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FERC V. BANKRUPTCY COURT TURF WAR UPDATE

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On June 22, 2020, the Federal Energy Regulatory Commission ("FERC") issued an order concluding that FERC and the U.S. bankruptcy courts have concurrent jurisdiction to review and address the disposition of natural gas transportation agreements that a debtor seeks to reject under section 365(a) of the Bankruptcy Code (11 U.S.C. §§ 101 *et seq.*). *See ETC Tiger Pipeline, LLC,* 171 FERC 61,248 (2020), *reh'g denied*, 172 FERC 61,155 (Aug. 21, 2020). The order was issued in response to a petition filed on May 19, 2020, by ETC Tiger Pipeline, LLC ("Tiger") in which Tiger asked FERC to issue a declaratory order as to whether Chesapeake Energy Marketing, L.L.C. ("Chesapeake"), a counterparty to Tiger's natural gas transportation agreements, must obtain FERC's approval under sections 4 and 5 of the Natural Gas Act, 15 U.S.C. ch. 15B §§ 717 *et seq*. ("NGA") prior to rejecting the agreements in an anticipated bankruptcy case. In the order, FERC stated that, "Where a party to a Commission-jurisdictional agreement under the NGA seeks to reject the agreement in bankruptcy, that party must obtain approval from both the Commission and the bankruptcy court to modify the filed rate and reject the contract, respectively."

FERC has previously taken the position that it shares jurisdiction with the bankruptcy courts to determine whether contracts subject to FERC regulation under sections 205 and 206 of the Federal Power Act, 16 U.S.C. §§ 791a *et seq*. ("FPA"), can be rejected in bankruptcy (most notably in connection with the chapter 11 case filed by PG&E Corporation*). See NextEra Energy, Inc. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,049 (2019); *Exelon Corp. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,053 (2019), *on reh'g*, 167 FERC ¶ 61,096 (2019). However, this is the first time that FERC has made such a finding with respect to contracts regulated under the NGA.

The issue was also before FERC in connection with a petition filed on April 29, 2020, by Rockies Express Pipeline LLC ("Rockies") seeking a declaratory order finding that FERC has concurrent jurisdiction with the bankruptcy courts under the NGA and FERC regulations over any request by an affiliate of Ultra Petroleum Corp. ("UPC"), which filed for a pre-packaged chapter 11 case on May 15, 2020, to reject a natural gas transportation agreement with Rockies. The U.S. Bankruptcy Court for the Southern District of Texas authorized rejection of that agreement on August 6, 2020, noting in its August 21, 2020, written ruling that a bankruptcy court "is not authorized to graft a wholesale exception to § 365(a) of the Bankruptcy Code . . . preventing rejection of FERC approved contracts." *In re Ultra Petroleum Corp.*, 2020 WL 4940240 (Bankr. S.D. Tex. Aug. 21, 2020).

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Court rulings to date on the jurisdictional turf war between FERC and the bankruptcy courts have been a mixed bag. FERC's position on the question has evolved—the commission's current view is that it and the bankruptcy courts have concurrent jurisdiction to determine whether FERC-regulated agreements can be rejected in bankruptcy. Here, we offer a brief discussion of what is likely to remain a disputed issue for some time, especially given the recent spike in oil and gas company bankruptcies.

BANKRUPTCY JURISDICTION AND REJECTION OF EXECUTORY CONTRACTS

By statute, U.S. district courts are given "original and exclusive" jurisdiction over every bankruptcy "case." 28 U.S.C. § 1334(a). In addition, they are conferred with nonexclusive jurisdiction over all "proceedings arising under" the Bankruptcy Code as well as proceedings "arising in or related to cases under" the Bankruptcy Code. 28 U.S.C. § 1334(b). Finally, district courts are granted exclusive jurisdiction over all property of a debtor's bankruptcy estate, including, as relevant here, contracts, leases, and other agreements that are still in force when a debtor files for bankruptcy protection. 28 U.S.C. § 1334(e). That jurisdiction typically devolves automatically upon the bankruptcy courts, each of which is a unit of a district court, by standing court order. 28 U.S.C. § 157(a).

A bankruptcy court's exclusive jurisdiction over "executory" contracts or unexpired leases empowers it to authorize a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") to either "assume" (reaffirm) or "reject" (breach) almost any executory contract or unexpired lease during the course of a bankruptcy case in accordance with the provisions of section 365 of the Bankruptcy Code. Assumption generally allows the debtor, after curing outstanding defaults, to continue performing under the agreement or to assign the agreement to a third party for consideration as a means of generating value for the bankruptcy estate. Rejection frees the debtor from rendering performance under unfavorable contracts. Rejection constitutes a breach of the contract, and the resulting claim for damages is deemed to be a prepetition claim against the estate on a par with other general unsecured claims.

Accordingly, the power granted to debtors by Congress under section 365 is viewed as vital to the reorganization process. Rejection of a contract "can release the debtor's estate from burdensome obligations that can impede a successful reorganization." *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 528 (1984) (holding that rejection is allowed for "all executory contracts except those expressly exempted"). Typically, bankruptcy courts authorize the proposed assumption or rejection of a contract or lease if it is demonstrated that the proposed course of action represents an exercise of sound business judgment. This is a highly deferential standard akin in many respects to the business judgment rule applied to corporate fiduciaries.

THE FEDERAL POWER ACT, THE FILED-RATE DOCTRINE, THE NATURAL GAS ACT, AND THE MOBILE-SIERRA DOCTRINE

Public and privately operated utilities providing interstate utility service within the United States are regulated by the FPA under FERC's supervision. Although contract rates for electricity are privately negotiated, those rates must be filed with FERC and certified as "just and reasonable" in order to be lawful. 16 U.S.C. § 824d(a). FERC has the "exclusive authority" to determine the reasonableness of the rates. *See In re Calpine Corp.*, 337 B.R.

27, 32 (S.D.N.Y. 2006). The FPA authorizes FERC, after a hearing, to alter filed rates if it determines that they are unjust or unreasonable. 16 U.S.C. § 824e.

On the basis of this statutory mandate, courts have developed the "filed-rate doctrine," which provides that "a utility's right to a reasonable rate under the FPA is the right to the rate that FERC files or fixes and, except for review of FERC orders, a court cannot provide a right to a different rate." *Calpine*, 337 B.R. at 32. Moreover, the doctrine prohibits any collateral attack in the courts on the reasonableness of rates—the sole forum for such a challenge is FERC. *Id.* Applying the doctrine, some courts have concluded that, once filed with FERC, a wholesale power contract is tantamount to a federal regulation, and the duty to perform under the contract comes not only from the agreement itself but also from FERC. *Id*. at 33 (*citing Pa. Water & Power Comm'n v. Fed. Power Comm'n*, 343 U.S. 414 (1952); *Cal. ex rel. Lockyer v. Dynergy Inc.*, 375 F.3d 831 (9th Cir. 2004)).

Although FERC has exclusive authority to modify a filed rate, its discretion is not unfettered. For example, FERC may not change a filed rate solely because the rate affords the utility "less than a fair return" since "the purpose of the power given to the Commission . . . is the protection of the public interest, as distinguished from the private interests of the utilities." *In re Mirant Corp.*, 378 F.3d 511, 518 (5th Cir. 2004) (citation omitted). In such a case, FERC can change a filed rate only when "the rate is so low as to adversely affect the public interest—as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Id.*

The NGA regulates interstate sales of natural gas for resale in much the same way the FPA regulates interstate sales of power. The language in the NGA regarding the requirement to file rates and FERC's power to fix unjust and unreasonable rates is nearly identical to the language in the FPA. *Compare* 16 U.S.C. § 824(e) (FPA) *with* 15 U.S.C. § 717c (NGA).

In a series of cases (*see United Gas Pipe Line Co. v. Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956); *Fed. Power Comm'n v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956)), the U.S. Supreme Court articulated what is referred to as the "Mobile-Sierra doctrine." Under this doctrine, FERC must presume that a rate set by a freely negotiated wholesale-energy contract meets the "just and reasonable" requirement of the NGA and the FPA. That presumption may be overcome only if FERC concludes that the contract seriously harms the public interest. *See NRG Power Mktg., LLC v. Maine Pub. Utilities Comm'n,* 558 U.S. 165 (2010).

If a regulated utility files for bankruptcy, FERC's exclusive discretion in this realm could be interpreted to conflict with the bankruptcy court's exclusive jurisdiction to authorize the rejection of an electricity supply or natural gas agreement. This thorny issue has been addressed to date by only a handful of courts, including two federal courts of appeals.

NOTABLE COURT DECISIONS AND FERC RULINGS

***In re Mirant Corp.*, 378 F.3d 511 (5th Cir. 2004).** In *Mirant*, the U.S. Court of Appeals for the Fifth Circuit ruled that the FPA does not prevent a bankruptcy court from ruling on a motion to reject a FERC-regulated rate-setting agreement as long as the proposed rejection does not represent a challenge to the agreement's filed rate.

The Fifth Circuit noted that, although the Bankruptcy Code places numerous limitations on a debtor's right to reject contracts, "including exceptions prohibiting rejection of certain obligations imposed by regulatory authorities," there is no exception that prohibits a debtor's rejection of wholesale electricity contracts that are subject to FERC's jurisdiction. Concluding that "Congress intended § 365(a) to apply to contracts subject to FERC regulation," the Fifth Circuit held that the bankruptcy court's power to authorize rejection of the agreement did not conflict with the authority conferred upon FERC to regulate rates for the interstate sale of electricity.

The Fifth Circuit, however, imposed a higher standard for rejection of such agreements. It concluded that, in determining whether a debtor should be permitted to reject a wholesale power contract, "the business-judgment standard would be inappropriate . . . because it would not account for the public interest inherent on the transmission and sale of electricity." Instead, a "more rigorous standard" might be appropriate, including consideration of not only whether the contract burdens the estate, but also whether the equities balance in favor of rejection, rejection would promote a successful reorganization and rejection would serve the public interest. Such a balancing exercise, the Fifth Circuit noted, could be undertaken with FERC's input.

***In re Calpine Corp.*, 337 B.R. 27 (S.D.N.Y. 2006).** In *Calpine*, the U.S. District Court for the Southern District of New York denied a chapter 11 debtor's motion to reject certain FPA-governed power agreements because the court concluded that FERC had exclusive jurisdiction over the modification or termination of such agreements.

According to the court, the requirement that FERC approval be obtained for any alteration of the "rates, terms, conditions, or duration" of a power agreement is not eliminated merely because the power provider files for bankruptcy. The district court found "little evidence" in the Bankruptcy Code of congressional intent to limit FERC's regulatory authority, remarking that "[a]bsent overriding language, the Bankruptcy Code should not be read to interfere with FERC jurisdiction."

***In re Boston Generating, LLC*, 2010 WL 4616243 (S.D.N.Y. Nov. 12, 2010).** In *Boston Generating*, the U.S. District Court for the Southern District of New York ruled that, in order to reject an NGA-governed contract for the transportation of natural gas to one of the chapter 11 debtors' power plants, the debtors "must also obtain a ruling from FERC that abrogation of the contract

does not contravene the public interest." "If either the bankruptcy court or FERC does not approve the Debtors' rejection of the [gas transportation agreement]," the court wrote, "the Debtors may not reject the contract."

***PG&E Corp. v. FERC (In re PG&E Corp.)*, 603 B.R. 471 (Bankr. N.D. Cal. June 7, 2019), *amended and direct appeal certified,* 2019 WL 2477433 (Bankr. N.D. Cal. June 12, 2019*), permission to appeal granted,* No. 19-71615 (9th Cir. Sept. 17, 2019), *vacated as moot*, D.C. No. 3:19-bk-30088 (9th Cir. Oct. 7, 2020).** In *PG&E*, the U.S. Bankruptcy Court for the Northern District of California ruled that the lack of any exception for FERC in section 365 of the Bankruptcy Code "simply means that FERC has no jurisdiction over the rejection of contracts."

The bankruptcy court concluded that FERC exceeded its authority by declaring that it shares jurisdiction with the bankruptcy court over the question of whether PG&E Corp. and its Pacific Gas & Electric Co. utility subsidiary (collectively, "PG&E") can reject FPA-governed power purchase agreements. The court rejected FERC's argument that, because wholesale power contracts are not "simple run-of-the-mill contracts," but implicate the public interest in the orderly production of electricity at just and reasonable rates, the modification or abrogation of such contracts by means of rejection should not be subject to a bankruptcy court's exclusive jurisdiction. According to the court, this argument "is completely contrary to the congressionally created authority of the bankruptcy court to approve rejection of nearly every kind of executory contract," including "run-of-the-mill types" as well as power purchase agreements and other contracts that implicate the public's interest, with certain exceptions not relevant in this case (e.g., sections 365(h) (certain leasehold interests), 365(i) (timeshare interests), 365(n) (intellectual property licenses), 365(o) (commitments to federal depository institutions), and 1113 (collective bargaining agreements). Those provisions, the court reasoned, demonstrate that Congress knows "how to craft special rules for special circumstances." The court added that lawmakers also knew how to condition confirmation of a chapter 11 plan on the approval by a governmental regulatory commission of any proposed rate change, but they failed to condition rejection of a contract on FERC's approval. *See* 11 U.S.C. § 1129(a)(6).

The bankruptcy court certified a direct appeal of its ruling to the U.S. Court of Appeals for the Ninth Circuit, where arguments were originally scheduled for August 14, 2020.

However, after the bankruptcy court confirmed PG&E's chapter 11 plan on June 20, 2020, the Ninth Circuit asked FERC and PG&E to explain the impact of confirmation on the pending appeal. FERC and PG&E agreed that plan confirmation mooted their turf war over power contract rejection in the PG&E bankruptcy, but disagreed as to whether the Ninth Circuit should dismiss FERC's appeal.

According to PG&E, U.S. Supreme Court precedent dictates that the Ninth Circuit should vacate all of the matters in the dispute, including FERC's January 2019 orders claiming concurrent jurisdiction, the bankruptcy court's June 2019 ruling rejecting FERC's claim of concurrent jurisdiction, and FERC's subsequent appeal. FERC countered that PG&E ceded its ability to challenge FERC's authority after confirmation of a chapter 11 plan in which PG&E pledged to honor its existing power purchase agreements.

The Ninth Circuit vacated the bankruptcy court's ruling as well as FERC's orders on October 7, 2020.

***FERC v. FirstEnergy Solutions Corp.* (*In re FirstEnergy Solutions Corp.),* 945 F.3d 431 (6th Cir. 2019), *reh'g denied*, No. 18-3787 (6th Cir. Mar. 13, 2020).** In *FirstEnergy Solutions*, a divided panel of the U.S. Court of Appeals for the Sixth Circuit ruled that, although the bankruptcy court had "concurrent" jurisdiction to decide whether chapter 11 debtors could reject certain FPA-regulated wholesale power contracts, the bankruptcy court exceeded its jurisdiction by enjoining FERC from requiring the debtors to continue performing under the contracts or from taking any other actions in connection with them. The Sixth Circuit also held that the bankruptcy court incorrectly applied the "business-judgment" standard to the debtors' request to reject the contracts. According to the Sixth Circuit:

> [W]hen a Chapter 11 debtor moves the bankruptcy court for permission to reject a filed energy contract that is otherwise governed by FERC, via the FPA, the bankruptcy court must consider the public interest and ensure that the equities balance in favor of rejecting the contract, and it must invite FERC to participate and provide an opinion in accordance with the ordinary FPA approach . . . within a reasonable time.

***ETC Tiger Pipeline, LLC*, 171 FERC ¶ 61,248 (2020) (*Chesapeake Energy*), *reh'g denied*, 172 FERC ¶ 61,155 (Aug. 21, 2020).** Tiger owns a 197-mile bidirectional pipeline and has been providing service to Chesapeake since 2016 under two transportation agreements regulated by FERC under the NGA. Chesapeake filed for chapter 11 protection on June 28, 2020, in the Southern District of Texas. In anticipation of the filing, Tiger filed a petition with FERC on May 19, 2020, seeking a declaratory judgment that Chesapeake could not reject the transportation agreements without FERC approval. In its June 22, 2020, order, FERC found that the principles it articulated in connection with the PG&E cases with respect to the FPA apply with equal force under the NGA. FERC concluded that, "Where a party to a Commission-jurisdictional agreement under the NGA seeks to reject the agreement in bankruptcy, that party must obtain approval from both [FERC] and the bankruptcy court to modify the filed rate and reject the contract, respectively."

FERC began the ruling by stating that the filed-rate doctrine and the Mobile-Sierra doctrine apply equally to contracts regulated under sections 4 and 5 of the NGA and contracts regulated under sections 205 and 206 of the FPA. It explained that the Mobile-Sierra doctrine is in fact derived from the Supreme Court's twin decisions issued the same day under the NGA and the FPA. Consistent with this precedent, FERC found that "the

Bankruptcy Code does not displace [FERC's] jurisdiction over filed rate contracts under the NGA." As filed rates, FERC wrote, NGA-regulated contracts "are not typical commercial contracts but rather establish public obligations that carry the force of law."

FERC cited *Mission Product Holdings, Inc. v. Tempnology,* 139 S. Ct. 1652, 1665 (2019), for the proposition that a debtor cannot grant itself an exemption from "all the burdens that generally applicable law . . . imposes" by rejecting a contract through the bankruptcy process. FERC accordingly concluded that a debtor cannot "extinguish its filed rate obligations under the NGA by rejecting a contract in bankruptcy." According to FERC, the "[r]ejection of a [FERC]-jurisdictional contract in a bankruptcy court alters the essential terms and conditions of a contract that is also a filed rate; therefore, the Commission's approval is required to modify or abrogate the filed rate."

On July 1, 2020, the bankruptcy court entered an agreed order authorizing Chesapeake to reject its negotiated rate natural gas transportation agreements with Gulf South Pipeline Co. ("Gulf South"). Prior to Chesapeake's bankruptcy filing, Gulf South had also filed a petition requesting declaratory relief from FERC to insulate its agreements against rejection. The agreed order provides that Gulf South's rejection damage claims are the "full and final remedy available" and that Gulf South will withdraw its FERC petition and "not pursue any additional rights or remedies" before FERC.

Another pipeline company having agreements with Chesapeake, Stagecoach Pipeline and Storage Co. LLC ("Stagecoach"), submitted a separate petition to FERC for a similar declaratory order on June 9, 2020. Chesapeake responded by filing an adversary proceeding against FERC in the bankruptcy court seeking a declaratory judgment confirming the court's exclusive jurisdiction to determine Chesapeake's right to reject the relevant agreements. Chesapeake also filed a motion to reject its transportation agreements with Gulf South, Tiger, and Stagecoach Pipeline.

On July 10, Chesapeake and FERC agreed that, during the pendency of Chesapeake's chapter 11 cases, FERC would not: (i) issue any ruling requiring Chesapeake to obtain FERC's approval to reject the agreements with Tiger, Gulf South, or Stagecoach; or (ii) issue any orders in response to Stagecoach and Gulf South's prepetition FERC petitions without obtaining relief from the automatic stay to do so.

On July 14, FERC asked the bankruptcy court to reconsider its July 1 agreed order authorizing the rejection of the negotiated rate gas transportation agreements with Gulf South. According to FERC, the language in the order providing that the bankruptcy court "retains exclusive jurisdiction with respect to all matters arising from or related to the implementation, interpretation, and enforcement of this Order" impermissibly intrudes upon FERC's authority under the NGA. On reconsideration, the bankruptcy court amended its order to provide that the court retains jurisdiction to "the maximum extent allowed by law under the applicable circumstances."

On July 24, Tiger filed an objection to Chesapeake's motion to reject its transportation agreement with Tiger and moved to withdraw the reference with respect to the rejection motion from the district court. In opposing rejection, Tiger argued that the bankruptcy court lacks exclusive subject matter jurisdiction over rejection of the transportation agreement, which is regulated by FERC, and "obtained the force of a regulation" under the NGA when the agreement was filed with FERC in 2016. In addition, Tiger contended that rejection would result in "significant harm to the public interest."

In its motion to withdraw the reference, Tiger argued that the district court, rather than the bankruptcy court, must adjudicate the rejection motion because any decision on rejection involves consideration of the relationship between the Bankruptcy Code and the NGA, which is a "federal non-bankruptcy law[] regulating organizations or activities affecting interstate commerce" within the meaning of the referral withdrawal statute, 28 U.S.C. § 157(d).

***In re Ultra Petroleum Corp.*, 2020 WL 4940240 (Bankr. S.D. Tex. Aug. 21, 2020).** UPC filed for chapter 11 protection for the second time in four years on May 14, 2020, in the Southern District of Texas. UPC immediately sought court authority to reject an NGA-governed natural gas transportation agreement with Rockies, which transports natural gas through a natural gas pipeline stretching from eastern Ohio to southwestern Wyoming.

Rockies objected to the motion, arguing that the public interest would be harmed by rejection and that the motion could not be considered until FERC was permitted to "meaningfully participate" on whether rejection would harm the public interest. Otherwise, Rockies contended, any order approving the rejection motion would contravene the Fifth Circuit's *Mirant* decision and the "primary jurisdiction doctrine," which applies when a claim is originally cognizable in the courts but involves issues that fall within the special competence of an administrative agency. According to Rockies, "A rejection standard that does not take into account the importance of stable FERC-regulated agreements, which the U.S. Supreme Court has held to be in the public interest, and the harmful [e]ffect that free-rider activity would have on [Rockies] and the interstate pipeline system as a whole, would create a dangerous discontinuity between the Bankruptcy Code and the NGA, and would be inconsistent with *Mirant*."

On August 6, 2020, the bankruptcy court granted UPC's motion to reject the Rockies gas transportation agreement. Addressing the standard for rejection, the court noted that *Mirant* is binding authority in the Southern District of Texas. As a consequence, a bankruptcy court should engage in a fact-intensive analysis of whether the rejection of a transportation agreement would lead to direct harm to the public interest through an "interruption of supply to consumers" or a "readily identifiable threat to health and welfare." According to the court, the evidence submitted by Rockies had "little to do with the contract at issue," and any identified harm was grounded in market-chilling effects that would stem from a "general ability to reject" FERC-regulated contracts.

Although the general business-judgment standard applicable to contract rejection may be elevated in certain circumstances, the court explained, imposing what would amount to a general bar to rejection (e.g., by requiring that a debtor's reorganization would fail absent rejection) would be a statutory-type exception that only Congress could create (as it has done with respect to certain other kinds of contracts).

The court found that the record overwhelmingly supported rejection. The evidence showed that there would be no interruption to the supply of gas to consumers, there would be no negative macroeconomic consequences, and UPC would "marginal[ly]" benefit by rejecting the transportation agreement.

The court issued a written opinion explaining its ruling on August 21, 2020. In its opinion, the court wrote that "The Court is not authorized to graft a wholesale exception to § 365(a) of the Bankruptcy Code . . . preventing rejection of FERC approved contracts." It further noted that "Public policy may, in certain circumstances, be considered when determining whether to authorize the rejection of a FERC approved pipeline contract." According to the court, whether the rejection of an executory FERC contract is "good or bad public policy" must be decided by Congress and not by the court or FERC. Finally, the court ruled that the rejection of the contract did not violate section 1129(a)(6) of the Bankruptcy Code because "FERC's rate setting authority will remain intact following rejection and potential confirmation of the plan."

On August 21, 2020, the bankruptcy court also confirmed a chapter 11 plan for UPC. FERC appealed the confirmation order to the extent it provided that the bankruptcy court retains "exclusive jurisdiction" over orders authorizing UPC's rejection of FERC-regulated contracts.

OUTLOOK

Courts have reached mixed conclusions regarding the power of a bankruptcy court to authorize the rejection of a regulated wholesale power contract or natural gas transportation contract in bankruptcy. However, although the two courts of appeals that have addressed this question disagree over whether it creates a jurisdictional conflict, they agree that FERC should play some role in determining whether such contracts can be rejected. FERC appears to be on board with this approach, expressing the view that it shares jurisdiction with the bankruptcy courts to determine whether a regulated contract can be rejected in bankruptcy. We can only speculate as to whether the Ninth Circuit would also have endorsed this view or a different approach in PG&E had it not vacated the appeal as being moot..

CLAIMS TRADERS ALERT: ANOTHER BANKRUPTCY COURT RULES THAT A TRADED CLAIM CAN BE DISALLOWED IF THE SELLER RECEIVED A VOIDABLE TRANSFER

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The U.S. Bankruptcy Court for the Southern District of New York recently added some weight to the majority rule on a hot-button issue for claims traders. In *In re Firestar Diamond, Inc.*, 615 B.R. 161 (Bankr. S.D.N.Y. 2020), the court ruled that a transferred claim can be disallowed under section 502(d) of the Bankruptcy Code even if the entity holding the claim is not the recipient of a voidable transfer. According to the court, claim disallowance under section 502(d) "rests on the claim and not the claim holder."

DISALLOWANCE OF CLAIMS OF AVOIDABLE TRANSFER RECIPIENTS

Section 502(d) of the Bankruptcy Code creates a mechanism to deal with creditors that have possession of estate property on the bankruptcy petition date or are the recipients of pre- or post-bankruptcy asset transfers that can be avoided because they are fraudulent, preferential, unauthorized, or otherwise subject to forfeiture by operation of a bankruptcy trustee's avoidance powers. Section 502(d) provides as follows:

> Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this

title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title.

As noted by the U.S. Court of Appeals for the Fifth Circuit in *In re Davis*, 889 F.2d 658, 661 (5th Cir. 1989), "[t]he legislative history and policy behind Section 502(d) illustrates that the section is intended to have the coercive effect of insuring compliance with judicial orders." *See also* H.R. Rep. No. 95-595, at 354 (1978); S. Rep. No. 95-989, at 64 (1978); *accord In re Odom Antennas, Inc.*, 340 F.3d 705, 708 (8th Cir. 2003). The provision "is designed to foster the 'restoration' of assets to a debtor's estate, thereby assuring 'equality of distribution' . . . by precluding anyone who has received a voidable transfer from sharing in any distribution . . . unless he first pays back any preference that he has received." *In re Chase & Sanborn Corp.*, 124 B.R. 368, 371 (Bankr. S.D. Fla. 1991) (citations omitted). Section 502(d) was "not [intended] to punish, but to give creditors an option to keep their transfers (and hope for no action by the trustee) or to surrender their transfers and their advantages and share equally with other creditors." *In re Enron Corp.*, 379 B.R. 425, 435 (S.D.N.Y. 2007) (citations and internal quotation marks omitted).

A body of case law has developed regarding the impact of the sale or transfer of a claim to a third party on the applicability of section 502(d). Some courts, representing the majority view, have held that a transferred claim must be disallowed under section 502(d) even if the transferee is not the entity from which property is recoverable—ruling, in effect, that a claim is not cleansed when it is sold or assigned. *See In re KB Toys Inc.*, 736 F.3d 247, 254 (3d Cir. 2013) ("the cloud on the claim continues until the preference payment is returned, regardless of whether the person or entity holding the claim received the preference payment"); *In re Metiom, Inc.*, 301 B.R. 634, 643 (Bankr. S.D.N.Y. 2003) (citing *Swartz v. Siegel*, 117 F. 13 (8th Cir. 1902), for the proposition that "[t]he disqualification of a claim from allowance created by a preference inheres in and follows every part of the claim, whether retained by the original creditor or transferred to another, until the preference is surrendered"); *see also In re Arctic Glacier Int'l, Inc.*, 901 F.3d 162, 168 (3d Cir. 2018) (stating that, when a claim is transferred, "the transferee assumes the same limitations as the transferor [and that] [o]therwise, buyers could revive disallowed claims, laundering them to receive better treatment in new hands").

The U.S. District Court for the Southern District of New York adopted a more nuanced approach *in Enron Corp. v. Springfield Associates, L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007) ("*Enron II*"), holding that infirmities travel with an assigned claim for purposes of section 502(d), but not if the claim is *sold*. In so ruling, the district court vacated a bankruptcy court decision finding that a claim transferred by means of sale or assignment can be disallowed under section 502(d), even if the assignee/buyer did not receive a voidable transfer. *See Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180 (Bankr. S.D.N.Y. 2006) ("*Enron I*"), *vacated*, 379 B.R. 425 (S.D.N.Y. 2007).

In *Enron II*, the district court examined the distinction between the legal concepts of "sale" and "assignment." Although each is a form of transfer, the court explained, the terms are not synonymous and have very different legal consequences for the transferee:

> With respect to assignments, "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor." In other words, "an assignee of a claim takes with it whatever limitations it had in the hands of the assignor . . . By contrast, these assignment law principles do not apply to sales. A purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor had in certain circumstances.
>
> These distinctions apply with the same force to transfers of debt and claims. An assignee of a claim takes no more than the assignor had to give. A purchaser of a claim may take more. Although characteristics that inhere in a claim may travel with the claim regardless of the mode of transfer, the same cannot be said for personal disabilities of claimants. A personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is *assigned*, but it will not travel to the transferee if the claim is *sold*.

Enron II, 379 B.R. at 435-36 (citations omitted). The district court rejected the argument that "all rights among competing claims to a bankruptcy estate are fixed and determined" as of the bankruptcy petition date, such that the claims transferred were "forever tainted" as of that point in time. The plain language of section 502(d), the court explained, indicates that: (i) court action is necessary before a claim will be disallowed; (ii) disallowance is completely contingent on the recipient's refusal or failure to return an avoidable transfer; and (iii) disallowance can be based solely on the postpetition receipt of and failure to return an avoidable transfer.

The district court wrote that the "language and structure of [section 502(d)] is plain and requires the entity that is asserting the claim be the same entity (*i.e.*, 'such entity') that is liable for receipt of and failure to return property." This result, the court emphasized, comports with one of the provision's primary purposes in coercing the return of assets obtained by means of an avoidable transfer. This goal would not be served if a claim could be disallowed in the hands of an entity that is not the recipient of an avoidable transfer and could therefore not be compelled to return the assets conveyed. Such a result, the court reasoned, would also be inconsistent with the statute's coercive, rather than punitive, nature. Applying section 502(d) to purchasers of claims would be punitive "because they have no option to surrender something they do not have."

The district court downplayed concerns that its ruling would "wreak havoc in the markets for distressed debt" and acknowledged that, although claim "washing" might be possible in some cases, "the risk of that scenario is outweighed by the countervailing policy at issue, namely the law's consistent protection of bona fide purchasers for value."

Other courts have found *Enron II*'s distinction between "assignment" and "sale" to be "problematic" because it is not supported by either the Bankruptcy Code or applicable non-bankruptcy law, which make no such distinction. *See KB Toys*, 736 F.3d at 252, 254 n.11 (stating that "[t]o allow the sale to wash the claim entirely of the cloud would deprive the trustee of one of the tools the Bankruptcy Code gives trustees to collect assets—asking the bankruptcy court to disallow problematic claims"); *In re Motors Liquidation Corp. Co.*, 529 B.R. 510, 572 n.208 (finding that the assignment-sale distinction in *Enron II* was "problematic").

Commentators have also criticized the *Enron II* assignment-sale approach as being unsupported by applicable law and practice. *See*, e.g., Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Com. L. 67, 92 (2009) ("The district court held that the answer depended on whether the claim was 'sold' or 'assigned,' a novel distinction that flew against the long-standing interchangeability of these terms in legal practice."); Jennifer W. Crastz, *Can a Claims Purchaser Receive Better Rights (Or Worse Rights) Than Its Transferor in a Bankruptcy?*, 29 Cal. Bankr. J. 365, 373 (2007) ("While the [*Enron II*] court went a long way to support the claims trading industry in terms of shielding buyers from liability for creditor misconduct, the district court created a new conundrum for the claims trading industry by turning its decision on the sale versus assignment analysis—terms that the financial world has always used interchangeably."); Tally M. Weiner & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. Pa. J. Bus. L. 35, 49 (2009) ("The District Court's [*Enron II*] ruling is unusual . . . [because] it draws a distinction between the consequences of transferring a claim through a sale, as opposed to an assignment, that neither the parties that appealed to the District Court nor the amici curiae thought carried any significance.").

The bankruptcy court weighed in on this debate in *Firestar Diamond*.

FIRESTAR DIAMOND

Three U.S. corporations indirectly owned by fugitive Indian businessman Nirav Modi (collectively, the debtors") filed for chapter 11 protection in the Southern District of New York in 2018. The bankruptcy court appointed a chapter 11 trustee for the debtors after a court-appointed examiner found that the debtors and their senior management were involved in Modi's alleged bank fraud.

The trustee objected to claims filed by four different banks (collectively, the "banks"), each of which was based on pledged receivables or invoices assigned or sold to the banks by three non-debtor companies (collectively, the "transferees") that did business with the debtors. The trustee alleged that the transferees received millions of dollars in avoidable fraudulent transfers from the debtors prior to their bankruptcy filings that had not been returned. He accordingly sought an order disallowing the banks' claims under section 502(d). Citing *Enron II*, the banks argued that, because they acquired their claims by means of sale rather than assignment, the claims should not be disallowed. The trustee countered that the court should be guided by *KB Toys* and other similar rulings, rather than *Enron II*. Alternatively, the trustee argued that the banks' claims should be disallowed even under the approach articulated in *Enron II*.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court ruled in the trustee's favor. Rejecting the banks' argument that it was bound by principles of *stare decisis* to follow *Enron II*, the bankruptcy court found "more persuasive the analysis of courts that have reached the opposite result." Like the courts in *KB Toys, Enron I, Metiom*, and other similar decisions, the court in *Firestar Diamond* concluded that claim disallowance under section 502(d) rests on the claim rather than the claimant. This conclusion, the court explained, comports with the language, purpose, and underlying policy of the provision.

The court dismissed the banks' argument that their claims should not be disallowed because they were innocent victims of the fraudulent schemes orchestrated by Modi and the debtors and engaged in no inequitable conduct themselves. "Given the Court's determination that Section 502(d) applies to the Banks' claims," the court wrote, "the question becomes whether the claims are disallowed under the applicable law." Such was the case, the court explained, because the trustee "demonstrated . . . [that] the claims are based on amounts owed to the entities that received fraudulent transfers from the Debtors in amounts exceeding their claims." Therefore, the court concluded that there was "no equitable basis to bypass Section 502(d)." Moreover, the court found that it would be inequitable to favor the banks over the debtors' other creditors.

Finally, the bankruptcy court rejected the banks' argument that disallowing their claims "would wreak havoc in the claims trading market or unfairly punish good faith transferees." According to the court, claims traders should bear the risk of disallowance under these circumstances because, unlike ordinary creditors:

(i) they voluntarily choose to take part in the bankruptcy process and are aware of the associated risks; and (ii) they can mitigate their risk through due diligence and indemnity clauses in transfer agreements.

In *dicta*, the bankruptcy court noted that, although it declined to decide whether the banks acquired their claims by means of sales rather than assignments, "there are reasons to think that some or all of these transactions might not even be 'sales' protected from disallowance under *Enron II*."

OUTLOOK

Fireside Diamond does not break new ground on the disallowance of transferred claims under section 502(d). Even so, it bolsters the majority view on the question and underscores the importance of rigorous due diligence and indemnity protections in connection with claims transfers—items that have been on traders' radar screens for many years.

Although it is the most prominent dispute concerning section 502(d), the disallowance of traded claims is not the only controversy regarding the provision making its way through the courts. For example, courts disagree as to whether a transferee's avoidance liability must be finally adjudicated (as distinguished from alleged) as a condition to disallowance of the transferee's claim under section 502(d). *Compare In re Southern Produce Distributors, Inc.*, 616 B.R. 667 (Bankr. E.D.N.C. 2020) (transferee's avoidance liability must be finally adjudicated) with *Thaler v. Korn*, 2014 WL 1154059 (E.D.N.Y. Mar. 19, 2014) (colorable allegations are sufficient to trigger temporary disallowance subject to later reconsideration). Interestingly, the court in *Fireside Diamond* skirts this issue, noting merely that the trustee "demonstrated" in his objection to the banks' claims that the transferors received fraudulent transfers.

LEGISLATIVE UPDATE: ENACTMENT OF THE UK CORPORATE INSOLVENCY AND GOVERNANCE ACT

Kay V. Morley ■ Ben Larkin ■ David Harding

On June 25, 2020, the new UK Corporate Insolvency and Governance Act ("Act") became law after it was given Royal Assent by Queen Elizabeth II. The changes introduced by the Act will have a significant impact on the future direction of the UK restructuring market.

Conceptually, the purpose of the Act is to promote a stronger rescue culture in the United Kingdom, providing companies in financial distress with a better chance of being restructured on a going-concern basis (in a similar way to restructurings under chapter 11 of the U.S. Bankruptcy Code).

The changes introduced by the Act were initially proposed by the UK Government in 2016 and went through a consultation period in 2018. A new restructuring regime for the United Kingdom had therefore been anticipated. However, in response to COVID-19, the timing of the implementation of the Act was accelerated, and certain provisions have been revised (compared to the Government's proposals announced in 2018) in order to ensure that the Act is more responsive to current economic conditions.

Key features of the Act include: (i) a new standalone statutory moratorium on creditor collection activities; (ii) a new restructuring plan process; and (iii) certain restrictions on the use of insolvency termination (*ipso facto*) clauses in contracts for the supply of goods and services. In addition, directly in response to COVID-19, the Act includes certain temporary measures relating to: (a) the suspension of director liability for wrongful trading; and (b) restrictions on the issuance of statutory demands and the presentation of winding-up petitions where the underlying financial distress is directly related to COVID-19.

A more detailed discussion of the Act and its key implications for stakeholders is available here.

"FLIP CLAUSE" PAYMENTS TO LEHMAN BROTHERS NOTEHOLDERS AFTER TERMINATION OF SWAP AGREEMENT SAFE HARBORED IN BANKRUPTCY

Charles M. Oellermann ■ Mark G. Douglas

"Safe harbors" in the Bankruptcy Code designed to insulate non-debtor parties to financial contracts from the consequences that normally ensue when a counterparty files for bankruptcy have been the focus of a considerable amount of scrutiny as part of evolving developments in the pandemic-driven downturn. One of the most recent developments concerning this issue in the courts was the subject of a ruling handed down by the U.S. Court of Appeals for the Second Circuit in connection with the landmark chapter 11 cases of Lehman Brothers Holdings Inc. ("Lehman") and its affiliates. In *In re Lehman Bros. Holdings Inc.*, 2020 WL 4590247 (2d Cir. Aug. 11, 2020), the Second Circuit affirmed lower court rulings that the Bankruptcy Code's safe harbor for the liquidation of swap agreements prevented a Lehman affiliate from recovering payments made to certain noteholders in accordance with a priority-altering "flip clause" triggered by Lehman's 2008 bankruptcy filing in agreements governing a collateralized debt obligation ("CDO") transaction. According to the court of appeals, even if the provisions were "*ipso facto*" clauses that are generally invalid in bankruptcy in other contexts, section 560 of the Bankruptcy Code creates an exception to this rule in connection with the liquidation of swap agreements.

THE BANKRUPTCY CODE'S SWAP AGREEMENT SAFE HARBOR

Over the past several decades, Congress has recognized the potentially devastating consequences that might ensue if the bankruptcy or insolvency of one financial firm were allowed to spread to other market participants, thereby threatening the stability of entire markets. Beginning in 1982, lawmakers formulated a series of changes to the Bankruptcy Code to create certain "safe harbors" to protect rights of termination and setoff under "securities contracts," "commodities contracts," and "forward contracts." Those changes were subsequently refined and expanded to cover "swap agreements," "repurchase agreements," and "master netting agreements" as part of a series of legislative developments, including the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") and the Financial Netting Improvements Act of 2006.

These special protections are codified in, among other provisions, sections 555, 556, and 559 through 562 of the Bankruptcy Code. Without them, sections 362 and 365(e)(1) of the Bankruptcy Code would prevent a nondebtor party to a financial contract from taking immediate action to limit exposure occasioned by a bankruptcy filing by or against the counterparty. Lawmakers, however, recognized that financial markets can change significantly almost overnight and that nondebtor parties to certain types of complex financial transactions may incur heavy losses unless the transactions are promptly and finally closed out and resolved. Congress therefore exempted the kinds of financial contracts covered in the safe harbors from the automatic stay and section 365(e)(2) to insulate transactions under such contracts from avoidance unless the transactions were made with actual intent to defraud creditors.

For example, section 560 provides in relevant part as follows:

> The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

11 U.S.C. § 560. Added to the Bankruptcy Code in 1990, the provision was designed to protect the stability of swap markets and ensure that such markets are "not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code." H.R. Rep. No. 101-484, at 1 (1990). Section 560 was amended by BAPCPA to: (i) broaden the definition of "swap agreement" in section 101(53B) of the Bankruptcy Code to include many types of financial derivatives; and (ii) clarify that, in addition to a swap participant's contractual right to terminate a swap agreement, a participant's right to liquidate and accelerate a swap agreement is also protected.

Section 365(e)(1) of the Bankruptcy Code provides that, after a bankruptcy filing, an executory contract may not be terminated or modified, and any right under such a contract may not be terminated or modified:

> solely because of a provision in such contract . . . that is conditioned on—(A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under this title; or (C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

11 U.S.C. § 365(e)(1). This general ban on the enforcement of "*ipso facto*" clauses in bankruptcy helps "deter the race of diligence of creditors to dismember the debtor before bankruptcy and promote equality of distribution." *Merit Mgmt. Grp. v. FTI Consulting, Inc.*, 138 S. Ct. 883, 888 (2018). It is reinforced by various other provisions of the Bankruptcy Code. *See* 11 U.S.C. §§ 363(l) and 541(c)(1); *see also* COLLIER ON BANKRUPTCY ¶ 362.03[5][a] (16th ed. 2020) ("[a]s property of the estate, the debtor's interests in [executory] contracts or [unexpired] leases are protected against termination or other interference that would have the effect of removing or hindering the debtor's rights in violation of section 362(a)(3)," which automatically stays any act to obtain possession of estate

property or of property from the estate or to exercise control over estate property).

Section 560 carves out an exemption from this general rule in the case of swap agreements.

LEHMAN

Lehman commenced the largest bankruptcy case in U.S. history when it filed for chapter 11 protection on September 15, 2008, in the Southern District of New York. Its indirect subsidiary, Lehman Brothers Special Financing Inc. ("LBSF"), filed a chapter 11 petition two weeks afterward.

Prior to filing for bankruptcy, LBSF entered into a synthetic CDO transaction involving the creation of a special purpose vehicle ("Issuer") to issue notes under an indenture ("Indenture"). The Issuer used the note proceeds to acquire securities that both generated income to pay interest on the notes and served as collateral under a credit default swap agreement ("CDS Agreement") between the Issuer and LBSF. In exchange for the credit protection under the CDS Agreement, LBSF made regular payments to the Issuer, which used the funds to supplement interest payments to noteholders. The CDO transaction and the CDS Agreement were documented separately, but the CDS Agreement and the Indenture referenced each other.

Upon the occurrence of an event of default under the Indenture, including a bankruptcy filing by Lehman, the Indenture trustee was empowered to issue a termination notice, which would accelerate payment due on the notes and trigger early termination of the swaps. The trustee could then liquidate the collateral and distribute the proceeds in accordance with the priority provisions in the Indenture. Those provisions included a "flip clause" providing that, in the event of a default by LBSF, LBSF's otherwise senior claim to the collateral proceeds would be subordinated to noteholder claims.

LBSF defaulted under the Indenture when Lehman filed for bankruptcy, triggering early termination of the credit default swaps. The trustee distributed $1 billion from the proceeds of the sale of the collateral to noteholders, but the proceeds were insufficient to make any payment to LBSF.

In September 2010, LBSF commenced an adversary proceeding in the bankruptcy court against the noteholders and certain other defendants seeking to recover the $1 billion in payments under the theory that the flip clause in the Indenture that subordinated LBSF's claim upon Lehman's bankruptcy filing was an unenforceable *ipso facto* clause.

The bankruptcy court granted the defendants' motion to dismiss the complaint, ruling that, among other things, even if the flip clause was an *ipso facto* provision, it was nevertheless enforceable under the section 560 safe harbor for the termination and liquidation of swap agreements. After the district court affirmed on appeal, LBSF appealed to the Second Circuit.

THE SECOND CIRCUIT'S RULING

A three-judge panel of the Second Circuit affirmed the ruling below. Initially, the court rejected LBSF's argument that the *ipso facto* flip clause in the Indenture was unenforceable because the priority provisions were not part of a swap agreement covered by section 560. According to the Second Circuit, the Indenture's priority provisions were part of a swap agreement, and therefore safe harbored by section 560, because the CDS Agreement incorporated them by reference.

Next, the Second Circuit determined that, consistent with the purpose of section 560, the term "liquidation," as used in the provision, includes the disbursement of proceeds from liquidated collateral. Construing the term in this way, the court wrote, "furthers the statutory purpose of protecting swap participants from the risks of a counterparty's bankruptcy filing by permitting parties to quickly unwind the swap." According to the Second Circuit, the right to liquidate "would hardly protect swap counterparties if it merely sheltered their ability to determine amounts owed, but not to distribute the proceeds from the sold Collateral."

Finally, the Second Circuit rejected LBSF's argument that the distributions to the noteholders were not safe harbored because the Indenture trustee who terminated the swaps and distributed the proceeds of the collateral was not a "swap participant." The court explained that neither party disputed that the Issuer was a swap participant within the meaning of section 101(53C) of the Bankruptcy Code. In addition, the Indenture expressly granted

the Indenture trustee all of the Issuer's contractual rights and obligations under the CDS Agreement, including the right to terminate and liquidate the swaps and the obligation to pay the noteholders and LBSF from the proceeds of the collateral. Moreover, the Second Circuit wrote, "section 560 requires the exercise of a contractual right '*of*' any swap participant, not *by* one."

OUTLOOK

Lehman is emblematic of a recent trend among many bankruptcy and appellate courts to apply the Bankruptcy Code's safe harbors for securities contracts broadly, consistent with lawmakers' intent to avoid disruptions in the securities and commodities markets.

To be sure, the U.S. Supreme Court tempered this approach when it held in *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018), that another safe harbor—section 546(e) (shielding certain margin and settlement payments from avoidance except in cases of actual fraud)—does not protect transfers made through a "financial institution" to a third party, regardless of whether the financial institution had a beneficial interest in the transferred property, unless either the transferor or the transferee in the transaction sought to be avoided overall is itself a financial institution. However, after the Court suggested that the section 546(e) safe harbor might apply if the transferor is a "customer" of a financial institution, several lower courts have held precisely that, once again expanding the range of transactions that can qualify for protection. *See, e.g., In re Tribune Co. Fraudulent Conveyance Litig.*, 2019 WL 1771786 (S.D.N.Y. Apr. 23, 2019); *Holliday v. K Road Power Management, LLC (In re Boston Generating LLC)*, 2020 WL 3286207 (Bankr. S.D.N.Y. June 18, 2020).

Lehman, *Merit*, and other cases also suggest that, in determining whether a bankruptcy safe harbor applies, courts are inclined to look at the overall transaction in question as a whole, rather than the individual components separately.

Interestingly, the Second Circuit avoided addressing whether section 365(e) even applied in this case because the provision by its terms invalidates contract termination or modification triggered by *the debtor's* financial condition or bankruptcy filing, whereas the flip clause in *Lehman* was activated by Lehman's, rather than LBSF's, bankruptcy filing. The bankruptcy court, which was confronted with several different transactions involving similar flip clauses, recognized the potential for future disputes on this score, but ultimately focused on the "integrated enterprise" of the Lehman entities and the "exigent circumstances" surrounding the chapter 11 filings as the operative facts supporting a "singular event" theory. Given its conclusion that the flip clause was enforceable under section 560, the Second Circuit "assume[d] without deciding the Priority Provisions are *ipso facto* clauses."

MATALAN: (SOME) ADDITIONAL CLARITY ON THE IMPACT OF ENGLISH SCHEMES AND CHAPTER 15 ON CDS

Corinne Ball ■ Kay V. Morley
Jayant W. Tambe ■ George J. Cahill

On August 11, 2020, a Credit Derivatives Determinations Committee for EMEA ("DC") unanimously determined that the chapter 15 filing by British retailer Matalan triggered a Bankruptcy Credit Event under standard credit default swaps ("CDS"). The DC's decision diverged from its only prior decision (involving Thomas Cook) on whether a chapter 15 petition constituted a Bankruptcy Credit Event. The DC statements accompanying the Thomas Cook and Matalan determinations provide useful guidance regarding the factors the DC will consider in determining whether a chapter 15 petition and, to a lesser degree, an English scheme constitutes a Bankruptcy Credit Event. However, given that the purpose and terms of each scheme can vary considerably and there is a discretion as to what relief, if any, a company will seek pursuant to Chapter 15, it remains the case that whether an English scheme or chapter 15 will constitute a Bankruptcy Credit Event needs to be carefully considered on a case-by-case basis.

ENGLISH SCHEMES, THE NEW RESTRUCTURING PLAN, AND CHAPTER 15

The English scheme of arrangement is a long-established procedure that can be used to alter the rights of creditors. Companies that would otherwise be unable to implement corporate actions due to unanimous consent requirements under their finance documents may be able to use schemes to effect such actions if: (i) they can obtain the support of a statutory majority (>50% in number and ·75% in value of creditors voting in person or by proxy) of each affected class of creditors; and (ii) the scheme is sanctioned by the court.

In addition to the English scheme, the new UK restructuring plan or "super scheme" (which has an approval threshold of ·75% in value of creditors voting in person or by proxy) will be a key feature of the UK restructuring market going forward. Unlike the scheme, the restructuring plan can be used to impose a cross-class cramdown on any dissenting class of creditors that does not vote in favor of the plan (subject to the satisfaction of certain conditions). Schemes and the new restructuring plan are a product of the Company Act 2006, which is not a bankruptcy or insolvency law, and can be used by solvent and insolvent companies alike.

Chapter 15 was added to the U.S. Bankruptcy Code in 2005 in order to adopt into U.S. law the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law in 1997. Chapter 15 was primarily designed to promote the fair and efficient administration of cross-border insolvencies; however, it can be used to recognize foreign proceedings under not only insolvency laws but also laws (such as schemes of arrangement) relating to the adjustment of debts.

THOMAS COOK SCHEME AND CHAPTER 15

In August 2019, Thomas Cook Group Plc ("Thomas Cook") proposed an English scheme of arrangement. The scheme was somewhat unusual in that it did not itself seek to implement a restructuring. Instead, Thomas Cook sought to, among other things, lower certain approval thresholds in its finance documents so that the company could more readily implement a restructuring outside of a scheme. As is common with English schemes, Thomas Cook sought recognition of the scheme in the United States pursuant to chapter 15 in order to prevent any creditor from taking any steps to act in breach of the terms of the proposed scheme pending its approval. Thomas Cook's chapter 15, however, was also unusual in that it sought to waive the automatic stay that automatically accompanies recognition of foreign main proceedings (and often accompanies foreign non-main proceedings).

MATALAN SCHEME AND CHAPTER 15

Like Thomas Cook, Matalan Finance Plc ("Matalan") also proposed a scheme of arrangement. The key purpose of the scheme, which was proposed as part of a wider balance sheet restructuring of the company, was to amend the terms of the company's 9.5% second lien secured notes to defer cash interest to payment-in-kind interest. On July 27, 2020, the English court sanctioned the scheme, and two days later Matalan sought recognition of the scheme in a chapter 15 case. However, unlike Thomas Cook, Matalan did not seek to waive the automatic stay that would apply if recognition of the scheme were granted in the chapter 15 case.

THE BANKRUPTCY CREDIT EVENT DC DETERMINATIONS

Following the chapter 15 filings of both Thomas Cook and Matalan, the DC was asked to consider whether a Bankruptcy Credit Event had occurred for credit default swaps subject to ISDA's 2014 and updated 2003 Credit Derivatives Definitions ("2014 Definitions" and "2003 Definitions"). The primary analysis conducted by the DC in each case was under limb (d) of the definition of "Bankruptcy." As set forth below, an important modification was made to this provision when the 2014 Definitions were published:

a ***the*** *Reference Entity . . . institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other* ***similar*** *relief under any bankruptcy or insolvency law or other* ~~**similar**~~ *law affecting creditors› rights. . . .*

As a result, under the 2003 Definitions, any proceeding seeking relief under a bankruptcy or insolvency or similar law will trigger a Bankruptcy Credit Event. Under the 2014 Definitions, however, the relief sought must be similar to a judgment of insolvency or bankruptcy.

The questions before the DC under the 2003 Definitions were fairly straightforward in connection with the Thomas Cook and Matalan chapter 15 filings. The filing of a chapter 15 petition commences a proceeding seeking relief under a bankruptcy law (the U.S. Bankruptcy Code) and triggers a Bankruptcy Credit Event under the 2003 Definitions.

The questions under the 2014 Definitions were far more complex. The key issue in each case was whether the relief sought was "similar" to that of a "judgment of insolvency or bankruptcy."

In considering the Thomas Cook case, the DC placed great emphasis on the fact that the company did not seek a stay of proceedings in the United States and that the chapter 15 petition did not otherwise seek to compromise creditor rights independent of the scheme. On this basis, the DC considered that the relief sought in the United States was limited and did not constitute relief "similar" to that of a judgment of insolvency or bankruptcy. Thus, it concluded that a Bankruptcy Credit Event had not been triggered under the 2014 Definitions. The DC noted in the statement accompanying its decision that the case involved unusual facts and was "not necessarily indicative of how the DC would approach chapter 15 filings in general."

As foreshadowed, the DC indeed reached the opposite conclusion in connection with Matalan's (more typical) chapter 15 filing. It determined that Matalan's chapter 15 had triggered a Bankruptcy Credit Event under the 2014 Definitions, as Matalan sought additional consequences affecting creditor rights (including the automatic stay) that, combined with the effect of the scheme itself, would constitute "similar relief" to a judgment under bankruptcy or insolvency law.

CAN AN ENGLISH SCHEME ITSELF CONSTITUTE A BANKRUPTCY CREDIT EVENT?

DC determinations in recent years have provided insight regarding which types of proceedings are likely to trigger Bankruptcy Credit Events under the 2014 Definitions. We now have evidence that a Brazilian RJ plan, a Dutch moratorium, an Italian *concordato con riserva*, or a French *sauvegarde* can constitute "similar relief," but a Spanish *preconcurso* likely will not. We have less clarity in connection with English schemes.

The DC did not directly address whether the Matalan scheme itself constituted a Bankruptcy Credit Event (and Thomas Cook's scheme was never implemented). However, the DC has effectively acknowledged that a one-size-fits-all approach cannot be taken in respect of English schemes. Limb (c) of the Bankruptcy definition specifically relates to schemes, providing that a Bankruptcy Credit Event will occur if the Reference Entity "makes a general assignment, arrangement, scheme or composition with or for the benefit of its creditors generally."

However, in many situations, a scheme is not an arrangement with or for the benefit of its creditors generally. As in the case of Matalan, a company that has multiple outstanding financial obligations and implements a scheme that impacts only certain of those obligations would be unlikely to constitute a scheme or arrangement with its creditors generally. Accordingly, the question as to whether an English scheme will constitute a Bankruptcy Credit Event pursuant to limb (c) needs to be considered on the facts of each case.

A Bankruptcy Credit Event could also arise in connection with a scheme under limb (b) of the Bankruptcy definition on the basis that the reference entity "becomes insolvent or is unable to pay its debts or fails or admits in writing in a judicial proceeding . . . or filing, its inability generally to pay its debts as they call due." While many scheme applications will include an admission that a default or insolvency is imminent if relief is not granted, as illustrated by Thomas Cook and Matalan, that will not always be the case.

CAN AN ENGLISH SCHEME ITSELF CONSTITUTE A RESTRUCTURING CREDIT EVENT?

Whether or not a scheme will trigger a Restructuring Credit Event will also depend on the specific facts and circumstances of the scheme. The DC was asked to consider whether the Matalan scheme gave rise to a Restructuring Credit Event but deemed such a decision unnecessary following the bankruptcy determination. Given that the scheme involved a deferral of interest (one of the enumerated types of events that may constitute a restructuring) that was binding on all holders of the second lien notes, the key question for the DC would have been whether the modification resulted from a deterioration in the creditworthiness or financial condition of the company. This consideration is always fact-intensive and adds an element of uncertainty to all restructuring determinations.

FOUR KEY TAKEAWAYS

1. Together, the Thomas Cook and Matalan determinations provide important guidance regarding the factors a DC is likely to consider in deciding whether a chapter 15 filing seeks "similar relief" to a judgment of insolvency or bankruptcy and thus triggers a Bankruptcy Credit Event under Section 4.2(d) of the 2014 Definitions.
2. The DC decisions are less instructive regarding when an English scheme will constitute a scheme or arrangement with or for the benefit of its creditors generally and thus trigger a Bankruptcy Credit Event under Section 4.2(c) of the 2014 Definitions.
3. Consideration of whether an English scheme or U.S. chapter 15 is likely to trigger a Bankruptcy Credit Event or Restructuring Credit Event under the 2014 Definitions requires thoughtful analysis and will largely depend on the facts and circumstances of each case.
4. The growing usage of schemes, and now super schemes, is likely to significantly impact the CDS market over the coming years, and we should expect many of such schemes to be crafted with CDS implications in mind.

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CRAM-UP CHAPTER 11 PLANS: REINSTATEMENT AND INDUBITABLE EQUIVALENCE

Stacey Corr-Irvine ■ Mark G. Douglas

"Cramdown" chapter 11 plans, under which a bankruptcy court confirms a plan over the objection of a class of creditors, are relatively common. Less common are the subset of cramdown plans known as "cram-up" chapter 11 plans. These plans are referred to as such because they typically involve plans of reorganization that are accepted by junior creditors and then "crammed up" to bind objecting senior creditors.

Generally, cram-up plans provide for either: (i) reinstatement of an objecting secured creditor's claim according to the original terms of the debt after curing most defaults—thereby rendering the claim "unimpaired" and depriving the secured creditor of the right to vote on the plan; or (ii) the secured creditor's realization of the "indubitable equivalent" of its claim, which can include, among other things, reinstatement of its debt secured by substitute collateral or abandonment of the collateral to the creditor (referred to in some cases as "dirt for debt"). Here, we briefly discuss the mechanics of chapter 11 cram-up.

CRAM-UP THROUGH REINSTATEMENT

Confirmation of cram-up chapter 11 plans involving reinstatement of an objecting secured creditor's claim hinges on the Bankruptcy Code's definition of "impairment." Classes of claims or interests may be either "impaired" or "unimpaired" by a plan. The distinction is important because only impaired classes have the ability to vote to accept or reject a plan. Under section 1126(f) of the Bankruptcy Code, unimpaired classes of creditors and shareholders are conclusively presumed to have accepted a plan.

Section 1124 provides that a class of creditors is "impaired" unless the plan: (i) "leaves unaltered the legal, equitable, and contractual rights" to which each claimant in the class is entitled; or (ii) cures any defaults (other than certain non-monetary defaults specified in section 365(b)(2) of the Bankruptcy Code), reinstates the maturity and other terms of the obligation, compensates the claimant for reasonable reliance damages and certain resulting losses, and does not "otherwise alter the legal, equitable or contractual rights" of each claimant in the class.

Section 365(b)(2) provides that a debtor's obligation to cure defaults under an executory contract or an unexpired lease prior to assumption does not include: (i) cure of *ipso facto* clauses relating to the debtor's insolvency or financial condition, the bankruptcy filing, the appointment of a trustee or custodian; or (ii) "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."

By reinstating an obligation and curing defaults under section 1124(2), a plan can "roll back the clock to the time before the default existed*." MW Post Portfolio Fund Ltd. v. Norwest Bank Minn., N.A. (In re Onco Inv. Co.)*, 316 B.R. 163, 167 (Bankr. D. Del. 2004); *see also* 11 U.S.C. § 1123(a)(5)(G) (providing that a plan shall provide adequate means for its implementation, such as "curing or waiving of any default").

However, this does not mean that reinstatement relieves the debtor of the obligation to pay postpetition interest at the default rate specified in a loan agreement or applicable nonbankruptcy law. *See In re New Investments, Inc,* 840 F.3d 1137 (9th Cir. 2016); *In re Sagamore Partners, Ltd.*, 620 Fed. App'x. 864 (11th Cir. 2015); *In re Moshe*, 567 B.R. 438 (Bankr. E.D.N.Y. 2017); *see also* 11 U.S.C. § 1123(d) (providing that notwithstanding the entitlement of oversecured creditors to collect postpetition interest under section 506(b), the "best interests" requirement of section 1129(a)(7), and the cramdown requirements of section 1129(b), "if it is proposed in a plan to cure a default[,] the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law"). As discussed in more detail below, a key point of contention in connection with reinstatement is whether there are any non-curable defaults unrelated to the borrower's financial condition, such as a loan agreement's "change in control" provisions.

For a chapter 11 debtor, reinstatement of a loan may be the preferable strategy if the loan bears an interest rate lower than the prevailing market rate and is otherwise subject to terms (including covenants) that are favorable to the debtor. Reinstatement may also allow the debtor to lock in a loan under favorable terms until post-reorganization financing becomes more available or attractive. Debt reinstatement grew in popularity during the aftermath of the Great Recession, when credit sources dried up and new financing to replace the cheap loans readily available before the recession became prohibitively expensive. It may reprise that role if the COVID-19 pandemic persists and ready sources of low-interest financing once again become scarce.

INDUBITABLE EQUIVALENT CRAM-UP

In order for a chapter 11 place to be confirmed, section 1129(a) of the Bankruptcy Code requires, among other things, that each class of claims or interests either votes to accept the plan or is not impaired (and thus deemed to accept the plan). However, confirmation is possible in the absence of acceptance by impaired classes under section 1129(b) if all of the other plan requirements set forth in section 1129(a) are satisfied and the plan "does not discriminate unfairly" and is "fair and equitable" with respect to each impaired, non-accepting class of claims or interests.

With respect to a dissenting class of secured claims, section 1129(b)(2)(A) provides that a plan is "fair and equitable" if the plan provides for: (i) the secured claimants' retention of

their liens and receipt of deferred cash payments equal to at least the value, as of the plan effective date, of their secured claims; (ii) the sale, subject to the creditor's right to "credit bid" its claim under section 363(k), of the collateral free and clear of all liens, with attachment of the creditor's lien to the sale proceeds and treatment of the lien or proceeds under option (i) or (iii); or (iii) the realization by the secured creditors of the "indubitable equivalent" of their claims.

The Bankruptcy Code does not define "indubitable equivalent," but courts interpreting the term have defined it as, among other things, "the unquestionable value of a lender's secured interest in the collateral." *In re Philadelphia Newspapers, LLC*, 599 F.3d 298, 310 (3d Cir. 2010); *accord In re Sparks*, 171 B.R. 860, 866 (Bankr. N.D. Ill. 1994) (a plan provides the indubitable equivalent of a claim to the creditor where it "(1) provides the creditor with the present value of its claim, and (2) insures the safety of its principle [sic]"); *see generally* COLLIER ON BANKRUPTCY ("COLLIER") ¶¶ 361.03([4] and 1129.04[2][c][i] (discussing the derivation of the concept from *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), and explaining that "abandonment, or unqualified transfer of the collateral, to the secured creditor," substitute collateral and the retention of liens with modified loan terms have been deemed to provide the "indubitable equivalent").

Providing a secured lender with the indubitable equivalent of its claim rather than reinstating the loan, allowing the creditor to retain its liens to secure a restructured loan, or selling the collateral may be the best course of action depending on the circumstances. For example, a chapter 11 debtor might determine that it would be preferable to abandon collateral to a secured creditor because it does not need the property as part of its reorganization strategy or because a sale of the property during the bankruptcy case may not be possible or beneficial. The availability of alternative financing and prevailing interest rates and loan terms at the time of confirmation may also have an impact.

NOTABLE COURT RULINGS

Charter Communications

Cable television company Charter Communications ("Charter") filed a prepackaged chapter 11 case in 2009 that proposed to reinstate its senior debt at the interest rate provided for in the prepetition credit agreement (which was below-market at the time) and effectuate a debt-for-equity swap with junior creditors.

The credit agreement between Charter's operating company ("borrower") and its senior creditors included as an event of default any "change in control" of the borrower. A "change of control" was defined as the failure of the borrower's controlling shareholder to retain at least 35% of the company's voting power or the acquisition by any entity or group of more than 35% of the voting power unless the controlling shareholder held a greater percentage.

Charter's chapter 11 plan proposed a settlement with the controlling shareholder, whereby he would retain 35% of the voting power in the reorganized company and receive $375 million in cash, but would retain no meaningful ongoing economic interest in the reorganized Charter. The settlement and the plan reinstated the senior debt under terms favorable to Charter and preserved $2.85 billion in net operating losses that would have been forfeited in the event of a change in control.

The senior lenders objected to Charter's plan, arguing, among other things, that the proposed reinstatement violated the change of control provision because: (i) the credit agreement required the controlling shareholder to retain an ongoing economic interest in addition to a 35% voting interest; and (ii) four of the borrower's junior bondholders would be holding more than 35% in aggregate of the voting power in the reorganized company, and the four bondholders constituted a "group" under federal securities laws.

In *In re Charter Commc'ns*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 449 B.R. 14 (S.D.N.Y. 2011), *aff'd*, 691 F.3d 476 (2d Cir. 2012), the bankruptcy court overruled the senior lenders' objections and confirmed the cram-up chapter 11 plan. The court noted that the senior lenders acknowledged that their objections were premised on a desire to obtain higher interest rates available in the prevailing market. The court further noted that the senior lenders were being paid in full, together with default-rate interest.

The court analyzed the language of the credit agreement and concluded that the requirement that the controlling shareholder retain not less than 35% of the ordinary voting power did not require that he likewise have a commensurate ongoing economic interest in the borrower. The court also determined that the prohibition in the credit agreement of the acquisition of a voting interest exceeding the controlling shareholder by any "group" did not apply to the bondholders because there was no proof that any formal agreement had been concluded among them.

Young Broadcasting

Television company Young Broadcasting, Inc. ("YBI") filed for chapter 11 protection in 2009 intending to sell its assets under section 363(b) of the Bankruptcy Code to a senior lender. YBI later pursued the sale as part of a chapter 11 plan after its business and cash flows improved.

YBI's plan provided for an exchange of all the senior secured debt for equity, $1 million to be distributed to general unsecured creditors, and the distribution of equity warrants to noteholders accepting the plan. A competing plan proposed by YBI's unsecured creditors' committee provided for: (i) reinstatement of the senior secured debt; (ii) a $1 million distribution to general unsecured creditors; and (iii) noteholders' receipt of 10% of the reorganized company's common stock and an opportunity to participate in a rights offering for preferred and common stock.

With YBI's consent, the bankruptcy court considered first whether the committee's plan should be confirmed. YBI's lenders argued, among other things, that reinstatement of their loans was not possible because the plan violated the change of control provision in their credit agreement. That provision mandated that YBI's founder retain control of at least 40% of the company's voting stock, whereas the committee's plan proposed to give the founder stock entitling him to cast 40% of the total number of votes for the reorganized company's board, but only permitted him to elect one of the seven directors.

The bankruptcy court ruled in favor of the senior lenders, finding that the committee's plan did not satisfy section 1124(2) due to the plan's proposal to materially modify the credit agreement's change of control provision. *See In re Young Broadcasting, Inc.*, 430 B.R. 99 (Bankr. S.D.N.Y. 2010). The court rejected the committee's argument that, in accordance with *Charter*, as long as a plan allows for a "formalistic retention of control," there will be no default under a change of control provision, notwithstanding the shift in economic ownership. According to the court, the benefit of the bargain struck by the lenders and the plain meaning of the credit agreement required the founder to have the power to influence 40% of the composition of the board—not simply the power to cast 40% of the total votes for directors.

The court confirmed YBI's chapter 11 plan instead.

DBSD

Prior to filing for chapter 11 protection in 2009, satellite communications company DBSD North America, Inc. ("DBSD") had a $51 million first-lien working capital facility with a 13-month term. The loan bore interest at 12.5% per annum (later increased to 16% pursuant to forbearance agreements) payable at maturity and was secured by a lien on substantially all of DBSD's assets.

During the bankruptcy case, one of DBSD's second-lien noteholders purchased the first-lien claim to acquire a blocking position with respect to any DBSD chapter 11 plan. DBSD proposed a chapter 11 plan under which the first lien creditor would receive the "indubitable equivalent" of its claim, in the form of an amended loan facility with a four-year term and payment-in-kind ("PIK") interest at 12.5%. The new loan was secured by a first lien on substantially all of the reorganized company's assets, except for certain auction rate securities and DBSD stock previously pledged by DBSD's parent. The amended facility included a standstill provision restricting the first-lien creditor from enforcing its rights against the collateral, eliminated or loosened certain covenants, and included less restrictive cross-default provisions. The second-lien noteholder class (notwithstanding the first-lien creditor's vote of its second-lien claim to reject the plan) and DBSD's unsecured creditors' committee supported the plan, which provided for a debt-for-equity swap.

The first-lien creditor objected to confirmation and voted against the plan. In addition to disqualifying ("designating") the first-lien creditor's votes because the court found that the creditor

acquired its claim in bad faith, the bankruptcy court concluded that the plan was fair and equitable because it provided the first-lien creditor with the indubitable equivalent of its claim under section 1129(b)(2)(A)(iii). *See In re DBSD N. Am., Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part on other grounds*, 634 F.3d 79 (2d Cir. 2011).

In so ruling, the court explained that: (i) the first-lien creditor's claim was comfortably oversecured because the value of the substitute collateral securing its post-confirmation claim vastly exceeded the face amount of the claim; and (ii) the 12.5% PIK interest rate was an appropriate rate of interest for the four-year amended loan facility, given the prevailing low interest rates on treasury securities.

River East

River East Plaza, LLC ("River East") owned a building in Chicago valued at $13.5 million. The property secured a loan from LNV Corporation ("LNV") in the amount of $38.3 million. River East defaulted on the loan early in 2009. LNV commenced foreclosure proceedings, but River East filed for chapter 11 protection shortly before the foreclosure sale was to occur.

The bankruptcy court denied confirmation of River East's initial chapter 11 plan after LNV elected to have its claims treated as fully secured under section 1111(b) of the Bankruptcy Code. In its second proposed chapter 11 plan, River East sought to provide LNV with the indubitable equivalent of its claim by substituting 30-year U.S. Treasury bonds with a face value of $13.5 million for LNV's existing collateral. According to River East, because (at the then-prevailing rate of interest) the value of the bonds would grow in 30 years to equal $38.3 million—the full face value of LNV's claim—the bonds represented the indubitable equivalent of LNV's secured claim within the meaning of section 1129(b)(2)(A)(iii).

The bankruptcy court disagreed, stating "flatly" that a secured creditor electing section 1111(b) treatment cannot be forced to accept substitute collateral. It accordingly denied confirmation of River East's second plan. The court later refused to consider a third plan proposed by River East and dismissed the bankruptcy case. The bankruptcy court certified a direct appeal of its rulings to the Seventh Circuit.

The Seventh Circuit affirmed. *See In re River East Plaza, LLC*, 669 F.3d 826 (7th Cir. 2012). "Substituted collateral that is more valuable and no more volatile than a creditor's current collateral," the court wrote, "would be the indubitable equivalent of that current collateral even in the case of an undersecured debt." However, the court noted, such was not the case here. According to the Seventh Circuit, the 30-year U.S. Treasury bonds were not the indubitable equivalent of LNV's collateral because: (i) the bonds carried a different "risk profile"; and (ii) they impermissibly stretched out the time period over which LNV would be paid.

The risk profile of the bonds was different, the court explained, because although Treasury bonds carry little default risk, long-term Treasury bonds carry "substantial inflation risk, which might or might not be fully impounded in the current interest rates on the bonds." In addition, River East might default under a plan providing for LNV to retain its lien on the building in a relatively short time period, allowing LNV potentially to realize increased value by foreclosing upon and selling the building. However, the court explained, the value of the Treasury bonds could not be realized for quite some time, regardless of how soon River East defaulted, and would likely be lower at that time due to inflation and/or rising interest rates.

According to the Seventh Circuit, the substitution of the bond collateral was impermissible, but not only because it demonstrated that the bonds were something other than the indubitable equivalent of the building: such an approach would also improperly conflate cramdown under section 1129(b)(2)(A)(iii) with cramdown under section 1129(b)(2)(A)(i). Under the latter, the court explained, cramdown confirmation is possible if a secured creditor retains its lien on collateral, but the maturity of the debt is extended. River East could not both extend the maturity date (by substituting 30-year bonds) under subsection (i) and substitute collateral as an "indubitable equivalent" under subsection (iii). "By proposing to substitute collateral with a different risk profile, in addition to stretching out loan payments," the Seventh Circuit wrote, "River East was in effect proposing a defective subsection (i) cramdown by way of subsection (iii)."

RadLAX

After filing for chapter 11 protection in 2009, RadLAX Gateway Hotel, LLC and an affiliate (collectively, "debtors"), the owners of a failed airport hotel construction project, proposed a liquidating chapter 11 plan under which they would sell substantially all of their assets at auction free and clear of their secured creditor's liens and repay the creditor with the sale proceeds. Rather than allowing the secured creditor to credit-bid under section 1129(b)(2)(A)(ii), the debtors argued that the proposed auction satisfied section 1129(b)(2)(A)(iii) because the proceeds of the auction sale represented the "indubitable equivalent" of the secured creditor's claim.

The Seventh Circuit ultimately disagreed and held that when a debtor proposes to sell assets subject to a lien in a chapter 11 plan, the debtor must comply with either section 1129(b)(2)(A)(i) or section 1129(b)(2)(A)(ii), but may not rely on section 1129(b)(2)(A)(iii). According to the court, the debtor must either: (i) sell the collateral with the secured creditor retaining its liens; or (ii) sell the collateral free and clear of liens, with the liens attaching to the sale proceeds, and permit the secured creditor to credit-bid as part of the sale.

The U.S. Supreme Court affirmed the Seventh Circuit's ruling. *See RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639 (2012). It concluded that the debtors' reading of section 1129(b)(2)(A)—under which clause (iii) would permit exactly what clause (ii) prohibits—was "hyperliteral and contrary to common sense." Writing for a unanimous court, Justice Scalia explained:

> [C]lause (ii) is a detailed provision that spells out the requirements for selling collateral free of liens, while clause (iii) is a broadly worded provision that says nothing about such a sale. The general/specific canon explains that the general language of clause (iii), although broad enough to include it, will not be held to apply to a matter specifically dealt with in clause (ii).

Thus, the Court determined that when the conduct at issue falls within the scope of both provisions, the specific provision presumptively governs, whether or not the specific provision also applies to some conduct that falls outside the general provision. In reaching this conclusion, the Supreme Court noted that section 1129(b)(2)(A)(ii) addresses a subset of cramdown plans and that section 1129(b)(2)(A)(iii) applies to all cramdown plans, including all of the plans within the narrower description in section 1129(b)(2)(A)(ii).

Other notable rulings discussing indubitable equivalence include: *In re LightSquared Inc.*, 513 B.R. 56 (Bankr. S.D.N.Y. 2014) (a chapter 11 plan proposed by a satellite communications company that would provide a first-lien secured creditor, a special purpose entity ("SPE") through which a principal of one of the debtors' competitors had acquired approximately $844 million of the debtors' secured debt, with a note secured by a third-priority lien on existing and new collateral, including the debtors' spectrum assets, did not provide the secured creditor with the indubitable equivalent, where there was enormous disagreement as to valuation and unresolved regulatory hurdles); and *In re Colony Beach & Tennis Club, Inc.*, 508 B.R. 468 (Bankr. M.D. Fla. 2014) (a proposed chapter 11 plan under which the collateral securing the claims of an undersecured lender that elected to have its claim treated as fully secured under section 1111(b) would be sold free and clear of liens in exchange for receiving either payment in an unspecified amount one year or the right to have its collateral

transferred back to it did not provide the indubitable equivalent of its claim), *aff'd*, 2015 WL 3689075 (M.D. Fla. June 12, 2015).

Another category of indubitable equivalence cases involve "dirt-for-debt" exchanges, whereby a secured creditor is given all or part of its collateral under a plan as a way to satisfy the fair and equitable requirement. *See generally* Collier at ¶ 1129.04[2][c][i] (noting that courts have generally not approved "dirt for debt" plans). The key issue in such cases is almost always the valuation of the collateral the plan proposes to abandon to the secured creditor. *See, e.g., Bate Land Co., LP v. Bate Land & Timber LLC (Bate Land & Timber LLC)*, 877 F.3d 188 (4th Cir. 2017) (upholding confirmation of a partial dirt-for-debt plan under which the secured lender would be given eight of the 79 tracts of land that originally secured its claim plus postpetition interest in cash, where the "highest and best use" appraisals for the properties indicated that their value exceeded the outstanding principal amount of the debt); *In re Nat'l Truck Funding LLC*, 588 B.R. 175 (Bankr. S.D. Miss. 2018) (confirming a chapter 11 plan under which the secured creditor had the option of either retaining its liens on the sale proceeds of the debtor's leased trucks and receiving deferred cash payments or receiving the truck collateral as the indubitable equivalent of its claims); *In re Wiggins*, 2018 WL 1137616 (Bankr. E.D.N.C. Feb. 28, 2018) (confirming a chapter 11 plan under which the secured creditor would receive a portion of the four tracts of land securing its claim as the indubitable equivalent after performing a "highest and best use" appraisal inquiry); *see also Havasu Lakeshore Investments, LLC, v. Fleming (In re Fleming)*, 2020 WL 1170722 (B.A.P. 9th Cir. Mar. 10, 2020) (a chapter 11 plan providing that the secured lender would receive a cash payment of $500,000 on the effective date, 49 units of real property valued at $3.7 million, and five annual payments of $241,000 with interest at 5% did not provide the lender with the indubitable equivalent of its $5.4 million claim because it did not provide compensation for the necessary time to sell the property and unfairly shifted the risk of selling it to the lender).

OUTLOOK

Depending on the circumstances, a cram-up chapter 11 plan may be part of a beneficial reorganization strategy that might otherwise be impossible due to the objections of a senior secured creditor or class of creditors. In a financial and lending climate fraught with uncertainty, cram-up plans may be an attractive alternative to more traditional chapter 11 cramdowns. With the recent significant decrease in corporate lending interest rates and the ready availability of inexpensive credit for certain corporate borrowers, reinstatement of loans under a plan may not be as common a restructuring strategy as it was under different conditions. Even so, corporate credit conditions may once again cycle to a point where it becomes an attractive option.

DELAWARE BANKRUPTCY COURT RULES THAT BANKRUPTCY BLOCKING RIGHT IN DEBTOR'S CORPORATE CHARTER VIOLATES FEDERAL PUBLIC POLICY

Mark A. Cody ▪ Mark G. Douglas

Courts sometimes disagree over whether provisions in a borrower's organizational documents designed to prevent the borrower from filing for bankruptcy are enforceable as a matter of federal public policy or applicable state law. There has been a handful of court rulings addressing this issue in recent years, with mixed results. Most recently, the Delaware bankruptcy court overseeing the chapter 11 cases of Pace Industries, LLC and affiliates denied on public policy grounds a motion to dismiss the cases filed by a preferred stockholder on the basis that the debtor group's parent corporation failed to obtain the preferred stockholder's written consent to any bankruptcy filing, which was required in the parent's certificate of incorporation. The court acknowledged that "there is no case directly on point, holding that a blocking right by a shareholder who is not a creditor is void as contrary to federal public policy that favors the constitutional right to file bankruptcy." Even so, the court stated, "based on the facts of this case, [the court is] prepared to be the first court to do so."

BANKRUPTCY RISK MANAGEMENT BY LENDERS

Astute lenders are always looking for ways to minimize risk exposure, protect remedies, and maximize recoveries in connection with a loan, especially with respect to borrowers that have the potential to become financially distressed. Some of these efforts have been directed toward minimizing the likelihood of a borrower's bankruptcy filing by making the borrower "bankruptcy remote," such as by implementing a "blocking director" organizational structure or issuing "golden shares" that, as the term is used in a bankruptcy context, give the holder the right to preempt a bankruptcy filing. Depending on the jurisdiction involved and the particular circumstances, including the terms of the relevant documents, these mechanisms may or may not be enforceable.

As a rule, corporate formalities and applicable state law must be satisfied in commencing a bankruptcy case. *See In re NNN 123 N. Wacker, LLC*, 510 B.R. 854 (Bankr. N.D. Ill. 2014) (citing *Price v. Gurney*, 324 U.S. 100 (1945)); *In re Gen-Air Plumbing & Remodeling, Inc.*, 208 B.R. 426 (Bankr. N.D. Ill. 1997); *In re Comscape Telecommunications, Inc.*, 423 B.R. 816 (Bankr. S.D. Ohio 2010). As a result, while contractual provisions that prohibit a bankruptcy filing may be unenforceable as a matter of public policy, other measures designed to preclude a debtor from filing for bankruptcy may be available.

Lenders, investors, and other parties seeking to prevent or limit the possibility of a bankruptcy filing have attempted to sidestep

the public policy invalidating contractual waivers of a debtor's right to file for bankruptcy protection by eroding or eliminating the debtor's authority to file for bankruptcy under its governing organizational documents. *See, e.g., DB Capital Holdings, LLC v. Aspen HH Ventures, LLC (In re DB Capital Holdings, LLC)*, 2010 WL 4925811 (B.A.P. 10th Cir. Dec. 6, 2010); *NNN 123 N. Wacker*, 510 B.R. at 862*; In re Houston Regional Sports Network, LP*, 505 B.R. 468 (Bankr. S.D. Tex. 2014*); In re Quad-C Funding LLC*, 496 B.R. 135 (Bankr. S.D.N.Y. 2013); *Green Bridge Capital S.A. v. Ira Shapiro (In re FKF Madison Park Group Owner, LLC)*, 2011 BL 24531 (Bankr. D. Del. Jan. 31, 2011); *In re Global Ship Sys. LLC*, 391 B.R. 193 (Bankr. S.D. Ga. 2007); *In re Kingston Square Associates*, 214 B.R. 713 (Bankr. S.D.N.Y. 1997).

These types of provisions have not always been enforced, particularly where the organizational documents include an outright prohibition of any bankruptcy filing. *See In re Lexington Hospitality Group*, 577 B.R. 676 (Bankr. E.D. Ky. 2017) (where an LLC debtor's operating agreement provided for a lender representative to be a 50% member of the debtor until the loan was repaid and included various restrictions on the debtor's ability to file for bankruptcy while the loan was outstanding, the bankruptcy filing restrictions acted as an absolute bar to a bankruptcy filing, which is void as against public policy); *In re Bay Club Partners-472, LLC*, 2014 WL 1796688 (Bankr. D. Or. May 6, 2014) (refusing to enforce a restrictive covenant in a debtor LLC's operating agreement prohibiting a bankruptcy filing and stating that the covenant "is no less the maneuver of an 'astute creditor' to preclude [the LLC] from availing itself of the protections of the Bankruptcy Code prepetition, and it is unenforceable as such, as a matter of public policy").

Many of these efforts have been directed toward "bankruptcy remote" special purpose entities. An SPE is an entity created in connection with a financing or securitization transaction structured to ring-fence the SPE's assets from creditors other than secured creditors or investors (e.g., trust certificate holders) that provide financing or capital to the SPE.

For example, in *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009), the court denied a motion by secured lenders to dismiss voluntary chapter 11 filings by several SPE subsidiaries of a real estate investment trust. The lenders argued, among other things, that the loan agreements with the SPEs provided that an SPE could not file for bankruptcy without the approval of an independent director nominated by the lenders. The lenders also argued that, because the SPEs had no business need to file for bankruptcy and because the trust exercised its right to replace the independent directors less than 30 days before the bankruptcy filings, the SPEs' chapter 11 filings had not been undertaken in good faith.

The *General Growth* court ruled that it was not bad faith to replace the SPEs' independent directors with new independent directors days before the bankruptcy filings because the new directors had expertise in real estate, commercial mortgage-backed securities, and bankruptcy matters. The court determined that, even though the SPEs had strong cash flows, bankruptcy remote structures, and no debt defaults, the chapter 11 filings had not been made in bad faith. The court found that it could consider the interests of the entire group of affiliated debtors as well as each individual debtor in assessing the legitimacy of the chapter 11 filings.

Among the potential flaws in the bankruptcy remote SPE structure brought to light by *General Growth* is the requirement under applicable Delaware law for independent directors to consider not only the interests of creditors, as mandated in the charter or other organizational documents, but also the interests of shareholders. Thus, an independent director or manager who simply votes to block a bankruptcy filing at the behest of a secured creditor without considering the impact on shareholders could be deemed to have violated his or her fiduciary duties of care and loyalty. *See In re Lake Mich. Beach Pottawattamie Resort LLC*, 547 B.R. 899 (Bankr. N.D. Ill. 2016) (a "blocking" member provision in the membership agreement of a special purpose limited liability company was unenforceable because it did not require the member to comply with its fiduciary obligations under applicable non-bankruptcy law).

Courts disagree as to the enforceability of blocking provisions and, in particular, "golden shares" that, as the term is used in a bankruptcy context, give the shareholder the right to preempt a bankruptcy filing. For example, in *Lexington Hospitality*, the bankruptcy court denied a motion to dismiss a bankruptcy case filed by an entity wholly owned by a creditor that held a golden share/blocking provision because the court concluded that the entity was not truly independent. 577 B.R. at 684–85. In addition, in *In re Intervention Energy Holdings, LLC*, 553 B.R. 258 (Bankr. D. Del. 2016), the court ruled that a provision in a limited liability company's governance document:

> the sole purpose and effect of which is to place into the hands of a single, minority equity holder [by means of a 'golden share'] the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief, and the

> nature and substance of whose primary relationship with the debtor is that of creditor—not equity holder—and which owes no duty to anyone but itself in connection with an LLC's decision to seek federal bankruptcy relief, is tantamount to an absolute waiver of that right, and, even if arguably permitted by state law, is void as contrary to federal public policy.

Id. at 265; *see also In re Tara Retail Group, LLC*, 2017 WL 1788428 (Bankr. N.D. W. Va. May 4, 2017) (even though a creditor held a golden share or blocking provision, it ratified the debtor's bankruptcy filing by its silence), *appeal dismissed*, 2017 WL 2837015 (N.D. W. Va. June 30, 2017).

By contrast, in *Squire Court Partners v. CenterLine Credit Enhanced Partners (In re Squire Court Partners)*, 574 B.R. 701, 704 (E.D. Ark. 2017), the court ruled that, where a partnership agreement required the unanimous consent of the partners before the limited partnership could "file a petition seeking, or consent to, reorganization or relief under any applicable federal or state law relating to bankruptcy," the bankruptcy court properly dismissed a bankruptcy filing by the managing partner without the consent of the other partners.

One of the seminal cases addressing this issue is *In re Franchise Services of North America, Inc.*, 891 F.3d 198 (5th Cir. 2018). In *Franchise Services*, a bank invested $15 million in Franchise Services of North America ("FSNA") as part of a transaction to purchase an FSNA competitor in exchange for 100% of FSNA's convertible preferred stock. The preferred stock was convertible to slightly less than 50% of FSNA's common stock. FSNA was also obligated to pay certain investment fees to the bank's parent in connection with the transaction. As a condition to the investment, FSNA amended its certificate of incorporation to provide that FSNA could not "effect any Liquidation Event" (defined to include a bankruptcy filing) without the approval of the holders of a majority of both its preferred and common stock.

FSNA filed for chapter 11 protection in 2017 without obtaining the consent of a majority of its preferred and common stockholders. FSNA still owed certain amounts to the bank's parent at time of the bankruptcy filing. The bank moved to dismiss the petition as having been filed without proper authorization. The bankruptcy court found that the bank itself was an owner, rather than a creditor, of FSNA and ruled that the shareholder consent provision was not contrary to federal bankruptcy policy. The court opted to leave to Delaware state courts the determination as to whether the provision violated Delaware law. It accordingly dismissed FSNA's chapter 11 case.

On direct appeal, the U.S. Court of Appeals for the Fifth Circuit affirmed. It rejected FSNA's argument that, even if Delaware law authorized the corporate charter provision at issue, federal law forbids such a provision due to the public policy against waiving the right to file for bankruptcy protection. The court wrote that "[t]here is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be [controlled by] an unsecured creditor. . . ."

The Fifth Circuit also rejected FSNA's contention that, even if a shareholder-creditor can hold a bankruptcy veto right, such a right "remains void in the absence of a concomitant fiduciary duty." No statute or binding case law, the court explained, "licenses this court to ignore corporate foundational documents, deprive a bona fide shareholder of its voting rights, and reallocate corporate authority to file for bankruptcy just because the shareholder also happens to be an unsecured creditor." In the absence of evidence showing that the bank was a controlling minority shareholder, the Fifth Circuit found that the bank did not have fiduciary duties to FSNA. Even if it were a controlling shareholder, the Fifth Circuit noted, the proper remedy for a breach of fiduciary duty "is not to allow a corporation to disregard its charter and declare bankruptcy without shareholder consent," but to seek redress under state law.

Another notable case is *In re Insight Terminal Solutions, LLC*, 2019 WL 4640773 (Bankr. W.D. Ky. Sept. 23, 2019). In 2018, Autumn Wind Lending, LLC ("Autumn Wind") provided up to $6.8 million in financing under a term loan facility to Delaware limited liability company Insight Terminal Solutions, LLC ("ITS"). The original maturity date of the loan was December 31, 2018. The loan was guaranteed by an ITS affiliate holding all of the outstanding ITS membership units and secured by a lien on substantially all of the assets of ITS and the guarantor. The pledged collateral included the ITS membership units held by the guarantor as well as certain warrants for ITS membership units.

In connection with an extension of the maturity date of the loan to June 30, 2019, Autumn Wind amended the loan agreement to include a bankruptcy rights waiver. The waiver provided that: (i) if the loan was not paid in full on or before June 30, 2019, and Autumn Wind refused to grant an additional extension of the maturity date, the guarantor agreed to relinquish its rights to the pledged ITS membership units; and (ii) ITS and the guarantor agreed to amend their respective organizational documents so that neither would be permitted to file for bankruptcy protection unless they first obtained the prior written consent of all holders of ITS membership units and any party holding warrants for such units. Both ITS and the guarantor later amended their operating agreements to include the bankruptcy rights waiver.

On July 1, 2019, ITS and the guarantor defaulted on the loan. The following day, Autumn Wind notified ITS and the guarantor that it intended to retain the pledged ITS membership units and that, in accordance with the Uniform Commercial Code ("UCC"), they had 20 days to object. After further amending their operating agreements to authorize a bankruptcy filing and adopting resolutions authorizing such a filing, ITS and the guarantor (collectively, "debtors") filed for chapter 11 protection in the Western District of Kentucky on July 17, 2019—prior to the expiration of the 20-day period.

Autumn Wind moved to dismiss the chapter 11 cases, arguing that, in accordance with the bankruptcy rights waiver, the debtors lacked the authority to file for bankruptcy. According to Autumn Wind, when the debtors defaulted on the loan, the guarantor's right to exercise voting and/or consensual rights and powers over the ITS membership units ceased immediately, and such rights became vested solely and exclusively in Autumn Wind. Moreover, Autumn Wind contended that, in its capacity as a holder of warrants for ITS membership units, Autumn Wind's consent was required for any bankruptcy filings by the debtors.

The bankruptcy court denied the motion to dismiss. Initially, the court found that, by amending their operating agreements in July 2019 and adopting resolutions authorizing a bankruptcy filing, the debtors had authority under Delaware law to file for chapter 11 protection.

The debtors argued that the ITS membership units were never transferred to Autumn Wind because it did not comply with the UCC's strict foreclosure requirements. The court acknowledged that "this is a compelling argument." However, the court noted that it need not address this argument because "there is a more compelling reason" to deny the motion to dismiss—specifically, the bankruptcy rights waiver violated federal public policy.

The court explained as follows:

> Autumn Wind's primary witness testified that it was well aware that a contractual provision limiting a debtor's right to seek relief under the Bankruptcy Code was legally unenforceable as against public policy. It was for this very reason that Autumn Wind included terms in the waiver and amendment that if Debtors did not achieve additional financing during the 3-1/2 month period they provided, then the agreement would provide a prohibition on filing for bankruptcy under this amendment. On July 1, 2019, the collateral would be turned over to Autumn Wind. Autumn Wind believed that by using this provision, they would avoid the public policy issue . . . However, the terms of the surrender of the collateral were not fully consummated as there was no completion of the strict foreclosure process. Furthermore, the attempt to circumvent the bankruptcy laws and public policy by "circuitry of arrangement," were ineffective. Autumn Wind tried to get around this argument by making itself an equity holder, however, the process to achieve this was not completed. Autumn Wind did not become an equity holder, nor did they become the owner of the collateral through the strict foreclosure process. Furthermore, attempts to limit the Debtors' access to the bankruptcy process were against public policy and invalid.

Pace Industries

Delaware corporation KPI Intermediate Holdings, Inc. ("KPI") and direct and indirect subsidiaries, including Pace Industries, LLC (collectively, "debtors"), filed pre-packaged chapter 11 cases in April 2020 in the District of Delaware to effectuate a debt-for-equity swap that would wipe out preexisting equity interests while paying general unsecured claims in full. In 2018, certain entities ("preferred shareholders") acquired 62.5% of KPI's preferred stock for approximately $37 million. In connection with the stock purchase, KPI amended and restated its certificate of incorporation to provide that any voluntary bankruptcy filing by KPI or its affiliates "shall require the written consent or affirmative vote of the holders of a majority in interest of the Series A Preferred Stock. . ., and any such action taken without such consent or vote shall be null and void ab initio, and of no force or effect."

The preferred shareholders moved to dismiss the chapter 11 cases. They argued that the court lacked subject matter jurisdiction over the cases because the debtors did not obtain the shareholder consent required by KPI's certificate of incorporation. They acknowledged court rulings finding that shareholder bankruptcy consent rights violate public policy if exercised by a shareholder that is also a creditor holding a "golden share." However, the preferred shareholders noted, they were preferred stockholders only, not creditors.

In addition, the preferred shareholders argued that, consistent with *Franchise Services*, a minority shareholder is not a controlling minority shareholder with fiduciary duties, and the failure of KPI even to ask for their consent to the bankruptcy filings demonstrated that they did not control KPI's board. The preferred shareholders also impugned the legitimacy of the chapter 11 filings, claiming that they were motivated not by genuine financial distress, but by the debtors' desire to obtain releases and other benefits for KPI's directors, KPI's equity sponsor, and other insiders and to wipe out preferred equity interests.

The debtors countered that they were forced to close facilities and terminate a large portion of their workforce as a result of the COVID-19 pandemic and that their directors, as fiduciaries, resolved that a bankruptcy filing was in the best interests of the companies. According to the debtors, the preferred shareholders' objection to the filings was merely a ploy to gain negotiating leverage.

Citing *Basho Techs. Holdco B, LLC v. Georgetown Basho Investors, LLC*, 2018 WL 3326693 (Del. Ch. 2018), *aff'd*, 221 A. 3d 100 (Del. 2019), the debtors argued that Delaware law imposes fiduciary obligations on minority shareholders when they control a particular transaction, and the preferred shareholders' bankruptcy blocking right was tantamount to control. In addition, the debtors argued, the blocking right violated federal public policy because it eviscerated their constitutional right to seek bankruptcy relief. According to the debtors, to the extent that the Fifth Circuit concluded in *Franchise Services* that a shareholder with a bankruptcy blocking right did not owe fiduciary duties to the company, that court was simply wrong.

Ruling from the bench on May 5, 2020, Bankruptcy Judge Mary Walrath denied the motion to dismiss, holding as a matter of first impression that, on these facts, "a blocking right by a shareholder

who is not a creditor is void as contrary to federal public policy that favors the constitutional right to file bankruptcy." According to Judge Walrath, there was no question that the debtors were in financial straits, particularly because of the pandemic. She also noted that the bankruptcy cases would benefit most stakeholders and concluded that "a lack of access to the Bankruptcy Code and the Bankruptcy Courts would violate the federal public policy [] to allow a debtor to file bankruptcy." Judge Walrath accordingly ruled that the bankruptcy blocking provision in KPI's corporate charter "violates public policy and is void as it is exercised by a minority shareholder" because it is a "restriction of that constitutional right [to file bankruptcy and] is against federal public policy."

In so ruling, she "respectfully declined" to follow *Franchise Services*, noting that she saw "no reason to conclude that a minority shareholder has any more right to block a bankruptcy—the constitutional right to file a bankruptcy by a corporation—than a creditor does." Moreover, Judge Walrath explained, contrary to the Fifth Circuit's interpretation of Delaware law in *Franchise Services*, under Delaware law, "a blocking right, such as exercised in the circumstances of this case, would create a fiduciary duty on the part of the shareholder; a fiduciary duty that, with the debtor in the zone of insolvency, is owed not only to other shareholders, but also to all creditors." In accordance with *Basho*, she noted, other factors combined with the blocking right (i.e., the debtors were in the zone of insolvency, lacked liquidity, and could not pay their debts as they matured without debtor-in-possession financing, coupled with severe operational disruption due to the pandemic) supported a finding in this case that the preferred shareholders' blocking right created a fiduciary duty.

Judge Walrath later entered a bare-bones order denying the preferred shareholders' motion to dismiss without any indication that a more detailed written opinion would be forthcoming. *See In re Pace Industries, LLC*, Case No. 20-10927(MFW) (Bankr. D. Del. May 11, 2020).

OUTLOOK

Recent court rulings have not resolved the ongoing dispute over the enforceability of blocking provisions, golden shares, and other provisions designed to manage access to bankruptcy protection. *Pace Industries, Franchise Services, Insight*, and other relevant decisions reinforce the importance of knowing what approach the courts have endorsed in any likely bankruptcy venue.

CREDITORS' COMMITTEE DENIED STANDING TO BRING DERIVATIVE CLAIMS ON BEHALF OF LLC DEBTOR IN BANKRUPTCY

Dan T. Moss ■ Mark G. Douglas

The practice of conferring "derivative standing" on official creditors' committees to assert claims on behalf of a bankruptcy estate in cases where the debtor or a bankruptcy trustee is unwilling or unable to do so is a well-established means of generating value for the estate from litigation recoveries. However, in a series of recent decisions, the Delaware bankruptcy courts have limited the practice in cases where applicable non-bankruptcy state law provides that creditors do not have standing to bring claims on behalf of certain entities. The latest of these rulings was handed down recently by Judge Karen B. Owens in the chapter 11 cases of Dura Automotive Systems, LLC and its affiliates (collectively, "Dura"). The court ruled that an official creditors' committee could not be granted derivative standing to prosecute claims against Dura's prepetition lenders because Delaware's limited liability company ("LLC") law restricts standing to prosecute actions on behalf of an LLC to its members and their assigns. *See In re Dura Automotive Systems, LLC*, No. 19-12378 (KBO) (Bankr. D. Del. June 9, 2020) (unpublished bench ruling).

The court's approach adopted in *Dura Automotive* has not been followed in most other cases. Many other bankruptcy courts, including the New York bankruptcy court overseeing the chapter 11 cases filed in February 2020 by The McClatchy Co. and its affiliates, have granted standing to committees in cases involving LLCs organized under state laws with restrictions similar to Delaware's LLC law.

DERIVATIVE STANDING

Standing is the ability to commence litigation in a court of law. It is a threshold issue—a court must determine whether a litigant has the legal capacity to pursue claims before the court can adjudicate the dispute. In the bankruptcy context, various provisions of the Bankruptcy Code confer standing on various entities (e.g., the debtor, the debtor-in-possession ("DIP"), a bankruptcy trustee, creditors, equity interest holders, official committees, and indenture trustees) to, among other things, participate generally in a bankruptcy case or commence litigation involving causes of action or claims that either belonged to the debtor prior to filing for bankruptcy or are created by the Bankruptcy Code.

The right to participate generally in a chapter 11 case is more explicit. Section 1109(b) of the Bankruptcy Code provides that any "party in interest," including the debtor, the trustee, a committee of creditors or equity security holders, a creditor, an equity security holder, or an indenture trustee "may appear and may be heard on any issue" in a chapter 11 "case." This general right to participate, however, does not confer standing upon every party in interest to engage in litigation expressly contemplated

by other provisions of the Bankruptcy Code, such as lien and transfer avoidance. Many Bankruptcy Code provisions deal with claims or causes of action belonging to the debtor prior to filing for bankruptcy, which become part of the debtor's bankruptcy estate on the petition date. Standing to prosecute such estate claims is expressly given by the Bankruptcy Code to the bankruptcy trustee (or the DIP, by operation of section 1107(a) of the Bankruptcy Code).

Most courts, however, will allow official creditors' committees to commence litigation on behalf of the estate under narrowly defined circumstances, reasoning that certain provisions of the Bankruptcy Code imply a qualified right to derivative standing for official creditors' committee, including: (i) section 1109(b); (ii) section 1103(c)(5), which provides that a creditors' committee may "perform such . . . other services as are in the interest of those represented"; and (iii) section 503(b)(3)(B), which provides that the court shall grant administrative priority in payment for the expenses of "a creditor that recovers, after the court's approval, for the benefit of the estate any property transferred or concealed by the debtor." Courts have also reasoned that derivative standing is an appropriate exercise of the court's broad equitable powers under section 105(a) of the Bankruptcy Code to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code. *See generally* COLLIER ON BANKRUPTCY ¶ 1103.05[6][a] (16th ed. 2020).

One of the seminal cases addressing this issue is *Unsecured Creditors Committee of Debtor STN Enterprises, Inc. v. Noyes (In re STN Enterprises)*, 779 F.2d 901 (2d Cir. 1985). In *STN Enterprises*, the U.S. Court of Appeals for the Second Circuit Court ruled that, in considering an official creditors' committee's request for leave to sue a director for misconduct, a court is required to consider whether the debtor unjustifiably failed to initiate suit against the director and whether the action is likely to benefit the debtor's estate (i.e., the time and expense for such litigation is justified given the likelihood of success in such litigation).

The Second Circuit later refined the doctrine of "derivative standing" in *Commodore Int'l Ltd. v. Gould (In re Commodore Int'l Ltd.)*, 262 F.3d 96 (2d Cir. 2001). In *Commodore*, the court ruled that a committee may bring suit even if the trustee or DIP does not unjustifiably refuse to do so as long as: (i) the trustee or DIP consents; and (ii) the court finds that the litigation is (a) in the best interests of the estate and (b) necessary and beneficial to the fair and efficient resolution of the bankruptcy proceedings.

The Third Circuit articulated a slightly different standard for derivative standing *in Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003). In *Cybergenics*, the court held that, to be granted derivative standing, a movant must demonstrate that: (i) the DIP or trustee has unjustifiably refused either to pursue the claim or to consent to the movant's prosecution of the claim on behalf of the estate; (ii) the movant has alleged colorable claims; and (iii) the movant has received leave to sue from the bankruptcy court.

Many other courts, including courts of appeals, have also countenanced the concept of derivative standing. *See, e.g., PW Enters., Inc. v. N.D. Racing Comm's (In re Racing Servs., Inc.)*, 540 F.3d 892, 904 (8th Cir. 2008); *Fogel v. Zell*, 221 F.3d 955, 965 (7th Cir. 2000); *Canadian Pacific Forest Prods. Ltd. v. J.D. Irving, Ltd. (In re Gibson Grp., Inc.)*, 66 F.3d 1436, 1446 (6th Cir. 1995).

Different rules regarding derivative standing exist under state corporation laws. For example, under Delaware law, although the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for fiduciary infractions, some courts have concluded that the creditors of an insolvent Delaware LLC do not because

Delaware's LLC Act expressly limits such standing to "[a] member or an assignee of a limited liability company interest." 6 DEL. C. § 18–1001. *See, e.g., CML V, LLC v. Bax*, 6 A.3d 238, 241 (Del. Ch. 2010), *aff'd*, 28 A.3d 1037 (Del. 2011), *as corrected* (Sept. 6, 2011).

On the basis of this statutory limitation, Delaware bankruptcy courts have denied standing to various entities, including official creditors' committees, creditors, and bankruptcy trustees, seeking to prosecute causes of action on behalf LLC debtors or their creditors. *See, e.g., In re HH Liquidation, LLC*, 590 B.R. 211, 284 (Bankr. D. Del. 2018) (committee denied derivative standing to prosecute breach of fiduciary duty claims); *In re PennySaver USA Publ'g, LLC*, 587 B.R. 445, 467 (Bankr. D. Del. 2018) (chapter 7 trustee denied derivative standing to prosecute claims for alleged breach of fiduciary duties owed to an LLC's creditors); *see also In re Citadel Watford City Disposal Partners, L.P.*, 603 B.R. 897, 905-06 (Bankr. D. Del. 2019) (granting a motion to dismiss a breach of fiduciary duty claim asserted by a creditors' committee because the creditors of a limited partnership lack standing to sue derivatively under Delaware law and because the creditors of an LLC lack derivative standing to sue under Wyoming law and, as predicted by the court, North Dakota law). *But see In re Golden Guernsey Dairy, LLC*, 548 B.R. 410, 413 (Bankr. D. Del. 2015) (ruling that a chapter 7 trustee, which under the Bankruptcy Code is the sole representative of the estate with the ability to sue and be sued, had standing to bring breach of fiduciary duty claims against the president and a managing member of a Delaware LLC whether such claims are direct or derivative in nature).

DURA AUTOMOTIVE

Tennessee-based auto parts manufacturer Dura filed for chapter 11 protection in October 2019 in the Middle District of Tennessee. After venue of the cases was transferred to the District of Delaware, the bankruptcy court approved the sale of substantially all of Dura's North American and European assets in May 2020 for $66 million and certain litigation recoveries to affiliates of Bardin Hill Investment Partners LP and the Charlton Group Inc. It was then anticipated that the cases would be converted to chapter 7 liquidations and a trustee would liquidate Dura's remaining assets.

Dura's official unsecured creditors' committee sought bankruptcy court authority to bring avoidance, equitable subordination, and recharacterization claims against various prepetition lenders controlled by or affiliated with former Dura manager and majority equity holder Lynn Tilton. In an order authorizing Dura to incur DIP financing, Dura, its estate, and the official creditors' committee expressly waived such claims unless "such party in interest with requisite standing . . . timely commence[s] an adversary proceeding or contested matter" asserting them. The committee argued that making a demand on Dura to assert the causes of action would be futile because, due to "Ms. Tilton's extensive involvement and influence over the Debtors, the Debtors are highly unlikely to bring such claims." In addition, the committee asserted that, based upon its extensive investigation, the claims stated in its proposed complaint were colorable.

Addressing court rulings that have relied on *Bax* as a basis for finding that the creditors of a Delaware LLC lack derivative standing in bankruptcy, the official unsecured creditors' committee argued that: (i) "none of the cases applying *Bax* in the bankruptcy context were decided in the procedural posture of the instant motion" (i.e., a motion made under the Third Circuit's three-part *Cybergenics* test); (ii) the courts in *Citadel* and *HH Liquidation* actually entered orders granting committees derivative standing before later dismissing the causes of action for lack of standing; (iii) applying *Bax* "would improperly supplant the applicable standard under *Cybergenics* in favor of a premature and claim-by-claim analysis of the merits of proposed claims"; (iv) *Bax* is preempted by Bankruptcy Code provisions governing the role of official unsecured creditors' committees in adversary proceedings and does not apply to avoidance, subordination, and recharacterization claims brought under the Bankruptcy Code; and (v) the appropriate time for the court to decide whether *Bax* applies is in the context of a motion to dismiss the complaint rather than a motion seeking derivative standing.

THE BANKRUPTCY COURT'S RULING

The bankruptcy court denied the official unsecured creditors' committee's motion for derivative standing. In an unpublished teleconference ruling, Judge Owens stated that she agreed with other Delaware bankruptcy courts that, in accordance with the relevant statute and case law applying it, only Delaware LLC members or entities holding assigned membership interests have standing to prosecute claims on behalf of the LLC. Judge Owens rejected the argument that the official unsecured creditors' committee's statutory role was impaired—or its investigation "rendered illusory"—by the inability to prosecute causes of action it perceived to be grounded in the Bankruptcy Code, rather than state law.

Judge Owens concluded that no provision in the Bankruptcy Code conflicts with (and thus preempts) the Delaware LLC standing rule. She also determined that the nature and origin of the potential causes of action are not relevant to the standing inquiry. According to Judge Owens, "[r]egardless of whether the claims arise under state law or the Code, the court must decide who may assert them." To answer that question, she stated on the record that "the court must look to the law of the debtors' state of formation."

Judge Owens also rejected the committee's argument that applying the *Bax* standing rule in bankruptcy would render "illusory" DIP financing order provisions that preserve the rights of committees to prosecute causes of action. She explained that "alternative remedies do exist to ensure that fiduciary duties are not neglected," including the appointment of a chapter 11 trustee or examiner. Acknowledging that these are "blunt tools," Judge Owens stated that she "suspects other creative or more effective options" could be devised to address the issue.

Judge Owens also denied the official unsecured creditors' committee's motion for an order extending the challenge period in

the DIP financing order to allow a chapter 7 trustee to consider claims against the prepetition lenders after the cases were converted. According to the judge, the parties stipulated that the standing issue had to be adjudicated before conversion.

THE MCCLATCHY COMPANY

The U.S. Bankruptcy Court for the Southern District of New York flatly rejected the *Dura Automotive* approach to derivative standing in cases involving Delaware LLCs. Newspaper publisher The McClatchy Co. ("McClatchy") filed for chapter 11 protection on February 13, 2020, with a plan to sell the companies to a group of bondholders led by Chatham Asset Management LLC ("Chatham"). McClatchy's official unsecured creditors' committee and the Pension Benefit Guaranty Corporation, which would be responsible for the company's $805 million in pension liabilities, both requested investigations into McClatchy's 2018 and 2019 debt refinancings, which they allege unlawfully converted $350 million unsecured debt owed to Chatham into a secured obligation. On June 22, 2020, the committee filed a motion seeking derivative standing to bring fraudulent transfer, breach of fiduciary duty, and equitable subordination claims against Chatham and certain other defendants.

In objecting to the motion, Chatham argued that *Dura Automotive* and *Bax* "make[] clear [that] statutory creditors' committees cannot obtain derivative standing when the debtor in possession is a Delaware limited liability company." In its response, the committee stated as follows:

> Citing to a single out-of-circuit unpublished order, Chatham contends that the Committee categorically cannot obtain derivative standing on behalf of Debtors that are Delaware limited liability companies—an issue that only applies to six Debtors . . . The Committee disagrees. *STN* and its progeny make clear that the Committee is not just seeking to sue derivatively on behalf of the Estates, rather, it is seeking Court authority to step in as the Estates.

On July 6, 2020, Bankruptcy Judge Michael Wiles held in an unpublished ruling that the committee's proposed complaint stated "colorable" claims. *See In re The McClatchy Co.*, No. 20-10418 (Bankr. S.D.N.Y. July 6, 2020) (transcript of hearing—Doc. No. 641). He rejected the argument that the Delaware LLC law prevents a bankruptcy court from conferring standing on a committee to bring derivative claims on behalf of LLC debtors. According to Judge Wiles, the Delaware LLC law was not controlling and "irrelevant" to committee derivative standing requests. He explained that federal bankruptcy law, rather than state law, governs because the committee sought to bring claims that became property of the bankruptcy estate on the petition date.

OUTLOOK

Derivative standing is an important tool to generate value for the benefit of all stakeholders in a bankruptcy case. Recent rulings in Delaware LLC chapter 11 cases denying derivative standing may ultimately reduce recoveries available to general unsecured creditors. Moreover, the courts' rationale for importing state law derivative standing requirements into the bankruptcy context is uncertain, given the role played by fiduciaries acting on behalf of the bankruptcy estate (e.g., DIPs, trustees, and official committees) and their ability to effectively represent the *estate's* interest in litigation matters.

Notably, there was no argument in these cases that a bankruptcy trustee could not have prosecuted the claims on behalf of the estate exercising the powers conferred on a trustee by the Bankruptcy Code, nor was there a challenge to the bankruptcy courts' power to confer derivative standing to sue upon an official creditors' committee as a representative of the estate under appropriate circumstances. Moreover, many bankruptcy courts, including Delaware bankruptcy courts, have conferred derivative standing to sue upon creditors' committees or individual creditors in cases involving LLCs, notwithstanding state laws where the debtor LLC is domiciled that purport to limit derivative standing to LLC members or their assigns. *See, e.g., Official Comm. of Unsecured Creditors v. Meltzer*, 589 B.R. 6, 16 (D. Me. 2018) (derivative standing conferred on the creditors' committee in a chapter 11 case filed by a Delaware LLC); *In re Pursuit Capital Mgmt., LLC*, 595 B.R. 631, 658 (Bankr. D. Del. 2018) (conferring derivative standing upon a creditor in a chapter 7 case filed by a Delaware LLC); *In re Know Weigh, L.L.C.*, 576 B.R. 189, 210 (Bankr. C.D. Cal. 2017) (conferring derivative standing upon creditors in chapter 11 case of a California LLC); *In Matter of Home Casual LLC*, 534 B.R. 350, 354 (Bankr. W.D. Wis. 2015) (conferring derivative standing upon a creditor in a chapter 7 case filed by a Wisconsin LLC); *In re SGK Ventures, LLC*, 521 B.R. 842, 847 (Bankr. N.D. Ill. 2014) (LLC formed under Illinois law).

Finally, consistent with other Delaware precedent, the court's ruling in *Dura Automotive* did not prohibit a chapter 7 trustee from asserting claims against the Dura's majority equity holder, Lynn Tilton, or other potential defendants for breach of fiduciary duty or related claims.

NEWSWORTHY

An article written by ***Corinne Ball*** ***(New York)*** and ***George J. Cahill*** ***(New York)*** entitled "Matalan: Enforcing English Schemes in the U.S. Under Chapter 15 on Credit Default Swaps" was published in the August 26, 2020, issue of the *New York Law Journal*.

Corinne Ball (New York), Bruce Bennett (Los Angeles and New York), Carl E. Black (Cleveland), Jeffrey B. Ellman (Atlanta), Brad B. Erens (Chicago), Gregory M. Gordon (Dallas), Heather Lennox (Cleveland and New York), Joshua M. Mester (Los Angeles), Charles M. Oellermann (Columbus), and ***Kevyn D. Orr (Washington)*** were among the 2020 *Lawdragon 500* "Leading U.S. Bankruptcy & Restructuring Lawyers."

An article written by ***Geoffrey S. Stewart (Global Disputes; Washington), Victoria Dorfman (Washington),*** and ***Gabrielle E. Pritsker (Business & Tort Litigation; Washington)*** entitled "Valuing Litigation in Bankruptcy: The Use of Expert Witnesses to Testify About the Merits and Value of Litigation Claims" was published in the Winter 2020 issue of the *American Bankruptcy Law Journal*.

Carl E. Black (Cleveland) was named a "Lawyer of the Year" in the field of Litigation—Bankruptcy in *The Best Lawyers in America* (2021).

Thomas M. Wearsch (Cleveland), T. Daniel Reynolds (Cleveland), Timothy W. Hoffmann (Chicago), Robert W. Hamilton (Columbus), Genna Ghaul (New York), and ***Marissa Alfano (Cleveland)*** are representing global auto parts manufacturer Shiloh Industries, Inc. and its affiliates in chapter 11 cases filed by the companies on August 30, 2020, in the U.S. Bankruptcy Court for the District of Delaware.

Bruce Bennett (Los Angeles and New York), Corinne Ball (New York), Gregory M. Gordon (Dallas), Heather Lennox (Cleveland and New York), **and** ***Kevyn D. Orr (Washington)*** were among the 2020 *Lawdragon 500* "Global Bankruptcy & Restructuring Lawyers."

Thomas A. Wilson (Cleveland), Danielle Barav-Johnson (Atlanta), Jeffrey B. Ellman (Atlanta), Kevyn D. Orr (Washington), Thomas M. Wearsch (Cleveland), Caitlin K. Cahow (Chicago), Danielle D. Donovan (Atlanta), Joshua K. Brody (New York), Oliver S. Zeltner (Cleveland), James O. Johnston (Los Angeles), Jonathan Noble Edel (Cleveland), Aldo L. LaFiandra (Atlanta and New York), Heather Lennox (Cleveland and New York), T. Daniel Reynolds (Cleveland), Gregory M. Gordon (Dallas), Corinne Ball (New York), Carl E. Black (Cleveland), Bruce Bennett (Los Angeles and New York), and ***Brad B. Erens (Chicago)*** were recognized in *The Best Lawyers in America (2021)* in the fields of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law and/or Litigation—Bankruptcy.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Expanding the Scope of the Bankruptcy Safe Harbor for Securities Transactions" was published in *Lexis Practice Advisor* on August 12, 2020.

An article written by ***Stacey L. Corr-Irvine (New York)*** and ***Mark G. Douglas (New York)*** entitled "Oversecured Creditor's Right to Contractual Default-Rate Interest Allowed under State Law" was published on August 10, 2020, in *Lexis Practice Advisor*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Force Majeure Clause Triggered by Pandemic Shutdown Order Partially Relieves Chapter 11 Debtor from Timely Paying Postpetition Rent" was published on August 6, 2020, in *Lexis Practice Advisor*.

An article written by ***Paul M. Green (Houston)*** and ***Mark G. Douglas (New York)*** entitled "Secured creditor's net economic damages estimate of disputed claims plainly insufficient to establish collateral value" was published in the August 28, 2020, edition of the *International Law Office Newsletter*.

An article written by ***Dan T. Moss (Washington)*** and ***Mark G. Douglas (New York)*** entitled "Eighth Circuit Rules That Bankruptcy Code's Cap on Lease Damage Claims Applies to Fraudulent Transfer Judgment" was published on August 10, 2020, in *Lexis Practice Advisor*.

An article written by ***Charles M. Oellermann (Columbus)*** and ***Mark G. Douglas (New York)*** entitled "Structuring LBO Payments After NY Ch. 11 Ruling" was published in the August 13, 2020, edition of *Law360*.

An article written by ***Marissa Alfano (Cleveland)*** and ***Mark G. Douglas (New York)*** entitled "Another bankruptcy court joins majority camp on post-plan confirmation set-off" was published in the August 21, 2020, edition of the *International Law Office Newsletter*.

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