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Creditors Do Not Have Standing To Pursue Derivative Claims On Behalf of Delaware Limited Liability Companies

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By Ted Zink and Francisco Vazquez

In a decision that may come as a surprise to many, the Court of Chancery of the State of Delaware (the "Court") recently dismissed a derivative suit brought by a creditor on behalf of an insolvent limited liability company. *See CML V, LLC* v. *Bax et al.*, 6 A.3d 238 (Del. Ch. 2010)(JetDirect Aviation Holdings, LLC, Nominal Defendant). After review of the Delaware Limited Liability Company Act (the "LLC Act"), the Court concluded that the plain meaning of the statute denies derivative standing to creditors of Delaware limited liability companies. Only holders of membership interests in a limited liability company or their assignees have standing to pursue derivative claims on behalf of a Delaware limited liability company.

Background

JetDirect Aviation Holdings, LLC ("JetDirect"), a Delaware limited liability company, defaulted on a loan owing to a creditor. A creditor sued derivatively on behalf of JetDirect alleging that its board of managers breached their duties of care, loyalty and good faith in connection with the operation and expansion of JetDirect's business. The creditor also alleged that JetDirect was insolvent, an assertion that the Court found "plausible." The individual defendants, members of JetDirect's board of managers, moved to dismiss the creditor's lawsuit on the basis that the creditor lacked standing to sue derivatively on behalf of JetDirect.

Derivative Standing under Delaware Corporate Law

It is well-established under Delaware corporate law that creditors of an insolvent corporation */ continued page 2*

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Derivative Claims

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may bring derivative claims on behalf of the corporation against directors for breach of fiduciary duty. *See, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007); *accord Prod. Res. Gp., L.L.C. v. NCT Gp., Inc.*, 863 A.2d 772, 776 (Del. Ch. 2004). The creditor in *JetDirect* asserted that the same equities underpinning derivative standing in favor of creditors in the corporate setting entitled creditors to sue derivatively on behalf of insolvent limited liability companies. The Court disagreed, resting on, among other rationales, a plain reading of the LLC Act.

The Court's Analysis and Holding

The Court found it odd that little attention has been paid to the statutory provisions relating to alternative entity derivative litigation, noting that "many assumed that creditor derivative standing exists," and that "the standing provisions in the alternative entity statutes have not been widely understood as barring derivative claims by a creditor of an insolvent entity." Nevertheless, the Court observed that the literal terms of the LLC Act control and accordingly examined the relevant statutory provisions.

After noting that section 18-1001 of the LLC Act creates a statutory right to bring a derivative action, the Court zeroed in on the next section entitled "Proper Plaintiff." That section provides:

> In a derivative action, the plaintiff must be a member or an assignee of a limited liability company interest at the time of bringing the action and:
> (1) At the time of the transaction of which the plaintiff complains; or
> (2) The plaintiff's status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transaction.
>
> 6 *Del. C.* § 18-1002.

Thus, the Court observed that under the plain language of section 18-1002, a plaintiff "must be a member or an assignee" and, accordingly, creditors do not have derivative standing in the limited liability company context. As a purely statutory matter, the LLC Act does not grant derivative standing to creditors of limited liability companies. section 18-1002 of the LLC Act limits standing to bring a derivative claim to holders of membership interests in a limited liability company and their assignees.

Although the Court stated that it could have decided the matter on the plain meaning of the statute, the Court also considered (a) interpretations of other alternative entity derivative standing provisions, including the Delaware Limited Partnership Act, and the Revised Uniform Limited Partnership Act ("RULPA"), (b) the source and development of such other derivative standing provisions, and (c) whether enforcing the plain meaning of section 18-1002 would be grossly at odds with the purposes and framework of the LLC Act.

The Court found that these additional considerations supported the plain meaning interpretation. First, a literal reading of Delaware's Limited Partnership Act, from which the LLC Act was modeled, bars any party other than limited partners from suing derivatively and Delaware courts have consistently interpreted the limited partnership standing provisions as exclusive. Second, the Court found that the evolution of Delaware's standing provisions in the limited partnership context suggests "a conscious decision to make the statutes exclusive." Third, the Court rejected the creditor's arguments that a literal reading of the section 18-1002 of the LLC Act would lead to unreasonable, if not absurd, results or that barring creditors derivative standing conflicts with the purpose of the LLC Act. The Court observed that there is nothing absurd about different legal principles applying to corporations and limited liability companies. Further, the Court noted that the policy of the LLC Act, as expressed therein, is to "give the maximum effect to the principle of freedom of contract." Creditors routinely provide for different protections in their agreements. Indeed, the LLC Act provides creditors with a number of opportunities to obtain additional rights against a limited liability company. For example, a creditor can obtain an agreement from individual members and managers to be personally obligated for the liabilities of the limited liability company. Further, the Court noted that under section 18-502(b) of the LLC Act, a creditor

Section 18-1002 of the LLC Act limits standing to bring a derivative claim to holders of membership interests in a limited liability company and their assignees.

possesses the statutory right to enforce a member's contribution obligation, notwithstanding the lack of derivative standing.

Conclusion

It may come as some surprise that creditors of Delaware limited liability companies do not have derivative standing. Given the statutory basis for this conclusion and the Court's focus on the evolution of Delawarean standing requirements for alternative entities, the same result may not obtain for limited liability companies formed under the laws of other states. Creditors should, therefore, carefully examine their relationships with limited liability companies and the laws of the state of the company's organization to ensure they have an accurate understanding of all available avenues of recourse in the event of a breach or default by their limited liability company counterparty. ◎

Mexicana Airlines: A New Test Case In Mexico

By Luis Enrique Graham and Salvador Fonseca

On August 28, 2010, Compañía Mexicana de Aviación ("Mexicana"), the third oldest airline in the world and one of the most important airlines in Latin America, stopped flying. This was disturbing news for Mexicana customers and for the thousands of Mexicana creditors in Mexico and elsewhere. With a bankruptcy filing on August 2, 2010, creditors of Mexicana saw things go from bad to worse and ultimately to the entry of an order for relief on September 7, 2010. As discussed in greater detail below, the Mexicana bankruptcy case raises a number of novel issues under the new bankruptcy law in Mexico.

Following the Metrofinanciera case, which was the first "pre-negotiated" bankruptcy case in Mexico, the Mexicana case raises its own set of novel issues. Indeed, Mexicana is the first bankruptcy case under the new bankruptcy law involving a company operating in a sector (commercial aviation) that is heavily regulated by the government. Further complicating matters was the bankruptcy filing by Mexicana's "low cost" airline sister companies: Aerovías Caribe, S.A. de C.V. a/k/a "Mexicana Click" and Mexicana Inter, S.A. de C.V. a/k/a "Mexicana Link." The three cases have been consolidated for procedural purposes only and are being jointly administered with the case of Nuevo Grupo Aeroportuario (Nuevo Grupo), the parent company of the members of the Mexicana Group.

Mexicana Operates Under A Public Service Concession

Under Mexican law, a company providing a public service must obtain a "concession" from the Mexican government. Air transportation falls within the definition of public service in Mexico and therefore an airline, such as Mexicana, must obtain a concession to operate. Typically, a concession is memorialized in a "concession title" or *título de concesión*, issued by a government agency, pursuant to which the terms, conditions and limitations regarding the provision of the public service are set forth by the authority. Given the public interest in the continued performance of public services, Mexican bankruptcy law allows the government to participate in bankruptcy cases involving public service companies. In connection with its operations, Mexicana obtained a concession from the government agency responsible for transportation in Mexico, *Secretaría de Comunicaciones y Transportes* (Ministry), which, under Mexican law, is authorized to participate in Mexicana's bankruptcy case.

The Government Appoints An Administrator

Under Mexican law, the government will appoint an administrator for a public service company that files for bankruptcy. An administrator will serve as the general manager of the company. In the case of Mexicana, the Ministry appointed Francisco Javier Christlieb Morales as the administrator of the company. Unless the Ministry decides otherwise, Mr. Christlieb will serve as the administrator of Mexicana during the bankruptcy case.

The Government Appoints The Conciliator

In a typical Mexican bankruptcy case, the individual who will serve as conciliator is selected by The Federal Institute of Reorganization Specialists (*Instituto Federal de Especialistas de Concursos Mercantiles* (IFECOM)), which was created for the sole purpose of guiding civil judges through the bankruptcy process and assisting them by appointing specialists such as conciliators, auditors and trustees. In the case of bankruptcy of a public service company, however, the Ministry, on behalf of the government, will appoint the conciliator.

The conciliator plays an extremely important role in the bankruptcy proceedings as he or she acts as a mediator between the debtor and its creditors and is responsible for preparing a reorganization plan. In addition, the conciliator monitors the administration of the company and presents the list of creditors and the value of their claims to the court for its approval. A conciliator may also be authorized to operate the debtor's business under certain circumstances, much like an operating trustee in the United States. In the Mexicana case, the Ministry appointed José Gerardo Badin Cherit, who has served as the conciliator in other Mexican bankruptcy cases.

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Mexicana Airlines

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The Government May Veto A Reorganization Plan

Normally, once a debtor and its creditors agree to the terms of a reorganization agreement, the bankruptcy case ends. However, in the case of a public service company, the government may veto such an agreement at its discretion. Accordingly, any reorganization agreement proposed by Mexicana and its creditors remains subject to the Ministry's veto. Moreover, if Mexicana is liquidated, the sale of the business and the concession remains subject to approval by the Ministry, which is entrusted with ensuring that the buyer fulfills all legal requisites set forth in the law to provide the public service.

Consolidation Of The Bankruptcy Proceedings of Mexicana And Related Companies

On September 22, 2010, the court in Mexico City entered an Order for Relief in favor of Mexicana Click, Mexicana Link, and Nuevo Grupo. In accordance with Article 15 of the Mexican Bankruptcy Code, these proceedings have been consolidated for procedural purposes only. Thus, while the bankruptcy cases are being administered by the same court, the estates of the different debtors have not been, and likely will not be, consolidated. Under Mexican law, creditors will have to assert their claims against each of the debtors that they believe may be liable to them. Moreover, an agreement reached with one debtor will not be binding on the others.

Next Steps In The Mexicana Bankruptcy Case

The deadline for creditors domiciled in Mexico to file proofs of claim against Mexicana and its affiliated debtors ended in early November, 2010. Foreign creditors had until early December 2010 to file their proofs of claim. According to Mexican law, upon the expiration of the deadline to file proofs of claim, the conciliator will prepare a list with the names of recognized creditors and the amounts owed. This process may take several weeks. This list will be the basis for the Order of Recognition, Ranking and Preference of Claims and, of course, for the subsequent negotiations on the terms of a reorganization agreement.

During the last several weeks, the administrator, the conciliator, the Federal Government of Mexico, and major creditor constituencies, including labor unions, have been evaluating several proposals by investors, pursuant to which Mexicana might renew its operations. If none of these proposals in some form is ultimately implemented, Mexicana will likely be liquidated. ◎

Self-Help Setoff in Lehman Case Deemed Impermissible

BY Robert J. Gayda

In *Bank of America, N.A*. v. *Lehman Brothers Holdings Inc*., Case No. 08-01753 (Bankr. S.D.N.Y. Nov. 16, 2010), the Bankruptcy Court of the Southern District of New York was called on to decide whether Bank of America, N.A. ("BOA") effectuated an improper setoff of $500 million shortly after Lehman Brother Holdings Inc. ("Lehman" or "LBHI") filed its petition on September 15, 2008 (the "Petition Date"), and whether the setoff violated the automatic stay. The Court ruled (i) that BOA did not have the right to setoff amounts in a special cash collateral account against unrelated amounts owed to BOA under certain derivative contracts and (ii) that BOA's actions in setting off those funds did not fall within any applicable exemption and therefore violated the automatic stay. Further, the Court stated that it would conduct a hearing to consider any appropriate sanctions to be imposed.

Background

For years prior to the Petition Date, BOA provided clearing services to support Lehman's worldwide foreign exchange and other financial activities. In connection with these clearing services, BOA permitted Lehman to incur unsecured intra-day overdrafts within certain limits, which was a fairly standard practice. By virtue of this banking practice, BOA allowed Lehman to transfer funds from its accounts in anticipation of receipts regardless of whether such accounts had a positive balance. BOA and Lehman understood, however, that any intra-day overdraft was to be eliminated by the close of each business day to prevent it from ripening into a "book" or "overnight" overdraft, and Lehman would be charged a fee for overnight overdrafts.

On Friday, July 25, 2008, Lehman incurred an overnight overdraft in the amount of $650 million in one of its accounts. The overdraft was cleared on the next business day, Monday, July 28, 2008. Regardless, this overdraft concerned BOA, which, considering the financial climate of the time, decided that it wanted protection against this type of event going forward. That additional protection took the form of a newly-created and newly-funded cash collateral account (the "Account"). After expedited negotiations, the parties entered into a security agreement (the "Security Agreement") executed on August 25, 2008, that governed the Account.

The Security agreement essentially provided that Lehman

would deposit $500 million into the Account, which was to be held at BOA. Notably, the Security Agreement provided that the funds in the Account could be used for one specific purpose — to cover overdraft exposure. No permissible use of the collateral other than to protect BOA against the risk of overdrafts was ever discussed during the negotiations.

As of the Petition Date, there were negligible, if any, overdrafts across all LBHI accounts at BOA. Regardless, on November 10, 2008, long after the Petition Date, BOA sent Lehman a “Demand for Payment Under Guarantee,” claiming that it had the right to set off some $1.9 billion that Lehman Brothers Specialty Financing Inc. (LBSF) allegedly owed under a swap agreement between LBSF and a BOA affiliate against some $509.3 million in funds held in various LBHI accounts at BOA. In the same letter, BOA notified Lehman that it would exercise its claimed right of setoff that same day. Consistent with that demand, on November 10, 2008, BOA swept $508,808,584.29 from various LBHI accounts into a suspense account and then onto BOA’s general ledger. The swept funds included, *inter alia*, the $500 million in the Account and $1.8 million in accumulated interest.

On November 21, 2008, Lehman sent a demand letter to BOA. The demand letter (i) stated that the setoff had violated the Security Agreement and the automatic stay and (ii) demanded return of LBHI’s funds. In response, on November 26, 2008, BOA commenced an adversary proceeding, seeking a judgment declaring that it acted within its rights when it exercised its alleged right of setoff. LBHI counterclaimed for the return of funds seized, statutory interest, and other relief, including attorneys’ fees and costs for BOA’s alleged violation of the automatic stay.

Bankruptcy Court Ruling

Setoff

The initial question before the Court was whether BOA could setoff the funds in the Account, which, pursuant to the terms of the Security Agreement, were earmarked for a specific purpose, against amounts owed by Lehman under seemingly unrelated derivative transactions. In arriving at its decision, the Court first reviewed section 553 of the Bankruptcy Code, which does not provide for an independent right of setoff, but rather incorporates any pre-existing rights under state law. The Court then turned to New York State law to determine whether a right of setoff existed.

The Court cited several cases for the proposition that under New York common law, funds within a “special purpose” account are not available for setoff against unrelated debts, while funds within a general deposit account may be subject to such a setoff. Therefore, the Court had to determine whether the Account constituted a special purpose account. The Court stated that as a general matter, a strong presumption exists under New York law that a deposit account is a general account / continued page6

IN OTHER NEWS

Chadbourne Hosts Cross-Border Restructuring Symposium

On October 26, 2010, Chadbourne’s bankruptcy and restructuring group held a highly successful symposium in New York City focusing on cross-border restructuring issues. The program consisted of two panel discussions. The first panel, which was moderated by Howard Seife, chairman of Chadbourne’s bankruptcy and restructuring group, focused on U.S. aspects of cross-border restructurings and addressed how the U.S. Chapter 11 process can be used to effectuate the restructuring of an international company. Featured speakers included Sean Cunningham, Capstone Advisory Group, LLC, W. Patrick Shropshire, Lazard Freres & Co. LLC, Nancy Rochford, Citigroup, Jim Wilson, Carl Marks Management Company, LLC and Chadbourne New York bankruptcy and restructuring partner Andrew Rosenblatt. The second panel was moderated by Alper Deniz, a partner in Chadbourne’s London bankruptcy and restructuring group, and focused on recent developments in the European restructuring market. Featured speakers included Simon Freakley, Zolfo Cooper, Tobias Verlende, Brinkmann & Partner and Adrian Harris, a partner in Chadbourne’s London bankruptcy and restructuring group.

Lehman

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and not a special purpose account. To override this presumption, evidence must demonstrate that the parties mutually intended to set aside the funds for a specific purpose. In determining the mutual intent of the parties, courts have considered "all of the circumstances" surrounding the creation of an account.

After a detailed analysis of the circumstances at hand, the Court surmised that the undisputed facts showed that BOA and LBHI mutually intended to create a special purpose account. This mutual intent was manifested in both the terms of the Security Agreement itself, as well as the parties' conduct at each stage of the creation, negotiation, and consummation of that agreement. For example, there was no evidence that BOA's negotiators had ever said anything to Lehman indicating that BOA believed it had a right to access the collateral for any obligations other than those relating to overdrafts. Accordingly, the Court determined that the setoff effectuated by BOA was not valid under New York law.

The Automatic Stay

Next, the Court considered whether BOA was entitled to retroactive approval of a setoff that had been taken while the automatic stay was in effect. To be entitled to such relief, the creditor "must (1) prove the validity of the setoff it seeks and (2) justify its failure to ... move for relief from the automatic stay to exercise setoff rights." Retroactive relief from the automatic stay is an "extraordinary measure" and a creditor must demonstrate "unusual and unusually compelling" facts to justify that relief. Clearly, considering this standard, retroactive relief from the automatic stay was not warranted as BOA was not entitled to setoff under applicable non-bankruptcy law.

Despite this determination, the Court further examined BOA's stated justification for its strategy of "seizing first and seeking comfort later." This stated justification was the exception to the automatic stay set forth in section 362(b)(17) of the Bankruptcy Code, one of the so-called "safe harbor" provisions. This provision deals expressly with "the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement . . . forming a part of or related to any swap agreement . . . ."

The Court noted that while the language of this subsection, as amended, had become broader, the current language is not so loose in its wording and reasonable application that unrelated security agreements or unrelated collateral such as that which was before the Court may be taken, without judicial oversight or restraint, to satisfy claims of a swap participant. The Court found that such a reading is not supported by the text and would conflict with contemporaneous legislative history. Moreover, the interpretation urged by BOA would run afoul of the longstanding maxim that exceptions to the automatic stay are to be construed narrowly. Accordingly, the Court ruled that BOA's conduct did not qualify for the exception set forth in section 362(b)(17). The collateral quite obviously never had any direct or indirect relationship to claims of BOA arising under a swap agreement and was pledged by LBHI exclusively to secure overdraft risks. The undisputed facts made clear that this particular exception to the automatic stay did not apply.

> The most important lesson to be learned from this case is simply stated by the Court — when analyzing setoff scenarios, restraint is paramount.

Sanctions

Finally, the Court turned to the topic of potential sanctions. In this regard, the Court noted that BOA acted with the advice of experienced and sophisticated counsel. The Court therefore assumed that BOA was fully informed regarding the "untested, uncertain and extremely aggressive legal position that it was advancing and the risks it was thereby assuming" that the exception to the automatic stay on which it relied might be found inapplicable to the seizure of LBHI's collateral. BOA, in the Court's view, had a responsibility to approach the setoff issue with far more restraint than was shown. The Court also stated that the actions taken were surprising and disappointing for a leading financial institution that should care a great deal about its reputation. BOA's setoff of property of Lehman was not supported by any reasonable application of the exception to the stay to the undisputed facts. The Court noted that further proceedings would be needed to determine an appropriate remedy for such a calculated violation of section 362(a)(7) of the Bankruptcy Code.

Conclusion

The most important lesson to be learned from this case is simply stated by the Court — when analyzing setoff scenarios, restraint is paramount. The Court was "disappointed" in the actions of BOA in this scenario. The Court stated its displeasure with the situation in several instances, noting first that BOA took advantage of its relationship with Lehman (and Lehman's dependence on BOA) to procure the Account. Additionally, the Court plainly stated that BOA acted in an "extremely aggressive" fashion in sweeping the funds in the Account and effectuating the setoff. Clearly, the Court would prefer future actors in a similar situation to seek relief from the stay prior to effectuating the setoff. It will be interesting to see what the Court decides in terms of sanctions, as the Court's order demonstrates that the Court suspects that BOA acted improperly. ◎

SCOPAC: New Opportunities for Secured Creditors in Sales of Bankrupt Companies through Chapter 11 Plans

By Eric Daucher

Section 507(b) of the Bankruptcy Code provides that if a secured creditor receives "adequate protection" for its interest in collateral held by a debtor, but that adequate protection ultimately proves insufficient, then the creditor is entitled to a "superpriority" administrative expense claim sufficient to cover any uncompensated diminution in the value of that collateral. On October 19, 2010, the Court of Appeals for the 5th Circuit (the "5th Circuit" or the "Court") broke new ground by granting a superpriority administrative expense claim to secured creditors under section 507(b), despite an already confirmed and consummated plan of reorganization, and allowing those creditors to assert the claim against the reorganized debtors. As a result of the 5th Circuit's ruling, the secured creditors will receive an additional $29.7 million in post-reorganization compensation on account of their secured claims. See In re Scopac, 624 F.3d 274 (5th Cir. 2010). */ continued page 8*

IN OTHER NEWS

Speeches and Events

- **Howard Seife** spoke at an International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) program in New Delhi, India in a program titled "Corporate Debt Restructuring" (December 2010)
- **Howard Seife** spoke at the American Bankruptcy Institute's 2nd Annual Mid-Level Professional Development Program on "Valuation Issues in Chapter 11 Cases" (October 2010). **Douglas Deutsch** was a co-chair of this fully sold-out New York City program.
- **Seven Rivera** spoke at a webinar sponsored by Stafford Publications titled "Lender Liability: Evaluating, Minimizing and Defending Claims" (December 2010)
- **Douglas Deutsch** spoke at the 30th Annual Bankruptcy Institute Forum in Kansas City, Missouri in a program titled "Leading Asset Sale Cases and Trends" (October 2010)

Publications

- **Douglas Deutsch** and **Eric Daucher** authored "Chapter 11 Confirmation Issues: Settlements, Releases, Gifting and Death Traps," *American Bankruptcy Institute Journal* (October 2010)
- **Francisco Vazquez** and **Eric Daucher** authored "Restructuring a Municipality Under Chapter 9," *American Bankruptcy Institute Journal* (July/August 2010)

SCOPAC

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Background

In January 2007, Scotia Pacific Co. ("Scopac") and several affiliated companies filed petitions for relief under Chapter 11 of the Bankruptcy Code. As of the petition date, Scopac's principal assets consisted of 200,000 acres of redwood timberland, as well as certain cash and cash equivalents. Its principal creditors were (1) the "Noteholders," who held $714 million in notes secured by a lien on substantially all of Scopac's assets, (2) Bank of America, which was owed $36.2 million and held a senior lien, also secured by substantially all of Scopac's assets, and (3) Marathon Structured Finance Fund LP ("Marathon"), which held $160 million in unsecured debt.

By January of 2008, the debtors and their various creditors had still not been able to agree on the terms of a plan of reorganization. As a result, the bankruptcy court entered an order terminating the debtors' exclusive period to propose and solicit votes for a plan. Shortly thereafter, Marathon partnered with Mendocino Redwood Co. ("Mendocino"), an unaffiliated timber company, in proposing a joint plan of reorganization for Scopac and its affiliate (the "Plan"). Under the terms of the Plan, Marathon would convert its $160 million unsecured claim into equity and, together with Mendocino, contribute $580 million in cash to purchase the company and fund payments to Scopac's other creditors. The Noteholders would be paid the current value of the secured portion of their claim while Bank of America would be paid the principal value of its claim, together with non-default interest. Trade creditors and general unsecured creditors would also receive partial distributions.

As part of the plan confirmation process, several hearings were held to determine the value of Scopac's timberland (and, consequently, the value of the Noteholders' secured claim). Ultimately, the bankruptcy found that the timberland was worth no more than $510 million. In light of the $714 million face value of their debt, the Noteholders were significantly undersecured. In response, the Noteholders filed a motion pursuant to section 507(b) of the Bankruptcy Code for an order awarding them a superpriority administrative expense claim based upon the substantial post-petition decline in the value of their collateral. The bankruptcy court delayed entry of the confirmation order and conducted further hearings to consider the Noteholders' 507(b) motion.

The undisputed evidence showed that the Noteholders' collateral included $48.7 million in non-timberland assets held by Scopac as of the petition date. The court deducted $36.2 million from this amount on account of Bank of America's first lien and $8.9 million on account of payments by Scopac to the Noteholders' professionals during the bankruptcy, leaving the Noteholders with $3.6 million in non-timberland collateral.

Although the Noteholders introduced evidence showing that the timberland collateral was worth $646 million as of the petition date, the court concluded — relying on evidence introduced by Marathon and Mendocino — that the timberland had not declined in value during the course of the bankruptcies. The court therefore held that the Noteholders were entitled to a total recovery of $513.6 million. Marathon and Mendocino agreed to modify the proposed Plan to provide payment of the additional $3.6 million. The Plan was confirmed on July 8, 2009 and the debtors emerged from bankruptcy shortly thereafter. The court also entered a separate final order denying the Noteholders' 507(b) motion in full.

The Noteholders appealed both confirmation of the Plan and the denial of the 507(b) motion. Additionally, the Noteholders requested (1) that the 5th Circuit hear the appeal of the Plan confirmation order directly (bypassing the district court) and (2) that consummation of the Plan be stayed pending that appeal. Although direct appeal to the 5th Circuit was granted, the stay pending appeal was denied. On appeal, the confirmation order was affirmed by the 5th Circuit, although the Court did not, in that instance, rule on the 507(b) motion. In the interim, the Plan was substantially consummated. Following substantial consummation of the Plan, the district court dismissed the appeal of the 507(b) motion, finding that (a) it lacked subject matter jurisdiction to consider the 507(b) claim following the Noteholders' appeal to the 5th Circuit of the Plan confirmation order and (b) the 507(b) dispute was equitably mooted by the substantial consummation of the Plan. The Noteholders then appealed the dismissal of their 507(b) claim to the 5th Circuit.

Equitable Mootness

After determining that the district court had the requisite subject matter jurisdiction to consider the 507(b) claim, the 5th Circuit considered whether the substantial consummation of the plan equitably mooted the Noteholders' appeal on the 507(b) issue. Generally, when confirmation of a plan of reorganization is not stayed pending appeal and is substantially consummated, courts will declare any appeal seeking to alter the terms of the plan to be equitably moot. However, courts occasionally allow post-consummation appeals to proceed where the relief requested would not affect either (a) the rights of parties not before the court or (b) the success of the plan.

Marathon and Mendocino argued that the appeal of the 507(b) order should be considered equitably moot because the relief sought by the Noteholders would upset the expectations of third parties not before the court. In support of this argument, they stressed that the reorganized debtors lacked sufficient liquid assets to pay even a modest judgment in favor of the Noteholders. The 5th Circuit rejected this argument, finding that Marathon and

Mendocino, as sophisticated investors, were aware of the possibility of adverse consequences on appeal, but nonetheless chose to "press the limits of bankruptcy confirmation and valuation rules." The Court further concluded that Marathon and Mendocino, as active participants in the plan litigation and owners of reorganized Scopac, were not "third parties" to the 507(b) appeal. Consequently, the court found that the 507(b) appeal was not equitably moot given that there was the possibility of at least a fractional recovery for the Noteholders.

Merits of the 507(b) Claim

By reversing the district court's findings on subject matter jurisdiction and equitable mootness, the 5th Circuit cleared the way for analyzing the Noteholders' 507(b) claim. In support of their position, the Noteholders argued that in fixing the value of their 507(b) claim, the courts below failed to properly acknowledge and account for certain replacement liens or continuing liens granted to the Noteholders over the proceeds of prepetition collateral.

As it assessed this argument, the Court noted that on six separate occasions the bankruptcy court entered orders that authorized Scopac to use the Noteholders' cash collateral. In each instance the bankruptcy court conditioned such use on Scopac providing the Noteholders with adequate protection against the diminution in value of their collateral. Quoting the earlier 5th Circuit decision of *In re Carpet Ctr. Leasing Co., Inc.*, 4 F.3d 940, 941 (11th Cir. 1993), the Court characterized section 507(b) of the bankruptcy code as "an attempt to codify a statutory fail-safe system in recognition of the ultimate reality that protection previously determined to be the 'indubitable equivalent' . . . may later prove inadequate." Indeed, the essence of the Noteholders' 507(b) claim was that the Plan, as approved by the bankruptcy court, inadequately compensated them for the value of the collateral that was intended to be protected by the adequate protection provisions of the cash collateral orders.

As discussed above, when the bankruptcy court calculated the value of the Noteholders' section 507(b) claim, it deducted $36.2 million from the cash collateral in existence on the petition date on account of Bank of America's first priority lien on the same collateral. It then further deducted $8.9 million on account of fees paid to the Noteholders' professionals.

The various cash collateral orders, however, protected the Noteholders in two significant ways. First, to the extent that there was any diminution in value of the prepetition collateral during the cases, the cash collateral orders granted the Noteholders replacement liens over any unencumbered property of the same type as the prepetition collateral, including cash. Second, the cash collateral orders granted the Noteholders continuing liens on the proceeds of the prepetition collateral. Based on this second protection, the Noteholders asserted that their collateral included $29.7 million in cash generated as proceeds / continued page 10

IN OTHER NEWS

Chadbourne Obtains Chapter 15 Recognition for Australian Liquidators

On November 16, 2010, the Honorable Kevin Gross of the United States Bankruptcy Court for the District of Delaware entered an order granting recognition as foreign main proceedings under Chapter 15 of the Bankruptcy Code to the proceedings of ABC Learning Centres Limited n/k/a ZYX Learning Centres Limited ("ABC Learning") and its affiliate, ABC USA Holdings Pty Ltd. ("ABC Holdings," and, together with ABC Learning, "ABC"), being conducted under Australia's Corporation's Act of 2001 (Cth) (the "Liquidations"). See In re ABC Learning Centres Ltd., Slip Op. 10-11711 (KG), 2010 WL 4735826 (Bankr. D. Del. Nov. 16, 2010). Notably, the Liquidations were granted recognition despite the fact that the Liquidations were occurring concurrently with receivership proceedings that could not themselves have been granted recognition under Chapter 15.

At its peak, ABC was one of the largest companies in Australia, operating approximately 1,045 childcare centers in Australia alone and employing over 15,000 full-time employees. In November 2008, 39 members of the ABC group of companies commenced voluntary administration proceedings in Australia due to increasing financial difficulties, thereby breaching the terms of the group's loan agreements with its secured creditors. Shortly thereafter, those secured creditors commenced receivership proceedings, which resulted in the appointment of a receiver charged with overseeing the day-to-day activities of the ABC group and realizing on the assets of the company over which the secured creditors had a lien (the "Receivership"). In June 2010, the administration proceedings were converted to voluntary liquidations.

In May 2010, the joint administrators (now the joint liquidators) of ABC, through Chadbourne, commenced Chapter 15 cases in the bankruptcy court in Delaware. The Chapter 15 cases were commenced in response to an adverse jury verdict issued against ABC Learning and one of its U.S. subsidiaries in a state court action brought in Arizona. In connection with the Chapter 15 filings, ABC sought and obtained a temporary restraining order enjoining continuation / continued page 11

SCOPAC

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of the timberlands during the course of the cases.

The courts below had essentially ignored these proceeds, which had been almost entirely consumed by professional fees that were generated and properly charged to the estate during the pendency of the cases. Nevertheless, the 5th Circuit found that such amounts were properly collateral of the Noteholders, except to the extent that they represented fees paid over to the Noteholders' professionals. Moreover, the Court found that Marathon and Mendocino would not be prejudiced by, and in any case should not be allowed to renege on, enforcement of the terms of the cash collateral orders. The 5th Circuit therefore concluded that the bankruptcy court erred by failing to provide payment to the Noteholders on account of their continuing liens over $29.7 million in proceeds generated by the timberlands, minus $8.9 million paid over to the Noteholders' professionals.

The Noteholders also argued that the bankruptcy and district courts erred by deducting an additional $8.9 million in payments that Scopac made to the Noteholders' professionals over and above the $29.7 million that it had already deducted. The 5th Circuit observed that by denying the Noteholders' claim to the $29.7 million in proceeds of their collateral, which were almost entirely consumed by the fees and expenses of various parties' professionals (including those of the Noteholders) and then further subtracting the $8.7 million paid to the Noteholders' own professionals, the bankruptcy court committed an additional clear error by double-counting the value of fees paid to the Noteholders' professionals.

The 5th Circuit concluded that the lower courts erred by underestimating the Noteholders' 507(b) administrative priority claim by $29.7 million. As a result, the Court vacated the orders of the courts below and remanded consideration of the 507(b) issue with a remarkable instruction for the lower court to enter a judgment for the Noteholders against reorganized Scopac in the amount of $29.7 million.

Conclusion

Scopac, as a newly reorganized company with entirely new ownership, does not appear to have $29.7 million in liquid assets that it can spare to satisfy the administrative expense claim. As a result, barring action by the Supreme Court of the United States, Marathon and Mendocino will be forced to contribute additional capital to reorganized Scopac in order to satisfy the Noteholders. The 5th Circuit's decision, therefore, retroactively increased the purchase price of Scopac paid by Marathon and Mendocino while stating that the terms of the confirmation order remained undisturbed. There are three principal, inter-related, lessons to take away from this decision. First, although equitable mootness is broadly applied, it cannot be assumed that a plan of reorganization will fix all parties' ultimate liability, even where the plan purports to do precisely that. Second, parties interested in buying a bankrupt company through a plan of reorganization should be aware that, should they choose to push for confirmation of a plan before resolving significant outstanding claim issues, they may ultimately find themselves paying more for the acquisition than they were planning, or even willing, to do. Third, secured creditors should take care to understand the full extent of their collateral, as doing so may enable them to receive additional compensation even after losing a plan confirmation fight. ◎

Going, Going, Gone: Selling the Cubs and Rangers in Bankruptcy

By Marc Roitman

In the last eighteen months, two Major League Baseball teams, the Chicago Cubs and the Texas Rangers, were sold in bankruptcy. Although both teams engaged in very similar processes leading up to their respective bankruptcy filings, the bankruptcy cases took very divergent paths.

On the one hand, the Cubs' trip through bankruptcy — made possible by a somewhat atypical sale process — was "as quick as a 1-2-3 inning."[1] The sale documents and sale procedures were signed, sealed and delivered by the bankruptcy court before the Cubs even filed for bankruptcy. At the time, the sale received praise as an innovative use of the Bankruptcy Code. On the other hand, despite an apparent effort to duplicate the Cubs' success by following a similar process, the Rangers' bankruptcy case followed a more traditional and less expeditious path. When the two transactions are viewed together, they highlight both the flexibility of bankruptcy sales and the many variables that can affect a sale process.

Sale of the Chicago Cubs: Accelerated by Tribune's Bankruptcy

In April 2007, Tribune Company publicly announced that it would sell the Chicago Cubs Major League Baseball franchise and began the sale process. Tribune identified a number of interested parties and initially received ten (10) bids for the Cubs. Before the sale process could be completed, however, Tribune Company and several

1 Ameet Sachdev, *Chicago Cubs Bankruptcy Case In A League Of Its Own, Chicago Tribune*, Oct. 13, 2009, http://articles.chicagotribune.com/2009-10-13/news/0910120439_1_ricketts-family-bankruptcy-case-bankruptcy-lawyers.

of its affiliated entities filed Chapter 11 bankruptcy cases on December 8, 2008 in the United States Bankruptcy Court for the District of Delaware. Significantly, the Cubs and related assets were left out of the Tribune entities' Chapter 11 cases.

At the time of Tribune's bankruptcy filing, there were three (3) bidders interested in purchasing the Cubs. Shortly thereafter, an evaluation of the remaining bids was conducted by Tribune in consultation with the Official Committee of Unsecured Creditors (represented by Chadbourne & Parke LLP) and the Steering Committee of Tribune's pre-bankruptcy lenders. Ultimately, on August 21, 2009, Tribune reached an agreement with the Ricketts family for the sale of the Cubs, Wrigley Field, the team's spring training and Dominican Republic baseball operations, certain other real estate assets, and Tribune's 25 percent interest in Comcast SportsNet Chicago, a regional cable network that broadcasts Cubs games. The agreement valued the Cubs franchise and related assets at approximately $845 million.

Tribune's agreement with the Ricketts family contemplated that the principal Tribune entity holding the assets and liabilities of the Cubs, Tribune CNLBC, would commence a brief Chapter 11 case as the final step to implement the sale. On August 24, 2009, Tribune filed a motion with the bankruptcy court seeking authority to perform the transactions necessary to effect the sale of the Cubs pursuant to section 363 of the Bankruptcy Code. It is noteworthy that the Cubs had not yet filed for bankruptcy at this point. Generally, a debtor files for bankruptcy *before* it seeks approval for procedures to sell its assets. The Cubs benefited from being in the unique position of having other related entities already in Chapter 11. This enabled the Cubs to have an audience with the bankruptcy court and to seek court approval of a proposed sale of its assets before becoming a Chapter 11 debtor.

In the motion to approve the sale procedures, Tribune argued — and the bankruptcy court agreed — that no further marketing or auction process for the Cubs should be required because (i) the Cubs had been thoroughly marketed for over two years, (ii) Tribune had already negotiated the sale with the Ricketts family and conducted negotiations with other bidders, and (iii) it was highly unlikely that additional marketing would identify an additional party with (a) a real interest in the Cubs, (b) a likelihood of assembling the necessary financial support and Major League Baseball approval, and (c) a willingness to exceed the consideration offered by the Ricketts family. In addition, the bankruptcy court found that notice to creditors was sufficient to satisfy the requirements of the Bankruptcy Code because any interested person or entity had a reasonable opportunity to be heard in connection with the motion to approve the sale procedures in the Tribune Chapter 11 cases.

On September 24, 2009, the bankruptcy court authorized Tribune to perform the sale transaction. On October 6, 2009, Major League Baseball announced unani- / *continued page 12*

IN OTHER NEWS

continued from page 9 of the Arizona lawsuit and collection efforts by creditors in the United States.

Although the Arizona plaintiff raised several objections to recognition of the Liquidations, its principal argument was that the Liquidations failed to meet the threshold definition of "foreign proceedings" under 11 U.S.C. § 101(23) because they were not "collective in nature." A proceeding is collective in nature if it considers the rights and obligations of all creditors. The Arizona plaintiff contended that the Liquidations were not "collective" because the Receivership, which benefited secured creditors exclusively and gave control of substantially all of ABC's assets to the receivers, effectively "trumped" the Liquidations. The court rejected this argument and observed that Australian law not only provides for concurrent liquidation and receivership proceedings, but also clearly delineates the respective roles of liquidators and receivers. Although receivers are appointed by secured creditors and are charged with recovering assets for the benefit of those secured creditors, liquidators are appointed by, act for and owe duties to all creditors. The bankruptcy court found that, because the Liquidations and Receivership were separate and distinct proceedings under Australian Law, the Liquidations should be evaluated on their own merits. Evaluated in their own right, the Liquidations were clearly foreign proceedings, and the bankruptcy court ultimately granted them recognition as foreign main proceedings.

The principal lesson to be drawn from In re ABC Learning Centres Ltd. is that U.S. bankruptcy courts are inclined to respect the structure of foreign insolvency laws when considering requests for recognition under Chapter 15 of the Bankruptcy Code. The purpose of Chapter 15 is to allow U.S. bankruptcy courts to provide assistance to foreign representatives in preserving and maximizing the value of a foreign debtor and recognition may be granted, as it was in the ABC cases, even when foreign insolvency proceedings do not perfectly mirror U.S. practices. ◎

Rangers

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mous approval of the sale. Tribune CNLBC filed its voluntary Chapter 11 petition on October 12, 2009, and the bankruptcy court granted the motion to approve the Cubs sale on October 14, 2009. The Cubs sale transactions closed on October 27, 2009.

Sale of the Texas Rangers: How a 1-2-3 Inning Turns Into a Slugfest

At the time of its bankruptcy filing on May 24, 2010, the Texas Rangers Major League Baseball franchise was directly owned and operated by Texas Rangers Baseball Partners ("Rangers Partners"). Rangers Partners was, in turn, owned by HSG Sports Group LLC ("HSG"), a sports and entertainment holding company indirectly controlled by Thomas O. Hicks.

During the summer of 2009, HSG and Rangers Partners began an auction process for the sale of the Rangers. After marketing the Rangers to prospective buyers, six (6) bids were received by the August 18, 2009 initial bid deadline. After a period of negotiations and due diligence, on December 15, 2009, HSG and Rangers Partners selected Rangers Baseball Express LLC ("Express") as the winning bidder. Express was a joint venture owned by Nolan Ryan, president of the Rangers and a Hall of Fame Major League Baseball player, and Chuck Greenberg, a sports lawyer and minor league club owner. On January 23, 2010, the parties entered into an asset purchase agreement governing the sale of the Rangers franchise to Express.

The asset purchase agreement was contingent on the consent of the lenders under HSG's First Lien Credit Agreement and Second Lien Credit Agreement. The lenders, however, would not consent to the sale. Major League Baseball fully supported the sale to Express and argued that the bidding process had been thorough. Eventually, Rangers Partners, in consultation with Major League Baseball, decided to file a bankruptcy case in order to bridge the impasse and to facilitate the sale of the Rangers to Express pursuant to a prepackaged plan of reorganization.

Expecting the filing to accelerate the sale process, Rangers Partners filed a Chapter 11 bankruptcy case on May 24, 2010 in the United States Bankruptcy Court for the Northern District of Texas. The bankruptcy filing, however, had a decelerating effect on the sale. After the lenders filed involuntary petitions against Rangers Partners' equity parents, the bankruptcy court determined on June 22, 2010 that any sale of the Rangers would require approval from a Chief Restructuring Officer in addition to bankruptcy court approval. Eventually, it became clear to Rangers Partners that the Chief Restructuring Officer would be more likely to support the prepackaged plan following an in-court auction process. Accordingly, on July 13, 2010, Rangers Partners filed a motion to approve bidding procedures to auction the Rangers.

The bankruptcy court's order approving sale procedures required Rangers Partners to seek approval of the sale pursuant to a plan of reorganization or, at the election of the winning bidder, pursuant to section 363 of the Bankruptcy Code. In either case, the court set certain requirements for the sale, including, among other things, Major League Baseball approval of the deal. In addition, the sale procedures order established Express as the stalking horse bidder with an initial bid valued at approximately $496 million.

The auction for the Rangers began on August 4, 2010 and was highly contentious. Ultimately, after more than 12 hours of bidding against a rival group led by Dallas Mavericks owner Mark Cuban and Houston businessman Jim Crane, Express won the auction with a bid valued at approximately $593 million in combined cash and assumed liabilities. On August 5, 2010, the bankruptcy court confirmed the sale as part of Rangers Partners' plan of reorganization. On August 12, 2010, Major League Baseball officially approved the sale of the Rangers to Express.

Conclusion

For all intents and purposes, the Rangers' process leading up to the bankruptcy filing followed the Cubs' model. Both teams conducted a rigorous marketing campaign and in due course identified preferred purchasers. Both teams reached agreement on all of the critical sale documents with their respective purchasers in advance of the bankruptcy filings. Both teams garnered the support of Major League Baseball and various creditor constituencies for their respective purchasers. Nevertheless, the Cubs were able to convince the bankruptcy court that the detriments of any delay in the process outweighed the benefits, whereas the Rangers were not permitted to consummate their proposed transaction without completing an in-court auction.

One significant difference is that Tribune was able to obtain bankruptcy court approval of the sale process before filing the Cubs' bankruptcy case. It is also significant that Tribune was able to persuade the bankruptcy court that further marketing of the Cubs would not yield a higher sale price. Conversely, the secured creditors of the Rangers were obstinate in their objections to the proposed sale, which resulted in the bankruptcy court questioning whether an alternative purchaser might come forward with a higher bid if given the opportunity.

Ultimately, the key difference between the two sale processes is found in the Rangers' and Cubs' respective capital structures. The Rangers were encumbered with secured loans, and a debtor may not sell encumbered assets without the consent of the secured creditors if the sale proceeds are less than the value of the secured loans in question.

To a certain extent, the Rangers' lenders were proven right in that the auction added almost $100 million in value to the purchase price. It must be noted, however, that the bankruptcy case proceeded smoothly following the auction in large part because Express, the purchaser preferred by the Rangers and

Major League Baseball, won the auction. As noted above, the sale procedures order required that Major League Baseball approve the sale. If the Cuban-Crane group had won the auction, Major League Baseball may not have given its approval, which would have led to a standoff between the league and the bankruptcy court.

The Third Circuit Rejects the Accrual Test and Adopts a Different Standard for Determining the Existence of a Claim

By Bonnie Dye

In a recent opinion, *JELD-WEN, Inc.* v. *Van Brunt* (*In re Grossman's Inc.*), 607 F.3d 114 (3d Cir. 2010), the United States Court of Appeals for the Third Circuit overruled its prior decision in *Avellino & Bienes* v. *M. Frenville Co.* (*In re Frenville Co.*), 744 F.2d 332 (3d Cir. 1984), which adopted the accrual test, a standard for determining the existence of a "claim" under the Bankruptcy Code. *In re Grossman's*, the Third Circuit reconsidered whether a claim arises at the time of exposure or when the injury manifests itself. Ultimately, the Third Circuit rejected the accrual test and adopted a different standard to determine the existence of a claim.

The Accrual Test

The *Frenville* court in its decision adopting the accrual test focused on the definition of "claim" to determine when a claim arises in a situation where a injury manifests itself some time after the occurrence of an event that caused the injury. Section 101(5) of the Bankruptcy Code defines claim as "a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured." Given that "right to payment" is not defined under the Bankruptcy Code, the court looked to state law. As a result, a valid claim will exist under the accrual test: (1) if the claimant possessed a right to payment; and (2) when that right arose as determined by non-bankruptcy law.

Rejecting the Accrual Test in Grossman's

The *Grossman's* case involved a claimant, Mary Van Brunt, who had been exposed to asbestos as a result of the debtor's pre-petition actions. Her injury from the asbestos exposure did not manifest itself, however, until after the confirmation of the debtor's plan of reorganization (the "Plan"). Ms. Van Brunt brought tort claims against the debtor's successor. In response, the successor moved to reopen the debtor's bankruptcy case and argued that Ms. Van Brunt was barred from asserting her claims. According to the successor, the claims arose at the time of the exposure, prior to the bankruptcy filing, and had been discharged pursuant the debtor's confirmed Plan. The successor further argued that the Plan's release provisions precluded Ms. Van Brunt from pursuing her claims against the debtor or any successor.

Relying on the *Frenville* decision, the lower courts rejected the successor's arguments and applied the accrual test. The courts held that the claims arose under state asbestos injury law — at the time the injury manifested itself — and therefore came into existence after the debtor's bankruptcy filing. As a result, Ms. Van Brunt's tort claims were not and could not have been released pursuant to the debtor's Plan; the claims could be asserted against the successor.

After the lower courts' decisions were appealed, the Third Circuit held that the lower courts had correctly applied the accrual test in the *Grossman's* case when determining that Ms. Van Brunt's tort claims were not released. The Third Circuit questioned, however, whether it should continue following its *Frenville* decision, recognizing that this decision was widely criticized by most courts for treating the term "claim" too narrowly. After considering the criticism of *Frenville*, along with the Bankruptcy Code's expansive treatment of the term "claim," the Third Circuit decided to reject the *Frenville* accrual test.

The Standard Adopted by the Third Circuit

Without a standard to apply, the Third Circuit looked to other courts' tests for determining the existence of a claim. The Court observed that the circuits are split, for the most part, between two different standards: (i) the "conduct test" and (ii) the "pre-petition relationship" test.

Several circuits employ the conduct test. Under this test, a claim arises when the acts giving rise to the defendant's liability occurred, not when the harm caused by those acts was manifested. Other courts have criticized the conduct test as being overly broad because it fails to consider whether the claimant had any relationship or contact with the debtor that would enable the debtor to identify the claimant for purposes of providing notice of its bankruptcy proceedings.

Those courts that criticize the conduct test employ the pre-petition relationship test. Under the pre-petition relationship test, a claim arises from a debtor's pre-petition tortuous conduct where there is also a pre-petition relationship between the debtor and claimant, such as a purchase, use, opera- */ continued page 14*

Accrual Test

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tion of, or exposure to the debtor's product. Courts have found a "pre-petition relationship" where evidence exists that would permit the debtor to identify potential victims during its bankruptcy proceedings and would thereby permit the debtor to provide them with notice of its bankruptcy.

The Third Circuit concluded that neither test was satisfactory. In particular, the Court observed that the conduct test is overly broad and the pre-petition relationship test is too narrow. Without expressly adopting either test, the Third Circuit concluded that a claim is appropriately recognized for purposes of bankruptcy claims administration at the time a person is exposed to a product or other conduct giving rise to an injury even if that injury does not manifest itself until after the debtor's reorganization. Under the standard adopted in *Grossman's*, a claim will arise when an individual is exposed pre-petition to a product or other injury-causing conduct giving rise to an injury, which underlies a "right to payment" under the Bankruptcy Code.

But, the Third Circuit continued, the fact that a claim is deemed to have arisen before the petition date does not necessarily result in the discharge of that claim. The Third Circuit noted that the application of the claims recognition standard must comport with due process to ensure that the claimant has adequate notice to protect the claim. The due process element of the Third Circuit's decision requires (i) an inquiry into the adequacy of the claims bar date notice; (ii) a determination as to whether the notice of the bar date came to the claimant's attention; (iii) whether the claimants were known or unknown creditors; (iv) whether the claimant had a colorable claim at the time of the bar date; and (v) other circumstances that are specific to the parties. The Third Circuit remanded the case to the lower court for further findings.

Conclusion

With its decision to overrule the *Frenville* opinion, the Third Circuit is the last circuit to reject the accrual test. The Third Circuit recognized and aligned itself with other circuit courts in concluding that a claim arises when an individual is exposed to a product or conduct that causes injury, even if the injury is not manifested until several years later. Ascribing a claim, for which injury first manifests itself after the debtor's reorganization, to a date before the commencement of the case does not, however, necessarily result in the discharge of that claim. The Third Circuit cautions that irrespective of the relationship or lack thereof between the debtor's conduct and the claimant, the discharge of such claims is best determined by the bankruptcy court after consideration of factors relevant to due process. ◎

The Scope of the Stay Under Chapter 15 of the Bankruptcy Code

By Francisco Vazquez

It is well established that the automatic stay imposed under section 362 of the United States Bankruptcy Code (the "Bankruptcy Code") in a typical bankruptcy case applies extraterritorially. Thus, creditors of a Chapter 11 debtor are generally prohibited from exercising any remedies against a debtor or its assets anywhere in the world. Up until recently, no court had addressed the scope of the stay applicable in a Chapter 15 case. According to one judge in the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), a stay under Chapter 15 is more limited than the automatic stay applicable in a plenary case. *In re JSC BTA Bank*, 434 B.R. 334 (Bankr. S.D.N.Y. 2010).

Background

In July 2008, JSC BTA Bank, one of the largest banks in the Republic of Kazakhstan ("BTA Bank"), and Banque International de Commerce-BRED Paris, succursale de Geneva, Switzerland ("BIC-BRED"), the Swiss branch of a French bank, entered into a loan agreement (the "Loan Agreement") pursuant to which BTA Bank borrowed $20 million. Neither bank has any employees nor conducts any business within the United States. Their only connection to the United States consists of balances in accounts of correspondent banks in New York. The Loan Agreement is governed by Swiss law and provides that any disputes would be submitted to arbitration in Switzerland.

In July 2009, BTA Bank announced that it would cease to pay all principal and interest owed on its debts. On August 4, 2009, BTA Bank defaulted on the Loan Agreement. Thereafter, BIC-BRED commenced arbitration against BTA Bank in Switzerland in accordance with the Loan Agreement (the "Arbitration").

Prior to the Arbitration, BTA Bank commenced reorganization proceedings in Kazakhstan (the "Reorganization Proceeding"). Subsequently, the Reorganization Proceeding was granted recognition in the United Kingdom and the Ukraine. On February 4, 2010, the Chairman of the Management Board of BTA Bank, in his role as the foreign representative of BTA Bank (the "Foreign Representative"), filed a petition for recognition of the Reorganization Proceeding under Chapter 15 of the Bankruptcy Code with the Bankruptcy Court.

Unlike the filing of a Chapter 7 or 11 petition, the filing of a Chapter 15 petition does not automatically trigger a stay of actions against the debtor or its assets. In general, relief in a Chapter 15

case is reserved until recognition of the foreign proceeding. By order issued on March 2, 2010, (the "Recognition Order"), the Bankruptcy Court granted recognition to the Reorganization Proceeding as a foreign main proceeding. Upon recognition of a foreign main proceeding, the foreign debtor automatically obtains the benefit of certain protections, including the automatic stay, provided by the Bankruptcy Code. Indeed, the Recognition Order expressly provided in pertinent part that BTA Bank was granted "all of the relief set forth in section 1520 of the Bankruptcy Code including, without limitation, the application of the protection afforded by the automatic stay under section 362(a) of the Bankruptcy Code to the Bank worldwide and to the Bank's property that is within the territorial jurisdiction of the United States."

Contempt Motion

Given the terms of the Recognition Order, BTA Bank requested that BIC-BRED suspend the Arbitration. BIC-BRED refused. BTA Bank countered, in its defense of the Arbitration, that BIC-BRED was in violation of the Recognition Order by refusing to suspend the Arbitration. The arbitrator concluded, however, that BTA Bank's allegation was not timely raised. Moreover, according to the arbitrator, the Recognition Order did not stay the Arbitration, which was pending in Switzerland and governed by Swiss law. Ultimately, the arbitrator issued an award in favor of BIC-BRED and against BTA Bank for the full amount of the loan plus interest and costs.

On July 2, 2010, the Foreign Representative filed a motion with the Bankruptcy Court for an order confirming that the Recognition Order stayed the Arbitration and finding that BIC-BRED was in contempt (the "Contempt Motion"). In support of the Contempt Motion, the Foreign Representative argued that the Arbitration was stayed by section 1520(a)(1) of the Bankruptcy Code, which provides that upon recognition of a foreign main proceeding, section 362 applies "with respect to the debtor and the property of the debtor that is within the territorial jurisdiction of the United States." According to the Foreign Representative, section 1520(a)(1) imposes a territorial limitation on the automatic stay with regard to actions against a foreign debtor's assets, but not in relation to the debtor itself. Thus, according to the Foreign Representative, the stay available in a Chapter 15 case "applies to the debtor in all jurisdictions and to the property of the debtor *that is* within the territorial jurisdiction of the United States."

In response, BIC-BRED argued that the Recognition Order does not stay proceedings against BTA Bank outside the United States. Moreover, BIC-BRED argued that the Bankruptcy Court lacked the requisite jurisdiction over it. Ultimately, the Bankruptcy Court denied the Contempt Motion.

The Decision

Guided by the international origin and the ancillary purpose of Chapter 15, the Bankruptcy Court concluded that section 1520(a)(1) would be best understood to provide that "the stay arising in a Chapter 15 case upon recognition of a foreign main proceeding applies to the debtor within the United States for all purposes and may extend to the debtor as to proceedings in other jurisdictions for purposes of protecting property of the debtor that is within the territorial jurisdiction of the United States." According to the Bankruptcy Court, this interpretation is consistent with the "international origin" and ancillary nature of Chapter 15.

The Bankruptcy Court acknowledged that the Foreign Representative's interpretation, on the face of section 1520(a)(1), was plausible. That interpretation was flawed, however, in that it failed to take into account the ancillary nature and limited jurisdiction of a Chapter 15 case and the international origin of Chapter 15. While a bankruptcy court has worldwide jurisdiction over a debtor and its assets in a plenary proceeding, its jurisdiction under Chapter 15, according to the Bankruptcy Court, is *in rem* in nature. Therefore, Chapter 15 draws a distinction between property within the United States and other property and limits the stay to property within the United States to "eliminate any doubt as to the extent of the authority of the bankruptcy court over property of a foreign debtor." The Bankruptcy Court explained that while Chapter 15 was vague as to the extent of the stay *vis-a-vis* the debtor itself, the unrestricted interpretation posited by the Foreign Representative would be "internally inconsistent" with section 1520(a)(1) and therefore unworkable.

Moreover, an expansive reading of section 1520(a)(1) would have absurd results. It would, according to the Bankruptcy Court, (i) convert recognition of a foreign main proceeding into "a worldwide anti-suit injunction as to any proceeding against the debtor," including those involving parties with no or insignificant contacts with the United States, and (ii) require the bankruptcy court to act as a "global clearing house" entrusted with determining whether litigation could proceed in foreign countries. This would lead to "needless intervention" into disputes having no relationship to the United States.

Nevertheless, section 1520(a)(1) enjoins litigation against a debtor outside the United States that could affect the debtor's property within the United States. For example, if the Arbitration involved a determination of rights in BTA Bank's property in the United States, the Arbitration should be stayed regardless of its venue. Such an interpretation of section 1520(a)(1) is consistent with the court's jurisdiction under Chapter 15 and other sections of the Bankruptcy Code, including section 1520(b), which permits litigation in a foreign country to preserve a claim against the debtor.

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Scope of Stay

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Conclusion

One of the most fundamental features of any bankruptcy case is the imposition of a moratorium staying actions against a debtor and its assets. In a typical United States bankruptcy case, the automatic stay extends beyond the borders of the United States and in theory protects the debtor and its assets wherever located. There may nevertheless be practical issues, such as lack of personal jurisdiction over certain creditors, that may negate the protection of a stay. Putting aside the practicalities of enforcing a stay under Chapter 15 outside of the United States, a Chapter 15 stay may by not be as broad as a Chapter 11 stay and may not protect a debtor from litigation in a foreign country. According to the Bankruptcy Court in *In re JSC BTA Bank*, the Chapter 15 stay does not protect a debtor from litigation outside the United States that would not affect the debtor's assets within the United States. ◎

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