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

SETH VAN AALTEN

As Spring arrives, things are certainly heating up for the Cooley bankruptcy group with two recent and momentous litigation results achieved in the *Mervyn's* and *Appleseed's* bankruptcy cases. In the *Mervyn's* case, Cooley, as counsel for the creditors' committee, obtained a substantial settlement of a $1 billion+ fraudulent conveyance litigation against several significant companies, private equity firms and financial institutions who participated in the 2004 sale of Mervyn's and the simultaneous stripping away of Mervyn's valuable real estate assets. And just weeks after obtaining the historic *Mervyn's* settlement, Cooley's bankruptcy litigators struck again, obtaining a favorable settlement of a $300 million fraudulent conveyance litigation against certain private equity firms on behalf of the *Appleseed's* creditors' committee.

The courts have also been busy deciding a number of important bankruptcy issues that are examined in this edition, from the U.S. Supreme Court's seminal credit bidding decision in *Radlax* to the Eleventh Circuit's noteworthy fraudulent conveyance reversal in the TOUSA case, to the Third Circuit's expansion of the standard for determining when a "claim" arises under the Bankruptcy Code. It's all here for your reading pleasure, so sit back, relax and enjoy the Spring 2013 edition of *Absolute Priority*…As always, the Cooley bankruptcy group has been busy representing creditors' committees in most of today's prominent 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 our world and the bankruptcy world at large. You are, after all, our *Absolute Priority*…

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

key attorney contacts

Jay R. Indyke, Dept. Chair . . +1 212 479 6080
jindyke@cooley.com

Jeffrey L. Cohen. . . . . +1 212 479 6218
jcohen@cooley.com

Robert Eisenbach . . . . . +1 415 693 2094
reisenbach@cooley.com

Lawrence C. Gottlieb. . . . . +1 212 479 6140
lgottlieb@cooley.com

Cathy Hershcopf. . . . . +1 212 479 6138
chershcopf@cooley.com

Richard S. Kanowitz . . . . . +1 212 479 6167
rkanowitz@cooley.com

J. Michael Kelly. . . . . +1 415 693 2076
kellyjm@cooley.com

Keith McDaniels. . . . . +1 415 693 2080
kmcdaniels@cooley.com

Ali M.M. Mojdehi. . . . . +1 858 550 6055
amojdehi@cooley.com

Ronald R. Sussman. . . . . +1 212 479 6063
rsussman@cooley.com

U.S. Supreme Court Says Secured Creditors Have Unqualified Right To Credit Bid For Collateral In Chapter 11 Asset Sales

On May 29, 2012, the U.S. Supreme Court answered in the affirmative the question of whether a secured creditor has the right to credit bid in any sale conducted under the Bankruptcy Code without regard to whether the sale occurs under Section 363 of the Bankruptcy Code or under a plan. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (U.S. 2012). Justice Scalia, writing for a unaminous court (8-0 with Justice Kennedy taking no part), held that plans of reorganization that seek to sell a debtor's assets free and clear of liens must provide secured creditors with the unqualified right to credit bid. The Supreme Court's decision resolves this hotly contested issue that, as reported in prior editions of *Absolute Priority*, had divided the circuit courts for the better part of the past two years.

In recent years, the volume of distressed companies filing for bankruptcy protection in order to sell all or substantially all of their assets pursuant to section 363 of the Bankruptcy Code has dramatically increased. Section 363(b)(1) provides that, after notice and a hearing, a debtor may sell or dispose of its assets outside of the ordinary course of business and 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 to be sold by the debtor. In other words, the secured creditor is entitled to offset the amount of its claim against the purchase price of the collateral to the extent it wishes to purchase such assets. This is a significant protection for secured creditors, particularly as the majority of courts have interpreted section 363(k) to allow the secured creditor to credit bid the "face amount" of its claim, even if the actual value of the collateral is less than the amount of the creditor's claim (i.e., even if the creditor is undersecured).

Section 363 of the Bankruptcy Code is not the only way a chapter 11 debtor may sell all or substantially all of its assets outside of the ordinary course of business; it may also pursue a sale in connection with a confirmed chapter 11 plan. Section 1123(b)(4) of the Bankruptcy Code provides that a plan of reorganization may be implemented through the transfer or sale of all or a part of the property of a debtor's estate. Importantly, even if a chapter 11 plan providing for the sale of all or substantially all of a debtor's assets is rejected by a class of secured creditors, the plan may still be confirmed through the so-called "cramdown" provisions of section 1129(b)(2) if additional requirements are met by the debtor. 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 the following three requirements, which are set forth in subclauses (i), (ii), and (iii) of section 1129(b)(2)(A):

1) The plan provides that the secured creditor (a) retains the lien securing its claim, regardless of whether the collateral is retained by the debtor or transferred to another entity; and (b) receives deferred cash payments totaling at least the allowed amount of its secured claim;

2) 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

ANALYSIS

BY

JAY INDYKE

The *RadLAX* decision ended the controversy caused by the *Philadelphia Newspapers* and *Pacific Lumber* decisions and provides clear guidance for chapter 11 debtors and their secured creditors. Secured creditors once again enjoy the definitive and unqualified right to credit bid the amount of their secured claims in chapter 11 asset sales whether under section 363 of the Bankruptcy Code or pursuant to the terms of a chapter 11 plan of reorganization. After RadLax, a party in interest that seeks to limit a secured creditor's right to credit bid will need to initiate a challenge to the nature, validity, or amount of the secured claim before the creditor has any opportunity to bid.

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Editor in Chief . . . . . Seth Van Aalten
Managing Editor . . . . . Michael Klein
Contributing Authors:
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Supervising Editor . . . . . Jeffrey L. Cohen

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3) 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 (emphasis added).

For decades following the enactment of the current Bankruptcy Code, it was presumed that a secured creditor had an unqualified right to credit bid its debt in connection with a sale of a debtor's assets pursuant to a plan of reorganization. Then, in 2009 and 2010, the Fifth and Third Circuit Courts of Appeals issued controversial opinions in *Pacific Lumber Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009) and *Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010), respectively, both of which held that a secured creditor may, in certain circumstances, be denied the right to credit bid under a chapter 11 plan.

In *Pacific Lumber*, two secured creditors filed a chapter 11 plan that was approved by the bankruptcy court over the objection of a group of secured noteholders. The plan provided for the sale of the noteholders' collateral to entities owned by the two secured creditors for a price to be determined at a valuation hearing conducted by the court (previous efforts to hold an auction were unsuccessful) without providing the noteholders the right to credit bid their own secured claims. After an extensive hearing, the value of the noteholders' collateral was determined by the court, and subsequently paid to the noteholders by the two secured creditors. The bankruptcy court concluded that the plan was confirmable under section 1129(b)(2)(A)(iii) because it provided the noteholders with the indubitable equivalent value of their claims as determined by the court's valuation. The noteholders appealed, arguing that the plan should not have been confirmed over their objection because they had not been afforded an opportunity to credit bid their secured claims for the collateral. The Fifth Circuit upheld the bankruptcy court's ruling, holding that the three subclauses of section 1129(b)(2)(A) provide independent alternatives, and because the debtor sought to confirm the plan under section 1129(b)(2)(A)(iii)—and not under section 1129(b)(2)(A)(ii)—the noteholders did not have an automatic right to credit bid at the sale.

In *Philadelphia Newspapers*, the Third Circuit concurred with the Fifth Circuit while writing a robust opinion on the issue. In that case, the debtors' chapter 11 plan provided for the sale of substantially all of the debtors' assets at a public auction. In an effort to ensure that the assets would be sold to the stalking horse (a buyer the debtors strongly preferred over other potential bidders), 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(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. Like the Fifth Circuit, the Third Circuit 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 in that section and could choose to proceed under the "indubitable equivalent" clause.

> Justice Scalia, writing for a unanimous Court (8-0 with Justice Kennedy taking no part), held that plans of reorganization that seek to sell a debtor's assets free and clear of liens must provide secured creditors with the unqualified right to credit bid.

A year after *Philadelphia Newspapers* was decided, the Seventh Circuit in *In re River Road Hotel Partners, LLC*, 651 F.3d 642 (7th Cir. 2011), 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 creditors if the secured creditors are denied the right to credit bid at the sale of their collateral. The Seventh Circuit's decision, which stood in direct contrast to the Third Circuit's decision in *Philadelphia Newspapers* and the Fifth Circuit's decision in *Pacific Lumber*, reaffirmed the conventional wisdom

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:

In November, Cooley, on behalf of the creditors' committee, obtained approval of a substantial settlement of the $1 billion+ fraudulent conveyance litigation initiated in 2008 against several significant companies, private equity firms and financial institutions who participated in the 2004 sale of Mervyn's and the simultaneous stripping away of Mervyn's valuable real estate assets. The disclosure statement for the joint chapter 11 plan of liquidation of the committee and debtors was approved and confirmed.

» *Read more about this noteworthy outcome.*

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

regarding a secured creditors' right to credit bid in asset sales under a plan.

The *Radlax* decision involved two sets of similarly situated bankruptcies, one by owners of a hotel near O'Hare airport in Chicago, and the other by 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 financing, 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 to a stalking horse bidder who was offering significantly less than the face 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 claims in connection with the sale. Amalgamated Bank, on behalf of both sets of secured lenders, objected to both plans of reorganization on the grounds that a plan could not be confirmed over the objection of secured creditors where the plan provides for the sale of their collateral without empowering the secured creditors to credit bid their claims. The bankruptcy court agreed with the lenders, and held that the plans providing for the credit bidding prohibitions could not be confirmed. 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' reorganization plans could not be confirmed over the secured creditors' objections because the plans did not satisfy the "fair and equitable" standard of section 1129(b)(2)(A) of the Bankruptcy Code. In so holding, the Seventh Circuit rejected the debtors' argument (successfully advanced in *Pacific Lumber* and *Philadelphia Newspapers*) 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 allow a secured creditor to credit bid so long as the secured creditor is provided with the "indubitable equivalent" of the value of its collateral. Instead, the Seventh Circuit 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 would not permit confirmation under the "indubitable equivalent" clause. 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 1129(b)(2)(A)(ii), which gives secured creditors the unqualified right to credit bid 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 denies secured creditors the right to credit bid lack a crucial check against the undervaluation of assets for sale. The debtors appealed the Seventh Circuit's decision and the Supreme Court granted certiorari.

The Supreme Court affirmed the Seventh Circuit's ruling. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (May 29, 2012). Unlike the Seventh Circuit, which found it necessary to look beyond the text of 1129(b)(2)(A), the Supreme Court determined that a general principal of statutory interpretation decided the case. Foregoing the Seventh Circuit's analogies to other parts of the Code, the Supreme Court employed the "general/specific" rule of statutory interpretation, under which a more specific provision is considered an exception to a more general rule. That is, if a general rule and a more specific rule each apply to an issue, the specific rule governs.

Applying this method of statutory interpretation, the Supreme Court rejected the debtors' argument that a plan could be

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 recently inked a favorable settlement resolving a $300 million fraudulent conveyance litigation commenced by the creditors' committee against the company's former owners. Prior to the settlement, Cooley defeated motions of the former owners to dismiss the litigation and in the process created new law regarding the applicability of certain defenses to fraudulent conveyance actions. As a result of the settlement, unsecured creditors (who were not previously projected to receive a distribution) will receive a significant return on their claims.

CASE:

***In re Atari, Inc., et al.,* Case No. 13-10176 (Bankr. S.D.N.Y)**

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Cooley was recently retained by the creditors' committee to represent its interests in connection with Atari's efforts to sell its assets, including its portfolio of intellectual property related to its iconic video games.

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

confirmed without permitting the secured creditor to credit bid if the plan provides the creditor with the indubitable equivalent of its claim because clause 1129(b)(2)(A)(iii) is a general provision, while clause 1129(b)(2)(A)(ii) "is a detailed provision that spells out the requirements for selling collateral free of liens." In other words, clause 1129(b)(2)(A)(ii), which grants secured creditors the right to credit bid, applies to any plan contemplating the sale of assets free and clear of a lien, and the more general "indubitable equivalent" standard of 1129(b)(2)(A)(iii) applies to assets sales under a plan that are not free and clear of the secured creditor's lien. The result is that a debtor cannot simply choose to provide a secured creditor with the indubitable equivalent value of its claim, while seeking to sell the secured creditor's collateral fee and clear of the underlying lien, and escape the credit bid requirement of clause 1129(b)(2)(A)(ii). •

UPCOMING

Cooley partners **Jay Indyke** and **Larry Gottlieb** will be speaking at the 2013 NACM Eastern Region Credit Conference on April 8, 2013, in Boston.

In addition, Cooley partner **Ron Sussman** will be speaking at the 2013 **TMA Spring Senate**, May 14–15, 2013, in Chicago.

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

» *View the complete Bankruptcy & Restructuring Event Calendar on page 15*

Third Circuits Expands Test For Determining When A Claim Arises Under The Bankruptcy Code

The timing of when a "claim" arises under the Bankruptcy Code is a deceptively complicated issue with significant implications for the administration of bankruptcy cases. Because claims may be discharged under section 727(a) and section 1141(d) of the Bankruptcy Code, a broad interpretation of "claim" can enable a debtor to shield itself and its successors from liability against a wide range of parties, including those with unknown latent claims for damages arising from defective products that have yet to manifest themselves. Over the last several years, the Third Circuit Court of Appeals has been re-shaping its decisional authority concerning the time when a claim arises, and has recently adopted a new standard that is more in tune with the jurisprudence applied in the majority of jurisdictions. In *Wright v. Owens Corning*, 679 F.3d 101 (3d Cir. 2012), the Third Circuit continued to flesh out its new and evolving standard in this important area of bankruptcy law.

Section 101(5) of the Bankruptcy Code defines a claim as "[a] right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured…" The Supreme Court has stated that the term "claim" is intended to have "the broadest available definition," *FCC v. NextWave Pers. Comm'cns Inc.*, 537 U.S. 293, 302 (2003), and it is widely accepted that Congress contemplated that "'all legal obligations of the debtor, no matter how remote or contingent, will be able to be dealt with in the bankruptcy'" to permit the "'broadest possible relief in bankruptcy court.'" *Grady v. A.H. Robins Co., Inc.*, 839 F.2d 198, 200 (4th Cir. 1988) (quoting H.R.Rep. No. 595, 95th Cong., 1st Sess. 309 (1977), S.Rep. No. 989, 95th Cong., 2d Sess. 21-22 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5807-08 and 6266)). A "right to an equitable remedy" that "gives rise to a right to payment" also constitutes a "claim" under Section 101(5)(b) of the Bankruptcy Code. *See, e.g., Ohio v. Kovacs*, 469 U.S. 274 (U.S. 1985) (a claim exists if a debtor can perform an obligation only by means of paying money). The Bankruptcy Code's broad definition of claim includes contingent claims, which although not defined by the Bankruptcy Code, is commonly held to include claims which a debtor will be required to pay only upon the occurrence of a future event triggering the debtor's liability. The inclusion of a contingent right to payment in the definition of claim under § 101(5) of

ANALYSIS

BY RONALD SUSSMAN

Both elements of the Third Circuit's ruling in *Owens Corning* are noteworthy in their own right. The extension of the test set forth in *Grossman's* to postpetition, pre-confirmation conduct demonstrates the Third Circuit's commitment to moving away from the oft-criticized *Frenville* decision and its progeny. Moreover, the court's holding regarding the insufficiency of due process underscores the difficulty that debtors face post-*Grossman's* in providing adequate notice of key case deadlines to all holders of claims, especially unknown claimants and other holders of contingent and unmatured claims. As the Third Circuit remarked at the conclusion of its decision in *Owens Corning*, "[t]he shadow of *Frenville* fades, but more slowly than we would like." *Id* at 109.

the Bankruptcy Code clarifies that a right to payment that is not yet enforceable under non-bankruptcy law at the time of the bankruptcy filing may still constitute a claim that is dischargeable in bankruptcy.

The Third Circuit agreed with the district court's extension of the *Grossman's* test to postpetition, pre-confirmation claims, but disagreed that the plaintiffs' due process rights were satisfied.

A broad definition of "claim" accords with the claims allowance process of section 502 of the Bankruptcy Code, which provides for estimation of contingent or unliquidated claims and allows bankruptcy courts to deal comprehensively with all claims in a case. Without such a broad reach, a debtor's ability to reorganize may be seriously threatened by the survival of lingering contingent claims and potential litigation rooted in the debtor's prepetition conduct. However, defining a claim too broadly means that claims of individuals or entities relating to injuries or damages that are not identified at the time of the bankruptcy filing and plan confirmation could be subject to discharge in bankruptcy. For example, a problematic case arises where a debtor's prepetition conduct injures a person after plan confirmation. While a state law cause of action or right to payment typically does not accrue until manifestation of the injury, a broad definition of claim may indicate that Congress meant to capture this very scenario under the § 101(5) claim definition.

Grappling with the competing interests of debtor protection and non-debtor due process, courts have created three tests to determine when a claim arises under the Bankruptcy Code: (1) the right to payment approach; (2) the conduct approach and (3) the relationship/ fair contemplation approach. Under the right to payment approach, which was famously adopted by the Third Circuit in *Avelino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984), a claim arises for bankruptcy purposes when a right to payment accrues or matures. A claim arises under the conduct test, applied by the Fourth Circuit in *Grady v. A.H. Robins Co., Inc.*, 839 F.2d 198, 200 (4th Cir. 1988), when the debtor engages in conduct that ultimately causes harm, even if the actual injury or accrual of a cause of action under state law does not take place until after the debtor's bankruptcy filing. Because of the breadth of claims encompassed by the conduct test, some courts have required a pre-bankruptcy relationship between the debtor and the purported claimant. Commonly referred to as the "prepetition relationship test," this test provides that a claim exists under the Bankruptcy Code only if it arises from the debtor's prepetition conduct *and* the claimant had some prepetition relationship with the debtor such as contact, exposure, impact or contractual privity. *See, e.g., Epstein v. Official Committee of Unsecured Creditors of Estate of Piper Aircraft Corp.*, 58 F.3d 1573 (11th Cir. 1995).

Courts outside the Third Circuit have routinely declined to follow *Frenville's* right to payment test, reasoning that a test focusing exclusively on when a right to payment accrues or matures conflicts with the Bankruptcy Code's expansive treatment of the term "claim." Indeed, the *Frenville* decision has long been labeled "one of the most criticized and least followed precedents decided under the current Bankruptcy Code." *See e.g., Firearms Imp. & Exp. Corp. v. United Capital Ins. Co. (In re Firearms Imp. & Exp. Corp.)*, 131 B.R. 1009, 1015 (Bankr. S.D. Fla. 1991); *see also Emons Indus., Inc. v. Allen (In re Emons Indus., Inc.)*, 220 B.R. 182, 193 (Bankr. S.D.N.Y. 1998).

In the wake of *Frenville*, courts generally adopted the conduct test or the prepetition relationship test. Perhaps as a result of this criticism, the Third Circuit departed from its prior jurisprudence, overruling its prior adoption of the right to payment approach in *Jeld-Wen, Inc. v. Van Brunt (In re Grossman's Inc.)*, 607 F.3d 114 (3d Cir. 2010). In that case, a claimant was allegedly exposed to asbestos when she used the debtors' products in 1977, twenty years before the debtors filed their chapter 11 cases. In 2007, the claimant was diagnosed with mesothelioma, a cancer linked to asbestos exposure. Shortly thereafter, the

claimant commenced a state court tort and breach of warranty action against the debtors' successor-in-interest and other companies that allegedly manufactured the asbestos-containing products. In response, the debtors' successor brought an adversary proceeding in the bankruptcy court to enjoin claimant's action and for a determination that any liability on the claims had been discharged pursuant to the debtors' chapter 11 plan of reorganization.

Relying on *Frenville*, the bankruptcy court held that the asbestos claims were not discharged by the debtors' chapter 11 plan because the claims arose subsequent to the plan's effective date according to state law. On appeal, the district court affirmed the bankruptcy court's holding with respect to the tort claims. The debtors' successor appealed to the Third Circuit. The Third Circuit concluded that *Frenville* had too narrowly construed what constituted a "claim", in effect, disregarding the "contingent" and "unmatured" language in the Bankruptcy Code's definition of claim. *In re Grossman's Inc.*, 607 F.3d at 121. The Third Circuit concluded that "[i]rrespective of the title used, there seems to be something approaching a consensus among the courts that a prerequisite for recognizing a 'claim' is that the claimant's exposure to a product giving rise to the 'claim' occurred prepetition, even though the injury manifested after the reorganization." *Id* at 125. The Third Circuit thus struck down the long-standing accrual test established in *Frenville* and held that a "claim" arises when an individual is exposed prepetition to a product or other conduct giving rise to an injury, which underlies a "right to payment" under the Bankruptcy Code.

Even though the Third Circuit appeared to sharply limit the claimant's rights based on its conclusion that the claim at issue arose prepetition under the conduct test, the Grossman's court declined to decide whether the claimant's claim was discharged by the bankruptcy court's 1997 confirmation order. Before the court could conclude that the claimant's prepetition claim was discharged by the debtor's confirmed plan, the court stated that it must be decided "whether discharge of the claim would comport with due process." *Id.* at 127. Accordingly, the Third Circuit remanded the case to the bankruptcy court for determination of whether the claimant had sufficient notice of the bankruptcy case and its implications to justify a discharge and insulate the debtors' successor from liability.

In *Wright v. Owens Corning*, 679 F.3d 101 (3d Cir. 2012), the Third Circuit extended its holding in *Grossman's* to claims arising after the commencement of the bankruptcy case, but prior to the confirmation of a plan of reorganization. In *Owens Corning*, two plaintiffs commenced a class action seeking damages related to defects in roofing shingles manufactured by the debtors. One of the plaintiffs, who did not file a proof of claim in the bankruptcy case, asserted damages that were discovered in 2009 that arose from the 2006 installation of shingles, a date that was after the commencement of the debtors' chapter 11 cases, but prior to the effective date of the plan of reorganization that was ultimately confirmed in the case. Under *Frenville*, the plaintiff would not have possessed a "claim" for bankruptcy purposes because the product defect that caused the purported damages did not become apparent until after the plan had been consummated. Nonetheless, based on *Grossman's*, the district court ruled that the plaintiff did in fact have a claim for damages that could be discharged under the plan because his relationship with the debtors and the defective product arose prior to the confirmation of a plan. In granting the debtors summary judgment on the grounds that the plaintiffs' claims were discharged under the plan of reorganization confirmed in the debtors' bankruptcy case, the district court extended the test set forth in *Grossman's* to postpetition claims and held that the published notices of the debtors' chapter 11 cases in numerous national publications constituted adequate notice of the claims bar date and afforded them procedural due process.

The Third Circuit agreed with the district court's extension of the *Grossman's* test to postptetition, pre-confirmation claims, but disagreed that the plaintiffs' due process rights were satisfied. It is generally held that, with respect to unknown claimants such as the plaintiffs, notice by publication in national newspapers is sufficient to satisfy due process requirements. However, as the Third Circuit noted, at the time when notice of the claims bar date was received by the plaintiffs, *Frenville* was still good law in the Third Circuit, and therefore the plaintiffs had no reason to believe that they held "claims" that were subject to discharge if they were not timely asserted and liquidated in the debtors' bankruptcy. *Owens Corning*, 679 F.3d at 108. It was not until *Frenville* was overturned in 2010, after the confirmation of the debtors' plan, that the plaintiffs could have reasonably understood the impact of those proceedings on their contingent and unmatured claims. According to the Court, in these situations "[d]ue process affords a re-do…to be sure all claimants have equal rights." *Id.* •

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.

TOUSA Creditors Vindicated On Appeal By Eleventh Circuit

In a much anticipated decision, the United States Court of Appeals for the Eleventh Circuit broke the stalemate between the bankruptcy and district courts for the Southern District of Florida by affirming the bankruptcy court's finding that TOUSA, Inc. had fraudulently transferred $500 million in liens and over $420 million in cash to settle a litigation with certain of its lenders in the months preceding TOUSA's bankruptcy filing.

TOUSA, Inc., once one of the largest homebuilders in the U.S., was precariously leveraged when the housing crisis hit and ultimately defaulted on various loan and other obligations. In July 2007, facing lawsuits from some of its lenders (the "Transeastern Lenders") alleging damages of over $2 billion, TOUSA agreed to pay approximately $420 million to the Transeastern Lenders to settle the lawsuit. To finance the settlement, TOUSA and certain of its subsidiaries (the "Conveying Subsidiaries") incurred $500 million of new debt and granted liens on substantially all of TOUSA's and the Conveying Subsidiaries' assets as collateral for the new loans. None of the Conveying Subsidiaries had been defendants in the litigation.

Less than six months later, TOUSA and the Conveying Subsidiaries filed for bankruptcy whereupon the creditors' committee commenced an adversary proceeding alleging that the transfer of the approximately $500 million in liens by the Conveying Subsidiaries to the "New Lenders" was a fraudulent transfer under section 548(a)(1)(B) of the bankruptcy code because (i) the Conveying Subsidiaries were insolvent when the transfer occurred, were made insolvent by the transfer, had unreasonably small capital, or were unable to pay their debts when due; and (ii) the Conveying Subsidiaries did not receive reasonably equivalent value in exchange for their transfer. After a 13-day trial, filled with extensive fact and expert testimony —including over 1,800 exhibits—the bankruptcy court granted judgment in favor of the creditors' committee. The bankruptcy court avoided the liens on the assets of the Conveying Subsidiaries and ordered the Transeastern Lenders to disgorge $403 million. The Transeastern Lenders and the New Lenders appealed. Four months later, the pendulum swung the opposite direction as the district court sided with the lenders.

The disputed issues before the Court of Appeals centered on (i) whether the Conveying Subsidiaries received less than reasonably equivalent value for the transfer of the liens, and (ii) whether the Transeastern Lenders were "subsequent transferees" entitled to immunity from recovery to the extent value was taken in good faith and without knowledge of the transfer's voidability. The parties agreed that the Conveying Subsidiaries were insolvent at the time the liens were conveyed to the New Lenders.

The Court of Appeals found that the bankruptcy court did not clearly err in determining that the Conveying Subsidiaries failed to receive reasonably equivalent value in exchange for the liens on their assets. The bankruptcy court had narrowly interpreted "value" under the bankruptcy code as being "property" or "satisfaction or securing of a present or antecedent debt of the debtor." The bankruptcy court reasoned that the Conveying Subsidiaries could not receive "property" unless they obtained some kind of "enforceable entitlement to some tangible or intangible article." Under this definition of "value," the bankruptcy court found that because the Conveying Subsidiaries did not receive any property it was therefore impossible for them to have received "reasonably equivalent value" for granting the liens to the New Lenders. The Transeastern Lenders and the New Lenders argued that this was a far too narrow interpretation of "value" and that in fact the settlement of the litigation provided great value to the Conveying Subsidiaries in a myriad of ways—the greatest of which being the opportunity to avoid bankruptcy, which the lenders argued would have been imminent and inevitable had the litigation continued.

The Court of Appeals was not persuaded by the lenders' argument—which was previously adopted by the district court—that the "chance to avoid bankruptcy" was a benefit reasonably equivalent in value to the obligations the Conveying Subsidiaries incurred. The Court of Appeals observed that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." Further, the Court of Appeals noted that the "opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden. After all, 'there is no reason to treat bankruptcy as a bogeyman, as a fate worse than

ANALYSIS
BY
CATHY
HERSHCOPF

While the TOUSA decision may appear at first blush to have heightened the risk of fraudulent conveyance liability for lenders in the restructuring context, the facts of the TOUSA transaction were particularly egregious in that (i) there was indisputable and publicly available evidence that TOUSA's finances were in dire straits at the time of the settlement, and (ii) the Conveying Subsidiaries were not party to the lender litigation, yet became entwined by incurring the new debt necessary to make the settlement payment.

> The Court of Appeals noted that the "opportunity to avoid bankruptcy does not free a company to pay any price or bear any burden. After all, 'there is no reason to treat bankruptcy as a bogeyman, as a fate worse than death.'"

death.'" The Court of Appeals also noted that there was overwhelming evidence that settling the litigation would not have been enough to save the company, acknowledging the bankruptcy court's finding that "at most it delayed the inevitable." Despite the lenders' arguments that the cause of TOUSA's demise was the unforeseeable and unprecedented severity of the global financial crisis, the Court of Appeals concluded that the record supported a determination that TOUSA's bankruptcy was "far more like a slow-moving category 5 hurricane than an unforeseen tsunami," thus undermining any arguments by TOUSA that it would be viable upon settlement of the litigation and despite the incurrence of millions of new debt. The Court of Appeals also gave credence to the bankruptcy court's alternative finding that even if it accepted all the purported benefits the lenders argued that the Conveying Subsidiaries received, they still fell well short of "reasonably equivalent value" because the costs of the new indebtedness far outweighed any of the purported benefits of the settlement to the Conveying Subsidiaries.

Next, the Court of Appeals rejected the lenders' affirmative defense that they were a "subsequent transferee" and thus immune from disgorgement on account of their purported good faith and lack of knowledge of the voidability of the transfer. The Court of Appeals dismissed the lenders' argument by looking to the loan agreement and noting that the proceeds of the new loan were to be immediately used to pay the Transeastern settlement. Although the loan proceeds technically passed through a TOUSA subsidiary before being wired to Transeastern, the Court of Appeals said that this formality did not make the Transeastern Lenders "subsequent transferees" of the funds because TOUSA never had control over the funds. The Court of Appeals affirmed the bankruptcy court's finding that the funds were unequivocally for the benefit of the Transeastern Lenders.

The Court of Appeals also rebuffed the Transeastern Lenders' doomsday prophecy that holding the lenders liable in this case would "drastically expand the potential pool of entities" that could be liable for any similar transactions and would impose "extraordinary" duties of due diligence on the part of creditors accepting repayment. The Court of Appeals noted that "every creditor must exercise some diligence when receiving payment from a struggling debtor. It is far from a drastic obligation to expect some diligence from a creditor when it is being repaid hundreds of millions of dollars by someone other than a debtor." •

IN THE NEWS

CASE:

***In re Big M, Inc.*, Case No. 13-10233 (Bankr. D.NJ. 2013)**

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Big M is the holding company for retailers Mandee's and Annie Sez. Cooley was recently retained by the creditors' committee to represent its interests in connection with Big M's efforts to sell multiple business units through section 363 sales and/or one or more plans of reorganization.

CASE:

***In re Vertis Holdings, Inc., et al.*, Case No. 12-12821 (Bankr. D. Del. 2012)**

COOLEY REPRESENTATION:

Counsel to the Official Committee of Unsecured Creditors

ACTION:

Vertis is one of the country's largest producers of direct marketing inserts for newspapers and other paper medium. Immediately upon its retention, Cooley played an active role in the debtors' expedited sale process which resulted in a sale of Vertis to Quad Graphics for approximately $240 million. In a case where the debtors' secured term lenders are projected to receive a return of less than 40% of their claims, Cooley successfully negotiated an $11 million set aside for unsecured creditors holding section 503(b)(9) claims and ensured that preference actions will not be pursued against creditors.

View the other current Cooley representations on page 16.

Trustee Cannot Recover Preferential Payments Made to Assumed Executory Contract Counterparty

A Delaware bankruptcy court held that transfers received by a preference claim defendant within the 90 days prior to the bankruptcy filing were not avoidable because the transfers were made pursuant to an executory contract that was assumed and assigned by the debtors. *In re Carolina Fluid Handling Intermediate Holdings Corp.*, Adv. Proc. No. 11-50393 (CSS), 2012 WL 859586 (Bankr. D. Del. Mar. 14, 2012).

To prevail on its preference claim, the chapter 7 trustee was required to establish, among other things, that, pursuant to section 547(b)(5) of the Bankruptcy Code, the transfer at issue left the creditor/defendant better off than it would have otherwise been had the transfer not been made and the creditor asserted a claim for payment in the bankruptcy case. In its motion for summary judgment, the creditor argued that the trustee could not satisfy section 547(b)(5) as a matter of law because the debtors, as a result of their decision to assume their contract with the creditor in the bankruptcy case, were legally obligated to "cure" their prepetition monetary defaults and pay all outstanding amounts due to the creditor as of the date of the contract assumption. The bankruptcy court agreed. Citing the Third Circuit's decision in *Kimmelman v. Port Authority of New York and New Jersey (In re Kiwi Int'l Air Lines, Inc.)*, 344 F.3d 311 (3d Cir. 2003), the court concluded that section 547(b)(5) cannot be satisfied if an executory contract is assumed or assumed and assigned pursuant to a court order.

The court also rejected the trustee's argument that the contract was not properly assumed because it was not listed in the initial list of contracts to be assumed by the debtors that was filed with the court. But, in fact, following the filing of the initial list of contracts to be assumed and assigned by the debtors, the debtors and the creditor amended the contract to, among other things, establish the amount of the creditor's cure claim and the amended contract was subsequently listed in an assumption and assignment notice annexed to the sale order and in an amendment to the asset purchase agreement setting forth the contracts to be assumed and assigned. The court further rejected the trustee's argument that the contract was not executory because the creditor had substantially performed its obligations by supplying products to the debtors. The court concluded that under contract the creditor was charged with the ongoing obligation to meet the supply requirement of the debtors and, therefore, was executory in nature. •

ANALYSIS

BY
LARRY GOTTLIEB

The court's ruling is not only consistent with the Third Circuit's dictate that section 547(b)(5) of the Bankruptcy Code cannot be satisfied if an executory contract is assumed during the bankruptcy case; it also recognizes that courts are likely to acknowledge and respect the "fluid" nature of cure notices, and the practical reality that these notices are designed to open the door to negotiations between debtors and creditors and bring value to estates and creditors.

IN THE NEWS

CASE:

***In re Cylex Inc.*, Case No. 12-13259 (Bankr. D. Del. 2012)**

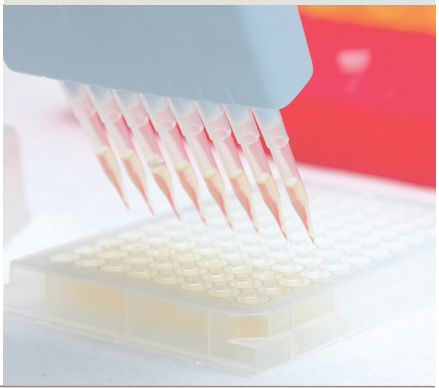
COOLEY REPRESENTATION:

Counsel to the Debtor

ACTION:

In December 2012, Cooley prepared and filed a chapter 11 case for Cylex Inc., the maker of a diagnostic kit used to assess immune function in organ transplant patients. Cooley represented the Debtor in connection with a sale and auction process that resulted in the successful sale of substantially all of Cylex's assets pursuant to Section 363 of the Bankruptcy Code. On January 22, 2013, an auction was held in Cooley's New York offices where three bidders competed to purchase Cylex's assets. After more than 12 hours and 16 rounds of bidding, the winning bid was $14.425 million—more than double the opening bid for the assets. The successful bid was approved by the Court the following day and the sale closed on February 8th. Cylex, now known as Immunology Partners Inc., remains in chapter 11 with the goal of winding down its affairs and distributing the sale proceeds to creditors and other stakeholders.

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



Delaware Bankruptcy Court Says Caveat Emptor To Claims Traders

A Delaware bankruptcy court held that a claim against a debtor's estate, transferred to a third party, is subject to the same infirmities as in the hands of the original holder of the claim. *In re KB Toys, Inc.*, 2012 WL 1570755 (Bankr. D. Del. 2012) (Judge Kevin Carey). The *KB Toys* decision underscores the importance of evaluating disallowance, avoidance and subordination risks when trading in the claims market.

In January of 2004, KB Toys, Inc. and its related entities filed for chapter 11 protection in Delaware (KB Toys would again file for chapter 11 relief in 2008, a case in which Cooley represented the creditors' committee). The bankruptcy court ultimately confirmed KB Toys' chapter 11 plan, which established a trust to liquidate and monetize KB Toys' assets, which included certain causes of action, for the benefit of creditors. The trustee thereafter commenced preference actions against certain trade creditors, seeking to avoid and recover various payments made by KB Toys during the 90 days prior to the chapter 11 filings.

Nine of the alleged preference recipients sold their claims postpetition to a claims trader. The claims trader purchased some of the claims prior to confirmation of the plan and acquired others after confirmation. Additionally, some of the "assignment agreements" contained indemnification clauses, while others did not. All but one of the claims were purchased by the claims trader prior to the trustee's commencement of the preference litigations against the selling creditors.

Ultimately, the bankruptcy court entered default or summary judgments against each of the original claim holders and the trustee sought orders disallowing the claims purchased by the claims trader pursuant to section 502(d) of the Bankruptcy Code. Under section 502(d), a court may "disallow" a claim if the claimholder, *inter alia*, has failed to return an avoided transfer to the estate. The purpose of disallowance under section 502(d) of the Bankruptcy Code is to preserve the Bankruptcy Code's priority scheme by ensuring equal treatment amongst similarly situated creditors.

Courts have reached different conclusions on the issue of whether the section 502(d) "disability" is a "personal disability" of the defendant, or if the "disability" travels with the claim itself. Prior to *KB Toys*, the leading case on this issue arose out of the Enron chapter 11 cases. There, the issue was whether bank loan claims in the hands of a claims trader were subject to disallowance under section 502(d). The Bankruptcy Court for the Southern District of New York issued two published opinions, one addressing section 502(d) and the other addressing section legal and equitable subordination under 510(c) of the Bankruptcy Code. The bankruptcy court held that under both sections 502(d) and 510(c), claim disabilities travel with the claim regardless of its ultimate holder. In both decisions, the court looked to the text of the statutes, their legislative history, and the policy against permitting holders to "wash" their claims by simply transferring them to others.

On appeal, the District Court for the Southern District of New York vacated the bankruptcy court's decision and held that "disabilities" under both section 502(d) and 510(c) are personal to the holder. The district court reasoned that inquiry hinged on whether the transfer was a "sale" (permitting the purchaser to take the claim free and clear of any disability) or an "assignment" (providing that the assignee steps into the shoes of the assignor with the same disabilities as the assignor). The district court provided little guidance on the legal or practical distinctions between a sale and assignment.

Many commentators criticized the Enron district court for creating an unworkable paradigm—that is, distinguishing between sales and assignments where the trading documents themselves use both terms interchangeably. Nonetheless, the Enron decision remained one of the few authorities on the issue. Indeed, some market participants viewed disallowance or subordination risk as minimal under the Enron framework so long as they characterized their claims purchases as sales rather than assignments, and acted in good faith and without actual knowledge of any disability.

Given the conflicting views over the proper interpretation of section 502(d), the *KB Toys* Court started with a blank slate, looking first to the legislative history and case law interpreting the statutory predecessor to section 502(d): Section 57g of the Bankruptcy Act. The *KB Toys* Court held that both the legislative history and the case law indicated that under section 502(d), disabilities attach to

ANALYSIS
BY
JEFFREY COHEN

The *KB Toys* decision serves as an important reminder to investors in bankruptcy claims (and distressed assets generally) that a bankruptcy claim acquired by transferee may be subject to challenge due to matters which have no relationship to, and entirely predate, the acquisition itself and the transferee's involvement with the credit. Purchasers of claims may wish to push harder for indemnities and seek enhanced representations and warranties with respect to prepetition conduct. Purchasers may also want to perform diligence on their seller's financial wherewithal and consider additional protections such as purchase price holdbacks.

and travel with claims and are not personal to claimants.

The *KB Toys* court then reviewed other cases addressing the issue and found support for the Enron bankruptcy court's application of section 502(d). Judge Carey distanced his ruling from the Enron district court's distinction between sales and assignments. "'The terms 'assignment' and 'sale' are not easily distinguishable," he reasoned, and although the Bankruptcy Code defines neither term, the definition of "transfer" in section 101(54)(D) arguably includes both assignments and sales. Moreover, Judge Carey emphasized, "[i]n this context, use of any distinction between the two terms has been widely criticized."

Judge Carey concluded that the claims trader had constructive notice, if not actual notice, of the potential avoidance actions. Notably, Judge Carey pointed out that the original holders of the claims were identified in the KB Toys' Statements of Financial Affairs as parties potentially subject to avoidance actions, which were were filed before the claims trader acquired the claims. Accordingly, Judge Carey reasoned that the claims trader was on notice of the potential for a challenge to the claims under section 502(d) of the Bankruptcy Code. The claims trader also had the option of protecting itself by including indemnity provisions in its agreements with the original claimants.

The court also rejected the claims trader's argument that disallowance was inappropriate because the claims were allegedly purchased in "good faith," explaining that "[a] purchaser of claims in a bankruptcy is well aware (or should be aware) that it is entering an arena in which claims are allowed and disallowed in accordance with the provisions of the Bankruptcy Code and the decisional law interpreting those provisions. Under such conditions, a claims purchaser is not entitled to the protections of a good faith purchaser." •

Seventh Circuit Appeals Court Reaffirms the Absolute Priority Rule and Expands the Scope of the So-Called "Competition Rule"

The absolute priority rule, which requires that all senior creditors be paid in full before a junior creditor or interest holder receives any return on their claims, has been a fixture of bankruptcy jurisprudence for decades. It arises out of the principle that any plan of reorganization has to be "fair and equitable" to any non-consenting class of creditors. Although the seemingly immutable principle of absolute priority has been eroded in recent years by judicial exceptions that have gradually opened the door to equity holders receiving value under so-called "new-value" plans, even while creditors remained unpaid, the Seventh Circuit's recent decision in *In re Castleton Plaza, L.P.*, 2013 U.S. App. LEXIS 3185, No. 12-2639 (7th Cir. Feb. 14, 2013), reaffirms that the absolute priority rule is not subject to limitation or evasion by creative plan drafting and, as such, strengthens the rights of creditors.

In *Castleton Plaza*, the appeals court considered whether a debtor could avoid the requirement to hold an auction for the equity of the reorganized company issued under a new-value plan, as is mandated by the Supreme Court's ruling in *Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 526 U.S. 434 (1999), by having the new value be contributed by an insider of the debtor rather than the equity holder itself. In *Castleton*, the debtor, the owner of a shopping center, proposed a cram down plan under which it rewrote the senior secured lender's $10 million debt at a significantly lower interest rate and extended the term of the loan for 30 years. The debtor's plan provided that $300,000 would be paid to the lender on confirmation and the balance would be written down to $8.2 million. The debtor's plan proposed to pay the unsecured creditors only 15% on their claims over a period of five years. The sole equityholder's wife was to receive 100% of the equity in the reorganized business in exchange for "new value" of $75,000. The plan was objected to by the secured lender, who had offered to pay $600,000 for the new equity and satisfy all other creditors in full.

Notwithstanding the lender's more generous offer to creditors, the debtor's plan ostensibly complied with the language of section 1129(b) of the Bankruptcy Code, which provides that a plan is fair and equitable if "the holder of any claim or interest that is junior to the claims of [unsecured creditors] will not receive or retain under the plan on account of such junior claim or interest any property…", even if that class

ANALYSIS

BY
ALI M.M. MOJDEHI

Castleton Plaza also signals that the absolute priority rule will likely be construed to have broad and independent application for the treatment of *unsecured* claims under proposed plans. Importantly, the *Castleton Plaza* interprets the Supreme Court's *LaSalle* decision as holding that the absolute-priority rule applies in all circumstances, regardless of the express language of section 1129(b) of the Bankruptcy Code, and underscores the continued preeminence of the absolute priority rule in the face of deal structures designed to circumvent its strict application.

of unsecured creditors will not be paid in full under the plan. Because the existing equity holder technically received nothing under the debtor's plan, and the spouse of the equityholder was not a creditor of the debtor, the bankruptcy court ruled and the district court concurred that the proposed plan satisfied this standard and was confirmable, even though the debtor's scheme to vest ownership of the reorganized debtor in the equityholder's spouse clearly was designed to evade the core principles of the absolute priority rule.

The Seventh Circuit disagreed, ruling that plans giving insiders preferential access to investment opportunities in the reorganized debtor must be subjected to competition to the same extent as plans in which existing claimholders put up the new money.

The Seventh Circuit disagreed, ruling that plans giving insiders preferential access to investment opportunities in the reorganized debtor must be subjected to competition to the same extent as plans in which existing claimholders put up the new money. In other words, the debtor could not do indirectly what it was forbidden to do directly. Importantly, the judicial basis for the Seventh Circuit's reasoning was *not* the express language of section 1129(b), but instead relied on the general principles of the absolute priority rule. The court noted that, under the Supreme Court's holding in *LaSalle* current equity holders cannot contribute new capital and receive ownership interests in the reorganized entity when that opportunity is given exclusively to those equity holders without consideration of other offers. The Supreme Court found that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii) and therefore violate the absolute priority rule.

The appeals court noted that, although *LaSalle* did not interpret section 1129(b)(2)(B), the competition rule was meant to curtail evasion of the absolute priority rule, and that a new-value plan that bestowed equity on an investor's spouse can be just as effective at evading the absolute-priority rule as a new-value plan bestowing equity on the original investor. The court also observed that the definition of insider in bankruptcy law includes family members. The court also noted the various ways in which the equity holder himself would receive value from the equity to be issued to his wife through the increase of his family's wealth and his continued receipt of a salary as the debtor's CEO. Accordingly, the court ruled that the absolute priority rule therefore applied despite the fact that the wife of the debtor's owner had not invested directly in the debtor pre-bankruptcy. Notably, application of the competition rule did not depend on the debtor's proposing the plan during its exclusivity period or on the identity of the plan proponent. On the contrary, the court ruled that it was appropriate to utilize the rule to "prevent the funneling of value from lenders to insiders, no matter who proposes the plan or when," stating that "an impaired lender who objects to any plan that leaves insiders holding equity is entitled to the benefit of competition."

The court's ruling in *Castleton Plaza* is a boon to secured lenders, who have another tool in their arsenal to maximize returns when faced with new value plans that threaten to understate the value of their collateral. This empowerment of secured creditors through application of the absolute priority rule is becoming a trend, as *Castleton Plaza* builds upon recent decisions that also re-affirmed the preeminence of the absolute priority rule. For example, in *Radlax Gateway Hotel LLC v. Amalgamated Bank*, 132 S.Ct. 2065 (2012), the Supreme Court recently ruled that a plan of reorganization providing for a sale of a secured creditor's collateral must afford an objecting secured creditor with the right to credit-bid up to the full amount of its claim for the assets in order to be "fair and equitable." The absolute-priority rule was the basis for such a requirement—protecting against the risk that the lender's collateral will be sold at a depressed price. Similarly, in *In re DBSD North America, Inc.*, 634 F.3d 79 (2d Cir. 2011), the Second Circuit ruled that so-called "gifting plans" violate the absolute-priority rule to the extent they allow the debtor's equity holders to receive an interest in the reorganized debtor if creditors remain unpaid. Each of these decisions are themselves based upon *LaSalle*, which relies upon the principle of absolute priority to require any new-value plan to value the equity of the reorganized debtor though a competitive auction. •

SDNY Bankruptcy Courts Strike Down Proposed KEIP Plans

The Bankruptcy Court for the Southern District of New York issued two opinions denying motions of chapter 11 debtors for approval of bonus plans for their executives labeled as key employee incentive plans ("KEIP"), ruling that the proposed plans were truly retention plans designed to pay the debtors' insiders for remaining with the debtor through the bankruptcy process. *See In re Hawker Beechcraft, Inc.*, No. 12-11873, 2012 WL 3637251 (Bankr. S.D.N.Y. Aug. 24, 2012); *In re Residential Cap.*, LLC, No. 12-12020, 2012 WL 3670700 (Bankr. S.D.N.Y. Aug. 28, 2012). Both cases explain that section 503(c) of the Bankruptcy Code, which governs key employee programs, was enacted to "eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process." *Hawker Beechcraft*, 2012 WL 3637251 at *4 (quoting *In re Global Home Prods., LLC*, 369 B.R. 778, 784 (Bankr. D.Del. 2007); *Residential Cap.*, 2012 WL 3670700 at *11 (same).

Section 503(c)(1) of the Bankruptcy Code sets forth a stringent standard for debtors seeking to make non-ordinary course payments designed to induce insider employees to remain with the debtor's business during the chapter 11 case. Specifically, section 503(c)(1) requires the debtor to show:

(A) the transfer or obligation is essential to retention of the person because the individual has a bona fide job offer from another business at the same or greater rate of compensation;

(B) the services provided by the person are essential to the survival of the business; and

(C) either—

> **1)** the amount of the transfer made to, or obligation incurred for the benefit of, the person is not greater than an amount equal to 10 times the amount of the mean transfer or obligation of a similar kind given to nonmanagement employees for any purpose during the calendar year in which the transfer is made or the obligation is incurred; or
>
> **2)** if no such similar transfers were made to, or obligations were incurred for the benefit of, such nonmanagement employees during such calendar year, the amount of the transfer or obligation is not greater than an amount equal to 25 percent of the amount of any similar transfer or obligation made to or incurred for the benefit of such insider for any purpose during the calendar year before the year in which such transfer is made or obligation is incurred…

11 U.S.C. § 503(c)(1) (emphasis added). In contrast to the rigors of section 503(c)(1), section 503(c)(3) of the Bankruptcy Code authorizes the debtor to make non-ordinary course payments to employees (insiders or non-insiders) to the extent "justified by the facts and circumstances of the case." 11 U.S.C. § 503(c)(3).

In *Residential Capital*, Judge Glenn explained that "[i]n order to show that the more permissive section 503(c)(3) applies, the Debtors must establish by a preponderance of the evidence that the KEIP is primarily incentivizing and not primarily retentive." *Residential Cap.*, 2012 WL 3670700 at *11. To meet this burden, the debtor "must show that the KEIP is a 'pay for value' plan that offers incentives based on performance rather than a 'pay to stay' plan." *Id.* If "a plan is designed to motivate employees to achieve specified performance goals, it is primarily incentivizing, and thus not subject to section 503(c)(1)." *Id.* at *12.

In both cases, the bankruptcy courts made clear that the title and labeling of the plan as incentivizing as opposed to retentive is of no great consequence. In *Hawker Beechcraft*, Judge Bernstein explained that, "[t]he concern in the type of motion presented in this case is that the debtor has dressed up a KERP [key employee retentive plan] to look like a KEIP in the hope that it will pass muster under the less demanding 'facts and circumstances' standard in 11 U.S.C. § 503(c)(3)." *Hawker Beechcraft,* 2012 WL 3637251 at *4 (citation omitted). Likewise, in *Residential Capital*, Judge Glenn explained that "[a] debtor's label of a plan as incentivizing to avoid the strictures of section 503(c)(1) must be viewed with skepticism; the circumstances under which the proposal is made and the structure of the compensation package control." *Residential Cap.*, 2012 WL 3670700 at *11 (citation omitted).

In *Residential Capital*, the debtor proposed a KEIP that would have awarded between $4.1 million and $7 million in the aggregate to 17 of its insider employees. Specifically, the plan provided that 63% of the KEIP awards would vest upon the closing of sales of the debtors' assets that were negotiated prepetition. *Id*. In denying the proposed KEIP plan, the Court noted that most of the work concerning the debtors' asset sales was performed prior to the bankruptcy filing. Judge Glenn explained that "an employee 'incentive' plan should incentivize employees for their post-petition efforts, not compensate them for the work they did before the bankruptcy filing." *Id*. at *4. The Court denied the motion to approve

ANALYSIS

BY
RICHARD
KANOWITZ

These cases indicate that courts will prudently examine key employee plans to determine whether the stringent standard of section 503(c)(1) applies, regardless of the label attached to the plan by the debtor or in the absence of objection from the official committee of unsecured creditors.

the KEIP without prejudice, advising that the "Debtors must more closely link the vesting of the KEIP Awards to metrics that are directly tied to challenging financial and operational goals for the businesses, tailored to the facts and circumstances of the case." *Id*. at *13.

Similarly, in *Hawker Beechcraft*, the debtor proposed a KEIP that positioned eight insiders to earn a bonus of up to 200% of their annual base salary in the event that the debtors were to consummate either a stand-alone reorganization plan or a sale transaction with a third party. The debtors were engaged in a dual-track restructuring process, through which they simultaneously proposed a plan to convert 100 percent of their debt to equity and engage in a marketing process to determine whether a third party transaction would generate greater value. Although the official committee of unsecured creditors did not object to the proposed KEIP, the Court found that the debtors failed to establish that the proposed KEIP was truly incentivizing because: (i) the debtor failed to appropriately identify the role that each key employee would play in achieving the proposed targets; (ii) the lowest target levels were "well within reach" because the debtors were on target to meet confirmation deadlines for a standalone plan and had already received an offer to purchase substantially all of their assets; and (iii) the deadlines could be extended in the debtors' discretion. *Hawker Beechcraft,* 2012 WL 3637251 at *5. The Court ultimately denied the debtors' proposed KEIP because the employees "will likely earn some bonus under the KEIP merely by remaining with the Debtors and regardless of the road the Debtors take." *Id*. at *6. •

Spring 2013 Bankruptcy & Restructuring Event and Speaking Appearances Calendar

Event	Date/Location	Cooley Participant/Topic
2013 TMA Taiwan Conference	April 1–4 Taipei, Taiwan	Ron Sussman, TMA Chairman TOPIC: Corporate Restructuring and the Legal System
American Bar Association Business Law Section Spring Meeting	April 4 Washington, DC	Bob Eisenbach TOPIC: Getting the Deal Done: Closing Sales by Distressed Companies in Bankruptcy
2013 NACM Eastern Region Credit Conference	April 8 Boston, MA	Jay Indyke, Larry Gottlieb TOPIC: Current Issues in Bankruptcy
American Bankruptcy Institute—31st Annual Spring Meeting	April 18–21 Washington, DC	Ron Sussman TOPIC: Multiple Ethical Schemes to Financial Advisors
Gordian Group Reception	May 2–4 Palm Beach, FL	Ron Sussman
Riemer Conference 2013	May 8–9 Boston, MA	Jay Indyke TOPIC: Strategies and Tactics For Dealing With Distressed Customers
TMA's Northeast Regional Conference	May 9–10 Montville, CT	Ron Sussman, TMA Chairman
2013 TMA Spring Senate	May 14–15 Chicago, IL	Ron Sussman, TMA Chairman
Knowledge Congress Webcast	May 15 Nationwide (Webinar)	Eric Haber TOPIC: Preferences and Fraudulent Conveyances in Bankruptcy Cases
NACM Credit Congress	May 19–22 Las Vegas, NV	Jeffrey Cohen TOPIC: 21st Century Financing for Bankruptcy: Forced Sales

Current Cooley Representations

CASE	COOLEY REPRESENTATION	RESULT
***In re Trident Microsystems, Inc., et al.,* Case No. 12-10069 (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.
***In re United Retail Group, Inc., et al., d/b/a Avenue,* Case No. 12-10405 (Bankr. S.D.N.Y. 2012)**	Creditors' committee counsel	Cooley assisted in the going-concern sale of this plus-size women's retailer and successfully leveraged potential claims against the debtors' parent company into a meaningful distribution to general unsecured creditors, representing a dramatic increase from the *de minimis* return initially projected by the Debtors. A distribution to creditors is expected in the 2Q 2013.
***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.
***P. David Newsome, Jr., Liquidating Trustee of Mahalo Energy (USA), Inc. v. Gallacher et al.,* Case No. 11-CV-140-GKF-PJC (N.D. Okla. 2011)**	Liquidating Trustee's counsel	After representing the creditors' committee in the underlying chapter 11 case, Cooley represents the Liquidating Trustee against the former officers, directors and attorneys of Mahalo Energy (USA), Inc. for, among other causes of action, breach of fiduciary duty. Having completed appellate briefing, Cooley represented the Liquidating Trustee in oral argument before the Tenth Circuit Court of Appeals in early March on the issue of whether the district court has personal jurisdiction over the defendants.
***In re Siliken Manufacturing USA, Inc. et al.,* Case No. 13-00119 (Bankr. S.D. Cal. 2013)**	Debtors' counsel	Cooley represents the U.S. subsidiaries of a Spanish company (involved in its own insolvency proceedings in Spain) that manufacture and sell high-quality photovoltaic solar panels, modules and related components to customers around the world.
***Securities Investor Protection Corp. v. Bernard L. Madoff Investment Securities, LLC,* Adv. Proc. No. 08-1789 (Bankr. S.D.N.Y. 2008)**	Counsel to Foreign Institutions	Cooley provides 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.

CASE	COOLEY REPRESENTATION	RESULT
In re Velo Holdings Inc., et al., Case No. 12-11384 (Bankr. S.D.N.Y. 2012)	Creditors' committee counsel	Cooley represented the committee in connection with the Debtors' section 363 sale of one of their business segments and the reorganization of the remaining business through a plan providing for a distribution to unsecured creditors and otherwise protecting their interests.
***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	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.
***In re Shoe Mania, LLC, et al.,* Case No. 12-13325 (Bankr. S.D.N.Y. 2012)**	Counsel to an ad hoc committee of unsecured creditors	Cooley commenced involuntary bankruptcy proceedings against this New York City shoe retailer to ensure that the interests of creditors were protected. Cooley prevailed over the Debtors' objections to the bankruptcy petitions, and is currently working with the Chapter 7 Trustee to investigate the prepetition conduct of the Debtors and their executives.
***In re Carefree Willows, LLC* Case No. 10-29932 (Bankr. D. Nev. 2010)**	Counsel to Joint Venture	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
***In re Orange County Nursery, Inc.,* Case No. 09-22100 (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

CASE	COOLEY REPRESENTATION	RESULT
***In re North Plaza, LLC,* Case No. 04-00769 (Bankr. S.D. Cal. 2004)**	Chapter 11 trustee's counsel	Cooley assisted in confirmation of 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. Cooley continues to advise on post-confirmation liquidation of estate claims.
***In re Qimonda Richmond, LLC,* Case No. 09-10589 (Bankr. D. Del. 2009)**	Creditor's counsel	Cooley represented the owner participant of a structured financing arrangement in connection with the disposition of certain semiconductor equipment and adjudication of its claim, which was eventually allowed by the bankruptcy court, settled upon by the debtor and other parties in interest, and paid by the estate at approximately $32.5 million.
***Kismet Acquisition, LLC v. Diaz (In re Icenhower)*, Case No. 03-11155 / Adv. Proc. Nos. 04-90392 and 06-90369 (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.