous publication, the Second Circuit has rejected the concept of "gifting" to unsecured creditors under a plan, while a SDNY bankruptcy court refused to apply the so-called "settlement payment defense" to shield from avoidance transfers involving the purchase and sale of privately held securities. Also included in this issue are discussions of the Third Circuit's rejection of a Delaware bankruptcy and district courts' application of *res judicata* against the plan administrator in the *Montgomery Ward* case and a SDNY bankruptcy court decision to green-light the *Madoff* trustee's actions against Ezra Merkin and several affiliated "feeder funds."

So, in other words, it's a great time for the Summer 2011 edition of *Absolute Priority*… As you have probably already noticed, in this issue we proudly unveil our new electronic format—redesigned for your reading pleasure! As always, the Cooley bankruptcy group has been busy representing creditors' committees in most of today's prominent 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.

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

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Third Circuit Strikes Down Application Of *Res Judicata* Against Plan Administrator In Successor Bankruptcy Case

In *In re Montgomery Ward, LLC*, 2011 WL 801981 (3d Cir. March 9, 2011), the United States Court of Appeals for the Third Circuit recently held that the debtor's plan administrator in a successor chapter 11 case, was not a "party in privity" to the debtor's initial chapter 11 case and was therefore not precluded from challenging the true nature of a so-called lease by the doctrine of claim preclusion, also called *res judicata*, notwithstanding the fact that the lease had been assumed by the plan administrator's predecessor-in-interest in the debtor's initial bankruptcy case. *Res judicata* bars the re-litigation of a claim if there has been a final judgment on the merits rendered in a prior suit involving the same claim and the same parties or their privies.

Montgomery Ward, LLC (Ward), one of the largest retailers in the United States prior to its bankruptcy filings, filed for bankruptcy protection on July 7, 1997 (Ward I) and subsequently emerged from chapter 11 in 1999 pursuant to a confirmed plan of reorganization. Less than 18 months following its emergence, Ward again filed for chapter 11 protection to liquidate substantially all of its assets (Ward II). Cooley acted as counsel to the official committee of unsecured creditors in Ward's successor chapter 11 case and, subsequently, to the plan administrator.

At the center of the dispute concerning the nature of the lease at issue was a transaction by and among Ward, Jolward Associates Limited Partnership and State Farm Life Insurance Co. that was consummated prior to the first bankruptcy filing, pursuant to which Ward leased a parcel of land in Joliet, IL to Jolward, who agreed to construct a department store for Ward's benefit. State Farm provided Jolward with a construction loan, which was evidenced by a non-recourse note, secured solely by a mortgage on the department store being built by Jolward. After the department store was built, Jolward leased the store to Ward and also subleased the underlying land back to Ward.

The Jolward lease was assumed in Ward I and all defaults existing under the lease at the time of the assumption were cured. But in Ward II, the Jolward lease was rejected, causing State Farm to file a claim on account of the unpaid note and Jolward to file a lease rejection damage claim. Both of these claims were ultimately purchased by an entity named Dika-Ward LLC.

The plan administrator objected to the Jolward claim, asserting that the lease was a structured financing agreement and not a true lease. As a non-recourse financing arrangement, the plan administrator argued that Dika-Ward's sole remedy was against the collateral that secured the financing (i.e., the department store) and was contractually prohibited from seeking remuneration from other assets of the Ward II estate.

Dika-Ward argued that the plan administrator was barred by principles of *res judicata* from challenging the nature of the lease in view of the fact that the Ward I debtor had previously affirmed the nature of the Jolward lease when it elected to assume the lease in the initial bankruptcy proceeding. Although *res judicata* does not typically apply when the party to be bound in the second case was not a party to the first case, courts have recognized limited circumstances where a non-party to the first case may be bound in the second case by an action taken in the first case where the non-party's interests were adequately protected. Accordingly, the dispute concerning the application of *res judicata* to the plan administrator's challenge focused on whether the plan administrator's interests were adequately protected by the Ward I debtor in the first bankruptcy proceeding. The Bankruptcy Court for the District of Delaware found that the plan administrator's interest had in fact been

ANALYSIS BY JAY R. INDYKE

The Third Circuit's decision will undoubtedly encourage trustees and plan administrators in serial bankruptcy proceedings to maximize value for all creditors by challenging earlier decisions made or actions taken by a debtor, particularly where the debtor's rationale for the action or decision is at odds with the trustee or plan administrator's goal of marshaling value for creditors.

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

protected by the Ward I debtor and granted summary judgment in favor of Dika-Ward. The Bankruptcy Court's judgment was affirmed on appeal by the Delaware District

Unlike the Ward I debtor, the Ward II plan administrator was charged with maximizing the value of a *liquidating* estate for the benefit of all creditors, and was therefore uniquely incentivized to pursue litigation having the potential to augment the pool of funds available for distribution to unsecured creditors.

Court. The plan administrator appealed the decision to the Third Circuit.

The Third Circuit overturned the lower court rulings and remanded the case back to the Bankruptcy Court to determine whether the Jolward lease was a true lease or a structured financing. The Third Circuit concluded that while a relationship between a successor-in-interest and its predecessor may trigger an application of *res judicata* in certain instances, the interests of the Ward II plan administrator and Ward I debtor were not sufficiently aligned to justify a finding that the plan administrator's interests in the determination of the nature of the Jolward lease had been adequately protected by the Ward I debtor in the first bankruptcy proceeding. Accordingly, the Third Circuit refused to apply principles of *res judicata* to preclude the plan administrator from challenging the nature of Jolward lease in the second bankruptcy proceeding.

The Third Circuit compared the relationship between the Ward II plan administrator and the Ward I debtor to that of a bankruptcy trustee and a debtor in possession, noting that the bankruptcy trustee is not simply a successor-in-interest to the debtor. A bankruptcy trustee has an obligation to represent the interests of a debtor's creditors, and that interest may sometimes differ from the interests of a debtor, particularly one that is pursuing a reorganization of its business. The Third Circuit illustrated this distinction by pointing to the well-recognized bankruptcy law principle that a debtor's decision to not prosecute preference actions against its creditors does not preclude such prosecution by a subsequently appointed trustee. The interests of a subsequently appointed trustee, as the representative of the debtor's creditors generally, may well contradict the interests of a debtor in possession in preserving its business relationships in furtherance of a reorganization process.

Unlike the Ward I debtor, the Ward II plan administrator was charged with maximizing the value of a *liquidating* estate for the benefit of all creditors, and was therefore uniquely incentivized to pursue litigation having the potential to augment the pool of funds available for distribution to unsecured creditors. The Third Circuit concluded that these contrasting motivations barred application of *res judicata* against the plan administrator and remanded the case to the Bankruptcy Court for a determination of the plan administrator's claim objection on the merits.

The Third Circuit's decision is one of only a few appellate decisions determining who is and is not a "party in privity" for *res judicata* purposes in the context of a bankruptcy case. •

IN THE NEWS

CASE:

***In re Metropark USA, Inc.*, Case No. 11-22866-RDD (Bankr. S.D.N.Y. 2011)**

COOLEY REPRESENTATION:

Counsel to the debtor, Metropark USA, Inc.

RESULT:

Cooley is counsel to Metropark, a 70-store retail clothing chain, in connection with its May 2, 2011 chapter 11 filing and the successful disposition of substantially all of its assets, including more than 40 of its unexpired real property leases. During the first days of the case, Cooley auctioned Metropark's inventory and received Bankruptcy Court approval to conduct going out of business sales in all of Metropark's locations. Shortly thereafter, Cooley conducted a lease auction that generated over $1.5 million in proceeds for Metropark's estate. Cooley continues to advise Metropark as it winds down its affairs.

» *View the other current Cooley representations on page 15.*

Second Circuit Curbs "Gifting" Under Chapter 11 Plan

The so-called "absolute priority" rule establishes a hierarchy of bankruptcy claims and interests and is codified as part of the "fair and equitable" requirement of plan confirmation in 11 U.S.C. § 1129. Pursuant to section 1129(b)(2)(B) of the Bankruptcy Code, a plan is not "fair and equitable" unless, with respect to a class of unsecured claims, (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property. In other words, the Bankruptcy Code prohibits confirmation of a plan of reorganization that provides for a distribution of property to the holders of any junior claims or interests unless and until all classes of senior claims either receive the full value of their claims or consent to the plan.

The Code does not, however, explicitly address the applicability of the absolute priority rule outside of a plan of reorganization—a statutory ambiguity which frequently arises in cases involving the concept of "gifting," as it has come to be known in bankruptcy parlance. Gifting among different classes of creditors most commonly refers to the carving-out by a senior creditor of a portion of its collateral for the benefit of one or more junior claimholders. Gifting is often utilized by senior, typically secured, creditors, as a tool to resolve the opposition of a junior, often out-of-the-money class of creditors, to the manner in which the bankruptcy case is being administered. For instance, gifts are often sought by creditors' committees to guarantee a recovery for unsecured creditors in cases where the debtors' administrative solvency and ability to meet the requirements of section 1129 and confirm a chapter 11 plan are in doubt. In exchange for this guaranteed recovery for unsecured creditors, committees often agree to resolve their objections to the secured lender's control over the chapter 11 process, thereby providing the lender with the flexibility needed to administer the chapter 11 process and liquidate its collateral in a manner that best serves the lender's own self-interest.

> The Second Circuit instead reasoned that the section 1129(b)(2)(B)(ii) of the Bankruptcy Code extends the absolute priority rule to 'any property,' not 'any property' not covered by a senior creditor's lien."

Recognizing these benefits to creditors who, in many cases, would not otherwise receive distributions, a series of decisions by the Delaware bankruptcy courts have affirmed the legality of gifting outside of a chapter 11 plan and have permitted secured lenders and third-party purchasers to provide "gifts" to general unsecured creditors where the strong likelihood of administrative insolvency dictated that unsecured creditors were not otherwise likely to receive a distribution.

Although the concept of gifting has been addressed by numerous bankruptcy courts throughout the country, there is limited Appellate law addressing the issue. Most recently, on February 7, 2011, the United States Court of Appeals for the Second Circuit issued an opinion in the *In re DBSD North America, Inc.* case, 634 F.3d 79 (2d Cir. 2011), concluding that section 1129 of the Bankruptcy Code was violated where a chapter 11 plan provided for gifting by a secured creditor to a prepetition equity holder without the consent of all intervening and impaired classes.

In *DBSD*, Sprint, an impaired unsecured creditor, objected to a gift proposed to be made by certain secured creditors to DBSD's prepetition equity holder. It was undisputed that the secured creditors held valid liens securing property that was worth less than the amount of the secured creditors' claims.

ANALYSIS

BY CATHY HERSHCOPF

Although the Second Circuit was careful to avoid expressly rejecting the jurisprudence approving gifting outside of a chapter 11 plan, the analysis employed in the *DBSD* decision may nevertheless implicitly reject certain legal bases used by courts to approve gifts to unsecured creditors outside of a plan. This harsh reality may be avoided if subsequent decisions clarify that the Second Circuit's interpretation of "property", as the term is used in section 1129(b) of the Bankruptcy Code, does not apply outside of a plan of reorganization. Such a conclusion would make it clear that in cases where a senior lender carves out a portion of its collateral for the benefit of a junior claimholder, no *estate* property is at issue. This would ensure that gifting outside of a plan remains a viable tool for parties seeking the consensual resolution of difficult bankruptcy cases.

Under the plan, which provided the secured creditors with the bulk of the equity in the reorganized company, unsecured creditors were to receive .15% of the equity, while a prepetition shareholder—an interest junior to general unsecured claims—was to receive 4.99% of the equity in the reorganized company. The Second Circuit concluded that the existing shareholder received property under the plan on account of its existing interest, and since Sprint was both impaired and senior to the existing shareholder, the plan violated the absolute priority rule.

While the Second Circuit expressly limited its holding to gifting under a chapter 11 plan—reasoning that it "need not decide whether the Code would allow the existing shareholder and [secured lenders] to agree to transfer shares *outside* of the plan"—the Second Circuit's legal reasoning is arguably at odds with recent bankruptcy court decisions permitting gifting outside of a plan of reorganization. *Id.* at 95 (emphasis added). Specifically, the Second Circuit dismissed the argument that the absolute priority rule is not implicated where a debtor is unable to pay secured creditors in full because the "gift" to unsecured creditors could never impact creditors of higher priority. The Second Circuit instead reasoned that the section 1129(b)(2)(B)(ii) of the Bankruptcy Code extends the absolute priority rule to 'any property,' not 'any property' not covered by a senior creditor's lien." *Id.* at 97-98. What matters, the Second Circuit explains, is not who *would* receive property under a plan, but who actually *does* receive it under a plan.

The broad scope of the Second Circuit's definition of "property" potentially runs counter to conclusions reached by the Third Circuit in *In re Armstrong World Industries, Inc.*, 432 F.3d 507 (3rd Cir. 2005), and subsequent bankruptcy cases approving gifting outside of a plan. In *Armstrong*, the proposed plan provided that in the event that a class of general unsecured creditors were to reject the plan, then another class of general unsecured claimants (asbestos personal injury claimants), would receive, but then immediately waive receipt of, certain warrants, with the end result being that the warrants would be issued to a class consisting of old equity. While the Third Circuit concluded that such a plan violated the absolute priority rule, it reasoned that a carve out from the collateral of a secured creditor for the benefit of a junior claimant would not offend the absolute priority rule because the property belongs to the secured creditor—not the bankruptcy estate. *Id.* at 514; see also, *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993) (permitting a secured creditor to share any proceeds it ultimately received with general unsecured creditors even though priority claims were unlikely to be paid in full).

Bankruptcy courts have commonly relied on this distinction to approve gifting by secured creditors outside of a plan of reorganization. For instance, in *In re World Health Alternatives, Inc.*, 344 B.R. 291 (Bankr. D. Del. 2006), Judge Walsh approved a settlement in which the creditors' committee agreed to forbear from prosecuting an objection to sale procedures in exchange for a carve out from the DIP facility for the benefit of general unsecured creditors, even though administrative claims would not recover in full. Judge Walsh relied on the existence of three conditions: (1) the dispute arose outside a plan context, (2) the gift was carved out from a secured creditor's perfected security interest which was not subject to distribution under the Code's priority scheme, and (3) the gift was a 'carve out' where a party whose claim is secured by assets in the bankruptcy estate allowed a portion of its lien proceeds to be paid to others. *Id.* at 298. Similarly, in *In re TSIC, Inc., f/k/a Sharper Image Corporation*, 393 B.R. 71 (Bankr. D. Del. 2008), Judge Gross approved a settlement pursuant to which the purchaser of Sharper Image gave a gift to general unsecured creditors in exchange for the creditors' committee's agreement to waive its right to challenge the sale. Judge Gross concluded that the absolute priority rule would not apply in this situation because the property being paid to the unsecured creditors was not part of the estate. *Id.* at 75-76. •

IN THE NEWS

CASE:

***In re Mervyn's Holdings LLC, et al.*, Case No. 08-11586 (Bankr. D. Del. 2008)**

COOLEY REPRESENTATION:

Counsel to the official committee of unsecured creditors.

RESULT:

Cooley, on behalf of the creditors' committee, currently represents Mervyn's in the pursuit of a complex $1.2 billion litigation against Target Corporation, Goldman Sachs, Cerberus, Sun Capital, Klaff Realty, Lubert Adler and others who participated in the 2004 sale of Mervyn's and the simultaneous stripping away of Mervyn's valuable real estate assets to the detriment of the retailer's creditors. The litigation is currently in the discovery phase and depositions are scheduled to begin in January 2012.

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UPCOMING

Cooley partner **Larry Gottlieb** will be speaking at the **Credit Research Foundation's Credits and Accounts Receivable Forum**, August 15–17, 2011, in Chicago.

» *View the complete Bankruptcy & Restructuring Event Calendar on page 10*

SDNY Bankruptcy Court Excludes Private Stock Transfers From Section 546(e) Safe Harbor

Section 546(e) of the Bankruptcy Code provides a "safe harbor" for certain transfers involving the purchase and sale of securities and protects those transfers from avoidance as preferences or fraudulent conveyances. Specifically, section 546(e) insulates transfers that are "settlement payments" used in the securities trade, as well as other transfers made to or from certain parties, including financial institutions, financial participants and stockbrokers, in connection with a securities contract.

Notwithstanding legislative history indicating that the purpose of the safe harbor of section 546(e) is to promote the stability of the *public* markets, some courts have broadly interpreted section 546(e) to shield a wide array of otherwise recoverable transfers in the context of private stock transactions. *See, e.g., Brandt v. B.A. Capital Co., L.P. (In re Plassein, Int'l Corp.)*, 590 F.3d 252, 258-59 (3d Cir.), *cert. denied*, 130 S.Ct. 2010 (2010) (upholding bankruptcy court's ruling that section 546(e) precluded a trustee from recovering transfers made to selling shareholders of a private company pursuant to a leveraged buy-out). Nonetheless, a growing number of courts have been persuaded to restrict section 546(e)'s safe harbor to only those transfers that pose a risk to the public securities markets. *See In re Norstan Apparel Shops, Inc., et al.*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007).

A recent ruling by United States Bankruptcy Judge Robert Drain in *In re MacMenamin's Grill Ltd.*, 2011 U.S. Bankr. LEXIS 1461 (Bankr. S.D.N.Y. April 21, 2011), is the latest example of this trend. MacMenamin's Grill was a restaurant and culinary institute located in New Rochelle, New York. As of August 31, 2007, each of MacMenamin's Grill's three major shareholders owned 31 percent of the outstanding shares of the restaurant. On that date, the three shareholders entered into a stock purchase agreement pursuant to which they collectively agreed to sell all of their shares back to the restaurant through a leveraged buyout transaction. Simultaneously, the restaurant entered into a loan agreement with TD Bank through which it borrowed the funds necessary to consummate the stock purchase agreement. Upon the closing of both transactions, the proceeds of the TD Bank loan were transferred directly from the bank to the shareholders' respective bank accounts. Owing in part to a decrease in business that began in 2006, MacMenamin's Grill filed for chapter 11 protection in November 2008, approximately one-year after the leverage buyout closed. Shortly after his appointment in March 2009, the operating trustee commenced an adversary proceeding seeking to avoid and recover as constructively fraudulent transfers pursuant to section 548 of the Bankruptcy Code and New York law the payments made to the shareholders, as well as the loan obligations undertaken by the company and the security granted to TD Bank in connection with the leveraged buyout transaction. Both the shareholders and TD Bank filed motions for summary judgment seeking to invoke the safe harbor provision of section 546(e) of the Bankruptcy Code to preclude recovery by the trustee.

Pursuant to section 548(a)(1)(B) of the Bankruptcy Code, a transfer of an interest in a debtor's property is deemed constructively fraudulent if, among other things, the debtor does not received reasonably equivalent value for the transfer and it is made at a time when the debtor is insolvent. Section 273 of the New York Debtor & Creditor Law similarly provides that "[e]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to actual intent if the conveyance is made or the obligation is incurred without fair consideration." NYD&CL § 273. In *MacMenamin's Grill*, the parties stipulated that the debtor was rendered insolvent by the stock sale transaction and that it did not receive reasonably equivalent value for the transfers made to the shareholders and TD Bank. Moreover, the parties did not dispute that the transfers at issue were made by and to "financial institutions" or that payments made to purchase stock may be viewed as a "settlement payment" for the purposes of section 546(e) of the Bankruptcy Code. Accordingly, the only issue before the Court on the defendants' motion for summary judgment was whether section 546(e)'s safe harbor was applicable to a *private* securities transaction so as to insulate the shareholders and TD Bank from recovery by the trustee.

In denying the defendants' summary judgment motion, Judge Drain acknowledged the division amongst courts that have considered the applicability of section 546(e) to private securities transactions. Courts

ANALYSIS

BY LAWRENCE GOTTLIEB

The *MacMenamin's Grill* decision also underscores how a debtor's bankruptcy court forum can impact creditor recoveries. The application of section 546(e)'s safe harbor has been far from uniform across jurisdictions and the extent to which it will insulate a particular transferee will depend as much on the venue of the bankruptcy proceeding as the nature of the transaction at issue.

that have extended the safe harbor in the private security context have done so based on the plain language of section 546, which precludes the trustee from avoiding "settlement payments…made by or to…a financial institution…in connection with a securities contract." See 11 U.S.C. § 546(e). The term "settlement payment" is defined in section 741 of the Bankruptcy Code as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment on account, a final settlement payment or any other similar payment commonly used in the securities trade." See 11 U.S.C. § 741. Judge Drain observed that notwithstanding the language of section 546(e), which contains no express limitation on the type of securities transactions covered by the safe harbor, a number of courts have interpreted section 546(e) more narrowly based on Congress's stated purpose of reducing risk in the public financial markets and their related complex clearing systems. See *MacMenamin's Grill*, 2011 Bankr. LEXIS 1461 at *11-*12 (citing cases). These decisions reason that granting transferees safe harbor in a constructively fraudulent private stock transaction has little, if anything, to do with Congress's stated intent in enacting section 546(e). *Id*. at *45 (citing *United States v. Ron Pair Enters*., 489 U.S. 235, 242 (1989) ("The plain meaning of legislation should be conclusive, except in the rare cases in which literal application of a statute will produce a result demonstrably at odds with the intention of its drafters. In such cases, the intention of the drafters, rather than the strict language, controls.").

For example, in *In re Norstan Apparel Shops, Inc.*, et al., 367 B.R. 68 (Bankr. E.D.N.Y. 2007) ("Norstan"), Chief Judge Carla E. Craig of the Bankruptcy Court for the Eastern District of New York was faced with a set of facts substantially similar to those in *MacMenamin's Grill* in an adversary proceeding prosecuted by Cooley on behalf of the creditors' committee against former shareholders who had received $55

Judge Drain joins a growing number of other courts to have narrowly interpreted the scope of section 546(e)'s safe harbor to protect creditors harmed by fraudulent transfers involving privately held companies.

million by wire transfer in exchange for their stock in the company. On motion to dismiss the committee's action, the former *Norstan* shareholders argued that the cash payments they received constituted unavoidable settlement payments under section 546(e) of the Bankruptcy Code. In denying the shareholders' motion to dismiss, Judge Craig rejected the argument that section 546(e) insulates private stock transfers, noting that "while the term 'settlement payment' as used in § 546(e) is to be read broadly, the term is not boundless." *Id*. at 76. Judge Craig further observed that section 546(e) was enacted by Congress "to minimize the displacement caused in the commodities and securities markets in the event [of] a major bankruptcy affecting those industries," and "to prevent the 'ripple effect' created by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry." Id. (internal quotations omitted). Finally, Judge Craig reasoned that if the term 'settlement payment' in section 546(e) is construed to encompass any payment made for securities, whether or not involving a public securities market, then any leveraged buyout, if structured as a direct purchase of stock from the shareholders would fall within section 546(e)'s safe harbor.

Citing *Norstan*, Judge Drain determined that in light of clearly stated legislative intent behind section 546(e) of the Bankruptcy Code, the defendants had failed to demonstrate how the private securities transactions at issue implicated the concerns voiced by Congress. Accordingly, the court concluded that the safe harbor of section 546(e) did not preclude the trustee's lawsuit against the shareholders or TD Bank. In so holding, Judge Drain joins a growing number of other courts to have narrowly interpreted the scope of section 546(e)'s safe harbor to protect creditors harmed by fraudulent transfers involving privately held companies. •

IN THE NEWS

CASE:

***In re Appleseed's Intermediate Holdings LLC, et al. d/b/a Orchard Brands*, Case No. 11-10160 (Bankr. D. Del. 2011)**

COOLEY REPRESENTATION:

Counsel to litigation trustee and oversight committee

RESULT:

In a complaint recently filed by Cooley, the litigation trustee asserts that the debtors' private equity sponsors loaded the debtors with secured debt and simultaneously paid themselves a $310 million dividend, constituting a fraudulent transfer which ultimately led to the bankruptcy filings.

» View the other current Cooley representations on page 15.

Bankruptcy Court Green Lights Madoff Trustee's Lawsuit Against Merkin-Managed Feeder Funds

In a decision that is sure to bolster the efforts of Irving Picard, the Trustee of the consolidated bankruptcy estates of Bernard L. Madoff and Bernard L. Madoff Investment Securities ("BLMIS"), to recover transfers made to investors in furtherance of Madoff's infamous Ponzi scheme, the United States Bankruptcy Court for the Southern District of New York recently ruled that the allegations contained in the Trustee's complaint alleging actual and constructive fraud against financier Ezra Merkin and several affiliated funds were sufficient to survive a motion to dismiss filed by Merkin and his co-defendants.

The Trustee's lawsuit seeks to avoid purportedly preferential and fraudulent transfers made to or for the benefit of Merkin, a sophisticated investment manager and financier with a longstanding business and social relationship with Madoff, and other defendants as initial or subsequent transferees under the actual and constructive fraud sections of the Bankruptcy Code and the New York Debtor & Creditor Law. Merkin's co-defendants include (i) Gabriel Capital, a $5 billion group of hedge funds that the Trustee alleges was dominated and controlled by Merkin; (ii) Ariel Fund Ltd., a mutual fund advised by Gabriel Capital; and (iii) Ascot Partners, a limited partnership in which Merkin was the sole general partner. Prior to 1995, Ariel, Gabriel and Ascot began investing heavily with Madoff, and ultimately placed over $1 billion into the Ponzi scheme. In so doing, Merkin and his affiliated entities served as one of the largest feeders of new capital to Madoff's criminal enterprise. The Trustee's complaint alleges that the defendants cashed out of the scheme at least 11 times during the six years prior to the commencement of the Madoff bankruptcy, with the sum of the withdrawals totaling approximately $494.6 million. Of these amounts, $313.6 million was transferred within two years of the Madoff bankruptcy filing and one payment of $45 million was made within 90 days of the filing.

The Trustee's complaint asserts that the defendants, either independently or through Merkin, were on notice of certain "red flags" regarding Madoff's fraudulent activities. Among other things, the Trustee alleges that:

- From 1995 to 2008 Ariel, Gabriel and Ascot received consistent annual returns of between 11% and 16% notwithstanding fluctuations in the stock market;
- The defendants' account statements reflected hundreds of trades exercised at prices outside the daily range possible for those securities;
- The defendants misled their investors as to Madoff's role in operating their accounts with BLMIS and sought to conceal that role;
- Merkin was warned by Wall Street professionals that Madoff's business appeared fraudulent; and
- Merkin had an unusually close relationship with Madoff, including serving together on the Board of Trustees of Yeshiva University, and had unique access to Madoff's business.

The Trustee also asserts that, as a result of the foregoing, Merkin proceeded in bad faith in conducting business with Madoff, and that Merkin's knowledge and lack of good faith are imputed to the other defendants by virtue of an agency relationship with Merkin. On their motion to dismiss the complaint, Merkin and his co-defendants argued that these allegations were not sufficient to sustain actual and constructive fraud claims.

In *Bernard L. Madoff Inv. Secs. LLC v. Merkin (In re Bernard L. Madoff Inv. Secs. LLC)*, 2010 Bankr. LEXIS 3875 at *17 (Bankr. S.D.N.Y. Nov. 17, 2010), the Court denied the motion to dismiss the actual and constructive fraudulent conveyance claims, finding that each is well-plead in the Trustee's complaint. With respect to actual fraudulent conveyances, section 548(a)(1)(A) of the Bankruptcy Code provides, in pertinent part, that a trustee acting for the debtor may avoid "a transfer of an interest of the debtor in property, or any obligation incurred by the debtor" if the debtor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." Similarly, under section 276 of the New York Debtor & Creditor Law, every conveyance that is made or every obligation that

ANALYSIS

BY

RONALD SUSSMAN

In essence, the Court ruled that the trustee had asserted sufficient facts to allege that sophisticated investors and those with close personal relationships with Madoff knew or should have known that his business was a sham and cannot now characterize themselves as hapless victims of a scheme in order to shield their potential liability to the Madoff estate. We anticipate that future rulings will provide further guidance in the Madoff bankruptcy cases as the adversary proceedings wind their way through the discovery process and summary judgment motions are contested.

is incurred, "with actual intent to hinder, delay, or defraud either present or future creditors" is fraudulent as to present and future creditors.

The Court joined a long line of cases that apply the "Ponzi scheme presumption," a general rule that provides that all transfers made by a Ponzi schemer are made with fraudulent intent.

In considering whether the Trustee's allegations of actual fraud met the heightened pleading standard set forth in Rule 9(b) of the Federal Rules of Civil Procedure, U.S. Bankruptcy Judge Burton R. Lifland noted that courts take a liberal approach in construing allegations of actual fraud asserted by a bankruptcy trustee on behalf of creditors of an estate. The Court then held that "the existence of a Ponzi scheme establishes that the transfers were made with the intent to hinder, delay and defraud creditors" for the purposes of section 548(a)(1)(A) of the Bankruptcy Code. *See Madoff,* 2010 Bankr. LEXIS 3875 at *20-*21 (Bankr. S.D.N.Y. Nov. 17, 2010) (stating that the "breadth and notoriety of the Madoff Ponzi scheme leave no basis for disputing the application of the Ponzi scheme presumption to the facts of the case). In so holding, the Court joined a long line of cases that apply the "Ponzi scheme presumption", a general rule that provides that all transfers made by a Ponzi schemer are made with fraudulent intent. *See, e.g., In re Bayou Group*, LLC, 2010 U.S. Dist. LEXIS 99590 at *15 (S.D.N.Y. Sept. 17, 2010) ("[W]here a Ponzi scheme exists, there is a presumption that transfers were made with the intent to hinder, delay and defraud creditors."); *Bear, Stearns Secs. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 8 (S.D.N.Y. 2007) ("Transfers made in the course of a Ponzi scheme could have been made for no purpose other than to hinder, delay or defraud creditors."). The Defendants sought to rebut this presumption by invoking the "good faith transferree" defense codified in section 548(c) of the Bankruptcy Code, which provides a safe harbor to any exchange taken for value and in good faith. The Court rejected this effort, concluding that because the Trustee's complaint was replete with allegations of Merkin's actual and constructive knowledge of Madoff's fraud, the defendants' good faith could not be ascertained based on the record before it.

Similarly, the Court found that the Trustee's complaint adequately pleads actual fraud under New York state law, reasoning that the facts alleged constituted "strong circumstantial evidence" of the defendants' motive and intent to commit fraud or, at a minimum, the recklessness of their actions. *Id.* at *30. In particular, the Court ruled that the numerous allegations that Merkin knew or should have known that Madoff's business was a massive fraud plausibly supported the claim that the defendants were engaged in conscious misbehavior and received transfers from Madoff with fraudulent intent. Further, the Court agreed with the Trustee that Merkin's knowledge and actions were attributable to the other defendants by application of agency principles.

The Court next turned its attention to the defendants' challenge of the adequacy of the constructive fraud allegations in the complaint. Pursuant to section 548(a)(1)(B) of the Bankruptcy Code and New York law, a transfer of an interest in a debtor's property is deemed constructively fraudulent without actual intent if, *inter alia*, the transfer is made at a time the debtor is insolvent and adequate consideration is not received. Section 548(a)(1)(B) of the Bankruptcy Code provides, in pertinent part, that a trustee may avoid transfer of an interest or obligation incurred if the debtor, "received less than reasonably equivalent value" and was insolvent at the date of the transfer or became insolvent as a result of the transfer. See 11 U.S.C. § 548(a)(1)(B)(i),(ii)(I). Similarly, section 273 of the New York Debtor & Creditor Law provides that "[e]very conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to actual intent if the conveyance is made or the obligation is incurred without fair consideration." These sections are founded upon a theory that a transfer by an insolvent entity is constructively fraudulent irrespective of any actual intent. *See Feist v. Druckerman*, 70 F.2d 333 (2d Cir. 1934). Although the federal and statue statutes share substantially the same meaning, the definition of "fair consideration" under New York law expressly incorporates the concept of good faith in making a transfer, a concept that is not encompassed by the Bankruptcy Code's "reasonably equivalent value" provision. *See United States v. McCombs*, 30 F.3d 310, 326 n. 1 (2d Cir. 1994); In re Bennett Funding Group, Inc., 220 B.R. 743, 754, n. 15 (Bankr. N.D.N.Y. 1997).

The defendants argued that the Trustee's constructive fraud claims failed under the Bankruptcy Code because Madoff's business received reasonably equivalent value from Merkin and his funds. The defendants cited case law providing that each investor in a fraudulent scheme possesses a claim for fraudulent inducement against the debtor that entitles it to restitution of its initial investment, and argued that their restitution claims constituted antecedent debts under the Bankruptcy Code, the satisfaction of which constitutes value. Because the total amount of the initial transfers to the defendants were less than their total principal investment, the defendants argued that the transfers challenged by the Trustee were made for value. The Court rejected this argument, noting that it was premised on the faulty assumption that the defendants were innocent investors entitled to assert a

claim for restitution. *Id.* at *44 (citing cases and concluding that only innocent investors are entitled to assert restitution claims as a matter of equity). In specifically addressing the Trustee's state law constructive fraud claims, the Court noted that New York law adds a good faith requirement to the fair consideration defense, and citing its analysis of the Trustee's actual fraud claims, ruled that the complaint included sufficient allegations of the Defendants' lack of good faith.

In a final effort to defeat the Trustee's Code-based constructive fraud claims, the non-Merkin defendants also argued that they were insulated from liability by operation of the safe harbor provisions of section 546(e) of the Bankruptcy Code, which provides that a "trustee may not avoid a transfer that is a…settlement payment…made by or to a…financial institution…in connection with a securities contract." 11 U.S.C. § 546(e). The Bankruptcy Code defines "stockbroker" as a "person (A) with respect to which there is a customer…and (B) that is engaged in the business of effecting securities transactions." 11 U.S.C. § 101(53). A "securities contract" is defined by the Code as, among other things, "a contract for the purchase, sale or loan of a security." 11 U.S.C. § 741(7). These defendants contended that the transfers from Madoff to their bank accounts were made by a "stockbroker" to a "financial institution" pursuant to a "securities contract" and are therefore protected from avoidance by section 546(e).

The Court ruled that section 546(e) did not apply to the transfers at issue because it was far from clear that Madoff acted as a stockbroker "engaged in the business of effecting transactions in securities" because it is alleged that Madoff never in fact purchased the securities that he claimed that his business acquired for his customer's accounts. In addition, the Court questioned whether the account agreements to which the defendants were a party qualified as "securities contracts" because the agreements did not effect the purchase of any security, but rather merely authorized Madoff to buy and sell securities on their behalf. *Id*, at *57. Most important, the Court ruled that application of section 546(e) was contrary to the stated purpose of that provision. The Court noted that section 546(e) was intended to promote stability and instill investor confidence in the commodities and securities markets, and concluded that, in the context of a SIPA proceeding, applying the safe harbor provision would eliminate most avoidance powers granted to a trustee thereby negating SIPA's remedial purpose. *Id*. *58

Based on the foregoing, the Court concluded that the Trustee's actual and constructive fraud causes of action could proceed against all of the defendants. This decision is noteworthy for several reasons and will likely impact the adjudication of many of the pending fraudulent conveyance actions against other parties commenced by the Trustee. First, by applying the Ponzi scheme presumption to the transfers at issue, the Court affirmed that the intent of the recipients of transfers from Madoff is irrelevant in the context of an actual fraud claim unless the investor can somehow demonstrate that it provided value to Madoff in exchange for the transfer. Second, by finding that the Trustee's assertion that Merkin had received outsized annual returns from Madoff and failed to question their legitimacy supported a claim for both actual and constructive fraud, the Court severely undercut the "good faith transferee" argument that is likely to be raised in response to every fraudulent transfer case brought by the Trustee. Third, by declining to apply the "settlement payment" defense set forth in section 546(e) of the Bankruptcy Code, the Court joined a growing number of courts that construe this safe harbor provision narrowly and only in accordance with its stated purpose. This trend stands in marked contrast to a series of earlier decisions that broadly applied the defense to insulate a myriad of otherwise fraudulent or preferential transfers from avoidance. •

Bankruptcy & Restructuring Event Calendar
Summer 2011 Speaking Appearances

Event	Date/Location	Cooley Participant/Topic
National Ski Suppliers Credit Association National Nordic/Backpacking Credit Association	August 1–2, 2011 Salt Lake City, UT	Jay Indyke and Richard Kanowitz TOPIC: "Navigating Chapter 11's Rough Waters: What Every Credit Executive Needs to Know About Insolvency, Out of Court Workouts, and Bankruptcy"
Credit Research Foundation's Credits and Accounts Receivable Forum	August 15–17, 2011 Chicago, IL	Larry Gottlieb and Jeffrey Cohen TOPIC: "Section 503(b)(9) of the Bankruptcy Code"
Credit Association of Footwear Executives	August 25, 2011 Las Vegas, NV	Jay Indyke and Seth Van Aalten TOPIC: "Navigating Chapter 11's Rough Waters: What Every Credit Executive Needs to Know About Insolvency, Out of Court Workouts, and Bankruptcy"

District Court Reverses Bankruptcy Court's Fraudulent Conveyance Judgment Against Lenders In *TOUSA* Case

In the Winter 2010 edition of *Absolute Priority,* we featured a decision issued by the Bankruptcy Court for the Southern District of Florida (the Bankruptcy Court) finding that TOUSA, Inc. had fraudulently or preferentially transferred, among other things, liens and hundreds of millions of dollars in cash to certain of its lenders in the months preceding the bankruptcy filing. *See In re TOUSA, Inc.*, 422 B.R. 783 (Bankr. S.D. Fla. 2009)

The tables have now turned—at least for the moment—on the heels of a recent decision issued by the District Court for the Southern District of Florida (the District Court) exonerating the lenders and reversing the Bankruptcy Court's decision, which the District Court characterized as imposing "extraordinary duties of due diligence on the part of creditors accepting repayment—duties that equal or exceed those imposed on lenders extending credit in the first place." *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of TOUSA, Inc. (In re TOUSA, Inc.)*, 444 B.R. 613, 675-76 (S.D. Fla. 2011).

As discussed in our Winter 2010 edition, the creditors' committee-prosecuted action against TOUSA's lenders stems from a prepetition settlement pursuant to which TOUSA agreed to resolve a litigation commenced against it by certain lenders (the Senior Transeastern Lenders) in exchange for a cash payment of approximately $420 million. In order to finance the settlement, TOUSA borrowed $500 million from its other lenders and granted them liens on substantially all of its assets, as well as on the assets of TOUSA's subsidiaries (the Conveying Subsidiaries) who were not defendants in the litigation, in order to secure the borrowings.

Less than six months after these transactions were consummated, TOUSA and the Conveying Subsidiaries filed chapter 11 cases in the Bankruptcy Court and the creditors' committee commenced an adversary proceeding seeking to avoid and recover, among other things, the approximately $420 million cash settlement payments made to the Senior Transeastern Lenders and the liens granted to the other lenders on substantially all of the Conveying Subsidiaries' assets. Among other things, the creditors' committee argued that the Conveying Subsidiaries did not receive reasonably equivalent value for the loans because the Conveying Subsidiaries were not defendants in the litigation against the Senior Transeastern Lenders.

The District Court first analyzed whether the transfer was avoidable under a "direct transfer" theory in response to the Senior Transeastern Lenders argument that the Conveying Subsidiaries never had a property interest in the loan proceeds and, therefore, there could be no avoidable transfer for the estate to recover. In the Eleventh Circuit, a transfer is avoidable only if the debtor exercised actual control over the property transferred. The District Court found that the Conveying Subsidiaries did not control the funds transferred to TOUSA, because "control does not exist where the loan from the third party was conditioned on payment to a particular creditor." *Id.* at 647. Accordingly, the District Court held that the funds were not property of the estate and the transfer was not avoidable under a "direct transfer" theory.

The District Court next turned to the Senior Transeastern Lender's argument that the transfer was not avoidable—even if the Conveying Subsidiaries had an interest in the transferred loan proceeds—because the Conveying Subsidiaries received reasonably equivalent value in exchange for the transfer. The Bankruptcy Court found that the Conveying Subsidiaries received minimal, if any, value but the District Court disagreed. Instead, the District Court concluded that the Conveying Subsidiaries had received "indirect, intangible, economic benefits, including the opportunity to avoid default, to facilitate the enterprise's rehabilitation, and to avoid bankruptcy, even if it proved to be short lived, [which] may be considered in determining reasonably equivalent value." *Id.* at 661.

Finally, the District Court overturned the Bankruptcy Court's finding that the Senior Transeastern Lenders were liable as the entities "for whose benefit" the Conveying Subsidiaries transferred the liens because the liens were used by the lenders to satisfy TOUSA's debt to the Senior Transeastern Lenders. In so doing, the District Court noted that "the 'for whose benefit' language does not apply where the 'benefit' is not the immediate and necessary consequence of the initial transfer, but flows from the manner in which the initial transfer is used by its recipient". *Id.* at 674.•

ANALYSIS BY KEITH MCDANIELS

Not only did the District Court rebuke the Bankruptcy Court's decision, it went a step further and "quashed" the Bankruptcy Court's ruling. In other words, the District Court found that the case should not even be remanded back to the Bankruptcy Court. The District Court's decision is certain not to be the last word on the matter, as the creditors' committee has appealed the decision to the Court of Appeals for the Eleventh Circuit. We will certainly keep you apprised of the outcome of this appeal in future issues of *Absolute Priority*.

Courts Continue To Struggle With Plan Requirements For Post-Confirmation Prosecution Of Pre-Confirmation Claims

Two recent bankruptcy court decisions highlight the continued struggle amongst courts to establish a uniform level of detail that a plan must contain in order to preserve the estate's post-confirmation rights to prosecute pre-confirmation claims against third parties.

It is well-settled that a plan confirmation order constitutes a final judgment of the bankruptcy court and thus binds any and all claims that could have been raised in the plan. Consequently, principles of *res judicata* bar relitigation of any issues raised or which could have been raised in the confirmation proceedings. However, section 1123(b)(3)(B) of the Bankruptcy Code sets forth an exception to this principle. Under section 1123(b)(3)(B), a plan may provide for the retention and enforcement of claims belonging to the debtor or its estate. Unfortunately, neither section 1123(b)(3)(B) nor any other provision of the Bankruptcy Code offers guidance on the level of detail that such reservations must contain in order for pre-confirmation estate claims to survive plan confirmation.

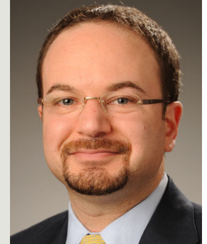
Courts have generally taken three approaches to the level of specificity required to preserve causes of action post-confirmation. Some courts, led by the Seventh Circuit, reason that broad categorical language is sufficient to preserve pre-confirmation causes of action given that the Bankruptcy Code itself requires nothing further. Other courts, including the Sixth Circuit, evaluate the reservation provisions in a plan within the context of each case and the particular claims at issue to determine the level of detail required by the plan in order to preserve claims post-confirmation. Lastly, the Fifth Circuit, among some other courts, requires that causes of action be specifically and unequivocally delineated in the plan in order to preserve the estate's right to prosecute such claims following confirmation.

In *In re MPF Holdings US LLC, et al.*, 443 B.R. 736 (Bankr. S.D. Tex. 2011) ("MPF"), the Bankruptcy Court for the Southern District of Texas followed the Fifth Circuit's precedent in *In re United Operating, LLC*, 540 F.3d 351, 355 (5th Cir. 2008), requiring plans to "expressly retain the right to pursue such causes of action" with language that is "specific and unequivocal." *Id.* at 740-45. The *MPF* court agreed with two recent cases in its district which characterized the Fifth Circuit's "specific and unequivocal" language as a bright-line rule for analyzing a plan's reservation provisions. However, the court disagreed with their conclusions that a plan provision generically preserving preference actions satisfies the Fifth Circuit's test. The court concluded that in order to satisfy the Fifth Circuit's test, the reservation language must, as a threshold matter, identify the parties to the actions designated for post-confirmation prosecution. Further, the court explained that the reservation language must also set forth the legal basis for the suit and affirmatively state that the named parties will be sued—not that they may be sued, could be sued or might be sued—following plan confirmation.

Applying this stringent test to the plan at issue, the *MPF* court concluded that while the plan expressly identified the putative defendants, it did not unambiguously reference the causes of action that were ultimately pursued by the estate. The court determined that the plan's "blanket reservation" violated the Fifth Circuit's precedent in *United Operating* by referring to causes of action that may exist, as opposed to causes of action that do exist and will be prosecuted post-confirmation. The court reasoned that this heightened specificity requirement serves the purpose of section 1123 of the Bankruptcy Code to provide creditors with sufficient and proper notice of a plan's provisions so as to allow them to make informed determinations of whether to vote to accept the plan. The court posited that the Fifth Circuit's *United Operating* decision clarifies that ambiguous reservation language will no longer suffice, and the estate must "[e]ither be straightforward in the proposed plan, or be straightjacketed after confirmation of the plan." *Id.*

ANALYSIS

BY JEFFREY COHEN



Given the substantial value to the estate often conferred to creditors through the post-confirmation prosecution of estate causes of action and the continued struggle of courts to establish uniform requirements governing plan reservation language, estate professionals are well advised to identify in plan documents the potential estate causes of action and parties to be pursued with as much specificity as possible.

More recently in *In re Antioch Company, et al.*, 2011 Bankr. LEXIS 1577, *50 (Bankr. S.D. Ohio 2011), the Bankruptcy Court for the Southern District of Ohio took a softer approach to preserving estate causes of action post-confirmation. Whereas the *MPF* court focused in part on specifically identifying future defendants and the actions that were to be brought against them in order to provide sufficient notice to such target defendants, the *Antioch* court stated that the function of section 1123 of the Bankruptcy Code is to provide notice to creditors generally that there are assets yet to be liquidated that are being preserved for prosecution by the debtor or its designees.

Id. at *50. The *Antioch* court reasoned that a plan's claim reservation language must be measured in the context of each particular case and the claims at issue.

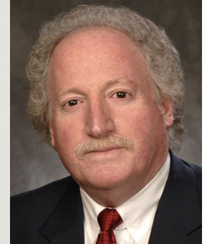
Although the *Antioch* court noted that general reservations are insufficient to satisfy section 1123 of the Bankruptcy Code, it stopped well short of the *MPF* court's "specific and unequivocal" language requirement.

Although the *Antioch* court noted that general reservations are insufficient to satisfy section 1123 of the Bankruptcy Code, it stopped well short of the *MPF* court's "specific and unequivocal" language requirement. Rather, the *Antioch* court found acceptable the plan's reference to claims that the debtor or estate "may hold" would alone be a generic reservation and thus insufficient, the confirmation order's reference to "claims including, but not limited to" certain claims listed on a schedule attached to the plan. The *Antioch* court reasoned that this non-exclusive list provided parties in interest with sufficient information to consider the potential value of the claims. Further, unlike the *MPF* court, the *Antioch* court determined that it was unnecessary for the plan and/or its related documents to specifically identify all target defendants for a given claim. In citing other cases in the Sixth and Seventh Circuits, the *Antioch* court concluded that plan provisions identifying causes of action by type or category are not mere blanket reservations and such categorical reservations can effectively avoid the *res judicata* bar without the need for specific and unequivocal identification. •

Second Circuit Blocks Adelphia Avoidance Actions Against Banks

ANALYSIS

BY
JAMES
BELDNER



By failing to ensure that all of its attorneys were aware of the potential avoidance actions, the Adelphia estate lost the ability to pursue them. Accordingly, even in the most complex of cases, courts in the Second Circuit may now seek to hold all attorneys engaged by a common client accountable for the statements of co-counsel handling different matters for their client under the equitable doctrine of judicial estoppel.

The Second Circuit recently upheld a decision barring the Adelphia Recovery Trust from pursuing avoidance actions against HSBC Bank USA, Key Bank and Fleet National Bank relating to loans issued by the banks to the owner of the Buffalo Sabres hockey team. *Adelphia Recovery Trust v. HSBC Bank USA et al.*, 634 F.3d 678 (2d Cir. 2011). The over arching issue that the Bankruptcy, District and finally the Second Circuit had to contend with was: whether the participants of the Debtor in Possession in the process of an asset sale and plan confirmation in the bankruptcy of an affiliate has the legal effect of having barred the prosecution of a subsequent adversary proceeding against former lenders with regard to the payments made upon or in satisfaction of loans originally extended by those lenders. The underlying facts of the case predate the 2002 bankruptcy filed by Adelphia Communications Corporation in the Southern District of New York and the subsequent 2003 bankruptcy filing of National Frontier Hockey, L.P., the owner of the Sabres.

In the 1990s National Frontier Hockey took out three loans from the banks in connection with the construction of what would become HSBC Arena in Buffalo, New York: $35 million for construction of the arena, $32.5 million to finance concession equipment at the venue and a $12 million line of credit for the Sabres. In 2000, Adelphia founder John Rigas used $34.1 million of company money to purchase the construction loan and credit line from the banks. The concession loan remained with the banks. The Adelphia bankruptcy estate, by virtue of its ownership of the secured loans to the Sabres, was National Frontier Hockey's largest creditor when it filed for bankruptcy protection.

The Buffalo Sabres franchise was sold in connection with the National Frontier Hockey bankruptcy through a §363 sale approved by the Bankruptcy Court for the Western District of New York, where that case was pending. Adelphia appeared in the National Frontier Hockey case as the largest secured creditor and consented to the sale of the Sabres franchise and other collateral free and clear of liens, claims and interests. Under §363 of the Bankruptcy Code, assets can be sold free and clear of an interest of "an entity other than the estate, only if… such entity consents." Importantly, counsel for Adelphia appeared at the sale hearing and gave notice to the bankruptcy court that Adelphia, as the owner of the loans, was the only party necessary to consent to the sale. Based in large part upon the representations of Adelphia's counsel, the Bankruptcy Court approved the sale free and clear of the liens.

A mere three months later, the Adelphia estate filed avoidance actions against hundreds of financial institutions, including HSBC, Key Bank and Fleet, seeking to,

among other things, avoid the payments Adelphia made to those banks in exchange for the National Frontier Hockey loans. The banks faced the unpleasant possibility that they would be forced to disgorge the funds received from Adelphia, without any recourse to the collateral securing the loans—the Sabres franchise, which had just been sold free and clear of their liens and claims. In their defense, the banks asserted various theories related to the Adelphia estate's apparently contrary position taken in the National Frontier Hockey case in connection with the sale of the Sabres. Among other arguments, the banks asserted that Adelphia was barred from attempting to avoid the transfers under the related legal theories of ratification, *res judicata* and judicial estoppel.

The Second Circuit addressed each of the defense theories in turn. First, the Second Circuit rejected the ratification analysis adopted by the District Court, which held that Adelphia had ratified the sale of the construction and concession loans and the purchase price paid for them by participating in the sale of the Sabres. The Second Circuit noted that ratification, the post hoc adoption of an action that has already occurred, requires the clear establishment of intent. The Second Circuit found the intent element lacking in this case.

The Second Circuit next turned to the banks' *res judicata* argument. The doctrine of *res judicata* or "claim preclusion" applies to bar the re-litigation of issues already determined by a final judgment on the merits. The Second Circuit ruled that *res judicata* did not apply to prevent the Adelphia Recovery Trust from pursuing claims against HSBC and Key Bank—neither of whom had appeared in the National Frontier Bankruptcy case—because the essential element of a final judgment on the merits was lacking. With respect to Fleet Bank, the Second Circuit held that the bankruptcy court's approval of the Sabres sale was a final decision on the merits as to the validity and amount owed by Adelphia to Fleet Bank, which had appeared in the National Frontier Hockey case in connection with the Sabres sale and, in fact, negotiated as a party-in-interest as to how the proceeds of that sale would be divided. Accordingly, the Second Circuit ruled that the doctrine of *res judicata* properly barred the Adelphia Recovery Trust from re-litigating that issue by seeking to avoid transfers made to Fleet Bank.

Finally, the Second Circuit analyzed the banks' judicial estoppel theory. Judicial estoppel is an equitable theory, the purpose of which is, in part, to ensure the ability of courts to render their decisions based on faithful representations by counsel. Judicial estoppel is applicable where (i) a party's later position is clearly inconsistent with its earlier position, (ii) the party's former position has been adopted in some way by the court in the earlier proceeding, and (iii) the party asserting the two positions would derive an unfair advantage by virtue of its change of position. In this case, the banks argued, and the Second Circuit agreed, that Adelphia's inconsistent positions taken in the National Frontier Hockey case and subsequent avoidance actions are precisely the type of flip-flopping the doctrine of judicial estoppel is meant to cure. The Second Circuit noted that a party "puts the integrity of the judicial process at risk not only when it knowingly lies but when it takes a position in the short term knowing that it may be on the verge of taking an inconsistent future action." The Court was not persuaded by Adelphia's contention that its counsel in the National Frontier Hockey case, a separate firm than Adelphia's main bankruptcy counsel, was simply not aware of the impending avoidance actions against the banks: "A party cannot escape judicial estoppel by keeping its attorney in the dark about its plans."

The Second Circuit ruled that the Adelphia Recovery Trust, the successor-in-interest to the creditors' committee in the Adelphia bankruptcy case, was barred under the equitable doctrine of judicial estoppel from pursuing actions to avoid the transfers made to the banks in connection with the National Frontier Hockey loans. •

IN THE NEWS

CASE:

***In re The Kasden Fuel Company*, Case No. 10-21973 (Bankr. D. Conn. 2010)**

COOLEY REPRESENTATION:

James A. Beldner, Cooley Partner and Chapter 11 Operating Trustee

RESULT:

On June 9, 2011, the Court approved the sale of the Kasden Fuel Company to Petro, Inc., one of the largest home heating oil providers on the East Coast, in a transaction that saved the jobs of virtually all of the company's employees and will deliver significant value to creditors.

CASE:

***In re Pacific Metro LLC (f/k/a The Thomas Kinkade Company LLC)* Case No. 10-55788 (Bankr. N.D. Cal. 2010)**

COOLEY REPRESENTATION:

Creditors' committee counsel

RESULT:

Cooley, as counsel to the creditors' committee, successfully negotiated a plan of reorganization which provides for a meaningful distribution which could potentially pay up to 100% of unsecured creditor claims. The plan includes the appointment of a third party plan agent, the preservation of certain valuable claims and grants unsecured creditors a senior security interest in inventory.

» *View the other current Cooley representations on page 15.*

Other Current Cooley Representations

CASE	COOLEY REPRESENTATION	RESULT
In re ArchBrook Laguna Holdings LLC Case No. 11-13292 (Bankr. S.D.N.Y. 2011)	Creditors' committee counsel	Cooley is advising the creditors' committee of this consumer electronics and housewares reseller and distributor in connection with the proposed sale of substantially all of the debtors' assets pursuant to section 363 of the Bankruptcy Code.
In re Signature Styles, LLC, et al. Case No. 11-11733 (Bankr. D. Del. 2011)	Creditors' committee counsel	Cooley is playing an active role on behalf of the creditors' committee in connection with the debtors' efforts to sell substantially all of their assets and is independently scrutinizing the prepetition conduct of Patriarch Partners, the sole equity owner of the company.
In re Goldcoast Liquidating, LLC, et al. f/k/a Claim Jumper Restaurants Case No. 10-12819 (Bankr. D. Del. 2010)	Creditors' committee counsel	Cooley objected to the $112-million-plus claim filed by the debtors' subordinated noteholders and successfully resolved the dispute in mediation
In re OTC Holding Corp., et al. Case No. 10-12636 (Bankr. D. Del. 2010)	Creditors' committee counsel	Cooley reconciled the unsecured claims asserted against the debtors' estates. The estates are now poised to make distributions to unsecured creditors in short order..
In re Urban Brands et al. d/b/a Ashley Stewart Case No. 10-13005 (Bankr. D. Del. 2010)	Creditors' committee counsel	Cooley engaged in lengthy post-closing settlement negotiations with the purchaser of the debtors' assets regarding reconciliation of the purchase price, the resolution of which will ensure the prompt payment of section 503(b)(9) claims and the preservation of value for unsecured creditors.
Blockbuster Inc., et al. Case No. 10-14997 (Bankr. S.D.N.Y. 2010)	Creditors' committee counsel	Cooley assisted the sale of the company as a going-concern to DISH, which subsequently assumed leases of more than half of Blockbuster's 3,000+ store locations.
In re Fortunoff Holdings, LLC, et al. Case No. 09-10497 (Bankr. S.D.N.Y. 2009)	Special counsel to the chapter 7 trustee	Cooley investigated the prepetition activities of the company's officers and directors, the circumstances surrounding the bankruptcy filing and subsequent fast-track liquidation.
In re Trade Secret, Inc., et al. Case No. 10-12153 (Bankr. D. Del. 2010)	Creditors' committee counsel	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 equity into the company as part of the sale.

CASE	COOLEY REPRESENTATION	RESULT
Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities, LLC Adv. Proc. No. 08-1789 (Bankr. S.D.N.Y. 2008)	Foreign institutions	Cooley is providing ongoing legal advice to various foreign institutions regarding potential claims by the Madoff trustee and potential claims related to "feeder funds" that invested in Madoff funds.
In re Robb & Stucky Limited LLP Case No. 11-02801 (Bankr. M.D. Fla. 2010)	Creditors' committee counsel	Cooley assisted the company in liquidating substantially all of its assets, and is currently assisting in the wind-down of the estate in order to preserve value for creditors.
Long Island College Hospital ***Proceedings in New York Supreme Court, County of Kings***	Counsel to an ad hoc group of tort claimants	Cooley represents the ad hoc committee in connection with the sale of the hospital's operations to SUNY Downstate Medical Center and the establishment of a trust to satisfy existing medical malpractice claims. Cooley will be advising the ad hoc group through the process of mediating and valuing these pending claims.
In re Lehr Construction Corp. Case No. 11-10723 (Bankr. S.D.N.Y. 2011)	Debtor's counsel	Cooley represented a general contractor in connection with its chapter 11 case.
Saint Vincents Catholic Medical Centers of New York, et al. Case No. 10-11963 (Bankr. S.D.N.Y. 2010)	Counsel to the Medical Malpractice Trust Monitor	Cooley represents the Monitor appointed pursuant to the plan of reorganization confirmed in SVCMC's initial bankruptcy cases. Cooley has assisted in the sale of various assets for the benefit of holders of medical malpractice claims. Appointed pursuant to the plan of reorganization confirmed in SVCMC's initial bankruptcy cases. Cooley has assisted in the sale of various assets for the benefit of holders of medical malpractice claims.