

INTERNATIONAL

# Restructuring NewsWire

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## Lessons to Be Learned from the Collapse of Amaranth

*by Adrian Harris and Mark Farrant*

### Introduction

This article deals with the collapse of Amaranth Advisors, LLC (“Amaranth”) and contains an evaluation of the legal and regulatory issues for OTC-traded energy derivatives following the U.S. Senate Permanent Subcommittee on Investigations’ Report “Excessive Speculation in the Natural Gas Market” published on 25th June 2007.

### Background

Amaranth was created in 2000 as a multi-strategy hedge fund, based in Greenwich, Connecticut. It began operations with approximately \$600 million in capital, using arbitrage trading strategies featuring in particular, convertible bonds, mergers and utilities. In 2002, Amaranth added energy commodity trading to its portfolio, employing several former Enron traders. JPMorgan Chase served as Amaranth’s clearing firm for its commodity

trades. During its early years, Amaranth generated excellent returns, exceeding 29% in 2001, 15% in 2002, and 21% in 2003.

In 2004, however, Amaranth was finding it increasingly difficult to maintain such high returns through its existing arbitrage strategies; Amaranth’s overall net return for 2004 was just over 3%. In mid-2004 Amaranth hired Brian Hunter as a natural gas trader, and as the convertible bond market continued to falter into 2005, Amaranth shifted more capital into energy trading, from a negligible fraction in mid-2004 to approximately 30% of its capital. Amaranth employed a variety of energy trading strategies, purchasing inexpensive deep out-of-the-money call options which paid off handsomely when natural gas prices spiked after Hurricanes Katrina and Rita, enabling Amaranth to buy very expensive natural gas futures contracts at a steep discount. The effect of these options and Amaranth’s other natural gas positions resulted in the domestic portfolio gaining 21% by 2005 year-end, with the energy positions accounting for 98% of profits. By early 2006, */ continued page 2*

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## Amaranth

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Amaranth had grown significantly, with approximately \$8 billion in assets under management and employing four hundred people on three continents.

However, Amaranth's success was to undergo a dramatic reversal. In September 2006, the natural gas market entered a period of extreme price volatility. Amaranth's positions lost \$2 billion in just three weeks and led to the liquidation of the fund's entire portfolio.

To what extent had Amaranth's own extreme trading activities created the price volatility that resulted in its spectacular collapse? Had such activities manipulated and increased natural gas prices for consumers, and how and why were such activities possible?

### Current U.S. Regulation of Energy Derivatives

The major organized commodity exchanges that trade standardized derivatives contracts for natural gas and other energy commodities in the U.S. are the New York Mercantile Exchange ("NYMEX") and the Intercontinental Exchange ("ICE"). NYMEX is a fully regulated futures exchange overseen by the Commodity Futures Trading Commission ("CFTC"), whereas ICE is an exchange which is virtually unregulated and operates largely

lated by the CFTC. In contrast, financial instruments that do not satisfy the definition are not required to be traded on a regulated exchange. This latter category is commonly referred to as the "over-the-counter" or "OTC" market. Like a futures contract, a commodity swap locks in the value of a commodity at a particular price. Unlike a futures contract, however, swaps do not involve the delivery of the commodity and were originally designed as a means to hedge positions against market fluctuations. ICE is now the leading exchange for the trading of energy commodity swaps in natural gas and electricity.

The ICE natural gas swap and the NYMEX natural gas futures contract perform the same economic functions, and the ICE swap contract provides that its final settlement price will equal the final settlement price of the NYMEX futures contract for the same month, which means that the final price for the two financial instruments will always be the same. The major difference is that the ICE swap is cash settled as opposed to being physically settled. The ICE swap is functionally equivalent, for risk management purposes, to the NYMEX natural gas futures contract, but is labeled by ICE as a "swap" rather than a futures contract.

Due to the provisions of the Commodity Futures Modernization Act of 2000 ("CFMA") often referred to as the "Enron loophole," electronic energy exchanges are exempt from

**ICE's exemption from regulatory oversight has undermined the effectiveness and market integrity of both ICE and NYMEX in pricing U.S. energy commodities.**

outside the oversight of the CFTC and the confines of the Commodity Exchange Act ("CEA"). The reason for this turns on whether a particular financial instrument falls within the definition of a "futures contract" under the CEA. Under the CEA, financial instruments that meet the statutory definition of a futures contract must be traded on a futures exchange regu-

this system of regulation. The result is that NYMEX is both self-regulated and regulated by the CFTC, whereas ICE is not required to be self-regulated and is not regulated by the CFTC. ICE's exemption from regulatory oversight has undermined the effectiveness and market integrity of both ICE and NYMEX in pricing U.S. energy commodities. This disparity in the regulation

of the two markets prevents the CFTC and the exchanges from fully analyzing market transactions, understanding trading patterns, and compiling accurate pictures of trader positions and market concentration; it requires them to make regulatory judgments on the basis of incomplete and inaccurate information and it impedes their authority to detect, prevent, and punish market manipulation and excessive speculation.

### Excessive Speculation in the Natural Gas Market and the Impact on Natural Gas Prices

It was against this backdrop that Amaranth was able to enter into a vast number of natural gas derivatives contracts without restriction and without having to report its position to the market regulators. Since the 2001 collapse of Enron, the Subcommittee has been examining the structure and operation of U.S. energy markets. In June 2006, the Subcommittee issued a bipartisan staff report, *"The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat"* analyzing the extent to which the increasing amount of financial speculation in energy markets has contributed to a steep rise in energy prices over the past few years. The report concluded: "Speculation has contributed to rising U.S. energy prices," but also that "gaps in available market data" made quantification of the speculative component problematic.

The Subcommittee's staff report recommended that the CFTC be provided with the same authority to regulate and monitor electronic energy exchanges, such as ICE, as it has with respect to the fully regulated futures markets such as NYMEX, to ensure that excessive speculation did not adversely affect the availability and affordability of vital energy commodities through unwarranted price increases. Congress has not taken any action since the publication of the report in 2006 (shortly before the collapse of Amaranth) to authorize CFTC to have oversight of unregulated energy markets like ICE. Amaranth's collapse in September 2006 led the Subcommittee to commission a special report in October 2006 entitled *"Excessive Speculation in the Natural Gas Market"* to examine why certain natural gas futures prices had remained so high in the face of above-average supplies and whether the large-scale trading conducted by Amaranth had contributed to those high prices. To conduct the investigation the Subcommittee subpoenaed natural gas trading records from NYMEX, ICE, and Amaranth and other traders. The Subcommittee's analysis of this trading data, which includes several million individual trades, indicates that the extreme levels of winter/summer price spreads were

driven by Amaranth's excessive speculative trading in natural gas contracts both on NYMEX and ICE, persisting over several months. The report was published on June 25, 2007.

The trading records examined by the Subcommittee disclosed that from early 2006 until its September collapse, Amaranth dominated trading in the U.S. natural gas financial markets, accumulating tens of thousands of natural gas positions on both NYMEX and ICE. The CFTC defines a "large trader" for reporting purposes in the natural gas market as one who holds at least 200 contracts; NYMEX examines a trader's position if it exceeds 12,000 natural gas contracts in any one month. Amaranth held as many as 100,000 natural gas contracts in a single month, representing some 5% of the natural gas used in the entire U.S. in a year. At times, Amaranth controlled 40% of all of the outstanding contracts on NYMEX for natural gas in the winter season, including as much as 75% of the outstanding contracts to deliver natural gas in November 2006. These large positions resulted in huge price spreads between the cost of delivery of natural gas in winter months as opposed to those in summer months.

In early 2006 it became clear that the effect of Hurricanes Katrina and Rita on natural gas supplies had dissipated. A warm winter meant that a large amount of natural gas remained in storage, indicating that there would be relatively high supply levels for the upcoming summer and the next heating season. Despite this, the price of natural gas in the futures markets remained extremely volatile, and the difference in spread between natural gas futures contracts for the next winter and the upcoming summer kept increasing. The paradox of unusually high winter/summer price spreads in the face of above-average supplies persisted throughout the summer and into early September. Then, in mid-September, the winter/summer price spreads suddenly collapsed. As these price spreads collapsed, so did Amaranth, the largest single trader in the natural gas markets.

Under current law, NYMEX is required to monitor the positions of its traders to determine whether a trader's positions are too large. If a trader's positions exceed pre-set "accountability levels," the exchange may require that trader to reduce its positions. Amaranth exposed two key flaws; firstly NYMEX has no routine access to information about a trader's positions on ICE in determining whether a trader's positions are too large, and secondly even if NYMEX orders a trader to reduce its positions on NYMEX, the trader can simply shift its positions to ICE where no limits apply. This is precisely

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## Amaranth

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what Amaranth did after NYMEX finally told Amaranth, in August 2006, to reduce its positions in two contracts nearing expiration, contracts to deliver gas in September and October 2006.

Some market observers have contended that Amaranth's collapse has proved that the energy markets are functioning well because Amaranth's demise did not effect other traders or the natural gas market as a whole. But the latest Subcommittee report contends that this notion is inaccurate; in fact, increased costs were passed onto end consumers by the utilities companies who were forced to pay inflated prices as a result of Amaranth's speculative trading activities. Amaranth accumulated such large positions and traded such large volumes of natural gas futures that it distorted market prices, widened price spreads, and increased price volatility.

### Conclusion

Since Enron, the regulatory status of OTC energy derivatives has been much debated. There is a growing movement in Congress to bring OTC energy derivatives under the control of the CFTC and within the remit of the CEA, in line with futures contracts, a movement which has intensified following the collapse of Amaranth. The Subcommittee's recently published report commissioned in the wake of Amaranth's collapse sets out a number of recommendations to change the current regulation of OTC energy derivatives. The report recommends that Congress should eliminate the "Enron Loophole" that exempts electronic energy exchanges from regulatory oversight, given that there is no sound rationale for such an exemption.

The report also recommends providing the CFTC with additional legal authority to monitor the aggregate positions on NYMEX and ICE to prevent excessive speculation for all of the months in which contracts are traded, not just for contracts near expiration. It goes on to say that Congress should also increase the CFTC budget and authorize CFTC user fees to help pay for the additional cost. This is necessary to provide the staff and technology necessary to monitor and analyze real-time transactional data from all U.S. commodity exchanges, including NYMEX and ICE.

It remains to be seen whether the above recommendations will be implemented. ☺

## Recent Decision Puts Added Disclosure Pressure on Unofficial Committees

*by David LeMay and Christy Rivera*

Earlier this year in the *Northwest* bankruptcy cases, the Bankruptcy Court for the Southern District of New York required an *ad hoc* equity committee of hedge funds and other investment entities (the "Ad Hoc Committee") to disclose details regarding each committee member's claims. Citing Bankruptcy Rule 2019, the court held that each member was required to disclose "the amounts of claims or interests owned by the members of the committee, the times when acquired, the amounts paid therefor, and any sale or other disposition thereof."

Rule 2019 provides that in a chapter 11 reorganization case, every entity or committee (other than an official committee) representing more than one creditor must file with the court a verified statement setting forth, among other things, (1) the name and address of the creditor or equity security holder, (2) the nature and amount of the claim or interest, (3) the time such claim or interest was acquired, and (4) any sales or dispositions thereof. The bankruptcy court can bar such committee or entity from participating in the bankruptcy case if it fails to comply with these disclosure requirements.

Rule 2019 disclosures help ensure that resolutions and ultimately a plan can be formulated free of "deception and overreaching." See *Northwest* decision dated February 26, 2007 (internal citation omitted). Unofficial committees often play leading roles in bankruptcy cases and these disclosures allow individual creditors to determine whether such committees are acting on their behalf, *i.e.*, whether the committee's claims and interests align with those of the individual creditor. See *Northwest* decision dated March 9, 2007 (prohibiting *ad hoc* committee members from filing the 2019 statements under seal).

In the *Northwest* cases, the Ad Hoc Committee was seeking the appointment of an official equity committee. The debtors, who vigorously opposed such appointment, moved to require the Ad Hoc Committee to supplement its 2019 statement with more detailed information about their claims than had been provided in two prior filings.

The Ad Hoc Committee argued that the language of Rule 2019 was limited in scope, applying only to its counsel, rather than each committee member. The Court rejected this argument and

granted the debtors' request. Ultimately nine of the Ad Hoc Committee members filed the required disclosures.

Some investors believe the *Northwest* decision will chill distressed investors' readiness to band together to take leading roles in future bankruptcy cases (which is often the case in order to defray costs and to present a stronger position). If a committee becomes embroiled in litigation, its opponent may, as a litigation tactic, try to sidetrack the committee by seeking information under Rule 2019. Indeed, the *Northwest* debtors' motion seeking more detailed claim information pursuant to Rule 2019 was clearly a litigation tactic to stall or halt the Ad Hoc Committee's actions.

However, another court has applied Rule 2019 less stringently. In the *Scotia Development LLC* bankruptcy case currently pending in the Bankruptcy Court for the Southern District of Texas, the debtor filed a motion to compel an ad hoc committee of noteholders to file a 2019 statement with detailed claim information. Noting that it had "been forced to expend considerable time and resources in responding to the [committee's] patently absurd pleadings and 'hard line' positions on everything from the character of [debtor's] business to [debtor's] request for a financial advisor," the debtor requested that the court refuse to further hear the committee unless and until a 2019 statement was filed.

The *Scotia Development* court, however, refused to grant the requested relief, ruling that the individual members of a group of noteholders did not need to individually disclose the information referenced in Rule 2019 as the group did not constitute an actual unofficial committee but was only a "bunch of creditors" represented by a law firm.

In several other cases, ad hoc committees have reached settlements with entities seeking further disclosure under Rule 2019 which allowed them to avoid the disclosures or to file the disclosures under seal. In *In re Barney's, Inc.*, a creditor involved in litigation with an ad hoc committee filed a motion to deny the committee the right to be heard pending its compliance with Rule 2019. The parties ultimately reached a settlement which allowed the ad hoc committee to avoid detailed disclosure. (David LeMay of this office was centrally involved in the *Barney's* litigation and ultimate settlement.) In *In re Mirant Corp.*, the ad hoc committee reached a settlement allowing them to file the requested disclosures under seal with the court.

The *Scotia Development* decision and settlements notwithstanding, the lesson from *Northwest* is that even when Rule 2019 is invoked as a litigation tactic, courts applying Rule 2019

literally may require very broad disclosures from members of *ad hoc* committees. If settlement is not possible, ad hoc committee members may be hard-pressed in many courts to avoid disclosure through a technical or a policy argument.

The disclosure concept embodied in Rule 2019 was first adopted in the 1930s and, in light of the changing dynamic of creditors in bankruptcy cases, it may be time to revisit Rule 2019 to reconcile its original Depression-era goals of disclosure with the complexities present in today's bankruptcy cases involving hedge funds and other major investment and financial institutions. ☺

## Limitations on the Definition of "Swap Agreements" for Purposes of the Safe Harbor Provisions in the Bankruptcy Code

by Seven Rivera

In *National Gas Distributors, LLC v Smithfield Packing Company, Inc.*, Adv. No. 06-267, 2007 WL 1531616 (Bankr. E.D.N.C. May 24, 2007), the United States Bankruptcy Court for the Eastern District of North Carolina was faced with the question of whether a creditor could avoid preference and fraudulent conveyance liability by classifying its natural gas supply contract as a "swap agreement" as that term is defined in the Bankruptcy Code. Swap agreements are protected from the reach of the estate in preference and fraudulent transfer actions by certain "safe harbor" provisions included in the Bankruptcy Code.

After reviewing the terms of the contracts at issue as well as the Congressional intent behind the creation of the swap agreement safe harbor provisions, the bankruptcy court ruled that simple supply contracts between two entities are not the type of agreements that Congress intended to protect. The safe harbor provisions for swap agreements are intended to prevent wide ranging financial market disruption and instability, not to prevent a trustee from recovering assets from an individual natural gas consumer.

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## Bankruptcy Code

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### Background

National Gas Distributors, LLC (“National Gas”) filed a petition for relief under Chapter 11 of the Bankruptcy Code on January 20, 2006. Shortly thereafter, the bankruptcy court appointed a chapter 11 trustee to administer the estate. As part of its role as administrator of the estate, the trustee filed complaints against more than 20 former customers of National Gas, including the defendant Smithfield Packing Company, Inc. (“Smithfield”). The complaints filed by the trustee sought to avoid, pursuant to sections 548(a)(1)(A) and (a)(1)(B) of the Bankruptcy Code, transfers made by the debtor, and to recover those transfers from the defendants pursuant to section 550(a)(1) of the Bankruptcy Code. Smithfield and two of the other defendants filed motions to dismiss the complaints and the court heard all three motions together.

The primary gist of the complaints filed by the trustee was

is subject to avoidance pursuant to section 548(a)(1)(B) of the Bankruptcy Code.

Smithfield responded with an affirmative defense stating that the transfers were not avoidable “because such transfers were made by or to a swap participant under or in connection with swap agreements before the commencement of the case, and the transfers are therefore excepted from avoidance pursuant to section 546(g) of the Bankruptcy Code.” Section 546(g) of the Bankruptcy Code is one of the so-called “safe harbor” provisions which protect swap agreements from avoidance or recovery by the estate. Smithfield then filed a motion to dismiss the complaint.

### Bankruptcy Court Ruling

The bankruptcy court examined the natural gas contracts at issue and the definition of “swap agreements” under the safe harbor statutes. Pursuant to section 101(53B)(A)(i)(VII) of the Bankruptcy Code, a swap agreement includes “a commodity index or a commodity swap, option, future or forward agree-

## The court confirmed the importance of protecting the financial markets even at the expense of creditors and the estate.

that National Gas sold natural gas to some of its customers, including the defendants, at below market prices as part of a fraudulent scheme. With respect to Smithfield, the complaint alleged that the losses resulting from the below market prices totaled approximately \$2.1 million. The trustee alleged that the below market sales were made by National Gas with the deliberate intent to hinder, delay and defraud creditors which would indicate actual fraud and support avoidance of the transfers pursuant to section 548(a)(1)(A) of the Bankruptcy Code.

The trustee also alleged that National Gas was insolvent at the time of the transfers and National Gas did not receive reasonably equivalent value for the transfers because they were made at below market price. Such facts, argued the trustee, constitute the elements of a constructively fraudulent transfer that

ment.” Smithfield argued that its contract to purchase natural gas constituted a swap agreement because its contract was a commodity forward contract (it was based on future delivery of gas at an agreed upon price, with a settlement provision for any price changes between the original payment date and the delivery date, and natural gas is a commodity). While the court’s opinion uses several pages to parse through the various statutory provisions and relevant legislative history in order to try to confirm Smithfield’s simplistic articulation of the issue, in the end it is the legislative intent behind the creation of the safe harbor provisions for swap agreements that sways the court.

The court found that Congress intended the definition of swap agreement to be broad in order to encompass the increasingly complicated and creative expansion of the swap market

without requiring repeated amendments to the Bankruptcy Code as new products and instruments are created. This broad definition, however, was not intended to encompass traditional commercial arrangements such as supply agreements that do not take place in the context of the greater swap market. The court recognized that the safe harbor provisions were created to protect the financial markets because the unraveling of certain broadly traded financial contracts could destabilize the market and create a domino effect. In such instances, it is appropriate to protect transfers which would otherwise result in assets which would go to the estate for the benefit of creditors. However, the court held that it is inappropriate to subjugate the interests of the estate and its creditors in situations involving simple supply contracts which do not involve greater market implications. The court finished by noting a principle of interpretation which was recently emphasized by the United States Supreme Court in *Howard Delivery Serv., Inc. v. Zurich American Ins. Co.*, 126 S.Ct. 2105 (2006), which states that, “any doubt concerning the appropriate characterization . . . is best resolved in accord with the Bankruptcy Court’s equal distribution aim.” The Court held that protecting the trustee’s full range of statutory avoidance powers is in line with both the Bankruptcy Code’s goal of equal distribution and the “complimentary principle that preferential treatment of a class of creditors is in order only when clearly authorized by Congress.”

### Analysis

This case is an important articulation of the limits to the safe harbor provisions that protect swap agreements. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended the Bankruptcy Code and expanded the definition of swap agreements for purposes of the safe harbor provisions. The *National Gas* case is one of the first to test the limits of the expanded definition. As a result, it has been closely watched by participants in the swap market. In fact, the International Swaps and Derivatives Association, Inc. filed an *amicus curiae* brief in support of Smithfield’s position.

While the court did not rule in favor of Smithfield, it did endorse the expanded scope of the safe harbor provisions and confirmed the importance of protecting the financial markets even at the expense of creditors and the estate. As noted by the court, the swap market is constantly expanding and evolving and the safe harbor provisions need to be flexible and broad enough to encompass this evolution. Smithfield’s contract, however, simply did not implicate the greater financial market con-

cerns recognized by Congress. Therefore, based upon the ruling of this case, if a party to a contract with the debtor wishes to avail itself of the safe harbor provisions of the Bankruptcy Code by, for example, terminating the contract upon the bankruptcy of its counterparty, but there is a question as to whether the contract fits within the definition of a swap agreement or a forward contract, careful consideration should be given to the contract’s connection with the greater swap market as a whole, as well as the basic elements of the transaction. ☺

## A Tip for Lenders When Drafting Make-Whole Provisions

by Andrew Rosenblatt

In order to ensure an expected rate of return and compensation for the use of their funds, lenders often require that loan instruments contain so-called “lock-out” provisions that prohibit a borrower from prepaying a loan before a specified date. Another common practice by lenders is to permit prepayment before a stated maturity date but to require that the borrower pay a premium, commonly referred to as a “make-whole” payment. It is not uncommon for a loan instrument to contain both a lock-out provision as well as a make-whole provision. For example, a loan instrument with a ten year stated maturity date might provide that the borrower may not make any prepayments before the third anniversary of the loan, but may make prepayments thereafter upon the payment of a 2% make-whole premium. Although these provisions may be generally enforceable outside of bankruptcy, their effectiveness in bankruptcy may be limited.

As a general rule, lock-out provisions that purport to prohibit the prepayment of debt are unenforceable in chapter 11 cases. The rationale is that prohibiting prepayment of debt would hinder a debtor’s ability to restructure its debt and, therefore, would be contrary to the primary objectives of chapter 11, which is the reorganization and rehabilitation of the debtor. In addition, invalidating prepayment restrictions gives a debtor the freedom to, among other things, refinance debt for the benefit of the estate as a whole (*e.g.*, use borrowed funds that may carry a lower interest rate to retire already existing debt with a higher interest rate).

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## Make-Whole Provisions

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Contrary to lock-out provisions, make-whole provisions are generally thought to be enforceable in bankruptcy cases unless they are deemed to be a penalty or if equitable considerations warrant their denial. Therefore, if a debtor intends to pay off an existing loan prior to maturity, it may have to comply with a make-whole provision set forth in the loan documents.

A recent dispute in the *In re Calpine Corp. et al.* (“Calpine”) bankruptcy cases highlights the importance of ensuring that a make-whole provision is properly drafted, especially when it exists in conjunction with a lock-out provision. In the *Calpine* case, the debtors sought to refinance their post-petition financing facility and to use the proceeds to pay down approximately \$2.516 billion of Calpine Generating Company, LLC (“CalGen”) secured debt, including the payment in full of certain first lien notes (the “Notes”) issued by Calgen. The Notes matured in 2009. The credit agreement (the “Credit Agreement”) pursuant to which the Notes were issued contained a lock-out provision prohibiting prepayment of the Notes prior to April 1, 2007. After April 1, the Credit Agreement permitted prepayment of the Notes upon the payment of a 2-1/2% make-whole premium on all principal amounts repaid (the “Make-Whole Premium”).

Notwithstanding these provisions, the debtors sought to prepay the Notes in full during the lock-out period without paying the Make-Whole Premium or otherwise compensating the lenders for the proposed prepayment. The debtors argued that the lock-out provision was unenforceable as a matter of law and that the make-whole provision did not apply to prepayments made during the lock-out period. Various parties in interest objected, arguing, *inter alia*, that the debtors’ technical reading of the Credit Agreement was inequitable and that the lenders were entitled to compensation for any prepayments made during the lock-out period.

The bankruptcy court ultimately ruled that although the lock-out provision set forth in the Credit Agreement was not specifically enforceable, the lenders were nevertheless entitled to damages as a result of the debtors’ breach of that provision. To be clear, the bankruptcy court did not find the lock-out provision to be invalid, but merely refused to grant specific performance in enforcing the provision against the debtors. In this case, the bankruptcy court used the make-whole premium as a reasonable measure of damages to award the lenders.

Despite the favorable verdict for the lenders, it is important to keep in mind that the bankruptcy court held that the lock-out

provision was unenforceable. The court also refused to expand the scope of the make-whole provision by adopting a literal reading of the Credit Agreement. The bankruptcy court noted that the language of the Credit Agreement (and other related loan documents) was “antiquated” and failed to include “some up-to-date commonly found [lender] protective provisions.” Specifically, the bankruptcy court noted that the loan documents should have provided for the Make-Whole Premium to apply *during the lock-out period* or upon repayment in response to the acceleration of the underlying loan.

It is worth noting that the contract damage claim awarded to the lenders was treated as an unsecured claim, as opposed to being included as part of the lenders’ secured claim (which the Make-Whole Premium would have been under section 506(b) of the Bankruptcy Code). Although in *Calpine*, where, according to the debtors’ recently filed disclosure statement, unsecured creditors are expected to recover the full or close to the full amount of their claims, this might not be material, in most cases there is often a significant difference between recoveries for unsecured creditors and secured creditors.

In short, lenders should take heed of the bankruptcy court’s decision in *Calpine* and not rely on the enforceability of a lock-out provision when drafting a make-whole provision. To the contrary, lenders should insist that make-whole premiums take effect whenever the underlying debt is prepaid, even if prepayment occurs during a lock-out period. This simple drafting tip may save lenders needless litigation and enhance their bankruptcy claims. ☺

## Litigation Funding — The New Kid on the Block?

*by Adrian Harris*

With the current turmoil in the credit markets spilling over into equities and other asset classes, investors are frantically re-pricing risk and de-leveraging their balance sheets. A wholesale liquidity squeeze is underway. Market sentiment holds that there is a lot more to come as the full effects of the losses from U.S. sub-prime mortgage bets, which were originally thought to be contained within the U.S., leak out and take their toll on investors in other parts of the world.

Investors have reacted with a flight to quality and increased

liquidity driven in part by the need for some funds to meet upcoming redemption calls, hence, for example, the recent surge of activity in short term Treasury bills. Perhaps this bodes well for a relatively new form of investment in the UK — litigation funding, where investors provide financial support to a party involved in litigation in return for a share of the spoils should that litigant turn out to be successful in its claim. Not exactly a safe haven but an alternative form of investment, which for some has the right risk/return metrics and is free of the whirling blades of volatile markets.

“Maintenance” — the giving of assistance or encouragement to one of the parties to litigation by a person who has neither an interest in the litigation nor any other motive recognized by law as justifying his interference and “Champerty” — a particular kind of maintenance which involves the maintenance of an action in consideration of a promise to give the maintainer a share in the proceeds or subject matter of the action used to be prohibited under English law save for a few limited exceptions in insolvency situations where, for example, liquidators could assign a company’s causes of action in return for a share in the recoveries.

These very old rules were originally introduced to prevent the courts becoming used by financial speculators to prosecute vexatious or oppressive law suits. However, a legislative change introduced in 1995 allowed lawyers to enter into conditional fee arrangements with their clients so as to enable those without the financial means to engage in litigation, to have access to the courts, particularly in light of the reduction in availability of legal aid. The availability of justice to all became one of the main drivers of the more relaxed approach by the English courts to litigation funding.

So how does this work? The business model was developed in Australia long before it started to get a foothold in the UK. The initial focus there was on insolvency cases but funding arrangements soon extended into large commercial claims with no particular insolvency context. There are five litigation funding companies in operation in Australia with the best known, IMF, being publicly quoted. In the UK, IM Litigation Funding has developed the model and is involved in a number of cases, including a high profile £90 million claim by creditors of a failed company called Stone & Rolls against the accountancy firm, Moore Stephens.

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CHADBOURNE  
& PARKE LLP

Briefing

*Invitation to a Briefing*

**The Coming Wave . . .**

*What the Turmoil in the Credit Markets Means - and What to Expect in 2008*

**Wednesday, October 24, 2007**  
**4:00 pm**  
*(Followed by a cocktail reception)*

Chadbourne & Parke LLP  
30 Rockefeller Plaza, 36th Floor  
New York, NY 10112

To register, please visit  
[www.chadbourne.com/events/2007/creditmarkets](http://www.chadbourne.com/events/2007/creditmarkets)

Please join us as a panel of experts discusses the recent dramatic changes in the credit markets, how those changes have affected the U.S. and international restructuring landscapes, and the anticipated practical and legal effects of the credit crunch.

The program will begin with introductory remarks from **The Honorable George E. Pataki**, former Governor of New York, who will speak about some of the public policy issues raised by the current turmoil in the markets.

The panel will then cover these fast-moving developments and how they will affect borrowers and lenders (both hedge fund and institutional agents and lenders) in the months to come.

The program promises to be educational, entertaining, and provocative.

*New York CLE credit available - 1.5 hours.*

**Introductory Remarks by  
The Honorable George E. Pataki,  
former Governor of New York and now  
Counsel at Chadbourne & Parke LLP**

**Speakers**

**Patrick Collins**  
*Senior Vice President  
Head of Special Situations Private Equity  
D.E. Shaw & Company*

**Anthony Murphy**  
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**Eric Siegart**  
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**Leon Szlezinger**  
*Senior Managing Director  
Mesirow Financial Consulting, LLC*

**Adrian Harris**  
*Partner  
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**Joseph H. Smolinsky**  
*Partner  
Chadbourne & Parke LLP*

**Howard Seife** - Moderator  
*Partner  
Chadbourne & Parke LLP*

## Litigation Funding

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Companies like IM Litigation Funding not only invest themselves but attract banks and hedge funds to co-invest. They focus on cases where the defendant has the means to pay and there is at least a 70% chance of success, assessed by litigation experts. To cover the possible downside of the case going against them, insurance cover is normally taken out to deal with the other party's costs in the litigation if there is a costs award against the plaintiff. However, professional funders need to avoid influencing how the claim is run, otherwise they run the risk of sanction by the courts as their actions could be seen as an abuse of process purely for financial gain.

Although any lawyer will tell you that the one certain thing about litigation is that the likely outcome is never certain, the risk/reward metrics are clearly sufficiently attractive to make this a realistic investment option for a growing number of investors looking for above average returns. ☺

# When Bankruptcy Policy Considerations May Limit Traditional Notions of Joint and Several Liability

*by Andrew Rosenblatt*

In *National Energy & Gas Transmission, Inc., et al. v. Liberty Power, LLC, et al.*, 2007 U.S. App. LEXIS 16263 (4th Cir. 2007), the United States Court of Appeals for the Fourth Circuit was faced with the question of whether a creditor may allocate funds received from a non-debtor guarantor in such a way as to preserve a larger claim against the debtor obligor.

Based on equitable considerations and general bankruptcy policies, the Fourth Circuit reversed the lower courts and held that the payment from a non-debtor guarantor must be allocated in such a way so that a debtor obligor's liability in its bankruptcy case is mitigated.

## Background

On July 8, 2003, National Energy & Gas Transmission Energy Trading Power L.P. ("ET Power") filed a petition for relief under

Chapter 11 of the Bankruptcy Code. Before filing for bankruptcy, ET Power had entered into an electricity tolling agreement (the "Tolling Agreement") with Liberty Electric Power LLC ("Liberty"), pursuant to which ET Power obtained an option to purchase energy from Liberty in exchange for monthly payments to Liberty. To backstop ET Power's payment obligations under the Tolling Agreement, Liberty obtained two guarantees from affiliates of ET Power. One guaranty was provided by National Energy & Gas Transmission, Inc. ("NEGT"), which later filed its own petition for bankruptcy relief with ET Power, and the other guaranty was provided by non-debtor Gas Transmission Northwest Corporation ("GTN"). The guarantees covered all amounts owed by ET Power under the Tolling Agreement, including any "Termination Payment" as well as any damage awards arising by reason of ET Power's breach. Each guarantor's liability was capped at \$140 million.

Upon filing bankruptcy, ET Power filed a motion to reject the Tolling Agreement, which, with Liberty's consent, the Bankruptcy Court granted. As a result of the rejection, Liberty sought, among other amounts, \$140 million as a termination payment. Liberty's claim proceeded to arbitration pursuant to the terms of the Tolling Agreement, and an arbitration panel awarded Liberty the full \$140 million, plus interest accruing from the date of rejection of the Tolling Agreement.

Following the issuance of the arbitration award, non-debtor GTN paid \$140 million to Liberty in full satisfaction of GTN's guarantee. Liberty's claim for accrued interest of approximately \$17 million was not paid. Liberty allocated GTN's \$140 million first to interest, then to principal — leaving an outstanding balance of approximately \$17 million in unpaid principal. Liberty sought to recover the balance of this claim against ET Power by asserting a claim in the full amount of \$140 million on the basis that ET Power remained jointly and severally liable until Liberty received full payment of the total debt.

The debtors objected to Liberty's claim, arguing, among other things, that the \$17 million that Liberty sought to collect constituted post-petition interest which is not recoverable under section 502(b)(2) of the Bankruptcy Code. That section provides that a claim shall not be allowed "to the extent that...[it] is for unmatu- red interest[.]".

## Fourth Circuit Ruling

Based on equitable principles — including the concept of ratable distributions of assets among creditors — the Fourth Circuit held that section 502(b)(2) of the Bankruptcy Code prevented

Liberty from collecting the \$17 million from ET Power, despite Liberty's characterization of that amount as principal. The Fourth Circuit reasoned that, as of the petition date, Liberty's damage claim against ET Power was \$140 million and that Liberty could not collect any additional amounts based on the accrual of interest. The Fourth Circuit held that "[t]his result is not altered simply because Liberty holds a guarantee from a non-debtor third party."

The Fourth Circuit rejected Liberty's argument that bankruptcy proceedings cannot affect the liability of a non-debtor on a debt. Liberty had argued that preventing it from collecting the \$17 million would essentially relieve GTN of its obligation to pay interest. The Fourth Circuit disagreed, finding that Liberty was free to pursue the full amount of its claim (including interest) against GTN to the extent permitted under the guarantee and non-bankruptcy law. The Fourth Circuit clarified that it was merely holding that Liberty may not affect the rights of a party in bankruptcy by its classification of a payment received from a non-debtor guarantor.

It is worth noting that, in a dissenting opinion, Judge Duncan adopted Liberty's argument, stating that the Fourth Circuit's ruling "has the effect of limiting the non-debtor guarantor's liability for interest accruing after the debtor's bankruptcy petition." This result, according to Judge Duncan, is contrary to the basic principle of contract law that a creditor is entitled to be paid in full, including interest, by its jointly and severally liable debtors.

## Analysis

The Fourth Circuit opinion should not be construed to suggest that limitations applicable to claims against a debtor will limit the liability of a non-debtor guarantor. As described above, the Fourth Circuit noted that if GTN's liability was unlimited, Liberty could have collected the full value of its claim from GTN.

Nevertheless, the case clearly stands for the proposition that a limited guarantee (*i.e.*, a guarantee that covers less than the full liability) must be applied in such a way so as to mitigate a debtor's liability. Stated another way, the proceeds of a limited guarantee must first be applied against that portion of the underlying claim that is recoverable against the debtor, thus reducing the debtor's liability.

Although the Fourth Circuit's ruling has the effect of diminishing the amount of a creditor's recovery against a primary obligor who later files for bankruptcy in the case where there is a limited guarantee, what is not clear from the ruling is whether the court's decision would have been different had the Tolling

Agreement or guaranty itself provided that the proceeds of the guaranty would be applied to interest before principal debt. Although it has yet to be determined whether parties can contract around this issue, in order to preserve this argument, it is advisable for parties to specify in their agreements exactly how the proceeds of a limited guarantee are to be applied (*i.e.*, first to pay expenses, then interest, then principal debt). ☺

# Under“standing” a Creditor’s Rights to Bring Actions Against Corporate Officers and Directors

*by Christy Rivera*

Earlier this year, the Supreme Court of Delaware clarified the standing of creditors to assert claims against corporate directors for breaches of fiduciary duties while the corporation is either insolvent or operating in the zone of insolvency. As described below, the court held that creditors do not have standing to assert a direct claim but may only assert a derivative claim for breaches of fiduciary duties.

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla (NACEPF)*, Case No. 521,2006, 2007 WL 1453705 (Del. May 18, 2007), a creditor had waived its right to assert derivative claims against corporate directors for breach of fiduciary duties and asserted instead direct claims against such directors for allegedly (i) failing to preserve assets of the corporation while it was operating in the zone of insolvency and (ii) failing to release the creditor from certain contractual obligations when it was clear the corporation no longer intended to utilize the benefits provided by such contract.

In dismissing the creditor's claims, the *NACEPF* court held that individual creditors of an insolvent corporation, as a matter of law, have no right to assert direct claims for breach of fiduciary duty against corporate directors of insolvent corporations. Nonetheless, the court noted that creditors may protect their interests by asserting (i) derivative claims on behalf of the insolvent corporation or (ii) any other direct nonfiduciary claims that may be available to them.

In the past, courts have held that, when / *continued page 12*

## Creditor's Rights

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brought by shareholders or creditors, claims for breach of fiduciary duties against corporate directors must be derivative claims. Whether it is shareholders or creditors who have standing to assert such derivative claims is based on the corporation's solvency. It is well settled that when a corporation is solvent, directors' fiduciary duties to the corporation are for the benefit of the corporation's shareholders, *Agostino v. Hicks*, 845 A.2d 1110, 1122 (Del. Ch. 2004) (citing cases), and standing to assert derivative claims for breach of fiduciary duty against corporate directors at that time is held by shareholders.

On the other hand, when a corporation operates in the zone of insolvency or becomes insolvent, directors' fiduciary duties to the corporation shift such that they benefit the corporation's creditors. *Credit Lyonnais Bank Nederland N.V. v. MGM-Pathe Comm. Corp.* and subsequent cases have held that that the scope of directors' fiduciary duties extend to protect the interests of a corporation's creditors while the corporation is operating in the zone of insolvency or insolvent. See *Credit Lyonnais Bank Nederland N.V. v. MGM-Pathe Comm. Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del.Ch. December 30, 1991); *Geyer v. Ingersoll Pubs. Co.*, 621 A.2d 784, 787-91 (Del.Ch.1992); *Prod. Res. Group v. NCT Group, Inc.*, 863 A.2d 772, 789 (Del. Ch. 2004) (citing cases).

A 2004 decision by the Delaware Court of Chancery in *Prod. Res. Group v. NCT Group, Inc.*, 863 A.2d 772, made the logical conclusion left unsaid by *Credit Lyonnais* and gave creditors standing to assert derivative claims against corporate directors. It only makes sense that creditors should replace shareholders with respect to standing in pursuing derivative claims against directors for breaches of fiduciary duties when the creditors, not shareholders, are the beneficiaries of those duties. However, the *Production Resources* court refused to rule out the possibility that a creditor in certain circumstances could have a direct claim against directors for breaches of their duties.

This was the question answered by the NACEPF court — it clearly held that regardless of directors' conduct, a creditor does not have a right to assert a direct claim against corporate directors for a breach of fiduciary duty in the insolvency context. Creditors have the same — no more or less — rights against directors with respect to fiduciary duty breaches, once they step into the shoes of shareholders.

With more aggressive and litigious creditors playing larger roles in bankruptcy cases, it is important to note that such creditors will not be able to pursue these types of actions against directors for their sole benefit. Instead, in today's current legal landscape, any claim brought by such creditor must be brought derivatively for the benefit of the bankruptcy estate, which will ensure that all creditors share in any litigation proceeds. ☺

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