

INTERNATIONAL

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Lehman Brothers: Another Derivatives Dispute Resolved In Favor Of Lehman

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By Christy L. Rivera

In a decision entirely consistent with its ruling in the "Perpetual" adversary proceeding last year, on May 12, 2011, the United States Bankruptcy Court in the Lehman chapter 11 cases endorsed a strict interpretation of certain Bankruptcy Code provisions to the benefit of Lehman, which will result in Lehman having more leverage in its negotiations with derivatives counterparties. *See Lehman Brothers Special Financing Inc. v. Ballyrock ABS CDO 2007-1 Limited and Wells Fargo Bank, N.A., Trustee*, Adv. Proc. 09-01032 (Bankr. S.D.N.Y. May 12, 2011). The decision relates to one of the synthetic collateralized debt obligation ("CDO") transactions to which Lehman Brothers Special Financing Inc. ("LBSF") was party.

Background

In July 2007, LBSF and Ballyrock ABS CDO 2007-1 Limited ("Ballyrock") entered into a credit default swap agreement, pursuant to which Ballyrock sold credit protection to LBSF. Under the swap agreement, LBSF was required to make periodic payments to Ballyrock and, in exchange, Ballyrock agreed to pay LBSF upon certain defaults with respect to an agreed upon pool of residential mortgage-backed securities. Lehman Brothers Holding Inc. ("LBHI") guaranteed LBSF's obligations to make the periodic payments to Ballyrock. Contemporaneously with execution of the swap agreement, Ballyrock entered into an indenture with Wells Fargo Bank, N.A. (the "Trustee"), pursuant to which Ballyrock issued several classes of notes to investors. LBSF is named in the indenture as an express third-party beneficiary. Ballyrock's primary assets were the credit default swap with LBSF and cash.

The credit default swap agreement and the indenture together established the terms govern- / continued page 2

Lehman Brothers

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ing the transactions between Ballyrock and LBSF. Payments due under the indenture, including termination payments owing to LBSF under the swap agreement, were subject to a “waterfall.” The priority of termination payments owing to LBSF depended on the reason for termination. In certain instances, LBSF was entitled to receive the termination payment before any payment was made to the senior noteholders under the indenture. However, if the termination payment owing to LBSF was the result of an event of default by LBSF or LBHI—a “Defaulted Synthetic Termination Payment”—LBSF’s payment priority dropped in ranking in the waterfall so that senior noteholders were entitled to be paid first. Under the indenture, the Defaulted Synthetic Termination

clause and could not be acted upon by Ballyrock. LBSF also sought a determination that the termination of the credit default swap agreement was improper. Finally, LBSF requested an injunction enjoining the Trustee from disbursing the remaining funds to any party other than LBSF.

Ballyrock moved to dismiss LBSF’s complaint for failure to state a claim. After considering arguments by both sides, the court reserved judgment to give the parties time to continue settlement discussions. Ultimately, however, the parties were unable to settle and therefore the court issued its ruling.

The Decision

The court denied Ballyrock’s motion to dismiss counts I and III of the complaint, holding that LBSF has asserted viable claims that

Section 560 permits a non-defaulting swap participant to exercise a contractual right “to cause the liquidation, termination, or acceleration of one or more swap agreements” based on a provision that would otherwise be deemed invalid pursuant to Bankruptcy Code section 365(e)(1)

Payment was capped at \$30,000.

After LBHI filed for bankruptcy on September 15, 2008, Ballyrock notified LBSF that LBHI’s bankruptcy filing constituted an event of default under the swap agreement and designated September 16, 2008 as the early termination date in respect of all outstanding transactions thereunder. The Trustee determined that Ballyrock owed LBSF approximately \$404 million, subject, of course, to the waterfall provisions of the indenture. After liquidating its assets, Ballyrock had approximately \$326 million. The Trustee disbursed approximately \$189 million of this to the senior noteholders pursuant to the waterfall, subordinating LBSF’s right to the Defaulted Synthetic Termination Payment.

After the Trustee announced its intention to distribute the remaining funds to the senior noteholders, LBSF filed a complaint seeking a judgment declaring that the Trustee’s proposed distribution would violate applicable New York and bankruptcy law. LBSF asserted that the indenture provisions modifying LBSF’s right to priority of payment under the waterfall solely as a result of the LBHI bankruptcy filing constituted an unenforceable “*ipso facto*”

the provisions relating to the Defaulted Synthetic Termination Payment constitute *ipso facto* clauses that may not be enforced and, as a result, LBSF may be entitled to an injunction of the proposed distribution to the noteholders. The bankruptcy court granted Ballyrock’s motion to dismiss with respect to count II of the complaint, which alleged Ballyrock’s steps to terminate the credit default swap agreement were ineffective. This article discusses the court’s rationale for denying Ballyrock’s motion to dismiss, but does not address the court’s decision to dismiss count II of LBSF’s complaint.

In analyzing the complaint, the court highlighted LBSF’s assertions that (i) the Defaulted Synthetic Termination Payment provisions were unenforceable because they modified LBSF’s right to a high-priority termination payment as a consequence of LBHI’s bankruptcy filing and, as a result, that (ii) Ballyrock did not have the contractual authority under the indenture to make the proposed distribution to the senior noteholders. These allegations, the court held, are sufficient to state a claim under the authority of the bankruptcy court’s earlier decision in *Lehman Bros. Special*

Fin. Inc. v. BNY Corporate Tr. Servs. (In re Lehman Bros. Holdings Inc.), 422 B.R. 407 (Bankr. S.D.N.Y. 2010) (“Perpetual”).

In refusing to dismiss LBSF’s count seeking a declaratory judgment that the Defaulted Synthetic Termination Payment provisions were invalid, the bankruptcy court noted that the Bankruptcy Code invalidates contractual provisions that alter the relationship of the contracting parties solely by virtue of a bankruptcy filing. See 11 U.S.C. § 365(e)(1) (stating that “an executory contract . . . may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract . . . that is conditioned on . . . the commencement of a case under this title..”); 11 U.S.C. § 541(c)(1)(B) (stating that a debtor’s interest in property “becomes property of the estate . . . notwithstanding any provision in an agreement . . . that is conditioned on . . . the commencement of a case under this title . . . and that effects . . . modification, or termination of the debtor’s interest in property.”). In cases where a debtor attempts to invalidate a contract provision triggered by a bankruptcy filing, the bankruptcy filing at issue is typically that of the debtor—here, LBSF. However, consistent with its ruling in Perpetual, the bankruptcy court noted that Bankruptcy Code sections 365 and 541 “are broadly worded and protect a debtor from the operation of a clause triggered by not only its own bankruptcy filing but also by the bankruptcy of a related entity.” In this case, LBHI.

In Perpetual, LBSF filed a complaint against a trustee of a multi-issuer secured obligation program which held collateral for the benefit of a noteholder and LBSF, as counterparty under a swap agreement. LBSF had sought a declaration that LBSF’s priority in the collateral did not transfer to the noteholder due to the bankruptcy filing of LBHI. In Perpetual, the court held that the provisions of a supplemental trust deed and the notes which modified LBSF’s payment priority to the collateral upon an event of default triggered by LBHI’s bankruptcy filing constituted unenforceable “*ipso facto*” clauses under section 365(e). In the Ballyrock case, the bankruptcy court concluded that its analysis in Perpetual “would render ineffective the changes in the Waterfall that would result from activation of the Defaulted Synthetic Termination Payment Clause.”

The court then held that Ballyrock could not rely on the “safe harbor” provisions of Bankruptcy Code section 560 in order to avoid the possible invalidation of the Synthetic Termination Payment provisions pursuant to Bankruptcy Code sections 365 and 541. Section 560 permits a non-defaulting swap participant to exercise a contractual right “to cause the liquidation, termination, or acceleration of one or more swap agreements” based on a provision that would otherwise be deemed invalid pursuant to

Bankruptcy Code section 365(e)(1). Also consistent with its ruling in Perpetual, the court held that section 560 should be narrowly construed, only applying to clauses that triggered termination, liquidation or acceleration of the agreement. Accordingly, the provisions regarding the Synthetic Termination Payment were outside the scope of section 560—the provisions proposed to lower LBSF’s priority of payment within the Waterfall, depriving LBSF of its pre-existing rights to distribution. According to the court, “[s]uch a mandated elimination of a substantive right to receive funds that existed prior to the bankruptcy of LBHI should not be entitled to any protection under the safe harbor provisions that, by their express terms, are limited exclusively to preserving the right to liquidate, terminate and accelerate a qualifying financial contract.” The parties were directed to submit an order consistent with the decision.

As is evident from the bankruptcy court’s ruling, there is very little case law addressing the issues raised in this lawsuit or in the Perpetual proceeding. It remains to be seen whether another court will follow the Lehman bankruptcy court’s lead on these issues. For now, Lehman has two very helpful decisions to refer to in seeking resolutions with its many derivatives counterparties. ☺

Update on Mexican Bankruptcy Law: Treatment of Bond Debt and Intercompany Claims

By Luis Enrique Graham, Salvador Fonseca, and Sergio Rodriguez Labastida

With the enactment of the *Ley de Concursos Mercantiles* (the “LCM”) in 2000, Mexico took a dramatic step towards modernizing its bankruptcy and insolvency laws. Several years later, in 2007, Mexico took additional steps by enacting a number of reforms aimed to create or clarify the legal framework regarding various important topics that were novel in Mexico, including implementation of a process to obtain approval of pre-negotiated plans.

Despite these steps and the obvious advancements made, certain issues regarding publicly traded bond debt and intercompany claims which are not expressly regulated in the LCM, have recently come up in some well-known bankruptcy cases. As discussed in this article, these issues have / continued page 4

Mexican Bankruptcy Law

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been addressed by the Mexican judiciary with mixed results. Considering that legislative amendments to the LCM are not expected in the near future, federal judges responsible for applying the bankruptcy laws in Mexico are posed with the challenge of establishing a clear line of precedents to address the shortcomings in the law and, in doing so, providing the financial and business community with a higher level of certainty.

Publicly Traded Bond Debt in Mexican Bankruptcy Cases

A debtor that issues publicly traded bond debt typically is not aware of the identity of its beneficial holders, especially where the

of claim, the bondholders had the requisite standing to object to the terms of a restructuring plan under Mexican law. Ultimately, the individual bondholders successfully persuaded the Mexican court not to approve the proposed restructuring plan notwithstanding that the indenture trustee had agreed to its terms.

The different outcomes in Metrofinanciera and Iusacell highlight a significant flaw in the current framework — it is not clear as to who has the requisite authority or standing under Mexican law to assert the rights of bondholders. Indeed, this lack of clarity exists out of court as well. In the out of court restructuring of Su Casita, a real estate developer, the indenture trustee was not involved in the negotiations. In that instance, the debtor negotiated the terms of the restructuring with a common representative of the bondholders, who acted in accordance with the

Intercompany claims have generally been treated like other claims under Mexican law and have been considered in determining a debtor's eligibility and the outcome of the vote on a restructuring plan.

bond debt is held by investment funds. Given that the identity of the creditors may not be clear, a Mexican court may be presented with issues related to a creditor's standing (i) to participate in a Mexican bankruptcy case, (ii) to file a proof of claim, (iii) to negotiate and agree to the terms of a restructuring plan, or (iv) to challenge the rulings of the Mexican court. At its heart, the issue is probably not the actual identity of the creditors, but rather who may assert the rights of creditors. Should it be the fund that purchased the bond with private investments, the beneficial holders, or the trustee?

In the bankruptcy case of Metrofinanciera, a Mexican home-finance company, the Mexican court allowed indenture trustees to file proofs of claim on behalf of bondholders for the face value of the issuances and precluded individual creditors from filing separate claims on account of their bonds. In the bankruptcy case of Iusacell, a Mexican mobile phone operator, the Mexican court allowed individual beneficial holders of bonds to file their own separate proofs of claim. By virtue of having filed their own proofs

instructions of the majority of the bondholders.

Although this lack of consistency has been criticized by the Mexican legal community, there is no consensus on a solution. Some commentators have proposed amending Mexican law. Others, however, believe that this issue is better left for the Mexican courts to decide. In any event, the time has come for either the Mexican legislature or judiciary to implement a set of criteria based on the experience acquired by the *Instituto Federal de Especialistas en Concursos Mercantiles* (IFECOM) in Mexican bankruptcy cases and resolves the divergent outcome in cases, such as Iusacell and Metrofinanciera.

Treatment of Intercompany Claims in Mexican Reorganization Proceedings

There has been a great deal of debate in Mexico about the treatment of intercompany claims in reorganization proceedings, particularly because the LCM is silent on the topic. Not surprisingly, some have argued that intercompany claims should not be considered for purposes of determining eligibility to file a request

for relief or for calculating the votes on a restructuring plan. Others, however, have argued that intercompany claims should not be treated differently than other claims. A similar debate has arisen in addressing debt held by a “friend” of the debtor (or a third party subject to *de facto* control by the debtor).

In the bankruptcy case of *Corporación Durango*, a large Mexican paper producer, the debtor proposed a plan that was approved by affiliates holding substantial intercompany claims and a minority of unsecured creditors. Absent the votes supporting the plan by the holders of intercompany claims, the restructuring plan would not have been approved. Ultimately, however, the Mexican court concluded that intercompany claims could be counted, like other claims, in determining the outcome of the vote on a restructuring plan. Thus, the debtor was able to implement a restructuring plan that was not supported by the vast majority of non-affiliate unsecured creditors.

In the bankruptcy case of *Vitro*, a leading Mexican glass producer, the Mexican court initially rejected the debtor’s voluntary petition for relief on the basis that most of its debt was intercompany debt and could not be taken into account for purposes of determining eligibility for an order for relief. On appeal, this decision was reversed and the debtor has been permitted to go forward with its voluntary petition. As of yet, however, an order for relief has not been entered. Moreover, this decision may be subject to further challenge, including on constitutional principles.

Intercompany claims have generally been treated like other claims under Mexican law and have been considered in determining a debtor’s eligibility and the outcome of the vote on a restructuring plan. Nevertheless, an intercompany claim may be subject to attack under other theories under Mexican law, such as a fraudulent transfer. ☺

Speeches, Events and Announcements

- **Seven Rivera** spoke with litigation partners **Thomas Hall** and **Thomas McCormack** at a webinar sponsored by Stafford Publications titled “Fraudulent Conveyance Actions: TOUSA Revisited” (May 2011).
- **Douglas Deutsch** spoke at the American Bankruptcy Institute’s 29th Annual Spring Meeting in National Harbor, Maryland in a program titled “Chapter 11 Creditors’ Committees and Examiners: Are they Effective?” (April 2011).
- **Seven Rivera** spoke with litigation partners **Thomas Hall** and **Thomas McCormack** at a webinar sponsored by ExecSense titled “The TOUSA Decisions—Efficacy of Saving Clauses, Post-Insolvency Amendments & More” (April 2011).
- **Seven Rivera** spoke with litigation partner **Thomas Hall** at the Turnaround Management Association (TMA) NY’s 14th Annual April Fools Educational Workshop in a program titled “Legal and Financial Issues Relating to In re TOUSA” (March 2011).
- **Douglas Deutsch** was reappointed to be a co-chair of the American Bankruptcy Institute’s Mid-Level Professional Development Program. This year’s program will be held in New York City on October 28, 2011.
- **Frank Vazquez** will be speaking at the June 15, 2011 New York State Bar Association seminar on “Basics of Bankruptcy Practice.”
- **Howard Seife** will be co-chairing INSOL International’s one day seminar in Buenos Aires on November 10, 2011.

Publications

- New York partners **Howard Seife** and **Seven Rivera** and London partners **Adrian Harris** and **Alper Deniz** co-authored chapters in Oxford University Press’s “*The Law and Practice of Restructuring in the UK and US*” (2011). Additional information on the book can be found in this issue of the NewsWire.
- **Douglas Deutsch** and **Michael Distefano** authored “The Mechanics of a Section 363 Sale,” *American Bankruptcy Institute Journal* (February 2011).

Unwrapping English Pre-Packaged Administrations: A Guide To “Pre-Packs” In England

By Alastair Goldrein

Introduction

It has become crucial in the current economic climate to maximize value and minimize losses for creditors. Thus, this recession has seen an increase in “pre-packs” (short for pre-packaged sales) in English administrations. Through a pre-pack, a debtor may avoid a firesale of its business and assets and deliver a better return to its stakeholders. Pre-packs, however, have been viewed with a degree of suspicion given the possibility that a debtor’s existing management may utilize a pre-pack to strip the company of its valuable assets, leaving behind debts and liabilities. This article examines pre-packs generally, summarizes their advantages and disadvantages, and considers the extent to which the concerns associated with the process are warranted.

What is a Pre-Pack And How are They Used?

Although the English Insolvency Act 1986 (the “Insolvency Act”) does not expressly authorize the use of pre-packs, English courts have permitted a debtor to implement a pre-pack in certain circumstances. The essence of a pre-pack is that the negotiations for the sale of some or all of the debtor’s business and assets occur prior to the formal appointment of an administrator (or liquidator), with the sale becoming effective immediately upon or soon after the appointment. Essential to the strategy is a swift and seamless transfer of the business to the incoming purchaser. This provides a clear “business as usual” message to the market, preserves enterprise value and avoids detriment to the business during a period of insolvency. Pre-packs have often been used by the pre-existing sponsors of the business, who establish and finance a purchase vehicle with a view to preserving the best assets, free from the liabilities.

The debtor, the prospective administrator and the secured creditors typically draw up a shortlist of potentially interested parties who are approached on a confidential basis with a view to establishing their level of interest. Occasionally, this limited marketing process may be avoided under certain circumstances,

including where a secured creditor is interested in acquiring the company or its assets. Under those circumstances, the prospective administrator, who is required to act in the best interest of all creditors, will typically satisfy himself as to the fairness and reasonableness of a proposal by obtaining an independent valuation from a third party.

Unsecured creditors are usually disenfranchised in an English pre-pack in that they are not given an opportunity to consider or vote on the proposed sale of the debtor or its assets. Secured creditors, however, must be involved in the process given the need to obtain a release of any liens to facilitate the sale.

Why Use Them?

The key drivers for adopting a pre-pack strategy are usually a combination of an absence of funding, preservation of goodwill (particularly in relation to suppliers), employee retention and a reduction of liabilities. A pre-pack is typically implemented where there is a perception that the company is worth more to its stakeholders as a going concern rather than as a debtor in an insolvency proceeding. Often a pre-pack is the only viable option of selling a business as a going concern, particularly where the company does not have access to sufficient funding to enable it to continue trading. A pre-pack provides a swift and efficient means of effectuating the sale of a business without the considerable costs that are frequently accumulated in an administration. Thus, a pre-pack often has the added advantage of enhancing the prospects of a better return to creditors.

What is the Downside?

Transparency

In a conventional administration, creditors are usually entitled to consider and vote on the administrator’s proposals. In a pre-pack, unsecured creditors generally do not have the ability to consider or vote on the proposal. Indeed, unsecured creditors often become aware of the sale only after its terms have been finalized. A secured creditor, however, is usually actively involved in the pre-pack process given that it must consent to the release of the security held by it over the assets being transferred. SIP 16 (see below) addresses some of the concerns arising from the lack of transparency.

Proceeds of sale not maximized

Because of the speed with which a pre-pack may be implemented, the marketing process of the business/assets may be relatively clandestine in comparison to the process in a traditional administration, leading to concerns that the potential maximum value of

the business being sold is not achieved.¹ As mentioned previously, in circumstances where the secured creditors are the purchaser, the marketing process may be dispensed with altogether and the administrator will utilize an independent valuation to determine the value of the business.

Phoenix companies

In the event that the business is sold to a company controlled by some or all of the previous shareholders and management, creditors will inevitably be suspicious that the process has been used as a way of jettisoning the liabilities of the previous company — a practice prohibited by the Insolvency Act.

Directors

A director involved in the pre-pack runs the risk of being accused of (i) failing to act in the best interests of creditors and (ii) other offenses under the Insolvency Act (e.g., engaging in an undervalue transaction). This risk will be heightened if the director subsequently acquires an interest in the assets of the business following the sale.

Pre-appointment expenses

On April 6, 2010, the Insolvency (Amendment) Rules 2010 (the “New Rules”) were introduced. Under the New Rules, an administrator may recover pre-appointment costs, including the costs associated with the negotiation of a pre-pack, as an expense of the administration. Nevertheless, there is some uncertainty as to the extent to which an insolvency practitioner and its advisors can recover their pre-appointment costs under the New Rules.

Statement of Insolvency Practice 16

In anticipation of an increased use in pre-packs, the “Statement of Insolvency Practice 16: Pre-packaged sales in Administrations” (“SIP 16”), a guidance note for insolvency practitioners on pre-packs in administrations, became effective on January 1, 2009. SIP 16’s purpose is to set out basic principles and essential processes which insolvency practitioners should follow when considering a pre-pack. It is considered a restriction on previous abuse of the process and sets forth new transparency and disclosure requirements. Although not legally binding, an insolvency practitioner will face regulatory or disciplinary action if they fail to comply with SIP 16.

Paragraph 8 of SIP 16 states that “it is in the nature of a pre-packaged sale in an administration that / *continued page 8*

IN OTHER NEWS

The Law and Practice of Restructuring in the UK and the US

Given Chadbourne’s pre-eminence in restructuring across “the Pond,” it was not surprising that New York partners Howard Seife and Seven Rivera and London partners Adrian Harris and Alper Deniz were asked to co-write several chapters of Oxford University Press’s new bankruptcy guide “The Law and Practice of Restructuring in the UK and US” (April 2011). The Law and Practice of Restructuring was designed to be a practical guide to the restructuring of corporate debt and associated restructuring issues from the perspective of both UK and New York law, the dominant systems of law in the world commercial and financial markets.

The Law and Practice of Restructuring examines the differences between United Kingdom and United States law as well as likely future developments in the corporate restructuring landscape. Howard Seife and Seven Rivera co-authored the chapter of the book on debt compromise agreements. Adrian Harris and Alper Deniz co-authored the chapter regarding structured finance transactions. Other leading restructuring experts contributed the remaining chapters of the book. With coverage of techniques available to both stressed and distressed companies, as well as looking at specialist markets and key stakeholders, The Law and Practice of Restructuring is certain to be an invaluable guide for banking, finance and insolvency practitioners and their clients.

¹ Research undertaken by Dr. Sandra Frisby of the University of Nottingham in 2007 supports the view that unsecured creditors lose out (albeit marginally) in a pre-pack sale, and secured creditors achieve substantially better recoveries in a pre-pack.

Pre-Packs

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unsecured creditors are not given the opportunity to consider the sale of the business or assets before it takes place. It is important, therefore, that they are provided with a detailed explanation and justification of why a pre-packaged sale was undertaken.” Thus, SIP 16 provides that creditors should be supplied with details of the marketing efforts undertaken, the identity of the buyer, any connection between the buyer and the insolvent company, the terms of sale of the business, and a justification for the decision to implement a pre-pack.

Challenging Pre-Packs

Creditors can bring an action against an administrator under Schedule B1 to the Insolvency Act. These provisions address those situations where an administrator (i) causes unfair harm to the interests of a creditor, or (ii) fails to perform his functions sufficiently, quickly and efficiently. Absent fraud and/or gross negligence, however, the English courts have been reluctant to interfere with the actions and decisions of an administrator. Creditors can complain of an administrator’s action, including the use of a pre-pack, on a “hotline” recently launched by the English Insolvency Service.

Combining a Scheme of Arrangement and a Pre-Pack

A pre-pack may be combined with a scheme of arrangement, which is akin to a plan under Chapter 11 of the United States Bankruptcy Code in that, among other things, it is a contractual arrangement entered into between a company and its creditors (or class of creditors) and/or shareholders. Like a plan under Chapter 11, a scheme is binding on non-consenting creditors. In the case of IMO Carwash, the administrator proposed (i) a scheme pursuant to which non-consenting senior lenders (accounting for around fifteen percent of the senior debt) were compelled to “rollover” into the new company, and (ii) a pre-pack, pursuant to which the group was transferred to the senior lender-owned newco at the “best price reasonably obtainable.”

An Administrator: A Man Who Knows the Price of Everything and The Value of Nothing?

In England, there is no statutory method of valuation in restructurings. The valuation of the business being sold will often represent the most contentious aspect of a pre-pack. By way of example, in the aforementioned case of IMO Carwash, the subordinated creditors were left with no value for their debt claims and unsuccessfully challenged the valuation and pre-pack. In that case, the English courts assessed valuation on the basis of the compa-

ny’s current value, rather than a future value when market conditions and financial performance have improved. The court’s view was that the correct approach to valuation would require “some real world judgments as to what is likely to happen . . . rather than a range to which other ranges are applied in a series of random calculations to come up with some mechanistic probability calculation.”

Conclusion

Critics complain that pre-packs do not allow either the directors of the distressed business or the creditors sufficient time to consider (or thwart) the sale of the business. Speed, however, remains the indispensable ingredient of a pre-pack. It is the swiftness of the process that reduces the potential damage of protracted insolvency proceedings, and the associated job losses and damage to the goodwill of the business. As such, pre-packs represent a critical instrument in the restructuring toolkit. Despite the unfavourable press coverage attracted by the process, it is to be hoped that the guidance contained in SIP 16 will go some way towards eradicating the criticism associated with the use of pre-packs given the role they play in preserving economic activity. ☺

The Gifting Doctrine Post-DBSD North Am., Inc.

By Eric Daucher

Introduction

In chapter 11 bankruptcies, the absolute priority rule states that a plan of reorganization may not be confirmed if it provides for a distribution to any class that is junior in priority to a rejecting impaired class, if such distribution is made under the plan and on account of the junior class’s claims or interests. However, the gifting doctrine, holds that a creditor may nevertheless reallocate its bankruptcy recoveries as it pleases, including by transferring a portion of those recoveries to favored junior creditors. Courts in various jurisdictions have approved this premise by confirming chapter 11 plans that incorporate gifts that reorder distributions in apparent contravention of the absolute priority rule or the prohibition against unfair discrimination.

Plans of reorganization based on gifting take three main forms. First, a senior creditor could gift a distribution to junior creditors or old equity over creditors of intervening priority.

Second, a senior creditor could make a gift to a favored subset of junior creditors, without skipping over an intervening class of creditors. Finally, a gift could be made to a subset of junior creditors, while also skipping over intervening creditors. While plans containing gifts designed to leap-frog intervening creditors have been analyzed under an absolute priority rubric, plans based on gifts to a subset of equal-priority creditors are more likely to face an unfair discrimination analysis.

On February 7, 2011 the Second Circuit Court of Appeals in *Dish Network Corp. v. DBSD N. Am. Inc. (In re DBSD N. Am. Inc.)* held that a bankruptcy court could not confirm a chapter 11 plan that provided for a gift from a secured lender in the form of equity in the reorganized debtor to old equity over the objections of unsecured creditors.¹ According to the Second Circuit, such “gifts” from senior creditors over intervening creditor classes violate the

chapter 11 petitions with the Bankruptcy Court for the Southern District of New York. As of the petition date, the company’s schedules listed \$627 million in assets and \$813 million in liabilities, leaving the second lien noteholders substantially undersecured.

Rather than providing equity in the reorganized company to holders of first lien debt, DBSD proposed a plan of reorganization pursuant to which the revolver lenders would receive new four-year PIK debt. The equity in reorganized DBSD would be allocated between the (second lien) noteholders, who would receive 99.85% of new equity, and unsecured creditors. The plan further provided that, following these distributions, the noteholders would automatically “gift” five percent of their recovery to old equity.

Sprint Nextel Corp., an unsecured creditor, argued that the plan violated the absolute priority rule. Despite Sprint’s objection, the bankruptcy court, and subsequently the district court,

Courts in various jurisdictions have approved this premise by confirming chapter 11 plans that incorporate gifts that reorder distributions in apparent contravention of the absolute priority rule or the prohibition against unfair discrimination.

absolute priority rule. The *DBSD* decision has drawn significant commentary, much of which suggests that the gifting doctrine is now a dead-letter in the Second Circuit jurisdictions. To the contrary, a close reading of *DBSD* reveals that only the subset of gifting plans that implicate the absolute priority rule have been disapproved.

DBSD: Background

DBSD was founded in 2004 to develop and operate a mobile communications network that combined satellite and land-based broadcast technologies. In 2005, DBSD issued \$650 million in convertible senior secured notes due in August 2009. In early 2009, when it became clear that the network would be unable to launch on schedule, the company obtained a \$40 million first lien revolving credit facility. Nevertheless, as the maturity date on its senior secured notes neared, DBSD concluded that it would be unable to meet its obligations. On May 15, 2009, DBSD filed

concluded that the distribution to old equity constituted a valid gift and therefore did not violate the absolute priority rule.

DBSD: The Second Circuit’s Holding

On appeal, the Second Circuit noted that the Bankruptcy Code prohibits cramdown of a chapter 11 plan unless the plan can be shown to be “fair and equitable” with respect to impaired classes of claims that vote to reject the plan. While the Bankruptcy Code does not fully define what it means for a plan to be “fair and equitable,” it makes clear that a plan cannot be fair and equitable if it violates the absolute priority rule. Specifically, a plan may not provide for a distribution to any class that is junior in priority to a rejecting impaired class, if such distribution is made (i) under the plan and (ii) on account of the junior class’s claims or interests. Accordingly, the Second Circuit found that “[a]bsent the consent of all impaired classes of unsecured claimants, therefore, a confirmable plan must ensure either (i) that the dissenting class receives the full value of its claim, or (ii) that / continued page 10

¹ No. 10-1175, 2011 WL 350480 (2d Cir. Feb. 7, 2011).

Gifts Doctrine

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no classes junior to that class receive any property under the plan on account of their junior claims or interests.”² Second, the court observed that it was undisputed that Sprint, an unsecured creditor, would receive less than the full value of its claims.

Given that Sprint would receive less than the full value of its claims under the plan, the court considered whether (i) the gifted distribution to old equity constituted “property,” (ii) those distributions were made “under the plan” and (iii) those distributions were made on account of old equity interests. The court found little difficulty in answering all three questions in the affirmative. First, as the Supreme Court held in *Ahlers*, the term property, as used in section 1129 of the Bankruptcy Code, should be construed broadly, and would, in any case, include shares of equity and warrants.³ Second, the plan’s disclosure statement stated that holders of old equity “shall receive the Existing Stockholder Shares and the Warrants.” Given that the disclosure statement unambiguously stated that the gift would be made as a result of the plan, the Second Circuit concluded that the gift was “clearly” made “under the plan.” Finally, the disclosure statement stated that the gift would be made “[i]n full any final satisfaction, settlement, release and discharge of each Existing Stockholder Interest.” In the face of explicit language stating that the gift would serve to discharge old equity interests, the Second Circuit concluded that, even under the test most favorable to holders of old equity, the gift constituted a distribution “on account of” old equity.

Conversely, the debtors and noteholders argued that creditors are free to reallocate their distributions at their discretion without running afoul of the absolute priority rule. The Second Circuit was unconvinced and concluded that where a plan allows old equity to (i) receive property, (ii) under the plan, (iii) on account of its prior interest, and (iv) over the objection of an objecting impaired creditor class, it violates the absolute priority rule, regardless of whether such recovery theoretically flows from the reallocation of a senior creditor’s recovery. Although the court acknowledged the existence of policy arguments in favor of a broad interpretation of the gifting doctrine, it also recognized countervailing arguments in favor of a robust absolute priority rule. The court reasoned that Congress had considered policy arguments both for and against robust absolute priority and made a conscious decision to adopt it when drafting the Bankruptcy Code. Thus, the court concluded that allowing a “gift” to circumvent absolute priority would “not square with the text of the Bankruptcy Code” as the absolute priority rule protects all property of the estate, rather than merely any estate property not covered by a lien.

² *DBSD*, 2011 WL 350480, at *11.

³ *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 208 (1988).

DBSD: What was Not Said

DBSD can properly be characterized, as many commentators have observed, as a staunch defense of the absolute priority rule in chapter 11 cases. It is not, however, a deathblow to the gifting doctrine in its entirety. While the court rejected the proposed application of the gifting doctrine to the facts of the case, it did not reject the gifting doctrine in full. Instead, the court distinguished prior case law on factual grounds. As an initial matter, the court noted that the gifting doctrine originated in *Official Unsecured Creditors’ Committee v. Stern (In re SPM Manufacturing Corp.)*,⁴ which was decided in the context of chapter 7, and thus did not face “the rigid absolute priority rule of §1129(b)(2)(B).”⁴ Second, the undersecured creditor making the gift in *SPM* had obtained relief from the automatic stay to foreclose on its collateral. In contrast, the noteholders in *DBSD* had not obtained such relief. The *DBSD* court therefore concluded that the undersecured creditor in *SPM* had a strong claim that the property at issue belonged to it, rather than the bankruptcy estate, whereas the noteholders in *DBSD* had no basis for such a claim. At the very least, the *DBSD* court’s analysis makes clear that the gifting doctrine has not been eliminated under the right facts and in the context of chapter 7.

Perhaps more important, however, the *DBSD* court’s analysis focused entirely on the absolute priority rule and did not address unfair discrimination. Accordingly, gifting may remain viable where a proposed gift distribution does not skip intervening creditor classes. Post-*SPM*, the gifting doctrine evolved along several distinct, if at times intertwined, branches. On the one hand, “traditional” gifting plans, such as those in *DBSD*, involve gifts that skip over intervening creditors to provide junior creditors (or old equity) with a recovery. These plans are analyzed under an absolute priority rubric. In the wake of *DBSD*, it may be fair to say that this sort of gift plan—subject to certain caveats—is a thing of the past in the Second Circuit. On the other hand, a second branch of the gifting doctrine involves plans that contain “selective gifts” that provide a recovery to a subset of equal-priority creditors. These plans have generally been analyzed under an unfair discrimination—rather than absolute priority—framework. As *DBSD*’s analysis was confined to absolute priority and did not speak to unfair discrimination, there may be reason to believe that “selective gifting” remains a valid tool in the Second Circuit.

Finally, it is unclear that *DBSD* foreclosed even the functional equivalent of a “traditional gifting” plan. One key to the Second Circuit’s ruling was that the distributions provided to old equity

⁴ *Id.* Although the *DBSD* court did not elaborate on this point, the court in *SPM* noted that section 726 of the Bankruptcy Code, which establishes distributional priorities in a liquidation, is not triggered until all liens have been satisfied in full.

occurred “under the plan.” Indeed, the court stated that it “need not decide whether the Code would allow the existing shareholder and Senior Noteholders to agree to transfer shares outside of the plan . . .”⁵ In *In re Journal Register Co.*, however, the court found that distributions made from an account funded with senior lender property, even if established by a chapter 11 plan, did not occur “under the plan.”⁶ Applying the logic of *Journal Register* to the holdings of *DBSD*, it is not difficult to envision a plan that accomplishes the functional equivalent of a traditional gifting plan while strictly adhering to the text of the absolute priority rule.

Conclusion: “Selective Gifting” Lives

DBSD is a rejection of the idea that creditors are free to end-run the absolute priority rule through “gifts.” It does not, however, necessarily follow that the Second Circuit intended to overturn the entire doctrinal edifice. Until a circuit court says otherwise, cases approving “selective gifting” remain good law and should be kept in mind as an option to maximize estate value and otherwise resolve a challenging reorganization. ☺

“Covered or Not Covered: That Is The Question” A Discussion of Directors & Officers Insurance Coverage Issues

By Heidi Lawson and Elizabeth Kurpis

It is important that directors and officers insurance provide the necessary protections. In times of financial turmoil, it is especially advisable for companies to review their D&O insurance coverage to ensure that their directors and officers are adequately protected. Although not exhaustive, set forth below are some of the critical issues to be considered in the context of D&O insurance policies.

The Extent of Coverage

In a D&O policy, the definition of “Claim” can significantly affect the scope of coverage provided under that policy. The breadth of

the definition, moreover, can differ significantly from one carrier’s form to another. Forms also vary considerably with respect to the extent to which administrative or regulatory investigations are included within the definition of Claim. Unless specifically negotiated and carefully worded, many D&O policies will not automatically cover investigations, or at best, will provide very limited coverage. The insured needs to make certain that the formal triggers providing for investigative coverage are not unnecessarily restrictive. The definition of Claim must also take into account the types of litigation and investigations that may occur across a wide variety of jurisdictions, in order for coverage to apply.

For companies with U.S. securities exposures, another important issue is whether the D&O policy specifically includes coverage of damages that fall under Section 11 of the Securities Act of 1933 within the definition of “Loss.” Courts in certain jurisdictions have held that in the absence of such express language, Section 11 damages are restitutionary in nature and are therefore not “Losses” as provided for under a D&O policy. In order for coverage to apply, wording should be carefully drafted and negotiated.

Wording should also be carefully reviewed with regard to the advancement of defense expenses to determine whether such advancement is mandatory or discretionary, as written. Where the advancement of defense expenses is permitted but not required by law, D&O policies (and carriers) will presume that the company’s discretion has been exercised, and that the advancement of expenses has been made pursuant to its indemnification obligations (whether it has or not). Therefore, the policy should reflect the advancement of expenses as provided for in the underlying indemnities, and further, should provide for mandatory advancement of expenses under the policy in circumstances where the company is not able to advance expenses due to, for example, legal prohibition or insolvency. If the policy is not properly drafted, a director or officer will be forced to pay his/her own expenses. In addition, the policy should provide that defense expenses will be advanced within a specified time period in order to ensure timely payment.

The Implications of Bankruptcy

Disputes under D&O policies can arise when the insured, whether voluntarily or involuntarily, files for bankruptcy or becomes insolvent. It is important to have bankruptcy provisions that adequately facilitate access to the policy proceeds in the event the scenarios above occur. The company should request specific provisions ensuring that the D&O insurance policy is available for the primary benefit of its directors and officers in the event of a company’s bankruptcy. Specifically, the company should request the inclusion of the following bankruptcy protections in its policy:

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⁵ *DBSD*, 2011 WL 350480, at *11.

⁶ 407 B.R. 520, 533 (Bankr. S.D.N.Y. 2009).

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Priority of Payments. In bankruptcy, the “automatic stay” prevents claims against the bankruptcy estate, including insurance policies and certain insurance policy proceeds that belong to the estate. However, the automatic stay will not prevent the assertion of claims against directors or officers, so directors and officers may be left without coverage if the proceeds of the D&O policy are deemed to belong to the estate. Proceeds of D&O policies with (i) Side A coverage, provided for directors and officers of the company in the absence of indemnification by the company, which usually does not have a retention (deductible) and (ii) Side B coverage, provided for the company for its obligation to indemnify the directors and officers in the event of claims against them, which usually has a significant retention will not generally be

properly drafted “bankruptcy clause” evidences, among other things, a clear intention that the company’s policy is intended to protect and benefit the individual directors and officers and that, in the event of bankruptcy of the company, the company will lift the automatic stay to the extent the stay is preventing the directors and officers from accessing the policy. The “bankruptcy clause” should also include an express statement that a bankruptcy filing by the company will not relieve the insurer of any of its obligations under the policy.

Financial Insolvency Clause. A properly drafted “financial insolvency clause” enables directors and officers to access the policy from the first dollar (*i.e.*, eliminating the retainer (deductible)) in the event that the company is unable to pay indemnifiable claims of directors and officers due to its insolvency.

Disputes under D&O policies can arise when the insured, whether voluntarily or involuntarily, files for bankruptcy or becomes insolvent.

deemed to belong to the bankruptcy estate and, therefore, may be distributed during bankruptcy. For policies that also provide Side C coverage (the majority of policies written since 2000), provided for liabilities of the company, which, like Side B coverage, usually has a significant retention, a properly drafted policy can ensure that certain of the proceeds of the policy are available to the directors and officers. A “priority of payments” provision provides that Side A claims have priority over Sides B and C claims and Side B claims have priority over Side C claims. Bankruptcy courts have concluded that the “priority of payments” provision has the effect of excluding from the bankruptcy estate certain of the proceeds of the policy, thereby conferring directors and officers access to those policy proceeds.

Bankruptcy Clause. Together with the “priority of payments” provision, the “bankruptcy clause” should ensure that the policy proceeds are available to the directors and officers. A

Change of Control. Policies do not usually cover claims made after a “change of control.” The policy must exclude, or not refer to, a bankruptcy as a change of control trigger.

Insured v. Insured Exclusion. In a bankruptcy, an “insured v. insured” exclusion is problematic because if a trustee or other party representing the interest of the company (an insured) brings a claim against the directors and officers (also insureds), the exclusion is triggered. Therefore, it is important that the policy include an exception to the exclusion to allow coverage for claims brought by a bankruptcy trustee, an examiner, a creditors’ committee and their respective assignees and functional (and, where relevant, foreign) equivalents.

In addition to the above issues, it is also important to determine whether the policy contains a “retroactive” or “continuity” date. D&O insurance policies are “claims made” policies. This means that a D&O policy will only cover claims made during the

policy's term, subject to any negotiated extensions. When a company changes carriers, there is a risk that the new carrier may impose a "retroactive" or "continuity" date, for example, reflecting the policy inception date, thereby excluding coverage for any alleged wrongful act committed prior to such date. The result is that directors and officers will be without coverage for claims relating to an alleged wrongful act that took place prior to the retroactive date, even if the claim is made during the current policy's term.

Further, a small but just as significant issue involves notification provisions. It is imperative such terms in the policy are clear and unambiguous because if claim notification requirements are not closely complied with, coverage will often be compromised. In certain circumstances, a claim may be deemed void. The notice provisions should afford the directors and officers greater flexibility when reporting a claim.

Lastly, in order to ensure adequate protection for directors and officers, a review of the language in each excess policy is necessary to determine whether coverage is consistent with the underlying policy. A company will often have additional layers of coverage which incorporate the terms and conditions of a number of insurance carriers. Even though excess policies are meant to "follow form," *i.e.*, have the same exact terms and conditions as the primary policy, subtle wording differences often create significant gaps in coverage. These gaps in coverage tend to go undetected until the directors and officers are faced with a significant claim. It is necessary to carefully review each of these policies to ensure that the definitions conform and that there are no additional exclusions or variations between the different layers. In addition, if the insured contributes its own funds towards a settlement, many excess insurers will not recognize the primary policy limits as being "exhausted." Therefore, unless the policy wording is changed to recognize an insured's contribution of its own funds towards settlement, the insured may not be able to access coverage beyond the limits of the primary policy.

Conclusion

Now more than ever it is essential that companies review their D&O policies with a more discerning eye to ensure that their directors and officers are provided with all the necessary protections. The discussion above addresses the key points to look for when doing so, and although not a complete list of potential issues, the major areas of concern have been addressed in the context of D&O insurance policies. Remember: it is better to negotiate these points with carriers during the placement or renewal stage, rather than have to unexpectedly face a denial of coverage later when directors and officers are most vulnerable and exposed to risk. ☺

"Sword of Damocles:" Pensions in an English Insolvency

By Alastair Goldrein

Introduction

In England, the Pension Regulator (the "Regulator"), who is responsible for overseeing certain pension schemes, may issue "financial support directions" ("FSD") and/or a "contribution notice" ("CN") pursuant to its moral hazard powers. The English High Court recently concluded that the Regulator can issue an FSD and/or a CN against insolvent companies as well as solvent ones.¹ [2010] EWHC 3010 (Ch). Additionally, the High Court determined that the amounts which arise from the Regulator's moral hazard regime post-insolvency are to be treated as an administration expense, rather than as an ordinary unsecured debt and therefore rank in priority to all creditors' claims other than those secured by a fixed charge.

Background: Defined Benefit Pension Schemes and Moral Hazard Explained

Defined Benefit Pension Schemes

In a Defined Benefit Pension Scheme (a "DB Scheme"), a member's retirement benefit is defined meaning that the member is promised a certain benefit on retirement depending on the scheme's accrual rate, his pensionable salary and his length of service. The employer is primarily responsible for funding a DB Scheme (although members may be required to contribute), and the system works on a pooled fund basis, whereby all contributions are paid into a common fund, which is invested to provide the retirement benefits. DB Schemes have become increasingly rare in the private sector given (i) the expense involved due to the volatility of funding requirements and (ii) the difficulty of predicting future funding requirements.

The Pensions Regulator

Created by the Pensions Act 2004, the Regulator is responsible for schemes that permit an employer to deduct employee's contributions. One of the Regulator's primary objectives is "protecting members' benefits under work-based

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¹ Given the potential extent of pension scheme liabilities, the High Court noted that CN and FSD liabilities would "hang like an enormous sword of Damocles above the administration, paralyzing it in all relevant respects." [2010] EWHC 3010 (Ch).

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pension schemes.” Section 5(1), Pensions Act 2004. The Regulator has the power to prevent a company from manipulating its business affairs to avoid pension liabilities.

The Moral Hazard Regime

The moral hazard regime provides an anti-avoidance framework, whereby pension liabilities are not confined to the employing company, but rather extend to the wider corporate group (which can include group companies, shareholders, individuals such as directors, and even managers of private equity funds). The Regulator has certain powers under the moral hazard regime to ensure that a corporate group does not avoid its pension liabilities. Although the potential consequences of the moral hazard regime are severe, the Regulator

Contribution Notices

If a person fails to comply with an FSD, the Regulator may issue a CN calling for an immediate contribution to the pension scheme. The CN can be issued to a group company or holding company and other persons who are “connected” or “associated” with the employer, in the event that there has been reduction or avoidance of a pension scheme obligation which requires payment into the pension scheme. The conditions for issuing a CN and also the consequences of receiving one are stricter and more severe than that of an FSD.

Lehman/Nortel Judgment — What Has Happened?

The Nortel and Lehman groups include UK companies with DB Schemes with deficits of £2.1bn and £140m respectively. These UK entities are not capable of providing sufficient support to their pension arrangements. In June 2010, the Regulator issued FSDs

The High Court determined that the amounts which arise from the Regulator’s moral hazard regime post-insolvency are to be treated as an administration expense, rather than as an ordinary unsecured debt and therefore rank in priority to all creditors’ claims other than those secured by a fixed charge.

has rarely exercised his powers, rather preferring negotiated solutions. The moral hazard regime has been particularly relevant to those companies with DB Schemes that can no longer ensure that pension liabilities remain ring-fenced.

Financial Support Directions

Where the Regulator determines that an arrangement in place imposes responsibility for funding a pension scheme on a company that is insufficiently resourced to fund the scheme, and there are other companies within the corporate group that are able and that could reasonably be asked to assist with the funding of the scheme, the Regulator may issue an FSD to ensure that the scheme is adequately funded. A showing of avoidance of pension liability or fault is not required.

against a large number of insolvent companies in the Nortel Group and in September, the Regulator took parallel action against a smaller number of Lehman Brothers entities, including Lehman Brothers International (Europe) (“LBIE”) and also the US parent Lehman Brothers Holding Inc.

The administrators of Nortel and LBIE responded by seeking the court’s direction regarding the treatment of the FSDs. Their uncertainty was based on the fact that prior to this case, as a rule, only debts incurred prior to insolvency were provable (unless they constituted administration expenses). The issue was not addressed by the Pensions Act 2004 (which had created the moral hazard regime), and therefore fell within the scope of insolvency legislation: the Insolvency Act 1986 and the Insolvency Rules 1986.

On December 10, 2011, the High Court ruled in favour of the Regulator and decided that:

1. the criteria in the legislation for imposing FSDs/CNs did not distinguish between solvent and insolvent companies (and so FSDs/CNs could be issued after the target entered administration/liquidation); and
2. where an FSD was issued against a company after the commencement of administration/liquidation, the cost of complying with that FSD was an expense of the insolvency ranking above the debts of unsecured creditors.

Consequences of the Decision

LBIE/Nortel

While fixed charge secured creditors will be unaffected by the decision, other creditors owed debts by LBIE/Nortel will only get paid if there are sufficient funds remaining after the distributions relating to the FSDs are paid. The decision has also had the effect of putting a freeze on parts of the administration process, and delaying further the distributions to creditors in LBIE/Nortel.

Companies with substantial pension deficits and their lenders

Companies with substantial pension deficits, such as British Airways and British Telecom, may struggle to raise funds following this decision. While the decision will be hugely welcomed by pensioners, the ruling has significant implications for lenders and the floating charges they hold given that their fixed charges may be re-characterised as floating charges. Lenders should, therefore, consider this in the context of their due diligence and when drawing up the security package with the borrower (in the event that the borrower has a DB Scheme with a considerable deficit). Additionally, insolvency practitioners may hesitate before accepting an appointment of an insolvent company where the pension deficits (and the risk of being issued a CN/FSD) are such that there is a danger that they will not be paid.

Company rescues generally

The decision is likely to yield considerable and uncertain liabilities which can arise from the use of moral hazard powers. A company (with a DB Scheme) that is considering restructuring will need to consider the implications of this case carefully and determine whether to seek advance clearance from the Regulator in relation to a restructuring. In particular, FSDs and CNs issued by the Regulator against insolvent companies will now be given super-priority against the claims of unsecured creditors, floating charge holders and expenses of insolvency practitioners. Following this decision, claims will have the following priority ranking in administration:

- (i) Fixed Charge Security.
 - (ii) Costs and expenses of the administration (in accordance with Rule 2.67 of the Insolvency Rules 1986); FSDs and CNs now included at this level.
 - (iii) Preferential creditors.
 - (iv) Unsecured creditors up to a maximum of £600,000 if the company's net property is £10,000 or more.
 - (v) Holders of a floating charge.
 - (vi) Unsecured creditors.
 - (vii) Post administration interest on debts.
 - (viii) Deferred creditors.
 - (ix) Shareholders.

What Happens Next?

The Judge may be interpreted as having misgivings regarding his ruling, which he sought to blame on a "legislative mess." The Judge also speculated that the Insolvency Service or Parliament might propose a suitable legislative amendment if they shared his view "that the conferring of super priority as expenses upon the financial liabilities arising from the FSD regime is both potentially unfair to the target's creditors and inconsistent with a (previous) decision...not generally to elevate employees' pension claims above the claims of those creditors." The Judge also invited the prospect of an appeal court being able to navigate a way through the statutory quagmire to arrive at a more equitable solution than he had determined. The administrators of both Nortel and Lehman are expected to appeal the decision.

Conclusion

A resolution of this confusion appears likely, whether by way of a successful appeal or statutory intervention. The decision dismayed those in the restructuring community who had understood moral hazard liabilities to be ranked as an unsecured claim, akin to other pension liabilities. There is clearly a manifest inconsistency in the fact that an FSD/CN issued moments before insolvency would rank as an unsecured creditor, whereas as FSD issued even immediately after insolvency attains "super-priority." Section 75 debts² were the means associated (at least until now), with addressing pension liabilities against an employer (on a non-preferential basis) in an insolvency process. Now, it seems that the Regulator can (at least for the moment) circumvent this by issuing a CN/FSD and thereby leap up the priority rankings. ☺

² Section 75 debts (under the Pensions Act 1995) fall on the participating company of an occupational pension scheme in the event of the company's insolvency, where the pension scheme has a deficit. While they are provable in a company's insolvency and the employer can be liable to meet all or part of that deficit, the debts are non-preferential. Both Lehman and Nortel had huge Section 75 debts.

A Sale “Free and Clear” Is Not Necessarily Free and Clear of All Future Tort Liability

By Michael Distefano

Under section 363 of the Bankruptcy Code, a trustee or debtor-in-possession may sell property free and clear of “any interest in such property of an entity other than the estate.” Thus, a buyer can generally acquire assets from a bankruptcy estate without subjecting itself to liability or claims based on the seller’s prior actions. In *Morgan Olson, LLC v. Frederico (In re Grumman Olson Indus., Inc.)*, No. 02-16131, 2011 WL 766661 (Bankr. S.D.N.Y. 2011), the Bankruptcy Court for the Southern District of New York recently held, however, that a sale under section 363(f) of the Bankruptcy Code did not absolve a buyer of successor liability claims asserted by individuals who were injured after the sale, but at the time of the bankruptcy petition had no identifiable relationship with the debtor or its conduct.

Background

Grumman Olson Industries, Inc. (“Grumman” or the “Debtor”) was a designer and manufacturer of parts for the truck body industry. Its products were sold to and incorporated into the products of, among other companies, Ford Motor Company and General Motors Corporation. Grumman filed for chapter 11 on December 9, 2002 in the Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court” or the “Court”). On July 1, 2003 the Court approved the sale of certain of the Debtor’s assets (the “Transferred Assets”) to a predecessor of Morgan Olson LLC (“Morgan”) free and clear of any liens, claims and interests pursuant to section 363 of the Bankruptcy Code.

Among other things, the sale order provided that the Transferred Assets were sold free and clear of any and all claims arising in connection with the acts of the Debtor and holders of such claims were permanently enjoined from proceeding against the Transferred Assets. Additionally, the sale order released Morgan from *in personam* liability for obligations of or claims against the Debtor arising prior to the sale or related to the Transferred Assets. Following the sale, the Court confirmed a joint liquidating plan and closed the case in 2006. After acquiring the Transferred Assets, Morgan continued to produce and market the product line as that of Grumman.

In 2009, John and Denise Frederico (the “Fredericos”) commenced a lawsuit against Morgan in New Jersey state court. They alleged that they were injured by a product manufactured, designed and/or sold by the Debtor in 1994—years before the commencement of the Debtor’s bankruptcy case. In particular, Ms. Frederico, a FedEx driver, alleged that she was seriously injured in 2008 when the truck she was driving hit a telephone pole and that Grumman’s product was responsible for her injuries. The Fredericos asserted their claims against Morgan based on theories of successor liability under New Jersey law. According to the Fredericos, Morgan had continued Grumman’s product line following its purchase of the Transferred Assets and was therefore liable for the Fredericos’ damages.

In response, Morgan commenced an adversary proceeding against the Fredericos in the Bankruptcy Court for declaratory and injunctive relief, alleging that the sale order relieved Morgan of any liability stemming from Grumman products manufactured or sold prior to the sale. After finding that the case presented a core proceeding over which it had subject matter jurisdiction, the Court turned to whether section 363(f) absolved a buyer of *in personam* liability for successor liability claims brought by persons who were injured after the sale but, at the time of the bankruptcy petition had no prior identifiable relationship to the debtor or its products.

The Scope and Effect of § 363(f)

Section 363(f) of the Bankruptcy Code allows a trustee to sell property of the estate “free and clear of any interest in such property of an entity other than the estate.” The phrase “interest in property” as used in this section includes “claims” that arise from or relate to the property. On its face, section 363(f) grants only *in rem* relief—that is, relief against the property—and allows a buyer to acquire property of the estate without fear that an estate’s creditor may later enforce its claim against the property. A number of courts have interpreted section 363(f) to extend to *in personam* relief as well, exonerating not only the transferred property but also the buyer itself. Such relief serves two important policies: (1) it preserves the priority scheme of the Bankruptcy Code and equality of distribution by preventing a plaintiff creditor from asserting claims against the buyer while other creditors are left to satisfy their claims from the sale proceeds; and (2) it maximizes the value of the sale assets inasmuch that it induces buyers to enter the transaction.

In the instant case, the Fredericos sought to enforce their claims not against the purchased property, but against Morgan itself. Consequently only the Court’s grant of *in personam* relief was called into question. Because the claim did not arise “as a

result” of the purchase and sale of the Transferred Assets, the Court noted that the sale order could only have released Morgan from claims “arising prior to . . . the purchase and sale of the [Transferred Assets].”

Did the Plaintiffs Hold a “Claim” at the Time of Sale?

Section 101(5)(A) of the Bankruptcy Code defines a claim as a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” This broad definition evinces Congress’ intent that all legal obligations of a debtor—no matter how remote or contin-

people who will be killed when they drive across the one bridge that will fail someday in the future? If the only test is whether the ultimate right to payment will arise out of the debtor’s pre-petition conduct, the future victims have a “claim.” Yet it must be obvious that enormous practical and perhaps constitutional problems would arise from recognition of such a claim. The potential victims are not only unidentified, but there is no way to identify them. Sheer fortuity will determine who will be on that one bridge when it crashes. What notice is to be given to these potential “claimants”?

To address this difficulty, *Chateaugay* adopted a “fair contemplation” test, which requires a court to determine whether the

A number of courts have interpreted section 363(f) to extend to *in personam* relief as well, exonerating not only the transferred property but also the buyer itself.

gent—can and should be resolved during the bankruptcy case.

Despite this expansive definition, courts have acknowledged certain limits on claims, particularly in areas dealing with future tort claims. In *In re Chateaugay Corp.*, 944 F.2d 997 (2d Cir. 1991), the Second Circuit identified two categories of future tort claims: (1) those where the claimant has had pre-petition contact with the debtor or its product but has not yet discovered the injury or manifested symptoms (*e.g.*, asbestos cases); and (2) those where the claimant is injured post confirmation by a product manufactured and sold by the debtor before the bankruptcy. The Court noted that the Fredericos’ claim fell within the second category. The second category of future claims poses a number of problems, however, as highlighted by the Second Circuit in the following hypothetical:

[A] company . . . builds bridges around the world. It can estimate that of 10,000 bridges it builds, one will fail, causing 10 deaths. Having built 10,000 bridges, it becomes insolvent and files a petition in bankruptcy. Is there a “claim” on behalf of the 10

occurrence of the contingency or future event that would trigger liability was “within the actual or presumed contemplation of the parties at the time the original relationship between the parties was created.” If yes, then there exists a contingent or unmatured “claim” under section 101(5). If no, there is merely a potential future tort claim not encompassed by section 101(5).

The Eleventh Circuit adopted a modified *Chateaugay* test in *In re Piper Aircraft*, 58 F.3d 1573 (11th Cir. 1995). As the following facts demonstrate, the hypothetical posed in *Chateaugay* became reality in *Piper Aircraft*. The debtor had manufactured aircraft and spare parts for more than five decades and at the time of its chapter 11 filing between 50,000 and 60,000 Piper aircraft were still operational in the United States. Knowing, as a statistical matter, that some of the planes would crash, the agreement to sell Piper’s assets required the establishment of a fund to compensate future products liability claimants. When the representative of the fund filed a \$100 million claim on account of such claims, the creditors’ committee objected, arguing that the future claimants did not hold “claims” under section 101(5). */ continued page 18*

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In *Piper Aircraft*, the Eleventh Circuit held that a claim fits within section 101(5) only if: “(i) events occurring before the confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor’s product; and (ii) the basis for liability is the debtor’s prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product.” Further, the court stressed that the relationship must be between an “*identifiable* claimant or group of claimants” and the debtor’s prepetition conduct. Applying this test, the Eleventh Circuit held that the fund’s \$100 million claim was not a “claim” within section 101(5)’s meaning.

Returning to *Grumman*, the Bankruptcy Court held that the Fredericos’ right to payment was not a “claim” within the meaning of section 101(5). This situation, explained the Court, fell squarely within the *Chateaugay* hypothetical and represented an “extreme case of pre-petition conduct that has not yet resulted in any tortious consequence.” The Fredericos had no contact with Grumman prior to the accident and, indeed, their only contact with Grumman was through Mrs. Frederico’s employer. Similarly, at the time of the sale, the Fredericos were not identifiable claimants and could not have been notified of the release of their claims as required by due process and section 363(b). Further, even had the Fredericos received notice, the knowledge would have been meaningless as there would have been nothing for them to do with it. Consequently, the Fredericos did not hold a claim against Grumman at the time of the asset sale and the sale order did not release the rights of the Fredericos to sue Morgan.

Conclusion

This case should serve as a reminder to potential buyers that “free and clear” are not magic words absolving all types of liability. Purchasers of section 363 assets must still carefully consider the nature of products already in the stream of commerce and how those products may give rise to future liability. How to best account for this risk and whether this ruling will cause future reluctance on the part of potential buyers to enter into section 363 transactions remains to be seen. In the interim, however, buyers should continue to beware. ☺

Bankruptcy Court’s Solution to Revive a Plan Based on Failed Substantive Consolidation

By Jessica Marrero

In general, substantive consolidation allows for the assets and liabilities of affiliated debtor entities to be consolidated and disbursed as if the assets were held and the liabilities were owed by a single legal entity. Unlike joint administration, which promotes procedural convenience and efficiency without affecting the substantive rights of creditors, substantive consolidation can force creditors of a solvent debtor to share in the debtors’ aggregate asset pool in parity with creditors of less solvent debtors.

Because substantive consolidation can have a significant, adverse effect on the recovery of unsecured creditors, courts have fashioned a strict standard, primarily focused on creditor expectations, to warrant the remedy’s application. For example, in *In re Augie/Restivo Baking Co., Ltd.*, the Second Circuit articulated a two-fold, disjunctive test which considers “(i) whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit, or (ii) whether the affairs of the debtors are so entangled that consolidation will benefit all creditors.” In a recent decision, however, a bankruptcy court in the Southern District of New York indicated that in cases where substantive consolidation does not pose a threat to creditors’ rights, the strict *Augie/Restivo* standard may not apply.

In re Jennifer Convertibles

In *In re Jennifer Convertibles Inc.*, Case No. 10-13779 (Bankr. S.D.N.Y. Feb. 4, 2011), the Bankruptcy Court for the Southern District of New York was asked to confirm a plan based on the “deemed” substantive consolidation of the debtors’ estates. With an eye toward the practicalities and effects of consolidation under the proposed plan, the court provided a solution that allowed the debtors to confirm a substantive consolidation plan despite the debtors’ inability to demonstrate that substantive consolidation was warranted under the *Augie/Restivo* standard.

Background

One of the *Jennifer Convertibles* debtors, Hartsdale Convertibles, Inc. (“Hartsdale”), operated six full-line furniture stores under the Ashley Furniture HomeStore brand (the “Ashley Stores”). The debtors’ joint plan of reorganization was premised on a “deemed” substantive consolidation of the debtors’ estates, solely for purposes of voting, confirmation and making distributions under the plan. A primary supplier to the Ashley Stores along with its affiliate filed the only opposition to confirmation.

The debtors’ proposed consolidation affected only a small number of Hartsdale’s creditors — specifically, the deficiency created by the proposed substantive consolidation affected creditors of Hartsdale holding less than \$100,000 out of a total \$1.6 million in trade debt. The plan objectors maintained, *inter alia*, that the plan did not satisfy Bankruptcy Code section 1129(a)(3)’s

unscramble their finances, the debtors failed to introduce evidence that separate accounting was “impossible or detrimentally expensive to all creditors.” Despite the deficiency in the record, however, the court noted that substantive consolidation is a flexible concept, principally concerned with whether creditors are adversely affected by consolidation and, if so, whether the adverse effects can be eliminated.

Although most of Hartsdale’s large creditors would be unaffected by the plan’s contemplated substantive consolidation, the debtors failed to demonstrate that Ashley’s trade creditors would be treated appropriately as a consequence of the consolidation. While the court found no evidence that the debtors purposely sought to disadvantage Hartsdale’s creditors through the proposed consolidation, it determined that the plan failed to satisfy the “best interests of creditors” requirements under

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good faith requirement because the debtors sought substantive consolidation in order to disadvantage Hartsdale’s creditors. The plan objectors also asserted that the plan did not satisfy the “best interests test” of section 1129(a)(7), which requires that the creditors of each debtor receive at least what they would receive in a chapter 7 liquidation of the debtors’ estates. These objections as to the treatment of Hartsdale’s creditors under the plan were the only objections to the debtors’ substantive consolidation.

The Court’s Analysis and Holding

The *Jennifer Convertibles* court found that substantive consolidation was not justified under the *Augie/Restivo* standard. According to the court, the debtors did not introduce any evidence with regard to the first prong of the *Augie/Restivo* test as to the expectations of Hartsdale’s creditors in extending credit. In addition, the court recognized that while it would be difficult for the debtors to

section 1129(a)(7) with regard to the Hartsdale creditors. Moreover, the court reasoned that in the absence of proof that substantive consolidation was appropriate under the *Augie/Restivo* standard, a separate liquidation analysis would be necessary to establish that none of the trade creditors of Hartsdale would receive less under the plan than in liquidation pursuant to chapter 7.

The court did not end its analysis there, however. Rather, the court suggested that the debtors could cure this bar to confirmation in one of two ways. First, the debtors could provide payment in full to Hartsdale’s trade creditors and immediately confirm the plan as to all creditors, including those holding claims against Hartsdale. Alternatively, the debtors could supplement the record on the issue of substantive consolidation and submit a separate liquidation analysis for Hartsdale. Either option would promote the underlying purpose of substantive consolidation: ensuring the equitable treatment of creditors. */ continued page 20*

Substantive Consolidation

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Conclusion

Substantive consolidation is generally viewed as an extraordinary remedy and courts have been reluctant to order substantive consolidation except in very limited circumstances. A court, however, may consider the underlying rationale for the creditor protections embodied in the standard and relax that standard to permit substantive consolidation where those protections are not necessary or may be addressed in alternative ways. ☺

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