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Recent Supreme Court Ruling May Dampen Sales in Bankruptcy Prior to Plan Confirmation

By Christy Rivera

Last month in *Florida Dept. of Revenue v. Piccadilly Cafeterias, Inc.*, the United States Supreme Court ruled that only assets transferred pursuant to a confirmed plan of reorganization or liquidation are exempt from certain stamp taxes. Any assets transferred before confirmation of a plan, even if such transfer is necessary for consummation of the plan, remain subject to stamp taxes.

Based on this decision, sales that ordinarily would occur early in a bankruptcy case may be delayed until confirmation of a plan. If a sale cannot be delayed, creditors will suffer as these taxes will reduce amounts ultimately available for distribution on creditors' claims.

Section 1146 and Stamp Taxes

The Supreme Court's decision was based on its analysis of Bankruptcy Code section 1146, which provides: "The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax." 11 U.S.C. § 1146(a). A stamp tax is a form of tax that is levied on documents such as deeds, notes and other transaction documents. For example, when real estate is transferred or sold, a real estate transfer tax will generally be collected at the time of registration of the deed in the public records.

Case Background

In 2003, Piccadilly Cafeterias (Piccadilly) filed for relief under chapter 11 of the Bankruptcy Code and sought court authorization to sell substantially all of its assets pursuant to a sale under Bankruptcy Code section 363. In preparing to sell its assets as a going concern, Piccadilly sought an exemption from / *continued page 2*

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any stamp taxes on the eventual transfer under Bankruptcy Code section 1146(a). A few months later and as a precondition to the sale, Piccadilly entered into a global settlement agreement with its senior secured noteholders and unsecured creditors that controlled how the sale proceeds would be distributed among the various constituents. The Bankruptcy Court approved the settlement agreement and also ruled that the transfer of assets was exempt from stamp taxes under Bankruptcy Code section 1146(a). The sale closed a month later.

Just 10 days after the sale closing, Piccadilly filed its chapter 11 plan, which provided that the sale proceeds would be distributed in a manner consistent with the global settlement agreement. Before the plan was confirmed, the Florida Department of Taxation (Florida) filed an objection, seeking a declaration that it was owed approximately $40,000 in stamp taxes on certain transferred assets. Florida asserted such assets were not transferred "under a plan confirmed" under chapter 11, as required by Bankruptcy Code section 1146(a), because such assets were transferred before Piccadilly had filed any such plan.

The Bankruptcy Court granted summary judgment in favor of Piccadilly, asserting that the sale was "under" its confirmed plan because the sale was necessary to consummate Piccadilly's plan. The District Court and the Court of Appeals for the Eleventh Circuit upheld the Bankruptcy Court decision.

Florida appealed. With conflicting rulings in the Third and Fourth Circuits, the Supreme Court agreed to hear the appeal to resolve the uncertainty as to whether Bankruptcy Code section 1146(a) applies to preconfirmation transfers.

Supreme Court's Analysis

In a 7-2 ruling, the Supreme Court reversed the lower courts' decisions, finding that the "most natural reading" of Bankruptcy Code section 1146(a) is that a stamp-tax exemption applies only to those transfers made pursuant to a plan that has been confirmed. While acknowledging that Congress could have used more precise language, the Court found it informative that section 1146(a) is placed in the subchapter entitled "Postconfirmation Matters".

The Court went on to note that even if it were to adopt Piccadilly's textual arguments and find that section 1146(a)'s text is ambiguous, it would still resolve any ambiguity in favor of Florida based on well established canons of construction. Relying on the canon that courts "should 'proceed carefully when asked to recognize an exemption from state taxation that Congress has not clearly expressed'" (set forth in *California State Bd. of Equalization v. Sierra Summit,* Inc., 490 U.S. 844, 851-51 (1989)), the Court reasoned that the proper result would be to read section 1146(a) as "setting forth a simple, bright-line rule" exempting only those transfers made pursuant to a confirmed plan.

In a dissenting opinion, Justice Breyer (joined by Justice Stevens) asserted that the Court would be better served by considering the purposes of chapter 11 in determining which transfers should be protected by Bankruptcy Code section 1146(a). Asserting that such purposes include preserving going concern values and maximizing property available to satisfy creditor claims, the dissent argued that it should make no difference whether a transfer takes place before or after a plan is confirmed. The dissent recognized that because the bankruptcy process takes time, certain sales and transfers may need to occur prior to confirmation. The dissent argued further

The Supreme Court ruled that the most natural reading of Bankruptcy Code section 1146(a) is that a stamp-tax exemption applies only to those transfers made pursuant to a plan that has been confirmed.

that the Court's ruling could result in serious harm to creditors as they may lose extra proceeds that a speedy sale might otherwise produce in certain circumstances.

Application

As a result of the Supreme Court's ruling, debtors may be more reluctant to sell assets during their bankruptcy cases before confirmation. For those assets that must be sold in advance of confirmation, for whatever reason, sale proceeds available for distribution to creditors may be reduced after the government gets its share in taxes. ◎

Debt Transferors Beware: Are You Assigning Your Rights to Indemnification?

By Robert J. Gayda

In *In re M. Fabrikant & Sons, Inc.*, 385 B.R. 87 (Bankr. S.D.N.Y. 2008), the Bankruptcy Court for the Southern District of New York was faced with the question of whether a group of secured lenders transferred certain rights to reimbursement granted under a cash collateral order when assigning their claims pursuant to a standard sale agreement for distressed trades.

The Bankruptcy Court, after engaging in a detailed analysis of the applicable documentation, held that the agreements by which the lenders transferred their claims were broad enough to include the lenders' right to be indemnified for reasonable attorney fees which they incurred in defending against claims asserted by the official committee of unsecured creditors.

Background

The debtors, M. Fabrikant & Sons, Inc. were established in 1895 and were one of the world's largest manufacturers and distributors of diamonds. In the course of their business, the debtors entered into separate loans or financial arrangements with a group of lenders. In each case, the debtors granted the lenders a security interest in their assets to collateralize the loan.

The debtors filed their chapter 11 petitions on November 17, 2006. On December 18, 2006, the Court entered the Final Order Authorizing Debtors' Use of Cash Collateral and Granting Adequate Protection Claim and Lien (the "Cash Collateral Order"). The Cash Collateral Order, *inter alia*, granted the lenders certain reimbursement rights (the "Reimbursement Rights"), which specifically provided the lenders with an administrative priority for their reasonable attorneys' and other professionals' fees and reimbursable expenses arising from or related to the bankruptcy proceedings.

Subsequently, each of the lenders transferred their secured claims and security interests to a group of transferees. Each lender entered into a transfer agreement with its respective transferee (collectively, the "Transfer Agreements"). The Transfer Agreements incorporated the Loan Syndications and Trading Association, Inc.'s Purchase and Sale Agreement for Distressed Trades, and its Standard Terms and Conditions.

After the entry of the Cash Collateral Order and the assignments, the official committee of unsecured creditors commenced an adversary proceeding against the lenders. The lenders vigorously defended the adversary proceeding, incurring substantial legal fees and expenses that they asserted were covered by the Reimbursement Rights. Accordingly, the lenders filed administrative claims to recover their actual attorneys' fees and expenses.

The debtors later filed a disclosure statement and a proposed plan of reorganization. When the debtors' proposed plan of reorganization did not provide for the reimbursement of the lenders, they objected to confirmation, arguing, among other things, that the plan violated their rights by failing to provide for the payment in full of their Reimbursement Rights.

Bankruptcy Court Ruling

The Bankruptcy Court overruled their objections, finding that the lenders had transferred the Reimbursement Rights to the transferees under the Transfer Agreements. In arriving at this conclusion, the Court undertook a detailed interpretation of the parties' various contracts, focusing on the Transfer Agreements and what the lenders had indeed assigned.

The Transfer Agreements stated that the lenders had transferred, *inter alia,* "all claims (including 'claims' as defined in Bankruptcy Code Section 101(5)), suits, causes of action, and any other right of Seller or any Prior Seller, whether known or unknown ... arising under or in connection with the [underlying credit documentation] or the transactions related thereto or contemplated thereby." The question / continued page 4

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was whether or not the Reimbursement Rights fell within this definition of "Transferred Rights," which did not expressly include the Reimbursement Rights.

In answering this question, the Court noted that § 101(5)(A), which defines "claim" within the Bankruptcy Code, is itself very broad. The Court, citing legislative history as support, stated that "[t]his broad definition was intended to reach all legal obligations, no matter how remote, and deal with them in the bankruptcy case." The Court also stated that the "Transferred Rights" included all claims, not just "claims" as defined in the Bankruptcy Code, and was broader than the definition of § 101(5)(A). Accordingly, it had little trouble determining that the Reimbursement Rights were "claims" which fell within the definition of Transferred Rights.

The Court also found that the Reimbursement Rights were "related" to, and arose "in connection with the [underlying credit documentation] or the transactions related thereto or contemplated thereby." The Court reasoned that the Reimbursement Rights were granted in exchange for the debtors' use of the lenders' cash and other collateral. The lenders' interests in this collateral arose by virtue of, and in connection with, the underlying credit documentation. Accordingly, the Court stated, the Reimbursement Rights plainly related to the underlying credit documentation, and thus fell within the scope of claims transferred pursuant to the Transfer Agreements.

The lenders advanced several arguments stating why the broad language of the Transfer Agreements should be read to exclude the Reimbursement Rights, but the Court rejected each in turn, finding that the Transfer Agreements contained an all-encompassing assignment of rights.

Analysis

Generally speaking, this case underlines the importance of drafting comprehensive transaction documentation, and spotting and carving out specific rights that a party may deem imperative. While chapter 11 cases, such as *Fabrikant*, as well as other highly complicated commercial transactions undoubtedly move at breakneck speeds, it is obviously absolutely crucial to preserve a party's rights, even those that may not seem significant at the time. Had the lenders anticipated the committee's adversary proceeding and specifically carved the Reimbursement Rights out of the rights transferred, there would never have been an issue.

More specifically, carving out rights to indemnification in a situation such as this is paramount to secured lenders. This issue takes on increased significance in today's bankruptcy climate. As can be seen in multiple recent and current chapter 11 cases, the credit crunch and resulting market situations have left many debtors in dire straits. This has forced constituencies, such as creditors' committees, to seek out and pursue every possible avenue of recovery, which definitely includes launching an attack on the debtors' secured lenders and any rights they may have. In this instance, rights to indemnification for attorneys' fees and expenses are increasingly valuable, as fending off such an attack can be costly. Accordingly, as illustrated by *Fabrikant*, if such rights ever come into question, a secured lender would be wise to expressly reserve them. ◎

The agreements by which the lenders transferred their claims were broad enough to include the lenders' right to be indemnified for reasonable attorney fees.

Unauthorized Post-Petition Transfers May Be Avoided Notwithstanding That the Bankruptcy Estate Was Not Diminished

By Meghan Towers

In *In re Straightline Investments, Inc.*, 525 F.3d 870 (9th Cir. 2008), the Court of Appeals for the 9th Circuit upheld the decisions of the Bankruptcy Court for the Northern District of California and the Bankruptcy Appellate Panel ("BAP") avoiding a debtor's post-petition transfers of accounts receivable over the recipient's objection that there was no depletion or diminution of the Debtor's assets.

Facts

Straightline, a company that leased commercial property and operated a sawmill and custom lumber milling and other lumber related activities, filed for relief under chapter 11. Straightline subsequently filed a motion seeking, pursuant to section 364(c) of the Bankruptcy Code, an advance of up to $500,000 from Aalfs, an individual whose prepetition relationship with the debtor was not identified. The bankruptcy court permitted Straightline to borrow up to $100,000, in exchange for a junior lien on Straightline's equipment and a senior lien on Straightline's inventory. The bankruptcy court expressly denied requests for additional loans, including loans that might be secured by Straightline's accounts receivable.

In direct contravention of the orders of the bankruptcy court, Aalfs advanced money to Straightline in exchange for accounts receivable, referring to the deal as a "factoring transaction". *Straightline*, 525 F.3d at 876. In all, Aalfs advanced a total of $186,455 to the Debtor (the "Transactions"). The accounts receivable transferred to Aalfs in exchange were valued at $200,600, but Aalfs collected only $163,007 on those accounts.

Straightline's chapter 11 bankruptcy case was subsequently converted to a case under chapter 7. The trustee appointed in Straightline's chapter 7 case filed a complaint to avoid the Transactions with Aalfs. Both the Bankruptcy Court and the BAP agreed that the transfers of the accounts receivable should be avoided. Aalfs then appealed to the Court of Appeals.

Conclusions of Law

I. Avoidable Transfers under 11 U.S.C. §549

In reviewing the decisions of the lower courts, the Court of Appeals first examined whether the Transactions were avoidable transfers under section 549 of the Bankruptcy Code. Section 549 permits a trustee to "avoid a transfer of property of the estate - (1) that occurs after the commencement of the case; and...(2)...(B) that is not authorized under this title or by the court." 11 U.S.C. §549. Aalfs argued, among other things, that the Transaction did not qualify as a "transfer" because "Straightline had no control over the money which might be collected from the accounts receivable." *Straightline*, 525 F.3d at 877. The Court of Appeals rejected that argument, noting that there is a distinction between the accounts receivable themselves and the funds paid by the account debtors. "Here, Straightline had a legal interest in its accounts receivable in the form of a right to collect them when it transferred them to Aalfs...Therefore 'a transfer of property of the estate' occurred." *Id*. (internal citations omitted). Ultimately, the Court of Appeals found that not only were the Transactions "transfers," they had also occurred after the commencement of the bankruptcy case and without the permission of the Bankruptcy Court and were therefore subject to avoidance under section 549.

A. Diminution of Estate Doctrine

Aalfs further argued that the Transactions did not result in a depletion or diminution of Straightline's estate and therefore could not constitute an avoidable transfer under section 549. *Id*. The Court of Appeals explained that "the question of whether depletion of the estate is a requirement for finding a transfer avoidable under §549 is an open question in this circuit." *Id*. at 878. Additionally, the Court of Appeals observed that the diminution of estate theory is most often a prerequisite for avoidability under sections 547 and 548, though the 6th Circuit has applied the doctrine in a §549 context. In any event, the Court of Appeals rejected Aalfs argument, preferring to "decline to expand the diminution of estate doctrine, from its established application in §547 and §548 cases, to this §549 case." *Id*. The Court of Appeals also concluded that the fact that the estate may or may not have been depleted by the Transactions was not enough to uphold the Transactions when */ continued page 6*

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they were otherwise avoidable under §549 as transfers occurring after the commencement of the bankruptcy and without the permission of the Bankruptcy Court.

B. Ordinary Course of Business Defense

The Court of Appeals then considered Aalfs' argument that the Transactions fell within the ordinary course of business exception under 11 U.S.C. §363(c). To determine if the Transactions were made pursuant to the ordinary course of Straightline's business the Court of Appeals used two tests. First, the "vertical dimension" or objective test, where "the disputed transaction is viewed from the vantage point of a hypothetical creditor [to determine] whether the transaction subjects a creditor to economic risks of a nature different from those he accepted when he decided to extend credit." *Id*. (citations omitted). This test often requires the court to examine the postpetition business transaction at issue in light of the debtor's prepetition business practices.

The Court of Appeals found that the vertical dimension test was not satisfied, noting the Bankruptcy Court's finding that Straightline's creditors would have reasonably expected notice of any attempt to obtain a security interest in Straightline's accounts receivable given Straightline's previous attempts to obtain bankruptcy court approval for financing secured by liens in its accounts receivable.

The second test the Court of Appeals used was the "horizontal dimension" or subjective test, where the question is "whether the postpetition transaction is of a type that other similar businesses would engage in as ordinary course." *Id*. at 880. Again, the Court of Appeals found that the Transactions failed the test, concluding that "Aalfs was unable to show that the sale of accounts receivable by a custom milling business was the type of transaction 'that other similar businesses would engage in as ordinary business.'" *Id*. (quoting *In re Dant & Russell, Inc.*, 853 F.2d at 704). Finally, the Court of Appeals noted that even if the Transactions had met the requirements of the ordinary course of business exception the Transactions would have still violated the bankruptcy court's order prohibiting the use of the accounts receivable as security for loans and therefore ran afoul of the Bankruptcy Code. *See* 11 U.S.C. §363(c)(1) ("If the business of the debtor is authorized to be operated under section...1108...of this title and *unless the court orders otherwise*, the trustee may enter into transactions...in the ordinary course of business, without notice or a hearing...") (emphasis added).

> The 'diminution of estate' theory will not protect parties dealing with the debtor in possession outside of the ordinary course of the debtor's business without court approval.

II. Earmarking and Recoupment Defenses

Having rejected Aalfs' interpretation of 11 U.S.C. §549, the Court of Appeals then turned to his "earmarking" and recoupment defenses. Earmarking applies when a third party lends money to a debtor for the purpose of paying a specifically identified creditor. The court made quick work of Allafs' earmarking defense, stating simply that "because the requirements of the earmarking doctrine are not satisfied the defense of earmarking does not apply." *Straightline*, 525 F.3d at 802.

The court then turned to the equitable defense of recoupment. Recoupment applies to adjust interrelated obligations arising from the same transaction, it is "in the nature of a right to reduce the amount of a claim..." 5 Collier on Bankruptcy ¶ 553.10, at 553-19 (15th ed. 2008). The Bankruptcy Court had entered judgment against Aalfs in the amount of $163,007 - the amount he collected from the accounts receivable - plus interest, costs and the return of the remainder of the uncol-

lected amounts. *Straightline*, 525 F.3d. at 883. The crux of Aalfs' argument was that, since he had paid the estate $186,455, the Bankruptcy Court's award would result in a windfall to the estates and therefore he was entitled to the defense of recoupment.

In response, the Court of Appeals stated that "Aalfs engaged in inequitable conduct, and he is not entitled to the equitable remedy of recoupment." *Id*. at 882. Since Aalfs was no "unsuspecting creditor" and had been fully aware of Straightline's bankruptcy petition prior to the Transactions the Court of Appeals refused to extend to him the equitable remedy of recoupment - despite the presence of case law where defendants had been entitled to an equitable credit for prepetition transfers made to debtors. See *Bakst v. Sawran* (In re Sawran), 359 B.R. 348 (Bankr. S.D. Fla. 2007). In the end the Court of Appeals affirmed the Bankruptcy Court's avoidance of the Transactions.

Conclusion

Although the fact in *Straightline* are somewhat unusual in light of what appears to be conduct is direct contravention to the court's order, the case serves as a reminder of the necessity of ensuring that all transactions with debtors in possession are in the ordinary course of the debtor's business or are otherwise approved by the bankruptcy court. Significantly the "diminution of estate" theory will not protect parties dealing with the debtor in possession outside of the ordinary course of the debtor's business without court approval. ◎

Estate Lacks Standing to Bring Avoidance and Subordination Actions Unless Creditors Benefit From Lawsuit

By Andrew Rosenblatt

A recent decision in *Adelphia Recovery Trust* v. *Bank of America, N.A., et al.*, 2008 U.S. Dist. LEXIS 47622 (S.D.N.Y. June 17, 2008) upheld the well established rule that avoidance actions, and subordination actions, may only be brought by a debtor's estate if creditors of the debtor will benefit from the recoveries thereunder. However, where unsecured creditors are otherwise paid in full under a chapter 11 plan of reorganization, a debtor's estate, and, in this case, the Adelphia litigation trust, has no standing to bring an avoidance or subordination action.

Case Background

During the *Adelphia* bankruptcy cases, the unsecured creditors' committee commenced an adversary proceeding against numerous commercial banks and their investment bank affiliates who were lenders to certain operating subsidiaries of Adelphia (the "Obligor Debtors") under four credit facilities, including three "Co-Borrowing Facilities." The claims stemmed from the banks' alleged dealings with Adelphia's former management against whom Adelphia brought suit for looting the company. Pursuant to Adelphia's confirmed joint plan of reorganization (the "Plan"), the lawsuit against the banks was transferred to the Adelphia Recovery Trust (ART), which filed an amended complaint against the banks asserting 57 claims for relief.

Significantly, the Plan provided that unsecured creditors of each of the Obligor Debtors would be paid in full in cash with interest. Although the Plan was a "joint plan," the Plan treated each debtor as a separate legal entity, recognizing that each debtor had is own creditors, assets and liabilities. The Plan also embodied a settlement among the Adelphia debtors which provided that intercompany claims would not receive any distributions under the Plan.

In its amended complaint, the ART sought, among other things, to (i) avoid and recover loan obligations incurred and security interests granted to the banks under the credit facilities as fraudulent transfers under both state and federal fraudulent conveyance laws, (ii) recover prepetition payments for principal, interest and fees made to the banks in the approximate amount of $605 million as preferential transfers, and (iii) equitably disallow or, alternatively, equitably subordinate the defendants' secured claims against the Obligor Debtors pursuant to section 510(c) of the Bankruptcy Code.

In October 2005, the lawsuit against the bank defendants was transferred to the United States District Court for the Southern District of New York. The bank defendants moved to dismiss the lawsuit following confirmation of the Plan. The issue before the District Court was / continued page 8

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whether the ART had standing to bring the avoidance/subordination claims against the bank defendants given that all creditors of the Obligor Debtors had been satisfied in full under the Plan and, therefore, would receive no benefit from the ART's lawsuit. The bank defendants asserted that dismissal was warranted because the only entities who would have benefitted from recovery by the ART in light of the Plan's provisions were the creditors and shareholders of the Adelphia parent debtors (the "Parent Debtors"), which are separate and distinct entities from the Obligor Debtors.

District Court Ruling

In addressing the substantive standing issue, the District Court focused on the plain language of the relevant statutes, noting that the Bankruptcy Code incorporates state fraudulent conveyance law and that the law in each of the relevant states at issue clearly provides that only an unpaid creditor may avoid a transaction, and then only to the extent necessary to satisfy that creditor's claim. The District Court then analyzed two Second Circuit decisions relied on by the bank defendants — *Whiteford Plastics Co.* v. *Chase National Bank*, 179 F.2d 582 (3d Cir. 1950), and *Vintero Corp.* v. *Corporacion Venezolana De Fomento (In re Vintero Corp.)*, 735 F.2d 740 (2d Cir.), *cert. denied*, 469 U.S. 1087 (1984) — for the proposition that a transfer cannot be avoided as a fraudulent transfer or preference under the Bankruptcy Code when doing so would not benefit any creditor of the particular debtor that incurred the obligations or made the transfer.

Despite the fact that *Whiteford Plastics* and *Vintero* were decided before the enactment of the Bankruptcy Code and interpreted avoidance provisions of the older Bankruptcy Act, the District Court determined that the reasoning of these cases applied equally to the avoidance provisions of the Bankruptcy Code. The District Court observed that the legislative history of the Bankruptcy Code indicates that Congress intended no substantive changes in enacting new section 544 of the Bankruptcy Code (the strong-arm powers of a trustee) to replace the old strong-arm powers set forth in section 70c of the Bankruptcy Act.

The District Court then noted that, under principles of federal jurisdiction, a party does not have standing to sue where the party is not able to allege an injury that is likely to be redressed by the relief sought. Against this legal backdrop, the District Court determined that here, given that the Obligor Debtors' creditors received full payment with interest under the Plan, the creditors would not benefit from the lawsuit and, therefore, the ART did not have standing to bring fraudulent conveyance claims on their behalf.

Under principles of federal jurisdiction, a party does not have standing to sue where the party is not able to allege an injury that is likely to be redressed by the relief sought.

In reaching this conclusion, the District Court rejected the ART's argument that unsecured creditors would indirectly benefit from a more financially sound estate. The District Court noted that distributions to the Obligor Debtors' creditors under the Plan were made in cash, rather than shares in the ART. Thus, there would be no apparent benefit to creditors from any recovery by the ART. The District Court also concluded that the plain language of the Plan made clear that all intercompany claims were resolved, so there was no merit to the argument that a recovery by the ART would benefit other debtors who were "creditors" of the Obligor Debtors.

The District Court also held that the ART lacked standing to assert the preference claims because, under the Plan's "payment in full" provisions, the bank defendants would not be

receiving any more than they would have received had the alleged preference payments not been made and the debtor had instead paid the bank defendants through the bankruptcy process. The District Court also noted that the concerns addressed by the preference laws (*i.e.*, equality of distributions among similarly situated creditors) are not implicated when creditors have all been paid in full.

Finally, the District Court held that the ART lacked standing to assert the equitable subordination and disallowance claims because the bank defendants would be paid in full even if their claims were subordinated. The District Court noted that subordination under section 510(c) of the Bankruptcy Code distinguishes between "claims" and "interests" and that a claim may be subordinated only to another claim. Moreover a claim may only be subordinated to a claim of the same debtor. Accordingly, the District Court accepted the bank defendants' argument that their claims against the Obligor Debtors could not be subordinated to the claims of other creditors represented by the ART because the Obligor Debtors' estates had not been substantively consolidated with the estate represented by the ART.

Analysis

The rule of law dictated by the *Adelphia* decision is fairly straightforward and noncontroversial, but could impact future bankruptcy cases in two respects. First, the *Adelphia* decision highlights the always important issue of substantive consolidation of affiliated estates and could very well be the focus of future substantive consolidation fights. Indeed, any potential target of an avoidance or subordination action who is also a creditor of a solvent debtor would be prudent to oppose any attempt to consolidate the debtor's estate with the estate of an insolvent debtor.

Second, the *Adelphia* decision could cause large, influential creditors, who may be subject to avoidance and subordination actions, to forego any upside in "payment in full plans" by insisting on cash payments as opposed to equity or security distributions. The *Adelphia* decision did not directly address the question of whether a debtor's estate would have standing to bring an avoidance action when a creditor is paid in full under a plan, but such payment is made, at least partially, in securities. However, the *Adelphia* decision could be interpreted to imply that creditors may "benefit" from estate recoveries in that scenario and, therefore, a debtor may have standing to pursue an avoidance action. With this question left unanswered, any creditor who is the potential target of an avoidance or subordination action may have more incentive to oppose a plan that proposes to pay creditors in full, but in consideration other than cash. ◎

"Deepening Insolvency" May Be a Measure of Damages

By Douglas Deutsch

Not long ago, legal newsletters were flush with articles on several opinions released by the Court of Appeals for the Third Circuit and the Delaware Court of Chancery which seemed to deal fatal blows to the legal concept of deepening insolvency as an independent cause of action. However, two new well-publicized court opinions have breathed life into the legal concept of deepening insolvency if raised as a measure of damages. Before addressing the new opinions, we provide some background on the evolvement of deepening insolvency.

Background on Deepening Insolvency

Deepening insolvency was initially suggested to be a state law cause of action that could be brought against a debtor's officers and directors, accountants, lawyers, bankers and other professionals for improperly prolonging the life of the company resulting in damages caused by increased debt. There was always a question, however, as to whether this relatively new legal concept should be recognized as a separate cause of action.

Rights related to damages for private wrongs (known as tort law rights) arise from common law rights which are rooted in principals and rules the United States inherited from England centuries ago. Courts questioned whether they needed the new judge-made tool of deepening insolvency in their time-tested arsenal. Adding fodder to the dispute was the fact that the courts creating the right were — unsurprisingly, given the nature of the cause of action — mostly federal bankruptcy courts.

Because the concept of "deepening insolvency" is not rooted in the Bankruptcy Code or other federal / continued page 10

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law, a federal court that considers whether this theory is an actionable tort does so by predicting how the court of the applicable state would likely rule. Thus, bankruptcy courts and federal courts hearing bankruptcy appeals found themselves in the somewhat unique position of determining whether a new state law right existed without the benefit of input from the relevant state court. Initially, certain prominent federal courts answered the question affirmatively.

In *R.F. Lafferty & Co.,* 267 F.3d 340 (3d Cir. 2001), the Third Circuit Court of Appeals determined that Pennsylvania law would recognize a deepening insolvency cause of action. After the *Lafferty* opinion was released in 2001, however, a number of courts questioned the legal soundness of the deepening insolvency theory. In the July 2006 ***Client Alert***, we examined the decision released in the *In re CitX Corp.,* 448 F.3d 672 (3d. Cir. 2006) case. There, the Third Circuit revisited the legal concept and found that (a) the harm of "deepening insolvency" can not be used to prove damages, one of the required elements of a malpractice action; and (b) that a deepening insolvency cause of action is only available where fraud is alleged and proven. As noted in the ***Client Alert***, the panel of judges who decided the *CitX Corp.* case seemed to have more fundamental question about the correctness of *Lafferty* but recognized that the Third Circuit's prior decision, even if wrong, could not be overruled unless the matter was considered by all of the judges in the Third Circuit (also known as an *en banc* opinion).

Finally, in 2006, a clear state court opinion on "deepening insolvency" was released by a leading state court. In *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,* 906 A.2d 168 (Del.Ch. 2006), the Delaware Court of Chancery found that Delaware would not recognize an action for "deepening insolvency." Explained the court, "If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success." The court colorfully explained that the "more fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting and not in the darker one." The Court of Chancery's opinion was subsequently affirmed by the Delaware Supreme Court. *See* 931 A.3d 438 (Del. 2007).

The New Opinions

The *Tremwick, Lafferty* and *CitX* decisions did not end discussions on deepening insolvency. More recently, in opinions reached in *In re Brown Schools*, 386 B.R. 37 (Bankr. D.Del. 2008), a Delaware bankruptcy case, and *Ario v. Deloitte & Touche LLP*, Case No. 7340 M.D. 2002 (Pa. Commw., July 13, 2008) (unpublished), a Commonwealth Court of Pennsylvania case, the courts acknowledge that deepening insolvency is not a valid cause of action but conclude that deepening insolvency is a valid measure of damages.

The courts acknowledge that deepening insolvency is not a valid cause of action but conclude that deepening insolvency is a valid measure of damages.

In *In re Brown Schools,* a trustee in a Chapter 7 trustee brought an action against, among others, the pre-bankruptcy insiders of the company for deepening insolvency, self-dealing, breach of fiduciary duty and for claims related to fraudulent transfers. On a motion to dismiss the action, the bankruptcy court acknowledged that no cause of action for deepening insolvency was available under Delaware law after the Delaware Supreme Court ruled in *Trenwick* and, accordingly, dismissed that cause of action.

The Court found, however, that *Trenwick* could not be read so broadly as to require dismissal of breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste, and civil conspiracy claims. These were not, as had been alleged, "disguised" deepening insolvency claims. Elements of these other causes of action had been properly asserted.

The defendants also asserted that deepening insolvency was an improper measure of damages after the Third Circuit's ruling in *In re CitX Corp.* According to the trustee, where a proper breach of fiduciary duty claim existed, deepening insolvency was a valid theory of damages. With little discussion, the Court agreed with the trustee's position.

In *Ario v. Deloitte & Touche,* the Pennsylvania Insurance Commissioner as "Liquidator" brought actions Deloitte & Touche, auditors of a now-liquidating insurance company named Reliance, for negligence, malpractice, misrepresentation and breach of contact. The Liquidator alleged that Deloitte has improperly certified Reliance's loss reserves as being "reasonably stated." The result was that Reliance escaped from regulatory scrutiny for a period of time during which it incurred additional underwriting losses. On a motion for summary judgment, Deloitte asked the Commonwealth Court of Pennsylvania to dismiss all the claims because the Liquidator failed to prove damages and because deepening insolvency damages are not available to support a malpractice action.

The Commonwealth Court quickly dismissed certain claims and focused on the deepening insolvency damages. To prevail on a professional malpractice claim based on negligence, stated the court, the Liquidator must establish (1) Deloitte owed a duty to Reliance, (2) Deloitte breached that duty, (3) Reliance was harmed and (4) Deloitte's breach caused the harm. The harm here was claimed to be the deepening insolvency of Reliance.

Recognizing that both *Lafferty* and *CitX* are federal court opinions that are not binding on it (as noted above, federal court opinions applying state law concepts do not bind subsequent state courts; *Trenwick* is not binding because, among other things, that opinion relates to Delaware and not Pennsylvania state law), the Commonwealth Court still liberally cites both cases for the proposition that deepening insolvency might be a cognizable form of legal harm. The court distinguishes *CitX* from the facts of *Ario* on the basis that there was no audited financial statement to rely on in *CitX*. The court explained: "an audited engagement, the accountant assumes responsibility for the accuracy of the figures presented [and] effectively warrants the reliability of the report." The court cites *Lafferty* for the proposition that "for every legal wrong there must be a correlative legal right." From its limited analysis of the applicable case law, which one commentator has called "nuanced" and we think was simply not sufficiently developed, the court determines that deepening insolvency can be "both a loss and an injury that occurs through the negligence of others."

Conclusion

In re The Brown Schools is one of the first to address the remaining "deepening insolvency" issues post-*Trenwick*. The *Brown Schools* case makes clear that while a separate claim of deepening insolvency does not exist, those same allegations can be used to determine damages. *Ario v. Deloitte & Touche* essentially reaches the same result but also includes broader language that would allow "deepening insolvency" be used to satisfy the harm element of an independent cause of action. Interestingly, the logic provided in *Ario* might also support recognition of deepening insolvency cause of action if the opinion did not somewhat inconsistently state — even though citing only to non-binding Third Circuit opinions — that Pennsylvania courts do not recognize such a cause of action. Given that the *Ario* opinion was designated by the court as an "unpublished" opinion and thus has limited utility as legal precedent, we await further instruction from Pennsylvania courts with regard to the exact limits of deepening insolvency in other situations.

Unilateral Post-Petition Non-Debtor Performance Does Not Prevent Executory Contract Rejection

By Jason Porter

Case Summary:

In *In re The Penn Traffic Company*, 524 F.3d 373 (2d Cir., 2008), the Federal Court of Appeals for the Second */ continued page 12*

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Circuit addressed the issue of whether the non-debtor party to a contract that is executory at the time a bankruptcy case is commenced can, by post-petition payment or performance of its own outstanding obligations, transform the contract into a non-executory contract that cannot be rejected by the debtor. In addressing this question, the Court held that where the parties' "Project Agreement" was an executory contract (a contract on which performance remains due to some extent on both sides) as of the time the debtor filed for bankruptcy, the non-debtor party to the executory contract cannot by postpetition tender or performance of its own outstanding obligations under the contract, deprive the debtor party of the ability to exercise its statutory rights to reject the contract as disadvantageous to the estate. In reaching this decision, the court noted that while sympathy for the non-debtor who bears the burden of rejection is understandable, the plain language and purpose of the Bankruptcy Code do not allow the non-debtor to prevent the exercise of the debtor's right to reject an executory contract under Section 365 of the Bankruptcy Code through post-petition performance.

While sympathy for the non-debtor who bears the burden of rejection is understandable, the plain language and purpose of the Bankruptcy Code do not allow the non-debtor to prevent the exercise of the debtor's right to reject an executory contract under Section 365 of the Bankruptcy Code through post-petition performance.

Background

The Appellant, COR Route 5 Company, LLC ("COR"), is a commercial real estate developer whose holdings include certain tracts of land near a shopping mall know as Town Center, in Fayetteville, New York. The Debtor-Appellee ("Penn Traffic") is one of the leading food retailers in the United States. Penn Traffic owned land with a building, adjacent to Town Center. This land could not have been developed into a modern suburban supermarket as part of the Towne Center without the inclusion of contiguous and connecting real property owned by COR.

In order to develop the land into a modern supermarket, Penn Traffic entered into a Project Agreement which provided for, among other things, the exchange of certain parcels of land, the site preparation and construction of a modern supermarket, reimbursement by COR to Penn Traffic of a specified portion of the construction costs, Penn Traffic's conveyance to COR of the parcel of land on which the supermarket is situated, and Penn Traffic's leaseback of the improved supermarket parcel. At the time of Penn Traffic's bankruptcy filing, all that remained to be completed under the contract was for (1) COR to (a) reimburse the approximately $3.5 million of construction costs and (b) tender the lease to Penn Traffic; and (2) Penn Traffic to convey the parcel to COR.

Several months after Penn Traffic filed for bankruptcy, COR wrote a letter to Penn Traffic stating that as required under the Project Agreement, it had tendered reimbursement of the $3.5 million in construction costs and signed the lease. Penn Traffic declined to accept COR's tender and, several months later, moved pursuant to Section 365 of the Bankruptcy Code (the "Code") to reject the Project Agreement.

Procedural History

In reviewing Penn Traffic's motion to reject the Project Agreement, the Bankruptcy Court noted that when a contract is executory, a deferential standard is applied to the debtor's business judgment as to whether an executory contract should be assumed or rejected. In this case, the debtor's decision to reject the Project Agreement appeared to have met the low threshold of the business judgment test for whether rejection of a contract is appropriate. The fair market value of the Penn Traffic Supermarket Parcel was appraised at $9.8 million, which is signif-

icantly higher than the $3.5 million reimbursement owed by COR under the contract. The Bankruptcy Court found, however, that while the Project Agreement was executory on the petition date (performance remained due on both sides) and rejection of the contract would pass the deferential business judgment standard, COR's reimbursement of the $3.5 million in construction costs and its signing of the lease had rendered the Project Agreement non-executory and thus incapable of being rejected. The Bankruptcy Court denied Penn Traffic's motion to reject the contract.

Penn Traffic appealed the Bankruptcy Court's order to the District Court. The District Court affirmed that the Project Agreement had been an executory contract as of the petition date but rejected the Bankruptcy Court's holding that the determination of whether a contract is executory should be made as of the rejection motion date and take into account post-petition performance. Based on this determination, the District Court reversed the Bankruptcy Court's holding that the contract was not executory and could not be rejected, and remanded the matter to the Bankruptcy Court for further proceedings consistent with its opinion.

After the District Court's decision, COR appealed the ruling to the Court of Appeals for the Second Circuit, arguing that the Bankruptcy Court had correctly found that COR's post-petition actions made the Project Agreement non-executory and thus the agreement could not be rejected by Penn Traffic. The Court of Appeals dismissed the appeal for lack of jurisdiction, explaining that due to the significant further Bankruptcy Court proceedings required, the District Court's order was not a final order. Following the Court of Appeal's dismissal, the Bankruptcy Court granted Penn Traffic's motion to reject the Project Agreement. On appeal, the District Court affirmed the Bankruptcy Court's rejection order without prejudice to the parties' appellate rights. COR then appealed this decision to the Court of Appeals.

Discussion

The first issue addressed by the Court of Appeals was whether the Project Agreement was an executory contract at the time of the bankruptcy petition. COR argued unsuccessfully that: (1) while there were unperformed obligations, the contract was not executory because it was in fact a "financing lease" or a "prepaid obligation"; and (2) that the agreement was not an executory contract because the transfer aspect of the Project Agreement constituted a provision for the return or redemption of property securing the money advanced. The Court of Appeals rejected these arguments and affirmed the previous rulings that the Project Agreement was an executory contract at the time of the bankruptcy petition.

The most significant issue addressed in the decision was whether the non-debtor party to a contract that is executory at the time a bankruptcy case is commenced can, by post-petition payment or performance of its own outstanding obligations, transform the contract into a non-executory contract that cannot be rejected by the debtor. The court held that it cannot.

In its review of this issue, the Court of Appeals stated that the statutory basis for Penn Traffic's motion to reject the Project Agreement was Section 365 of the Bankruptcy Code (which when read alongside Section 1107 of the Bankruptcy Code) provides that subject to certain exceptions, the debtor may, with the permission of the court, assume (continue performance) or reject (discontinue and abandon further performance) any executory contract or unexpired lease of the debtor. The Code allows the debtor to assume or reject the executory contract at any time before the confirmation of the bankruptcy plan. If the contract is rejected, the non-debtor party has an unsecured claim for breach of contract. This shift in status is significant because where assets of the estate are insufficient to pay unsecured creditors in full, the non-debtor party to a rejected executory contract (like other unsecured creditors of the estate) may receive only a fraction of the value of its claim rather than receive full performance under the contract.

The Court noted that while in some instances unilateral post-petition actions can render a contract non-executory, this was not the case when the unilateral actions were undertaken by the non-debtor. The Court of Appeals explained that unlike the cases where the contract becomes non-excutory due to the contract expiring by its own terms in the course of the bankruptcy or the debtor taking an action in the course of the bankruptcy to terminate the outstanding obligations, in this case, the contract had not expired and the actions were unilateral ones taken by COR (the non-debtor).

While the Court understood the feeling of sympathy for the non-debtor, who through no fault of its own, bears the burden of the debtors rejection, it justified the distinction between unilateral actions by the debtor and unilateral actions by the non-debtor for determining whether post-petition actions made a contract non-executory by citing to the plain language and the policy of the Code authorizing the rejection of these contracts. With regards to the plain language of the Code, the Court noted that Section 365 does not condition the right to assume or reject a contract on lack of prejudice to the non- */ continued page 14*

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debtor party. With respect to the policy of the Code, the Court found that "the main purpose of Section 365 is to allow a debtor to reject executory contracts in order to relieve the estate of burdensome obligations..." Citing *Orion Pictures Corp.* v. *Showtime Networks, Inc.* (*In re Orion Pictures Corp.*), 4 F.3d 1095, 1098 (2d. Cir 1993), the Court summarized the rational behind its ruling by writing "[i]n short, Section 365 permits the trustee or debtor-in possession, subject to the approval of the bankruptcy court, to go through the inventory of executory contracts of the debtor and decided which ones it would be beneficial to adhere to."

Analysis

Penn Traffic is an important case because it clearly stands for the proposition that once a bankruptcy petition is filed, the non-debtor party to a contract that is executory cannot, by unilateral postpetition tender or performance of its outstanding obligations under the contract, transform the contract into a non-executory one. Allowing this shift in the nature of the contract would deprive the debtor of its statutory right to reject the contract as disadvantageous to the estate. ◎

The Second Circuit Affirms Recognition of an Acuerdo Preventivo Extrajudicial

By: Francisco Vazquez

The United States Court of Appeals for the Second Circuit has affirmed an order granting recognition to an Argentine restructuring process known as an Acuerdo Preventivo Extrajudicial ("APE"). Although the decision was issued under former section 304 of the Bankruptcy Code, which has been replaced by Chapter 15 of the Bankruptcy Code, it could have implications for other companies involved in cross border restructurings.

Background

In the early 2000's, Telecom Argentina, S.A. ("Telecom"), a major Argentine telecommunications company, suffered a liquidity crisis and was unable to satisfy approximately $3.3 billion in outstanding debt, including certain notes issued in Europe and the United States (the "Old Notes"). As a result, Telecom negotiated a possible restructuring with an ad hoc committee of creditors. Ultimately, those discussions broke down and on January 9, 2004, Telecom publicly announced its own restructuring proposal and its intention to implement an APE. Under Argentine law, an APE is a privately negotiated debt restructuring supported by a qualified majority of the debtor's creditors, which upon approval by an Argentine court, is binding on all creditors.

Having obtained approval from 82.2% of creditors holding approximately 94.4% of the principal face amount of the Old Notes, Telecom submitted for approval its APE to an Argentine commercial court. Four objections were filed. The Argentine court rejected the objections and approved the APE. The Argo Fund Ltd. ("Argo"), a Cayman Island based entity that held over $34 million of the Old Notes, did not participate in the Argentine proceedings notwithstanding that it had actual notice of the proceedings.

While the APE court approval process was pending, Telecom and the indenture trustee for the Old Notes were discussing the procedures for implementing the APE and the cancellation of the Old Notes. Argo also contacted the indenture trustee and instructed it not to exchange Argo's Old Notes as required by the APE. In the course of its discussion with Telecom, the indenture trustee agreed to cancel the Old Notes held by consenting creditors, but informed Telecom that it was not unwilling to take any action to cancel the Old Notes held by non-consenting creditors, such as Argo, unless it was directed to by a United States court.

Telecom then commenced an ancillary proceeding by filing a petition under section 304 with the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court") and requested an order declaring that the APE should (i) be given full force and effect in the United States, (ii) made binding on all creditors, and (iii) result in the cancelation of the Old Notes. Argo filed an answer to Telecom's petition and a motion to withdraw the reference on the grounds that consideration of Telecom's request would require substantial and material consideration of the Trust Indenture Act of 1939 ("TIA"). Argo's motion to withdraw the reference was denied and the Bankruptcy Court issued an order granting recognition to Telecom's APE. Argo appealed and the United States District Court for the Southern District of New York (the "District

Court") affirmed the Bankruptcy Court's decision. Argo then appealed the District Court's decision to the United States Court of Appeals for the Second Circuit.

Appeal

Former section 304 of the Bankruptcy Code permitted a court to issue a broad range of relief in connection with a foreign proceeding. Section 304 provided that in considering whether to grant relief, a court "shall be guided by what will best assure an economical and expeditious administration of [a debtor's] estate, consistent with" certain factors. On appeal, Argo contended that the APE did not satisfy two of the relevant factors under section 304: just treatment of all creditors and comity.

Argo argued that the APE did not provide for just treatment of all creditors, because it allowed "only limited objections and limited recourse against a majority approved APE." The Second Circuit noted, however, that creditors are justly treated if the foreign proceeding "provides for a comprehensive procedure for the orderly and equitable distribution of [the debtor]'s assets among all of its creditors." Here, Argo had notice of the Argentine proceedings and had several opportunities to object to the APE. Moreover, the Argentine court approved the APE only after concluding that the APE was not abusive, fraudulent or discriminatory. Given the ability of creditors to participate and the level of the Argentine court's involvement in the APE proceeding, the Second Circuit was satisfied that the foreign proceeding comported with due process and ensured the just treatment of creditors.

Argo further contended that the APE violated public policy and was therefore not entitled to comity. According to Argo, the APE was inconsistent with (1) protection of bondholders' rights under the TIA, and (2) the best interests of creditors test and the good faith requirement set forth the Bankruptcy Code.

The TIA provides, in pertinent part, that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security . . . shall not be impaired or affected without the consent of such holder." Argo argued that the TIA protected Argo from majority-imposed impairment of its rights through the APE. The Second Circuit, however, noted that "TIA protected bonds are subject to restructuring under the United States' bankruptcy law." Accordingly, the refusal to recognize a foreign proceeding simply because it effected a restructuring of TIA protected bonds "would turn the principle of comity on its head."

Argo acknowledged that TIA protected bonds could be restructured in the United States. Argo argued, however, that the non-consensual restructuring of TIA protected bonds under the APE should not be recognized because it lacks certain protection for the benefit of non-consenting creditors — namely, the best interest of creditors test and the good faith requirement. The best interest of creditors test is embodied in section 1129(a)(7) of the Bankruptcy Code, which provides that a court cannot confirm a Chapter 11 plan unless the court is satisfied that each non-consenting creditor will receive no less under the plan than it would in a liquidation. Moreover, under section 1129(a)(3) a court cannot confirm a Chapter 11 plan unless the plan is proposed in good faith. Given that Argentine law does not impose a good faith requirement or require that an APE satisfy the best interest test, an APE, according to Argo, is not entitled to comity.

"Comity, however, does not require that foreign proceedings afford a creditor identical protections as under U.S. bankruptcy law." As long as the other factors of section 304 are satisfied, a court will not require that the foreign pro- / continued page 16

Comity, however, does not require that foreign proceedings afford a creditor identical protections as under U.S. Bankruptcy law.

Recognition of APE

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ceeding treat creditors identically to the way they would be treated in a United States bankruptcy. In particular, United States law does not require that the amount distributed in a foreign proceeding be equal to the hypothetical amount a creditor would receive in a United States proceeding. Moreover, Argo's assertion that Telecom could have paid all its debts in full would not support a refusal to grant recognition absent evidence that Telecom abused the APE process or entered it in bad faith.

Conclusion

Although section 304 of the Bankruptcy Code has been replaced by Chapter 15, this decision may have implications in future cross-border bankruptcy cases. Under Chapter 15, a court may refuse to grant recognition or other relief if it would be "manifestly contrary to the public policy of the United States." In the Telecom case, Argo argued that Telecom's APE should not be recognized based upon certain public policy concerns. Nevertheless, the Second Circuit held that Telecom's APE could be recognized in the United States.

In the Telecom decision, the Second Circuit confirmed that public policy would not be violated by the recognition of a foreign proceeding solely because it provided for the restructuring of TIA protected bonds given that TIA protected bonds may be restructured in a United States bankruptcy proceeding. In addition, the Second Circuit further restated the well established principle that a foreign proceeding does not have to provide creditors with the identical treatment they would receive in a United States proceeding to be recognized. Moreover, the Second Circuit noted that recognition of Telecom's APE is consistent with "our longstanding recognition that foreign courts have an interest in conducting insolvency proceedings concerning this or domestic business entities and that 'creditors of an insolvent foreign corporation may be required to assert their claims against a foreign bankruptcy before a duly convened bankruptcy tribunal.'" ◎

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