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from the editor

JEFFREY L. COHEN

In our prior edition of *Absolute Priority*, we focused your attention on the early bankruptcy and district court decisions addressing the U.S. Supreme Court's watershed ruling in *Stern v. Marshall*, which raised (but did not answer) the seminal question of whether the federal bankruptcy courts, as non-Article III tribunals, are constitutionally authorized to enter final judgments. Not unexpectedly, the *Stern* debate continues to divide the federal judiciary. In this edition of *Absolute Priority*, we bring you up to speed on two crucial rulings by the Delaware bankruptcy courts expounding a narrow interpretation of *Stern*, and contrast them with a recent decision by a Northern California district court taking a broader interpretation of the Supreme Court's ruling.

While the bankruptcy and district courts struggle to tie up *Stern's* loose ends, the Supreme Court recently resolved the hot button question of whether a secured creditor has the unqualified right under section 1129 of the Bankruptcy Code to credit bid its debt in connection with the sale of a debtor's assets under a plan of reorganization. As discussed in prior editions of *Absolute Priority*, this issue first arose in the *Philadelphia*

Newspapers case in which the Third Circuit held that secured creditors do not have unqualified credit bidding rights in chapter 11; a conclusion that was later reached by the Fifth Circuit in the *Pacific Lumber* case. But the Seventh Circuit refused to join its sister circuits in the *River Road* case and vindicated the rights of secured creditors to credit bid on assets sold under a chapter 11 plan. On May 29, 2012, the Supreme

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Court affirmed the Seventh Circuit's ruling and held that the "unambiguous" language of section 1129 dictates that a debtor may not sell property free and clear of a secured creditor's lien without permitting the creditor to credit bid its secured claim. Look for a full report on the Supreme Court's decision in our next edition.

In this edition, we'll also fill you in on the latest in the seemingly endless saga that is section 546(e) of the Bankruptcy Code, the Fifth Circuit's significant extension of the "recharacterization" doctrine to non-insider claims, and the Seventh Circuit's decision to permit creditor "gifting" in the context of a chapter 7 liquidation. So sit back, relax and enjoy our Summer 2012 edition of *Absolute Priority*.

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

absolute PRIORITY

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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.

Delaware Bankruptcy Courts Narrow Impact Of *Stern v. Marshall* In Fraudulent Conveyance Litigation

In the Winter 2012 issue of *Absolute Priority*, we dedicated many pages to the United States Supreme Court's decision in *Stern v. Marshall*, Case No. 10-179, 131 S. Ct. 2594, 2011 WL 2472792 (June 23, 2011) and several of the important bankruptcy court decisions rendered in its wake. In *Stern*, the 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, lacks the constitutional authority to decide state law counterclaims brought by a debtor against a creditor even if the matter is part of the "core" statutory jurisdiction of the bankruptcy court. The *Stern* decision failed to provide clear guidance as to the scope of a bankruptcy court's authority to adjudicate state law claims and bankruptcy courts continue to struggle to interpret its meaning. However, in two recent decisions discussed below, the Delaware bankruptcy courts have adopted narrow interpretations of the *Stern* decision which significantly lessen the impact of its precedent.

In re *USDigital, Inc.*

In *In re USDigital, Inc.*, 461 B.R. 276 (Bankr. D. Del., Dec. 20, 2011), Judge Sontchi reasoned that "[t]o broadly apply *Stern's* holding is to create a mountain out of a mole hill." In that case, the chapter 7 trustee had brought various adversary proceedings against the debtor's insiders, including for equitable subordination of the insiders' claims under Section 510(c) of the Bankruptcy Code. Certain of the defendants filed a motion in the bankruptcy court seeking a determination of whether these actions were "core" or "non-core" proceedings under 28 U.S.C. §157, which would then determine whether the bankruptcy court had statutory authority to enter a

ANALYSIS

BY
JAY INDYKE



In light of the explicit limiting language in the *Stern* opinion and the far-reaching (and likely unintended) consequences of its broad interpretation, both Judge Gross and Judge Sontchi adopted the narrow interpretation and concluded that a bankruptcy court is authorized to issue final rulings on preference, fraudulent transfer and equitable subordination actions. While the *Direct Response* and *USDigital* decisions are not binding on other courts, they offer reasoned analyses of the *Stern* opinion from well-respected bankruptcy judges in one of the most prominent jurisdictions in the country.

final judgment in the actions. The trustee conceded that all of the claims against the insiders were non-core, except for the equitable subordination action. Therefore, the sole question before the court was whether the trustee's equitable subordination action was a core or non-core proceeding.

Judge Sontchi offered seven general observations concerning the scope and meaning of the *Stern* decision: (1) *Stern* does not limit the bounds of a bankruptcy court's subject matter jurisdiction; (2) *Stern* does not affect the statutory distinction between core and non-core proceedings as defined under 28 U.S.C. § 157; (3) if a matter is core under the statute, then the bankruptcy judge must also have judicial authority

under the Constitution to enter final orders for the proceeding to be “truly core”; (4) if a matter is core under the statute and the Constitution, then the bankruptcy judge may enter final orders subject to normal appellate review; (5) non-core proceedings are (a) not core under the statute or (b) are core under the statute but the bankruptcy judge lacks constitutional authority to enter final orders; (6) a bankruptcy judge’s power over non-core proceedings is limited to issuing proposed findings of fact and conclusions of law that are subject to *de novo* review by the district court; and, (7) a finding that a matter is a non-core proceeding when it has been asserted to be core does not, in and of itself, result in dismissal of the claim.

With these observations in tow, Judge Sontchi proceeded to apply the holding in *Stern* to the subject matter before him. First, in analyzing whether the equitable subordination action was a core proceeding, Judge Sontchi examined whether equitable subordination fit into any of the 16 categories of core proceedings specifically enumerated in 28 U.S.C. § 157(b)(2), and ultimately concluded that equitable subordination was a round peg that did not fit into the statute’s square holes.

Next, Judge Sontchi analyzed whether the equitable subordination action was a core proceeding notwithstanding its exclusion from the enumerated categories listed in 28 U.S.C. § 157(b)(2), because the enumerated categories of section 157(b)(2) are non-exclusive. The Court applied the Third Circuit’s existing two step test to determine whether this non-enumerated claim was core. The Court looked to whether the equitable subordination proceeding (i) invoked a substantive right provided by title 11, or (ii) is a proceeding that by its nature could arise only in the context of a bankruptcy case. The court concluded that equitable subordination satisfied both elements and was thus core given that it is a “unique creature of bankruptcy law.”

Having established that equitable subordination proceedings are core under the statute, Judge Sontchi next addressed whether the bankruptcy court had constitutional authority to enter a final judgment regarding the matter, which turned on the applicability of *Stern*. If *Stern* were to be found inapplicable, the matter would be considered a core proceeding and the inquiry would be over. But if *Stern* were found to be applicable, then the court must apply *Stern* to determine whether the court has sufficient judicial power under the Constitution to enter a final order.

Judge Sontchi described the tension over *Stern* as between those who broadly interpret the holding to generally impact the judicial power of bankruptcy courts and those who narrowly confine its scope to the adjudication of state law counterclaims.

Judge Sontchi described the tension over *Stern* as between those who broadly interpret the holding to generally impact the judicial power of bankruptcy courts and those who narrowly confine its scope to the adjudication of state law counterclaims. Judge Sontchi documented the inconsistent statements within the *Stern* decision which have fueled the debate on interpretation, but concluded that *Stern* must be read narrowly because to do otherwise is “contrary to the letter and the spirit of the Supreme Court’s holding.”

Judge Sontchi ultimately limited his interpretation of the scope of the *Stern* holding to the following: bankruptcy courts lack

constitutional authority to enter final judgments on state law counterclaims that are not resolved in the process of ruling on a creditor’s proof of claim. The Court was then able to quickly dispose of the issue at hand. The trustee’s claim for equitable subordination was a non-enumerated core proceeding under 28 U.S.C. § 157(b)(2) and did not involve a state law counterclaim raised in response to a creditor’s proof of claim. Therefore, the Supreme Court’s holding in *Stern* was not applicable and the Court was authorized to enter a final order adjudicating the proceeding.

In re Direct Response Media, Inc.

Just weeks following Judge Sontchi’s *USDigital* decision, Chief Delaware Bankruptcy Court Judge Kevin Gross similarly analyzed the *Stern* decision and, relying in part on Judge Sontchi’s reasoning, adopted what he called the “Narrow

IN THE NEWS

CASE:

In re BEOBI, Inc., et al. f/k/a Beyond Oblivion, Inc., Case No. 12-10282 (Bankr. S.D.N.Y. 2012)

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley recently advised the Committee during an expedited section 363 sale process which resulted in the going concern sale of the Debtor’s digital streaming music service platform and related intellectual property. Cooley continues to advise the committee in connection with the wind down of the debtor’s estate and complicated claims issues.

» [View the other current Cooley representations on page 12.](#)

Interpretation” of the Supreme Court’s ruling. *In re Direct Response Media, Inc.*, 466 B.R. 626 (Bankr. D. Del. Jan. 12, 2012). Tasked with determining whether *Stern* prohibited the bankruptcy court from issuing a final order on the fraudulent and preferential transfer causes of action before him, Judge Gross contrasted the two potential interpretations of *Stern*.

The Broad Interpretation

In the *Direct Response* decision, Judge Gross rejected the “Broad Interpretation” of the *Stern* opinion. The Broad Interpretation, if followed, would result in a seismic shift in the role of bankruptcy courts

within the Federal judiciary. Effectively, the Broad Interpretation holds that bankruptcy courts lack constitutional authority “to make final adjudications on a bankruptcy estate’s avoidance action claims against defendants, even if those defendants filed proofs of claim against the estate, and where the bankruptcy estate’s claims seek to augment the bankruptcy estate by obtaining a money judgment and taking the defendant’s property.” *Id.* at 641. Under the Broad Interpretation of *Stern*, only Article III courts have the authority to render final decisions on various matters, including preference and fraudulent conveyance actions that have traditionally been adjudicated in the bankruptcy courts. Adoption of the Broad Interpretation of *Stern* would result in a dramatic influx to the dockets of the district courts and would severely limit the jurisdiction of bankruptcy courts.

The Narrow Interpretation

In contrast to the Broad Interpretation, the “Narrow Interpretation” holds, according to Judge Gross, that *Stern* was “by the express language in the opinion intended to be very narrowly construed” in that it “only specifically removed a debtor’s state law counterclaims...from final adjudicatory authority of the bankruptcy court.” *Id.* at 642. Judge Gross placed a great deal of emphasis on Justice Roberts’ repeated insistence in the *Stern* opinion that the decision is limited in scope and intended to invalidate only one aspect of bankruptcy court’s jurisdiction—where a debtor asserts a state law counterclaim against a creditor who filed a proof of claim in the bankruptcy case. Judge Gross also noted that the Broad Interpretation, which he rejected, did not receive a majority of votes on the Supreme Court because Justice Scalia’s partial concurrence in the judgment did not accept Justice Roberts’ reasoning thereby requiring *Stern* to be narrowly interpreted as a 4-4-1 plurality. •

IN THE NEWS

CASE:

In re Velo Holdings Inc., et al., Case No. 12-11384 (Bankr. S.D.N.Y. 2012)

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley was recently retained by the committee to represent its interests in connection with Velo’s efforts to sell multiple business units through section 363 sales and one or more plans of reorganization.

CASE:

In re United Retail Group, Inc., et al., d/b/a Avenue, Case No. 12-10405 (Bankr. S.D.N.Y. 2012)

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley assisted in the going-concern sale of this plus-size women’s retailer and recently reached a settlement with the debtor’s parent company resolving certain potential causes of action.

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PRESS

Ali M.M. Mojdehi has joined Cooley as a partner in its Bankruptcy and Restructuring practice. He is based in the San Diego office. Mr. Mojdehi advises debtors and creditors and provides counsel to boards on innovative and efficient strategic transactions and restructurings.

Ronald Sussman, Cooley partner and President of the Turnaround Management Association (TMA), recently authored an article on the progress the TMA is making in 2012. [Read the article online.](#)

» [Cooley articles, press releases and previous issues of Absolute Priority can be viewed at: www.cooley.com/news.](#)

California District Court Strips Bankruptcy Court Of Final Authority Over Fraudulent Conveyance Litigation

As recent decisions of the Northern California bankruptcy and district courts in *Heller Ehrman LLP v. Arnold & Porter, LLP* (*In re Heller Ehrman LLP*) illustrate, the impact of *Stern v. Marshall* has extended far beyond the New York and Delaware court opinions discussed in this and prior issues of *Absolute Priority*. In *Heller Ehrman*, the Northern California bankruptcy and district courts considered important questions such as (i) whether bankruptcy judges have authority to enter final judgments in fraudulent transfer cases and (ii) how should bankruptcy and district courts divide responsibility for the adjudication of cases that were generally left to the bankruptcy courts prior to the Supreme Court's decision in *Stern*.

Heller Ehrman, once an international law firm with more 730 attorneys in 15 offices worldwide, filed for bankruptcy in late 2008. Prior to the bankruptcy, Heller gave waivers to other law firms of its right to recover fees associated with unfinished firm business that was generated by its attorneys after their departure. But subsequent to the bankruptcy filing, Heller commenced adversary proceedings against sixteen of these law firms seeking to avoid the waivers as actual and/or constructively fraudulent transfers under the Bankruptcy Code. The defendant law firms filed motions to withdraw the reference to the district court, arguing, among other things, that the bankruptcy court's reference should be withdrawn under *Stern* because the bankruptcy court lacked authority to enter a final judgment in the fraudulent conveyance action.

Bankruptcy Judge Dennis Montali of the Northern District of California exercised his right under the local rules to issue a recommendation to the District Court regarding the motions to withdraw the reference. *Heller Ehrman LLP v. Arnold &*

ANALYSIS
BY
LAWRENCE
GOTTLIEB



As the *Heller* decisions make clear, bankruptcy and district courts are still struggling to interpret the Supreme Court's decision in *Stern v. Marshall*. The decision by the *Heller* District Court exemplifies the middle ground approach of authorizing bankruptcy courts to make proposed findings of fact and conclusions of law for *de novo* district court review.

Porter, LLP (*In re Heller Ehrman LLP*), Adv. Pro. 10-3203, 2011 WL 4542512 (Bankr. N.D. Cal Sept. 28, 2011). In his recommendation, Judge Montali answered two questions: (1) are fraudulent transfer actions "core" proceedings under 28 U.S.C. § 157(b)(3), and (2) if so, did *Stern* hold that bankruptcy judges lack authority to issue final judgments on core matters? Judge Montali explained that as long as a proceeding is a "core" proceeding, he would be authorized to issue a final judgment, reasoning that "the statute says so and *Stern* does not hold to the contrary." As fraudulent transfer actions are delineated as "core" proceedings under section 157(b)(3), Judge Montali concluded that he could issue a final judgment in the *Heller* litigation. Judge Montali further explained that even if the fraudulent transfer actions were not "core" proceedings, or even if *Stern* held that bankruptcy judges are prohibited from issuing final judgments in fraudulent transfer cases, the District Court could still treat his findings as "proposed findings" and review them *de*

novo—the very opposite of the conclusion reached by the Bankruptcy Court for the District of Montana in *In re Blixseth*, 2011 WL 3274042 (Bankr. D. Mont. Aug. 1, 2011), a case that we discussed in the prior edition of *Absolute Priority*.

Although United States District Court Judge Charles Breyer disagreed with a portion of Judge Montali's recommendation, he nevertheless refused to withdraw the reference. *Heller Ehrman LLP v. Arnold & Porter LLP*, No. 11-04848 (CRB) (N.D. Cal. Dec. 13, 2011). The District Court first addressed the

Although United States District Court Judge Charles Breyer disagreed with a portion of Judge Montali's recommendation, he nevertheless refused to withdraw the reference.

issue of whether, after *Stern*, bankruptcy judges have constitutional authority under Article III of the Constitution to enter a final judgment in fraudulent conveyance actions. Looking to the reasoning employed by the Supreme Court in *Stern*, Judge Breyer concluded that a bankruptcy judge does not have authority to enter a final judgment on a fraudulent conveyance action, even if the matter is a "core" proceeding. In *Stern*, the Supreme Court reiterated that a bankruptcy judge can generally decide a case on a final basis where the cause of action falls into the "public rights" exception to the exercise of Article III judicial power. Because *Stern* "specifically linked the public rights exception...to the

question of whether [a bankruptcy court] had authority to enter a final judgment on a claim,” and because the Supreme Court has made clear that a fraudulent transfer claim is properly characterized as a “private right,” Judge Breyer concluded that “*Stern* clearly implied that the bankruptcy court lacks constitutional authority to enter final judgment on the fraudulent conveyance claims presented here.”

Having determined that the Bankruptcy Court could not issue a final judgment on the fraudulent transfer claims, the District Court turned to whether the Bankruptcy Court could still propose findings of fact and conclusions of law for the District Court to consider. For reasons similar to those expressed in Judge Montali’s recommendation, the District Court rejected the reasoning in *Blixseth*, and concluded that a bankruptcy court could propose findings of fact and conclusions of law even if it cannot enter final judgments. In so doing, Judge Breyer joined the majority of courts that have considered the matter. See e.g., see *Dev. Specialists, Inc. v. Akin Gump Strauss Hauer & Feld LLP (In re Coudert Brothers LLP)*, No. 11-5994 et. al., 2011 WL 5244463, at *7 (S.D.N.Y. Nov. 2, 2011); *In re Canopy Fin., Inc.*, No. 11-5360, 2011 WL 3911082, at *5 (N.D. Ill. Sept. 1, 2011); *In re The Mortgage Store, Inc.*, No. 11-0439, 2011 WL 5056990, at *6 (D. Haw. Oct. 5, 2011). •

Questions about Bankruptcy Preference Actions? Cooley has the Answers

To help better position you for preference action defenses, Cooley has prepared a detailed summary of the responses to frequently asked questions about bankruptcy preferences. [Read more about Preference Actions.](#)

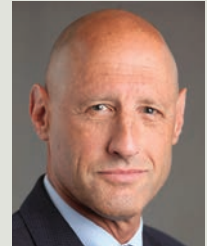
Section 546(e): Defendant’s Best Friend In Fraudulent Transfer Litigation

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 constructively 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. Section 741(8) of the Bankruptcy Code defines “settlement payment” somewhat cryptically, as a “preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment or any other similar payment commonly used in the securities trade.” Congress’s stated purpose for enacting the safe harbor was initially limited, as section 546(e) was intended to reduce the risk in the public financial markets and their related complex clearing systems from the avoidance of long-settled securities transactions. In practice, however, the exception has taken on a life of its own, and in recent years section 546(e) has become one of the most important restrictions on a trustee’s ability to pursue chapter 5 causes of action for the benefit of creditors.

Some courts have interpreted this safe harbor broadly, applying section 546(e) to shield a wide array of otherwise recoverable transfers from avoidance. 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. 2010), 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 transaction). Other courts have read section 546(e) more narrowly, based

ANALYSIS

BY
RONALD R.
SUSSMAN



In the coming months and years, the body of section 546(e) jurisprudence will undoubtedly be developed further at the circuit court and perhaps Supreme Court levels. In the interim, section 546(e) will remain one of the most controversial provisions of the Bankruptcy Code in bankruptcy litigation, and the settlement payment defense will continue to serve as an important weapon for transferees defending against fraudulent transfer suits that implicate the securities industry or any transaction that can be characterized as fitting into the Bankruptcy Code’s amorphous definition of “settlement payment.”

on Congress’s stated purpose, finding the safe harbor inapplicable in cases that do not implicate public securities markets. See *MacMenamin’s Grill Ltd.*, 2011 Bankr. LEXIS 1461 at *11-*12 (Bankr. S.D.N.Y. April 21, 2011) (citing cases); *In re Mervyn’s Holdings, LLC, et al.*, 426 B.R. 488, 500 (Bankr. D. Del. 2010) (holding that section 546(e) of the Bankruptcy Code does not apply to claims arising from multiple transactions that were part of an integrated or “collapsed” sale transaction because they did not involve the sale of securities); *In re Norstan Apparel Shops, Inc., et al*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007).

Two recent decisions have joined the canon of authority that view the safe harbor as an expansive one, invoking section 546(e) as a

basis to dismiss lawsuits seeking to recover transfers that, as first glance, do not fit neatly into any of the categories of transfers enumerated in sections 546(e) and 741(8) of the Bankruptcy Code. Together, these decisions serve as a reminder of section 546(e)'s notoriety and that the controversy surrounding its proper scope is far from resolved.

In *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329 (2d Cir. 2011), the United States Court of Appeals for the Second Circuit held that payments made by Enron to investors for pre-maturity redemption of Enron's commercial paper constituted settlement payments under section 546(e), and were therefore insulated from recovery under the Bankruptcy Code. Prior to the collapse of Enron's business in 2001, the company redeemed \$1.1 billion of its unsecured commercial paper at amounts well in excess of the debt's market value. Pursuant to customary practices, Enron effectuated these redemptions through investor accounts maintained at the Depository Trust Company. The redemptions at issue in the dispute before the Second Circuit were then transferred to investors through accounts at broker/dealer J.P. Morgan in exchange for the redemption price.

When Enron sought to recover these transfers as preferences and fraudulent conveyances under sections 547 and 548 of the Bankruptcy Code, the investors countered that the transfers were immune from avoidance because they were settlement payments. The bankruptcy court disagreed, holding that the transfers did not constitute settlement payments because they were made to acquire title to the commercial paper, not to retire debt. The district court reversed the bankruptcy court's decision, ruling that the definition of "settlement payment" is not limited to payments that are "commonly used" in the securities industry and that the redemptions qualified as securities transactions, even if their purpose was to acquire title to the commercial paper, because they involved the delivery and receipt of funds and securities.

In a victory for those that espouse an expansive reading of section 546(e), the Second Circuit affirmed the district court's ruling in a split opinion. In so doing, the court rejected Enron's argument that the definition of "settlement payment" should be limited so that the payment must (i) be a type of transfer commonly used in the securities industry; (ii) involve the transfer of title (i.e., the purchase and sale) of a security; and (iii) the transfer at issue must involve the participation of a financial intermediary that gains a beneficial interest in

The influence of these two rulings is likely to be magnified by the fact that they emanate from two of the highest profile insolvencies of the past 15 years.

the securities as part of the transaction. The Second Circuit found that the phrase "commonly used in the securities trade" from the Bankruptcy Code definition of "settlement payment" pertains only to the catchall portion of the definition (i.e., "any other similar payment") and not other securities settlement transactions subsumed by the definition. The court also found no basis to preclude the transfer of tradable debt securities, such as those at issue in *Enron*, from the safe harbor. Finally, the court joined appellate courts in the Third, Sixth and Eighth circuits in declining to adopt a *per se* rule that financial intermediaries must obtain a beneficial interest in the securities in order for the policy concerns underlying section 546(e) to be implicated, concluding that there was no reason to think that the unwinding of debt securities transactions such as the one at issue (in which the intermediary did not obtain a beneficial

interest) would not have a significant negative impact on financial markets.

A decision rendered several months after *Enron* by United States District Judge Jed Rakoff of the Southern District of New York also expanded the reach of section 546(e) in the adversary proceeding commenced by Irving Picard, the SIPA trustee tasked with liquidating the estate of Bernie Madoff and the broker-dealer business that served as a front for his notorious Ponzi scheme, against the owners of the New York Mets and a number of their investment vehicles. Judge Rakoff, who is presiding over the matter after granting the Mets' motion to withdraw the reference to the bankruptcy court, was asked by the Mets to dismiss the Trustee's complaint, which sought recovery of approximately \$1 billion in transfers

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 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. Depositions began in June 2012 with trial expected to take place in the Spring of 2014.

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that were made by Madoff's brokerage to the defendants through their accounts. Among other things, the Mets asserted that all transfers that were made on account of what they believed to be legitimate securities transactions (other than transfers that were made within the two-year look back period for actual fraud claims set forth in section 548(a) of the Bankruptcy Code) were shielded from avoidance by section 546(e). The Trustee countered that the safe harbor should not apply where the purported "settlement payments" at issue were not in fact made in connection with transfers implicating the securities markets because the broker-dealer did not effectuate any actual securities transactions. *In Picard v. Katz, et al.*, 2011 U.S. Dist LEXIS 109595 (S.D.N.Y. September 27, 2011), Judge Rakoff sided with the Mets and concluded, with little analysis, that the plain meaning of the definition of "settlement payment" clearly included all payments made by Madoff to his customers. *Id.* at *10.

The *Enron* and *Katz* decisions are just two of the latest in a rapidly growing body of jurisprudence addressing the scope of the settlement payment defense. The influence of these two rulings is likely to be magnified by virtue of the fact that they emanate from two of the highest profile insolvencies of the past 15 years. Nonetheless, it remains to be seen whether these decisions signal a shift in the Second Circuit towards the broad interpretation of section 546(e) that generally pervades the decisional authority in the Third Circuit and away from the restrictive construction of section 546(e) evidenced by *MacMenamin's Grill, Norstan* and authority in other circuits. •

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) and Case No. 11-807 (D. Del. 2011)

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley successfully defeated the defendants' motions to dismiss a \$310 million fraudulent transfer action against, among others, the debtors' private equity sponsors.

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Bankruptcy & Restructuring Event Calendar Summer 2012 Speaking Appearances

Event	Date/Location	Cooley Participant/Topic
WestLegalEdCenter Webinar	June 5 Webinar	Cathy Hershcof TOPIC: "My Estate is Administratively Insolvent: What Do I Do? What to Do When Your Case Turns Out Differently Than Planned"
Turnaround Management Association (TMA) Europe Conference 2012	June 7-8 Madrid, Spain	Ron Sussman, TMA President
NACM Credit Congress	June 11-13 Grapevine, Texas	Jeffrey Cohen Seth Van Aalten
TMA Western Regional Conference	July 12-13 Santa Barbara, California	Ron Sussman, TMA President TOPIC: "The status of the restructuring world in today's economic climate"
CRF Credit Forum	August 13-15 Chicago, Illinois	Jeffrey Cohen Larry Gottlieb
Turnaround Management Association (TMA) Webinar	September 20 Webinar	Keith McDaniels TOPIC: "Construction Turnarounds: The Rules are Different"

Fifth Circuit Extends Recharacterization Remedy To Non-Insider Claims

A recent decision issued by the Fifth Circuit Court of Appeals, *In re Grossman v. Lothian Oil, Inc.* (*In re Lothian Oil, Inc.*), 650 F.3d 539 (5th Cir. 2011), considered the circumstances under which a claim asserted against a debtor's estate may be recharacterized by the bankruptcy court as an equity investment. The Fifth Circuit found that the bankruptcy court had the requisite authority to recharacterize debt as equity as part of the claims allowance process set forth in section 502(b) of the Bankruptcy Code and looked to state law to determine whether the purported claims at issue should be recharacterized in the unique circumstance where the claimant is not an insider of the debtor.

Courts typically consider a variety of factors concerning the structure of the underlying transaction to determine whether “a debt actually exists” that could give rise to a claim. See e.g. *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748 (6th Cir. 2001) (listing 11 factors, including among others, the names given to the instruments, the presence or absence of a fixed maturity date and rate of interest and the debtor's ability to obtain financing from outside lending institutions). The recharacterization of debt as equity can have a significant impact on a debtor's estate and creditors because the Bankruptcy Code provides unsecured creditors with priority in payment ahead of equity stakeholders.

In *In re Lothian Oil*, the claimant entered into two “loan” agreements with the debtors. The first agreement provided for the claimant's transfer of \$200,000 to the debtors in exchange for a 1% royalty of the debtors' gross oil and gas production on certain properties in New Mexico. The second agreement provided for the claimant's transfer of \$150,000 to the debtors in exchange for a second 1% royalty of the debtors' gross oil and gas on the New Mexico properties. Both agreements required the debtors to repay the claimant

from the proceeds of a \$0.75 per share equity placement. The claimant filed two proofs of claim on account of these agreements in the debtors' chapter 11 cases. The bankruptcy court recharacterized these claims as equity investments, but the district court reversed, concluding that the remedy of recharacterization applies only to the purported claims of insiders of a debtor.

On appeal, the Fifth Circuit rejected the district court's per se prohibition against the recharacterization of non-insider claims. The Fifth Circuit concluded that “recharacterization extends beyond insiders and is

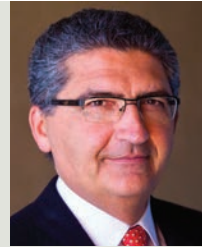
Applying Texas state law (which uses a sixteen factor test imported from federal tax law), the Fifth Circuit agreed with the bankruptcy court's determination that the purported loans should be recharacterized as equity investments.

part of the bankruptcy court's authority to allow and disallow claims under 11 U.S.C. § 502.” *Id.* at 542. Relying on Supreme Court precedent in *Butner v. United States*, 440 U.S. 48 (1979), the Fifth Circuit explained that: “Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law... “[u]nless state law makes insider status relevant to characterizing equity versus debt, that status is irrelevant in federal bankruptcy proceedings.” *Id.* at 543-44 (quoting *Butner v. U.S.*, 440 U.S. 48, 54 (1979)).

Applying Texas state law (which uses a sixteen factor test imported from federal

ANALYSIS

BY
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The Fifth Circuit's decision in *In re Lothian Oil, Inc.* suggests that non-insiders will not be immunized from recharacterization challenges if the facts and circumstances of the underlying transaction more closely resemble an equity investment. The Fifth Circuit's decision may provide a broader basis for recharacterization challenges, which, if successful, will often significantly enhance returns to general unsecured creditors.

tax law), the Fifth Circuit agreed with the bankruptcy court's determination that the purported loans should be recharacterized as equity investments. The Fifth Circuit focused its analysis on “the fact that [claimant] would be paid from royalties and ‘equity placements’ as well as the lack of a specified interest rate, term of repayment and maturity date.” *Id.* at 544-45. The Fifth Circuit concluded that these factors supported the conclusion that the claimant's transfer of funds to the debtors was intended as an investment in, rather than a loan to, the debtors notwithstanding the fact that the claimant was not an insider of the debtors. In February 2012, the Supreme Court denied the claimant's petition for writ of certiorari. *Lothian Cassidy LLC v. Lothian Oil, Inc.*, No. 11-792, 2012 WL 538409 (U.S. Feb. 21, 2012). •

Actual Success Not Required For Payment of “Success Fee”

In the *Borders Group, Inc.* case, Judge Martin Glenn of the United States Bankruptcy Court for the Southern District of New York recently awarded a “Liquidation Fee” to Jefferies & Company, Inc., over the objection of the official committee of unsecured creditors, even though Jefferies was not involved in the actual liquidation sale process. *In re Borders Group, Inc., et al.*, Case No. 11-10614-MG (Bankr. S.D.N.Y. Dec. 5, 2011). Jefferies, rather, was retained by Borders to provide investment banking services for the purpose of attracting a going concern buyer. Jefferies’ engagement letter and the bankruptcy court’s order approving Jefferies’ retention provided for the payment of a \$5.5 million fee if Jefferies found a going-concern buyer and a \$1.5 million fee if Borders was sold through a liquidation sale. Neither the order nor the engagement letter specifically provided that Jefferies had to be actively involved in the liquidation sale process in order to earn the \$1.5 million Liquidation Fee.

Borders filed for chapter 11 protection in early 2011 with the intention of selling its business as a going concern. Jefferies engaged in an extensive marketing process in an attempt to accomplish a going concern sale of Borders. After reviewing Jefferies’ time records attached to its fee application, the Bankruptcy Court noted that Jefferies (i) contacted approximately eighty parties potentially interested in acquiring the debtors’ assets, (ii) worked with the debtors to negotiate and execute confidentiality agreements with interested buyers; (iii) facilitated due diligence for potential buyers; (iv) prepared numerous presentations to interested parties; (v) organized and attended meetings with interested parties and the debtors’ senior management; and (vi) arranged and participated in meetings between interested parties and creditors’ committee advisors and representatives. When Borders’ efforts to reorganize as a going concern

ANALYSIS

BY
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This decision serves as a reminder that professional fee arrangements must be carefully reviewed by interested parties prior to court approval. Once an order is entered approving professional compensation arrangements, courts and interested parties may not be able to alter their terms.

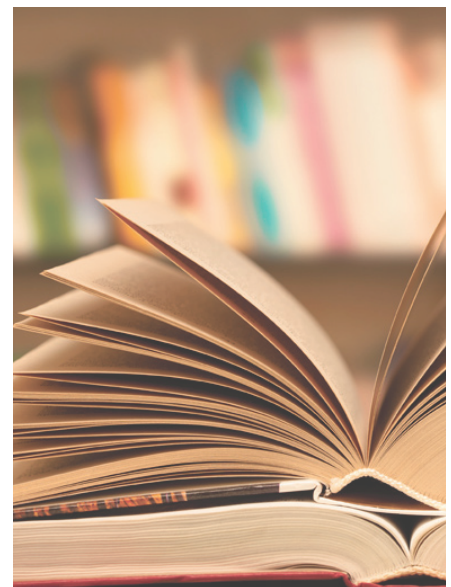
Judge Glenn noted that while the committee may not have intended for Jefferies to be paid a Liquidation Fee if Jefferies did not contribute to the liquidation sale process, the terms of the order dictated otherwise.

proved unsuccessful, the bankruptcy court approved the sale of Borders’ assets through going out of business sales. Jefferies applied to the Bankruptcy Court for payment of its Liquidation Fee.

The creditors’ committee argued that Jefferies was not entitled to the Liquidation Fee because Jefferies did not play any role in the liquidation sale, which was arranged by management and other advisors. Moreover, the committee argued that the order approving Jefferies’ retention did not reflect the “intent” of the committee and Jefferies. According to the committee,

it was understood between the committee and Jefferies that no Liquidation Fee would be payable unless Jefferies played a major role in the liquidation process.

Judge Glenn rejected the committee’s arguments and relied on the “clear and unambiguous language” of the retention order, which provided that Jefferies would be entitled to a Liquidation Fee if Jefferies “ran a sale process with respect to such assets.” Based on its finding that Jefferies spent significant time and effort running a going concern sale process (albeit an unsuccessful one), the bankruptcy court ruled that Jefferies was entitled to the Liquidation Fee under the terms of the engagement letter and retention order. Judge Glenn rejected the committee’s attempt to submit parole evidence in the form of an email exchange between committee counsel and Jefferies. Parole evidence is generally inadmissible where the language of an order is clear on its face. Judge Glenn noted that while the committee may not have intended for Jefferies to be paid a Liquidation Fee if Jefferies did not contribute to the liquidation sale process, the terms of the order dictated otherwise. •



Seventh Circuit Permits “Gifting” In Chapter 7 Case

In a recent decision in *In re Holly Marine Towing, Inc.*, Case No. 11-1787 (7th Cir. 2012), the Seventh Circuit Court of Appeals permitted one creditor to give a “gift” to another creditor in the context of a chapter 7 liquidation, even though the payment resulted in an unequal distribution among similarly situated creditors. The Seventh Circuit’s opinion comes on the heels of *In re DBSD North America, Inc.*, 634 F.3d 79 (2d Cir. 2010), a recent opinion from the Second Circuit Court of Appeals addressing the propriety of “gifting” under a chapter 11 plan, and which was discussed in the Summer 2011 edition of Absolute Priority.

“Gifting” is a term used to describe the statutorily ambiguous situation where a senior creditor agrees to carve-out a portion of its collateral for the benefit of one or more junior claimholders. In its most common incarnation, a senior creditor will resolve the opposition of a junior, out-of-the-money class of creditors, by giving them a “gift” of a portion of their collateral, the proceeds of their collateral, or some other assets under their control. By way of example, 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 its own interests.

In *DBSD*, the Second Circuit curtailed gifting under a chapter 11 plan, holding that the practice violates the Bankruptcy Code’s requirement that no junior claimholder retain or recover any money or property under a plan unless each senior claimholder is paid in full. This rule, codified in section

1129(b)(2)(B) of the Bankruptcy Code, is commonly referred to as the “absolute priority” rule. In *DBSD*, the Second Circuit explicitly limited its holding to gifting under a chapter 11 plan, stating that it did not need to address gifting outside of a plan given the facts and circumstances before the court. Nevertheless, the Second Circuit’s reasoning is potentially at odds with court decisions permitting gifting outside of a plan, including the Seventh Circuit’s recent decision in *Holly Marine*. Specifically, the Second Circuit, stating that the absolute priority rule in section 1129(b)(2)(B) extended “to ‘any property;’ not any ‘any property’ not covered by a senior creditor’s lien,” dismissed the argument that the absolute priority rule is not implicated where a debtor is unable to pay secured creditors in full, even though the “gift” from the undersecured lender to the junior claimholder could never impact creditors of a higher priority. Thus, even though the holding in *DBSD* is explicitly limited to gifting under a plan, it may be used by those seeking to oppose gifting outside of a plan of reorganization as well.

In contrast, in *Holly Marine*, the Seventh Circuit affirmed the bankruptcy court’s decision approving a settlement agreement that resulted in disparate recoveries for similarly situated creditors, which is generally prohibited in the context of a chapter 7 liquidation by the absolute priority rule codified in sections 726, 503, and 507 of the Bankruptcy Code.

The facts at issue in the *Holly Marine* case are fairly simple. Holly Marine Towing, Inc. filed its chapter 11 case on January 8, 2007, and the bankruptcy court converted the case to chapter 7 the following year. During the proceeding, a dispute arose over the sale of real estate. The debtor’s principals, who were in the process of divorce, both claimed ownership of the property, as did the chapter 7 trustee on behalf of the estate. A settlement was ultimately reached between the parties, providing that the proceeds from the sale of

ANALYSIS

BY

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The Seventh Circuit’s reasoning is arguably at odds with the Second Circuit’s in *DBSD*. As discussed, the *DBSD* Court rejected the concept of gifting under the plan even where the assets being “gifted” would not otherwise inure to the benefit of the estate, an argument that the Seventh Circuit seems to inherently reject, at least in the context of chapter 7 cases.

the property would be shared by the two principals and the estate. As part of the settlement, the two principals were required to pay the debtor’s bankruptcy attorneys’ fees out of their personal share of the proceeds from the sale. An administrative creditor that provided postpetition consulting to the debtor challenged the agreement, arguing that the payout to the debtor’s bankruptcy attorneys was prohibited by the absolute priority rule, and that proceeds used to pay the attorneys should have been distributed to all administrative creditors on a *pro rata* basis.

The Seventh Circuit did not address the concept of “gifting” by name. Nevertheless, in upholding the bankruptcy court’s decision, the Seventh Circuit rejected appellant’s argument that the payment to the debtor’s attorney violated the absolute priority rule. The Seventh Circuit concluded that the funds paid were not assets of the estate and therefore “the priority scheme simply does not apply.” Thus, the principals’ “gift” of part of the sale proceeds to the debtor’s bankruptcy attorney was affirmed. •

Other Current Cooley Representations

CASE	COOLEY REPRESENTATION	RESULT
<i>In re Trident Microsystems, Inc., et al., Case No. 12-10069</i> (Bankr. D. Del. 2012)	Counsel to Entropic Communications, Inc. (stalking horse purchaser)	Cooley represents Entropic in connection with its purchase of the debtors' set-top-box business and a broad portfolio of intellectual property assets for approximately \$65 million.
<i>In re Wave 2 Wave Communications, et al., Case No. 12-13896</i> (Bankr. D. N.J. 2012)	Creditors' committee counsel	Cooley is in the process of negotiating a plan of reorganization with the debtors and their secured lenders.
<i>In re Signature Styles, LLC, et al., Case No. 11-11733</i> (Bankr. D. Del. 2011)	Creditors' committee counsel	Cooley successfully leveraged potential claims against the debtors' equity holder and proposed purchaser into a meaningful distribution to general unsecured creditors in a case where unsecured creditors would not otherwise receive a distribution. The debtors and the committee have confirmed a joint liquidating plan and made distributions to creditors.
<i>In re Goldcoast Liquidating, LLC, et al. f/k/a Claim Jumper Restaurants, Case No. 10-12819</i> (Bankr. D. Del. 2010)	Counsel to the GUC trustee	Following Cooley's successful efforts in resolving the \$112-million-plus claim filed by the debtors' subordinated noteholders, the trust created for the benefit of general unsecured creditors recently made its first and final distribution.
<i>In re Urban Brands et al. d/b/a Ashley Stewart, Case No. 10-13005</i> (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.
<i>Blockbuster Inc., et al., Case No. 10-14997</i> (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.
<i>Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities, LLC, Adv. Proc. No. 08-1789</i> (Bankr. S.D.N.Y. 2008)		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.
<i>In re Ritz Camera & Image, LLC, et al., Case No. 12-11868 (KG)</i> (Bankr. D. Del. 2012)	Counsel to the Official Committee of Unsecured Creditors	Cooley was recently obtained by the committee to represent its interests in connection with the planned restructuring of Ritz Camera

CASE	COOLEY REPRESENTATION	RESULT
<i>Saint Vincents Catholic Medical Centers of New York, et al., Case No. 10-11963</i> (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.
<i>In re Carefree Willows, LLC</i> Case No. 10-29932 (Bankr. D. Nev. 2010)	Counsel to asset purchaser	Cooley, on behalf of a joint venture that purchased the note and deed of trust on an age-restricted apartment complex in Las Vegas, successfully attacked the debtor's first plan, which proposed imposition of a post-confirmation injunction for the benefit of the debtor's principals, who are non-debtors and personal guarantors on the note. The bankruptcy court's ruling is significant not only from a strategic perspective, but also helps to develop law in the Ninth Circuit on plan-proposed injunctions / releases for the benefit of non-debtors in technical derogation of section 524(e) of the Bankruptcy Code.
<i>In re Orange County Nursery, Inc., Case No. 09-22100</i> (Bankr. C.D. Cal. 2009)	Minority shareholders' counsel	Cooley obtained a district court order which reversed the bankruptcy court and conclusively established that the minority shareholders' pre-petition state court judgment for dissolution constituted a claim in the bankruptcy case, and was not mere equity, thus rendering the debtor's plan unconfirmable.
<i>In re North Plaza, LLC, Case No. 04-00769</i> (Bankr. S.D. Cal. 2004)	Chapter 11 trustee's counsel	Cooley is advising the chapter 11 trustee on a consensual plan of liquidation providing for 100 percent payment to general unsecured creditors and significant payments to junior secured lienholders, after nearly six years of contentious litigation and mediation with the senior secured lender.
<i>In re Qimonda Richmond, LLC, Case No. 09-10589</i> (Bankr. D. Del. 2009)	Creditors' committee counsel	Cooley represents the owner participant of a structured financing arrangement in connection with the disposition of certain semiconductor equipment and adjudication of its \$191 million claim.
<i>Kismet Acquisition, LLC v. Diaz (In re Icenhower), Case No. 03-11155 / Adv. Proc. Nos. 04-90392 and 06-90369</i> (Bankr. S.D. Cal. 2003)	Chapter 7 Trustee's assignee's counsel	Cooley successfully avoided the fraudulent post-petition transfer of interests in certain Mexican real property, obtained affirmance from the district court and is currently awaiting a decision from the Ninth Circuit.