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Lehman Brothers: Limiting the Safe Harbors

By Christy Rivera and Bonnie Dye

Generally, the Bankruptcy Code invalidates clauses ("ipso facto clauses") within a debtor's contract that are triggered by a financial condition of the debtor or a bankruptcy filing. In deference to the financial markets, however, the Bankruptcy Code provides certain "safe harbor" provisions, which allow qualifying counterparties to derivatives contracts (such as swaps, repos, commodities and forward contracts) to terminate, liquidate, or accelerate these contracts based on what would otherwise be unenforceable ipso facto clauses. These "safe harbor" provisions are intended to limit the ripples in the financial markets if a large financial institution, party to many of these contracts, files for bankruptcy.

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As one of the largest, most complex bankruptcy cases ever filed, the Lehman Brothers chapter 11 case is providing many test cases to determine the scope of these "safe harbor" provisions. The bankruptcy filing of Lehman Brothers Holdings Inc. ("Holdings") on September 15, 2008 triggered events of defaults on thousands of derivatives contracts, as did the subsequent bankruptcy filing of Lehman Brothers Special Financing ("LBSF"), the Lehman subsidiary party to the majority of these contracts.

Disputes have arisen in connection with a number of these derivatives contracts, some of which were terminated upon the Lehman bankruptcy filings and others of which were not. Two of these disputes have been adjudicated by the bankruptcy court and, as seen below, the bankruptcy court in both cases has interpreted the safe harbor provisions in a manner which has favored Lehman and limited the relief available to counterparties to derivatives contracts.

The Metavante Decision

Many counterparties out of the money under their contracts with Lehman at the time of the bankruptcy filings did not terminate their contracts, and instead chose to wait and see if their positions under their contracts would improve over time.

One of the parties that chose this "wait and see" approach was Metavante Corporation ("Metavante"). Metavante had entered into an interest rate swap with LBSF in December 2007 in order to hedge its exposure under a $1.75 billion loan. Metavante */ continued page 2*

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was required to make quarterly payments to LBSF based on the product of a fixed interest rate (3.865%) and a notional amount of $600 million, which decreased over the life of the swap, whereas LBSF was required to make quarterly payments to Metavante based on the product of a floating interest rate (the 3-month USD-LIBOR-BBA rate) and the same decreased notional amount. Due to the low interest rates at the time the Lehman entities filed for bankruptcy, Metavante was out of the money on its swap and did not choose to terminate the swap, even though the bankruptcy filing of both Holdings, as credit provider, and LBSF, as counterparty, triggered events of default.

Although the swap was not terminated, Metavante stopped making quarterly payments to LBSF under the swap, asserting that (a) the bankruptcy filing of Holdings constituted an event of default thereunder, and (b) Section 2(a)(iii) of the ISDA Master Agreement provided for the suspension of payments when an event of default occurred and was continuing.

In the summer of 2009, Lehman filed a motion in the bankruptcy court seeking to compel Metavante to perform its obligations under the swap and to make quarterly payments when due. Lehman argued that relief under the safe harbor provisions is available only to counterparties that seek to terminate, liquidate, or accelerate their contracts with LBSF. Metavante had taken none of these actions. The bankruptcy court agreed with Lehman and in September 2009 held that Metavante was required to make quarterly payments to LBSF under the swap. The court observed that Metavante's withholding of payments did not fall within the scope of actions protected by the safe harbor provisions and, as such, Metavante was not permitted to enforce its rights under Section 2(a)(iii) of the ISDA Master Agreement because those rights were triggered by an event of default (bankruptcy filing) that was an invalid ipso facto clause.

Another interesting aspect of the bankruptcy court's ruling, though, was its imposition of a time limit on a counterparty's right to seek relief under the safe harbor provisions. Although not asked to rule on the issue, the bankruptcy court stated that Metavante waived its rights under the safe harbor provisions and, even if Metavante now wished to do so, it would no longer be permitted to terminate, liquidate, or accelerate its swap with LBSF. The bankruptcy court stated that "while [Metavante] may not have had the obligation to terminate immediately upon the filing of Holdings or LBSF, its failure to do so, at this juncture, constitutes a waiver of that right at this point." (September 15, 2009 Transcript, pp. 111-112.)

Metavante appealed, but it was recently announced that the parties have reached a settlement for which they will seek bankruptcy court approval in April. The bankruptcy decision remains in place, and it strictly limits the scope of protection provided by the safe harbor provisions to the actions stated therein and admonishes counterparties to not delay if they wish to avail themselves of those actions falling with the scope of the safe harbor provisions.

The Dante Decision

In a second decision, on January 25, 2010, the bankruptcy court again ruled in favor of a more narrow application of the safe harbor provisions. At issue was whether LBSF or third party investors had priority to collateral, which secured certain series of credit-linked synthetic portfolio notes. The notes were issued by a special purpose entity called Saphir, as part of a multi-issuer secured obligation program. This program is governed by a Principal Trust Deed between BNY Corporate Trustee Services Ltd. ("BNY"), as the current trustee, and Dante Finance Public Limited Company ("Dante"). Each series of notes issued under the program is also governed by a Supplemental Trust Deed, and the Supplemental Trust Deed references a swap between LBSF and Saphir. The Supplement Trust Deed contains a "flip clause" — LBSF has priority to the collateral securing the notes unless there is an event of default under the swap. In that instance, the noteholders are then given priority with respect to the collateral. The bankruptcy filings of Holdings and LBSF each constituted an event of default under the swaps.

A few months after Holdings and LBSF filed for bankruptcy, Saphir sent notices to LBSF terminating the swaps, designating the LBSF bankruptcy filing as the event of default and asserting that December 1, 2008 was the Early Termination Date under the relevant ISDA Master Agreements. Under the terms of the Principal Trust Deed, this termination obligated Saphir to redeem the notes.

English Litigation

Perpetual Trustee Company Limited, one of the noteholders, filed suit against BNY in the High Court of Justice, Chancery Division (the "High Court"), asserting priority with respect to the collateral pursuant to the flip clause. LBSF intervened in the litigation and challenged the enforceability of the flip clause under English law, which governed the transaction. Ultimately, the High Court held that (a) the Holdings bankruptcy filing triggered application of the flip clause and noteholder priority as well as the calculation of a subordinated Early Termination

Payment to LBSF which was subordinated pursuant to Condition 44 of the terms and conditions of the notes ("Condition 44") and (b) the application of the flip clause was independent of Saphir's early termination of the swaps. The Court of Appeal, Civil Division, in the United Kingdom, affirmed the High Court's decision.

U.S. Bankruptcy Litigation

While the English litigation was still pending, LBSF commenced an adversary proceeding in the bankruptcy court against BNY, seeking a declaratory judgment (a) that the event of default based on LBSF's bankruptcy filing was an unenforceable ipso facto clause and therefore the flip clause (enabling LBSF to retain its right to receive priority payments under the swaps) was not triggered and (b) subordination of LBSF's rights to the collateral as a result of its bankruptcy filing violated the automatic stay under section 362 of the Bankruptcy Code.

LBSF and BNY both filed summary judgment motions. In reply to the relief sought, BNY argued that because the various transaction documents were governed by English law, the bankruptcy court should defer to the High Court and Court of Appeal's decisions that the noteholders had priority effective September 15, 2008, when Holdings filed for bankruptcy. Accordingly, BNY argued, the noteholders, and not LBSF, had priority to the collateral by the time LBSF filed for bankruptcy, such that the property right claimed by LBSF was lost before LBSF's petition date. BNY asserted that LBSF could not use its bankruptcy to obtain greater rights with respect to the collateral than it possessed prepetition.

If the bankruptcy court would not defer to the English courts' decision and find the flip clause and subordination under Condition 44 to be ipso facto clauses, BNY argued that the provisions, as part of an integrated swap, fell within the Bankruptcy Code "safe harbor" provisions, allowing BNY to enforce them against LBSF.

US Bankruptcy Court's Decision

As in the Metavante decision, the bankruptcy court ruled in favor of LBSF and agreed to enter a declaratory judgment that (a) the flip clause was not triggered because the event of default which would have triggered it (bankruptcy filing) was an unenforceable ipso facto clause and (b) any action to enforce the flip clause or subordinate payment under Condition 44 violated the automatic stay.

Contrary to the English courts, the bankruptcy court found that the sequence of events that needed to occur for the flip clause to become effective and for Condition 44 to be applied did not occur until after LBSF filed for bankruptcy and, as such, LBSF held a property interest in the transaction documents and the collateral at the time of its bankruptcy filing.

In an unprecedented move, the bankruptcy court then held that even if the Holdings bankruptcy filing had triggered the change in priority — from LBSF to the noteholders — before LBSF's bankruptcy filing, the flip clause flipping priority when based on Holdings's bankruptcy filing, was also an unenforceable ipso facto clause in LBSF's bankruptcy case. The court stated that Bankruptcy Code section 365(e)(1), which prohibits invalidation of the modification of a debtor's rights based solely on "the commencement of a case under this title" (11 U.S.C. § 541(c)(1)(B)), is not explicitly limited to the commencement of a bankruptcy case by or against that specific debtor. Therefore, an event of default based on Holdings's bankruptcy filing (i.e. the filing of a related debtor), not LBSF's, could, and did, constitute an ipso facto clause in LBSF's bankruptcy case, and the / continued page 4

The Bankruptcy Code provides certain "safe harbor" provisions, which allow qualifying counterparties to derivatives contracts (such as swaps, repos, commodities and forward contracts) to terminate, liquidate, or accelerate these contracts based on what would otherwise be unenforceable ipso facto clauses.

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noteholders could not rely on this event of default to trigger the flip clause or Condition 44. Recognizing the controversial nature of this decision, the bankruptcy court explicitly limited its decision to the facts and complexity of the Holdings and LBSF bankruptcy cases and asserted that this issue would be best left to a case-by-case determination.

After holding that the implementation of the flip clause was invalidated by Bankruptcy Code section 365(e), the court ruled that the clause did not fall within the scope of the permissible actions relating to derivative contracts protected by the safe harbor provisions. In so ruling, the court reasoned that the flip clause and Condition 44 were contained only in the Supplemental Trust Deed. In this case, the only possibly protected contracts in the transaction were the swaps, and the swaps made no reference to the flip clause, Condition 44, or even the Supplemental Trust Deed itself.

Conclusion

These decisions highlight the bankruptcy court's protective stance toward the Lehman debtors. To date, the court has favored a narrow interpretation of the scope of relief available to counterparties under the safe harbor provisions. In Metavante, the court imposed an indistinct time limit by which counterparties must act under the safe harbor provisions. If they fail to act in a timely fashion, they risk losing the ability to forever do so. In the same decision, the court strictly interpreted the type of relief provided by the safe harbor provisions, holding that a counterparty could not choose to continue its swap agreement with a debtor upon its bankruptcy filing but then fail to comply with the swap's obligations based on that same filing. Again, in Dante, the court favored a strict review of the statute in limiting not only the type of actions protected by the safe harbor provision (termination, liquidation, or acceleration of derivatives contracts) but also the type of contracts for which these actions may be sought.

The court's narrow reading of the safe harbor provisions is logical in light of the Bankruptcy Code's protective policies toward debtors in helping them to reorganize. However, the last few years have highlighted the need to ensure the financial markets are not held hostage to a bankruptcy filing of one its larger players. ◎

Prepacks Rising: A Primer on Prepackaged Bankruptcies

By Meghan S. Towers

Introduction

In the past several years, prepackaged bankruptcies have become increasingly popular. In fact, 2009 marked a banner year for prepacks. While increasing in frequency steadily for several years now, the rate of prepackaged bankruptcy filings tripled — up to a total of 30 as opposed to 10 filed in 2008.[1] Many predict that the rate of prepackaged bankruptcy filings will only increase in the years to come, especially given the current contraction of the credit markets, making familiarity with the procedures and mechanisms used in such situations even more important.

What is a Prepack?

A prepackaged bankruptcy or "prepack" generally refers to the situation where, prior to actually filing a bankruptcy petition, the soon-to-be debtor approaches its creditors and proposes a plan of reorganization. Following a period of negotiation, the debtor will file for bankruptcy protection with substantial creditor support and its course of reorganization already laid out. Typically a prepackaged bankruptcy describes a situation where votes for a plan of reorganization have already been solicited by the debtor and agreed to by the requisite amount of creditors prior to the filing of the bankruptcy petition. In this scenario the debtor will file a chapter 11 petition and its "first day" motions simultaneously with the creditor-supported plan of reorganization and disclosure statement. This simultaneous filing permits the bankruptcy court to immediately set a hearing date to approve the disclosure statement and, thereafter, the plan. In general, a prepackaged plan can be confirmed in as little as thirty days from the commencement of the bankruptcy case.[2]

[1] Mike Spector, "The Quickie Bankruptcy: More Companies Enter Court, and Exit, in a Flash," *Wall St. J.,* Jan. 5, 2010, at C1.

[2] In some instances, confirmation can be achieved in even less time. See *In re Blue Bird Body, Co.,* No. 06-50026 (Bankr. D.Nev.) (plan was confirmed one day after the petition was filed).

What is a Prenegotiated or Prearranged Bankruptcy?

Prenegotiated or prearranged bankruptcies, which are also becoming more common, generally refer to the situation where the future debtor and its creditors agree on some but not all terms of the plan prior to the filing of the bankruptcy petition. The past few years have also revealed an additional, related trend, that of the pre-arranged 363 sale, so named for section 363 of the Bankruptcy Code, which governs debtors' asset sales. The most prominent examples of the prearranged 363 sale are the U.S. government brokered restructurings of Chrysler LLC, General Motors Corp., and Lehman Brothers. These cases were unusual given the substantial governmental involvement. Nonetheless, creditors in more typical circumstances could find an understanding of prepackaged bankruptcies useful in the years to come.

A Creditor's Toolbox

Bankruptcy policy encourages the cultivation of an environment where a debtor and its creditors can reach consensual resolution, including resolutions that occur outside of a bankruptcy court. To that end, there are several provisions of the Bankruptcy Code that encourage and assist the development of out-of-court workouts, including prepacks.

Useful Bankruptcy Code Provisions

The Bankruptcy Code explicitly provides for prepacks. In particular, section 1126(b) of the Bankruptcy Code and Bankruptcy Rule 3018(b) govern the allowance of prepetition solicitation of votes for approval of a plan of reorganization, as long as certain criteria are met. In particular, the prepetition solicitation must (i) comply with applicable nonbankruptcy law, rule or regulation governing the adequacy of disclosure in connection with such solicitation, or (ii) if there is no such applicable nonbankruptcy law, then the solicitation conducted must have occurred after the disclosure of "adequate information," as defined in Bankruptcy Code Section 1125(a)(1).

In addition section 1102(b)(1) permits the members of a committee of creditors organized before the commencement of the case to become members of the official committee of unsecured creditors, provided that they are "fairly chosen" and are "representative of the different kinds of claims to be represented." Accordingly, the creditors who entered into negotiations with the debtor prepetition can continue their involvement in the debtor's bankruptcy case, with the additional benefit of enjoying the powers granted to official committees by the Bankruptcy Code.

Additional and more recent changes to the Bankruptcy Code have actually assisted debtors to negotiate a prepackaged or prearranged bankruptcy. For example, prior / *continued page 6*

Bankruptcy policy encourages the cultivation of an environment where a debtor and its creditors can reach consensual resolution, including resolutions that occur outside of a bankruptcy court.

Why Are Prepacks So Popular?

The benefits of a prepack derive from the ability to simultaneously take advantage of the flexibility of out-of-court negotiations and the protections of the Bankruptcy Code. Its myriad advantages include: speed in comparison to a traditional chapter 11 case; reduced costs; and reduced disruption of the debtor's business and privacy. Additionally, by seeking confirmation of a plan of reorganization through the bankruptcy process, instead of merely negotiating an out-of-court workout with certain creditors, the debtor can bind all of its creditors and equity security holders. Indeed, a debtor can "cram-down" a plan on a dissenting class of creditors or interests, neatly resolving the problem of non-compliant creditors. Of course there are certain disadvantages to a prepack over a simple out-of-court restructuring, including all the potential delays present in any chapter 11 case and the necessity of obtaining bankruptcy court approval of cash collateral use and other operating issues.

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to the 2005 amendments, section 1125 was used to penalize debtors who sought a prepack or prenegotiated plan but were unable to achieve a resolution prepetition. Section 1125 governs postpetition disclosure and solicitation and prevents debtors from soliciting a plan after the commencement of a case unless the debtor complies with the normal written disclosure requirements, which includes notice, a hearing and court approval. In the past, debtors who continued plan negotiations begun prebankruptcy after the filing of the petition were at risk of violating this section. Recognizing this limitation, in 2005 Congress provided a safe harbor for such situations by enacting section 1125(g), which provides that debtors can solicit plan approval if such solicitation complies with applicable nonbankruptcy law and if the holder whose approval is solicited was approached prior to the commencement of the case in a manner complying with applicable nonbankruptcy law. Finally, many jurisdictions have even developed local rules further streamlining prepackaged bankruptcies.

Other Bankruptcy Provisions

Creditors should be aware that even if a debtor obtains the requisite number of acceptances for its prepackaged plan, there nevertheless remains a risk that a bankruptcy court may rule that the debtor's prepetition solicitation and/or disclosure statement were not "adequate" under Bankruptcy Code section 1125. Disclosure and solicitation challenges are the most successfully used objections facing prepacks.

Additionally, when negotiating a prepack, potential debtors and its creditors should understand that sections 1126(c) and 1129(a)(10) of the Bankruptcy Code, which govern the confirmation of a plan of reorganization, cannot be ignored. Specifically, section 1129(a)(10) states that a plan of reorganization cannot be confirmed unless at least one class of impaired creditors votes to accept the plan. Section 1126(c) provides that a class of impaired creditors will be deemed to have accepted the plan if and only if the creditors in that class voting hold 2/3 in amount and at least a majority in number of claims voted do in fact vote to accept the plan.

Prepacks are also, like all other plans, vulnerable to challenge on feasibility grounds. Given the short time frame and the tendency of prepacks to deal mainly with the major bond or secured debt of the debtor, prepacks often fail to address other claims. Since the feasibility requirement dictates that a plan can be confirmed only if it is not likely to be followed by the liquidation or further financial reorganization of the debtor or any successor to the debtor, unless explicitly contemplated by the plan, the failure to address all the claims against a debtor could potentially violate this provision and kill a prepack. One solution to this problem is for the debtor to pay all other creditors in full.

Finally, potential debtors and their cooperating creditors should also be cautious of disgruntled creditors. Creditors in a subordinate position may attempt to use the Bankruptcy Code's involuntary bankruptcy provisions to disrupt prepack negotiations. Section 303 of the Bankruptcy Code provides that an involuntary bankruptcy case can be commenced against a business or commercial corporation by the filing of a petition by, inter alia, three or more creditors holding claims that aggregate at least $13,475 more than the value of any lien on the property of the debtor securing such claims. While a court can abstain from hearing an involuntary bankruptcy petition, if the interests of the creditors and the debtor would be better served by dismissing such case, an involuntary filing will nonetheless disrupt or delay prepack negotiations and should be anticipated by those negotiating a prepack.

Lockup or Plan Support Agreements

One often essential tool for the successful operation of a prepack is the lockup agreement, also referred to as a "plan support" agreement. Essentially a lockup agreement "locks" a debtor's creditors into place by memorializing the material terms of a prepetition restructuring proposal, which can be as simple as a term sheet, binding creditors to vote in favor of a plan of reorganization and the debtor to implementing a plan consistent with the terms of the proposal. A related mechanism is the forbearance agreement, whereby creditors may not only agree to support the debtor's plan of reorganization, but also agree to forbear upon existing rights they have under a relevant credit agreement while the debtor prepares for bankruptcy filing. Such agreements can provide the breathing room essential to prepack negotiations.

Selected Success Stories and Cautionary Tales

A prepack is most effective for companies whose creditors are a small group of sophisticated financial entities and whose financial difficulties arise from overleveraged balance sheets as opposed to institutional failures. Recent examples of successful prepackaged and prearranged bankruptcies include the bankruptcies of CIT Group Inc. and Charter Communications.

However, prepacks are not the best solution for companies that have structural or institutional problems leading to their distressed states. That is because a prepack is designed for an expeditious restructuring, not for an in-depth analysis and complex

reorganization. Therefore, prepacks do not always ensure that a company's core problems are addressed. If creditors are not careful, the company could end up in a revolving door bankruptcy, where the prepack has all the effect of placing a band-aid on a gaping wound. Additionally, there are other situations where creditors may consider rejecting attempts at a prepack. For example, if a debtor is burdened with costly executory contracts or leases, it may be best to commence a consensual bankruptcy case, reject the leases to create a pool of unsecured claims, and then negotiate a plan. Similarly, a debtor that has defaulted on a debt obligation or is in danger of litigation might seek the refuge of the automatic stay by immediately filing for bankruptcy. ◎

The Senior Creditor Gift Doctrine: Practical Solutions for Challenging Reorganizations

By Eric Daucher

Introduction: Seeking Flexibility in Absolute Priority

Although a reorganization under chapter 11 is generally thought of as a consensual process, section 1129(b) of the Bankruptcy Code provides an avenue for confirming a plan over the objection of one or more classes of dissenting creditors. In short, a plan may be "crammed down" and confirmed over the objections of dissenting impaired creditors if it meets all of the requirements for confirmation of a consensual plan (aside from acceptance by each class), if, as to each rejecting class, it (i) does not discriminate unfairly and (ii) is fair and equitable.

In general, a plan cannot be deemed "fair and equitable" unless it satisfies the "Absolute Priority Rule," which requires that no class of claims or interests may receive any compensation under a plan unless all dissenting classes senior to such a class are paid in full. As a general premise, the rule is perfectly logical: the essence of a priority system for handling claims is ensuring that senior claimholders have some protection against dilution of their interests by junior claimholders. In some instances, however, the Absolute Priority Rule may interfere with otherwise viable and desirable schemes of reorganization. Consider the example of a debtor facing three classes of claims: senior undersecured claims, priority unsecured claims, and junior unsecured claims, including trade claims held by creditors whose goodwill and cooperation is vital to a feasible reorganization. Under a traditional application of the absolute priority rule, it would be impossible to secure the good will of the trade creditors without first appeasing the priority unsecured claimant — which would necessarily come on the back of the secured party's claim. In such a case, mechanical application of absolute priority could force an otherwise viable business to liquidate, to the detriment of all parties involved. To address this conundrum, plan proponents have created — and courts have in many cases approved — innovative "gift" structures designed to facilitate successful reorganizations under these challenging conditions.

Origins and Evolution of the Gift Doctrine

Under certain circumstances, a senior claimant may agree to forego or "gift" a portion of its bankruptcy recoveries in favor of transferring that portion to a junior claimant, often leapfrogging intermediate claimants. The first major reorganization featuring a "gifting" arrangement was in the case of *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). In that case, an undersecured senior creditor and the unsecured creditors' committee agreed to coordinate strategies in order to facilitate the reorganization of the debtor. In exchange for the committee's support, the senior creditor agreed to share a portion of its bankruptcy disbursement with the unsecured creditors' committee. When reorganization efforts failed, and the case was converted to chapter 7 liquidation, the senior creditor proposed to share its disbursement with the creditors' committee. The IRS, which held a priority unsecured tax claim, objected and claimed the arrangement violated the absolute priority rule. The First Circuit Court of Appeals disagreed, and held that the sale proceeds were effectively the property of the senior creditor rather than the bankruptcy estate, and as such the creditor was generally free to disburse its bankruptcy dividends as it chose.

The court reasoned that because the undersecured creditors' claim was sufficient to absorb all of the proceeds of the liquidation, the distributional priorities of any junior claims were essentially moot. Further, regardless of the amount of the sale proceeds, the sharing agreement was to take effect after the bankruptcy distribution, and would therefore have no impact on distributions to other creditors. The sharing arrangement thus amounted to a gift distribution consisting of a portion of the secured party's assets.

In the wake of *SPM*, a number of cases have provided guidance on the limits of acceptable gift plans. */ continued page 8*

Senior Creditor Gift Doctrine

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For example, a court confirmed a plan of reorganization under which a secured creditor voluntarily relinquished a portion of its claim in order to fund the settlement of litigation against the debtor, without making any provision for full payment to bondholders whose claims were senior to the unsecured litigation claim.[1] The court found no fault with the arrangement because the settlement was funded entirely by assets incontestably allocated to the senior claimant. Similarly, at least one court has approved gifts by a senior under-secured party to subordinated debt-holders and old equity over the objection of an out-of-the-money objecting class.[2] The key in both cases was that the gifts in question were clearly of a purely voluntary nature and flowed from assets that were owed to the senior secured party.

In contrast, courts do not approve of "gift" plans that appear to be less than purely voluntary or lack a sufficient business justification. For example, a court refused to confirm a plan of reorganization where, in the event that one class of unsecured creditors rejected the plan, it called for new warrants to be distributed to a second class of unsecured claimants that, by virtue of voting to accept the plan, would be deemed to have waived the rights to the new warrants and agree to contribute those warrants to old equity.[3] There, the court observed that the gifts at issue in *SPM* and its progeny resembled ordinary carve-outs from the senior creditor's recovery in order to facilitate the successful reorganization of the debtor, whereas in that case the senior creditor had no substantive right to cause the debtor to create or dispose of the new warrants, and no clear reason for needing to retain old equity holders.

Journal Register Company

Although the "gift doctrine" originated as an explanation for apparent deviations from the absolute priority rule, its logic has been expanded to plans that arguably involve unfair discrimination. The most recent decision in the "gift doctrine" line of cases is *In re Journal Register Company*, 407 B.R. 520 (Bankr. S.D.N.Y. 2009), *reargument denied* 2009 Bankr. LEXIS 1898 (Bankr. S.D.N.Y., July 21 2009). In Journal Register, the court was faced with a proposed plan of reorganization that included provisions for executing a gift payment to unsecured trade creditors that excluded other members of the general unsecured creditor class. Ultimately the court followed the reasoning of the *SPM* line of cases and confirmed the plan, holding that the gift consisted entirely of assets belonging to the secured party and would have no impact on the distributions to the dissenting unsecured creditors.

In general, a plan cannot be deemed "fair and equitable" unless it satisfies the "Absolute Priority Rule," which requires that no class of claims or interests may receive any compensation under a plan unless all dissenting classes senior to such a class are paid in full.

The facts of *Journal Register* are straightforward, but there are several salient distinctions from *SPM* that make it noteworthy. Journal Register Company and its subsidiaries filed for chapter 11 protection on February 21, 2009 and within three months moved for confirmation of an amended plan of reorganization that was the result of prepetition negotiations with its prepetition lenders. Although the lenders held first priority liens on substantially all of the debtors' assets, they were significantly undersecured.

The proposed plan divided claims into six classes, including a single class for general unsecured claims (including trade claims). Despite the lenders' undersecured position, the plan called for a pro-rata distribution of $2 million to the general unsecured creditors. Further, based on testimony that trade-

1 See *In re MCorp Financial, Inc.*, 160 B.R. 941 (S.D. Tex. 1993).
2 See *In re Genesis Health Ventures, Inc.*, 266 B.R. 591 (Bankr. D. Del. 2001).
3 See *In re Armstrong World Industries, Inc.*, 320 B.R. 523 (E.D. Pa. 2005), *aff'd* 432 F.3d 507 (3d Cir. 2005).

creditor goodwill was vital for the survival of the reorganized debtors, the plan included a separate provision that provided an additional gift to a newly created "trade account" which would provide further court-supervised distributions to unsecured trade creditors. As a result, the trade creditors, although classified identically to all other general unsecured creditors, were to recover disproportionately to other members of their class. Three unsecured creditors objected to confirmation of the plan.

The principal objection to the plan argued that the trade creditor gift constituted impermissible unfair discrimination (rather than characterizing the gift as a violation of absolute priority). After summarizing other jurisdictions' handling of the gift doctrine, the Journal Register court noted that the proper treatment of the gift doctrine in the Second Circuit was unresolved.[4] The court was therefore left to its own devices in resolving the objection.

The court first noted that it was "undisputed that the payment that certain 'trade creditors' in Class 4 are to receive subsequent to the confirmation of the Plan is intended to be higher than that of other unsecured creditors in Class 4, and that the Plan contains certain 'means of execution' that facilitate this intended disparity." These facts differ from those in *SPM*, where the plan itself was devoid of anything that could be characterized as a priority or discrimination problem. Nevertheless, the court observed that it is common for certain unsecured creditors to have various rights to payment that result in disproportionate recovery, and that such additional rights do not create classification problems that amount to unfair discrimination. The court thus reasoned that the appropriate question was, given that no principle restricts a secured party's right to make a gift outside of the bankruptcy context, whether providing "means of execution" for such a gift through the plan itself made the gift a questionable distribution "under the Plan."

The court then returned to the pragmatism of *SPM* and its progeny; it concluded that because the gift consisted of proceeds that would otherwise flow to the gifting parties, striking the gift from the plan would have no impact on the distribution to the objecting creditors. The court further reasoned that the plan's provisions for an administrator to execute the gift distribution and ongoing court oversight did not implicate the classification or priority schemes. The court also reasoned that forcing the gift to occur outside of the plan process and denying court oversight would subject the gift (and the attendant plan confirmation) to undesirable uncertainty. The court foresaw two possible results if the gift was excised from the plan. First, the debtors and secured lenders could confirm a plan that provided no recovery to the unsecured creditors, and then pay trade creditors post-confirmation if they so chose. Second, the secured lenders could seek foreclosure outside of chapter 11. Under either scenario, excising the gift would "create the possibility of a result that would contravene the overriding purpose behind chapter 11 of maximizing the going concern value of a debtor's business for the benefit of its stakeholders." Finally, the court noted the importance of the fact that the gift was not being used for any ulterior purpose, but was instead designed to further the purpose of chapter 11. Given the significant support the proposed gift provided to the reorganization process, and the lack of any notable downside to its inclusion in the plan, the court held that the gift plan was permissible.

Conclusion

The lesson to be learned from the court's decision in *Journal Register* is not merely that the gift doctrine has a reach beyond issues of absolute priority; instead, readers should observe the unabashed pragmatism that drove the court's analysis of a proposed cramdown plan. When considering the validity of the gift portion of the plan, the court wanted to know: (a) did the gifted assets indisputably flow from what would otherwise be the dividend of the gifting party, (b) would the objecting parties be in any way prejudiced by the gift, or were they merely hoping to extort a better recovery than they were owed, (c) was there a legitimate business justification for the gift, (d) could an identical result be reached outside of bankruptcy, and most importantly (e) would making the gift intrinsic rather than extrinsic to the bankruptcy process further the reorganization effort. Essentially, the court decided that there was no reason to stand in the way of a gift where doing so would only imperil the reorganization. It is clear that gift plans can provide grease for sticky reorganizations so long as they are employed appropriately. ◎

4 See *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007).

Third Circuit Denies $15 Million Break-Up Fee for Stalking Horse Bidder

By Marc Roitman

Introduction

In *In re Reliant Energy Channelview LP*, No. 09-2074, 2010 WL 143678 (3d Cir. Jan. 15, 2010), the Third Circuit affirmed the district court's decision upholding the bankruptcy court's order denying a $15 million break-up fee for a stalking horse bidder. In rendering its decision, the Third Circuit held that the requested break-up fee was not actually necessary to preserve the value of the estate, as required for the payment of administrative expenses under section 503(b) of the Bankruptcy Code.

Stalking horse bidders are common in section 363 asset sales. A stalking horse, which is often a friendly bidder chosen by the bankrupt company, offers the first bid on a bankrupt company's assets and, in doing so, sets the bidding procedures, deal structure, and has an opportunity to negotiate bid protections. From the perspective of the seller in bankruptcy, the stalking horse is beneficial because it helps to avoid low bids on the asset at auction. However, due to the selling company's financial distress and the threat of potential bankruptcy litigation, the due diligence for a stalking horse bid is particularly expensive and exhaustive. Future bidders can ride the stalking horse's due diligence rather than pay to perform their own. Thus, in compensation for the groundwork performed, and because it would otherwise be difficult to attract bidders, courts generally grant a break-up fee and expense reimbursement to the stalking horse, with payment usually due when the stalking horse bidder is outbid.

The bid protections that are so often bundled with a stalking horse bid are not guaranteed and must be approved by the bankruptcy court. In the Third Circuit, in what has become known as the *O'Brien* standard, the reimbursement of expenses and break-up fees will not be approved unless the stalking horse can demonstrate that the payments are "actually necessary to preserve the value of the estate." *Calpine Corp. v. O'Brien Env't Energy, Inc.* (*In re O'Brien Env't Energy, Inc.*), 181 F.3d 527, 535 (3d. Cir. 1999).

Background

After filing for chapter 11, the debtors in *Reliant* decided to sell their largest asset, a power plant in Channelview, Texas. After substantial marketing efforts, 38 potential bidders emerged, eventually leading to 12 bids for the plant. The winning bid, submitted by Kelson Channelview LLC ("Kelson"), was the highest initial bid that was not contingent on the bidder obtaining financing. Subsequently, Kelson entered into an asset purchase agreement with the debtors to purchase the plant for $468 million, subject to approval of the bankruptcy court.

The asset purchase agreement required the debtors to seek an order approving certain bid protections and procedures, by which Kelson sought to insulate itself from the risk of being outbid. The proposed protections stipulated that the debtors could not accept a competing bid unless it exceeded Kelson's by at least $5 million. And, if a competing bid was accepted, Kelson would be entitled to reimbursement of expenses up to $2 million and a $15 million break-up fee, representing about three percent of its bid.

Pursuant to the agreement, the debtors, with the support of the creditors' committee, requested bankruptcy court approval of the sale as well as approval for the bid protections. Fortistar, LLC, a company which had previously submitted a losing contingent bid, objected to the sale and argued it would be willing to make a "higher and better" bid at auction, but would be dissuaded from doing so if the court approved the bid protections. In March 2008, the bankruptcy court held a hearing at which it declined to approve the sale of the plant without an auction. In its ruling, the court approved both the $5 million overbid requirement and the $2 million expense reimbursement, but rejected the $15 million break-up fee that Kelson would have been entitled to if unsuccessful at auction. Ultimately, Fortistar submitted a fully financed bid at auction, which exceeded Kelson's bid by approximately $32 million.

After the bankruptcy court approved the sale to Fortistar, Kelson appealed to the district court from the bankruptcy court's order denying the payment of the $15 million break-up fee. In March 2009, the district court affirmed the bankruptcy court's decision, which was subsequently appealed to the Third Circuit.

Third Circuit Analysis

The Third Circuit began its analysis with a general discussion of the *O'Brien* standard regarding payment of break-up fees from the bankruptcy estate. In *O'Brien*, the Third Circuit strictly interpreted section 503(b) of the Bankruptcy Code as limiting the

payment of postpetition administrative expenses, including break-up fees, to the "actual, necessary costs and expenses of preserving the estate."

In applying the *O'Brien* standard to the instant case, the Third Circuit remarked that there are two ways a break-up fee could preserve the value of the estate: (a) generally a break-up fee may be necessary to induce the stalking horse to make its bid before the bankruptcy court orders an auction; and/or (b) a break-up fee may be necessary to preserve the stalking horse's bid after the bankruptcy court orders an auction.

Break-Up Fee Was Not Necessary to Induce Kelson's Bid

In many cases, the stalking horse bidder creates an actual benefit to the estate by establishing the minimum price for the asset sale. Accordingly, the payment of a break-up fee in such cases may be a necessary cost of preserving the estate. Here, the Third Circuit acknowledged that Kelson's bid "undoubtedly provided a benefit to the estate by establishing a minimum price and a complete set of offer terms." However, the Third Circuit noted the key distinction that Kelson's bid only required the debtors to seek court approval of the break-up fee and was not actually contingent on the inclusion of the fee. Therefore, the Third Circuit concluded that the break-up fee was not necessary to induce the bid given that Kelson submitted its bid without the assurance of a break-up fee. Instead, "the mere possibility of the payment of a break-up fee was sufficient for that purpose."

Break-Up Fee Was Not Necessary to Preserve Kelson's Bid

Even where the assurance of a break-up fee is not needed to induce a stalking horse bid, it may nevertheless be necessary to ensure adherence to the bid in the event of a court-ordered auction. In such a situation, the bankruptcy court must balance the potential benefit of the stalking horse's continued participation against the potential detriment of discouraging other bidders. Here, the bankruptcy court believed the provision for the break-up fee would deter other possible purchasers from bidding, which would outweigh the possible benefit achieved by keeping Kelson committed to the purchase.

The Third Circuit recognized the difficult choice, noting, "If another suitable bid had not materialized and Kelson had walked away permanently from the purchase, the estate would have been harmed severely by the denial of a break-up fee." Nevertheless, considering (i) Fortistar's assertion that it planned to bid at auction, (ii) the binding language of the asset purchase agreement, and (iii) the logical belief that Kelson would not walk away from the fully negotiated business opportunity, the Third Circuit concluded that the bankruptcy court was within its discretion in deciding that the break-up fee would cause more harm than good. On balance, the deterrence of other bidders would have been more negative than Kelson's continued interest would have been positive.

With the benefit of hindsight, the Third Circuit could say that the bankruptcy court made the correct determination because Fortistar did indeed bid more than Kelson at the auction. However, the bankruptcy court's determination was something of a gamble. By opening up the possibility that Kelson would walk away from the transaction over the disallowance of the break-up fee, the court made the estate vulnerable to being left without a purchaser for the asset.

There are two ways a break-up fee could preserve the value of the estate: (a) to induce the stalking horse to make its bid before the bankruptcy court orders an auction; and/or (b) to preserve the stalking horse's bid after the bankruptcy court orders an auction.

Conclusion/Lessons Learned

The *Reliant* case has several important lessons for potential asset purchasers in bankruptcy proceedings within Third Circuit jurisdiction. First, a stalking horse bidder / continued page 12

Stalking Horse Bidder

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should negotiate its bid such that it is expressly contingent on approval of the break-up fee. This will avoid the peculiarity that arises when a bid is made contingent on the debtors merely seeking court approval. Second, the *Reliant* case reflects the Third Circuit's commitment to critical review of break-up fees. Finally, despite the Third Circuit declining to construct a per se rule that break-up fees are not available when there is another bidder, the stalking horse bidder should be aware that the award of a break-up fee in such a situation is unlikely. According to the Third Circuit, "break-up fees often are not needed when there are bidders for an asset other than the initial bidder."

Looking ahead, the question is whether the difficulties in obtaining break-up fees in the Third Circuit will make entities less willing to take on the role of the stalking horse in asset sales. Informed buyers can still secure the benefits of a break-up fee by carefully drafting the agreements. For example, a stalking horse bidder could (i) obtain a guaranty from a secured creditor, which would grant an enforceable right to payment independent of bankruptcy court approval, or (ii) negotiate the asset purchase agreement such that it would incorporate a carve-out from a secured creditor's lien. Of course, both of these alternatives would require the participation of a secured creditor. Nevertheless, there are myriad inventive substitutes that could provide incentives to stalking horse bidders. ◎

Developments in Rule 2019 Disclosure Controversy

By Young Yoo

In *In re Premier Int'l Holdings, Inc.* and *In re Philadelphia Newspapers, LLC*, the Bankruptcy Courts for the District of Delaware and the Eastern District of Pennsylvania addressed the issue of whether informal or ad hoc committees were subject to the disclosure requirements of Rule 2019 of the Bankruptcy Rules.

Recognizing a sharp split in authority and added controversy over recently proposed amendments to Rule 2019, both courts analyzed the plain meaning of, and the legislative intent behind, the rule and held that informal or ad hoc committees were not subject to the disclosure requirements under the current Rule 2019.

Background

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, (i) the name and address of the creditor or equity security holder, (ii) the nature and amount of the claim or interest, (iii) the time such claim or interest was acquired, and (iv) any sales or dispositions thereof. A bankruptcy court can bar such entity or committee from participating in the bankruptcy case if it fails to comply with these disclosure requirements. Rule 2019 statements are filed publicly.

Rule 2019 disclosures foster openness and transparency, aiding judges and parties in interest in determining whether a committee's claims and interests align with those of the individual creditor. This helps ensure that resolutions and ultimately a plan can be formulated free of deception and overreaching. But unofficial or ad hoc committees often play leading roles in bankruptcy cases. And due to the rule's sufficiently ambiguous language, courts around the country have disagreed on whether Rule 2019 applies to such committees.

In 2007, the Bankruptcy Court for the Southern District of New York in *In re Northwest Airlines Corp*. required ad hoc committee members to file Rule 2019 statements and denied their request to file them under seal. That same year, the Bankruptcy Court for the Southern District of Texas in *In re Scotia Development, LLC* held that a group of noteholders did not constitute an actual unofficial committee but was only a "bunch of creditors" represented by a law firm and excused them from filing a Rule 2019 statement. Last December, the Bankruptcy Court for the District of Delaware in *In re Washington Mutual, Inc*. followed the reasoning of *Northwest*, and held that an ad hoc group of noteholders made up of hedge funds and other investment entities were subject to Rule 2019 and required disclosure by each member.

The heart of the controversy lies in how Rule 2019 disclosure has significant impact on the willingness of hedge funds, institutional investors and other distressed investors to participate in bankruptcy proceedings. Requiring detailed and public disclosure of their claims and interests endangers proprietary and confidential information which is closely protected as part of their investment strategy. Accordingly, should informal or ad hoc committees become embroiled in litigation, opponents may try to sidetrack them by seeking information under Rule 2019. This controversy is amply demonstrated by the new decisions this year in *Premier* and *Philadelphia*.

Premier

The debtors in *Premier* own and operate amusement parks under the Six Flags name. They filed for chapter 11 in the Bankruptcy Court for the District of Delaware on June 13, 2009 with almost $2.8 billion in aggregate debt, $1.1 billion of it secured. In addition to the official committee, two informal committees of noteholders were formed: (i) the Informal Committee of SFO Noteholders, holding nearly $400 million in unsecured notes, and (ii) the Ad Hoc Committee of SFI Noteholders, holding nearly $290 million in separate unsecured notes. After several months of negotiation, the debtors filed a revised plan with the support of the secured lenders and SFO Noteholders. However, the official committee and SFI Noteholders opposed the plan.

On December 29, 2009 (days after filing the plan), the official committee filed a motion for an order compelling the SFO Noteholders to file a Rule 2019 statement, alleging that the debtors cut a deal with them and further disclosure was critical to evaluating their credibility and motives. The SFO Noteholders objected, arguing that Rule 2019's plain language and legislative history foreclosed its application to them and that the motion was a thinly veiled litigation tactic.

In a decision rendered on January 20, 2010, the court framed the issue as whether an informal committee of bondholders was "a committee representing more than one creditor for Rule 2019 purposes." The court held that a "committee," by definition, must be appointed and this requires an action by a larger body "either by consent, contract or applicable law — not by self-help." The court interpreted "representing" as contemplating an active appointment of an agent. Because the SFO Noteholders did not represent any persons other than its members either by consent or operation of law, the court held that they were not a committee under Rule 2019.

In addition, after reviewing the legislative history and the disclosures concept as it was adopted in the 1930s, the court recognized that Rule 2019's original purpose was to act as a check on the expansive powers abused by the protective committees of yesteryear, who were targeted for reform by the Chandler Act of 1938. The decision also notes that the official committee was "clearly engaged in a litigation tactic to apply pressure on it[s] current adversary," which was made self-evident by the official committee's decision not to file a similar motion against the SFI Noteholders.

Philadelphia Newspapers

On February 4, 2010, mere weeks after the *Premier* decision, the Bankruptcy Court for the Eastern District of Pennsylvania ruled on the same issue in the *Philadelphia Newspapers* case. Philadelphia Newspapers, LLC and its affiliates filed for chapter 11 on February 22, 2009. On March 27, 2009, a Steering Group made up of prepetition lenders holding a majority of the secured debt, attempted to begin negotiations for a consensual plan of reorganization. The debtors, however, filed a plan without the Steering Group's input on August 20, 2009 pursuant to which the debtors would sell substantially all their assets. Under the proposed bidding procedures order, the prepetition lenders would be barred from credit bidding. The bankruptcy court rejected these procedures. On appeal, the District Court reversed. The debtors appealed the District Court's decision to the Third Circuit.

While on appeal to the Third Circuit, the debtors filed a motion seeking Rule 2019 disclosure from each of the Steering Group's members. The Steering Group objected on the grounds that Rule 2019's plain language and legislative history foreclosed its application to a group of lenders acting only on / continued page 14

As noted by the bankruptcy court in Philadelphia, the Judicial Conference Advisory Committee on Bankruptcy Rules have proposed amendments to Rule 2019 that would explicitly apply to informal and ad hoc committees.

Rule 2019

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its own behalf and that the motion was an inappropriate litigation tactic.

The bankruptcy court in *Philadelphia Newspapers* agreed and adopted most of the conclusions set forth in the *Premier* decision. Unlike *Premier,* however, the *Philadelphia Newspapers* court pointed out that the existence of newly proposed amendments to Rule 2019 helped inform whether the current Rule 2019 includes informal or ad hoc committees. The proposed amendments would expressly extend Rule 2019 to "a group of creditors that act in concert to advance common interests, even if the group does not call itself a committee." Accordingly, the court concluded that the current Rule 2019 did not apply to informal or ad hoc committees: "Inductive reasoning supports the conclusion reached herein. In other words, it is logical to infer that if the rule already covered the Steering Group, there would be no need to expand the Rule to do so."

Conclusion

As noted by the bankruptcy court in *Philadelphia*, the Judicial Conference Advisory Committee on Bankruptcy Rules has proposed amendments to Rule 2019 that would explicitly apply to informal and ad hoc committees. Far from stemming the tide of controversy, these proposed amendments have met with resistance from hedge funds, institutional investors and other distressed investors. A public hearing on the proposed amendment was conducted on February 5, 2010. Most witnesses agreed that the current Rule 2019 should be revised to resolve ambiguity in light of *Northwest, Scotia Development, Washington Mutual, Premier* and *Philadelphia Newspapers*. But there was ample testimony opposing the disclosure requirements of the amounts and dates of claim purchases in the secondary market. Opponents testified that a revised Rule 2019 could accomplish its goals of openness and transparency without such information. The Committee is expected to propose a final amended Rule 2019 that, if timely adopted, could take effect as early as December 1, 2010. But it remains uncertain what final form it will take.

Equally uncertain is how courts will interpret the current Rule 2019 before a final amended Rule 2019 emerges. Despite the seeming solidarity between *Premier* and *Philadelphia Newspapers*, the two decisions should not be seen as necessarily reversing a trend started by *Northwest* and *Washington Mutual* which applies current Rule 2019 to informal or ad hoc committees. Case in point: on January 22, 2010, in between the rulings of *Premier* and *Philadelphia*, the Bankruptcy Court for the District of Delaware in *In re Accuride Corp*. granted the official committee's motion for Rule 2019 disclosure from an ad hoc group of noteholders. While the order contains no discussion, in a brief bench ruling, the court noted that it concurred with most of the conclusions advanced in *Northwest* and *Washington Mutual*. Both *Premier* and *Philadelphia* are being appealed and the controversy on current Rule 2019 remains wide open. ◎

Madoff's "Net Winners" Lose Net Equities Argument

By Francisco Vazquez

The Madoff Ponzi Scheme

The rise and fall of Bernie Madoff and his massive Ponzi scheme has been well documented in the popular media, but a brief recap at the outset of this article may be helpful.

Bernard L. Madoff Investment Securities LLC ("BLMIS") was a New York limited liability company registered with the Securities and Exchange Commission as a broker-dealer and investment adviser under the Securities Exchange Act of 1934. As a broker-dealer, BLMIS was a member of Securities Investor Protection Corporation ("SIPC").

Madoff perpetrated his fraudulent scheme primarily through BLMIS investment advisory business (the "IA Business"). Through the IA Business, Madoff was able to solicit billions of dollars from investors, who, pursuant to their agreements with Madoff, agreed to relinquish all investment authority to Madoff. Customers retained only the authority to make deposits into and withdrawals from their accounts. Unfortunately for customers, Madoff never invested their funds, which were deposited into a BLMIS bank account and used to enrich Madoff and fund customer's withdrawals. Although each customer received account statements that reflected trading activity and a profit, any purported gains were fictitious. Madoff "essentially pulled the fictitious amounts from thin air." Despite its representations, BLMIS never acted as a legitimate investment advisor to its customers. Madoff's scheme imploded in December, 2008, leaving a wake of financial devastation and loss.

The Securities Investor Protection Act

The Securities Investor Protection Act ("SIPA") was designed to protect "customers" from losses caused by the insolvency or financial distress of a broker-dealer. A liquidation proceeding under SIPA bears many of the same characteristics of liquidation under Chapter 7 of the United States Bankruptcy Code. Indeed, several key sections of Chapter 7 apply to SIPA proceedings, which are supervised by a bankruptcy court. Further, a trustee, with virtually the same powers as a Chapter 7 trustee, is appointed in a SIPA liquidation to administer a broker-dealer's estate.

Under SIPA, customers are entitled to certain protections, including priority distributions from a fund of "customer property." In general, each customer is entitled to share pro rata in customer property to the extent of its net equity, as defined in SIPA ("Net Equity"). If the fund is insufficient to pay each customer its Net Equity, the trustee is entitled to an advance from SIPC, an independent, non-profit membership corporation created by SIPA, to pay each customer the amount by which its Net Equity exceed its pro rata share of customer property subject to a $500,000 cap.

The Madoff SIPA Proceeding

On December 15, 2008, the United States District Court for the Southern District of New York, upon SIPC's application, entered an order (i) placing BLMIS's customers under the protection of SIPA, (ii) appointing a trustee (the "Madoff Trustee"), and (iii) removing the SIPA liquidation of BLMIS and Madoff to the United States Bankruptcy Court for the Southern District of New York.

On December 23, 2008, the Bankruptcy Court issued an order (the "Claims Procedure Order") pursuant to which a procedure for the filing, determination and adjudication of claims against BLMIS was established. Pursuant to the Claims Procedure Order, all customer claims were required be filed with the Madoff Trustee, who was charged with the responsibility of determining the amount of each claim. If the customer did not object to the Madoff Trustee's valuation, the claim was deemed allowed by the Bankruptcy Court. Certain claimants objected to the Madoff Trustee's valuation of their claims and the methodology employed by him.

The Madoff Trustee's "Net Equity" Methodology

The Madoff Trustee argued that "Net Equity" is equal to the amount deposited by a customer into his BLMIS customer account, less any amounts previously withdrawn (the "Net Investment Method"). Under the Madoff Trustee's analysis, customers could be divided into three categories. The first group consisted of so-called "Net Winners" — those BLMIS customers that were fortunate enough to have withdrawn more funds from BLMIS than they deposited. According to the Madoff Trustee's thinking, a Net Winner had zero Net Equity and was therefore not entitled to any further distribution.

The second category of BLMIS customers included "Over the Limits Net Losers" — those customers that deposited more with BLMIS than they withdrew funds with such excess greater than the $500,000 SIPC cap. According to the Madoff Trustee's calculations, an Over the Limits Net Loser has positive Net Equity and a claim for the amount deposited less the amount withdrawn. Accordingly, an Over the Limits Net Loser would receive (i) a $500,000 advance from SIPC, and (ii) their pro rata share of customer property.

The third and final category of customers consisted of so-called "Under the Limits Net Losers" (together with the Over the Limits Net Losers, the "Net Losers"). This group of customers withdrew funds from BLMIS totaling less than their deposits with a net investment under the $500,000 cap. According to the Madoff Trustee's calculations, an Under the Limits Loser has a positive Net Equity. An Under the Limits Loser's Net Equity, however, will be fully satisfied by the SIPC payment and thus an Under the Limits Loser will not be entitled to a further distribution from customer property.

The Net Winners Argument

The Net Winners argued that Net Equity should be defined as the amounts reflected on the last BLMIS customer statements, dated November 30, 2008 (the "November 30 Statements"). Referring to SIPA's legislative history and its intent to protect investors' "legitimate customer expectations" and "make customer accounts whole," the Net Winners argued that the Net Equity should be defined as the amounts reflected on the November 30 Statements.

The Bankruptcy Court's Analysis

Based upon its interpretation of SIPA and pertinent Second Circuit precedent as well as the equities of the circumstances, the Bankruptcy Court concluded that the Madoff Trustee's analysis was correct and upheld his valuation of customer claims. The Bankruptcy Court observed that "[t]he account statements are entirely fictitious, do not reflect actual securities positions that could be liquidated and therefore cannot be relied upon to determine Net Equity." The Bankruptcy Court reasoned that Net Equity should be interpreted in light of the requirement on a SIPA's trustee to discharge Net Equity claims only "insofar as such obligations are [1] ascertainable from the books and records of the debtor or [2] are otherwise established to the satisfaction of the trustee." In this instance, */ continued page 16*

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the only amounts that could be verified from BLMIS's books and records were the customers' deposits and withdrawals.

The Bankruptcy Court's conclusion was further supported by prevailing precedent from the Court of Appeals for the Second Circuit. Previously, the Second Circuit concluded that customer claims should be based upon the net cash invested by the customer and not by any fictitious profit. Indeed, the Second Circuit noted the absurdity and unfairness that would result by relying on false account statements. Similarly, here, the Bankruptcy Court would not value claims based upon the customers' expectations resulting from their fabricated account statements. "It would be simply absurd to credit the fraud and legitimize the phantom world created by Madoff when determining Net Equity."

According to the Bankruptcy Court, adoption of the value reflected in the November 30 Statements would not be fair or equitable. Under that approach, the Net Winners would benefit at the expense of the Net Losers. Through the use of two hypothetical investors, the Bankruptcy Court demonstrated that the Net Winners' approach "would only exacerbate the harm caused to Net Losers and would improperly distribute customer funds based on Madoff's arbitrary design." Under that approach, the Net Winners would receive (i) their pro rata share of customer property and (ii) the benefit of their withdrawals that were funded by the Net Losers, who recovered little or nothing from Madoff or their investments. Equity would only be accomplished by making the greatest number of investors closest to their actual position and this could only be accomplished by adopting the Net Investment Method.

Conclusion

The Bankruptcy Court readily acknowledged that the Net Winners were victimized by Madoff's fraud. The Net Losers, however, were equally innocent. Rather than adopt a methodology that it perceived would benefit one group to the detriment of the other group, the Bankruptcy Court adopted the methodology that it perceived would accomplish the greater good — the Net Investment Method. Nevertheless, the Bankruptcy Court acknowledged that its decision would "inevitably be unpalatable" to the loser, which, in this case, was the Net Winners. In accordance with the Bankruptcy Court's certification, any appeal of its decision will bypass the district court and be heard directly by the Second Circuit, where, regardless of the decision, each party will continue to lose.

For additional information, please contact

In the New York Office:

Howard Seife
+1 (212) 408-5361
hseife@chadbourne.com

N. Theodore Zink
+1 (212) 408-5356
tzink@chadbourne.com

Seven Rivera
+1 (212) 408-5529
srivera@chadbourne.com

David M. LeMay
+1 (212) 408-5112
dlemay@chadbourne.com

Douglas E. Deutsch
+1 (212) 408-5169
ddeutsch@chadbourne.com

Andrew Rosenblatt
+1 (212) 408-5559
arosenblatt@chadbourne.com

In the London Office:

Adrian Harris
+44 (0)20 7337-8025
aharris@chadbourne.com

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Chadbourne & Parke LLP

New York
30 Rockefeller Plaza
New York, NY 10112
+1 (212) 408-5100

Washington
1200 New Hampshire Ave., NW
Washington, DC 20036
+1 (202) 974-5600

Los Angeles
350 South Grand Ave., 32nd Floor
Los Angeles, CA 90071
+1 (213) 892-1000

Mexico City
Chadbourne & Parke SC
Paseo de Tamarindos, No. 400-B Piso 22
Col. Bosques de las Lomas
05120 México, D.F., México
+ 52 (55) 3000-0600

London
Chadbourne & Parke (London) LLP
an affiliated partnership
Regis House, 45 King William Street
London EC4R 9AN, UK
+44 (0)20 7337-8000

Moscow
Riverside Towers
52/5 Kosmodamianskaya Nab.
Moscow 115054 Russian Federation
+7 (495) 974-2424
Direct line from outside C.I.S.:
+1 (212) 408-1190

St. Petersburg
Stroganovskiy Business Centre
19A Nevskiy Prospect
St. Petersburg 191186 Russian Federation
+7 (812) 332-9300

Warsaw
Chadbourne & Parke
Radzikowski, Szubielska and Partners LLP
ul. Emilii Plater 53
00-113 Warsaw, Poland
+48 (22) 520-5000

Kyiv
25B Sahaydachnoho Street
Kyiv 04070, Ukraine
+380 (44) 230-2534

Almaty
Dostyk Business Center
43 Dostyk Avenue, 4th floor
Almaty 050010, Republic of Kazakhstan
+7 (727) 258-5088

Dubai
Chadbourne & Parke LLC
City Tower I, Sheikh Zayed Road
P.O. Box 23927, Dubai, United Arab Emirates
+971 (4) 331-6123

Beijing
Beijing Representative Office
Room 902, Tower A, Beijing Fortune Centre
7 Dongsanhuan Zhonglu, Chaoyang District
Beijing 100020, China
+86 (10) 6530-8846

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