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US "Ipso Facto" and UK "Anti-Deprivation": the Lehman "Flip" Clause

By Alastair Goldrein

Background

On November 6, 2009, the English Court of Appeal issued a judgment in the case of *Perpetual Trustee Company Limited & another v BNY Corporate Trustee Services Ltd & another* [2009] EWCA Civ 1160, an action commenced in the English High Court by the noteholders representative — Perpetual Trustee Company Limited ("Perpetual"). The case concerned a number of collateralized debt obligation ("CDO") transactions structured and arranged by Lehman Brothers Inc. and its subsidiaries, pursuant to which a number of SPVs (each an "Issuer") had issued interest-bearing notes (the "Notes") to investors. At the same time, each Issuer had entered into a credit default swap contract (each a "CDS") with Lehman Brothers Special Financing Inc. ("LBSF"), with the Issuer as credit protection seller, and LBSF as credit protection buyer.

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All of the relevant contractual documentation was governed by English law. LBSF was incorporated in Delaware with its principal office in New York and had filed for Chapter 11 protection on October 3, 2008.

The proceeds of the Notes had been invested and security in the form of fixed and floating charge had been granted in favor of BNY Corporate Trustee Services Limited (the "Security Trustee"), for the benefit of the Noteholders and LBSF (to the extent that amounts would become payable to LBSF as a result of the early termination of the CDS). The security documentation provided that LBSF would have priority over the Noteholders in respect of the Note proceeds unless an event of default occurred where LBSF was the defaulting party (which included the bankruptcy of LBSF or its parent). At the point at which the event of default occurred (LBSF entered into insolvency proceedings in October 2008[1]), the order of priority of distribution of the security therefore changed or "flipped".

Following the collapse of the Lehman Group, payments due to the noteholders were not made and Perpetual asserted claims against the Security Trustee, seeking orders that the Security Trustee make distribu- / continued page 2

[1] LBSF entered insolvency proceedings following the insolvency of Lehman Brothers Holdings Inc. which provided credit support to LBSF - each of these events was an event of default under all of the CDS.

This publication may constitute Attorney Advertising in some jurisdictions.

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tions in their favor and in priority to the claims of LBSF. LBSF did not accept that the noteholders were entitled to priority over LBSF in the security realisations waterfall (of the security trust deed) and asserted a claim in the United States Bankruptcy Court, seeking an order that the provisions under the trust deed were contrary to the "ipso-facto" provisions of the US Bankruptcy Code (see V below).

LBSF's allegation in the US Bankruptcy Court was heard on August 11, 2009. Prior to this, Perpetual asserted claims in the English High Court against the Security Trustee to procure realisation of the collateral held by the Security Trustee pursuant to the trust deed and its application (i.e., payment to the noteholders in priority to paying the claims of LBSF). LBSF sought a temporary stay of the English proceedings pending resolution of the proceedings in the US Bankruptcy Court. The issue was whether the provision in the Security Trust Deed giving priority to noteholders over LBSF upon the occurrence of an event of default was valid as a matter of English law?

The US and UK Courts had recognised the potential for conflicting judgments from the start of the litigation. On the application of certain noteholders, the English High Court sent a letter to the US Bankruptcy Court which was characterized by the US Bankruptcy Court as follows:

> "[T]he English court has confined itself to making a declaration that the relevant contractual provisions are 'valid, effective and enforceable as a matter of English law as the proper law of such contracts, so as to give effect to Noteholder Priority," and requested that if the US court were to conclude that "the relevant provisions are void or otherwise unenforceable under US bankruptcy law" it "go no further at that stage than to make a declaratory judgment to that effect."

The English Proceedings and Anti-Deprivation Principle

The principle of "anti-deprivation" dates back to the 19th century. A long line of cases have, in different ways, expressed a rule that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors" (Ex parte Jay (1880)).

The principle operates to support the fundamental rule that distributions in a winding-up must be made to creditors in the same category on a pari passu basis (s107, Insolvency Act 1986 and rule 4.181, Insolvency Rules 1986 (SI 1986/1925)). In essence, the anti-deprivation principle provides that a contractual provision is void if it provides for the transfer of an asset from the owner to a third party upon the insolvency of the owner. Attempts to avoid the anti-deprivation principle have been ruled void as a matter of public policy (*British Eagle International Airlines Ltd v Cie Nationale Air France* [1975]).

Nevertheless, the application of this principle by courts in numerous cases has given rise to some degree of uncertainty. As the Master of the Rolls himself said in the case: "It is not entirely easy to define the rule's precise limits, or even its precise nature as the reasoning in the various judgments in which the rule has been considered is often a little opaque, and some of the judgements are a little hard to reconcile."

In *Perpetual Trustee Company Limited v BNY Corporate Trustee Services Ltd*, the issue arose as to whether the provision in the security trust deed which gave priority to noteholders over LBSF upon the occurrence of an event of default, fell foul of the anti-deprivation principle.

The Decision

LBSF argued that such a provision in the trust deed that flipped the order of priority of distribution of the security was void under English law as it had the effect of depriving creditors of LBSF of an asset upon its insolvency.

Perpetual responded that the clause was valid and relied on the distinction drawn by the courts between a contract which by reason of the insolvency seeks to remove assets from the estate of the bankrupt and a contract under which the insolvent's interest in the asset is limited and determined upon insolvency (also referred to as a "determinable interest"). Perpetual contended that LBSF had a determinable interest because, under the terms of the trust deed, LBSF only ever had an interest, in respect of its payment in priority, which determined on an event of default in the event that LBSF was the Defaulting Party. After considering a number of cases where the anti-deprivation principle had been considered,[2] the judge concluded (at paragraph 43) that while a provision that serves to deprive creditors of assets upon an insolvency "was contrary to public policy and therefore void, it is also clear that there exists an exception to that principle for the grant of an interest in property determinable on the insolvency of the grantee, but not the grantor. Between those extremes exists an uncertain area... In any given case it is necessary to construe the

[2] These included (amongst others) Ex parte Mackay (1873); *British Eagle International Airlines -v- Compagnie National Air France* [1975] 1 WLR 758; *Money Markets International Stockbrokers Ltd -v- London Stock Exchange Ltd* [2002] 1WLR 1150; and *Squires -v- AIG Europe (UK) Ltd* [2006] BCC 233 .

relevant documents in light of the decided cases."

The judge had two separate reasons for concluding that the rule did not prevent Perpetual from relying on the flip clause. The first reason was based on the nature of the right triggered by the insolvency event, and essentially turned on the extent of the anti-deprivation rule. But even if the flip constituted a deprivation, the court's decision relied on a second reason, which was based on the alleged deprivation itself. The anti-deprivation principle was not applicable to a deprivation effected pursuant to the Chapter 11 filing of a different entity.

The judge held that the clause in the trust deed was valid and not contrary to public policy for the following reasons:

- It was not possible to examine the "flip" clause in isolation, but rather the transaction should be analyzed as a whole: the collateral was bought by each Issuer with the note proceeds; it was not derived from LBSF as the swap counterparty;
- It was clear that the intention of all the parties was that priority afforded to LBSF was conditional. The priority of LBSF did not continue after an event of default, where LBSF was the defaulting party; and
- LBSF's priority security interest in the collateral was always conditional and limited and could not pass to a liquidator free from those conditions and limitations.

The judge also expressed his view on the argument made by Perpetual that the anti-deprivation principle could not apply to LBSF as it was not the subject of an English insolvency proceeding and was only the subject of a Chapter 11 case in the US. On this point, the judge held that it could not be said that the English anti-deprivation principles would only apply in the context of an English insolvency proceeding. Under both common law and/or statute (Cross Border Insolvency Regulations 2006), English courts were obliged to recognise and provide assistance to the US courts and, if necessary, to apply this principle in the context of non-UK insolvency proceedings.

The Appeal

In its judgment, the Court of Appeal unanimously dismissed LBSF's appeal and upheld the decision of the High Court on the following grounds:

- The anti-deprivation principle only applies to arrangements which take effect at the date of insolvency of the insolvent where the estate is allegedly "deprived" of assets; disposals of assets made prior to the onset of insolvency are not affected, unless caught by specific statutory provisions affecting antecedent transactions; and
- The priority which LBSF had to the collateral as provided by the issuers was contingent on there being no event of default. The effect of the "flip" provision was to vary the order of priorities in which the rights were to be exercised in relation to the proceeds of sale of the collateral (rather than divesting LBSF of assets vested in it and vesting those assets in the noteholders).

LBSF filed a further appeal on March 26, 2010, and the Supreme Court (the highest court in the United Kingdom) has decided to hear the case, with hearings provisionally set for March 2011.

Battle of Bunker Hill?

In the US, ipso facto clauses (provisions in an agreement that would deprive a party of a right as a result of its insolvency or its bankruptcy filing) are generally unenforceable in a bankruptcy proceeding (section 365(b)(2), US Bankruptcy Code). This represents the US equivalent of the English "anti-deprivation" rule albeit the US doctrine is wider than the English principle.

The US Bankruptcy Court for the Southern District of New York (The Honorable James M. Peck) in the parallel proceedings (re: *Lehman Brothers Special Financing Inc. v BNY Corporate Trustee Services Limited* (Case No: 09-01242) has declined to follow the decision of the English courts and has issued a memorandum decision finding that the "flip" was an unenforceable ipso facto clause. Consequently, the Security Trustee is currently trapped between two contradictory court decisions in two jurisdictions with one telling it to pay the noteholders first and the other telling it to pay LBSF first.

The US court found that the English courts had not taken into account principles of US bankruptcy law and in particular section 365 of the Bankruptcy Code. Judge Peck emphasised that "(US) courts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States." Despite the challenges posed by conflicting judgments Judge Peck concluded that the US had a sufficiently strong interest in the circumstances to justify and require the application of US bankruptcy law, noting in particular where the relevant provisions of the Bankruptcy Code would provide the debtor with greater protection than that available under English law.

It has been reported that the parties had been directed to appear at a hearing to explore "means to harmonise" the US decision with the English decision, but it has been further reported that this has been postponed pending the outcome of the UK Supreme Court hearing in 2011. Reconciling the US and English approach would appear a first glance to be problematic and one alternative might involve limiting the geographical reach of each judgment to their respective territorial assets. Another option might involve LBSF attempt- / *continued page 4*

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- Chadbourne was recognized as one of the leading firms in the bankruptcy/restructuring area in *Chambers USA – America's Leading Lawyers for Business* (2010). Howard Seife was specifically recognized in Chambers USA 2010 as a "deeply experienced lawyer" and for his "expertise in cross-border and Chapter 15 issues."
- Howard Seife, David LeMay and Ted Zink were recognized by *New York Super Lawyers* (2010) in the areas of bankruptcy and creditor/debtor rights.
- Douglas Deutsch was appointed to the Board of Directors of the American Bankruptcy Institute, a 12,000 member multi-disciplinary, non-partisan organization of insolvency professionals. Doug was also reappointed to be co-chair of the Secured Credit Committee of the American Bankruptcy Institute.
- Howard Seife and David LeMay were recognized in *The Best Lawyers in America* (2011) in the areas of bankruptcy and creditor/debtor rights.

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ing to have the US judgment recognized in England by means of the UNCITRAL Model Law on Cross-Border Insolvency, which has been adopted by both countries.

Conclusion

The judgment of the Court of Appeal, certainly for the meantime, has limited the scope of the anti-deprivation principle. There also remains no small degree of uncertainty following the judgement of the Court of Appeal regarding the distinction between the grant of a proprietary interest in property which is determinable upon insolvency (and valid) and a provision providing for the transfer of property on terms that it shall be forfeited on insolvency (which is not valid).

Meanwhile, the case is of enormous consequence to all English structured finance transactions (and particularly those which involve U.S. counterparties) that contractually provides for the order of priority of payments to secured counterparties to be changed in certain specified circumstances. It is pleasing to see that the English courts have so far upheld the clear contractual intentions of the parties as determined in the transaction documentation and recognised the noteholders priority. The judgement may also represent a serious challenge for rating agencies when assessing the likelihood of timely or ultimate payment of principal and interest on rated notes.

Glimmers of Hope for Trademark Licensees

By Christy Rivera

For decades, trademark licensees have been treated as second class citizens relative to licensees of other intellectual property in bankruptcy cases of the related licensor. While licensees of patents or certain other intellectual property retain the right to use the licensed property upon the licensor's "rejection" of the license, trademark licensees' right to use the licensed trademark typically terminates upon rejection of the license. A decision earlier this summer by the Third Circuit, however, has given new hope to trademark licensees that they may be entitled to some of the same protections provided to other "first class" intellectual property licensees. *See In re Exide Techs*., 2010 U.S. App. LEXIS 11029 (3d Cir. 2010).

In *Exide*, a trademark licensee argued successfully that the debtor licensor could not prevent the licensee from continuing to use the licensed trademark by rejecting the license. In April 2002, Exide filed for bankruptcy and, shortly thereafter, sought to reject various agreements that it had entered into over 10 years prior with EnerSys Delaware Inc. ("EnerSys"), when Exide sold to EnerSys substantially all of its industrial battery business. EnerSys objected to the rejection of four of those agreements (a trademark and trade name license agreement, the asset purchase agreement, the administrative services agreement and a letter agreement). Both the bankruptcy court and the district court approved Exide's request to "reject"

the four agreements, together which the courts held constituted a single integrated agreement (the "Agreement").

On appeal to the Court of Appeals for the Third Circuit, EnerSys argued, among other things, that Exide could not reject the Agreement because it was not "executory." Section 365(a) of the Bankruptcy Code only allows debtors to reject "any executory contract or unexpired lease." Courts have held that an executory contract is one under which the obligations of both parties are so far unperformed that the failure of either to complete performance would constitute a material breach.

The Third Circuit agreed that the Agreement was not executory, holding that under New York law, which governed the Agreement, no obligations remained for either Exide or EnerSys which were so material that failure to perform would constitute a material breach by either party. In ruling as such, the Third Circuit rebuffed several arguments raised by Exide. First, the Third Circuit held that EnerSys's obligation to not use the trademark outside the industrial battery business was not a material obligation because it was a condition subsequent which required EnerSys to use the mark in accordance with the related license. Next, the Third Circuit held that EnerSys's obligation to observe a "quality standards" provision was minor because it only required meeting certain standards of the marker for each battery produced; it did not relate to the transfer of the industrial battery business to EnerSys. Other arguments raised by Exide relating to an indemnity obligation and a "further assurances" obligation also failed to persuade the Third Circuit that the Agreement remained executory at the time of the bankruptcy case.

The above analysis, of course, does not necessarily produce hopeful feelings for trademark licensees. That hope comes from The Honorable Thomas L. Ambro, who issued a concurring opinion in which he took issue with the district court's statement that "[r]ejection of the Agreement leaves EnerSys without the right to use the Exide mark." Judge Ambro noted that the exclusion of trademark licenses from a list of intellectual property licenses automatically protected by Bankruptcy Code section 365(n), a safe harbor available when a debtor licensor seeks to reject a license, should not be interpreted to mean that trademark licensees should never qualify for protection when a debtor licensor seeks to reject a trademark license.

Bankruptcy Code section 365(n) provides that if a debtor seeks to reject an executory contract under which the debtor is the licensor of a right to intellectual property, the licensee may elect to (a) treat the contract as terminated by such rejection or (b) retain its rights to the intellectual property for the duration of the contract and any period for which the contract could be extended by the licensee as of right under applicable nonbankruptcy law. The Bankruptcy Code's definition of "intellectual property" does not include trademarks, which has caused courts to hold by negative inference that trademark licensees cannot avail themselves of the protections of section 365(n) and, upon a debtor licensor's rejection of a trademark license, licensees are typically deprived of the right to continue using the trademark.

In asserting that trademark licensees may sometimes be entitled to protection, Judge Ambro referred to, among other things, the Senate report discussing section 365(n). That report stated that "trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts." S. Rep. No. 100-505, at 5, reprinted in 1988 U.S.C.C.A.N. at 3204. Noticeably missing is any statement suggesting that trademarks are not as important or worthy of protection as other intellectual property. Rather, trademark licenses raise more complex issues, which suggested to Congress that a bright line safe harbor protecting these licenses in all cases was not appropriate.

Judge Ambro suggested that a more equitable approach is appropriate for trademark licenses, noting that in light of these congressional statements of intent, it is inappropriate to "read rejection of a trademark license to effect the same result as termination of that license." In this case, Judge Ambro asserted that the Exide bankruptcy court and district court should have used "their equitable powers to give Exide a fresh start without stripping EnerSys of its fairly procured trademark rights." Judge Ambro closed his opinion noting that section 365 should be used to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization, but it should not be used to let a licensor take back trademark rights it bargained away. "This makes a bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve."

Two glimmers of hope emerge from the *Exide* decision for trademark licenses in bankruptcy cases of the licensor. (These are glimmers and not bright rays, due to the fact that (a) Judge Ambro's concurring opinion is merely persuasive authority and has no binding, precedential effect on courts and (b) whether any agreement is executory is an extremely fact-sensitive analysis and, in the *Exide* case, the trademark license was but one part of several related agreements, all related to an earlier sale of the related business.) To capitalize on these glimmers, going forward licensees should review carefully whether an argument exists that a trademark license is no longer execu- */ continued page 6*

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tory at the time of the bankruptcy filing such that the licensor is unable to seek its rejection under section 365 of the Bankruptcy Code. Second, even if the license is executory and rejection possible, trademark licensees should consider whether an argument exists that the facts and equities of the case should persuade a court to protect the licensee's continued use of the trademark, consistent with the safe harbor protections in section 365(n) provided to other intellectual property contracts. ◎

Revisions to Proposed Amendments to Bankruptcy Rule 2019

By Young Yoo

The Advisory Committee on Bankruptcy Rules recently issued a report to the Standing Committee on Rules of Practice and Procedure on amendments and new rules that were published for comment the previous year. The Advisory Committee's report recommends substantial revisions to the amendments that were initially proposed to Bankruptcy Rule 2019. The revisions are responsive to the numerous comments, suggestions and objections made by hedge funds, institutional investors and other distressed debt investors.

Background

Not long ago, Rule 2019's application was being fiercely litigated in courts around the country. Due to the rule's ambiguous language, courts disagreed on whether Rule 2019's disclosure requirements applied to informal and ad hoc committees. The level of disclosure required when Rule 2019 requires some information significantly affects the willingness of hedge funds, institutional investors and other distressed investors (who often make up such committees) to participate in bankruptcy proceedings.

Indeed, requiring detailed and public disclosure of their claims and interests would endanger proprietary and confidential information that is closely protected as part of their investment strategy. Some have argued that Rule 2019 was being used as a litigation tactic against such informal or ad hoc committees. The possibility for misuse became increasingly evident — and in some cases, outright criticized — with the conflicting decisions in *In re Northwest Airlines Corp., In re Scotia Development, LLC, In re Washington Mutual, Inc., In re Premier Int'l Holdings, Inc.* and *In re Philadelphia Newspapers, LLC.*[1]

Against this backdrop, the Advisory Committee proposed amendments last year that would clear up any ambiguity. Rule 2019's operative definition of "disclosable economic interest" would now include, among other things, any claim, interest, pledge, lien, option, participation and derivative instrument. Most importantly, Rule 2019 would now explicitly apply to informal and *ad hoc* committees.

While the overwhelming majority of commentators supported clarifying and reinvigorating Rule 2019, there was concerted opposition on what types of information should be required under subsection (c). As proposed, the amendments would have required disclosure of (i) the amount paid for each disclosable economic interest, and (ii) the date when each disclosable economic interest was acquired (if not more than one year before the filing of the petition).

Most of the opposition came from hedge funds, institutional investors and other distressed debt investors, who testified that disclosing the purchase amount would allow competing firms to determine the disclosing party's trading strategy. They further testified that disclosing the purchase date would allow competing firms to extrapolate the purchase amounts. Thus, the required disclosure of the purchase date would result in the purchase amounts being revealed, and in turn, the trading strategy. They argued that compromising their trading strategies would discourage their participation in bankruptcy proceedings and the purchase of distressed debt overall and an amended Rule 2019 could accomplish its goals of openness and transparency without such information.

Revised Amendments

Ultimately, the Advisory Committee was highly responsive to the concerns of these groups and made several revisions to the proposed amendments. While these revisions would preserve Rule 2019's explicit application to informal and *ad hoc* committees, the Advisory Committee eliminated the disclosure requirement of the purchase amount of the disclosable economic interest. With respect to the disclosure requirement of the purchase date, the requirement would be limited only to the quarter and year of acquisition.

In addition, other substantive revisions to the proposed amend-

[1] For a discussion of these cases, see our article, "Developments in Rule 2019 Disclosure Controversy," from our International Restructuring Newswire, dated April 2010, available on our website at www.chadbourne.com/publications/.

ments include (i) limiting the application of Rule 2019 only to those entities or groups that are actively taking positions before the court, thereby removing entities that are only passively involved from coverage under the rule, (ii) exempting indenture trustees, administrative agents under credit agreements, class action representatives and certain governmental units from Rule 2019's disclosure requirements (unless the court ordered otherwise), and (iii) limiting subsection (d)'s requirement of updated supplemental statements, only when there was a material change to any fact disclosed in its most recently filed 2019 statement.[1]

Conclusion

These revisions to the proposed amendments resolve many of the issues that have led to the recent controversy and split in the courts under current Rule 2019. The revised and amended Rule 2019 as it now stands, must still be approved by the Standing Committee on Rules of Practice and Procedure, the Judicial Conference of the United States and the U.S. Supreme Court before being reviewed by Congress and becoming effective. This will take several months but a final revised Rule 2019 should eventually take effect around December 1, 2011. Until then, current Rule 2019 still remains in full force and effect. ◎

Proceeds of D&O Insurance Policies: Property of the Estate?

By Robert J. Gayda

In *In re Downey Financial Corp.*, 2010 WL 1838565 (Bankr. D. Del. May 7, 2010), the Bankruptcy Court for the District of Delaware was faced with the question of whether the proceeds (the "Proceeds") of a directors and officers insurance policy (the "Policy") were property of the estate. The Bankruptcy Court, after engaging in a detailed analysis of the Policy and applicable case law, held that, because depletion of the proceeds would not have an adverse effect on the estate, the Proceeds were not property of the estate.

[1] A copy of the Advisory Committee's full report and revisions is available at http://www.lsta.org/WorkArea/showcontent.aspx?id=10462 and http://www.lsta.org/WorkArea/showcontent.aspx?id=10460.

Background

The Policy

The debtor, Downey Financial Corp. (the "Debtor"), commenced a Chapter 7 proceeding on November 25, 2008. Prior to the filing of the proceeding, the Debtor had taken out the Policy from National Union Fire Insurance Company of Pittsburgh, PA. The Policy covered claims made from July 7, 2007 to July 1, 2008, up to a limit of $10 million. The Policy provided three different kinds of coverage, including (i) direct coverage to the directors and officers of the Debtor (the "Insureds") for losses arising from covered claims, (ii) entity coverage, which covered organizational liability of the Debtor arising from certain covered securities claims ("Entity Coverage") and (iii) indemnification coverage, which covered the costs the Debtor incurred indemnifying the Insureds ("Indemnification Coverage").

Prior to a bankruptcy filing, the Policy required the Insureds to first seek indemnification from the Debtor for their defense costs. The Debtor would only be entitled to indemnification coverage under the Policy after it had exhausted a $1 million retention (the "Retention") — that is, after it had paid $1 million in indemnification costs to the Insureds. However, once the Debtor filed for bankruptcy, the Insureds' defense costs became "Non-Indemnifiable Loss[es]." Because the Retention did not apply to Non-Indemnifiable Losses, once the Debtor filed for bankruptcy, the Retention ceased to apply, and the Insureds could seek coverage for their defense costs directly from National Union.

The Actions

In May and June 2008, prior to the bankruptcy filing, two shareholder class action complaints were filed in the United States District Court for the Central District of California against the Debtor and three of the Insureds, alleging various violations of federal securities laws. The district court consolidated these class actions and appointed a Lead Plaintiff (as consolidated, the "Securities Class Action"). The district court subsequently dismissed the complaint with leave to amend; in the amended complaint, the Debtor was not named as a defendant. On August 21, 2009, the district court dismissed the Lead Plaintiff's amended complaint with prejudice. Thus, the Securities Class Action was terminated.

Additionally, in June 2008, two shareholder derivative actions were filed in California state court against the Debtor, as a nominal defendant, and all of the Insureds. The court consolidated these two shareholder derivative actions (as consolidated, the "Derivative Action"), and ordered the filing of a consolidated amended complaint. However, due to the substantial overlap between the Derivative Action and the / continued page 8

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Securities Class Action, the parties agreed to stay the defendants' response until the resolution of the motions to dismiss in the Securities Class Action. When the Debtor commenced the bankruptcy proceeding, any claim against the Debtor as a nominal defendant in the Derivative Action was stayed. The trustee, on behalf of the Debtor's estate, was subsequently substituted as the real party in interest in the Derivative Action. However, the trustee had not filed a consolidated complaint, or taken any other action, in the Derivative Action.

Prior to the bankruptcy filing, the Debtor had indemnified the Insureds for their defense costs in the amount of $588,000.

Bankruptcy Court Ruling

The Insureds sought a determination that the Proceeds were not property of the estate. The Court noted that generally a debtor's liability insurance policy is considered property of the estate. However, courts are in disagreement over whether the proceeds of a liability insurance policy are property of the estate. Cases determining whether the proceeds of a liability insurance policy are property of the estate are controlled by the language and scope of the specific policies at issue.

Generally, the Court stated, when a debtor's liability insurance policy only provides direct coverage to the debtor, courts have held that the proceeds are property of the estate. Conversely, when the liability insurance policy only provides direct coverage to the directors and officers, courts have held that the proceeds are not property of the estate. When the liability insurance policy provides direct coverage to both the debtor *and* the directors and officers, "the proceeds will be property of the estate if depletion of the proceeds would have an adverse effect on the estate to the extent the policy actually protects the estate's other assets from diminution."

The Court examined the Entity Coverage and Indemnification Coverage separately. With respect to Entity Coverage, the Court found that because the Securities Class Action had been terminated as to the Insureds and the Debtor, and the Derivative Action had been stayed as to the Debtor (as a nominal defendant), there were no longer any covered securities claims. Therefore, the Policy's Entity Coverage was no longer protecting the estate's assets from diminution.

In regard to the Indemnification Coverage, the analysis was slightly more complicated. The Court cited precedent stating that "when the liability policy provides the debtor with indemnification coverage but indemnification either has not occurred, is hypothetical, or speculative, the proceeds are not property of the bankruptcy estate." In this case, the Court ruled, there had been no "actual payment of indemnified cost" and such payment was speculative.

The trustee argued that "[i]ndemnification by [the Debtor] ha[d] in fact occurred, and there ha[d] been more than just a request by the directors and officers for indemnification." The Court disagreed because while the Debtor had, in fact, indemnified the Insureds in the amount of $588,000 prior to filing the bankruptcy proceeding, it had still not exhausted the Policy's Retention. Therefore, no indemnification *for which the Debtor would be entitled to coverage under the Policy* had occurred. Unless the Debtor would be entitled to coverage under the Policy, indemnification would not "adversely affect the Debtor's estate," because such indemnification would not deplete the Policy proceeds.

Further, it was extremely unlikely that any indemnification for which the Debtor would be entitled to coverage would ever occur. The trustee would need to pay $412,000 in indemnification costs just to exhaust the Retention and had given no indication that he planned to indemnify the Insureds. Additionally, the Insureds did not, post-petition, seek indemnification from the Debtor for defense costs, nor did they even file a proof of claim by the bar date. Therefore, the Court stated, it was extraordinarily unlikely that the trustee would ever pay over $412,000 in indemnification costs, which was the minimum amount that the trustee would have to pay to be entitled to indemnification coverage under the Policy. Accordingly, the Court found that indemnification for which the Debtor was covered had not occurred, and future indemnity was hypothetical or speculative. Therefore, the Policy's Indemnification Coverage, like its Entity Coverage, was no longer protecting the estate's other assets from diminution and the Proceeds were not property of the estate.

Conclusion

This case highlights the fact that whether the proceeds of director and officer insurance policies are property of the estate will be a factual determination that may not be clear cut. Both insured directors and officers and debtors should be aware that such a determination will come down to an examination of the applicable documents, and may need to prepare accordingly when heading towards a restructuring. This is especially relevant considering the current economic climate, in which creditors who are out of the money may seek to bring an action against the directors and officers of the debtor or the debtor itself for pre-petition actions. ◎

"Silent Second Lender's" Efforts to Seek the Appointment of an Examiner Are Sidelined by Its Prepetition Waiver

By Meghan Towers

Introduction

The recent decision in the case of *In re Erickson Retirement Communities, LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010) provides ammunition for those opposing the appointment of an examiner in a debtor's Chapter 11 case and a cautionary tale for lenders entering into subordination agreements.

In *Erickson*, a subordinated creditor, the Michigan Retirement System Entities, moved for the appointment of an examiner to investigate and report to the Court on the fairness of the allocation of value, including sales proceeds, among sixteen different estates of the collective *Erickson* debtors. Various parties in interest objected to the motion for an examiner.

Section 1104

Section 1104 of the Bankruptcy Code governs the appointment of examiners. That section provides that a bankruptcy court shall appoint an examiner in a Chapter 11 case if:

> (a) there is a request of a party-in-interest or the United States Trustee for such an appointment; (b) the request is made prior to the confirmation of a plan of reorganization; (c) there has been notice and a hearing; and (d)(1) it is in the interests of creditors, any equity security holders and other interests of the estate; or (ii) the debtor's fixed, liquidated, unsecured debts (other than for goods, services, or taxes or insider debt) exceed $5 million.

The statute contemplates that an examiner will "conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor...." An examiner is typically an independent third-party who investigates a specific area of inquiry and then submits a report to the bankruptcy court detailing its findings.

Standing

The *Erickson* court identified two central questions posed by the subordinated lender's motion. First, whether, given the relevant facts and the advanced status of the case, the court was compelled to appoint an examiner in accordance with the "shall" language of section 1104. Second, whether the movant lacked standing under section 1104 to request the appointment of an examiner or, alternatively, the movant had waived its right to make such a request pursuant to the "silent second" provisions of the prepetition subordination agreement to which the movant was party.

The Court began its analysis by noting that most of the criteria for the appointment of an examiner had been met, including the $5 million threshold. The Court agreed with the majority of case law that, where the $5 million unsecured debt threshold of 11 U.S.C. §1104(c) is met, a bankruptcy court is mandated to appoint an examiner. Indeed, the only judicial discretion that the Court believed could be exercised was in defining the scope of the examiner's role/duties. Through the use of this discretion the Court had the ability to make the scope of an examiner's duties very broad or very narrow.

The Court quickly turned to the question that it believed was more pertinent under the facts of the case — whether the Michigan Retirement System Entities had standing as a party in interest to request the appointment of an examiner or whether, as a result of certain prepetition subordination agreements to which they were parties, they had waived their right to bring the examiner motion.

The Michigan Retirement System Entities were parties to a subordination agreement wherein they agreed, among other things, to refrain from exercising "any rights or remedies or take any action or proceeding to collect or enforce any . . . [obligations] . . . without the prior written consent of the Agent until the senior secured lenders had been fully satisfied." On the strength of the subordination agreement and the waiver of rights provision, the Court sided with the Debtors' senior lenders and held that the Entities lacked standing and/or had waived their right to pursue the examiner motion because they had agreed in the subordination agreement to yield in all respects to the senior lenders until those lenders were paid in full. Holding that the filing of a motion to appoint an examiner was an "indirect demand for payment", the Court held that, since the subordination agreements were enforceable under Maryland law, by filing the motion to appoint an examiner the movants had violated their contractual obligation to "stand still" until the senior lenders were paid in full.

Only after the Court determined that the Michigan Retirement System Entities did not have standing to file / continued page 10

In re Erickson Retirement Communities

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the examiner motion did the Court explain its earlier determination that the appointment of an examiner was not necessary under the facts of the case. The Court noted that the Michigan Retirement System Entities' concerns about the apportionment of value would be fully vetted during the plan confirmation process, when the "multitude of experts involved" would "testify as to value and let the court decide whether the Debtors' proposed allocation of value is appropriate," a inquiry that bankruptcy courts often perform without the aid of an examiner. Given the above, the Court concluded that, given the lack of "allegations of wrongdoing on the part of the Debtors", it would "be hard pressed to find any useful purposes for an examiner" and thus would have appointed "an examiner with no duties." However, there was no requirement of appointing even a limited-scope examiner because of the Court's determination on the lack of standing and waiver issues.

Conclusion

While *Erikson* ultimately turned on the issue of the enforceability of subordination agreements — and "silent seconds" should understand that they may be waiving the right to seek the appointment of an examiner — the Court's analysis of section 1104 of the Bankruptcy Code is useful for those seeking to defeat a request for the appointment of an examiner when no such waiver exists. Though courts may view section 1104 as mandatory where the criteria of the statute is met, there is still an element of judicial discretion governing the mandate of an examiner. With a sufficiently narrow mandate a court can make the appointment of an examiner practically ineffective, while staying true to the letter of the statute. ◎

Automatic Stay may be Extended to Enjoin Non-Debtors

By Bonnie Dye

The automatic stay is one of the most fundamental bankruptcy protections. It enjoins the initiation or continuance of any action by any creditor against the debtor or the debtor's property, including causes of action possessed by the debtor at time of the bankruptcy filing. The automatic stay offers this protection while bringing all of the debtor's assets and creditors into the same forum, the bankruptcy court. Similarly, the commencement of a liquidation under the Securities Investor Protection Act ("SIPA"), enacted to protect customers of failed investment companies, operates as an automatic stay. The purpose of the stay in a SIPA proceeding is to protect the bankrupt investment company's customers by fostering the fair, uniform, and efficient distribution of customer property.

But how far can a bankruptcy court apply the stay in order to promote fair distribution? The United States Bankruptcy Court for the Southern District of New York recently extended the stay in the SIPA liquidation of Bernard L. Madoff Investment Securities LLC ("BLMIS") to a third party action by BLMIS customer claimants in a Florida district court against non-debtor entities that were involved in litigation with the BLMIS estate.

Background Litigation

The BLMIS SIPA Proceeding

Bernard L. Madoff was arrested in December 2008 and charged with perpetrating a multi-billion dollar securities fraud scheme through his investment company, BLMIS. After the discovery of the fraudulent scheme, Madoff was charged with, among other things, violations under SIPA. The Securities Investor Protection Corporation ("SIPC"), a federally-created nonprofit corporation that steps in when an investment company fails, subsequently sought and obtained court authorization to place BLMIS customers under the protection of SIPA before the Bankruptcy Court. Accordingly, a trustee ("Trustee") was appointed to oversee the liquidation of the BLMIS estate.

The Picower Adversary Proceeding

In its role to recover and distribute customer property to the BLMIS customer claimants, the Trustee commenced an adversary proceeding against the estate of Jeffry M. Picower and related entities (the "Picower Defendants"). The Trustee alleged claims of fraudulent transfers, preferences, turnover, and state law fraudulent conveyances and sought the recovery of over five billion dollars. After the commencement of the adversary proceeding, the Trustee engaged in months of settlement negotiations with the Picower Defendants and was on the verge of a settlement at the time of this litigation. The Trustee represented to the Bankruptcy Court that if the settlement efforts were successful, the estate would receive a multi-billion dollar sum for distribution to the Madoff victims.

The Florida Litigation

Two of BLMIS customer claimants, Adele Fox and Susanne Stone Marshall, independently brought putative class actions against the Picower Defendants for their alleged involvement in the

Madoff ponzi scheme in the United States District Court for the Southern District of Florida, West Palm Beach Division (the "Florida District Court"). Both Fox and Marshall had filed customer claims in the SIPA liquidation. Marshall's customer claim was deemed allowed in the amount in which Marshall deposited into her account with BLMIS, less any withdrawals (total of $30,000). In exchange for receiving a payment from the Trustee for her allowed claim, Marshall released any claims against BLMIS or third parties for any illegal or fraudulent activity with respect to her BLMIS account. Fox's claim had not been determined at the time of this litigation, but, the Trustee claimed that Fox had withdrawn more than that deposited into her BLMIS account and therefore Fox's customer claim should be denied.

Each of the complaints filed in the Florida District Court asserted claims against the Picower Defendants for conversion, unjust enrichment, conspiracy, and violations of Florida's Racketeer Influenced and Corrupt Organizations Act ("RICO"). Both Fox and Marshall asserted injuries in the form of lost investment income and returns on their BLMIS investments, and tax payments made in connection with non-existence profits.

The Bankruptcy Court's Analysis

Application of the Automatic Stay

On March 31, 2010, the Trustee filed a complaint against Marshall and Fox, asserting that the litigation before the Florida District Court against the Picower Defendants violated the automatic stay of the BLMIS SIPA liquidation. The Trustee further sought to extend the stay to enjoin the Florida litigation. Fox and Marshall responded by asserting that their claims against the Picower Defendants were not property of the BLMIS estate and therefore the Trustee did not have standing to assert their claims.

The Bankruptcy Court sided with the Trustee and held that the Florida litigation violated the automatic stay protecting BLMIS. The Bankruptcy Court noted that it was necessary to determine whether claims asserted by Fox and Marshall were in fact causes of action to be included as property of the estate. The Bankruptcy Court reasoned that because Fox and Marshall were not in privity with, did not have a direct relationship with, nor acted in reliance upon misrepresentations made by the Picower Defendants, these claims were in fact property of the estate as they sought to redress a harm common to all BLMIS customer claimants. Therefore, the Trustee had exclusive standing to assert such claims.

The Bankruptcy Court further observed that it is possible for a bankruptcy estate and a creditor to own separate claims against third parties arising out of the same general con- / continued page 12

Chadbourne Participates in First Pre-Negotiated Mexican Bankruptcy Case

In 2007, the Ley de Concursos Mercantiles (the Mexican bankruptcy law) was amended to include provisions for "pre-negotiated" bankruptcy plans. There was, however, no immediate rush to the filing of such plan. Instead, it took three years for the first pre-negotiated bankruptcy case to be filed. On August 13, 2009, Metrofinanciera S.A. de C.V., Sociedad Financiera de Objeto Múltiple, Entidad no Regulada filed its pre-negotiated bankruptcy proceedings. Chadbourne's Mexico City partners Luis Enrique Graham, Boris Otto, and Salvador Fonseca represents two creditors in these landmark bankruptcy proceedings.

Metrofinanciera was a mortgage originator and real estate financier with approximately $1.4 billion in pre-petition debt, a majority of which was documented or derived from complex financial instruments. To satisfy Mexico's relatively new statutory requirements for a pre-negotiated plan, Metrofinanciera obtained pre-filing plan support from creditors holding over 40% of its total debt and, at the time of filing, an "Order for Relief" from the Mexican court. As a result, most creditor collection efforts were enjoined. As the statute requires (and unlike United States' law), a "Conciliator" — a specialist responsible for negotiating the terms of a plan between a debtor and its creditors and perform certain other duties — was appointed. The Conciliator considered the terms of the pre-negotiated plan before finalizing the plan to be submitted to creditors. Following negotiations among the parties, the Conciliator submitted a plan to the court the generally followed the key terms of the pre-negotiated plan. The Conciliator obtained court approval for that plan on June 9, 2010.

Although there undoubtedly certain disappointments on the recovery side of the Metrofinanciera bankruptcy case, the results of Metrofinanciera's bankruptcy can be considered a success from a process standpoint. The first pre-negotiated plan bankruptcy case was approved by a Mexican court.

Automatic Stay

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duct. However, the Bankruptcy Court failed to find separate claims where the Picower Defendants did not direct their actions to Fox and Marshall and where the injuries asserted by Fox and Marshall were common to all BLMIS customers.

Enjoining the Florida Litigation using the Bankruptcy Court's Equitable Powers

Threat to the Estate Warranted Extension of the Automatic Stay
In addition to concluding that the Florida litigation implicated the automatic stay, the Bankruptcy Court, to further protect its decision upon appeal, used its equitable powers under Bankruptcy Code section 105 to extend the stay to enjoin the Florida litigation. Section 105 of the Bankruptcy Code provides a bankruptcy court with the equitable powers to facilitate the implementation of other Bankruptcy Code provisions. To the extent that the automatic stay would not stay the Florida litigation, the Bankruptcy Court noted that it could use its equitable powers to extend the stay to enjoin a third-party action against a non-debtor entity when such third-party claim would have an immediate adverse economic consequence for the debtor's estate.

The Bankruptcy Court reasoned that the threat to the BLMIS estate warranted the extension of the stay because (i) both the Trustee and the Florida plaintiffs targeted the same limited pool of funds and (ii) Marshall and Fox threatened the Trustee's ability to collect on any possible judgment in the adversary proceeding. The Bankruptcy Court placed great weight on the fact that the Trustee sought to have the funds recovered from the Picower Defendants for the pro rata allocation among all Madoff victims, whereas Fox and Marshall sought recovery for themselves and a discrete class of investors. Additionally, the Bankruptcy Court found that the Florida litigation was an immediate threat to the BLMIS estate as a result of the efforts towards the impending settlement between the Trustee and the Picower Defendants.

Threat to the Bankruptcy Court's Jurisdiction Warranted an Injunction
The Bankruptcy Court further held that an injunction of the Florida litigation was warranted because the continuation of the Florida actions would interfere with the administration of the BLMIS SIPA proceedings. A bankruptcy court can use its equitable powers under Bankruptcy Code section 105 to enjoin a proceeding in another court when such proceeding would defeat or impair its jurisdiction with respect to a case before it. The Bankruptcy Court reasoned that any attempt by either Fox or Marshall to recover funds sought by the Trustee would undermine the Bankruptcy Court's jurisdiction to distribute estate assets because the Florida litigation could result in the Florida District Court's distribution of potential BLMIS estate funds among certain BLMIS customers. Additionally, the Bankruptcy Court observed that any judgment in the Florida litigation would exceed what Fox or Marshall was entitled to under SIPA.

Conclusion

This recent decision to come out of the Madoff drama illustrates the expansive powers of the bankruptcy court. The purpose of the automatic stay in a SIPA proceeding is to ensure an orderly and fair distribution of customer property. As this case illustrates, a third party action against non-debtor entities may be deemed an attempt to bypass the automatic stay when such third party action would affect estate distributions. The Bankruptcy Court in the case at hand extended the powers of the automatic stay as well as exercising its equitable powers to ease any concern that attempts to run around the automatic stay may "convert the bankruptcy proceeding into a race to the courthouse and derail the bankruptcy proceedings." ◎

Avoidance Powers in Chapter 15 Proceedings

By Marc Roitman

The Court of Appeals for the Fifth Circuit recently held that Chapter 15 of the Bankruptcy Code does not prohibit a foreign representative from bringing an avoidance action so long as the claim for relief is based on the substantive laws of the jurisdiction where the foreign proceeding is located. The Fifth Circuit's decision is consistent with the dual policy considerations of comity and predictability. *Fogerty v. Petroquest Res., Inc. (In re Condor Ins. Ltd.)*, 601 F.3d 319 (5th Cir. 2010).

Background

Condor Insurance Limited ("Condor") was a Nevis corporation operating an insurance and surety bond business. On November, 27, 2006, one of Condor's creditors filed a winding-up petition in Nevis, which is similar to a Chapter 7 liquidation proceeding under the United States Bankruptcy Code. The petition was granted and Richard Fogerty and William Tacon were appointed as the official liquidators (the "Foreign Representatives"). On July 26, 2007,

Condor filed a Chapter 15 proceeding in the Bankruptcy Court for the Southern District of Mississippi, which subsequently recognized the Nevis proceeding as a foreign main proceeding.

Shortly thereafter, on November 20, 2007, the Foreign Representatives initiated an adversary proceeding in the Bankruptcy Court seeking to recover $313 million in assets that Condor had transferred to an entity called "Condor Guaranty" shortly before the commencement of the Nevis proceeding. In the adversary proceeding, the Foreign Representatives sought to avoid that transfer under various Nevis legal theories, including (i) knowing receipt of property transferred in violation of fiduciary duty under Nevis law, (ii) dishonest assistance in transferring property in violation of fiduciary duty under Nevis law, (iii) fraudulent conveyance under the Statute of Elizabeth 1571, and (iv) void dispositions under Nevis law. Essentially, the Foreign Representatives alleged that Condor formed Condor Guaranty specifically for the purpose of placing the $313 million outside the reach of creditors, and that the transfer of those assets violated Nevis law.

Under the Bankruptcy Code, a trustee has certain "avoidance powers" – the capacity to petition a court to invalidate a prepetition transfer of the debtor's property that inequitably depleted the debtor's estate at the expense of creditors. However, under Chapter 15, foreign representatives are specifically precluded from using the avoidance powers that would typically be available in a Chapter 7 or Chapter 11 case. *See* 11 U.S.C. § 1521(a)(7). Accordingly, defendant Condor Guaranty filed a motion to dismiss on the basis that avoidance actions are prohibited by Chapter 15 (and are only permitted in Chapter 7 or Chapter 11 proceedings), and Condor could not file a Chapter 7 or Chapter 11 proceeding because, as a foreign insurance company, it was not permitted to do so. The Foreign Representatives conceded that they would not be permitted to bring the avoidance action if it were based on U.S. law, but argued that their suit should not be dismissed because the relief requested was based on Nevis law.

The Bankruptcy Court agreed with Condor Guaranty and dismissed the adversary proceeding. The District Court affirmed and the issue was appealed to the Fifth Circuit. As described in further detail below, the Fifth Circuit overturned the lower court decisions and remanded the case to the Bankruptcy Court.

Fifth Circuit Analysis

The foremost question for the Fifth Circuit was whether the exceptions listed in section 1521(a)(7) to the relief available under Chapter 15 exclude not only avoidance actions under U.S. law but also exclude such actions based on the law of the foreign jurisdiction where the main proceeding is located.

The Court first examined the language of Chapter 15 to determine whether further investigation was appropriate, noting that "when a statute speaks with clarity to an issue, judicial inquiry . . . is finished." Indeed, section 1521(a)(7) delineates that the Bankruptcy Code avoidance powers are specifically excluded from the relief available under Chapter 15. However, no mention is made of avoidance powers provided by foreign law. As the Court noted, where there are enumerated exceptions to a statute, additional exceptions are not to be implied. Therefore, "it does not necessarily follow that Congress intended to deny Foreign Representatives powers of avoidance supplied by applicable foreign law. If Congress wished to bar all avoidance actions, whatever their source, it could have stated so; it did not."

Finding the statute to be sufficiently ambiguous to warrant more scrutiny, the Court turned to an analysis of the origins and principles of Chapter 15. Among the stated purposes of Chapter 15 are fostering cooperation between courts of the United States and the courts of foreign countries, and promoting greater legal certainty for trade and investment. *See* 11 U.S.C. § 1501(a). Moreover, Chapter 15 directs courts to "consider its international origin, and the need to promote an application of th[e] chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions." *See* 11 U.S.C. § 1508. The Court observed that Chapter 15 is derived in large part from the United Nations Commission on International Trade Law (UNCITRAL), which "represents a culmination of a long standing effort by the United States and other countries to develop a uniform system guiding needed cooperation."

The Fifth Circuit also evaluated the predecessor to Chapter 15, section 304, noting that Congress intended for the case law under section 304 to provide precedence "unless contradicted by Chapter 15." The Fifth Circuit determined, after an analysis of the case law, that avoidance actions based on foreign law were generally allowed to proceed. *See, e.g., Metzeler v. Bouchard Transportation Co., Inc.* (In re Metzeler), 78 B.R. 674, 677 (Bankr. S.D.N.Y. 1987) (holding that "foreign substantive law governs the avoiding powers of a foreign representative"). Moreover, as with Chapter 15 and UNCITRAL, section 304 was meant to promote comity, greater legal certainty, and the just treatment of all creditors.

Such guiding principles, the Fifth Circuit stated, "strongly suggest the answer — section 1521(a)(7) does not exclude avoidance actions under foreign law." Although the language of Chapter 15 does not explicitly address the use of foreign avoidance law, it does suggest a broad interpretation of the statute to promote comity with foreign jurisdictions. The Fifth Circuit determined that if U.S. Bankruptcy Courts were barred from apply- / *continued page 14*

Avoidance Powers in Chapter 15

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ing foreign avoidance laws in Chapter 15 proceedings, the result would be to enable debtors to hide assets in the United States. In such a scenario, the only recourse available to foreign creditors would be a costly Chapter 7 or Chapter 11 proceeding. Such an unfair result could not have been the intent of Congress, because that is exactly the situation Chapter 15 was meant to prevent.

Conclusion

The Fifth Circuit's holding is consistent with Chapter 15's stated purpose and scope, and affords creditors of transnational corporations a degree of predictability. Furthermore, in encouraging the cross-border application of legal principles, the *Condor* decision prevents the United States from becoming a "safe haven" for fraudulent transfers. ◎

The Politics of Bankruptcy: California's Struggle over Municipal Bankruptcy Access

By Eric Daucher

Introduction

Chapter 9 of the Bankruptcy Code permits a "municipality" — generally meaning a subdivision or instrumentality of a state government — to reorganize its debt under the auspices of a U.S. bankruptcy court. While Chapter 9 filings differ from mainstream bankruptcy filings in many ways, Chapter 9 does afford debtors the right to reject executory contracts and propose plans of reorganization that, if approved, can and often do result in bondholder haircuts. However in order to comply with the 10th Amendment to the U.S. Constitution, which imposes restrictions on the ability of the Federal government to interfere in the affairs of the several states, Chapter 9 only permits a municipality to seek bankruptcy protection if that municipality has been authorized to be a debtor by an appropriate state authority.

Many states have responded to this requirement by enacting statutes authorizing municipalities to reorganize through Chapter 9, but have frequently required the satisfaction of one or more preconditions before filing. In light of the difficulties plaguing municipalities in the wake of the recent financial crisis and the range of powerful interests that stand to be severely impacted by a potential wave of municipal bankruptcies in the most fiscally challenged states, the content of statutes authorizing municipal bankruptcy filings has become politically contentious.

California

In California in particular, the terms under which municipalities may reorganize have become the subject of a highly-partisan political struggle. On one side, labor-friendly Democrats and public employee unions are seeking to impose new restrictions on municipal bankruptcies. Opposing them, Republicans and municipal governments seek to maintain the status quo, which provides municipalities ready access to Chapter 9. Currently, Section 53760 of California's Government Code provides that "[e]xcept as otherwise provided by statute, a local public entity in this state may file a petition and exercise powers pursuant to applicable federal bankruptcy law." CA GOVT § 53760. Given the broad language of this grant of authority, California municipalities have essentially *carte blanche* to file for Chapter 9, assuming that they meet the requirements of the Bankruptcy Code.

On May 23, 2008 the City of Vallejo, California filed for bankruptcy and sought to reject executory contracts between it and four public employee unions. The city subsequently renegotiated contracts with three of those unions, while the fourth is currently appealing the bankruptcy court's decision authorizing the rejection of its contract. As of yet, the city has not filed a plan of adjustment. Certain of the city's creditors have filed a motion to establish a deadline for the filing of a plan or, in the alternative, to dismiss the bankruptcy case. The hearing on the motion is expected to be held on August 9, 2010.

Assembly Bill 155

In response to these events, in 2009 Assemblyman Tony Mendoza (D – 56th) introduced Assembly Bill 155 ("AB 155"), which would limit municipal access to bankruptcy protection. Although AB 155 passed the State Assembly by a vote of 47-25, it stalled in the Senate Local Government Committee, which was required to approve the bill before it could be heard by the full Senate. Despite being declared "dead," the bill was revived this spring by State Senator Mark DeSaulnier (D – 7th) as Senate Bill 88 following the removal of two likely opponents of the bill from the Local Government Committee and their replacement with strong supporters of organized labor (including Senator DeSaulnier). On April 19th, the Committee approved the bill in a 3-2 party-line vote, clearing it to be heard by the full State Senate.

The bill, as initially drafted, would have required a municipality to obtain the approval of the California Debt and Investment

Advisory Commission ("CDIAC") before filing a Chapter 9 petition. The CDIAC is a nine-person regulatory body consisting of the State Treasurer, the Governor or the Director of Finance, the State Controller, two local government finance officials appointed by the State Treasurer, two Assembly Members appointed by the Speaker of the Assembly, and two Senators appointed by the Senate Rules Committee. The bill contains several requirements for securing such approval, including, but not limited to:

- proof that the prospective debtor is or will become unable to pay its undisputed debts;
- a showing that the municipality has exhausted all options to avoid a bankruptcy filing;
- presentation by the debtor of a complete plan of reorganization; and
- submission of a list of all creditors that may be impaired or otherwise damaged by the proposed plan.

However, in the wake of severe criticism that the bill would further politicize the bankruptcy process by subjecting it to the control of a government panel dominated by labor-friendly political appointees, the bill was amended several times in an attempt to make it palatable to more moderate legislators. In its most recent version, the bill would allow municipalities to hold a public hearing to adopt a resolution overriding an adverse finding by the CDIAC. Upon overriding the CDIAC, the municipality would be permitted to file for bankruptcy, but would be required to submit the findings of the CDIAC along with its petition.

Initially, the bill would also have allowed the CDIAC to impose terms and conditions on the type of bankruptcy relief that a municipality could seek, including limiting or outright eliminating a municipality's right to reject executory contracts. Critics of the bill charged that this provision was designed to protect public employee union contracts. For example, the CDIAC could, in theory, authorize a municipality to proceed with a bankruptcy filing that would impair bondholders, but preclude abrogation of municipal employee union contracts. These critics argued that California's municipalities would face further difficulties issuing bonds in the future if it becomes apparent that politically favored public employees will be protected in bankruptcy to the detriment of bondholders. In contrast, supporters of the bill argued that the bill as proposed was necessary to prevent contracts relating to certain constituencies from being unfairly targeted for rejection or renegotiation. Moreover, the critics asserted that allowing municipalities to easily file for bankruptcy would impose costs on the state as a whole. On June 1st, the critics appeared to get the better of the argument — or bill supporters decided to mitigate the risk of the bill drawing a veto — and the offending language was stripped from the bill.

Regardless of the debate over the bill's other possible merits, the bill would without question create potentially detrimental delays for a desperate municipality. The bill proposes that applications to the CDIAC would face an initial 5 day evaluation, during which time the CDIAC would decide whether to (a) approve the application, (b) evaluate the application further, or (c) deny the application. The CDIAC would only be authorized to immediately approve the petition upon a showing that the municipality would suffer "irreparable harm" if subjected to a lengthier review. Absent a showing of / *continued page 16*

Bankruptcy & Financial Restructuring Group

PUBLICATIONS

- Howard Seife authored "Negotiating with Lenders: Forbearance, Waivers, Lender Approval and the Collective Action Conundrum," *The Directors and Officers' Guide to Restructuring* (July 2010)
- Douglas Deutsch and Francisco Vazquez authored "Introduction to Recognition Under Chapter 15," *American Bankruptcy Institute Journal* (May 2010)
- Douglas Deutsch and Meghan Towers authored "Top Business Bankruptcy Cases of 2009," *American Bankruptcy Institute Journal* (March 2010)

SPEECHES AND EVENTS

- Howard Seife acted as moderator and Luis Enrique Graham was a speaker in an Emerging Markets Trade Association program titled "Mexican Bankruptcy — Legislation, Practices, Trends and Cross-Border Issues," New York, NY (June 2010)
- Douglas Deutsch was a speaker at the Texas Bench Bar Conference for a program titled "Section 363 Bankruptcy Sales" in San Antonio, Texas (June 2010)
- Andrew Rosenblatt and Douglas Deutsch were panelists in a program for clients at Chadbourne's New York office titled "Section 363 Bankruptcy Sales: What Savvy Buyers Need to Know" (March 2010)

Municipal Bankruptcy Access

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such irreparable harm, all applications would face a 30 business-day evaluation period followed by a 15-day hearing period. The bill does not provide any guidance as to what constitutes irreparable harm or how such a showing should be made. As a result, a municipality could face delays approaching two months before receiving the result of an application to the CDIAC. Should such a decision prove adverse, the municipality would face an additional delay in complying with the statutory requirements to override the CDIAC.

Moreover, certain of the bills provisions appear vague and may give the CDIAC virtually unlimited discretion to deny an application. As previously noted, the CDIAC would be required to determine that a municipality had exhausted all options prior to filing. In light of the fact that many municipalities possess the authority to levy taxes or raise fees on the public and thereby raise revenues by fiat, it is difficult to see on what grounds a municipality could contend that it has exhausted all alternatives to a bankruptcy filing if the CDIAC was inclined against granting the petition.

Given that, according to the terms of the most recent draft of the bill, the CDIAC's rulings could be overruled by any municipality that chooses to do so and the CDIAC would not possess the authority to limit the relief available to municipalities in bankruptcy, it appears that there is only one remaining purpose of the bill, although that purpose remains open to two opposing interpretations. One view is that the bill would ensure a fair and public hearing of the very serious consequences of a municipal bankruptcy filing. The more cynical are likely to suggest that the bill's only purpose is to authorize the bureaucratic delay of Chapter 9 petitions in an effort to discourage their filing.

Conclusion

In the face of a likely veto by Governor Arnold Schwarzenegger, on June 14th the bill was, at least temporarily, moved to the inactive folder on the motion of its sponsor, Senator DeSaulnier. While the bill is not expected to reemerge before the November elections, there is a possibility that it may reappear in early 2011 should a more labor-oriented candidate succeed Governor Schwarzenegger. ◎

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