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The Rise and Fall of Monolines

By Christy Rivera

Financial guaranty companies today are often referred to as “monolines” because they provide only one line of coverage — insurance against credit defaults. The financial guarantees provided by monolines are almost always unconditional. Given the unconditional nature of these guarantees, both state insurance regulators and the rating agencies which issue financial strength ratings on these companies have strict capital adequacy requirements. It is critical for monolines to comply with these capital requirements in order to maintain high ratings (typically AAA) which, in turn, boosts their ability to write new business.

When they first began doing business, monolines stayed within the public finance realm by insuring municipal bonds. States and municipalities, and their public agencies, issue

these bonds to raise funds for local capital projects, and promise to repay the bondholders over a period of time.

Municipalities generally insure these bonds in order to enhance the bond’s rating, which in turn reduces the borrowing costs (because of lower interest rates) and makes the bonds more attractive to potential purchasers. In insurance lingo, the insurer “wraps” the bond with its high credit rating, giving the bondholders more confidence in the ultimate repayment of the bond.

Providing public finance insurance was the bread and butter business of monolines for many years. In the early 1990s, however, monolines began to diversify away from pure municipal finance and began insuring asset-backed securities (ABS) and collateralized debt obligations (CDOs).

During the late 1990s, the market grew exponentially for CDOs, which are debt securities backed by a pool of bonds, loans or other assets such as mortgages. Like other securitizations, the credit risk associated with a CDO is often sliced into several layers, or tranches, and losses are applied in reverse order of seniority. Investors buy into the different levels of risk and receive corresponding levels of return based on the risk levels. The market for CDOs grew to the point where the investment banks and institutions creating such obligations were not able to place them quickly enough with investors, and CDOs started to pile up / *continued page 2*

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Monolines

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on these institutions' balance sheets. This situation presented an opportunity for the monoline bond insurers.

To hedge their exposure under CDOs, the financial institutions holding the CDOs bought insurance from the monolines, which insured the timely payment of principal and interest under the CDOs. The monolines typically used credit derivative contracts to insure the super senior tranches (i.e., the least risky tranches of debt) of the CDOs.

Providing insurance for these new structured products was extremely lucrative for monolines, and they continued to grow this business to the point where by September 30, 2007, monolines guaranteed more than \$1 trillion of ABS, including over \$700 billion U.S. ABS. This \$700 billion included approximately \$200 billion of U.S. residential mortgage-backed securities and securities backed by home-equity loans and approximately

and credit losses to the super senior tranche levels are now becoming real possibilities. This has caused the monolines to report significant losses, requiring them to raise additional capital reserves if they wish to maintain their ratings. Several monolines have been unable to raise the required capital, and have suffered rating downgrades.

The first monoline to suffer a ratings downgrade was ACA Financial Guaranty Corporation (ACA FG). ACA FG was a niche bond insurer that strategically operated with a rating below AAA. Unlike other bond insurers, ACA FG's insurance protection provided insured entities with the right to demand collateral upon a ratings downgrade of ACA FG below a specified level, regardless of whether there were any actual losses on the underlying portfolio. On December 19, 2007, Standard & Poor's downgraded ACA FG from A to CCC. ACA FG did not have sufficient funds to satisfy the collateral demands from its counterparties and it has been working with its counterparties and

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\$125 billion of CDOs collateralized in part by U.S. subprime residential mortgage-backed securities. In addition, monolines guaranteed more than \$300 billion of U.S. and international corporate CDOs.

The amount guaranteed by monolines was far in excess of their capital. As the crisis in the subprime market began to accelerate at the end of 2007, the increasing exposure of monolines on the structured products they insured led to significant capital erosion for the monolines. Rising defaults on home loans undermined the value of the complex structured products that were backed by subprime mortgages, which resulted in downgrades of these products. Even though monolines tend to insure the least risky tranches, the losses on the underlying collateral have been so severe that lower, more risky, tranche levels of these products are suffering huge hits

the Maryland Insurance Administration since December to try to arrange an out-of-court restructuring. Chadbourne & Parke LLP has played a leading role in that restructuring, serving as counsel to the steering committee of ACA FG's counterparties.

While ACA FG may be the most extreme example of the problems facing monolines today, other bond insurers have also suffered. For example, Financial Guaranty Insurance Corporation (FGIC) has also been unable to raise additional capital to meet capital requirements in light of its increased exposure. It recently announced a proposal to split the company into a municipal bond insurer and a structured finance insurance company, which will allow it to maintain the requisite capital necessary to maintain the rating for its municipal business at a satisfactory level. The rating agencies, however, have not yet been persuaded that FGIC remains financially

viable and able to satisfy claims that may be asserted against it. After FGIC filed certain statutory statements noting its capital levels on March 28, all three rating agencies downgraded the insurance financial strength ratings of FGIC below investment level.

Last December, bond insurance company CIFG received approximately \$1.5 billion from its parents Banque Federale des Banques Populaires and Caisse Nationale des Caisses d'Epargne to help offset the rise in default claims it expects in the near future. Notwithstanding this capital infusion, the rating agencies initially lowered CIFG's rating to A+, or A1, from AAA. Fitch Ratings cut CIFG's ratings a second time down to AA- and assigned a "negative" outlook, meanings cuts are more likely than upgrades in the future. In response, CIFG Holding has asked Fitch to withdraw ratings for its CIFG bond insurance unit and two affiliates, citing a lack of confidence in the credit agency's approach. CIFG Holdings has said that it will continue to work with Moody's and S&P to address the rating agencies' concerns as quickly as possible to regain a higher rating, if possible.

Other bond insurers have fared better. Financial Security Assurance Holdings Ltd. (FSA) received a capital infusion of \$500 million in February from its parent Dexia SA, allowing FSA to lock in a top credit rating. February was also a good month for Assured Guaranty — during that month billionaire investor Wilbur Ross committed to invest up to \$1 billion in Assured Guaranty. Like FSA, Assured Guaranty has maintained its high rating.

Two other major bond insurers, Ambac Assurance Corp. and MBIA, have also managed to maintain high ratings from all three ratings agencies, but the rating agencies have taken the initial steps to possibly downgrade these insurers in the future. In an effort to maintain its rating, just this past month Ambac raised \$1.5 billion in new capital by issuing \$1 billion of common shares and \$500 million of equity units. This came after the company set aside \$1.4 billion to pay expected claims on securities backed mostly by residential loans during the fourth quarter last year. Notwithstanding these steps, Ambac has been placed on negative "credit watch," demonstrating that the market remains skeptical as to whether Ambac's worries are truly behind it.

To protect its rating, MBIA Insurance Corporation has raised \$3 billion in capital, eliminated its dividend and shut its asset-backed insurance business for six months to overcome losses on subprime mortgages. While Standard & Poor's and Moody's

recently affirmed MBIA's rating, it placed MBIA on negative "credit watch." MBIA also continues to face a possible downgrade by Fitch Ratings. MBIA has requested that Fitch withdraw its ratings on several MBIA companies, including the AAA rated MBIA insurance entity. When Fitch refused to withdraw the rating, MBIA stated that it will no longer provide financial information to Fitch, which it believes will make it difficult for Fitch to continue rating MBIA.

Despite the perceived monoline crisis, it is important to note that the losses here are not the result of actual claims against the monolines or the underlying secured assets, but rather are the consequence of ratings downgrades, which have had a domino effect within the industry. To maintain or regain their ratings, which is crucial to their ability to garner new business, the insurers have two options — reduce their exposure or raise new capital to support such exposure. As seen above, different bond insurers are taking different approaches in an attempt to salvage their businesses. Which bond insurers will be successful, especially in light of the continued market stress, remains to be seen. ☺

Amaranth Continues to Face Separate Lawsuits from US Regulators in Respect of its Natural Gas Trading Activities of 2006

By Adrian Harris and Mark Farrant

Amaranth Advisers, LLC ("Amaranth"), the US hedge fund that collapsed in September 2006 after losing approximately US\$6bn as a result of natural gas futures contracts that imploded, is facing two separate lawsuits from regulators in the US — The Commodity Futures Trading Commission ("CFTC") and Federal Energy Regulatory Commission ("FERC"), concerning Amaranth's trading activities in 2006 prior to its demise. The CFTC commenced its lawsuit on 25 July 2007 in the US District Court of New York, alleging, inter alia, that Amaranth intentionally and unlawfully / continued page 4

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attempted to manipulate the price of natural gas futures contracts on the New York Mercantile Exchange (“NYMEX”), and provided false statements to NYMEX, in violation of the Commodity Exchange Act of 1936. FERC commenced an administrative enforcement proceeding against Amaranth on 26 July 2007 regarding essentially the same transactions, seeking civil penalties and the disgorgement of unjust profits, pursuant to the Energy Policy Act of 2005. The lawsuits come in the wake of the United States Senate’s Permanent Subcommittee on Investigations official report, “Excessive Speculation in the Natural Gas Market”, of 25 June 2007, which concluded that Amaranth’s excessive trading activities in the US natural gas futures market deliberately manipulated prices and called for the closing of the so-called “Enron loophole” created by the Commodity Futures Modernization Act 2000 to put an end to such practices which can directly affect market prices of

Act, and acknowledged that the court did not have the standing to determine the question as to whether FERC had jurisdiction under the Energy Policy Act to commence proceedings against Amaranth, contested by Amaranth on the grounds that the trading activities concerned relate exclusively to futures trading and not physical trading activities for which FERC is the regulator. Mr. Justice Chin concluded, “Although I decline to enjoin FERC from proceeding with its administrative action, I do note that Congress intended the CFTC and FERC to coordinate their efforts, at least to some degree”. Mr. Justice Chin continued, “Amaranth’s concern in having to defend itself in two separate actions for the violations of two Acts based on the same underlying conduct does not justify a stay of the FERC proceeding, but the concern is understandable. Accordingly, I urge FERC to work with the CFTC and Amaranth to coordinate their efforts in the two proceedings, to maximize efficiency and minimize duplication”. It remains to be seen whether this recommendation will be adopted.

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energy commodities for consumers. Amaranth is vehemently denying the allegations facing it, asserting that it has at all times complied with the law and has provided full cooperation with the regulators since the outset of investigations.

Amaranth sought a preliminary injunction to enjoin the proceedings being brought against it by FERC with the CFTC proceedings, pending the outcome of the CFTC decision. Amaranth contends that the CFTC has primary jurisdiction to regulate NYMEX and sought to have the FERC action stayed in order to avoid a possible inconsistent outcome. On 1 November, Mr. Justice Chin, presiding over the CFTC proceedings, declined to order FERC to stay its administrative action on the basis that Amaranth had failed to satisfy the requirements for the granting of a preliminary injunction under Rule 65 and the All-Writs

The CFTC and FERC allege that Amaranth deliberately manipulated settlement prices by selling vast numbers of contracts during the last 30 minutes of trading immediately before contracts were due to expire, which artificially reduced overall market prices to the benefit of other derivative contracts held by Amaranth. Such manipulation, it is argued, has the potential to affect prices in the wider natural gas market, thus affecting consumers.

At present, the ‘Enron loophole’ means that over-the-counter electronic trading exchanges are outside the scope of regulation. The Intercontinental Exchange (ICE) is one such exchange, in contrast to NYMEX which falls within the ambit of the regulations. A bill was laid before Congress in September which, if enacted, would amend the Commodity

Exchange Act and effectively close the so-called ‘Enron loophole’ and prevent price manipulation and excessive speculation in the trading of energy commodities.

In the end, the outcome of the lawsuits is likely to add yet further impetus to support the passing of the bill before Congress to close the Enron loophole whereby the same rules and regulations would apply to over-the-counter energy exchanges as currently apply to futures exchanges such as NYMEX. ☺

Can a Failure to Vote For or Against a Plan be Deemed an Acceptance?

By Robert J. Gayda

In *In re Vita Corp.*, 380 B.R. 525 (C.D. Ill. 2008), the United States District Court for the Central District of Illinois was faced with the question of whether the failure of the members of an impaired class under a proposed Chapter 11 plan to cast a ballot could be deemed to be an acceptance of the plan by the class pursuant to 11 U.S.C. § 1126(c).

After considering a split of authority on the issue and engaging in a statutory analysis, the District Court held that the failure on the part of creditors in impaired classes to cast ballots either accepting or rejecting a debtor’s proposed Chapter 11 plan could not be deemed an “acceptance” of the plan, so as to satisfy the requirements for plan confirmation.

Background

Vita Corp., which operates an Old Chicago restaurant franchise in Peoria, Illinois, commenced its bankruptcy case by filing a petition under Chapter 11 of the Bankruptcy Code on January 25, 2006. Subsequently, Vita filed a plan of reorganization. The plan proposed to create nine classes of creditors, six of which were impaired (in that their legal, equitable, or contractual rights were altered under the plan). Of the six classes of impaired creditors, creditors in three classes cast ballots to affirmatively accept the plan, while creditors in the other three classes (Classes V, VII, and IX) did not cast ballots to accept or reject the proposed plan.

After receiving no ballots rejecting the plan, Vita filed a motion to confirm the plan. During the hearing on the motion, the Bankruptcy Court, on its own volition, raised its concern that the plan could not be confirmed because the requirements of Bankruptcy Code section 1129(a) had not been met. Specifically, the Bankruptcy Court questioned whether the failure of any of the class members in Classes V, VII and IX to cast any ballot was considered acceptance of the plan by the class pursuant to section 1126(c). This question was briefed, and the Bankruptcy Court issued an Order and Opinion on January 11, 2007 denying the motion for failure to satisfy the requirements of section 1129(a). Vita appealed, arguing that the classes of impaired creditors that failed to return ballots either accepting or rejecting its plan are deemed to have accepted the plan for purposes of confirmation.

District Court Ruling

The District Court upheld the decision of the Bankruptcy Court, ruling that an impaired class that failed to vote to reject a proposed Chapter 11 plan would not be deemed to have accepted the plan. In reaching its conclusion, the District Court acknowledged the existence of a split of authority on this question and the lack of any binding precedent in the Seventh Circuit.

Vita chiefly relied upon *In re Ruti-Sweetwater, Inc.*, 836 F.2d 1263 (10th Cir. 1988), which it argued stands for the proposition that a non-voting class is deemed to have accepted the plan. The District Court, however, was persuaded by several other cases, including *In re Friese*, 103 B.R. 90 (Bankr. S.D.N.Y. 1989), which expressly held that a court “cannot deem an impaired class to have accepted a plan if no creditors in that class have voted.” *Friese*, 103 B.R. at 92. The *Friese* court had distinguished *Ruti-Sweetwater*, noting that it involved a very complicated plan with 83 separate classes of creditors in which a single creditor class objected to having been deemed to have consented by failing to cast a ballot. *Id.* The District Court also relied on *In re Higgins Slacks Company*, 178 B.R. 853 (Bankr. N.D. Ala. 1995), where that court observed that *Ruti-Sweetwater* represented a “case of the tail wagging the dog,” as the plan at issue involved hundreds of claims and millions of dollars, and the Tenth Circuit clearly wanted the confirmation of the plan to stand.

The District Court analyzed the plain language of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to find further support for its holding. The District Court noted that under section 1126, a class of claims has accepted a plan “if such plan has been *accepted* by creditors ... that hold at least two-thirds in amount / continued page 6

A Plan Class's Failure to Vote

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and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.” 11 U.S.C. § 1126(c) (emphasis added). This provision plainly requires each creditor to affirmatively accept the plan in order to constitute acceptance.

Additionally, the District Court noted that Rule 3018(c) of the Bankruptcy Rules provides that “[a]n acceptance or rejection shall be in writing, identify the plan or plans accepted or rejected, be signed by the creditor or equity security holder or an authorized agent, and conform to the appropriate Official Form.” The requirement for an affirmative writing is in sharp contrast to other provisions of the Bankruptcy Code, during which the failure to act is expressly deemed an acceptance. See 11 U.S.C. § 1111(a) (deeming creditors’ claims to be filed when scheduled by the debtor); 11 U.S.C. § 1126(f) (deeming an unimpaired class to have accepted without voting).

Finally, the District Court stated that the Bankruptcy Code provides an alternative means of obtaining confirmation where an impaired class of creditors does not cast a ballot in the cram-down provisions of section 1129(b), thereby addressing the policy concerns raised in *Ruti-Sweetwater* and similar cases.

Analysis

This case is significant in its support of the majority point of view that a failure to accept or reject a plan cannot be considered an implicit acceptance. The District Court concluded that the Code and Rule based analysis in *Friese* and other cases was far more persuasive than what the Court deemed to be the “result-oriented holding in *Ruti-Sweetwater*.”

From a creditor’s perspective, this case suggests an effort by the District Court to maintain a creditor’s right to due process and ensure that they are not disenfranchised in the Chapter 11 process. On the other hand, a creditor must remain wary of the minority position, as well as the spectre of cramdown. While this case indicates that a court will not allow a debtor to circumvent the creditor acceptance requirements of section 1129, a creditor cannot sit idly by and not participate in the case, merely to raise an issue after a plan has been voted upon, citing its lack of acceptance or rejection of the plan. Clearly, courts, such as the 10th Circuit in *Ruti-Sweetwater*, may possibly confirm a plan over the objection of a non-voting creditor class that failed to vote if it feels that the result may be justified. ☺

The Second Circuit Limits the Reach of a Bankruptcy Court’s Channeling Injunction

By Ted Zink

Insurers should take note that bankruptcy courts do not have jurisdiction to enjoin a suit against the insurer if the suit seeks to recover for the insurer’s breach of a duty that is independent of the insurer’s indemnification obligation under the policy.

Background

The Second Circuit’s most recent examination of the “outer reaches” of a bankruptcy court’s jurisdiction arose out of a case that was commenced almost 26 years ago. As most insolvency professionals know, Johns Manville, burdened by thousands of asbestos related lawsuits, filed for chapter 11 protection in the summer of 1982. Early on in the case Manville recognized that its insurance policies were its most valuable asset and critical to the funding of its plan of reorganization. Manville ultimately settled with its insurance carriers for approximately \$770 million.

An important inducement for Manville’s insurers to settle was the issuance by the bankruptcy court of an injunction barring so-called “direct action suits” against the insurers and instead directing all such litigation against the Manville Injury Settlement Trust. Accordingly, the confirmation order (and related orders, the “1986 Orders”) enjoined all persons from commencing any action against any of the settling insurance companies for the purpose of collecting, recovering, or receiving payment of, on or with respect to any claim or other asbestos obligation. Read literally, this language suggests that any claim against Manville’s insurers with any conceivable nexus to its insurance relationship with Manville was enjoined. The question recently addressed in *Johns-Manville Corp. v. Chubb Indemnity Ins. Co.*, ___ F.3d ___, 2008 WL 399010 (2d Cir. February 15, 2008) was whether the bankruptcy court had jurisdiction to enjoin such third-party non-debtor suits.

Subsequent Direct Action Suits Against a Participating Insurer

Travelers (Manville’s primary insurer) paid nearly \$80 million to

the bankruptcy estate as part of the insurance settlement. Notwithstanding the broad injunction set forth in the 1986 Orders, several groups of claimants thereafter filed actions against Travelers under various legal theories falling into two broad categories — statutory regulation of insurance companies and various common law claims. Travelers ultimately moved the bankruptcy court to enjoin these various actions on the basis of the 1986 Orders. The bankruptcy court referred the matter to mediation.

As a result of the mediation, certain classes of plaintiffs agreed to settle with Travelers in exchange for its agreement to contribute another \$500 million on account of the claims asserted by the plaintiffs in their direct actions suits. The settlements were conditioned upon the entry of an order by the bankruptcy court clarifying that the underlying direct actions suits are, and always were, enjoined by the 1986 Orders.

court because the orders sought to protect a valuable asset of Manville's bankruptcy estate. The district court affirmed the bankruptcy court's clarifying order, whereupon several non-settling plaintiffs appealed to the Second Circuit.

The Second Circuit Overturns the Bankruptcy Court's Clarifying Order

Although on appeal the parties asserted various contentions, the Second Circuit saw the controversy as principally jurisdictional — did the bankruptcy court have jurisdiction to enjoin third-party non-debtor suits against Travelers? The appellants argued that the bankruptcy court had failed to distinguish between claims that seek to recover directly from Travelers for its own conduct (in such case, the appellants argued, the bankruptcy court lacked jurisdiction), from true direct action suits that seek to recover from an insurer that had contractually

The Second Circuit ruled that a non-debtor third party's lawsuit against a debtor's insurer for breach of the insurer's obligations, that are wholly independent of the insurer's indemnification obligation under a policy can have no effect on the estate and therefore does not fall within a bankruptcy court's jurisdiction.

The Bankruptcy Court Rules that Its 1986 Injunction Barred Direct Action Suits

The bankruptcy court approved the settlements and entered, over the objection of various non-settling plaintiffs, a clarifying order providing that the direct action suits filed against Travelers were enjoined by the 1986 Orders. Although several objectors argued that the plaintiffs' claims against Travelers were separate and distinct from those incurred from exposure to asbestos and therefore did not implicate Manville's insurance policies, the bankruptcy court was of the view that the direct actions suits arose from or were related to Travelers insurance relationship with Manville and therefore were enjoined by the 1986 Orders. The bankruptcy court bolstered its conclusion by invoking an earlier decision of the Second Circuit confirming that the 1986 Orders were firmly within the jurisdiction of the bankruptcy

agreed to indemnify Manville for its conduct (where the bankruptcy court was on firmer jurisdictional footing).

The Second Circuit was critical of the district court's reasoning in support of the bankruptcy court's clarifying order. The district court first examined whether the direct action suits against Travelers were covered under the 1986 Orders. The district court believed it reasonable to interpret the 1986 Orders as providing Travelers with broad protection as a necessary inducement for Travelers to contribute funds to the Manville Trust, which was critical to Manville's bankruptcy plan.

The district court then turned to whether the 1986 Orders were themselves a proper exercise of jurisdiction over non-debtor third parties. The district court reasoned that the bankruptcy court had jurisdiction over Traveler's insurance policies and therefore had jurisdiction to protect those policies from dissipation by third party actions. Without

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Limits on Channeling Injunction

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carefully distinguishing among the various direct action claims, the district court concluded that those claims would necessarily reduce the bankruptcy estates recovery under the policies and therefore would adversely affect property of the estate.

Accordingly, the district court concluded that the clarifying order was within the bankruptcy court's "related to jurisdiction."

The Second Circuit found the lower courts' reasoning flawed. The question was not whether the direct action suits implicated the insurer-insured relationship but rather whether the claims sought recovery from the insurer independently of the insurer's indemnification obligations under the policy. Significantly, Travelers admitted that the direct action claims were unrelated to the policy proceeds, and the claims at issue did not seek to recover on the basis of Manville's conduct. Because the claims did not seek to recover insurance proceeds, the proper analysis, according to the Second Circuit, did not turn on the Manville-Travelers relationship as the lower courts believed, but on the nature of the claims asserted against Travelers.

The Second Circuit reasoned that the district court did not look closely enough at the nature of the claims asserted against Travelers. The Second Circuit observed that while claims seeking direct recovery against the policies could reduce the estate's recovery on the policies and thereby adversely affect property of the estate, claims asserted against Travelers for its conduct independent of its indemnification obligations under the insurance policies did not implicate the estate's *res* and therefore fell outside the bankruptcy court's "related to" jurisdiction. Stated another way, a non-debtor third party's lawsuit against a debtor's insurer for breach of the insurer's obligations that are wholly independent of the insurer's indemnification obligation under a policy can have no effect on the estate and therefore does not fall within a bankruptcy court's jurisdiction.

Conclusion

Insurers must understand the limitation of a bankruptcy court's channeling injunction and recognize that they will not necessarily bar claims against the insurer for obligations, if any, that exist independently of its indemnification obligations. ☉

Standing of a Creditor to Seek to Equitably Subordinate a Claim of Another Creditor

By Andrew Rosenblatt

In *Algonquin Power Income Fund v. Ridgewood Heights, Inc.*, 2007 Bankr. LEXIS 3004 (Bankr. N.D.N.Y. August 30, 2007), the United States Bankruptcy Court for the Northern District of New York addressed the issue of whether a creditor has standing to prosecute an equitable subordination action against another creditor without first obtaining approval from the bankruptcy court.

The Bankruptcy Court held that a creditor does have standing to prosecute an equitable subordination action against another creditor without first obtaining court approval. The holding was based primarily on the Bankruptcy Court's determination that (i) equitable subordination claims arising under section 510(c) of the Bankruptcy Code, unlike avoidance claims arising under sections 547 or 548 of the Bankruptcy Code, are not claims belonging to the estate, and (ii) the concerns necessitating bankruptcy court approval before a creditors' committee may bring an equitable subordination claim do not exist for individual creditors.

Equitable Subordination

Equitable subordination, which has been codified in section 510(c) of the Bankruptcy Code, is an equitable, and extraordinary, remedy which permits a court "to subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." In general, equitable subordination will only be invoked where a claimant has engaged in some type of inequitable conduct and the misconduct has resulted in injury to creditors or equity holders or has conferred an unfair advantage on the claimant. The most common scenarios where equitable subordination is appropriate are the following: (i) when a fiduciary of the debtor misuses its position to the disadvantage of other creditors; (ii) when a third party controls the debtor to the disadvantage of other creditors; and (iii) when a third party actually defrauds other creditors.

Courts have disagreed on which parties have standing to assert equitable subordination actions. Some courts have held that equitable subordination is a creditor claim, while other courts have held that subordination is strictly an estate claim and, therefore, a creditor (or creditors' committee) may have standing, but only after obtaining court approval when a debtor-in-possession or trustee has unjustifiably declined to act.

Case Background

In *Algonquin*, the debtors' prepetition lenders (the "Plaintiffs") commenced an adversary proceeding against certain of the debtors' affiliates and insiders (the "Defendants") seeking to challenge the insiders' intercompany claims, all of which appeared on the debtors' schedules as valid claims. Specifically, the Plaintiffs sought to (i) expunge the insider claims, (ii) have the claims recharacterized as equity contributions as opposed to debt, and (iii) subordinate the claims to the claims of all

claim because they failed to obtain authority from the bankruptcy court to act on behalf of the other unsecured creditors.

In support of their position, the Defendants relied on cases for the proposition that claims for equitable subordination must be brought by a trustee or debtor-in-possession as a representative of the estate. The Defendants then argued that an adversary proceeding commenced by a party in a representative capacity cannot be maintained without (i) the unjustifiable refusal of the trustee or debtor-in-possession to bring the suit and (ii) court approval to act as a representative after the party seeking to act has moved the court for permission to do so.

The Plaintiffs countered by arguing that it would have been futile to have requested the debtors to commence the adversary proceeding given that the Defendants were affiliates of the debtors and that the debtors, in their bankruptcy papers, had already conceded the validity of the Defendants' claims. The Plaintiffs also argued that the cases relied on by the

The Bankruptcy Court rejected the notion that a creditor must seek court approval before bringing an equitable subordination claim. In reaching this conclusion, the Bankruptcy Court distinguished cases involving avoidance actions, which are estate claims.

other unsecured creditors.

In support of their claims, the Plaintiffs alleged that (i) the insider debt was not reflected on the debtors' books and records, (ii) the insider debt was incurred in violation of the prepetition financing documents which prohibited the incurrence of additional indebtedness, (iii) the debtors knowingly misrepresented that they owed no debt for borrowed money, (iv) the debtors concealed the existence and extent of the insider claims from the debtors' lenders; and (v) the debtors were undercapitalized at the time the insider debt was allegedly incurred.

The Defendants filed a motion to dismiss the adversary proceeding on several grounds, including that the Plaintiffs lacked standing to bring the action. The Defendants argued that in bringing the subordination claim, the Plaintiffs were acting in a representative capacity and lacked standing to bring the

Defendants were distinguishable and not relevant to the facts at hand because they involved avoidance claims (*i.e.*, preference and fraudulent conveyance claims under sections 547 and 548 of the Bankruptcy Code) which, pursuant to the Bankruptcy Code, belong to the trustee or debtor-in-possession. The Plaintiffs noted that, unlike sections 547 and 548 of the Bankruptcy Code, the language of section 510(c) of the Bankruptcy Code does not provide that equitable subordination claims belong to the estate.

Ruling

The Bankruptcy Court adopted the Plaintiffs' position and denied the Defendants' motion to dismiss. First, the Bankruptcy Court rejected the Defendants' position that the Plaintiffs were acting in a representative capacity. The

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Bankruptcy Court made this determination despite the fact that the Plaintiffs sought to subordinate the Defendants' claims to those of all other unsecured creditors. In support of this finding, the Bankruptcy Court adopted the reasoning set forth by the Court of Appeals for the 7th Circuit (*In re: Vitreous Steel Prods. Co.*, 911 F.2d 1223 (7th Cir. 1990)) that equitable subordination is not a benefit to all unsecured creditors equally (in particular the creditor whose claim is objected to) and, therefore, a creditor that seeks equitable subordination is not necessarily acting in the interests of all unsecured creditors.

The Bankruptcy Court then rejected the notion that a creditor must seek court approval before bringing an equitable subordination claim. In reaching this conclusion, the Bankruptcy Court distinguished cases involving avoidance actions, which are estate claims that require prior court approval. In support for its holding, the Bankruptcy Court relied on a recent decision from the 8th Circuit Bankruptcy Appellate Panel (*In re: Racing Services, Inc.*, 363 B.R. 911 (8th Cir. BAP N.D. 2007)), which held that although a creditor must seek authority in order to have derivative standing to assert an avoidance action on behalf of the estate, a creditor is under no obligation to seek court authority to assert a subrogation claim. The court's reasoning was based on the language of section 510(c) which contains no restrictions on who may request the subordination of a claim.

Finally, the Bankruptcy Court distinguished a recent case decided by the Court of Appeals for the Second Circuit (*In re: AppliedTheory Corp.*, 493 F.3d 82 (2d Cir. 2007)), which held that a creditors' committee must seek court approval before bringing an equitable subordination action against a creditor. The Bankruptcy Court held that the Second Circuit's rationale for requiring bankruptcy court approval before a creditors' committee can commence a subordination action does not apply to individual creditors. Specifically, the Bankruptcy Court noted that unlike litigation commenced by a committee, which is funded out of the limited resources of the estate, litigation commenced by an individual will rarely be funded by the estate. Accordingly, the Bankruptcy Court reasoned that cost monitoring and other administrative concerns relevant to a creditors' committee are not implicated when dealing with an individual creditor. In short, the Bankruptcy Court held that the Second Circuit's ruling was limited to creditors' committees and did not provide a basis for denying the Plaintiffs the right to pursue the subordination action.

Analysis

Although the Bankruptcy Court's ruling only addressed the narrow issue of whether a creditor has standing to assert a subordination claim against another creditor without prior court approval, the holding raises many questions that could have far reaching implications. For example, in rejecting the notion that equitable subordination claims reflect generalized harm to all creditors and must be brought in a representative capacity, has the Bankruptcy Court implicitly held that debtors do not have standing to assert a subordination claim? It is well established that a trustee in bankruptcy may only pursue claims that belong to the estate itself and has no standing to sue third parties for injuries to the estate's creditors. If *Algonquin* can be interpreted as standing for the proposition that equitable subordination claims should be considered solely creditor claims, then that may preclude a debtor or trustee from asserting a subordination claim. If the answer is that both debtors and creditors have standing to assert subordination claims, then that could lead to administrative and procedural problems.

In short, *Algonquin* may have generated more questions than it answers. Given the lack of any bright line rule, the issue of creditor standing to assert an equitable subordination claim may be the subject matter of future bankruptcy litigation. ☺

Secured Lenders Take Note: Overstating Contractually Allowed Fees or Costs May Subject Claim to Subordination Attack

By Douglas Deutsch

In a case decided earlier this year, *English-Speaking Union v. Johnson*, 381 B.R. 1 (D.D.C. 2008), the District Court for the District of Columbia reviewed a bankruptcy court's determination that a secured lender's claim should not be subordinated. The grounds for the attack on the secured lender's claim were (a) an alleged miscalculation of interest and (b) an alleged

overstatement of attorney costs. Although the District Court affirmed the bankruptcy court's decision dismissing the subordination request, the decision should serve as a reminder that each of the components of a lender's claim must be well-founded.

The debtors in this case were the owners of a parcel of real property located in the District of Columbia. There were several parties holding liens in that real property including Elm Company and English-Speaking Union. Elm Company held first and second liens in the real property which totaled \$244,000. Following a default, Elm also was apparently entitled to interest and costs associated with recovering any obligations owed. English-Speaking Union held a third lien in the real property for \$355,000.

After the debtors filed for bankruptcy, the real property was sold free and clear of all liens. Elm then filed a motion to fix priorities of all claims. The bankruptcy court subsequently issued a decision that set forth the priorities and confirmed that Elm was the first lienholder and one of two second lienholders and that English-Speaking was the third lienholder. All creditors except English-Speaking then sought to enter an agreement regarding payment of the real property proceeds. The agreement presumed that the principal balance, interest and attorneys' fees due the most senior creditors, along with an IRS lien, consumed all the proceeds available. Given its low third-priority lien, English-Speaking was to receive nothing.

Ultimately, English-Speaking filed an objection to the agreement arguing that Elm's claim should be subordinated because there was a miscalculation of interest in its claim and because the attorney fees set forth in the claim were overstated.

Section 510(c) of the Bankruptcy Code states that a claim or part of a claim may be subordinated under principles of equitable subordination to all or part of another allowed claim. As explained by the District Court, to apply equitable subordination, three circumstances must exist: (1) a creditor must be engaged in some type of inequitable conduct; (2) the inequitable conduct must result in an injury to other creditors or conferred an unfair advantage; and (3) the equitable subordination will not be inconsistent with the provisions of the Bankruptcy Code. Equitable subordination of claims in bankruptcy has been described as an extraordinary remedy that, like other forms of equitable relief, may not be invoked lightly, but may be used only sparingly to rectify obvious inequities.

Because of various procedural blunders by English Speaking,

the bankruptcy court believed it was able to dismiss the subordination request without detailed review and focus instead on whether the attorney fees for Elm were excessive. The bankruptcy court found that the attorney fees were not inflated and allowed them. Without disputing the bankruptcy court's conclusions as to the procedural blunders, the District Court provided a somewhat more detailed analysis of subordination. The District Court specifically found that there was no evidence in the record of inequitable conduct by Elm. Absent satisfaction of that element of subordination, the Elm claim could not be subordinated.

English-Speaking Union v. Johnson does not apply novel legal concepts but it does highlight a risk for secured lenders: post-petition actions can subject a claim to a subordination attack. Even oversecured lenders should note that all components of a claim, including fees and costs that are allowed pursuant to a contract provision, should be carefully reviewed for accuracy. Failing to do so not only violates bankruptcy law, it may also — as highlighted by the *English-Speaking* case — subject your claim (or part of your claim) to subordination. ☺

Automatic Stay May Be Lifted to Permit Litigation to Proceed

By Frank Vazquez

In a recent decision, the United States Bankruptcy Court for the District of Delaware, *The SCO Group, Inc., 2007 WL 4224407, No. 07-11337 (KG) (Bankr. D.Del. Nov. 27, 2007)* reminds us that, under certain circumstances, litigation against a debtor may be permitted to proceed notwithstanding its bankruptcy. Creditors and other parties in interest, especially parties to litigation, should be cognizant that while the automatic stay generally protects a debtor and its estate from litigation, the stay is not absolute and may be lifted.

A Bankruptcy Filing Generally Stays all Litigation.

The filing of a bankruptcy petition operates as an automatic stay enjoining a wide range of actions against a debtor including, among other things, the commence- / *continued page 12*

Relief From the Automatic Stay

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ment or continuation of litigation that was commenced prior to the bankruptcy filing. The automatic stay is intended “to prevent certain creditors from gaining a preference for their claims against the debtor; to forestall the depletion of the debtor’s assets due to legal costs in defending proceedings against it; and, in general, to avoid interference with the orderly liquidation or rehabilitation of the debtor.”

The automatic stay, however, is not absolute and under certain circumstances may be modified or lifted “for cause, including the lack of protection of an interest in property of such party in interest.” Cause, however, is not defined in the Bankruptcy Code. Accordingly, courts generally conduct a fact intensive test on a case-by-case basis to determine whether sufficient cause exists to lift the automatic stay. If cause exists, a court may conclude that the automatic stay should be lifted to permit litigation to proceed against the debtor. This is what occurred in the chapter 11 case of The SCO Group, Inc.

suit, SCO asserted (i) claims for slander of title and interference with the UNIX copyrights and (ii) claims for copyright infringement, unfair cooperation and breach of a technology licensing agreement. Novell counterclaimed against SCO and asserted that: (i) it retained all UNIX copyrights under the asset purchase agreement; and (ii) SCO’s retention of funds from certain SCO Source licenses constituted breaches of fiduciary duty and contract, and conversion.

Subsequently, the District Court dismissed several of SCO’s claims against Novell and scheduled a trial for September 17, 2007 to consider (i) the amount of the royalties to which Novell is entitled from certain licenses and whether SCO had the authority to enter into certain licensing agreements and (ii) the amount of funds held by SCO that are subject to a constructive trust. On September 14, 2007, SCO filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code with the Bankruptcy Court. On October 4, 2007, Novell filed a motion for relief from the automatic stay so that the lawsuit could proceed.

Under appropriate circumstances, a bankruptcy court may lift the automatic stay to allow litigation (or certain aspects thereof) to be adjudicated by another court.

The SCO Case

The SCO Group, Inc. is a provider of Linux software for certain systems, SCO OpenServer for certain businesses and companies, and UnixWare and SCO Mobile Serve for enterprise applications and digital network services. Pursuant to an asset purchase agreement between Novell, Inc. and SCO’s predecessor, The Santa Cruz Operation, Inc., Novell transferred all of its UNIX SVRX software licenses to Santa Cruz. Subsequently, SCO entered into a licensing campaign, which was based on those licenses.

On January 20, 2004, SCO commenced a lawsuit against Novell in Utah State Court that was ultimately removed to the United States District Court for the District of Utah. In the law-

The Court’s Analysis

As an initial matter, the Bankruptcy Court noted that in analyzing whether cause exists to determine whether litigation should be allowed to proceed against a debtor, most courts apply an “equitable balance test.” In particular, Delaware courts consider the following three factors in determining whether to lift the stay:

- whether any great prejudice to either the bankruptcy estate or the debtor will result from continuation of the civil suit;
- whether the hardship to the non-bankrupt party by maintenance of the stay considerably outweighs the hardship to the debtor; and

- ⊙ the probability of the creditor prevailing on the merits.

This test embodies the following twelve general principles previously outlined by the United States Court of Appeals for the Southern District of New York:

- ⊙ whether said relief would result in a partial or complete resolution of the issues;
- ⊙ lack of any connection with or interference with the bankruptcy case;
- ⊙ whether the other proceeding involves the debtor as a fiduciary;
- ⊙ whether a specialized tribunal with the necessary expertise has been established to hear the cause of action;
- ⊙ whether the debtor's insurer has assumed full responsibility for defending it;
- ⊙ whether the action primarily involves third parties;
- ⊙ whether litigation in another forum would prejudice the interests of other creditors;
- ⊙ whether the judgment claim arising from the other action is subject to equitable subordination;
- ⊙ whether the moving party's success in the other proceeding would result in a judicial lien avoidable by the debtor;
- ⊙ the interests of judicial economy and the expeditious and economic resolution of litigation;
- ⊙ whether the parties are ready for trial in the other proceeding; and
- ⊙ impact of the stay on the parties and the balance of the harms.

After applying the three part balancing test, the Bankruptcy Court concluded that the automatic stay should be lifted to permit the lawsuit to proceed. In particular, the Bankruptcy Court concluded that lifting the automatic stay would not prejudice SCO. While SCO argued that allowing the lawsuit to proceed would cause its management to turn its attention to the lawsuit and away from SCO's reorganization efforts, the Bankruptcy Court concluded, however, that was not the case. Indeed, SCO had separate counsel that was fully prepared to go forward with the lawsuit. Moreover, the Bankruptcy Court concluded that the continued and indefinite enjoining of the lawsuit would unduly prejudice Novell (and SCO). Indeed, the Bankruptcy Court noted that until Novell's rights are determined, "the Debtors simply cannot file a confirmable plan of reorganization." As such, the lifting of the automatic stay "will assist the Debtors, not burden them." Thus, a further delay of the lawsuit would prejudice both sides and therefore lifting

the automatic stay would satisfy the first two prongs on the three part test.

Under the three part test, the Bankruptcy Court had to consider the probability of Novell prevailing on the merits. The Bankruptcy Court noted that "[e]ven a slight probability of success on the merits may be sufficient to support lifting an automatic stay in the appropriate case." SCO contended that Novell had failed to demonstrate that (i) it had prevailed on the license issues and (ii) the amount of funds that are subject to a constructive trust. The Court, however, held that while the license issues could be heard by the District Court, the constructive trust issue would be decided by the Bankruptcy Court. Indeed, the effect of a constructive trust on a bankruptcy case was "profound" and would affect the Bankruptcy Court's determination of what is property of the estate. Based upon the evidence presented, including the District Court's earlier decision dismissing several of SCO's claims, the Bankruptcy Court concluded that there was sufficient evidence to support a finding of reasonable probability of success on the merits and lifted the automatic stay to allow the District Court to consider the license issues.

Conclusion

Parties to litigation against a debtor should not assume that litigation will be stayed indefinitely or that the Bankruptcy Court will be the ultimate adjudicator of all the issues raised in litigation. Under appropriate circumstances, a bankruptcy court may lift the automatic stay, in whole or in part, to allow litigation (or certain aspects thereof) to be adjudicated by another court. Whether a court will lift the automatic stay will depend on the court's consideration of certain facts, including (i) the status of litigation, (ii) whether the litigation is pending before a special tribunal, and (iii) whether the tribunal has extensive knowledge of the relevant facts and issues on made findings. ⊙

Adequate Protection Requires More Than Just an Equity Cushion

By Seven Rivera

In *In re Strug-Division, LLC*, 380 B.R. 505 (N.D. Ill. 2008), the United States District Court for the Northern District of Illinois recently addressed a prepetition secured lender's request for relief from the automatic stay in order to allow the lender to foreclose upon the debtors' real property, namely two Chicago area apartment complexes. The debtors in the case resisted, arguing that they could successfully reorganize if the court would allow them to obtain postpetition financing to fund extensive renovations to the apartment complexes.

The Debtors alleged that these renovations would make the complexes profitable enough to service the debt. To obtain the necessary postpetition financing, however, the debtors requested authorization from the court to grant a priming lien to another lender. Section 364(d)(1) of the Bankruptcy Code allows a debtor to prime existing secured debt only if the interests sought to be primed are adequately protected.

In this case, the court held that even if the debtors' proposed plan to improve the value of the property was successful, the value of the collateral would still not be enough to provide adequate protection to the prepetition secured lender. Further, the risk of a speculative return on the investment in the renovations should not be borne by the prepetition secured lender. Therefore, the motion for relief from the automatic stay was granted.

Background

This case involved four related debtors: (i) Strug-Division LLC ("*Strug-Division*"); (ii) Strug-Lawrence ("*Strug-Lawrence*"); (iii) Boan LLC ("*Boan*"); and (iv) 910 West Lawrence, LLC ("*910 West*") (together, the "*Debtors*"). Strug-Division and Strug-Lawrence were the parent companies and their only assets were the sole membership interests in Boan and 910 West, respectively. Boan and 910 West were the operating companies and their sole assets were two apartment complexes known as the "Gold Coast Suites" and "Lakeside Tower."

In August of 2006, the Debtors borrowed \$15,750,000 from

Natixis (the "*Prepetition Loan*"). The Prepetition Loan was secured by a first priority lien upon both of the apartment complexes.

The Debtors made only one payment on the Prepetition Loan and failed to make any further payments due to insufficient rental income from the apartments. The rental income was insufficient primarily due to the fact that both apartment complexes were in a serious state of disrepair due to neglect and mismanagement. In fact, only 40 of the 110 units in the Gold Coast Suites were in rentable condition due to severe water damage caused by frozen pipes. In early March of 2007, Natixis accelerated the debt due under the Prepetition Loan and filed a complaint to foreclose on the two apartment complexes. The Debtors filed their Chapter 11 petitions two days before the scheduled foreclosure sale.

Shortly after the bankruptcy filing, Natixis moved for relief from the automatic stay in order to realize upon its collateral. In the alternative, Natixis moved for dismissal of the bankruptcy case or the appointment of a Chapter 11 trustee. The Debtors responded by arguing that proposed renovations to the properties would allow them to adequately service the debt and reorganize the companies. In order to fund the proposed renovations, however, the Debtors intended to request the authority to prime Natixis's security interests by borrowing from \$1.3 to \$2 million in postpetition debtor-in-possession financing ("*DIP Financing*") secured by a first priority lien on the two apartment complexes.

Factual Findings

As of the date of the hearing, the debt due under the Prepetition Loan totaled \$17,866,382.11 with daily interest continuing to accrue at a rate of \$4,828.57 per day. After listening to the testimony of various appraisal experts, the court relied upon one of the Debtors' experts who assessed the value of the two properties (assuming a renovation of the properties and an optimum marketing effort) at \$19,300,000.

Comparing this value to the amount of the outstanding prepetition secured debt, the court found that the Debtors would have no equity cushion to protect Natixis should another lender be allowed to lend between \$1.3 to \$2 million through a priming of the Natixis liens (Natixis's debt of approximately \$17,900,000 plus the DIP Financing of at least \$1.3 million plus outstanding real estate taxes of \$106,000 would total \$19,300,000, the same amount as the valuation). While the Debtors presented other valuations, the court noted that the appraisals came from experts who were connected to

the Debtors or who were interested in participating in the proposed venture. As the court noted, none of these experts indicated that they were ready to rely upon their high value estimates by taking a second mortgage on the properties.

Ruling

The Court began by analyzing the Bankruptcy Code sections relevant to the issues. Specifically, section 364(d)(1), which provides that if the debtor is unable to obtain unsecured or junior loans, it may be allowed to obtain financing that primes the existing secured debt only if “there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.”

With this as its legal framework, the court analyzed the facts at issue and held that the only adequate protection offered by the Debtors for the proposed subordination of the

prospects for successful reorganization of the debtors’ affairs by means of the plan and the debtor’s performance in accordance with the plan. The important question, in the determination of whether the protection to a creditor’s secured interest is adequate, is whether that interest, whatever it is, is being unjustifiably jeopardized.” Applying this standard to the case before it, the court noted that even if there was an equity cushion in the collateral, it was being eroded on a daily basis and any possible improvement in value was based upon a projected business plan that would take at least 18 months to fully implement. With a non-existent, or at most a small and eroding equity cushion, the court determined that Natixis should not be required to bear the risk of whether the renovations would generate income necessary to service its loan and the new loan, or whether the ultimate increased value would protect its loans if subordinated. Therefore, the court granted the Natixis request for relief from the automatic stay.

The important question, in the determination of whether the protection to a creditor’s secured interest is adequate, is whether that interest, whatever it is, is being unjustifiably jeopardized.

Natixis liens was the projected increase in property value resulting from the renovations. However, the court noted that the projected increase in value, even if accurate, would not bring the total value of the collateral to much more than the amount of the outstanding secured debt plus the proposed DIP Financing. At best, the “equity cushion” would be small, and therefore, the risk of being primed would be entirely on Natixis.

The court also looked at cases that looked beyond the “equity cushion” test of adequate protection. It cited several cases for a more “holistic” or “flexible” approach to examining adequate protection issues. Under this approach, the adequate protection is “measured by an analysis of all the relevant facts, with a particular focus upon the value of the collateral, the likelihood that it will depreciate or appreciate over time, the

Analysis

This is an important case for secured lenders because of the court’s focus on the value of the collateral beyond just the equity cushion at the time of the request for a postpetition priming loan. Even an over-secured prepetition lender in the case of a priming DIP financing can run a real risk of its collateral hemorrhaging because the debtor is no longer constrained by the operating or financial covenants under the prepetition credit agreement. In such circumstances, if the debtor is losing money, operating in a deteriorating market, liquidating its assets or substantially reducing its operations, then the secured lenders’ collateral can only decrease, leaving the secured lenders essentially helpless as they watch their once oversecured position erode. By focusing on the projected operations of the debtor and the apprecia- / *continued page 16*

Adequate Protection

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tion or depreciation of the collateral throughout the case, the court is better able to determine if the secured lender is truly adequately protected.

This does mean, however, that if courts adopt this approach, it may be more difficult to prove that a prepetition secured lender is adequately protected. The debtor bears the burden of proof on adequate protection and a simple showing that the value of the collateral is sufficiently greater than the amount of the prepetition secured debt may no longer be sufficient proof of adequate protection. A debtor will need to show that the prepetition secured lenders' interests will be preserved throughout the pendency of the case. Such a showing may even involve proving the viability of the debtor's business plan or even the plan of reorganization. This comprehensive standard may make a priming DIP financing or a request to use cash collateral much more difficult to get approved.

On the other hand, this approach to adequate protection gives the prepetition secured lender a greater amount of leverage over the debtor. The prepetition secured lender can exercise this leverage by insisting upon greater concessions from the debtor in exchange for its consent to a priming DIP financing or to the use of cash collateral. For example, aside from interest payments or expense reimbursements, a prepetition secured lender can also try to impose controls upon the debtor's operations through an operating budget or it can request financial covenants or mandatory paydowns from asset sales. Essentially, in a case before a court that adopts this adequate protection standard, the prepetition secured lender may be in a better position to retain some of the protections that it had under the prepetition loan documents and that a postpetition lender has under postpetition loan documents. Therefore, if other bankruptcy courts adopt the "holistic" approach to adequate protection analysis as advanced in the *Strug-Division*, the case may very well have the effect of shifting even more bargaining power in favor of the prepetition secured lender. ☺

In re Winn-Dixie Stores, Inc.: A Lesson in Claim Amendment

By Meghan Towers

In one of the latest decisions in the Winn-Dixie Stores bankruptcy cases, the Bankruptcy Court for the Middle District of Florida sustained the objection of Winn-Dixie and twenty-three of its affiliates ("Debtors") against the amended claims of two of its creditors, holding that the *res judicata* effect of a confirmed plan of reorganization prevented creditors who failed to protect their interests prior to confirmation of the plan from amending their claims post-confirmation. *In re Winn-Dixie Stores, Inc.*, 381 B.R. 804 (Bankr. M.D. Fla. 2008).

Facts

Early on in the bankruptcy cases of the southern grocery giant, Winn-Dixie Stores Inc., the Bankruptcy Court permitted the Debtors to reject their lease with IRT Partners, L.P. for a store located in Stanley, North Carolina and their lease with Equity One, Inc. for a store located in Orlando, Florida. Pursuant to the rejection order, the two creditors filed proofs of claim against Debtors, IRT in the amount of \$20,364.24 and Equity One for \$87,498.59. Debtors objected to these claims on the basis that they were overstated. IRT and Equity One did not respond to this objection and the Bankruptcy Court entered an order sustaining the objection and reducing the IRT claim to \$11,636.71 and the Equity One Claim to at \$16,913.96.

On November 9, 2006 the Debtors' Joint Plan of Reorganization was confirmed by the Court following proper disclosure and notice to all interested parties; the plan became effective on November 21, 2006. Pursuant to the plan, all allowed unsecured claims were entitled to receive a distribution of new common stock issued by Debtors in exchange for their claims. The claims of IRT and Equity One, classified under the Plan as unsecured Class 13 landlord claims, fell under this category. Neither IRT nor Equity One objected to or appealed from the confirmation of the Plan.

The Plan contained two pertinent sections: Section 12.13 provided that distributions of New Common Stock to unsecured creditors would be in "complete satisfaction of any claim such creditors would have against Debtors;" while Section 4.3 pro-

vided that each holder of a claim received its distribution of New Common Stock in “full satisfaction, settlement, release and discharge of and in exchange for Class 13 Landlord Claims,” which included the IRT and Equity One claims. Equity One accepted shares of New Common Stock on and December 22, 2006, while IRT received its shares on January 9, 2007.

On January 5, 2007 Equity One filed an amended proof of claim in the amount of \$878,478.41, asserting additional rejection damages allowable under Bankruptcy Code Section 502 related to the rejection of the Orlando, Florida lease. That same day, IRT filed a claim in the amount of \$185,244.67, amending their original claim and alleging additional rejection damages for the rejection of the Stanley, North Carolina lease. Debtors objected to these amendments, asserting the claims were barred by the terms of the confirmed Plan of Reorganization.

Conclusions of Law

In determining whether the doctrine of *res judicata*, or “a thing adjudicated,” barred the amendment of the IRT and Equity

plan of reorganization creates a contractual relationship between the debtor and creditor.” In other words, the prior claim is wiped out and is replaced by a new claim, determined by the criteria as set forth in the confirmed plan. In addition to this argument, Debtors also pointed out that the Confirmation Order, confirming the Plan of Reorganization, had a *res judicata* effect. Furthermore, IRT and Equity One were given ample opportunity to amend their rejection damages claims prior to confirmation of the Plan, but failed to do so.

According to the court in *In re New River Shipyard Inc.*, cited by the Debtors in support of their argument, the doctrine of *res judicata* in bankruptcy proceedings would bar the court from “relitigating issues that have already been litigated...[and] also bars the court from litigating issues that may have been litigated.” *In re New River Shipyard Inc.*, 355 B.R. 894, 912 (Bankr. S.D.Fla. 2006). The Bankruptcy Court agreed with this determination and observed that claims asserted after plan confirmation have a disruptive effect on the orderly adjudication of claims.

It is the policy of this Court that a creditor cannot reasonably expect to sit on its rights through the process leading to confirmation, then argue that it is entitled to relief post-confirmation, without consideration to the specified terms of the confirmed plan.

One claims, the Bankruptcy Court examined the specific language of Debtors’ confirmed Plan and the effect that *res judicata* has on confirmed plans generally. Policy considerations were also relevant to the court’s determination.

The Debtors’ arguments in opposition to the amendment of the claims centered around the *res judicata* effect of the Confirmation Order and the failure of IRT and Equity One to amend their claims in a timely fashion. The Debtors asserted that the terms and specific language contained in the Plan of Reorganization precluded IRT and Equity One from amending their claims to assert additional amounts. The Bankruptcy Court noted that “a creditor’s treatment under a confirmed

The arguments of IRT and Equity One in support of their amendments focused on the practice of allowing claims to be freely amended, as well as reservation of rights language contained in the last paragraph of each claim. IRT and Equity One cited *In Re International Horizons* for the proposition that in the Eleventh Circuit, claims as amended should be “freely allowable.” *In Re International Horizons*, 751 F.2d 1213 (11th Cir. 1985). The relevant holding in that case was that “in a bankruptcy case, amendment to a claim is freely allowed where the purpose is to cure a defect in the claim as originally filed, to describe the claim with greater particularity or to plead a new theory of recover on the facts set forth in / continued page 18

Post-Confirmation Claim Amendment

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the original claim.” While the Bankruptcy Court recognized that *International Horizons* was controlling precedent, it distinguished the holding in that case from the facts related to IRT’s and Equity One’s claims. The Bankruptcy Court instead found that “the holding [in *International Horizons*] does not support the proposition that a claim can be freely amended at *any* point in time.” (emphasis in original). The Bankruptcy Court pointed out that the Eleventh Circuit had noted that the amended claim at issue in *International Horizons* had not been timely asserted and the appellant in that case had not objected to the confirmed plan, as such “the court concluded that equitable considerations did not support the amendment as the appellant was given every chance to assert its rights yet failed to do so in a timely fashion.” This was the same criticism that the Bankruptcy Court had with the amended claims of IRT and Equity One, a criticism that led the Bankruptcy Court to the determination that amendment of the claims under the circumstances was not permissible.

As an alternative to their failed “freely allowable” argument, IRT and Equity One pointed to language in the last paragraph of each statement of claim as proof that their right to amend the claims post-confirmation had been preserved. The last paragraph states: “CLAIMANT RESERVES THE RIGHT TO AMEND AND SUPPLEMENT THIS REJECTION DAMAGES CLAIM AS ESTIMATED AMOUNTS ARE FIXED AND ADDITIONAL INFORMATION BECOMES AVAILABLE.” (emphasis in original). Additionally, IRT and Equity One claimed that they did not originally include a damages calculation for unpaid future rent in their proof of claims prior to the confirmation of the Plan because they were attempting to mitigate their damages. The Bankruptcy Court quickly dealt with this assertion, pointing to the fact that the two creditors could have approximated their damages at any time prior to confirmation. Furthermore, the Bankruptcy Court found that the language in the last paragraph of each statement of claim was standard language that could not reasonably be considered to operate as a post-confirmation reservation of rights.

Ultimately the Bankruptcy Court held that “a creditor cannot reasonably expect to sit on its rights throughout the process leading up to confirmation, then argue that it is entitled to relief post-confirmation, without consideration to the specified terms of the confirmed plan.” If the Court allowed a creditor, who failed to protect its interest prior to plan confir-

mation despite adequate opportunity to do so, to amend its claim post-petition in direct contravention of the plan’s provisions, then the confirmed plan would be rendered meaningless. The result would be to “open [P]andora’s box” — where no resolution or finality, the motivating forces behind plan confirmation, would result. As such, the Court found in favor of Debtors’ objections to the amended claims of IRT and Equity One and later entered an order disallowing those amended claims.

Creditors should take heed of this decision and strive to file timely, complete and accurate claims on the basis that claim amendments, particularly those subsequent to confirmation, may not be allowed. ☺

Post-Bar Date Amendments to a Proof of Claim Cannot Assert New Claims

By Frank Vazquez

In general, the Bankruptcy Code requires that a creditor timely file a proof of claim setting forth its claims against a debtor. Under the Federal Rules of Bankruptcy Procedure, the deadline for filing a proof of claim (the “Bar Date”) against a debtor in a Chapter 7 case is 90 days after the first date set for the meeting of creditors scheduled pursuant to section 341 of the Bankruptcy Code. In a Chapter 11 case, the court will issue an order that sets forth the Bar Date.

If a creditor fails to assert a particular claim in a timely filed proof of claim, it will generally be forever barred, estopped and enjoined from asserting such claim against the debtor. While a creditor can freely amend a previously filed proof of claim to assert additional claims anytime prior to the Bar Date, amendments made after the Bar Date are subject to court approval. In a recent decision, the United States District Court for the Southern District of New York affirmed the Bankruptcy Court’s Order disallowing certain claims amended after the Bar Date, because they did not “relate back” to the timely filed proof of claim.

Prior to filing for bankruptcy, Calpine Corporation issued, pursuant to certain indentures (the “Indentures”), several

series of unsecured convertible notes, including (i) 6% Convertible Senior Notes due 2014 (the “6% Notes”), (ii) 7.75% Contingent Convertible Senior Notes Due 2015 (the “7.75% Notes”), and (iii) the 4.75% Contingent Convertible Senior Notes due 2023 (the “4.75% Notes” and together with the 6% Notes and the 7.75% Notes, the “Convertible Notes”). On December 20, 2005, Calpine and certain affiliates filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code.

In the debtors’ Chapter 11 case, the bankruptcy court established August 1, 2006 as the Bar Date for filing proofs of claim. Wilmington Trust Company, as the indenture trustee for the 7.75% Notes, timely filed a proof of claim for (i) principal and interest and (ii) “all other interest, charges, penalties, premiums, and advances which may be due or become due under the Notes and the Indenture.” Similarly, HSBC Bank, as the successor trustee for the 4.75% and 6% Notes, filed two proofs of

The debtors filed a limited objection to the Supplemental Proofs of Claim and requested the disallowance of the conversion right claims. The Bankruptcy Court sustained the objection and held, among other things, that “(i) the timely-filed proofs of claim did not encompass the conversion right claims; (ii) the conversion right claims did not ‘relate back’ to the Original Proofs of Claim and therefore were new claims rather than amendments; [and] (iii) equitable factors weighed against considering the conversion right claims, whether as new claims or as amendments to the timely-filed proofs of claim.”

On appeal, the Appellants argued that the broad language of the Original Proofs of Claim included the Conversion Right Claims. The Appellants further argued that the Conversion Right Claims related back to the Original Proofs of Claim and therefore the late filed Supplemental Proofs of Claim should have been treated as amendments rather than new claims. Furthermore, the Appellants argued that if the Supplemental

**Reliance on broad “catch-all” language or a reservation of rights
in a proof of claim may not provide sufficient notice of claims not
specifically enumerated — leading to a loss of recovery on such claims.**

claim (together with the proof of claim filed by Wilmington, the “Original Proofs of Claim”) asserting claims for (i) principal, interest and trustee fees, and (ii) “any and all other amounts due or to become due under the Indenture and the Notes, whether now due or hereafter arising, which amounts may, presently, be unliquidated or contingent, but may become fixed and liquidated in the future, including . . . compensatory, secondary and/or punitive damages.”

Subsequent to the Bar Date, HSBC and Manufacturers and Traders Trust Company, as successor trustee (together, the “Appellants”) filed supplemental proofs of claim (the “Supplemental Proofs of Claim”). By the Supplemental Proofs of Claim, the Appellants asserted claims for (i) principal and interest and (ii) conversion rights and damages for breach of the Indentures, including the conversion rights.

Proofs of Claim were indeed new claims, they should be allowed as late filed claims.

The District Court noted that the purpose of filing a proof of claim is “to ensure that all those involved in the proceeding will be made aware of the claims against the debtor’s estate and will have the opportunity to contest those claims.” Accordingly, a proof of claim may cover claims not specifically mentioned if it provides notice of such possible claim. Moreover, a proof of claim can be amended after the Bar Date if the amendment relates back to the original claim. “A claim relates back to a timely filed claim if it (i) corrects a defect of form in the original claim; (ii) describes the original claim with greater practicality; or (iii) pleads a new theory of recovery on the facts set forth in the original claim.”

In this instance, the District Court held / *continued page 20*

Post-Bar Date Amendments

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that the Conversion Right Claims did not relate back to the Original Proofs of Claim notwithstanding the broad “catch-all” language contained in the Original Proofs of Claim or the reference to the Indentures. The fact that the Conversion Right Claims arise out of the Indentures was not sufficient to establish that they related back given that there was nothing in the Original Proof of Claim or the Indenture that would have placed the debtors on notice of such possible claims. Moreover, the Conversion Right Claims were novel. “Given the novel nature of the Conversion Right Claims, the catch-all provision would not have provided the Debtors reasonable notice that the Noteholders were asserting claims for breach of rights.”

Having concluded that the Conversion Right Claims did not relate back and were new claims, the District Court analyzed whether the Conversion Right Claims could be allowed as late filed claims. Under the Bankruptcy Rules, a court may accept late filed claims if the failure to timely file was the result of “excusable neglect.” In analyzing whether there was excusable neglect, the District Court noted that courts consider “(i) the size of the claim in relation to the estate, (ii) whether the plan has been filed with the knowledge of the existence of the claim, and

(iii) the disruptive effect allowance of the claim would have on a plan close to completion or upon the economic model upon which the plan was formulated and negotiated.” In this instance, the factors supported a disallowance of the Conversion Rights Claim. Indeed, the Conversion Right Claims, which totaled approximately \$258 million, were filed at an advanced stage of plan negotiations and would, if allowed, disrupt the negotiations between creditors and the debtors and ultimately the confirmation of a plan. Accordingly, the District Court held that the Bankruptcy Court did not abuse its discretion and affirmed the Bankruptcy Court’s Order disallowing the Conversion Right Claims.

Although a proof of claim does not “require absolute precision,” a creditor should take every effort necessary to assert all of its possible claims prior to the Bar Date. The failure to do so may forever bar such claims. Moreover, reliance on broad “catch-all” language or a reservation of rights in a proof of claim may not provide sufficient notice of claims not specifically enumerated — leading to a loss of recovery on such claims. ☉

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