absolute
PRIORITY

Cooley LLP

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

in this issue

from the editor

JEFFREY L. COHEN

On June 27, 1994, 89-year old billionaire J. Howard Marshall II and 26-year old former Playmate of the Year Anna Nicole Smith were married at the White Dove Wedding Chapel in Houston, Texas. Nary a soul would have guessed that this blessed union would be remembered most prominently for reigniting a long-dormant controversy concerning the jurisdictional reach of the United States bankruptcy courts. That's right—and here's the short of it: Anna Nicole's billionaire husband left her nothing in his will when he died in 1995 and soon thereafter Anna Nicole filed for bankruptcy. Anna Nicole's husband's son—Pierce Marshall—filed a claim against her in her bankruptcy case, alleging that she defamed him when testifying in probate court that he had induced his father to disinherit her. Anna Nicole counterclaimed against Pierce for tortious interference with expectancy, the bankruptcy court agreed and a $400 million judgment was entered against Pierce Marshall.

But the U.S. Supreme Court didn't agree with the bankruptcy court. In fact, the Supreme Court held that the bankruptcy court did not have the jurisdictional right—under the United States Constitution—to enter a final judgment on a claim (tortious interference with expectancy) that is not defined by the Bankruptcy Code as a "core" bankruptcy issue. The U.S. Supreme Court concluded that bankruptcy courts lack the constitutional authority to render final judgments on non-core bankruptcy issues that are unrelated to the bankruptcy claims process. Pretty deep stuff—and to think that it all started with just a couple of crazy kids in love!

In this issue, we bring you up to speed on *Stern v. Marshall* and some of the interpretative

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bankruptcy court decisions that have been rendered in its wake. We'll also fill you in on some interesting decisions concerning credit bidding, postpetition interest accruals and the treatment of recharacterization claims against insiders. So, in other words, it's a great time to settle in next to that warm winter fire and peruse our Winter 2012 edition of *Absolute Priority…* As always, the Cooley bankruptcy group has been busy representing creditors' committees in many 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. You are, after all, our *Absolute Priority…*

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

absolute PRIORITY

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Bankruptcy Courts Grapple With Jurisdictional Limitations Following *Stern v. Marshall*

In *Stern v. Marshall*, Case No. 10-179, 2011 WL 2472792 (June 23, 2011), the United States Supreme Court, in a 5-4 opinion authored by Chief Justice Roberts, affirmed a 2010 ruling of the Ninth Circuit Court of Appeals and held that a bankruptcy court, as a non-Article III court, did not have the constitutional authority to decide a state law claim brought by a debtor against a creditor, even though the matter was part of the "core" statutory jurisdiction of the bankruptcy court. The *Stern* decision revived a long-dormant controversy regarding the constitutionality of the exercise of "judicial power" by bankruptcy judges. By failing to provide clear guidance as to the extent of a bankruptcy judge's authority in the aftermath of its decision, the Supreme Court has thrown the bankruptcy system into a state of flux. In the months since Stern was handed down, bankruptcy courts have struggled to discern the full implications of the Court's decision, and as the published decisions summarized herein demonstrate, the prevailing mood is one of caution and uncertainty.

Article III, section 1 of the Constitution mandates that the "judicial power of the United States, shall be vested in one Supreme Court, and in such other inferior courts as the Congress may from time to time ordain and establish." U.S. CONST art. III, § 1. Article III further provides that the judges of Article III courts must be afforded life tenure during "good behavior" and a salary that cannot be reduced by Congress. *See Stern*, 2011 WL 2472792 at *6. The Supreme Court has long recognized that Congress may not withdraw from an Article III court "any matter which, from its nature, is the subject of a suit at the common law, or in equity, or admiralty." *Murray's Lessee v. Hoboken Land & Improvement Co.*, 18 How. 272, 284 (1856). When a suit is made of "the stuff of the traditional actions at common law tried by the courts at Westminster in 1789," and is brought within the bounds of federal jurisdiction, the responsibility for deciding that suit generally rests with Article III judges in Article III courts. *See Stern*, 2011 WL at *6 (citing *Northern Pipeline*, 458 U.S. 50, 90 (1982) (Rehnquist, J., concurring in judgment).

ANALYSIS
BY
RONALD R.
SUSSMAN

Recently, Judge Dennis Montali of the Bankruptcy Court for the Northern District of California issued a recommendation to the District Court against the motions of sixteen defendants to withdraw the reference in fraudulent transfer adversary proceedings commenced against them. Judge Montali reasoned that the Supreme Court emphasized that the scope of its holding in *Stern v. Marshal* is limited to the narrow context of state law counterclaims and that fraudulent transfer actions are core proceedings. *Heller Ehrman LLP v. Arnold and Porter, LLP (In re Heller Ehrman LLP)*, Adv. Pro. No. 10-03203 (Bankr. N.D. Cal. Sept. 28, 2011). Numerous other bankruptcy judges, including Judge Drain in the SDNY and Judges Gross and Sontchi in Delaware, have authored opinions addressing the scope of *Stern v. Marshall*. We will report on these and other opinions in future editions of *Absolute Priority.*

In 1978, Congress enacted the Bankruptcy Code, which established a new system of non-article III bankruptcy courts, which were vested with broad jurisdiction to hear and determine all civil proceedings arising under or related to the Bankruptcy Code. Notably, Congress did not provide life tenure for bankruptcy judges or protect their salaries from Congressional reductions. In its 1982 *Northern Pipeline* decision, the Supreme Court declared the grant of jurisdiction in the 1978 statute invalid, holding that Congress could not grant non-Article III courts jurisdiction to finally decide state law claims that were merely "related to" a bankruptcy case because doing so removed "the essential attributes of judicial power from the Art. III district court." *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. at 87.

In direct response to the *Northern Pipeline* decision, Congress enacted 28 U.S.C. § 157(b)(2)(C) in 1984, which classified bankruptcy judges as non-Article III "units" of the district court, and enacted sections 1334(b) and 157 of the U.S. Code to govern the exercise of federal bankruptcy jurisdiction. Section 157(b)(1) authorizes a bankruptcy judge to finally decide all core proceedings under the Bankruptcy Code or in a case under title 11 subject to ordinary appellate review. Section 157(c)(1), in contrast, authorizes a bankruptcy judge to hear, but not finally decide, a proceeding that is "related to" a case under title 11. For these matters, the bankruptcy judge is required to submit findings of fact and conclusions of law, which are subject to *de novo* review, to the district court. *See* 28 U.S.C. § 157. This statutory scheme has governed the jurisdictional authority of the bankruptcy courts without controversy for almost 30 years.

The *Stern* decision turned this system on its head. *Stern* arises from a dispute over who was entitled to the assets of the late oil tycoon J. Howard Marshall—Pierce Marshall, his son, or Vickie Lynn Marshall (more commonly known as Anna Nicole Smith, a former model and Playboy Playmate of the Year), his wife and Pierce's step-mother. Two courts, a Texas state court and a federal bankruptcy court, reached opposite conclusions regarding which potential heir was entitled to J. Howard Marshall's assets. Just prior to J. Howard's death, Vickie filed suit in Texas state probate court, asserting that Pierce had fraudulently induced J. Howard to exclude her from his will. The Texas state court rejected Vickie's claim and ruled in Pierce's favor. Contemporaneously with these proceedings, Vickie filed for bankruptcy, and Pierce filed a complaint and a proof of claim in the bankruptcy court alleging that Vickie had defamed him. Vickie responded by filing a counterclaim seeking damages based on Pierce's alleged tortious interference with J. Howard's gift to Vickie.

The bankruptcy court granted summary judgment to Vickie on the defamation claim, and subsequently ruled in her favor on the tortious interference counterclaim, awarding her $400 million in damages. Pierce later contended that the bankruptcy court lacked jurisdiction over Vickie's state law counterclaim, asserting that bankruptcy courts only have limited jurisdiction over such claims. On appeal, the Ninth Circuit agreed, and held that (i) the bankruptcy court lacked authority to enter judgment on Vickie's counterclaim, because it was not a "core" proceeding; and (ii) the decision of the Texas state court, which was first-in-time, controlled. The Supreme Court affirmed the Ninth Circuit's ruling, but did so on different legal grounds. The Court unanimously found that Vickie's counterclaim was a "core" proceeding under 28 U.S.C. § 157(b), but a majority of the Court nonetheless concluded that the bankruptcy court lacked the authority under Article III of the Constitution to decide the counterclaim to the extent that it was not resolved in connection with the process of allowing or disallowing Pierce's proof of claim.

In addressing the constitutionality of 28 U.S.C. § 157, the Supreme Court noted that the goal of Article III, section 1 was to establish an independent judiciary free from the undue influence of the other branches of government. *Stern*, 2011 WL 2472792 at *14. The Supreme Court stated that, in furtherance of this goal, traditional common-law actions within the scope of federal jurisdiction *must* be heard by Article III judges, and determined that the bankruptcy court improperly exercised the "judicial power of the United States" because it purported to enter a final judgment on a state common-law claim. The majority also found that this abuse of judicial power was not cured by the "public rights" exception, which recognizes that Congress may constitutionally assign cases involving public rights to "legislative" courts for resolution. While the Court acknowledged that its treatment of the public rights exception has not been entirely consistent, it concluded that this case could not fit within any of the varied formulations of the doctrine because Vickie's common-law

IN THE NEWS

CASE:

***In re ArchBrook Laguna Holdings LLC*, Case No. 11-13292 (Bankr. S.D.N.Y. 2011)**

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley advised the creditors' committee of this consumer electronics and housewares reseller and distributor in connection with the sale of substantially all of the debtors' assets pursuant to section 363 of the Bankruptcy Code and conducted an investigation into potential causes of action.

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counterclaim: (i) did not flow from a federal statutory scheme and was not "completely dependent" upon adjudication of a claim created by federal law; (ii) was not a matter that can be pursued only by the grace of the other branches; (iii) was not the type of matter that historically could have been determined only by those branches; and (iv) was not limited to a particularized area of the law, such as the examination and determination of a specialized class of questions of fact assigned to an administrative agency as an expert in dealing with such matters. *Id*. at *15-*16.

> A chorus of commentators quickly concluded that Stern is the most significant bankruptcy-related Supreme Court decision since Northern Pipeline. Others have echoed Justice Breyer's concerns that Stern will cause inefficiencies, uncertainty, delays and added costs to the bankruptcy system that will frustrate and overwhelm debtors, creditors, bankruptcy courts and district courts alike.

The Court also rejected Vickie's argument that the bankruptcy court had the authority to adjudicate her counterclaim because Pierce filed a proof of claim in the bankruptcy. The Court distinguished the cases of *Katchen v. Landy*, 382 U.S. 323 (1966), and *Langenkamp v. Culp*, 498 U.S. 42 (1990), and held that, unlike in those cases, Vickie's counterclaim did not arise from the bankruptcy itself and that it was not necessary to resolve the counterclaim in the claims allowance process. The Court also noted that Pierce had not consented to the resolution of Vickie's counterclaim in the bankruptcy and that Pierce had nowhere else to go if he wished to recover on his claim. The Court also rejected practical arguments made by Vickie, various amicus briefs and Justice Breyer's dissenting opinion regarding the negative impact that its ruling would have on the operation of the bankruptcy system that had been in place since Congress's enactment of section 157(b) of title 28. The majority was not convinced that the consequences would be significant and contended that its decision "does not change all that much." *Id*. at *24.

At first glance, the Court's reticence regarding the import of its holding appears to be misplaced. A chorus of commentators quickly concluded that *Stern* is the most significant bankruptcy-related Supreme Court decision since *Northern Pipeline*. Others have echoed Justice Breyer's concerns that *Stern* will cause inefficiencies, uncertainty, delays and added costs to the bankruptcy system that will frustrate and overwhelm debtors, creditors, bankruptcy courts and district courts alike. As the academic debate over *Stern's* importance rages, the actual consequences of the Court's ruling are already manifesting themselves, as bankruptcy judges have begun to grapple with the implications of the Court's ruling that bankruptcy courts cannot issue final orders in some core matters. Two of the numerous recent decisions that have been rendered by bankruptcy judges across the country regarding the extent to which bankruptcy courts may hear and determine fraudulent conveyance actions are indicative of issues that will be addressed in countless proceedings in the future.

In *Samson v. Blixseth (In re Blixseth)*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011) the court ruled, *sua sponte*, that it could not constitutionally assert jurisdiction over a fraudulent transfer claim, even though it was a core proceeding. In *Blixseth*, the trustee had sued to invalidate a marital settlement agreement and asserted fraudulent transfer claims, among others, against the debtor's ex-husband. The court determined that the fraudulent conveyance claims do not fall within the public rights exception, characterizing such claims as "quintessentially suits at common law that more nearly resemble state law contract claims brought by a bankrupt corporation to augment the bankruptcy estate than they do creditors' hierarchically ordered claims to a pro rata share of the bankruptcy res." *Blixseth*, 2011 WL 3274042 at *11. The court further noted that the distinction between actions that seek to augment the bankruptcy estate, over which it did not have authority to issue final orders, and those that seek a pro rata share of the bankruptcy res, over which it did have such authority, "reaffirms that Congress may not bypass Article III simply because a proceeding may have some bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be

IN THE NEWS

CASE:

***In re Alexander Gallo Holdings, LLC, et al.*, Case No. 11-14220 (Bankr. S.D.N.Y. 2011)**

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley assisted in the going-concern sale of this court reporting and litigation services provider to its prepetition subordinated second lien lenders and is conducting an investigation into potential causes of action against certain of the debtors' insiders.

» *View the other current Cooley representations on page 16.*

resolved in the claims allowance process." Id. Since the trustee's fraudulent conveyance claim was essentially a common law claim attempting to augment the estate, did not stem from the bankruptcy itself and would not be resolved in the claims allowance process, the court ruled that it must be adjudicated by an Article III court.

In *Meoli v. Huntington Nat'l Bank, (In re Teleservices Group, Inc.)*, 2011 WL 3610050 (Bankr. W.D. Mich. August 17, 2011), Judge Jeffrey R. Hughes lamented the fact that *Stern* had offered no guidance on the scope of his authority to administer the thousands of bankruptcy proceedings before him. The immediate matter before Judge Hughes concerned a motion by a defendant in a fraudulent conveyance action to amend a pre-trial order to eliminate the order's designation of the adversary proceeding as a matter in which the court could enter a final determination subject only to ordinary appellate review. Judge Hughes expressed frustration that *Stern* offered him "virtually no insight as to how to recalibrate the core-non core dichotomy" so that he could proceed in a manner that he was assured was constitutional, but noted that "[u]nfortunately, this is not a situation where those who labor in the fields can wait until the next fistfight between an expectant heir and his stepmom finds its way to the [Supreme] Court." *Teleservices*, 2011 WL at *2. Judge Hughes concluded that he could not decide the specific issue before him without first having a better understanding of whether, in light of *Stern*, he possessed the authority to enter final orders with respect to any issue arising in the debtor's bankruptcy case.

After a lengthy analysis of the English and American bankruptcy systems from the colonial period, the Supreme Court's decisions in *Northern Pipeline, Murray's Lessee and Katchen*, among others, and the Constitution itself, Judge Hughes concluded that he was "still constitutionally capable of entering final orders in at least those instances where the order involves only empowering the estate's representative to engage in an activity that he could have done on his own had Congress chosen that alternative instead." *Id.* at *12. The court satisfied itself that "Congress has the authority under the Constitution to designate someone other than an Article III judge to make final decisions concerning the administration of the bankruptcy estate it has created and the enforcement of the statutory injunctions it has imposed", including the administration of claims that may be the "stuff" that common law courts or courts of equity also handle. *Id.* at *13. Turning to the matter before him, Judge Hughes determined that, notwithstanding the foregoing and consistent with *Blixseth* and the narrow scope of the public rights exception, any judgment to be entered in a fraudulent conveyance action must be done so by an Article III judge, unless the parties consented to the exercise of jurisdiction by the bankruptcy court. Judge Hughes went further however, in light of the fact that he had already heard twelve days of testimony, examined a large number of exhibits, and issued a 127-page opinion setting forth his assessment of the matter. With a nod to the treatment of non-core matters under 28 U.S.C. § 157, Judge Hughes stated that he would "convert my endeavor to a report and recommendation so that a district court may later make his own independent assessment of the Trustee's claim[.]" *Id.* at *15. The extent to which the district court adopts Judge Hughes's findings and conclusions, or elects to start the discovery and fact finding process over again, remains to be seen. •

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

ACTION:

Cooley, on behalf of the creditors' committee, currently represents Mervyn's as plaintiff in the pursuit of a $1.2 billion litigation against Target Corporation, 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. Cooley recently obtained relief from the court, over the objections of the defendants, to modify its retention structure to provide the estates with the financial flexibility needed to prosecute the litigation through conclusion. The Court recently directed the parties to mediation, which is expected to begin in March 2012.

» *View the other current Cooley representations on page 16.*

SDNY Bankruptcy Court Grants Plan Relief In Wake Of *Stern v. Marshall*

ANALYSIS
BY
JAY INDYKE

The *BearingPoint* decision provides yet another illustration of the jurisdictional uncertainty created by the *Stern* decisions and the manner in which bankruptcy courts are grappling with these difficult issues.

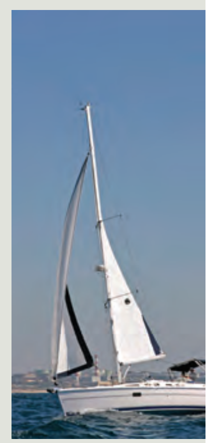
In the wake of the recent United States Supreme Court decision in *Stern v. Marshall*, the July 11, 2011 decision issued by the Honorable Judge Robert E. Gerber of the Bankruptcy Court for the Southern District of New York in *In re BearingPoint, Inc. et al.*, 09-10691 (REG), 453 B.R. 486 (Bankr. S.D.N.Y. July 11, 2011) adds to the murky case law applying *Stern* to matters concerning the administration of the bankruptcy estate. In *In re BearingPoint*, the Court granted a motion for limited relief from the Debtors' chapter 11 plan and confirmation order to permit the trustee of the liquidating trust (the "Trustee") to bring suit against BearingPoint's former CEO and directors outside of the Bankruptcy Court for the Southern District of New York in order to comply with the Supreme Court's direction in *Stern v. Marshall.*

When the *BearingPoint* plan was confirmed by the bankruptcy court, a trust was created to own any and all claims that could be pursued by BearingPoint, including an action for breach of fiduciary duty against BearingPoint's former CEO which the Trustee sought to commence. *Id*. at 488. The confirmed plan "required that the bankruptcy court and the district court in the Southern District of New York have exclusive jurisdiction over actions such as the one that the Trustee would like to bring." *Id*. at 489. Fearful that the bankruptcy court would lack jurisdiction to render a final decision on its non-core, state law-based breach of fiduciary duty action in the wake of the *Stern*, the Trustee requested Judge Gerber to modify the confirmation order solely to permit the Trustee to bring the action in Virginia state court in Fairfax County, Virginia, where BearingPoint is headquartered. *Id*. at 491-92.

After reviewing a draft of the Trustee's complaint, the bankruptcy court found the allegations to be "colorable" and explained that "modification of the Confirmation Order here would have no adverse effect on creditor expectations under the plan, or raise issues as to the unscrambling of eggs that often are a concern…in modifying confirmation orders after the fact." *Id*. at 495. Judge Gerber reasoned that the provisions at issue were included solely to implement the bankruptcy court's sense of what was appropriate in defining the scope of the limited releases provided to the BearingPoint's directors and officers under the plan. Relying on a mistake of fact theory to support relief under Rule 60(b) of the Federal Rules of Civil Procedure, Judge Gerber noted the jurisdictional uncertainy created by the *Stern* decision and explained that he previously did not "consider how litigants could tie a case up in knots by exploiting their rights to an Article III judge determination when litigation against them is non-core." *Id*.

Judger Gerber's also expressed his concern for the *Stern* majority's decision to find Pierce Marshall's consent to bankruptcy court jurisdiction inadequate under the circumstances, reaosning that "it's fair to assume that it will now be argued, that consent, no matter how uncoerced and unequivocal, will never again be sufficient for bankruptcy judges ever to issue final judgments on non-core matters." *Id.* at 496-97. According to Judge Gerber, the Supreme Court's failure to recognize Pierce Marshall's consent to bankruptcy court jurisdiction "would at least seemingly invite litigants to consent, see how they like the outcome, and then, if they lose, say their consents were invalid." *Id*. at 497. Wanting to avoid a scenario where the bankruptcy court would maintain jurisdiction over the Trustee's action—premised upon the former CEO's presumed consent to bankruptcy court jurisdiction vis-à-vis the confirmed plan—only to have the CEO raise a jurisdictional objection in the event the bankruptcy court was to ultimately enter judgment against the CEO, Judge Gerber granted the Trustee's motion for limited relief from the confirmed plan to permit the action to be brought in Virginia state court. *Id*. at 498. •

UPCOMING



Cooley partners **Lawrence Gottlieb** and **Jeffrey Cohen** will be speaking at the **CRF's Credit & Accounts Receivable Forum** on March 20, 2012, in Marina del Rey, California.

In addition, Cooley partner **Jay Indyke** will be speaking at **TMA's Spring Conference**, April 3–5, 2012, in Atlanta, Georgia.

» *For more information visit www.cooley.com/events*

» *View the complete Bankruptcy & Restructuring Event Calendar on page 14*

Seventh Circuit Delivers Credit-Bidding Win For Secured Creditors

In recent years, debtors have increasingly utilized the chapter 11 process to dispose of their assets free and clear of liens and claims pursuant to section 363 of the Bankruptcy Code. Section 363(b) provides that, after notice and a hearing, a debtor may sell or dispose of its assets outside of the ordinary course of business free and clear of all liens, claims, interests and encumbrances. Section 363(k) protects the debtor's secured creditors by empowering them to "credit bid" the amount of their claim against the collateral being sold by the debtor. In other words, if the secured creditor wants to purchase the asset being sold, it is entitled to offset the amount of its claim against the purchase price. This is a significant protection for secured creditors and many courts have held that the creditor is entitled to credit bid the "face amount" of the secured claim, even if the secured creditor is undersecured— i.e., where the value of the underlying collateral is less than the face amount of the claim.

The Bankruptcy Code also permits the debtor to sell assets pursuant to a chapter 11 plan. Section 1123(a)(5) of the Bankruptcy Code provides that a plan may be implemented through the transfer of all or a part of the property of a debtor's estate. Additionally, section 1123(b)(4) provides that a plan may provide for the sale of all or substantially all of the assets of an estate. If a chapter 11 plan providing for the sale of a debtor's assets is rejected by a class of secured creditors, then the plan may only be confirmed through the so-called "cramdown" provisions of section 1129(b)(2). This process imposes additional requirements on the debtor that would not otherwise be required. Specifically, section 1129(b)(2)(A) mandates that the proposed plan be "fair and equitable" to such secured creditors. The debtor may satisfy the fair and equitable standard by meeting one of three requirements:

- The plan provides that the secured creditor (i) retains the lien securing its claim, regardless of whether the collateral is retained by the debtor or transferred to another entity; and (ii) receives deferred cash payments totaling at least the allowed amount of its secured claim;
- The plan provides for the sale of the secured creditor's collateral free and clear of its lien, with such lien attaching to the proceeds of the sale, and with the secured creditor retaining the right to credit bid in any such sale; or
- The plan provides for the sale of the secured creditor's collateral, with the secured creditor receiving other value that is the "*indubitable equivalent*" of its claim.

> The Seventh Circuit's decision, which stands in direct contrast with the Third Circuit's decision in *Philadelphia Newspapers*, reaffirms the conventional wisdom regarding a secured creditor's right to credit bid in asset sales under a plan and represents a significant victory for secured creditors.

Importantly, the third requirement of the fair and equitable standard is silent as to whether the secured creditor retains the right to credit bid its claim against the purchase price of the collateral.

ANALYSIS
BY
LAWRENCE
GOTTLIEB

In the Third and Fifth Circuits a debtor may confirm a plan that sells a secured creditor's collateral without providing that creditor the right to credit bid. After *River Road*, however, such a plan will not pass muster in the Seventh Circuit. Accordingly, the extent of a secured creditor's influence over a sale process and its ability to realize the market value of its collateral in a bankruptcy case may vary widely depending on the venue of the debtor's bankruptcy proceeding. On August 5, 2011, the River Road debtors petitioned the U.S. Supreme Court to review the Seventh Circuit's decision and on December 12, 2011, the Supreme Court granted the debtor's request for certiorari. We will certainly report on the Supreme Court's analysis of the credit bidding dispute once adjudicated.

Until recently, it was presumed that a secured creditor had an unqualified right under section 1129 to credit bid its debt in connection with a sale of a debtor's assets pursuant to a plan of reorganization. Then came the Third Circuit's controversial opinion in *Philadelphia Newspapers*, a decision highlighted in a prior issue of *Absolute Priority*, in which the court held that no such right exists under section 1129 of the Bankruptcy Code. Now, however, in a much anticipated decision in *In re River Road Hotel Partners, LLC*, 2011 WL 2547615 (7th Cir. June 28, 2011), the United States Court of Appeals for the Seventh Circuit has held that a plan of reorganization that provides for the sale of encumbered assets may *not* be confirmed over the objection of a debtor's secured creditor if the secured creditor was denied the right to credit bid at the auction of their collateral. The Seventh Circuit's decision, which stands in direct contrast with the Third Circuit's decision in *Philadelphia Newspapers*, reaffirms the conventional wisdom regarding a secured creditor's right to credit bid in asset sales under a plan and represents a significant victory for secured creditors.

In *Philadelphia Newspapers*, the debtors filed a chapter 11 plan that provided for the sale of substantially all of the debtors' assets at a public auction, free and clear of liens. In an effort to ensure that the assets would be sold to the debtors' preferred buyer, the bidding procedures for the auction provided that no holder of a lien on any asset of the debtors would be permitted to credit bid because the sale was being conducted under section 1123(a) and (b) of the Bankruptcy Code, and not section 363 of the Bankruptcy Code. On appeal, the Third Circuit held, in a 2-1 decision, that the sale through a plan without allowing credit bidding was permissible. The court held that the disjunctive "or" in section 1129(b)(2)(A) of the Bankruptcy Code meant that a debtor had the option of satisfying any of the three requirements set forth above and could choose to proceed under the "indubitable equivalent" prong even if the sale of assets through a chapter 11 plan fell under the description set forth in the second prong. The court further concluded that its reading of section 1129(b)(2)(A) was not inconsistent with Congressional intent because credit bidding and other protections provided to secured creditors under the Bankruptcy Code are not absolute, but subject to certain exceptions, and that a plan need not provide a secured creditor the right to credit bid in all situations.

In a lengthy dissent, Judge Thomas Ambro, a former bankruptcy practitioner, concluded that the fair and equitable requirements are ambiguous and that more than one reading of the provision was reasonable. He reasoned that a fair interpretation of the Bankruptcy Code as a whole, and the legislative history of section 1129 in particular, support the conclusion that all chapter 11 asset sales free and clear of liens must be subject to the right of secured creditors to credit bid the value of their claim. In disagreeing with the majority's holding, Judge Ambro highlighted what he viewed as the practical consequences of the court's ruling, noting that the decision "frustrates the settled expectations for lenders' interests in bankruptcy" which were relied on by the lenders in the *Philadelphia Newspapers* case in extending credit to the debtors. Judge Ambro further predicted that the decision would lead to the systemic undervaluation of collateral property in future asset sales conducted without credit bidding, which in turn could reduce the amount of secured creditor recoveries and depress the trading value of distressed debt.

The *River Road* decision involved two sets of similarly situated bankruptcies, one by River Road Hotel Partners, LLC and River Road Expansion Partners, LLC, the owners of a hotel near O'Hare airport in Chicago, and the other by RadLAX Gateway Hotel, LLC and RadLAX Gateway Deck, LLC, the owners of a hotel near LAX airport in Los Angeles. The construction of the hotels was financed by, among other things, secured loans of approximately $155 million and $142 million respectively, with Amalgamated Bank serving as the administrative agent for both loans. Subsequent to their construction, both hotels required additional financing to maintain operations. Unable to obtain such funding, the hotels filed for bankruptcy in August 2009. In June 2010, both hotels filed plans of reorganization that provided for the sale of substantially all of their assets. Each hotel had a stalking horse bidder who was offering significantly less than the amount of the secured creditor's respective claims. Importantly, the bidding procedures governing each sale did not allow the secured creditors to credit bid their secured debt in connection with the sale. Amalgamated Bank, on behalf of both sets of secured lenders, objected to both reorganization plans on the grounds that a plan could not be confirmed over the objection of a secured creditor where the plan provides for the sale of such collateral without empowering the secured creditor to credit bid. The bankruptcy court agreed with the lenders, holding that the plan needed to provide the secured creditors with the right to credit bid. The debtors appealed, and the issue was certified for direct review by the Seventh Circuit.

The Seventh Circuit affirmed the bankruptcy court's determination that the hotels' plans could not be confirmed over the objections of secured creditors because the plans did not satisfy the "fair and equitable" standard, holding that the Bankruptcy Code requires that such so-called "cramdown" plans that contemplate selling encumbered assets free and clear of liens at an auction must provide secured creditors with the right to credit bid. In so ruling, the Seventh Circuit rejected the debtors' argument that the plain language of section 1129(b)(2)(A), which is written in the disjunctive, permits a court to approve a cramdown plan that does not empower a secured creditor to credit bid pursuant to subsection (iii)'s requirement of providing the "indubitable equivalent." Instead, the court found that section 1129(b)(2)(A) does not have only one plain meaning, and applied principles of statutory construction to ultimately determine that the better interpretation of that section would not permit confirmation of the hotels' proposed plan under the "indubitable equivalent" prong. The Seventh Circuit found that the "infinitely more plausible" interpretation of section 1129(b)(2)(A) is that plans that provide for a sale of assets must be judged for fairness under subsection (ii), which provides secured lenders with the unqualified right to credit in connection with the sale of their collateral. The court cited Judge Ambro's dissent in *Philadelphia Newspapers* extensively and approvingly, and noted that auctions conducted pursuant to a plan that denied secured creditors the right to credit bid lacked a crucial check against undervaluation of the assets for sale, which could lead to an increased risk that the winning bid could fail to provide the lenders with the current market value of their collateral. *See* 2011 WL 2547615 at *20. •

SDNY Bankruptcy Court Awards Default Rate Postpetition Interest To Secured Lender In *General Growth Case*

ANALYSIS

BY

RICHARD KANOWITZ

The *General Growth* decision appropriately limits its holding to those cases in which the debtor's solvency and ability to pay its unsecured creditors is not threatened by payment of default rate interest to the lender.

In a recent decision issued in the *General Growth* case, *In re General Growth Properties, Inc., et al.*, 09-11977 (ALG), 451 B.R. 323 (Bankr. S.D.N.Y. June 16, 2011), Honorable Judge Allan L. Gropper of the Bankruptcy Court for the Southern District of New York held that a secured lender is entitled to postpetition interest on its claim at the contract default rate from the date of the bankruptcy filing through the effective date of the plan of reorganization. *Id.* at 331.

In the *General Growth* case, the Common Retirement Fund (the "Fund") made a $254 million loan to GGP Limited Partnership ("GGP") in connection with GGP's purchase of a 50% interest in a joint venture that is the indirect owner of twelve shopping centers or malls. The promissory note executed by GGP was secured by a pledge of its shares in the joint venture, and provides that the commencement of a voluntary chapter 11 case by GGP would constitute an automatic event of default without any requirement that the Fund call the default by providing notice to any party. Upon GGP's April 16, 2009 bankruptcy filing, the Fund argued that an event of default had occurred notwithstanding the fact that the note was not in default prior to the bankruptcy. *Id.* at 324-25.

Under the chapter 11 plan, GGP proposed to cure the default on the Note by reinstating the principal amount of the debt and paying any outstanding interest due to the Fund at the *non-default* rate of 5.95%." *Id.* at 325. The Fund objected claiming that GGP incorrectly assumed that the non-default rate is sufficient and did not account for the fees and expenses incurred by the Fund. The parties agreed to defer the objection until after GGP's emergence from bankruptcy, and on the effective date of the plan of reorganization, GGP reinstated the Note and paid cash to the Fund to compensate it at the non-default interest rate from the petition date through the effective date plus professional fees. The parties did not dispute that GGP is and was "highly solvent." *Id.*

Judge Gropper explained that section 502(b)(2) of the Bankruptcy Code generally disallows post-petition interest because the delay of the case is "delay necessitated by law if the courts are properly to preserve the estate for the benefit of all interests involved." *Id.* at 326. However, there are two exceptions to this general rule, one provided by section 506 of the Bankruptcy Code and one created by the courts. *Id.*

Section 506(b) of the Bankruptcy Code provides that "[t]o the extent that an allowed secured claim is secured by property the value of which…is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, any reasonable fees, costs, or charges provided for under the agreement…under which such claim arose." 11 U.S.C. 506(b). In addition, the courts

PRESS

Ronald Sussman, a partner in Cooley's Bankruptcy & Restructuring practice group, was elected president of the Turnaround Management Association.

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The Court recalled that, "[a]s the Second Circuit said many years ago in *Ruskin v. Griffith*, if creditors could not rely on the courts to enforce the default interest rate clauses, creditors would have to 'anticipate a possible loss in the value of the loan due to his debtor's bankruptcy or reorganization, [and a lender] would need to exact a higher uniform interest rate for the full life of the loan' unnecessarily increasing the cost of credit for all borrowers."

have created a second "exception to the disallowance of post-petition interest based on the principle that before there is a return to equity in a reorganization case, creditors should receive interest as compensation for the delay of the bankruptcy process." *In re General Growth Properties, Inc.*, 451 B.R. at 326. GGP argued that under Section 1124 of the Bankruptcy Code—which "permits a debtor to reinstate debt in connection with confirmation of a Plan by curing any existing defaults and reinstating the maturity of the debt, without altering the legal, equitable or contractual rights of the debt holder"—cure and reinstatement erase the effects of default, including the right to the default rate of interest. *Id.* at 327.

Over objection by GGP and relying on *Ruskin v. Griffith*, 269 F.2d 827 (2d Cir. 1959) *cert. denied* 361 U.S. 947 (1960), the Court held that the Fund was entitled to the default rate of interest from the filing date through the effective date. Judge Gropper reasoned that in *Ruskin*, the Second Circuit enunciated the requirement that solvent debtors must pay default rate interest in order to reinstate debt, absent factors that would make such payment inequitable. In the instant case, Judge Gropper found none of the factors justifying the nullification of the default rate interest to be present. Specifically, Judge Gropper noted that GGP stipulated that, as a stand-alone rate, the default rate was not a penalty, GGP did not allege any misconduct by the Fund and payment of default interest would neither inflict harm on unsecured creditors nor impair GGP's fresh start given its considerable solvency upon emergence. *Id.* at 328.

The Court recalled that, "[a]s the Second Circuit said many years ago in *Ruskin v. Griffith*, if creditors could not rely on the courts to enforce the default interest rate clauses, creditors would have to 'anticipate a possible loss in the value of the loan due to his debtor's bankruptcy or reorganization, [and a lender] would need to exact a higher uniform interest rate for the full life of the loan' unnecessarily increasing the cost of credit for all borrowers." *Id.* (quoting *Ruskin*, 269 F.2d at 832) (alterations in original). The Court also looked to section 1123(d) of the Bankruptcy, finding that "§ 1123(d) certainly does not preclude the payment of default interest – under the facts of this case, § 1123(d) points to its payment 'in accordance with the underlying agreement and applicable nonbankruptcy law.'" *Id.* at 327 (quoting 11 U.S.C. § 1123(d)).

Finally, in rebutting arguments made by GGP against the imposition of the default interest rate, the Court explained that the payment of the default rate of interest is consistent with section 506(b) of the Bankruptcy Code and that the automatic default upon bankruptcy provision of the note is not an invalid ipso facto clause that penalizes GGP for seeking chapter 11 relief. *In re General Growth Properties, Inc.*, 451 B.R. at 328. Rather, the Court explained that "such clauses are not per se invalid in the Second Circuit except where contained in an executory contract or unexpired lease," and the Note is not executory and not an unexpired lease. *Id.* at 330. •

Delaware Bankruptcy Court Sustains Recharacterization Claim

In a recent decision in *In re Friedman's, Inc.*, Case No. 08-10161 (Bankr. D. Del. July 12, 2011), Judge Sontchi of the Delaware Bankruptcy Court refused to dismiss recharacterization claims brought against certain of the Debtor's prepetition equity holders. Judge Sontchi's opinion provides a useful precedent for creditors' committees seeking to improve their recovery through actions seeking to recharacterize purported loans as equity contributions.

Recharacterization is a cause of action seeking to elevate form over substance where necessary to reclassify a purported debt transaction (giving rise to a claim) as a capital contribution (giving rise to an equity interest). For example, while a transaction may have been called a "loan" by the parties to the agreement, if the parties actually intended the transfer to be an equity investment, a bankruptcy court may recharacterize the transaction, thereby reclassifying the alleged claim as equity. Courts infer intent from (i) what the parties say in their contracts, (ii) what the parties do, and (iii) the economic reality of the underlying transaction. Under the Bankruptcy Code, equity holders only receive a distribution after general unsecured creditors are paid in full; therefore, recharacterizing a claim as equity can have a significant impact on the return to general unsecured creditors by freeing up cash that would have otherwise been distributed to the purported claim holder.

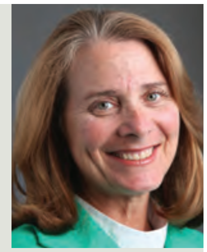
However, those seeking to recharacterize a "debt" as equity frequently face an uphill battle, because the purported lender—often a sophisticated party, such as an investment or private equity fund—is typically careful to follow the legal formalities associated with the making of a loan.

As a result of this potential impact on unsecured creditors' recovery, debtors or creditors' committees can initiate litigation seeking to recharacterize a purported debt as equity, particularly where the "lender" was an insider of the debtor. However, those seeking to recharacterize a "debt" as equity frequently face an uphill battle, because the purported lender—often a sophisticated party, such as an investment or private equity fund—is typically careful to follow the legal formalities associated with the making of a loan. As a result, recharacterization claims brought in Delaware and New York sometimes fail to survive motions to dismiss. Nevertheless, Judge Sontchi's recent decision in *Friedman's* demonstrates that recharacterization claims against sophisticated parties can survive motions to dismiss under certain circumstances.

In July 2006, Friedman's, a large retail jewelry chain purchased Crescent, another retail jewelry chain, while Crescent was in bankruptcy. To fund its purchase of Crescent, Friedman's borrowed approximately $22 million from its shareholders. All of Friedman's shareholders at the time of the transaction were parties to the financing, and each shareholder contributed an amount based on its percentage equity interest in Friedman's. The shareholders also agreed that they would contribute sufficient equity to Friedman's to enable Friedman's to acquire all of the preferred stock and common equity of Crescent. In return for providing the funding, Friedman's executed "unsecured promissory notes" in favor of each of the shareholders. The notes, which were expressly subordinate to Friedman's secured lender, ostensibly paid interest at 8%; however, so long as Friedman's owed money to a certain secured lender, the interest would not be paid in cash, but would rather accrue and be added to the principal amount of the notes. During the year following Friedman's purchase of Crescent, Friedman's obtained a substantial tax refund which could have been used to pay the interest owing under the notes in cash, but wasn't. Ultimately, no interest was ever paid on the notes.

In 2008, Friedman's filed for bankruptcy and in June 2009 Friedman's filed a complaint objecting to the general unsecured claims of certain of its prepetition equity holders and seeking to recharacterize those claims as equity. On July 12, 2011, Judge

ANALYSIS
BY
CATHY
HERSHCOPF



While Judge Sontchi's use of a multi-factor test to determine whether to recharacterize a transaction is not unusual, the decision is notable for Judge Sontchi's willingness to permit the recharacterization suit to continue despite the fact that the "notes" were issued pursuant to a sophisticated promissory note agreement with a fixed maturity date. The case is particularly helpful for creditors' committees because Delaware courts have previously dismissed recharacterization claims early in proceedings, an outcome that has become increasingly likely in the last two years as pleading standards have heightened in the wake of recent Supreme Court precedent.

Sontchi refused to dismiss the suit, finding that Friedman's had made facially plausible allegations supporting recharacterization. Judge Sontchi reached this decision by applying a multi-factor test to determine the parties' intentions. Those factors, and their application, include:

1) **Names Given to the Instruments**, if any, Evidencing the Indebtedness. Judge Sontchi concluded that because (i) the monies were provided for a "Subordinated Promissory Note Due December 9, 2010" and (ii) the governing agreements stated that the infusion would be made as an "unsecured subordinated loan", this factor weighed in favor of characterizing the defendants' claims as debt.

2) **Presence or Absence of a Fixed Maturity Date and Schedule of Payments**. While the notes here were payable after four years, Friedman's was not required to make any principal payments during those four years, so Judge Sontchi found that this factor neither weighed in favor of characterizing the notes as equity or debt.

3) **No Fixed Rate of Interest and Interest Payments**. While the notes had an interest rate of 8% per year, the Court decided that this factor cut in favor of characterizing the notes as equity because (i) accrued interest was added to the principal amount of the notes, (ii) the interest rate was below prime, and (iii) the tax refund was not used to pay the interest then owing.

4) **Repayment Dependent on Success**. This factor was held to weigh in favor of characterizing the notes as equity because (i) the complaint alleged that the defendants' expectation of repayment depended solely on the success of Friedman's business and (ii) there were no allegations that the notes could be paid from anything other than Friedman's earnings (as the tax refund was insufficient to pay off the principal of the notes).

5) **Inadequacy of Capitalization**. The Court held that this factor weighed in favor of characterizing the notes as equity because the Complaint alleged that Friedman's was undercapitalized after it issued the notes to finance the purchase of Crescent.

6) **Identity of Interests Between Creditor and Stockholder**. Because the complaint alleged an exact correlation between the equity holders' ownership interests in Friedman's and their proportionate share of the "loan" used to finance the purchase of Crescent, this factor was held to strongly weigh in favor of characterizing the notes as equity.

7) **Security, if any, for the Advances**. Judge Sontchi concluded that this factor weighed in favor of characterizing the notes as equity because the notes were unsecured.

8) **Ability to Obtain Financing from Outstanding Lending Institutions**. The Court held that this factor did not weigh in favor of characterizing the notes as equity or debt because there were no allegations in the complaint regarding alternative sources of financing.

9) **Extent to Which the Advances were Subordinated to the Claim of Outside Creditors**. The notes were subordinate to Friedman's secured debt, but purportedly on par with trade and other general unsecured debt. As the notes provided for a right to payment above other interests, this factor was held to weigh in favor of characterizing the notes as debt.

10) **Extent to Which the Advances Were Used to Acquire Capital Assets**. The notes were issued to finance the purchase of Crescent; therefore, Judge Sontchi found that this factor weighed in favor of characterizing the notes as equity.

11) **Presence or Absence of a Sinking Fund**. This factor was held to weigh in favor of characterizing the notes as equity because the Complaint alleged that there was no sinking fund and that the repayment of the notes depended solely on the success of Friedman's.

12) **Presence or Absence of Voting Rights**. As the notes did not provide any right to vote, the Court held that this factor weighed in favor of characterizing the notes as debt.

Judge Sontchi recognized that the majority of the foregoing factors weighed in favor of characterizing the notes as equity, and used this analysis as part of a "common sense" evaluation of the facts and circumstances surrounding the transaction. Ultimately, Judge Sontchi concluded that Friedman's had alleged sufficiently plausible facts to overcome the motions to dismiss (although he noted that the defendants' arguments may ultimately prevail regarding intent). •

Third Circuit Grants Administrative Expense Priority To Pension Plan Withdrawal Liability Allocable To Postpetition Period

In a case of first impression, the Third Circuit, in *In re Marcal Paper Mills Inc.*, agreed with the District Court for the District of New Jersey and held that multi-employer pension plan withdrawal liability should be apportioned between pre- and postpetition time periods and that the post-petition portion should be classified as an administrative expense, thus having priority over the claims of general unsecured creditors. See 2011 U.S. App. LEXIS 12109 (2011). This decision adds a key cost consideration that must be factored in to a potential debtor's chapter 11 strategy.

Marcal Paper Mills, Inc., a manufacturer of paper products, operated a fleet of trucks to distribute its products. The truck drivers employed by Marcal were members of a union and over the years had entered into a series of collective bargaining agreements ("CBAs") with Marcal. As part of the CBAs, Marcal was required to participate in the Trucking Employees of North Jersey Welfare/Pension Fund – a multiemployer defined benefit pension fund. When Marcal filed for chapter 11, it continued its operations as a debtor-in-possession and chose to continue employing the members of the union. Those employees accrued pension credits and other corresponding benefits under the continuing CBA and Marcal was required to satisfy its pension fund obligations, including making contributions to the pension fund on behalf of the covered employees. Marcal continued to make contributions to the fund until May 30, 2008, when its assets were sold to Marcal Paper Mills, LLC (the "Purchaser"). The Purchaser ceased employing the union employees as of the purchase date, thus triggering the pension fund's withdrawal liability claim at issue in the case.

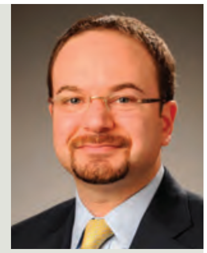
The Employee Retirement Income Security Act ("ERISA"), as amended by the Multiemployer Pension Plan Amendments Act ("MPPAA"), regulates multiemployer defined benefit pension plans, such as the plan covering Marcal's union employees. A defined benefit plan is a pension plan under which an employee receives a set monthly amount upon retirement for his or her life, with the benefit amount typically based upon the participant's wages and length of service. The assets held by these plans are used to pay such benefits to the covered employees. The plan assets include the employer's continuing contributions and the income expected to be earned on plan investments. Withdrawal liability is imposed on employers when they withdraw from the plan earlier than anticipated. The MPPAA provides that if an employer withdraws from a multiemployer plan, then the employer is liable for its proportionate share of the unfunded vested benefits. The pension fund covering the Marcal union employees asserted that the cessation of employment by the Purchaser constituted a complete and early withdrawal from the pension fund under ERISA and assessed the debtor with $5,890,128 in total withdrawal liability.

> The Court observed that by treating the postpetition portion of the withdrawal liability as an administrative expense, Congress' objectives in passing the MPPAA are fulfilled.

The Court found that apportioning the claim between pre- and postpetition periods and treating the postpetition amount as an administrative claim was commensurate with the requirements and goals of the Bankruptcy Code. To qualify as an administrative expense under Section 503(b) of the Bankruptcy Code, an expense must: (i) arise from a postpetition transaction, (ii) be beneficial to the debtor-in-possession and its on-going business operations, and (iii) be an actual and necessary cost of preserving the estate. As the Court explained, these requirements balance the twin goals of the "continued functioning of the debtor-in-possession and preservation of the estate for downstream creditors."

ANALYSIS

BY JEFFREY COHEN



The Third Circuit's ruling adds an important factor to be considered when formulating a potential debtor's chapter 11 strategy and is generally consistent with the so-called "proration" approach to administrative expense treatment applied by the Third Circuit. Notably, the Third Circuit's ruling runs counter to the Second Circuit's position concerning the administrative expense entitlement of withdrawal liability, as set forth in *Trustees of the Amalgamated Insurance Fund v. McFarlin's Inc.*, 789 F.2d 98 (2d Cir. 1986). In the McFarlin's case, Jay Indyke of Cooley successfully argued that a debtor's withdrawal liability is a prepetition claim not entitled to administrative priority because the consideration supporting the liability is furnished prior to the commencement of the Chapter 11 case.

Applying this standard to the Marcal case, the Court found that the covered union employees were required to perform work postpetition necessary to support the debtor's on-going business and thus were "unquestionably conferring a benefit to the estate." In return, under the CBA and pension plan, the debtor promised to provide pension benefits in exchange for these postpetition services. The Court observed that by treating the postpetition portion of the withdrawal liability as an administrative expense, Congress' objectives in passing the MPPAA are fulfilled: "[i]f withdrawal liability…were automatically classified as a general unsecured claim, it would greatly undercut the purpose of the MPPAA to secure the finances of pension funds and prevent an employer's withdrawal from negatively affecting the plan and its employee beneficiaries." •

South Carolina Bankruptcy Court Grants Directors and Officers Access To D&O Policy Proceeds

Directors and officers of companies that file for bankruptcy are often targets of litigation as shareholders, creditors, and other stakeholders seek to minimize the losses from their dealings with the debtor. In turn, those directors and officers will often try to obtain benefits under insurance policies previously purchased by the debtor that provide individual coverage for directors and officers. However, the debtor may have a property interest in the proceeds of such insurance policies, and, where that is the case, it is a violation of the automatic stay for directors and officers to access those proceeds without a court order (even if the insurance policy was originally purchased by the debtor to protect its directors and officers).

In recent years, courts have developed a framework for addressing whether the proceeds of an insurance policy that provides individual coverage for directors and officers are part of the estate, and, if so, whether directors and officers should be granted relief from the automatic stay to access the proceeds of those policies. Recently, on April 29, 2011, the United States Bankruptcy Court for the District of South Carolina issued a memorandum order in *In re Beach First National Bancshares, Inc.*, No. 10-03499-DD, that serves as a notable example of the growing consensus on these issues.

In *Beach First National*, the debtor owned an interest in a bank that was shut down

Bankruptcy & Restructuring Event Calendar
Winter 2012 Speaking Appearances

Event	Date/Location	Cooley Participant/Topic
F&D Reports/Creditntell Presentation on Sears	January 13, 2012 Webinar	Jay R. Indyke
Turnaround Management Association's Distressed Investing Conference	January 18-20, 2012 Las Vegas, NV	Ronald Sussman Jeffrey Cohen
ABCD Motor Credit Association	January 19, 2012 Tampa, FL	Jay R. Indyke TOPIC: "Cross-Border Insolvencies and other Credit Executive Issues"
Cooley In-House Counsel MCLE Workshop	January 26, 2012 San Francisco, CA	Bob Eisenbach TOPIC: "Bankruptcy Update"
CRF's Credit & Accounts Receivable Forum	March 20, 2012 Marina del Rey, CA	Lawrence Gottlieb Jeffrey Cohen TOPIC: "Where is Bankruptcy Headed and How Could It Be Made Better?"
Turnaround Management Association's Spring Conference	April 3-5, 2012 Atlanta, GA	Ronald Sussman Jay R. Indyke TOPIC: "Capital Markets"

The Court found that there was cause to lift the stay, and that the directors and officers should receive payment for their defense costs. The Court concluded that the debtor purchased the insurance policy in order to protect its directors and officers, who should not be prevented from accessing the proceeds of the policy "simply because [the] Debtor wishes to save the policy limit for any potential claims of its own."

by the FDIC in April 2010. As a result of the bank failure, certain of the debtor's directors and officers were sued for breach of fiduciary duty and negligence. The debtor had purchased an insurance policy which included the following coverage: directors and officers individual coverage, company indemnification coverage, company liability coverage, and investigative costs coverage. The policy was a "declining balance policy" (a type of policy also known as a "wasting policy" in which legal defense costs are paid out of the policy limits).

The Court in *Beach First National* recognized that while the majority of courts view insurance policies as property of the estate, there is less of a consensus on whether the proceeds of insurance policies are also part of the estate. Nevertheless, courts generally agree that a debtor must have a direct interest in the proceeds of an insurance policy in order for those proceeds to qualify as property of the estate. As a result, where an insurance policy only provides direct coverage to directors and officers, the proceeds are not property of the estate.

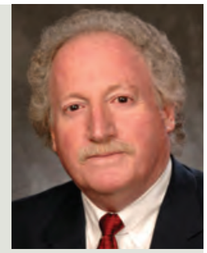
More complicated issues arise where both the debtor and the directors and officers have direct interests in the proceeds of an insurance policy. In this situation, courts have developed a test, which was stated by the Court in *Beach First National* as follows: "the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution." Furthermore, if a debtor's direct coverage is limited to indemnification coverage, then the policy proceeds are not property of the estate where "indemnification either has not occurred, is hypothetical, or speculative."

In *Beach First National*, the Court found that the debtor had an interest in the policy because the aggregate limit for each policy is allocated not only to individual coverage of directors and officers, but also for company indemnification, and, most importantly, company liability coverage. Moreover, because the policy is a declining balance policy, defense costs paid through the policy will reduce the amount available to pay any claims of the debtor; therefore, if the directors' and officers' legal defense costs exhaust the policy limit, the debtor could be forced to use other assets to satisfy potential claims.

However, just because the debtor has a direct interest in the policy proceeds (which are therefore property of the estate and protected by the automatic stay) does not mean that directors and officers will not have access to those proceeds. Under section 362(d)(1) of the Bankruptcy Code, a court can grant directors and officers relief from the automatic stay to access the policy proceeds "for cause." "Cause" is not defined in the Bankruptcy Code, and courts look at case-specific facts in order to determine whether sufficient cause exists to grant relief from the automatic stay.

ANALYSIS

BY JAMES BELDNER



In reaching this decision, the Court in *First Beach National* followed similar decisions from courts in Delaware and New York. For the reasons discussed in *First Beach National*, Courts have become increasingly willing to lift the automatic stay to provide directors and officers with access to the proceeds of insurance policies bought for their benefit, even where those policies also provide direct coverage to the debtor.

Following a growing trend in decisions addressing matters like those at issue in Beach First National, the Court found that there was cause to lift the stay, and that the directors and officers should receive payment for their defense costs. The Court concluded that the debtor purchased the insurance policy in order to protect its directors and officers from personal liability and having to pay legal defense costs, and those same directors and officers should not be prevented from accessing the proceeds of the policy "simply because [the] Debtor wishes to save the policy limit for any potential claims of its own." The directors and officers bargained for and obtained a policy to protect them from liability arising from actions taken in their professional capacity, and the Court held that the policy should be used for its intended purpose. Therefore, the Court determined that there was sufficient cause to lift the stay and permit the directors and officers access to the policy. •

Other Current Cooley Representations

CASE	COOLEY REPRESENTATION	RESULT
In re Signature Styles, LLC, et al., Case **No. 11-11733 (Bankr. D. Del. 2011)**	Creditors' committee counsel	Cooley successfully leveraged potential claims against the debtors' equity holder and proposed purchaser into a projected 8-10% distribution to general unsecured creditors in a case where unsecured creditors would not otherwise receive a distribution. The committee is currently promulgating a joint liquidating plan with the debtors and expects to make a distribution to creditors early in 2012.
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.
Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities, LLC, **Adv. Proc. No. 08-1789 (Bankr. S.D.N.Y. 2008)**	Defense Counsel	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 LLLP, **Case No. 11-02801 (Bankr. M.D. Fla. 2011)**	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.

CASE	COOLEY REPRESENTATION	RESULT
Proceedings in New York Supreme Court, County of Kings	Counsel to an ad hoc group of tort claimants in connection with the sale of Long Island College Hospital's operations to SUNY Downstate Medical Center and the establishment of a trust to satisfy existing medical malpractice claims against the hospital	Cooley is 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 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.
***McCarthy, Trustee v. Wells Fargo Bank, N.A. (In re Osama M. El-Atari)*, Adv. Pro. No. 11-01427 (Bankr. E.D. Va. 2011)**	Defense counsel	Cooley is representing Wells Fargo in connection with the chapter 7 Trustee's fraudulent conveyance action.
***In re Appleseed's Intermediate Holdings LLC, et al.* d/b/a Orchard Brands, Case No. 11-10160 (Bankr. D. Del. 2011)**	Creditors' committee counsel	Cooley filed a complaint on behalf of the committee asserting that the debtors' private equity sponsor 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. The reference was recently withdrawn by the Delaware District Court and the defendants' motion to dismiss the complaint remains pending.