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DISTRESSED INVESTING: SELECTED TOPICS

by

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I. INTRODUCTION

Modern corporate restructuring practice has evolved to a great extent into a mergers and acquisition ("M&A") practice, albeit it in the context of troubled companies. While one of the primary means for effectuating an M&A transaction in the non-troubled context is via the acquirer's purchase of stock in the target corporation, one of the primary means for effectuating an M&A transaction in the troubled context is via the acquirer's purchase of claims against the target corporation; claims that frequently are converted into stock in the reorganized enterprise. The acquisition of troubled company claims and troubled companies has grown into a major industry, with numerous hedge funds and other private equity firms specializing in the take-over of businesses in distress.

There are a host of legal issues that may confront a distressed investor as it pursues an acquisition strategy. These issues are important not only for distressed investors, but also for reorganizing corporations and their other stakeholders. Indeed, distressed investors often dictate the direction and timing of restructurings, and frequently are the source of new funding for reorganizing companies that enables such companies to consummate their turnaround plans. As a consequence, legal rules that impede the strategies of distressed investors could harm companies in need of the funding ability and turnaround expertise provided by many distressed investors. This article provides an overview of certain recent developments in bankruptcy and related rules that affect the activities of distressed investors, and the potential impact of these developments on distressed investors, debtors, and their various constituencies.

II. AD HOC COMMITTEES AND DISCLOSURE OBLIGATIONS

The reorganization process requires full and productive discussions and negotiations among stakeholders if they are to reach a consensus on a workable restructuring plan. One of the great strengths of Chapter 11 is that it provides a framework for, and impetus toward, such negotiations. The Bankruptcy Code stimulates these negotiations by providing for, among other things, the establishment of an official committee of unsecured creditors and, in appropriate circumstances, official committees of shareholders, retirees or other creditor groups. Sometimes, however, groups of creditors with common interests, whether because their rights are derived from similar instruments (such as a particular issuance of securities) or a similar relationship with the debtor (such as landlords, asbestos claimants or trade creditors), have found it beneficial to establish an unofficial (or ad hoc) committee to represent their interests in the bankruptcy case.

Historically, ad hoc committees tended to act as representatives of their constituencies, even though only a portion of any given constituency was active. More recently, members of ad hoc committees have used their membership to show their *bona fides* and that they should be dealt with seriously, rather than reflecting a desire (or intention) to act on behalf, or in the interest, of the named constituency. Moreover, it is not uncommon for members of modern ad hoc committees to simultaneously hold significant claims and/or equity interests in multiple classes, or to have other interests regarding the estate (such as a desire to purchase assets of the estate).[2] These other interests arguably may lead to conflicts between the interests of the ad hoc committee members and those other members of the class from which the ad hoc committee has taken its identity, or even among the members of the ad hoc committee itself.

A. Proliferation of Ad Hoc Committees

The increase in distressed investing, particularly by hedge funds, has resulted in the proliferation of ad hoc committees. Indeed, distressed investors have increasingly turned to ad hoc committees to take advantage of their many benefits. First, recent ad hoc committees have operated under the presumption that they do not have fiduciary duties to other stakeholders, including to the class by which they identify themselves, leaving them free to pursue their own agendas.[3] Second, ad hoc committees are largely unregulated, often subject only to the requirement to file a verified statement (a "2019 Statement") pursuant to Rule 2019 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules").[4] Third, ad hoc committees provide their members with a unified voice during the Chapter 11 process. Fourth, ad hoc committees can allow their members to diffuse and defray costs stemming from participation in the Chapter 11 process. Finally, Section 1109(b) of the Bankruptcy Code provides parties-in-interest, including ad hoc committees, with a broad opportunity to appear and be heard on any issue that arises in the bankruptcy case.[5]

B. Bankruptcy Rule 2019

Bankruptcy Rule 2019(a) provides that every entity or committee representing more than one creditor or equity security holder must file a verified statement setting forth, among other things, (i) the names and addresses of the creditors or equity security holders represented, (ii) the nature and amount of the claims or interests held, and the time of acquisition, unless acquired more than one year before the petition date, (iii) the amounts paid for the claims and interests and

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2 *See, e.g.*, *In re Northwest Airlines Corp.*, 363 B.R. 701, 702 (Bankr. S.D.N.Y. 2007) ("*Northwest Airlines I*") (members of "Ad Hoc Equity Committee" collectively owned 19,065,644 shares of debtors' common stock and claims against the debtors in the amount of $264,287,500); *Bank of New York v. Adelphia Commc'ns Corp.* (In re Adelphia Commc'ns Corp.), 307 B.R. 432, 433-34 & n.3 (Bankr. S.D.N.Y. 2004) (holders of approximately $665 million in principal amount of subordinated debt owned more senior debt, "at least collectively," than subordinated debt).

3 This presumption could be open to challenge. The *Northwest Airlines* court assumed *arguendo* that the ad hoc committee before it did not have fiduciary responsibilities. *See In re Northwest Airlines Corp.*, 363 B.R. 704, 709 (Bankr. S.D.N.Y. 2007) ("*Northwest Airlines II*," and together with *Northwest Airlines I*, "*Northwest Airlines*"). However, the 1937 Securities and Exchange Commission Report on abuses in bankruptcy practice took the position that the types of committees prevalent at that time had fiduciary responsibilities to their constituencies. SEC, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees*, pts. 1-8 (1937-1940) (the "*SEC Report*"). A closely related question is whether contemporary ad hoc committees have a constituency beyond their members. *Northwest Airlines* suggests that they do. *See Northwest Airlines II*, 363 B.R. at 708-09; *see also Official Comm. of Equity Sec. Holders of Mirant Corp. v. Wilson Law Firm, P.C.* (In re Mirant Corp.), 334 B.R. 787, 793 (Bankr. N.D. Tex. 2005) (holding that attorney for an ad hoc committee of shareholders owed a duty to the entire class of shareholders, not just members of the ad hoc committee).

4 However, as discussed below, some recent cases have involved disputes regarding the application of Rule 2019 to ad hoc committees.

5 *See* 11 U.S.C. § 1109(b); *see also Ad Hoc Bondholders Group v. Interco Inc.* (In re Interco Inc.), 141 B.R. 422, 425 (Bankr. E.D. Mo. 1992) (noting that ad hoc group could participate as a party-in-interest under Section 1109 of the Bankruptcy Code).

(iv) any sales or other disposition of the claims or interests.[6] If an ad hoc committee fails to comply with Bankruptcy Rule 2019, a bankruptcy court can prohibit further participation in the bankruptcy case by the committee, including by disqualifying votes cast by the members of an ad hoc committee on a Chapter 11 plan.[7]

Bankruptcy Rule 2019 has been in force for about 70 years. Until recently, however, there have been few cases discussing its application and the required contents of a 2019 Statement. There are several reasons for the sparse case law. For instance, for most of the period since the adoption of the Bankruptcy Code, the U.S. Trustee was more likely to appoint multiple official committees, decreasing the need for, or relevance of, ad hoc committees.[8] Recently, however, the U.S. Trustee has favored the appointment of only one official creditors' committee in any given case.[9] This trend is not expected to change in the future.[10]

Similarly, distressed debt investing has become widespread only relatively recently, resulting in committee members holding more diverse interests. Prior to this development, the members of ad hoc committees could be more homogeneous. For example, landlords would comprise an ad hoc committee of landlords or trade creditors would join in an ad hoc committee of trade creditors.[11] As such, parties arguably had little to gain from forcing strict compliance with Bankruptcy Rule 2019. In the event that a party did seek strict compliance, it was not likely to be litigated to a written opinion because, unlike the hedge funds comprising many of today's ad hoc committees, the ad hoc committee members of the past would be unlikely to claim they used confidential, proprietary strategies in acquiring the claims.[12]

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[6] Fed. R. Bankr. P. 2019(a).

[7] *See* Fed. R. Bankr. P. 2019(b)(3).

[8] *See* Kurt F. Gwynne, *Intra-Committee Conflicts, Multiple Creditors' Committees, Altering Committee Membership and Other Alternatives for Ensuring Adequate Representation Under Section 1102 of the Bankruptcy Code*, 14 Am. Bankr. Inst. L. Rev. 109 (2006) (discussing trend away from multiple official creditors' committees).

[9] *See* 3 *United States Trustee Manual* § 3-4.5 (1998) (discussing problems of multiple official creditors' committees and policy preference for only one official creditors' committee).

[10] However, U.S. Trustees have recently tended to appoint equity committees more frequently. *See* Corinne Ball, *Distressed Mergers and Acquisitions:* '*Delphi' May Encourage Formation of Equity Panels*, N.Y.L.J., Apr. 27, 2006, at 5.

[11] *Cf. V.S. of Paul, Weiss, Rifkin, Wharton & Garrison LLP Pursuant to Bankr. Rule 2019, In re Musicland Holding Corp.*, No. 06-10064 (SMB) (Bankr. S.D.N.Y. July 31, 2006) (2019 Statement filed on behalf of Informal Committee of Secured Trade Vendors that consists of, *inter alia*, Cargill Financial Services International, Inc., The Walt Disney Co., Credit Suisse International, and Mayer-Goldwyn Mayer Home Entertainment LLC.); *Am. V.S. of Brown Rudnick Berlack Israels LLP Pursuant to Fed. R. Bankr. P. 2019(a), In re WorldCom, Inc.*, No. 02-13533 (AJG) (Bankr. S.D.N.Y. May 1, 2003) (2019 Statement filed on behalf of Ad Hoc MCI Trade Claims Committee that consisted of hedge funds such as Longacre Management, Contrarian Capital Management, L.L.C., Stark Investments, Sierra Liquidity Fund, LLC, *inter alia*, rather than vendors.).

[12] *See* 11 U.S.C. § 107(b) (providing that the bankruptcy court "shall" place material under seal upon request of party in interest); Fed. R. Bankr. P. 9018; *Mot. of the Ad Hoc Equity Comm. for an Order (a) Pursuant to §§ 105(a) and 107(b) of the Bankr. Code and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File its Bankr. Rule 2019(a) Statement Under Seal, and (B) Granting a Temporary Stay Pending Determination of this Mot., In re Northwest Airlines Corp.*, at 3-4, ¶¶ 6-7, 6-7, ¶ 15, 8-9, ¶¶ 19-20, No. 05-17930 (ALG) (Bankr. S.D.N.Y. filed Mar. 1, 2007) (arguing that the trading information sought under Bankruptcy Rule 2019 is confidential proprietary information).

In light of the dearth of decisions interpreting Bankruptcy Rule 2019, there has been little debate, until recently, regarding the application of Bankruptcy Rule 2019 to ad hoc committees and distressed investors. However, recent cases like *Owens Corning*, *Mirant*, *Northwest Airlines* and *Scotia Development* have spurred a new focus on how Bankruptcy Rule 2019 applies to ad hoc committees and their members.[13]

1. Owens Corning and Mirant

The first of the recent cases involving Bankruptcy Rule 2019 was *Owens Corning* in the Bankruptcy Court for the District of Delaware.[14] In *Owens Corning*, the debtor filed a motion (the "OC 2019 Motion") seeking full compliance with Bankruptcy Rule 2019 by an ad hoc bondholder committee (the "OC Committee"), whose 2019 Statement contained only the members' names and addresses and the aggregate principal amount of debt held by the OC Committee.[15] After the Bankruptcy Court entered orders requiring only the 2019 Statement itself to be filed electronically, with its exhibits containing sensitive material to be submitted on compact disc (and apparently available through the Clerk's Office),[16] the OC 2019 Motion was withdrawn.[17] In light of this resolution, *Owens Corning* generated little controversy.

Matters became more complex in *Mirant*. In *Mirant*,[18] the debtor filed a motion seeking an order compelling the ad hoc committee of bondholders of Mirant Americas Generation, LLC (the "Mirant Committee") to supplement its 2019 Statement to include information regarding, among other things, the amount of claims owned by each member of the Mirant Committee and when those claims were obtained.[19] After an initial objection by the Mirant Committee, the parties negotiated an agreed order resolving the matter that provided: (i) for the Mirant

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13 In addition, disputes regarding the application of Bankruptcy Rule 2019 to ad hoc committees have arisen in a number of more recent cases, but these disputes have either settled or remain unresolved as of the date this article was prepared. *See Mot. to Compel the Informal Comm. of Secured Trade Vendors to File a V.S. in Compliance with Bankr. Rule 2019(a), In re Musicland Holding Corp.*, No. 06-10064 (SMB) (Bankr. S.D.N.Y. filed July 31, 2007); *Mot. of New Mirant Entities to Compel Certain Holders of Class 3 Claims of Mirant Corp. to Comply with Rule 2019 of the Fed. R. Bankr. P., In re Mirant Corp.*, No. 03-46590 (DML) (Bankr. N.D. Tex. filed May 16, 2007) (Motion withdrawn on August 22, 2007.); *Mot. of Wachovia Bank, Nat'l Ass'n for Order Compelling Ad Hoc Comms. to Fully Comply with Bankr. Rule 2019*, *In re Le-Nature's, Inc.*, No. 06-25454 (MBM) (Bankr. W.D. Pa. filed May 9, 2007) (Motion withdrawn on August 16, 2007.).

14 *In re Owens Corning*, Nos. 00-03837 to -03854 (JKF) (Bankr. D. Del.).

15 *Debtors' Mot. to Compel the Ad Hoc Comm. of Bondholders to Comply with Fed. R. Bankr. P. 2019 or to Deny Further Right to be Heard, In re Owens Corning*, Nos. 00-03837 to -03854 (JKF) (Bankr. D. Del. filed Aug. 18, 2004).

16 *Amendatory Order Requiring Filing of Statements Pursuant to Fed. R. Bankr. P. 2019, In re Owens Corning*, Nos. 00-03837 to -03854 (JKF) (Bankr. D. Del. Aug. 27, 2004); *Order Requiring Filing of Statements Pursuant to Fed. R. Bankr. P. 2019, In re Owens Corning*, Nos. 00-03837 to -03854 (JKF) (Bankr. D. Del. Aug. 25, 2004).

17 *Notice of Withdrawal of Debtors' Mot. to Compel the Ad Hoc Comm. of Bondholders to Comply with Fed. R. Bankr. P. 2019 or to Deny Further Right to be Heard, In re Owens Corning*, Nos. 00-03837 to -03854 (JKF) (Bankr. D. Del. filed Sept. 29, 2004).

18 *In re Mirant Corp.*, No. 03-46590 (DML) (Bankr. N.D. Tex.).

19 *Mot. of Debtors to Compel the Ad Hoc Comm. of Bondholders of Mirant Americas Generation, LLC to Produce Certain Information in Compliance with Rule 2019 of the Fed. R. of Bankr. P. or, Absent Such Compliance, to Prevent the Comm. from Further Participation in These Chapter 11 Cases, In re Mirant Corp.*, No. 03-46590 (DML) (Bankr. N.D. Tex. filed Apr. 11, 2005).

Committee to file a supplemental 2019 Statement under seal each month with a copy of such supplemental 2019 Statement served on the debtors, the official committees and the U.S. Trustee; (ii) such supplemental 2019 Statement would (a) disclose the time of acquisition or sale of claims by members of the Mirant Committee in terms of the "calendar month" (not the day) the transfer was consummated, (b) separately classify claims transactions as purchases, sales or other dispositions and (c) provide disclosure on an aggregate, not an individual member, basis; and (iii) if the aggregate principal amount of certain bonds owned by the Mirant Committee changed by more than 5% since the most recent disclosure, the Mirant Committee would "promptly" file a supplemental 2019 Statement under seal and serve it on the parties specified in (ii) above.[20]

2. Northwest Airlines

Neither *Owens Corning* nor *Mirant* captured much attention, likely because neither case resulted in a written opinion. In February 2007, however, a written opinion on Bankruptcy Rule 2019 was issued in *Northwest Airlines* that did capture the attention of restructuring professionals.[21] In that case, the United States Bankruptcy Court for the Southern District of New York required an ad hoc committee of equity security holders (the "NWA Committee") comprised of hedge funds to fully comply with Bankruptcy Rule 2019 by including the date of investment and the price paid for claims against, or interests in, the debtor.[22] A few weeks later, the court rejected a motion by the NWA Committee to place under seal, as proprietary information, the timing and pricing of purchases.[23] The Bankruptcy Court also rejected the NWA Committee's argument that such information was confidential commercial information, the release of which would permit competitors to gain a direct competitive advantage.[24]

Distressed investors were alarmed by the *Northwest Airlines* rulings, asserting that the possibility of forced disclosure of information that they view as proprietary and highly sensitive could impair their ability to compete in the market.[25] Indeed, it has been suggested that the

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20 *Agreed Order Regarding Mot. of Debtors to Compel the Ad Hoc Comm. of Bondholders of Mirant Americas Generation, LLC to Produce Certain Information in Compliance with Rule 2019 of the Fed. R. Bankr. P. or, Absent Such Compliance, to Prevent the Comm. from Further Participation in These Chapter 11 Cases*, *In re Mirant Corp.*, No. 03-46590 (DML) (Bankr. N.D. Tex. May 24, 2005).

21 *Northwest Airlines I*, 363 B.R. at 701.

22 *Id.* at 703-04.

23 *Northwest Airlines II*, 363 B.R. at 707 ("In any event, any interest that individual Committee members may have in keeping this information confidential is overridden by the interests that Rule 2019 seeks to protect.").

24 *Id.* at 706 (The "improbable contention" that public filing of "the information it seeks to seal would allow competitors of the funds that make up the Committee to discern the members' 'investment strategies' . . . was unsupported by the affidavits filed on behalf of the Committee . . . and counsel at oral argument conceded that the 'trading strategies' of his clients are not at issue.").

25 Securities industry trade groups filed *amicus* briefs supporting the ad hoc committees in *Northwest Airlines* and a number of other cases referenced herein. *E.g., Br. of* Amicus Curiae *the Loan Syndications and Trading Ass'n and the Sec. Indus. and Fin. Mkts. Ass'n in Opp'n to Wachovia Bank's Mot. to Compel Ad Hoc Comms. to Fully Comply with Bankr. Rule 2019* ("Le-Nature's *Amicus* Br."), *In re Le-Nature's Inc.*, No. 06-25454 (MBM) (Bankr. W.D. Pa. filed June 12, 2007); *Br. of Amicus Curiae Sec. Indus. and Fin. Mkts. Ass'n and Loan Syndications and Trading Ass'n in Support of Noteholder Group's Obj. to Scotia Pac. Co. LLC's Mot. for Order Compelling* Ad Hoc *Comm. to Fully Comply with Rule 2019(a) by Filing Complete and Proper V.S. Disclosing its Membership and Their Interests* ("Scotia *Amicus* Br."), *In re Scotia Dev. LLC*, No. 07-20027-C-11 (Bankr. S.D. Tex. filed Apr. 9, 2007)

Northwest Airlines rulings could cause hedge funds to withdraw from, or reduce their involvement in, the distressed securities market, thereby eliminating a key source of liquidity for creditors and investors seeking to sell claims against financially distressed companies.[26] In addition, some have suggested that *Northwest Airlines* could discourage hedge funds from acting in a coordinated manner to monitor debtor behavior and the administration of bankruptcy cases.[27]

3. Scotia Development

Relying extensively on *Northwest Airlines*, the debtors in *Scotia Development LLC*[28] filed a motion seeking to compel an "ad hoc committee of noteholders" (the "Scotia Noteholders") to make full disclosure pursuant to Bankruptcy Rule 2019.[29] However, the Scotia Noteholders[30] argued that they were not a "committee" for purposes of Bankruptcy Rule 2019 because they did not purport to act in a representative capacity for any persons other than the Scotia Noteholders, who individually approved all actions taken by their shared counsel. As a consequence, their arguments focused on Congressional intent in enacting the predecessors to Bankruptcy Rule 2019, which was to protect small investors from the abuses of so-called "protective committees"[31] during the Great Depression.[32] The Scotia Noteholders also argued that even if

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26 *See* Le-Nature's *Amicus* Br. at 3-4 (asserting that to require members of ad hoc committees to "reveal not only their holdings but the prices at which these entities purchased their securities—will likely have a dramatic effect on the willingness of financial institutions to participate in the restructuring process").

27 *Id.* at 4 ("Given the choice between disclosing their highly confidential and proprietary trading strategies, on the one hand, and not participating in informal groups, on the other, most institutions will choose the latter.").

28 *In re Scotia Dev. LLC*, No. 07-20027-C-11 (Bankr. S.D. Tex.).

29 *Scotia Pac. Co. LLC's Mot. for an Order Compelling the Ad Hoc Comm. to Fully Comply with Bankruptcy Rule 2019(a) by Filing a Complete and Proper V.S. Disclosing its Membership and Their Interests*, at 1, *In re Scotia Dev. LLC*, (Bankr. S.D. Tex. filed Mar. 16, 2007) (the "Scotia 2019 Mot.").

30 During the litigation on the application of Bankruptcy Rule 2019, the Scotia Noteholders stopped referring to themselves as an "ad hoc committee" and started using the term "noteholder group," instead. April 10 Tr. at 34-35 ("As of March 28th, they're a group. Nothing changed . . . except that they changed their name from a committee to a group, because they wanted to get out from under 2019.").

31 Common in early 20th century reorganizations, a "protective committee" was privately formed on behalf of one or more classes of a debtor's securities. The committee solicited other holders to deposit their securities with the committee to centralize bargaining on behalf of the class. David A. Skeel, Jr., *Debt's Dominion* 58 (2001); *see also* William G. Fennell, *Protective Committees and Deposit Agreements in Railroad Reorganizations*, 49 Yale L.J. 224 (1939). "By depositing their bonds, investors gave the committee complete control over the bonds for the duration of the negotiations, with one limitation: bondholders would have the right to withdraw their bonds if they disapproved of the plan negotiated on their behalf." Skeel, *supra* at 58. According to one source, as a practical matter, the protective committee, often organized by the investment bank that underwrote the debtor's securities or other insiders, effectively ran the reorganization process with no real input from smaller creditors. *Id.* at 59; *see also In re Rosenbaum Grain Co.*, 13 F. Supp. 600, 601 (N.D. Ill. 1935) ("In a great many cases, . . . the bondholders' committee is set up by the debtor, itself, or by individuals who promoted the organization of the debtor and the sale of its securities."); Charles Jordan Tabb, *The History of Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 22 (1995) ("[T]he entire elaborate proceeding often resulted in old management retaining control of the enterprise, and dictating the terms of the [reorganization]."). The SEC Report investigated these abuses and its "essential conclusion . . . was that public investors needed protection from" the misconduct of insiders and protective committees. Tabb, *supra* at 30.

32 *Noteholder Group's Obj. to Scotia Pac. Co. LLC's Mot. for an Order Compelling the Ad Hoc Comm. to Fully Comply with Bankr. Rule 2019(a) by Filing a Complete and Proper V. S. Disclosing its Membership and Their Interests* at 12-16, ¶¶ 29-35, *In re Scotia Dev. LLC*, No. 07-20027-C-11, (Bankr. S.D. Tex. filed Apr. 6, 2007) (the "Noteholder Objection"); *see generally* Evan D. Flaschen & Kurt A. Mayr, *Bankruptcy Rule 2019 and the Unwarranted Attack on Hedge Funds*, 26-SEP Am. Bankr. Inst. J. 16 (2007) (Counsel to the Scotia Noteholders restating, and expanding upon, arguments from the Noteholder Objection.).

Bankruptcy Rule 2019 was applicable, the court had (and should exercise) discretion to excuse the Scotia Noteholders from further disclosure under Bankruptcy Rule 2019.[33]

The Scotia Noteholders also sought to distinguish *Northwest Airlines* on the basis that (i) the NWA Committee actively sought appointment as an official equity committee, which "effectively announced its desire to serve in a representative and fiduciary capacity on behalf of other equity holders," while the Scotia Noteholders did not purport to represent anyone but themselves; (ii) the NWA Committee only held 27% of the equity in Northwest Airlines, whereas the Scotia Noteholders owned 95% of the so-called "Timber Notes," so the Scotia Noteholders, unlike the NWA Committee, had no need to represent (or purport to represent) anyone other than the members of the Scotia Committee;[34] (iii) unlike the NWA Committee, the only class of claims owned by the Scotia Noteholders were Timber Notes, so there were "no divided loyalties and no secrets . . .;" and (iv) the NWA Committee allegedly sought to increase its leverage "by seeking to negotiate on behalf of the entire class" with only 27% of the stock, whereas the vote of the Scotia Noteholders alone would be determinative of whether the Timber Notes class accepted or rejected a plan.[35]

In an oral ruling sustaining the Scotia Noteholders' objection, the court rejected the *Northwest Airlines* approach by employing a "practical approach" to conclude that the Scotia Noteholders were "not a committee . . . just one law firm representing a bunch of creditors."[36] In making its decision, the court focused on whether an ad hoc committee purports to represent anyone other than its members, and the practical benefits of permitting a single counsel to represent multiple entities "so that we don't have 500 noteholders . . . with 500 lawyers."[37] In addition, the court suggested that even if the Scotia Noteholders were a "committee" subject to Bankruptcy Rule 2019, the court had discretion, and would exercise such discretion on the facts before it, to excuse the Scotia Noteholders from full compliance with Bankruptcy Rule 2019.[38]

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33 Noteholder Objection, at 23-25, ¶¶ 55-59.

34 In addition, the Scotia Noteholders' extremely high level of ownership of the Timber Notes effectively mooted the argument in *Northwest Airlines II* that "other shareholders have a right to information" regarding an ad hoc committee's holdings and transactions "so that the [other shareholders] can make an informed decision whether this [ad hoc c]ommittee will represent their interest or whether they should consider forming a more broadly based committee of their own." *Northwest Airlines II*, 363 B.R. at 709.

35 Noteholder Objection, at 18-20, ¶¶ 39-45.

36 Mot. Hr'g Tr., at 4-5, *In re Scotia Dev. LLC*, No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 17, 2007) ("April 17 Tr.").

37 Mot. Hr'g Tr. at 74-75, 85 *In re Scotia Dev. LLC*, No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 10, 2007). (discussing the importance of disclosure when a committee "purports" to represent parties beyond its members and considering whether Bankruptcy Rule 2019 only applies to fiduciaries).

38 Mot. Hr'g Tr., at 18 *In re Scotia Dev. LLC*, No. 07-20027-C-11 (Bankr. S.D. Tex. May 22, 2007). (The Scotia Noteholders are "not a committee. But to the extent that they are, then I grant them permission not to file" the information regarding the amount and pricing of claims held by individual members.).

C. Is Bankruptcy Rule 2019 Limited to Committees Acting as Fiduciaries?

The foregoing rulings raise a number of questions. For instance, the applicability of Bankruptcy Rule 2019 to an ad hoc committee could turn on whether or not an ad hoc committee is deemed to have fiduciary responsibilities to similarly-situated stakeholders.[39] One could argue that Bankruptcy Rule 2019 should not apply to ad hoc committees unless they have a responsibility to a broader constituency – even if it is only to let the members of the class "know where their champions are coming from" – so they can make "an informed decision whether th[e ad hoc committee] will represent their interests or whether they should consider forming a more broadly-based committee of their own."[40]

As noted above, the predecessor to Bankruptcy Rule 2019 was adopted as a result of the SEC Report, which detailed abusive practices in certain aspects of 1930s reorganization practice.[41] Many of these abuses revolved around "protective committees" being used by insiders to manipulate the process at the expense of other investors. The malfeasance of protective committees led to emphasis, by the SEC and others, on the fiduciary duties owed by the representatives of protective committees to their members.[42] By contrast, many of today's ad hoc committees argue that they only speak for their members and no one else. Given the lack of any fiduciary responsibilities, so the argument goes, Bankruptcy Rule 2019 simply is inapplicable to them. This argument proved successful in *Scotia Development*; it remains to be seen whether it will be successful in other cases.

D. Does the Applicability of Bankruptcy Rule 2019 Turn On Whether or Not a Group of Creditors Decides to Describe Itself as a "Committee"?

In order to mitigate the risk of having to comply with Bankruptcy Rule 2019, some practitioners have opted to avoid using the term "committee" altogether. Rather than using the term "committee," they use terms such as "consortium" or even "group." In *Scotia Development*, the ad hoc committee first described itself as a committee, but later opted to describe itself as a group of noteholders.[43] However, it is not clear that the *Scotia Development* court was

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39 9 *Collier on Bankruptcy* ¶ 2019.02 (Alan N. Resnick & Henry J. Sommer, eds., 15th ed. rev. 2006) ("Entities, including unofficial committees, that assume the representation of a group must be subject to [Bankruptcy Rule 2019] . . . because they are fiduciaries to those they purport to represent.") (citing *Young v. Higbee Co.*, 324 U.S. 204 (1945)).

40 *Northwest Airlines II*, 363 B.R. at 709.

41 SEC Report, *supra* note 3, at 215-216, 897; *see* Le-Nature's *Amicus* Br. at 10 (The "rules [of Chapter X] were laid down in light of abuses which had become manifest in reorganization proceedings . . . [where] it had appeared that unqualified and unrepresentative committees sought and obtained the right to represent defenseless security holders while actually working in the interests of the debtor or other adverse parties.") (quoting *In re Philadelphia & Reading Coal & Iron Co.*, 105 F.2d 358, 359 (3d Cir. 1939)).

42 These concerns lead to "the Interstate Commerce Commission receiv[ing] authority to supervise the role of protective committees in railroad reorganizations." Le-Nature's *Amicus* Br. at 9 (citing Section 77(p) of the Bankruptcy Act of 1935, 11 U.S.C. § 205(p) (Supp. 1938) and Fennell, *supra* note 31). However, what might be considered the closest forerunners of today's ad hoc committees "were not subject to such oversight, as the statute stated, 'groups of mutual institutions shall not be prohibited from acting together for their own interests through representatives.'" Le-Nature's *Amicus* Br. at 9 (quoting 11 U.S.C. § 205(p) (Supp. 1938)).

43 *See supra* note 30.

persuaded simply by the change in terminology. Rather, the court based its ruling on whether or not duties to other creditors were involved and the impact of less than full disclosure on other parties. For instance, the court noted that this was only a "financial reorganization," implying that any conflicts in the case would largely be among sophisticated financial parties with their own counsel rather than less sophisticated parties that might rely on an ad hoc committee to represent their interests.[44]

Notwithstanding the terminology used in *Scotia Development*, the applicability of Bankruptcy Rule 2019 arguably should not turn on whether a group of creditors decides to describe itself as a "committee." Indeed, Bankruptcy Rule 2019 applies not only to "any committee," but also to "any entity . . . representing more than one creditor. . . ."[45]

E. Is Bankruptcy Rule 2019 Applicable to Agents Under Credit Agreements?

One question that has arisen in *Le-Nature's* is whether Bankruptcy Rule 2019 should apply to an agent under a credit agreement.[46] Although Bankruptcy Rule 2019 does not explicitly mention agents under a credit agreement, it does reference indenture trustees, who fulfill a similar role under an indenture.[47] Moreover, as noted above, Bankruptcy Rule 2019 requires compliance by any "entity" representing multiple creditors – which, arguably, the agent does on behalf of the loan syndicate.[48] However, requiring an agent under a credit agreement to fully comply with Bankruptcy Rule 2019 could be a heavy administrative burden given the wide syndication of loans and the increasingly heavy volume of secondary trading in distressed loans.

III. CREDIT DERIVATIVES

While many distressed investors acquire claims against or interests in a troubled company directly, many of them choose to hedge against the possibility of losses on such claims or interests through the purchase of derivatives. Moreover, some distressed investors opt to forego the direct purchase of claims and interests altogether, deciding instead to acquire the potential

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44 April 17 Tr. at 4.

45 Fed. R. Bankr. P. 2019(a) (emphasis added); *cf.* Flaschen & Mayr, *supra* note 32, at 47 (discussing application of Rule 2019 to counsel to an ad hoc committee).

46 *Obj. of the Ad Hoc Lenders' Comm. to Mot. of Wachovia Bank, Nat'l Ass'n for Order Compelling Ad Hoc Comm. to Fully Comply with Bankr. Rule 2019 and Cross-Mot. of the Ad Hoc Lenders' Comm. to Compel Wachovia Bank, Nat'l Ass'n and its Co-Counsel to Fully Comply with Bankr. Rule 2019, In re Le-Nature's, Inc.*, No. 06-25454 (MBM) (Bankr. W.D. Pa. filed May 25, 2007).

47 However, an indenture trustee is a fiduciary of bondholders under the indenture, while the duties of an agent are often only contractual in nature. *See* Le-Nature's *Amicus* Br. at 15 ("Case law supports the view that credit facility administrative agents serve only in a contractually limited role and do not serve in a fiduciary capacity."); *see also Fid. Summer St. Trust v. Toronto Dominion (Texas), Inc.*, No. Civ.A. 02-11285-GAO, 2002 WL 1858763, at *4 (D. Mass. Aug. 14, 2002) (holding that, in lender's action against the administrative agent, the agent did not have fiduciary duty to the lender under the credit agreement); *Banque Arabe et Internationale D'Investissement v. Maryland Nat'l Bank*, 57 F.3d 146, 158 (2d Cir. 1995) (holding that arm's-length transactions between sophisticated financial institutions generally do not give rise to fiduciary duties).

48 *Muralo Co. v. Synkoloid Asbestos Pltfs.* (In re Muralo Co.), 295 B.R. 512, 524 (Bankr. D.N.J. 2003) (quoting 8 *Collier on Bankruptcy* ¶ 2019.03 (15th ed. 1989) for proposition that Bankruptcy Rule 2019 applies to fiduciaries).

benefits of claims and interests "synthetically" through the purchase of derivatives. The purchase and sale of derivatives is a complex and evolving area. Accordingly, the following discussion provides a brief overview of the nature of derivatives, along with some of the potential impacts of the derivative market upon distressed investors and troubled companies.

A. General Description of Credit Derivatives

A "derivative" is a contract between two parties, the value of which is based on (or derived from) reference to an extrinsic event or value.[49] Historically, derivatives were used to hedge (or speculate on) risk relating to commodities, interest rates and currency exchange rates. More recently, derivatives used to hedge and trade credit risk, called "credit derivatives," have comprised much of the growth and innovation in the derivatives market.[50] Credit derivatives have become mainstream, and are even employed by pension funds, mutual funds and retail investors.[51]

First developed in the mid-1990s, credit derivatives allow parties to isolate and transfer credit risk from one party to another by providing for payments keyed to a credit event, such as a company defaulting on its debts.[52] Most credit derivatives are sold by dealers in the over-the-counter ("OTC") market.[53] The International Swaps and Derivatives Association, Inc. (the "ISDA") has developed standard documentation that governs the majority of OTC derivatives.[54] Typical ISDA documentation for a credit derivative transaction consists of: (i) an ISDA Master Agreement, which is a standard agreement establishing default terms for future derivatives transactions between particular counterparties;[55] (ii) a schedule to the ISDA Master Agreement,

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49 *See, e.g.*, David Mengle, *Credit Derivatives: An Overview*, at 3 (Apr. 13, 2007) (presented at Federal Reserve Bank of Atlanta 2007 Financial Markets Conference—Credit Derivatives: Where's the Risk?, May 15, 2007), *available at* http://www.frbatlanta.org/news/conferen/07fmc/07FMC_mengle.pdf.

50 David Yeres, *An Overview of the Uses of and Issues Surrounding Credit Derivatives*, *in Nuts & Bolts of Financial Products 2007*, at 529, 531 (PLI Corp. Law & Practice, Course Handbook Series No. B-1589, 2007) ("The International Swaps and Derivatives Association, Inc. . . . estimates that the notional value of credit default swaps alone grew by 52% during the first half of 2006 to reach a notional value of over [US$]26.0 trillion. This is up from [US$]2.69 trillion in 2003.").

51 Nicoletta Kotsianas, *CalPERS Credit Jump Expected to Bring Copycat Moves*, Derivatives Wk., Apr. 16, 2007, at 1, 12 (major pension fund permitting use of credit derivatives.); *Mutual Funds Hold Out for Softer FIN48*, Derivatives Wk., May 14, 2007, at 4 (mutual funds make up a small, but growing, portion of the OTC credit derivative market); *Mutual Fund Preps CDS Exposure for Retail*, Derivatives Wk., Apr. 23, 2007, at 6-7.

52 Yeres, *supra* note 50, at 531.

53 Todd L. Padnos & Brett J. Kitei, *Exchange-Traded Solvency Derivatives: Considerations for the Restructuring Community*, Bankr. Strategist, Apr. 2007, at 2 ("*Exchange-Traded Solvency Derivatives*"); Aaron Lucchetti & Alistair MacDonald, *Trading Up: Inside Exchanges' Race To Invent New Bets*, Wall St. J., July 6, 2007, at A10 (discussing difficulties in creating and popularizing exchange-traded credit derivatives).

54 *See generally* http://www.isda.org. However, some dealers prefer their own forms of documentation for certain types of trades. *See* Paul J. Davies, *Protection promise offered by CDSs*; *Re-Tailored to Offer Protection*, Fin. Times (London), Aug. 28, 2006, at 35.

55 The ISDA Master Agreement typically specifies terms such as events of default, representations and warranties, covenants, liquidated damages and choice of law. *Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co.*, 375 F.3d 168, 173 & nn.17-18 (2d Cir. 2004) (citing Allen & Overy, *An Introduction to the Documentation of OTC Derivatives* 2 (2002), *available at* http://www.isda.org/educat/pdf/documentation_of_derivatives.pdf).

which sets forth party-specific modifications to the ISDA Master Agreement applicable to their series of transactions; (iii) a confirmation, which sets forth the economic terms of individual transactions;[56] and (iv) any credit support documents, which provide for the granting of collateral when the parties are of differing credit quality.

The most common form of credit derivative is the credit default swap ("CDS"),[57] which is conceptually similar to an insurance contract.[58] In the typical CDS transaction, one party (the "protection buyer") will pay another (the "protection seller") to assume the credit risk on a specified principal amount (the "notional amount") of debt (the "reference obligation")[59] issued by a specified entity (the "reference entity").[60] The protection buyer pays the protection seller a premium,[61] consisting of a series of fixed payments, in exchange for the protection seller agreeing to pay a certain notional amount of the reference obligation upon the occurrence of a "credit event" with respect to the reference entity or reference obligation. If a credit event does not occur during the term of the CDS,[62] the protection buyer will not receive any payments from the protection seller.

The standard ISDA documentation for a corporate CDS provides for five "credit events."[63] The most significant credit events to distressed investors are bankruptcy, failure to

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56 For credit derivative transactions, ISDA's 2003 Credit Derivatives Definitions (the "2003 Definitions") would be used. *See generally* Paul C. Harding, *A Practical Guide to the 2003 ISDA Credit Derivatives Definitions* (2004) ("*Practical Guide to 2003 Definitions*") (providing commentary on the 2003 Definitions).

57 As of the end of 2006, the estimated size of the OTC CDS market was $29 trillion in notional amount. Roger Merritt & Eileen Fahey, *Hedge Funds: The Credit Market's New Paradigm*, FitchRatings, June 5, 2007 at 6-7 ("*Credit Market's New Paradigm*").

58 *But see Aon Fin. Prods., Inc. v. Société Generale*, 476 F.3d 90, 96 (2d Cir. 2007) (observing CDS agreements significantly different from insurance contracts as "they 'do not, and are not meant to indemnify the buyer of protection against loss'" but "' [r]ather allow parties to 'hedge' risk by buying and selling risks at different prices and with varying degrees of correlation'") (citation omitted).

59 Yeres, *supra* note 50, at 536; *accord Aon Fin. Prods.*, 476 F.3d at 96. CDS have been developed that reference secured loans or second-lien debt. *See* James Batterman, *et al.*, *Loan-Only Credit Default Swaps*, FitchRatings, May 31, 2006; Nicoletta Kotsianas, *CLO Managers Zero in on Second-Lien CDS*, Derivatives Wk., Feb. 26, 2007, at 1, 12.

60 Yeres, *supra* note 50, at 535-36.

61 Although the premium is calculated and quoted on an annual basis, it is paid on standard quarterly payment/maturity dates – March 20, June 20, September 20 and December 20. Mengle, *supra* note 49, at 17. A CDS transacted prior to a standard payment date pays a larger premium on the first payment date and then follows the standard payment schedule. *Id.* The amount of the premium is generally fixed for the term of the CDS. However, if the reference entity is sufficiently distressed, the protection seller may require the present value of a certain portion of the premium to be paid up front with the remaining premium paid quarterly. *Id.* at 18.

62 The term of most CDS is 5 years, but can vary. *See Morgan Stanley Taps CDS to Model Debt Value*, Derivatives Wk., Feb. 12, 2007, at 4.

63 The five "credit events" are (1) bankruptcy, (2) failure to pay, (3) obligation acceleration, (4) obligation default and (5) restructuring. *Practical Guide to 2003 Definitions*, *supra* note 56, at 30. In addition, a "repudiation/moratorium" credit event is available for transactions in emerging markets or referencing sovereign entities. Nomura Fixed Income Research, *Credit Default Swap (CDS) Primer*, at 3 & n.6 (2004) ("Nomura CDS Primer"), *available at* http://www.securitization.net/pdf/content/Nomura_CDS_Primer_12May04.pdf (last visited July 18, 2007) (citing 2003 Definitions); *see Practical Guide to 2003 Definitions*, *supra* note 56, at 106-17.

pay and restructuring.[64] The definitions of bankruptcy and failure to pay are straightforward. In contrast, it can be difficult to determine whether a "restructuring" credit event has occurred.[65] As a result, many transactions exclude restructuring as a credit event.[66] In any event, after the occurrence of a credit event, either the protection buyer or the protection seller must deliver a "credit event notice" to the other that describes the credit event and its formal notice of intent to settle the CDS.[67] The mechanics of settlement depend on whether the confirmation provides for the CDS to be "physically settled" or "cash-settled." In a "physically settled CDS," the protection seller must pay the protection buyer the notional amount in cash in exchange for the protection buyer physically delivering the notional amount of the reference obligation to the protection seller (measured by principal amount or the fair market value of the reference obligation on the date of the CDS).[68] In a "cash-settled CDS," the protection seller pays the protection buyer the difference between (i) the original principal amount of the reference obligation (or its fair market value on the date of the CDS) and (ii) the market value of the reference obligation after the credit event occurs.

Historically, physically settled CDS have been more common, although there is a trend toward cash-settled CDS in at least some circumstances.[69] The biggest advantage of physical settlement is that it does not require a determination of the reference obligation's value after a credit event occurs – a time when the market for the reference obligation may be distorted. However, the notional amount of CDS for certain popular reference obligations far exceeds the amount of the reference obligations that is outstanding.[70] As a result, the market for reference obligations can be distorted after a credit event occurs as protection buyers of physically settled CDS struggle to obtain sufficient amounts of the reference obligations to satisfy their delivery obligations.

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64 Nomura CDS Primer, *supra* note 63, at 3.

65 *Id.* at 5-6.

66 *Practical Guide to 2003 Definitions*, *supra* note 56, at 85-96.

67 *Id.*, at 99-100.

68 The specific obligations of the reference entity that would satisfy the physical delivery requirement can be established in the CDS or determined in accordance with standard ISDA terms. Yeres, *supra* note 50, at 536. Typically, the delivery requirement can be satisfied by any senior unsecured notes or loans. In a number of cases, market participants have disputed whether convertible bonds satisfied delivery requirements. *Practical Guide to 2003 Definitions*, *supra* note 56, at 25-26 (discussing *Nomura Int'l Plc v. Credit Suisse First Boston Int'l*, 2003 EWHC 160 (Q.B. Comm. 2003)); Richard Beales, *Calpine Chaos Leaves the Lawyers Laughing*, Fin. Times (London), Dec. 28, 2005, at 31 (discussing arguably subordinated convertible bonds).

69 James Batterman & Roger Merritt, *CDS Update: Cash Settlement Protocol, Loan CDS Index, and Successor Events*, DerivativeFitch, Nov. 17, 2006, at 2; Moorad Choudhry, *Credit Derivatives and Structured Credit Products: Transforming the Debt Capital Markets*, Euromoney, Nov. 2004, at 2, 4, *available at* http://www.yieldcurve.com/Mktresearch/files/Euromoney_ChoudhrySCPGuide2005.pdf (last visited July 24, 2007) (noting that it is standard practice for CDS referencing structured finance securities to be cash-settled because the small issue size makes physical settlement difficult).

70 *See* James Batterman & Eric Rosenthal, *Delphi, Credit Derivatives, and Bond Trading Behavior After a Bankruptcy Filing*, FitchRatings, Nov. 28, 2005, at 2. Further, the frequency and magnitude of such disparities have increased due to the popularity of index-based CDS and the use of CDS to establish synthetic credit-risk positions.

Most CDS allow for the delivery of any bond or loan issued by the reference entity, provided that the debt is not subordinated, bearer paper or scheduled to mature in 30 years or more from the settlement date.[71] In some cases, one of the reference obligations satisfying the delivery requirement may have a market value significantly lower than that of the other reference obligations.[72] This gives the protection buyer a "cheapest to deliver" option, *i.e.*, the ability to maximize its recovery under the CDS by delivering the cheapest qualifying debt of the reference entity.[73]

There is little transparency in the CDS market; when an investor enters into a credit derivative transaction, only two parties receive knowledge of the position's timing, pricing, direction and magnitude.[74] In contrast all, "actual trades" in the secondary cash market for approximately 4,000 securities (including distressed and high-yield securities) are "publicly reported and available for viewing through Bloomberg or other information services" pursuant to the Trade Report and Compliance Engine ("TRACE") adopted by NASDAQ.[75] The result is that almost all bond and other debt and equity positions are TRACE-reported.[76] As discussed in Section I above, however, many distressed investors view their trading patterns as proprietary information, and are loathe to permit disclosure of the timing, pricing, direction and magnitude of their transactions.[77] As a result of the reduced disclosure required of credit derivative

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[71] Stephen J. Lubben, *Credit Derivatives & the Future of Chapter 11*, Seton Hall Public Law Research Paper No. 906613, at 12 (July 17, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=906613 (last visited July 24, 2007).

[72] *Id.* at 11-12. For instance, in 2000, Conseco restructured certain bank loans to extend their maturity. Dresdner Kleinwort Wasserstein Research, *Credit Derivatives*, at 5 (Sept. 11, 2002), *available at* http://www.gtnews.com/article/4716.pdf (last visited Aug. 5, 2007). Although lenders were compensated for the maturity extension, it was technically a "restructuring" credit event under the then-applicable ISDA definitions. *Id.* In seeking their protection payments, protection buyers did not deliver Conseco loans (trading at 92% of par) but rather long-term Conseco bonds that were trading at 66-69% of par. *Id.* Protection sellers suffered a loss of approximately $60 million. Creditflux Ltd., *Documentation Standards*, http://www.creditflux.com/resources/documentation+standards.htm (last visited Aug. 5, 2007). As a result, the ISDA definitions were modified to provide alternative definitions of "restructuring" and an option for requiring delivery of obligations maturing within 30 months of the credit event. *See* ISDA, *Restructuring Supplement to the 1999 ISDA Credit Derivatives Definitions* (May 11, 2001), *available at* http://www.isda.org (describing "modified restructuring" credit event); *see also Practical Guide to 2003 Definitions*, *supra* note 56, at 85-96, 113-14.

[73] Lubben, *supra* note 71, at 11-12. For greater detail regarding delivery requirements, see ISDA Credit Derivatives Physical Settlement Matrix (Apr. 18, 2006), *available at* www.isda.org, which sets forth CDS "market terms" for various jurisdictions that the parties can incorporate by reference. Lubben, *supra* note 71, at 12 & n.48.

[74] *See*, *e.g.*, Satyajit Das, *Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives* 26 (2006) (noting the "absence" of transparency in OTC derivative markets).

[75] Marti P. Murray, *Risk Management for a Distressed Securities Portfolio, in Managing Hedge Fund Risk: Strategies and Insights from Investors, Counterparties, Hedge Funds and Regulators* 193, 209 (Virginia Reynolds Parker, ed., 2d ed. 2005), *available at* http://www.murraycapital.com/pubs/risk_2 ed.pdf.

[76] *Id.*

[77] *See* Richard Bookstaber, *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation* 88 (2007) ("[I]ndividual positions can take days or even weeks to work into the market and later liquidate. If other funds know that you have a large position and are in the process of closing it out—and especially if the reason for closing it out is that the price has been going against you—they will start to sit on the sidelines or even trade the other way."); *see also Mot. of the Ad Hoc Equity Comm. for an Order (a) Pursuant to §§ 105(a) and 107(b) of the Bankr. Code and Rule 9018 of the Fed. R. Bankr. P. Granting Leave to File its Bankr. Rule 2019(a) Statement Under Seal, and (B) Granting a Temporary Stay Pending Determination of this Mot.* at 3-4, ¶¶ 6-7, 6-7, ¶ 15, 8-9, ¶¶ 19-20, *In re Northwest Airlines Corp.*, No. 05-17930 (ALG) (Bankr.

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positions, many investors prefer to trade "synthetically" through credit derivatives rather than in the actual cash market.[78]

The role of major banks in making corporate loans has also evolved, as many of them now focus more on the origination and syndication of corporate loans rather than holding loans to maturity.[79] However, banks' ability to originate and syndicate loans derives from their relationships with potential borrowers.[80] When a bank sells a loan that it originated, the relationship with the borrower may be damaged.[81] Through the use of credit derivatives, a lender nonetheless can hedge or otherwise reduce its exposure to the borrower's credit while maintaining the loan on its books and minimizing any disclosure of it reducing its exposure to the borrower.[82] As a result, the lender can protect itself from credit risk while maintaining its relationship with the borrower.

B. Do Credit Derivatives Undermine Fundamental Assumptions Underlying the Bankruptcy Code?

As stated above, the Bankruptcy Code establishes a framework for negotiations between various stakeholders. The Bankruptcy Code contemplates that stakeholders will participate in the bankruptcy and monitor the debtor's administration of the estate to protect their interests.[83] Accordingly, the Bankruptcy Code provides a debtor with "substantial power[s]," but these powers are balanced by significant "avenues for creditor action" and response.[84] However,

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S.D.N.Y. filed Mar. 1, 2007) (arguing that the trading information sought under Bankruptcy Rule 2019 is confidential proprietary information).

78 *See Credit Market's New Paradigm*, *supra* note 57, at 5 ("In general, prime brokers reported that hedge funds showed an increasing preference for executing their credit strategies through the CDS rather than the cash market.").

79 Tim Weithers, *Credit Derivatives: Macro Risk Issues; Credit Derivatives, Macro Risks, and Systemic Risks*, at 6 (Apr. 20, 2007) (presented at Federal Reserve Bank of Atlanta 2007 Financial Markets Conference—Credit Derivatives: Where's the Risk?, May 16, 2007), *available at* http://www.frbatlanta.org/news/CONFEREN/07FMC/07FMC_Weithers.pdf (last visited Aug. 9, 2007) ("'[T]he role of banks as the ultimate holders of credit assets has become less important. . . . We are therefore witnessing a fundamental change in the business of banking from buy and hold strategies to so-called "originate to distribute" models.'") (alteration and ellipsis in original; citation omitted).

80 Nicoletta Kotsianas, *Hedge Funds Stock Up on Emerging-Market Corporate Loan Risk*, Derivatives Wk., Feb. 12, 2007, at 1, 12.

81 Hilary Rosenberg, *Compromising Positions: Will credit derivatives encourage more lending, or will they harm the interests of borrowers?*, CFO Magazine Sept. 1, 2003 *available at* http://www.cfo.com/printable/article.cfm/3010251/c_3046597?f=options (last visited July 8, 2007) ("One Fortune 500 treasurer . . . says he prefers to work with institutions that hold on to his company's debt."); John Kiff & Ron Morrow, *Credit Derivatives*, Bank of Canada Rev., Autumn 2000, at 3, 7, *available at* http://www.bankofcanada.ca/en/review/2000/r005-ea.pdf (last visited July 8, 2007) ("[L]oan sales can potentially damage valuable client relationships (i.e., clients may resent the fact that their bank is reducing its exposure to them . . .).").

82 "Buyers of protection . . . are able to hedge risk on loans without the borrower knowing. This is particularly important for bank portfolio managers . . . for whom managing client relationships is paramount." Lubben, *supra* note 71, at 16 n.59 (quoting LCDS Forum Summary, www.markit.com/marketing/lcds_summary.php).

83 Lubben, *supra* note 71, at 20; *see* 11 U.S.C. § 1109(b) (providing creditors and other parties right to appear and be heard).

84 Lubben, *supra* note 71, at 21.

creditors do not have an affirmative duty to participate in Chapter 11 cases. Rather, they must have an incentive to do so.[85] Generally, this incentive comes from a rational self-interest: participation in a Chapter 11 case may benefit the creditor by increasing the value of the debtor's estate and, thereby, the recovery on the creditor's claim.[86] As noted above, the Bankruptcy Code encourages creditor involvement by, *inter alia*, (i) contemplating establishment of an official committee of unsecured creditors whose professionals are compensated by the estate,[87] and (ii) providing that creditors whose participation in the bankruptcy benefits the estate may seek reimbursement of the expenses incurred through such participation.[88]

It has been suggested, however, that the use of credit derivatives may undermine creditor participation by altering (or removing) creditors' economic interests in maximizing the value of the debtor's estate. Indeed, one model of the possible behavior of a fully hedged creditor predicts that the creditor will have little or no incentive to participate in the restructuring process unless either (i) the creditor has better information than other creditors regarding the debtor's prospects or (ii) the "cheapest to deliver" option arises in settling the CDS.[89]

If CDS hedging reduces the incentive of creditors to participate in the reorganization process, other stakeholders may be forced to step in to fill the void, insofar as the CDS settlement process may cause large blocks of claims to aggregate in the hands of protection sellers.[90] However, it is not clear whether protection sellers, as a group, would want to take an active role in the Chapter 11 restructuring process, even if the opportunity arose.[91] But this is a risk assumed by any party to a CDS transaction, so once the CDS settlement process runs its course after a bankruptcy credit event – typically, about a month after the petition date – the ultimate holders of the reference obligations presumably will have the economic incentive to participate in the Chapter 11 proceedings.

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[85] *Id.* at 24.

[86] *Id.*

[87] *See* 11 U.S.C. § 1102. Additional official committees may be established, depending on the circumstances. *See* 11 U.S.C. §§ 1102, 1114.

[88] *See* 11 U.S.C. § 503(b)(3)-(5).

[89] Note that this model of creditor behavior assumes that the cost of the debt used to settle the CDS and the ultimate recovery on the creditor's claim will be identical, at least on average. *See* Lubben, *supra* note 71, at 32-33 (noting that the cost of the debt used to settle the CDS is the market's best estimate regarding the ultimate recovery of the debtor's unsecured creditors). This assumption may overestimate the efficiency of markets in distressed debt and derivatives. *See* Andrew M. Thau, Jonathan P. Friedland & Eugene J. Geekie, Jr., *Postconfirmation Liquidation Vehicles (Including Liquidating Trusts and Postconfirmation Estates): An Overview*, 16 J. Bankr. L. & Prac. 201, 206 & n.9 (2007).

[90] Lubben, *supra* note 71, at 35. However, in a substantial downturn, it is possible that a significant percentage of protection sellers will not have the wherewithal to make the protection payment after a credit event. *See* Henny Sender, *Insuring Against Credit Risk Can Carry Risks of Its Own*, Wall St. J., Aug. 6, 2007, at C1 ("[H]edge funds that are losing money but also selling [CDS protection] may not be able to honor their commitments, rendering the protection worthless."). Similarly, in 1998, many international banks sought to hedge the risk of a default by the Russian government through the purchase of CDS, often from Russian banks. *Id.* The Russian banks, however, were even more exposed to these risks, rendering them unable to perform under the CDS after the Russian government did, in fact, default. *Id.*

[91] *See* Lubben, *supra* note 71, at 36 (noting as an example hedge funds selling credit protection for the fee income and with no particular interest in, or experience regarding, the underlying credit).

Another potential problem is that official committee members that use credit derivatives may have interests unrepresentative of (or contrary to) their constituencies.[92] Indeed, credit derivatives may also complicate the process of choosing members of official committees, as CDS obscures the actual economic exposure of prospective members. Similarly, it is possible that credit derivatives could skew the Bankruptcy Code's voting regime for confirming a plan of reorganization under Section 1126(c) of the Bankruptcy Code due to so-called "empty voting."[93] "Empty voting" occurs when a creditor engages in derivative transactions that provide the creditor with voting power far beyond its economic interest. This issue recently arose in the non-distressed context from Perry Capital's use of OTC derivatives to obtain a 9.9% voting stake in Mylan Laboratories ("Mylan"), without any commensurate economic exposure, in an effort to influence shareholder approval of a merger between Mylan and King Pharmaceuticals.[94] It remains to be seen whether empty voting in the bankruptcy plan context can be successfully challenged as a bad faith tactic warranting disqualification of the empty votes.

In addition to the foregoing issues, some have suggested that credit derivatives could have a significant impact on the implementation of out-of-court restructurings for distressed companies. In particular, credit derivatives could place time constraints on the workout or distort creditor's incentives in negotiating a restructuring. These concerns could arise because "credit default swaps are often relatively short term instruments that expire without value to the protection buyer if no credit event occurs before maturity."[95] Therefore, a fully hedged creditor conceivably could have an "increasing disincentive" to negotiate or participate in a restructuring that might not be announced or consummated until after the CDS hedge expires.[96] Similarly, a CDS hedge could distort the negotiations by providing creditors with an incentive to play "hardball" or to accept an overly risky restructuring plan, because even if such tactics fail and a

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[92] *See Mot. of Official Comm. of Equity Holders for Disc. Under Bankr. Rule 2004 as to Certain Matters Concerning Conduct of Case and Related Matters*, at 3, ¶ 8, *In re Mirant Corp.*, No. 03-46590 (DML) (Bankr. N.D. Tex. filed Mar. 2, 2004) (the "Mirant 2004 Mot.") (questioning whether a protection buyer is a proper representative on an official committee).

[93] Section 1126(c) of the Bankruptcy Code provides that, for a creditor class to approve a plan, two-thirds of the claims, by amount, and one-half of the claims, by number, of the class must vote to approve the plan. 11 U.S.C. § 1126(c); *see also* 11 U.S.C. § 1126(d) (providing a parallel system for equity interests). For this purpose, only the votes of those creditors who actually vote on the plan are counted. *See* 11 U.S.C. § 1126(c), (d). This hybrid voting system is intended to balance the interests of a few claimants with large claims and those of a large number of claimants with small claims.

[94] *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, Univ. of Pa. Inst. for L. & Econ. Research Paper No. 06-16, at 41-42 (July 2006), *available at* http://ssrn.com/abstract_id=919881 (last visited Aug. 5, 2007) (discussing "empty voting" in the King/Mylan merger); *see also* Chris Hughes, *A Controversial Investment Choice*, Fin. Times (London), Sept. 5, 2006, at 43 (discussing contracts for difference, which are similar to the equity swaps used by Perry Capital).

[95] Lubben, *supra* note 71, at 37; *see* James Batterman, Roger Merritt & Paul Mancuso, *High Yield Credit Default Swaps: Restructuring as a Credit Event – A Closer Look*, FitchRatings, Dec. 2, 2004, at 5-6 ("*Restructuring as a Credit Event*"); *see also* Mirant 2004 Mot. at 3, ¶ 8 (The equity committee suggests that the failure of negotiations for out-of-court restructuring "at the proverbial eleventh hour, after all, or substantially all, of the requisite creditors" had indicated their consent was due to one or more hedged creditors determining that they would benefit more from a bankruptcy filing than the restructuring.).

[96] Lubben, *supra* note 71, at 37; *see Restructuring as a Credit Event*, *supra* note 95, at 5-6; *see also* Mirant 2004 Mot. at 3, ¶ 8 (alleging that a fully hedged creditor torpedoed an out-of-court restructuring in self-interest).

bankruptcy petition is filed, the CDS would provide full downside protection to the hedged creditor.[97]

It has also been suggested that the use of credit derivatives could increase the number of involuntary bankruptcy petitions filed in large bankruptcy cases. To a large extent, this is a corollary of how credit derivatives will affect creditor motivations in out-of-court restructurings. In particular, creditors whose CDS hedges expire in the near future might seek to file an involuntary bankruptcy petition against the borrower to avoid the borrower limping along until the CDS expires.[98] Indeed, the use of an involuntary petition might be particularly attractive to some hedged creditors because an involuntary bankruptcy is the only credit event whose timing can be unilaterally controlled.[99]

Moreover, a group of creditors could purchase CDS protection on a reference entity and use a relatively small amount of claims, and a possibly immaterial default, as the basis for filing an involuntary petition. In other words, hedged creditors might seek to profit from precipitating an involuntary petition by a company.[100] It has been suggested that the Bankruptcy Code be amended to address this risk by requiring an involuntary bankruptcy petition to include disclosure of any credit derivative positions held by the petitioning creditors referencing the debtor-to-be (as well as any short sales of securities).[101] Such disclosure would provide "courts considering [involuntary] petitions [with] some awareness if the creditors[ ] had incentives to 'jump the gun' in filing the involuntary petition."[102]

C. A Note on Physically Settled Derivatives

As described above, after a credit event occurs under a physically settled CDS, the protection buyer must deliver the proper amount of the reference obligation to the protection seller in order to receive the protection payment.[103] However, many protection buyers do not own sufficient amounts of the reference obligations to satisfy delivery requirements and must purchase them on the open market in order to make timely delivery to the protection seller. In

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97 *See* Kiff & Morrow, *supra* note 81, at 7.

98 Although no involuntary bankruptcy petition was filed, it is notable that Calpine filed its bankruptcy petition approximately four hours after the standard, quarterly expiration date of CDS referencing Calpine. *See* Beales, *supra* note 68, at 31.

99 *See* Lubben, *supra* note 71, at 37 ("illustrating the important point that 'bankruptcy' is the one credit event that can be controlled by many credit buyers"); *see also* 11 U.S.C. § 303 (setting forth the criteria for commencing an involuntary bankruptcy case).

100 Conceptually, this is similar to recent situations where bondholders have declared defaults on the basis of an issuer filing its financial statements late. *See* Peter Lattman & Karen Richardson, *Hedge Funds Play Hardball With Firms Filing Late Financials*, Wall St. J., Aug. 29, 2006, at A1; *see also Bank of New York v. BearingPoint, Inc.*, No. 600169/06, 2006 N.Y. Slip Op. 51739U, at 2-3 (Sup. Ct. N.Y. County Sept. 18, 2006), *appeal withdrawn*, No. M-6818X, 2007 N.Y. App. Div. LEXIS 524 (1st Dep't Jan. 16, 2007).

101 Lubben, *supra* note 71, at 37-38.

102 *Id.* (citing Fed. R. Bankr. P. 2019).

103 *See* Batterman & Rosenthal, *supra* note 70, at 2.

many larger cases, this task is complicated by the extent to which the notional amount of CDS exceeds the amount of reference obligations available for delivery.[104]

The *Delphi* case presents one of the best-known occurrences of this type of "short squeeze" among protection buyers seeking to satisfy their delivery obligations after a credit event. Delphi was referenced by $28 billion, in notional amount, of CDS, but only $2 billion in reference obligations had been issued in the cash market and were available for delivery.[105] The volume of trading in Delphi's notes increased the week after its bankruptcy filing as protection buyers scrambled to find relatively scarce Delphi reference obligations. In conjunction with the spike in volume, the price of Delphi notes increased. While common reference obligations in other cases also increase in value post-petition, the increase was more pronounced in Delphi, with the price of its bonds briefly reaching 70% of par after the petition date compared to approximately 63% prior to the petition date.[106]

The ISDA has established protocols in recent major bankruptcy cases that allow physically settled CDS to be settled with cash payments, thereby minimizing the market dislocation arising from a short squeeze.[107] Through an auction process, the ISDA protocols set a cash settlement value for the reference obligation which market participants then use to settle CDS with cash rather than physical delivery.[108] Thus far, each major bankruptcy has required its own customized protocol, although the ISDA is working on a template protocol for all cases.[109] The general market reaction to the ISDA protocols has been positive and, although participation is optional, the adherence rate has been high.[110]

IV. INTERCREDITOR ISSUES

A focus of distressed investors' diligence efforts in connection with any potential acquisition strategy for a troubled company is the company's capital structure, including the

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104 *See id*. Dealers frequently enter into offsetting CDS as both protection buyer and protection seller on the same reference entity, intending to use the reference obligations received as a protection seller to cover their own delivery obligations as a protection buyer. However, if a dealer's protection buyers are late in delivering the reference obligations, the dealer may not be able to timely satisfy its own delivery obligations to its protection seller and, depending on the terms of the CDS, may forfeit its protection payment. *See Deutsche Bank AG v. Ambac Credit Prods., LLC*, No. 04 CIV. 5594(DLC), 2006 WL 1867497, at *12-13 (S.D.N.Y. July 6, 2006) (Ambac was not required to make a protection payment due to Deutsche Bank's failure to timely deliver the reference obligations under the terms of the CDS.).

105 Kimberly A. Summe & David L. Mengle, *Settlement of Credit Default Swaps: Mechanics, Challenges, and Solutions*, at 17, Credit Derivative Symposium, Fordham Grad. School of Bus. (Sept. 29, 2006), *available at* http://www.bnet.fordham.edu/event/creditconference/slide_ISDA.pdf (last visited July 15, 2007).

106 Batterman & Rosenthal, *supra* note 70, at 4.

107 The ISDA protocols from past bankruptcies are available at http://isda.org/protocol/prot_nav.html. Summe & Mengle, *supra* note 105, at 5. *But see* Craig Pirrong, *Cash Settlement of Credit Derivatives: A Cure or a Nostrum?*, http://streetwiseprofessor.com (Mar. 13 2006 at 10:31 a.m. CST) (arguing that a cash settlement process is *more* susceptible to manipulation than a physical delivery settlement process).

108 Lubben, *supra* note 71, at 18; Summe & Mengle, *supra* note 105, at 6.

109 Summe & Mengle, *supra* note 105, at 9.

110 *Id.* at 8.

terms of operative documents governing various stakeholders' relative rights. This section and the next section provides an overview of several of the more common points of potential concern in this context, including the rights of so-called "second-lien" lenders; the terms of any so-called "X clauses;" the risks of equitable subordination with respect to claims purchased by the distressed investor; the enforceability of yield-maintenance or "makewhole" premiums; and the circumstances under which distressed investors' claims could be re-characterized as equity.

A. ***Second-Lien Loans***

1. What is a Second-Lien Loan?

A second-lien loan is a loan that is secured by a security interest in collateral, but which is subordinated to the first-lien lender's security interest in the same collateral.[111] While the second-lien lender's *lien* is subordinated to the lien of the first-lien lender, its debt is not. This means that ordinary obligations for scheduled principal and interest payments to the second-lien lender are *pari passu* with those of the first-lien lender. The first-lien lender is only entitled to repayment priority with proceeds from the shared collateral, proceeds that become available for distribution usually as the result of a sale or liquidation.[112] Thus, the first-lien lender's lien priority is only significant in situations where the borrower is distressed.

The most critical agreement relating to a second-lien loan is the intercreditor agreement, which sets forth the relative rights of the first- and second-lien lenders. The intercreditor agreement reflects the economics of the transaction and the relative bargaining power of the parties. In a typical second-lien transaction, the intercreditor agreement will provide not only that the second-lien lenders are subordinated to the first-lien lenders with respect to proceeds from the sale or liquidation of collateral, but also that the second-lien lenders waive certain rights both outside of, and within, bankruptcy. These matters are discussed below.

2. Rise in Popularity of Second-Lien Loans

The expansion of the second-lien loan market in recent years has been explosive. The total volume of outstanding second-lien loans grew from $430 million in 2002 to $20.6 billion as of October 2006.[113] Second-lien loans have been established as "one of the cheapest, most available, quickest to close, and most flexible alternative sources of additional debt capacity."[114] Even companies in, or emerging from, bankruptcy are able to incorporate second-lien facilities

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111 *See* Jo Ann J. Brighton, *Silent Second Financings: Popular Lending Structure May Give Rise to Enforcement Problems Part I: What Is a Silent Second Lien Financing?*, 24-FEB Am. Bankr. Inst. J. 18, 22 (2005).

112 *See* Glenn E. Siegel, *Watching the Seconds Tick Away: Finding Value in Second Liens in Bankruptcy*, 1 Bloomberg Corp. L.J. 471, 474 (2006).

113 Rob Graver, *The Benefits of Second Lien Loans*, Bank of America CapitalEyes (Nov. / Dec. 2006), *available at* http://corp.bankofamerica.com/public/public.portal?_pd_page_label=products/abf/capeyes/archive_index&dcCapEyes=indCE&id=339 (last visited Aug. 9, 2007).

114 *The Evolution of the U.S. Second-Lien Leveraged Loan Market – 2006 Year-End Update*, FitchRatings Corporate Finance, Jan. 17, 2007, at 2.

into their capital structures.[115] The increase in growth of second-lien loans has been propelled by a similar increase in the number of potential second-lien lenders. Hedge funds, proprietary trading operations, and collateralized loan funds all seek this sort of high-yield paper.[116]

Second-lien loans also have risen in popularity because they provide significant benefits to borrowers and both sets of lenders. For borrowers, second-lien loans provide access to additional financing at competitive rates by using the borrower's assets to cover more secured debt. First-lien lenders lower the loan-to-value ratio of their loans by inserting the cushion of the second-lien money behind them with relatively little risk. Second-lien lenders receive a lien on collateral which should place them ahead of the unsecured creditors in a bankruptcy and, in many cases, a stronger negotiating position.

3. Bankruptcy Rights Typically Waived by Second-Lien Lenders

(a) DIP Financing, Cash Collateral and Adequate Protection

First-lien lenders will often negotiate a waiver by the second-lien lenders of their right to object to a proposed DIP financing or to the use of cash collateral where the first-lien lenders have given their approval to such financing or use. An intercreditor agreement may also provide that the first-lien lenders are expressly permitted to provide DIP financing or that the second-lien lenders will not attempt to provide DIP financing without the consent of the first lien lenders. In addition, second-lien lenders will often waive their right to raise adequate protection objections in connection with approval of DIP financings or the use of cash collateral.

It remains unclear, however, whether the pre-petition waiver of these fundamental bankruptcy rights will be enforced by bankruptcy courts. Although there is little case law on the subject, some courts, such as the Bankruptcy Court for the District of Minnesota in *Beatrice Foods Co. v. Hart Ski Manufacturing Co.* (In re Hart Ski Manufacturing Co.),[117] hold that these provisions are unenforceable. In *Hart Ski*, the first-lien lender objected to the second-lien lenders' attempts to seek adequate protection and to lift the stay because these actions were specifically prohibited by the parties' intercreditor agreement. [118] The court held that while Section 510(a) allows the contractual priority of payment to be maintained among the parties in a bankruptcy proceeding "[t]here is no indication that Congress intended to allow creditors to alter, by a subordination agreement, the bankruptcy laws unrelated to distribution of assets."[119]

The lack of case law regarding the enforceability of waivers of bankruptcy rights in intercreditor agreements is partially due to the fact that many of these issues are resolved

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115 For example, Delphi Corporation's DIP refinancing included a $2.5 billion second-lien term loan and Foamex International, Inc.'s used a $175 million second-lien component within its pending exit financing. *Id.* at 2.

116 *Id.*

117 5 B.R. 734 (Bankr. D. Minn. 1980).

118 *Id.* at 735.

119 *Id.* at 736.

consensually at the beginning of the bankruptcy case. DIP financing arrangements and consent to the use of cash collateral are critical to any bankruptcy, and generally need to be in place before a case is filed. If issues related to DIP financing and the use of cash collateral are not resolved quickly and consensually, the results may be catastrophic.

Indeed, the *American Remanufacturers Inc.*[120] bankruptcy is an example of the dangers of failing to reach an agreement among the first- and second-lien holders in connection with DIP financing arrangements. In that case, the debtor received separate offers for DIP financing from both the first- and second-lien holders.[121] However, neither group of lien holders would consent to being primed by the other.[122] The debtor ultimately accepted the DIP financing facility proposed by the first-lien lenders because it believed that the first-lien lenders were undersecured and the second-lien lenders were entirely unsecured.[123] The second-lien lenders objected to the motion to approve the DIP financing on several grounds, including that the DIP financing facility violated Section 2.2 of the intercreditor agreement, which provided, in relevant part:

> if the first lien agent voluntarily agrees to subordinate any liens on any collateral securing the first-lien obligations to any liens securing obligations owing from the company or other credit parties to any third party . . . then the provisions related to the priority of liens and subordination of payments set forth herein shall not be effective with respect to the collateral which is the subject of the liens securing the first-lien obligations that were voluntarily made subordinate to the liens securing the obligations owing to third parties.[124]

The second-lien lenders believed that this provision, in light of the first-lien agent's agreement to subordinate the first-lien obligations to the DIP financing, would render the first- and second-liens *pari passu*.[125] In contrast, the first-lien lenders believed that since the first-lien lenders provided the DIP financing, Section 2.2 would not impact the priority of the first-lien obligations.[126] "In what it probably believed would set the stage for a negotiated resolution between the first and second lienholders, the court, in a preliminary ruling, decided that the proposed DIP credit facility triggered the proviso in [Section] 2.2 of the intercreditor

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120 *In re American Remanufacturers, Inc*., No. 05-20022 PJW (Bankr. D. Del. filed Nov. 7, 2005).

121 See Mark Berman & Jo Ann J. Brighton, *Second-Lien Financings Part II: Anecdotes and Speculation—the Good, the Bad and the Ugly*, 25-MAR Am. Bankr. Inst. J. 14, 24-25 (2006) (discussing American Remanufacturers case); *see also A Case Study Approach to U.S. Second-Lien Leveraged Loan Recovery Expectations*, FitchRatings, Leveraged Finance, Apr. 3, 2007, at 5.

122 Berman & Brighton, *Second-Lien Financings Part II, supra* note 121, at 25.

123 *Id.*

124 *Id.* at 24-25 (quoting Section 2.2 in its entirety).

125 *Id.* at 57.

126 *Id.*

agreement."[127] Unwilling to risk its first-lien position, however, the first-lien lenders withdrew their offer of DIP financing.[128]

The debtor appeared to have believed that the first- and second-lien lenders would thereafter reach a compromise.[129] But each of the first- and second-lien lenders sought to impose its position on the other. In an effort to break the standoff, the second-lienholders sought to buy out the first-lien lenders, but their offer was rejected.[130] Meanwhile, American Remanufacturers' business deteriorated.[131] The debtor had no access to the cash necessary for operations, and no way to break (or negotiate an end to) the impasse between the first- and second-lien lenders. With its cash position dwindling, the debtor sought conversion to a Chapter 7 liquidation.[132] As a result, 1,400 employees lost their jobs.

By contrast, in *Atkins Nutritionals, Inc.*, the lien holders were able to negotiate a pre-bankruptcy lock-up agreement, despite the fact that the first-and second-lien lenders clearly had different goals for the bankruptcy process. The first-lien lenders wanted a quick sale of the debtor, while the second-lien lenders wanted the debtor to reorganize because they believed their collateral had value if the business continued to operate.[133] The lock-up agreement provided for a Chapter 11 filing, a DIP credit facility that would provide the debtor with sufficient funds for operations during the Chapter 11 case, and a plan that would either allow the company to be reorganized, with both the first- and second-lien holders sharing in the equity of the reorganized debtor, or a sale of the business.[134] During the bankruptcy case, the DIP facility was approved and the plan of reorganization was implemented based on the structure contemplated by the lock-up agreement.[135]

(b) <u>Assignment of the Right to Vote</u>

Another bankruptcy related restriction that may be included in an intercreditor agreement is the waiver of the second-lien lender's right to propose a plan of reorganization or its right to vote on a plan of reorganization. Some intercreditor agreements provide that the second-lien lender is obligated to vote on the plan in accordance with the first-lien lender's vote, or, alternatively, that the second-lien lender must assign its vote to the first-lien lender. While subordination agreements generally are enforceable in bankruptcy pursuant to 11 U.S.C. § 510(c),

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127 *Id.*

128 *Id.*

129 *Id.*

130 *Id.*

131 *Id.*

132 *Id.*

133 Jo Ann J. Brighton & Mark Berman, *Second-Lien Financings Part III: Anecdotes—the Good, the Bad and the Ugly: Atkins—the Good*, 25-JUN Am. Bankr. Inst. J. 1, 14, 46 (2006).

134 *Id.*

135 *Id.* at 47.

as discussed above, it is less clear whether the waiver of such bankruptcy rights may be enforceable. For example, in *Bank of America v. North LaSalle Street Ltd. Partnership* (In re 203 North LaSalle Street Partnership),[136] the Bankruptcy Court for the Northern District of Illinois held that pre-petition waivers of voting rights are unenforceable. In that case, the senior secured lender filed an adversary complaint seeking to vote the claim of the junior secured creditor in accordance with the terms of the subordination agreement.[137] The Court held that the provision of the subordination agreement relating to voting was contrary to Section 1126(a) of the Bankruptcy Code and, therefore, was not enforceable.[138]

The Bankruptcy Court for the Northern District of Georgia has recently taken a contrary position. In *Blue Ridge Investors, II, LP v. Wachovia Bank, N.A.* (In re Aerosol Packaging, LLC),[139] the subordinated creditor filed a ballot voting to *reject* the debtor's plan of reorganization. On the same day, the senior secured lender filed a ballot on behalf of the subordinated creditor voting to *accept* the plan of reorganization pursuant to the terms of the subordination agreement, which gave the senior lender the right to vote the subordinated creditor's claims in any bankruptcy proceeding of the debtor.[140] Thereafter, the subordinated creditor filed a motion seeking a determination of its voting rights.[141]

In upholding the terms of the subordination agreement, the Bankruptcy Court held that while Section 1126(a) of the Bankruptcy Code grants the right to vote to the holder of a claim, it "does not expressly or implicitly prevent that right from being delegated or bargained away by such a holder."[142] The Court observed that under Section 510(a), subordination agreements are enforceable to the extent they are enforceable under state law, and that the subordination agreement in question was enforceable under applicable Georgia state law.[143] Finally, the court pointed to Bankruptcy Rules 3018 and 9019 to support its holding, noting that these rules explicitly permit agents and other representatives to take actions, including voting, on behalf of parties, and that, in this case, pursuant to the terms of the subordination agreement, the senior lender was acting as the duly authorized agent of the subordinated creditor.[144]

(c) Asset Sales

Another common provision included in intercreditor agreements is the waiver by the second-lien lenders of the right to object to a sale of the shared collateral, where the sale is

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[136] 246 B.R. 325 (Bankr. N.D. Ill. 2000).

[137] *Id.* at 328.

[138] *Id.* at 331.

[139] 362 B.R. 43 (Bankr. N.D. Ga. 2006).

[140] *Id.* at 44.

[141] *Id.* at 44.

[142] *Id.* at 47.

[143] *Id.*

[144] *Id.*

approved by the first-lien lenders, along with the right to bid at a sale of the debtor's assets. However, where there are multiple layers of debt secured by the assets being sold in bankruptcy, parties must be careful to ensure that the structure of the sale does not violate the bankruptcy rights of the other secured parties, that the language in the credit documents regarding priority and manner of repayment is clear, and that the sale is not an attempt to accomplish what may only be accomplished through a plan of reorganization.

The opinion of the District Court for the Southern District of New York in *Contrarian Funds, LLC v. WestPoint Stevens, Inc.* (In re WestPoint Stevens, Inc.)[145] illustrates the above considerations. In *WestPoint Stevens*, a sub-group of the first-lien lenders and the majority of the second-lien holders each made separate bids for the debtor's assets.[146] The bid of the second-lien lenders prevailed and the Bankruptcy Court entered a sale order allowing the assets to be sold free and clear of liens.[147] The bid by the second-lien lenders included cash which would be used to pay down the DIP credit facility, plus unregistered equity securities and unregistered subscription rights to the stock of the acquirer's parent company which would be distributed to the first-and second-lien lenders.[148] The first-lien lenders were to receive a portion of the equity securities and subscription rights in full satisfaction of their claims, and the balance of the equity securities and subscription rights were to be distributed to the second-lien holders.[149] The first-lien lenders objected to their claims being satisfied with illiquid minority interests in the acquirer's parent company.[150]

The Bankruptcy Court overruled the first-lien lenders' objection and found that the use of the word "amounts" in the credit documents, as opposed to cash, was significant and signaled that the parties anticipated the possibility that the first-lien lender's secured claims could be satisfied by something other than cash.[151] The first-lien lenders appealed the decision of the Bankruptcy Court to the District Court.[152] The District Court reversed, holding that it could not find authority within the Bankruptcy Code that permitted the first-lien lenders' claims to be satisfied by an in-kind distribution of equity securities over the first-lien lenders' objections.[153] The District Court also found that the Bankruptcy Court had improperly interpreted the credit documents.[154] The District Court held that the first-lien lender was entitled to be paid in full and

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[145] 333 B.R. 30 (S.D.N.Y. 2005).

[146] *Id.* at 36.

[147] *Id.*

[148] *Id.* at 37; *see also* Mark N. Berman & Jo Ann J. Brighton, *Second-Lien Financings: Part V: Who Gets What?*, 25-AUG Am. Bankr. Inst. J. 38, 38 (2006).

[149] *See* Berman & Brighton, *Second-Lien Financings: Part V*, *supra* note 148.

[150] *In re West Point Stevens*, 333 B.R. at 34.

[151] *Id.* at 35.

[152] *Id.* at 34.

[153] *Id.* at 53-55.

[154] *Id.* at 43-47.

in cash before the proceeds of its collateral could be disbursed, over its objections, to subordinated creditors.

B. Enforceability of X Clauses

Intercreditor agreements typically provide that all distributions or payments from the borrower received by the junior creditors must be turned over to the senior creditors until the senior creditors have been paid in full. Once the senior creditors have been paid in full, the junior creditors may retain any remaining distributions or payments from the borrower. However, intercreditor agreements often include what is called an "X Clause" that provides an exception to the subordinated creditors' turn-over obligation by "allow[ing] the subordinated [lender] to retain its securities only if the securities given to the senior [lender] have higher priority to future distributions and dividends."[155]

In other words, an "X-Clause allows securities to be retained if they 'are subordinated to the same extent as the existing subordinated debt.'"[156] Junior creditors are not required to turn over to senior creditors securities within the X Clause's terms because the structure of these securities is such that the senior creditors retain the benefit of their priority.[157] For example, in *Metromedia*, the Second Circuit Court of Appeals held that an "X Clause is triggered where 'mortgage bonds, preferred stock or similar higher class security' are provided to senior note holders and 'common stock' is provided to subordinated note holders because 'this kind of distribution gives practical effect to the subordination and therefore turnover is not required.'"[158]

Courts typically enforce X Clauses by requiring junior creditors to turn over non-subordinated securities to senior creditors. This is true even in cases where courts have noted sloppy drafting, as the policy underlining X Clauses is so clear. Commonly, junior creditors argue that the X Clause should permit them to retain stock or warrants issued under the plan, even where the senior lenders have not been paid in full, but courts have not agreed with this approach.[159] At least one court has also rejected the contention that an X Clause requires the

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155 *In re Envirodyne Indus., Inc.*, 29 F.3d 301, 306 (7th Cir. 1994) (citing Am. Bar Found., *Commentaries on Model Debenture Indenture Provisions* 570-71 (1971)); *Deutsche Bank AG, London Branch v. Metromedia Fiber Network, Inc.* (In re Metromedia Fiber Network, Inc.), 416 F.3d 136, 140 (2d Cir. 2005).

156 *Metromedia*, 416 F.3d at 140 (quoting *In re PWS Holding Corp.*, 228 F.3d 224, 244-45 (3d Cir. 2000)).

157 Ad Hoc Committee for Revision of the 1983 Model Simplified Indenture, *Revised Model Simplified Indenture*, 55 Bus. Law. 1115, 1221 (2000) ("If Senior Debt were to receive preferred stock and subordinated debt were to receive common stock, for example, where the preferred stock precluded distributions to the common stockholders until the preferred stock was redeemed, the X-Clause would permit that distribution.").

158 *Metromedia*, 416 F.3d at 140 (quoting Am. Bar Found., *Commentaries on Model Debenture Indenture Provisions* 570 (1971)).

159 *Metromedia*, 416 F.3d at 140-41 (Junior creditors not allowed to retain warrants for common stock under X Clause because such warrants would permit junior creditors "to buy the same class of stock allocated to the Senior Indebtedness, giving [Junior] and Senior Indebtedness *equal* priority to any future distribution. . . .") (emphasis in original); *Envirodyne Indus.*, 29 F.3d at 306 (The Court rejected a request that sloppily drafted indenture allowed junior creditors to retain common stock where senior creditors received common stock, and were not paid in full, because there is no reason "why a distribution of equity should erase the priority of a senior class of creditors." In addition, the Court noted that if the result were the opposite, it would incentivize

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debtor to issue subordinated securities to the subordinated creditors.[160] Rather, the X Clause is merely an exception to the general obligation of junior creditors to turn their recoveries over to senior creditors.

C. Equitable Subordination

Creditors who act inequitably, before or after the petition date, may have their bankruptcy claims "equitably subordinated" to the claims of all other creditors.[161] Whether a claim should be equitably subordinated is a highly fact specific inquiry. A number of courts have held that equitable subordination is appropriate when (i) the claimant has engaged in inequitable conduct, which need not be illegal; and (ii) the misconduct has resulted in injury to the creditors of the debtor or conferred an unfair advantage on the claimant.[162] The definition of "inequitable conduct" is narrow, with courts limiting application of the doctrine to cases of fraud, illegality and breach of fiduciary duty.[163] In addition, courts are in agreement that the doctrine of equitable subordination is remedial, not penal; as a consequence, they normally subordinate claims only to the degree necessary to offset the unfair advantage or harm caused by the inequitable conduct.[164]

The growth of the secondary market in bankruptcy claims has led to difficult issues regarding the proper application of the doctrine of equitable subordination. If a bad actor sells its claim in the secondary market to a distressed investor, can (and should) the claim be equitably subordinated in the hands of the investor? Can the claim be equitably subordinated even if the transferee of the claim is entirely innocent of wrongdoing? These and related issues require a balance between censoring inequitable behavior, on the one hand, and damaging the liquidity of the secondary market for bankruptcy claims, on the other hand.

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senior creditors to push for liquidation, thereby avoiding the issuance of stock, which would be contrary to Chapter 11's goal of reorganization.).

160 *In re PWS Holding Corp.*, 228 F.3d 224, 245 (3d Cir. 2000).

161 11 U.S.C. § 510(c)(1).

162 *Benjamin v. Diamond* (In re Mobile Steel Co.), 563 F.2d 692, 700 (5th Cir. 1977) (cited with approval in *United States v. Noland*, 517 U.S. 535, 538-39 (1996)); *e.g.*, *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986-87 (3d Cir. 1998); *Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp*. (In re Verestar, Inc.), 343 B.R. 444, 461 (Bankr. S.D.N.Y. 2006). *Mobile Steel* also set forth a third prong requiring that equitable subordination must not be inconsistent with other bankruptcy laws, but this prong is of "little significance today" because the Bankruptcy Code, unlike the Bankruptcy Act, "expressly authorizes the remedy of equitable subordination." *Verestar*, 343 B.R. at 461 (citation omitted).

163 *Carter-Waters Oklahoma, Inc. v. Bank One Trust Co., N.A.* (In re Eufaula Indus. Auth.), 266 B.R. 483 (B.A.P. 10th Cir. 2001); *see also 80 Nassau Assocs. v. Crossland Fed. Sav. Bank* (In re 80 Nassau Assocs.), 169 B.R. 832 (Bankr. S.D.N.Y. 1994) (mem.); *Sloan v. Zions First Nat'l Bank* (In re Castletons, Inc.), 990 F.2d 551 (10th Cir. 1993); *Rosania v. Haligas* (In re Dry Wall Supply, Inc.), 111 B.R. 933, 938 (D. Colo. 1990) (mem.).

164 *See In re Mobil Steel*, 563 F.2d at 699 (under Bankruptcy Act) (noting that in cases of egregious conduct, claimants may seek disallowance of a claim in full); *see also Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 323 F.3d 228 (3d Cir. 2003); *In re Mid-American Waste Sys., Inc.*, 284 B.R. 53, 69 (Bankr. D. Del. 2002).

In 2005, in a highly publicized decision in the *Enron* bankruptcy case, the Bankruptcy Court for the Southern District of New York extended the risk of subordination to innocent investors by holding that a claim could be equitably subordinated in the investor's hands solely on the basis of the claim transferor's misconduct.[165] In *Enron*, the debtor filed an adversary proceeding to equitably subordinate or, in the alternative to disallow, claims on account of Enron bank debt that certain hedge funds had purchased from the banks. Enron had accused the banks of engaging in inequitable conduct with Enron prior to the petition date,[166] although Enron did not allege that the hedge funds had engaged in inequitable behavior themselves, nor that they had knowledge of the banks' alleged behavior when purchasing the bank debt.[167]

The Bankruptcy Court denied the hedge funds' motion to dismiss the debtor's claims, issuing three important rulings in doing so: (i) a claim may be equitably subordinated on account of inequitable conduct unconnected to the claim; (ii) equitable subordination survives the transfer of the claim, so a claim that may be subordinated in the hands of an inequitable actor also may be subordinated in the hands of an innocent transferee; and (iii) the good faith purchaser defense is not available to the transferee of a bankruptcy claim because this defense is limited to avoidance actions and purchasers of claims are aware of the risk of equitable subordination.[168] The *Enron* decision was driven by two policy issues: (i) equitable subordination risk must extend to transferees to prevent inequitable creditors from cleansing their claims by merely selling their claims in the secondary market,[169] and (ii) equitable subordination is preferable to a direct action by the debtor's estate against an inequitable actor because it involves lower litigation expenses.[170]

The possibility of equitable subordination of claims on the basis of the transferor's conduct clearly adds a new dimension of risk to the bankruptcy claims market and requires further diligence by claims purchasers and other distressed investors. Indeed, in order to assess the possibility of equitable subordination, a purchaser of bankruptcy claims must conduct due diligence not only on the immediate seller of the claim, but also on the conduct of the originator of the claim (and prior transferors), including conduct unrelated to the claim. Because of this risk, claims acquirers frequently obtain agreements from claim sellers that the sellers will indemnify the acquirers in the event the claim is equitably subordinated or disallowed.

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165 *Enron Corp. v. Ave. Special Situations Fund II, LP* (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005), *leave to appeal granted*, No. M-47, 2006 WL 2548592 (S.D.N.Y. Sept. 5, 2006).

166 *Enron*, 333 B.R. at 212-13.

167 *Id.*

168 *Id.* at 222, 231, 233, 235; Adam J. Levitin, *The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading*, 15 Norton J. Bankr. L. & Prac. 389, 392 (2006).

169 *Enron*, 333 B.R. at 225.

170 *Id.* at 227; s*ee also Adelphia Commc'ns Corp. v. Bank of Am., N.A.* (In re Adelphia Commc'ns Corp.), 365 B.R. 24, 70 (Bankr. S.D.N.Y. 2007) (endorsing *Enron*'s holding in declining to dismiss equitable subordination claims "not just as to the Bank Agents, but also the members of their syndicates, and, within those syndicates, as to both original members and assignees of claims").

Notwithstanding such indemnities, the *Enron* decision sent shock waves through the distressed investing community, with investors alleging that the decision would severely disrupt the active trading in distressed securities, thereby harming creditors and troubled companies alike. It also was suggested that the reverberations from *Enron*'s impact on the market for bankruptcy claims could extend to other capital markets transactions by reducing liquidity in the bankruptcy claims market.[171] Indeed, many sources of capital for distressed companies outside chapter 11 provide credit in reliance on the bankruptcy claims market as a means of exiting failed investments.[172] For these reasons, the distressed investors in *Enron* appealed, with numerous industry associations filing amicus briefs in connection with the appeal.[173]

On appeal, the United States District Court for the Southern District of New York reversed the Bankruptcy Court's decision and remanded the matter for further proceedings.[174] The District Court first held that equitable subordination is a concept that relates to a *claimant*, not to the *claim* itself. In other words, claims are equitably subordinated based upon the "personal disabilities" of a particular claimant, not by virtue of some inherent aspect of the claim. Whether any personal disabilities of a claim transferor will "travel with the claim" when it is sold to a transferee depends on the mode of transfer.[175] Specifically, when a claim is *assigned*, the personal disability will follow the claim because "[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor."[176] In contrast, when a claim is *sold*, "[a] purchaser does not stand in the shoes of the seller and, as a result, can obtain more than the transferor has in certain circumstances."[177] The court opined that the distinction is

> particularly imperative in the distressed debt market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a transferee up the line) has acted inequitably or received a preference. No amount of due diligence on their part will reveal that information, and it is unclear how the market would price such unknowable risk. Parties to true assignments, by contrast, can

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171 *See* Adam J. Levitin, *Finding Nemo: Rediscovering the Virtues of Negotiability in the Wake of Enron*, 2007 Colum. Bus. L. Rev. 83, 148-64 (2007); *see also* Levitin, *The Limits of Enron: Counterparty Risk in Bankruptcy Claims Trading*, 15 J. Bankr. L. & Prac. at 411-14.

172 Levitin, *Finding Nemo*, *supra* note 171, at 149.

173 These associations included the Loan Syndications and Trading Association, the Securities Industry and Financial Markets Association, and the International Swaps and Derivatives Association.

174 *Enron Corp. v. Springfield Assocs. L.L.C. and Westpac Banking Corp.*, Nos. 06 Civ. 7828 (SAS) and 07 Civ. 1957 (SAS), 2007 WL 2446498, at *1 (S.D.N.Y. Aug. 27, 2007).

175 *Enron*, 2007 WL 2446498, at *10 ("The Bankruptcy Court expressly extended its holding to all transfers of bankruptcy claims. By doing so, it ignored the distinction between assignments and sales and never addressed whether equitable subordination travels with the claim or is a personal disability.").

176 *Enron*, 2007 WL 2446498, at *5 (quoting *Goldie v. Cox*, 130 F.2d 695, 720 (8th Cir. 1942)). The court observed, however, that this rule may be subject to certain exceptions that were not relevant to the issue before it. *See Enron*, 2007 WL 2446498, at *6, *12.

177 *Enron*, 2007 WL 2446498, at *5. The court did recognize, however, that its analysis did not extend to bad faith purchasers or purchasers with actual notice of the seller's inequitable conduct. *See Enron*, 2007 WL 2446498, at *10, *12.

> easily contract around the risk of equitable subordination or disallowance by entering into indemnity agreements to protect the assignee.[178]

The District Court's decision clearly increases the importance of negotiated indemnity agreements between *assignors* and *assignees* of distressed claims, while allowing the markets in distressed claim *sales* to be immune from equitable subordination risk. Indeed, it appears that the District Court believed it heeded the trade associations' concern: "Moreover, in order to ensure that untenable distinctions and unreasonable results are avoided, it is proper to consider the effect that the Court's interpretation would have on the markets. The unnecessary breadth of the Bankruptcy Court's decisions threatened to wreak havoc on the markets for distressed debt. That result has now been avoided."[179]

While the District Court vacated the Bankruptcy Court's decision and, in doing so, purported to heed the concerns of distressed investors over the Bankruptcy Court's decision, it remains to be seen whether the District Court's decision will have long-term positive effects on the distressed claims market. The distinction between a claim *assignment* and a claim *purchase* arguably is very fine. The District Court's decision did not establish a definitive rule distinguishing the two terms, although it noted that "sales of claims on the open markets are indisputably sales and subrogation of a surety to the rights under a claim is indisputably an assignment."[180] Moreover, it said that any concern that a bad faith transferor can "wash" its claim by selling it to a purchaser "is outweighed by the countervailing policy at issue, namely the law's consistent protection of bona fide purchases for value."[181]

Additionally, the Court's decision did not end the dispute: it remanded the case to the Bankruptcy Court for further factual findings on whether the transaction at issue in the case qualifies as an assignment, in which case the claim could be subordinated in the hands of the transferee, or as a purchase, in which case the claim could not be subordinated in the hands of the transferee. Regardless of the Bankruptcy Court's determination on remand, if the District Court decision stands, one can expect continuing disputes over the proper characterization of particular transactions and the consequences thereof.[182]

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178 *Enron*, 2007 WL 2446498, at *10.

179 *Enron*, 2007 WL 2446498, at *15; *see also Enron Corp. v. Springfield Assocs. L.L.C. and Westpac Banking Corp.*, Nos. 06 Civ. 7828 (SAS) and 07 Civ. 1957 (SAS), 2007 WL 2780394, at *2 n.20 (S.D.N.Y. Sept. 24, 2007) (The trade associations' concerns are "not significant given this Court's pointed statements in the August 27 Opinion that 'the concerns raised by Industry Amici with respect to the effects of the Bankruptcy Court's rulings on the markets for distressed debt are no longer present. *Equitable subordination and disallowance arising out of the conduct of the transferee will not be applied to good faith open market purchasers of claims.*'") (quoting *Enron*, 2007 WL 2446498, at *13 n.76 and citing *Enron*, 2007 WL 2446498, at *13 n.104).

180 *Enron*, 2007 WL 2446498, at *13 n.104.

181 *Enron*, 2007 WL 2446498, at *15.

182 Interestingly, the purported "winners" of the District Court's decision sought an interlocutory appeal to the Second Circuit regarding (i) whether equitable subordination and disallowance can be applied to innocent transferees based solely on the conduct of the transferor and (ii) if so, whether potential equitable subordination and/or disallowance turn on the distinction between a claim transferred by sale and a claim transferred by assignment. *See Notice of Mot. by Springfield Assocs., LLC to Modify Order*

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V. OTHER CLAIM ENFORCEABILITY MATTERS

A. *Enforceability of No-Call Provisions and Makewhole Premiums*

So-called "no-call" provisions that purport to prohibit the repayment of debt are not enforceable in a Chapter 11 case.[183] Indeed, the "essence of bankruptcy reorganization is to restructure debt . . . and adjust debtor-creditor relationships."[184] Accordingly, enforcement of a contractual prohibition on prepayment would violate the purpose behind the Bankruptcy Code by denying a debtor the ability to reorganize because a creditor has contractually forbidden it.[185] Notwithstanding these general principles, the Bankruptcy Court for the Southern District of New York in the *Calpine* reorganization proceedings recently imposed damages upon a debtor for violation of a no-call provision, even though there was no prepayment premium payable under the documentation.[186] The damage claims awarded to the lenders were deemed unsecured claims in the amount of the prepayment premium applicable under the indentures once the no-call period expired.

In addition to the foregoing, indentures and credit agreements frequently include so-called "makewhole" provisions or prepayment premiums designed to compensate a lender "for the anticipated interest [the] lender will not receive if [its] loan is paid off prematurely . . . [A] prepayment premium insures the lender against loss of [its] bargain if interest rates decline" and the borrower elects to repay the loan to take advantage of the lower rates.[187] Courts have suggested that such premiums may be included in the secured claim of an oversecured lender pursuant to Section 506(b) of the Bankruptcy Code.[188] However, the governing documents must

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and Judgment for Certification of Interlocutory Appeal, at 2, *Enron Corp. v. Springfield Assocs. L.L.C. and Westpac Banking Corp.*, Nos. 06 Civ. 7828 (SAS) and 07 Civ. 1957 (SAS) (S.D.N.Y. filed Sept. 7, 2007); *see also Statement of Amici Curiae The Securities Indus. and Fin. Mkts. Ass'n., the Int'l Swaps and Derivatives Ass'n., and the Loan Syndications and Trading Ass'n. in Support of Motion of Springfield Assocs., LLC to Modify Order and Judgment for Certification of Interlocutory Appeal*, *Enron Corp. v. Springfield Assocs. L.L.C. and Westpac Banking Corp.*, Nos. 06 Civ. 7828 (SAS) and 07 Civ. 1957 (SAS) (S.D.N.Y. filed Sept. 19, 2007). However, the District Court denied the request. *Enron*, 2007 WL 2780394, at *2-*3.

183 *Law Debenture Trust Co. of New York v. Calpine Corp.* (In re Calpine Corp.), 356 B.R. 585, 596-97 (Bankr. S.D.N.Y. 2007); *see also In re Calpine Corp.*, 365 B.R. 392, 397 (Bankr. S.D.N.Y. 2007) ("*Calpine II*"); *In re LHD Realty Corp.*, 726 F.2d 327, 329 (7th Cir. 1984); *Cont'l Sec. Corp. v. Shenandoah Nursing Home P'ship*, 193 B.R. 769, 774 (W.D. Va.) (affirming bankruptcy court's holding that "while there is a prepayment prohibition, [it] is not enforceable in this [Chapter 11] context"), *aff'd mem.*, 104 F.3d 359 (4th Cir. 1996); *In re Skyler Ridge*, 80 B.R. 500, 502 (Bankr. C.D. Cal. 1987).

184 *Calpine II*, 365 B.R. at 397 (quoting *In re Ridgewood Apts. of DeKalb County, Ltd.*, 174 B.R. 712, 720 (Bankr. S.D. Ohio 1994)).

185 *Id.* at 399-400 (citation omitted).

186 *Id.* at 399 (none of the debt at issue provided for a prepayment premium during the no-call period and at least some of the debt did not provide for a premium at all). *But see In re Vest Assocs*., 217 B.R. 696, 699-700 (Bankr. S.D.N.Y. 1998) (court cannot "read into a contract damage provisions which the parties themselves had failed to insert regarding the liquidation or calculation of damages arising out of the prepayment of a loan") (cited in *Calpine II*, 365 B.R. at 400).

187 Ingrid Michelsen Hillinger & Michael G. Hillinger, *The Story of YMPS ("Yield Maintenance Premiums") in Bankruptcy*, 3 DePaul Bus. & Com. L.J. 449, 449 (2005) ("*YMPS*") (quoting *In re LHD Realty Corp.*, 726 F.2d 327, 330 (7th Cir. 1984)).

188 *See, e.g.*, *Cont'l. Sec.*, 193 B.R. at 775; *UPS Capital Bus. Credit v. Gencarelli*, No. C.A. 05-39T, 2006 WL 3198944, at *3 (D.R.I. Nov. 3, 2006).

specifically provide for the premium, as courts have consistently held that a makewhole will not be inferred.[189]

In addition, in determining the enforceability of makewhole premiums, courts have examined whether a prepayment was voluntary or involuntary.[190] The basis for this distinction is that many prepayment provisions are only triggered by the borrower voluntarily prepaying the loan.[191] As a corollary, courts have held in some cases that creditors waived the prepayment premium by accelerating the debt or taking other actions to enforce their rights.[192] These courts reason that acceleration made the loan immediately due, thereby eliminating any "prepayment."[193] However, at least one court has held that the acceleration triggered by bankruptcy "is not the kind of acceleration that eliminates the right to a prepayment premium."[194] In contrast, prepayment premiums have been enforced, even after acceleration, where the documentation specifically provided for the prepayment premium to be enforceable in such circumstances.[195]

To the extent makewhole premiums are considered interest, they may be enforceable in accordance with the terms of the parties' agreement, as contemplated by Section 506(b) of the Bankruptcy Code, regardless of whether they are "reasonable" in amount. There is a risk, however, that they could be characterized as "unmatured interest," which is specifically disallowed by Section 502(b)(2) of the Code. Moreover, to the extent such premiums are

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189 *Calpine II*, 365 B.R. at 399-400.

190 *See, e.g.*, *AE Hotel Venture v. GMAC Commercial Mortgage Corp.*, No. 05 C 2109, 2006 U.S. Dist. LEXIS 2040, at *9 (N.D. Ill. Jan. 20, 2006) (holding that payment from proceeds of sale of hotel in bankruptcy was voluntary in nature, and thus prepayment premium was enforceable); *In re A.J. Lane & Co.*, 113 B.R. 821, 826-27 (Bankr. D. Mass. 1990) (Sale of property in bankruptcy was voluntary.); *Imperial Coronado Partners, Ltd. v. Home Fed. Sav. & Loan Ass'n* (In re Imperial Coronado Partners, Ltd.), 96 B.R. 997, 1000 (B.A.P. 9th Cir. 1989) (concluding that decision to sell the property rather than refinance and decelerate the loan as part of reorganization plan was a voluntary decision, and thus prepayment premium was enforceable).

191 *In re Pub. Serv. Co. of New Hampshire*, 114 B.R. 813, 818-19 (Bankr. D.N.H. 1990) (finding makewhole not triggered where it was limited to voluntary prepayments and repayment came through a plan that was principally a "takeover plan by another utility"); *Imperial Coronado Partners*, 96 B.R. at 999-1000 (finding makewhole limited to voluntary prepayments to have been triggered where debtor decided to sell property, and repay loan, through Section 363 asset sale rather than reinstating loan); *cf. YMPS*, *supra* note 187, at 457-60.

192 *See, e.g.*, *LHD Realty*, 726 F.2d at 330-31 (Insurer lost its right to a prepayment penalty by seeking relief from stay, which court interpreted as effort to accelerate.); *Pub. Serv. Co. of New Hampshire*, 114 B.R. at 816 (determining that indenture trustee's consistent opposition to any plan that did not provide for bonds to be cashed out constituted waiver of makewhole premium).

193 *LHD Realty*, 726 F.2d at 330-31 ("[A]cceleration, by definition advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."); *In re Pinebrook, Ltd.*; 85 B.R. 160 (Bankr. M.D. Fla. 1988) ("[A] party is not entitled to both an acceleration of its debt and a prepayment penalty."); *In re Duralite Truck Body & Container Corp.*, 153 B.R. 708 (Bankr. D. Md. 1993) (Creditor prompted prepayment by its collection efforts: when a lender exercises its option to accelerate upon default, the economic justification for a prepayment premium as alternative performance of the bargained loan is negated.); *In re Planvest Equity Income Partners IV*, 94 B.R 644, 645 (Bankr. D. Ariz. 1988) (It is questionable whether creditor is entitled to premium when it sought to lift automatic stay.); *cf. YMPS*, *supra* note 187, at 460-462.

194 *In re Skyler Ridge*, 80 B.R. 500, 507 (Bankr. C.D. Cal. 1987).

195 *See Norwest Bank Minn., N.A. v. Blair Road Assocs., L.P.*, 252 F. Supp. 2d 86, 96-97 (D.N.J. 2003) (finding that prepayment premium was enforceable even when lender accelerated the debt because loan documents provided for the premium in such circumstances); *United States v. Harris*, 246 F.3d 566, 572-73 (6th Cir. 2001); *Parker Plaza West Partners v. UNUM Pension & Ins. Co.*, 941 F.2d 349, 355-56 (5th Cir. 1991).

characterized instead as fees or charges, they must be "reasonable" insofar as Section 506(b) of the Code allows fees and charges on oversecured claims only if they pass a "reasonableness" threshold. [196]

Some courts have applied federal law in determining reasonableness under Section 506(b),[197] while other courts look to state law to determine the validity of the prepayment premium.[198] Moreover, different approaches have been employed in evaluating the reasonableness of the amount of a makewhole premium. Some courts have limited prepayment premiums to the lender's actual damages,[199] looking to the difference between (i) the present value of the future interest payments under the loan at the contract rate and (ii) the present value of the market rate of interest on the prepayment date.[200] Other courts have employed a liquidated damages analysis.[201] For instance, a contractual liquidated damages sum is valid under New York law where (i) actual damages are difficult to determine and (ii) the sum stipulated is not "plainly disproportionate" to the possible loss.[202]

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196 One of the highest prepayment premiums approved by a bankruptcy court was 24.9% of the principal amount. *See Fin. Ctr. Assocs. of E. Meadow, L.P. v. Funding Corp.* (In re Fin. Ctr. Assocs. of E. Meadow, L.P.), 140 B.R. 829, 839 (Bankr. E.D.N.Y. 1992); *see also In re Kroh Bros. Dev. Co.*, 88 B.R. 997, 1002 (Bankr. W.D. Mo. 1988) (finding a 22.9% premium unreasonable). Generally, courts have found makewhole premiums to be reasonable when they are between 5% to 10% of the principal amount of the repaid debt. *See, e.g.*, *Anchor Resolution Corp. v. State St. Bank & Trust Co.* (In re Anchor Resolution Corp.), 221 B.R. 330, 341 (Bankr. D. Del. 1998) (finding a 6.9% premium reasonable); *Connecticut Gen. Life Ins. Co. v. Schaumburg Hotel Owner Ltd. P'ship* (In re Schaumburg Hotel Owner Ltd. P'ship), 97 B.R. 943, 954 (Bankr. N.D. Ill. 1989) (finding a 10% premium reasonable).

197 *See, e.g.*, *In re Outdoor Sports Headquarters, Inc.*, 161 B.R. 414, 424 (S.D. Ohio 1993); *Duralite Truck Body*, 153 B.R. at 713; *A.J. Lane*, 113 B.R. at 823-24.

198 *See, e.g.*, *AE Hotel Venture*, 2006 U.S. Dist. LEXIS 2040, at *6 (Prepayment premium must (i) be enforceable under state law and (ii) satisfy Section 506(b) reasonableness standard.); *Noonan v. Fremont Fin.* (In re Lappin Elec. Co.), 245 B.R. 326, 329 (Bankr. E.D. Wis. 2000); *Anchor Resolution Corp.*, 221 B.R. at 341.

199 *See, e.g.*, *Sachs Elec. Co. v. Bridge Info. Sys., Inc.* (In re Bridge Info. Sys., Inc.), 288 B.R. 556, 564 (Bankr. E.D. Mo. 2002) (Prepayment penalty is enforceable under Section 506(b) only if it accurately measures actual damages arising from early prepayment.); *Duralite Truck Body*, 153 B.R. at 714-15; *Outdoor Sports Headquarters*, 161 B.R. at 424; *Imperial Coronado Partners*, 96 B.R. at 1001.

200 *Sachs Elec. Co.*, 288 B.R. at 564; *Outdoor Sports Headquarters*, 161 B.R. at 424; *Duralite Truck Body*, 153 B.R. at 714; *A.J. Lane*, 113 B.R. at 829; *cf. Skyler Ridge*, 80 B.R. at 505 (finding that prepayment formula unreasonable because it (i) relied on the Treasury note rather than the market rate for the first mortgages and (ii) did not discount to present value).

201 *See, e.g.*, *CP Holdings, Inc. v. California Pub. Employees Ret. Sys.* (In re CP Holdings, Inc.), 206 F. App'x 629 (8th Cir. 2006) (*per curiam*); *United Merchs. & Mfrs., Inc. v. Equitable Life Assurance Soc'y* (In re United Merchs. & Mfrs., Inc.), 674 F.2d 134, 140-43 (2d Cir. 1982); *UPS Capital Bus. Credit v. Gencarelli*, No. C.A. 05-39T, 2006 WL 3198944, at *3-4 (D.R.I. Nov. 3, 2006); *Lappin Elec. Co.*, 245 B.R. at 329-331; *A.J. Lane*, 113 B.R. at 827-30.

202 *United Merchs. & Mfrs.*, 674 F.2d at 142-43; *see Fin. Ctr. Assocs.*, 140 B.R. at 835-36; *see also A.J. Lane*, 113 B.R. at 828 (Damages for breach may be liquidated in the agreement but only at an amount that is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.); *Lappin Elec. Co.*, 245 B.R. at 329 (Under Illinois law, "a liquidated damage provision is enforceable if the amount is a reasonable estimate of damages for the harm caused by the breach and if the harm is incapable or very difficult to estimate accurately. . . . "); *Kroh Bros. Dev. Co.*, 88 B.R. at 999 (Missouri law enforces liquidated damages clauses if (i) the amount fixed as damages is a reasonable forecast of the damages, (ii) the harm caused by the breach is incapable of estimation or very difficult to determine accurately, and (iii) there are actual damages.); *Ferrari v. Barclays Am. Bus. Credit, Inc.* (In re Morse Tool Co.), 87 B.R. 745, 750 (Bankr. D. Mass. 1988) (Courts will enforce a liquidated damages provision under Connecticut law if (i) the damages expected as a result of the breach of contract were uncertain in amount or difficult to prove, (ii) the parties intended to liquidate damages in advance and (iii) the amount stipulated

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B. Recharacterization Risk

Yet another potential risk to a distressed claims investor is the possibility that its claim may be recharacterized as equity rather than debt. Unfortunately, this risk can be heightened with respect to out-of-court rescue financing provided by distressed investors. Such financing frequently is provided by holders of existing debt (and/or equity) in an effort to protect their existing exposure, and it is often provided in exigent circumstances where the distressed entity is most in need of cash to sustain its operations.[203] So not only does the distressed investor face the business risk of non-payment in connection with rescue financing, it also faces the legal risk that its loan later will be attacked as an equity contribution rather than a loan.

Numerous bankruptcy courts have held that they have the equitable power to re-characterize debt to equity, despite the fact that there is no clear legal authority for doing so in the Bankruptcy Code.[204] Courts consider a host of factors relating to the nature of the loan transaction when determining whether the loan should be re-cast as an equity contribution.[205] This multi-factored analysis arguably poses greater risks to the distressed investor than equitable subordination risk, discussed above. While equitable subordination requires proof of inequitable conduct, no such proof is required in connection with a recharacterization claim.[206] In addition, in a successful recharacterization suit, the entire claim is converted to equity;[207] in an equitable subordination suit, by contrast, the creditor's claim is subordinated only to the extent necessary to offset specific harm to other creditors.

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was "reasonable."); *Skyler Ridge*, 80 B.R. at 504 (Under Kansas law, liquidated damages are authorized if (i) the amount of damages are difficult to ascertain and (ii) the estimate of the damages was reasonable.).

203 *See Cohen v. KB Mezzanine Fund II, LP* (In re SubMicron Sys. Corp.), 432 F.3d 448, 457 (3d Cir. 2006) ("[W]hen existing lenders make loans to a distressed company, they are trying to protect their existing loans."); *Fairchild Dornier GMBH v. Official Comm. of Unsecured Creditors* (In re Dornier Aviation (N. Am.), Inc.), 453 F.3d 225, 234 (4th Cir. 2006) ("In many cases, an insider will be the only party willing to make a loan to a struggling business, and recharacterization should not be used to discourage good-faith loans."); *see also Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC* (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006) (citing *SubMicron*).

204 *See, e.g., Bayer Corp. v. MascoTech, Inc.* (In re Autostyle Plastics), 269 F.3d 726, 749 (6th Cir. 2001); *Summit Coffee Co. v. Herby's Foods, Inc.* (In re Herby's Foods, Inc.), 2 F.3d 128 (5th Cir. 1993); *In re Cold Harbor Assocs.*, 204 B.R. 904 (Bankr. E.D. Va. 1997).

205 An eleven factor recharacterization inquiry originated in the Sixth Circuit and has become the template for subsequent recharacterization tests: (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments. *See Autostyle Plastics*, 269 F.3d at 750.

206 *But see* Hilary A. Goehausen, *You Said You Were Going to Do What to My Loan?*, 4 DePaul Bus. & Com. L.J. 117, 138 (2005) (questioning whether there is truly an absence of any bad faith inquiry into debt recharacterization in light of courts' tendency to justify recharacterization in order to recognize the "true" substance of a "disguised loan" that was "camouflaged" as debt – all suggestive of concealment and bad faith).

207 *Dornier Aviation*, 453 F.3d at 232; *SubMicron*, 432 F.3d at 454; *Insilco*, 480 F.3d at 214.

Within the last year, several recharacterization decisions have been published that afford important guidance to distressed investors, debtors, and other stakeholders. For instance, in *In re SubMicron Systems Corp.*, the Court of Appeals for the Third Circuit concluded, as other courts have, that the Bankruptcy Code authorizes a bankruptcy court to recharacterize claims when the circumstances warrant.[208] However, the Court affirmed the Bankruptcy Court's determination not to recharacterize certain claims as equity, endorsing the Bankruptcy Court's consideration of multiple factors considered by other courts in undertaking a recharacterization analysis. Significantly for distressed investors, the Third Circuit found important the fact that the financing was referred to as "debt" in the loan documents; that the financing had a fixed maturity date and interest rate; and that the parties evidenced their intent to create a debt instrument by referring to the debt as "debt" in their public filings.

Perhaps of greater significance to the distressed investor who is considering providing rescue financing to a troubled company, the Third Circuit dismissed arguments that the borrower's dire financial situation at the time of the loan supported an equity characterization. The Court stated that while a bankruptcy court should be more skeptical of purported loans made when a corporation is undercapitalized, "when existing lenders make loans to a distressed company, they are trying to protect their existing loans and traditional factors that lenders consider (such as capitalization, solvency, collateral, ability to pay cash interest and debt capacity ratios) do not apply as they would when lending to a financially healthy company."[209] The Court similarly gave short shrift to the lenders' participation on the debtor's board, relying on expert testimony to emphasize that it is "not unusual for lenders to have designees on a company's board, particularly when the company is a distressed one."[210]

Six months after the *SubMicron* decision was rendered, the Fourth Circuit Court of Appeals issued a recharacterization decision in *Dornier Aviation*.[211] Like the Third Circuit, the Fourth Circuit found that it had the equitable power to recharacterize a claim to an equity interest. However, unlike the Third Circuit, the *Dornier Aviation* Court actually invoked that power and affirmed the bankruptcy court's conversion of an $84 million claim for the sale of spare parts used in the parent's aircraft manufacturing business to equity.[212] In doing so, the Fourth Circuit emphasized the heavily fact-dependent nature of a recharacterization inquiry. The Court relied principally on the facts that the holder of the claim was the parent of the debtor corporation, and found significant (i) the parent's insider status; (ii) the lack of fixed maturity date for the loan; (iii) the fact that the debtor did not have to repay the loan until it became profitable; (iv) the debtor's long history of unprofitability; (v) the fact that the debtor's liabilities far exceeded its

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208 *See SubMicron*, 432 F.3d at 454-56.

209 *Id.* at 457 (quoting *In re SubMicron Sys. Corp.*, 291 B.R. 314, 325 (D. Del. 2003)).

210 *Id.*

211 *See Dornier Aviation*, 453 F.3d at 232-35.

212 *Id.*

assets at the time the parent extended the credit; and (vi) the parent's assumption of the debtor's losses.[213]

Many of the foregoing facts could be present in connection with a distressed investor's provision of rescue financing to a struggling corporation. In order to minimize the risk that such financing could be recharacterized as equity, the investor should take care to ensure that the loan bears the hallmarks of a loan, i.e., it must have a fixed maturity date and it must be payable at a date certain, not when (or if) the borrower becomes profitable.

These principles were important in *In re Radnor Holdings Corp.*,[214] recently decided by the United States Bankruptcy Court for the District of Delaware. That case involved a hedge fund's pre-petition investment in a distressed company, which the creditors committee argued was as a "loan to own" strategy.[215] In particular, in mid 2005, Radnor was experiencing short-term financial problems, but it had long-term positive EBITDA projections.[216] Radnor's investment banker, Lehman Brothers, canvassed the market and brought in Tennenbaum Capital Partners LLC, along with two of its affiliated hedge funds, to supply needed cash for working capital purposes. At Lehman's suggestion, Tennenbaum structured the cash infusion through a commitment to buy $25 million of preferred stock and to loan an additional $95 million on a secured basis. As is common with these types of investments, Tennenbaum received the right to designate one seat on the board of directors and one observer to the board.[217]

Radnor used the new capital to fund an expansion of its growing polypropylene cup business, to pay down equipment loans and a revolving credit facility, and to refinance its senior secured notes. When the company announced its dismal earnings in 2005 and the first quarter of 2006, it returned to Tennenbaum and obtained an additional advance of $23.5 million. The terms of the 2006 loan were substantially similar to the terms of the 2005 loan. Of particular significance, certain holders of the company's unsecured notes signed consents acknowledging that the 2006 loan was a debt investment.

As the business further deteriorated, the company prevailed upon Tennenbaum to submit a stalking horse bid for substantially all of its assets as part of a prepackaged bankruptcy proceeding. After Radnor filed its voluntary bankruptcy petitions, the creditors committee (composed of some of the same noteholders who had signed the 2006 consent) challenged Tennenbaum's proof of claim and asserted that Tennenbaum's loans to the debtors should be recharacterized as equity. After hearing testimony from fourteen witnesses during an eight-day

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213 *Id.* at 234.

214 *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC* (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006).

215 *Id.* at 830.

216 At the time the hedge fund contemplated making its investment, Radnor had strong projections showing its expectations to earn over $40 million in EBITDA in 2005 and nearly doubling it to $81 million in EBITDA in 2006. *Id.* at 828.

217 "It is not unusual for lenders to have designees on a company's board, particularly when the company is distressed." *Id.* at 839 (quoting *SubMicron*, 432 F.3d at 457-58).

trial, the Delaware Bankruptcy Court dismissed the committee's challenge and allowed Tennenbaum's claims in full.[218] Relying on the common-sense factual approach in *SubMicron*, the Bankruptcy Court reviewed the amply documented transaction and took into account the terms of the loan documents, the facts and circumstances surrounding the negotiations and making of the loans, as well as the economic reality of the circumstances to conclude that, at the time of the transactions, the parties intended the transactions to be debt and not equity.

Specifically, the court found that the parties consistently referred to the loans as "debt and/or indebtedness" in their transaction documents, that the loans had a fixed maturity date, and that Tennenbaum had a right to enforce payment of principal and interest. The court further noted that it was reasonable for Tennenbaum to provide more financing as the company faced a liquidity crisis, finding it legitimate for an existing lender to extend additional credit to a distressed borrower as a means to protect its existing loans.[219]

C. Credit Bidding

A common means by which distressed investors acquire troubled companies is to purchase secured debt of the troubled entity and then credit bid their debt at any subsequent sale of the troubled company's assets. Section 363(k) of the Bankruptcy Code specifically preserves the right of secured creditors to bid their claims at sales of their collateral, "unless the court for cause orders otherwise."[220] Obviously, the ability of a distressed investor to employ this strategy can be jeopardized to the extent its claim is recharacterized or subordinated, or to the extent portions of it (such as makewhole premiums) are disallowed. Unsecured creditors utilized such tactics, albeit unsuccessfully, in the *SubMicron* and *Radnor* cases. Of particular significance to distressed investors is the unsecured creditors' committees' argument in *SubMicron* that secured lenders may only bid the economic value of their liens rather than the full face amount of their secured debt. The Third Circuit disagreed with this assertion, holding that Section 363(k) allows a secured creditor to bid the *entire amount* of its claim, including any and all deficiency portions, regardless of the actual economic value of the claim.[221]

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218 *Id.* at 838-40. The Creditors Committee filed a Notice of Appeal of the decision on December 1, 2006. *See Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, LLC* (In re Radnor Holdings Corp.), Case No. 06-735 (D. Del.).

219 "I find that it would be irrational to believe that [Tennenbaum] would have made a $25 million equity investment if it believed Radnor were insolvent at the time . . . If, as the Committee argues, Tennenbaum's scheme was a 'loan to own,' why would it make an equity investment in addition to the debt transaction? The logical alternative would be to make a debt investment only so that Tennenbaum would have a better position in the event of a meltdown, i.e. liquidation." *Id.* at 830.

220 "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property. . . ." 11 U.S.C. § 363(k).

221 "Nothing about the logic of allowing credit bids up to the full face value of the collateral changes if the collateral has no actual value." *SubMicron*, 432 F.3d at 461.

VI. PENSION CLAIMS AND RELATED MATTERS

A distressed investor's strategies for acquiring claims against or interests in a troubled company may be significantly affected by whether the company maintains a qualified pension plan and, if so, whether it intends to maintain the plan or terminate it as part of its reorganization strategy. A comprehensive discussion of these matters is beyond the scope of this article. Accordingly, this article provides only a brief overview of pension plans in bankruptcy, focusing on two issues that could be of particular interest to distressed investors: (i) the circumstances under which liens may be imposed upon a troubled company's assets in connection with its pension funding obligations and (ii) the method for determining the amount of any unsecured claim on account of termination of a pension plan.

Under a defined benefit pension plan, a plan sponsor sets aside funds to provide retirement income to its employees or those of affiliates. Defined benefit pension plans are generally governed by the Employee Retirement Income Security Act of 1974 ("ERISA").[222] ERISA established the Pension Benefit Guaranty Corporation (the "PBGC") to guarantee a certain level of benefits for participants in insolvent pension plans. The PBGC is funded through premiums paid by pension plan sponsors and the investment income from plan assets assumed by the PBGC. The sponsor of a pension plan is subject to certain statutory minimum funding contribution requirements. Under certain circumstances, the IRS can waive the minimum funding requirements, but such relief can only be granted for three years out of every fifteen year period.[223] Any contributions not made when and as due because of such a waiver must be paid, with interest, over a 5-year period.[224]

The minimum funding regime is enforced by, among other things, the possibility of imposition of a lien on the assets of the plan sponsor and members of its "controlled group," i.e., its affiliates. There are two circumstances under which a lien may be imposed that are particularly relevant to distressed companies and their stakeholders. First, a lien may be imposed upon termination of a plan to secure the promised benefits (a "Termination Lien"), and second, a lien may be imposed automatically upon the delinquency of $1 million or more in minimum funding contributions (a "Funding Lien"). If either a Termination Lien or a Funding Lien is perfected prior to the bankruptcy filing of the plan sponsor, the PBGC will have a secured claim to the extent of the value of any collateral subject to such lien.[225]

The amount of the Termination Lien is limited to the lesser of (i) the total liability owed to the PBGC (as determined by ERISA) as of the date the pension plan is terminated, and (ii)

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222 ERISA is codified at 29 U.S.C. §§ 1001 to 1461, although certain provisions codified in various portions of the Internal Revenue Code, 26 U.S.C. §§ 1 to 9833 (the "IRC"), are relevant.

223 Nell Hennessy & Laura Rosenberg, *Pension Benefit Guaranty Corporation in Workouts and Bankruptcy Reorganizations*, at 5 (March 2006), *available at* http://www.fiduciarycounselors.com/press/PBGCBK_WhitePaper031206.pdf (last visited July 26, 2007).; *see* 26 U.S.C. § 412(c)(1)(A).

224 Hennessy & Rosenberg, *supra* note 223, at 5; *see* 26 U.S.C. §§ 412(c)(1)(B), 430(e).

225 Mitchell A. Seider & Bradd L. Williamson, *Pension and OPEB Obligations in U.S. Bankruptcies: Answers to the Most Frequently Asked Questions*, 1 Pratt's J. of Bankr. L. 346, 355 (2005).

30% of the "collective net worth" of the controlled group.[226] The Termination Lien has the same priority as a tax lien and is perfected in the same manner.[227] Virtually parallel sections of ERISA provide for the Funding Lien to automatically be imposed on all assets of the controlled group in favor of the PBGC when unpaid minimum funding contributions exceed $1 million.[228] The amount of the Funding Lien is equal to the aggregate unpaid minimum funding contributions and certain other payments (including interest).[229] The Funding Lien has the same priority as a tax lien and is perfected in the same manner.[230]

Historically, the PBGC has had difficulty effectively using its lien remedy because plan sponsors (and other members of the controlled group) often file for bankruptcy before the PBGC is able to assert or perfect its statutory lien. [231] Once the plan sponsor (and other members of the controlled group) have filed bankruptcy, the automatic stay of Section 362 of the Bankruptcy Code prevents the PBGC from asserting or perfecting a lien against controlled group members.[232] Even if the automatic stay did not prohibit post-petition lien perfection by the PBGC, Section 545 of the Bankruptcy Code allows a debtor to avoid statutory liens that were unperfected as of the petition date.[233]

Post bankruptcy, the PBGC has two main claims as trustee of a terminated pension plan: (i) a claim for unfunded benefits and (ii) a claim for any accumulated minimum funding contributions that have not been made. In particular, as to the first claim, the PBGC may assert a claim for "the total amount of the unfunded benefit liabilities (as of the termination date) . . . calculated in accordance with regulations prescribed by the [PBGC]."[234] In short, this claim

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[226] 29 U.S.C. § 1368(a); *Bankruptcy Litigation Manual* § 19.03[C][1] (Michael L. Cook, ed., 2007). The "collective net worth" is determined by adding the individual net worths of the members of the controlled group that have a positive individual net worth. 29 U.S.C. §§ 1362(d)(1), 1368(f)(1). The PBGC has broad discretion in determining the factors relevant to determining the individual net worth of each person that may be subject to the lien. *See* 29 U.S.C. § 1362(d)(1)(B) (permitting the PBGC to determine net worth of individual controlled group members "on whatever basis best reflects, in [its] determination . . . the current status of such person's operations and prospects" including adjustment for transfers that would be "inappropriate" for a debtor under Chapter 7 of the Bankruptcy Code).

[227] The Termination Lien shall have the same priority as a tax lien under 26 U.S.C. § 6323 and, in bankruptcy, "shall be treated in the same manner as a tax due and owing to the United States." 29 U.S.C. § 1368(c)(1), (2).

[228] 29 U.S.C. § 1082(f); 26 U.S.C. § 412(n); *Bankruptcy Litigation Manual*, *supra* note 226, § 19.03[C].

[229] 29 U.S.C. § 1082(f)(3); 26 U.S.C. § 412(n)(3).

[230] "Any amount with respect to which a [Funding L]ien is imposed . . . shall be treated as taxes due and owning to the United States and rules similar to the rules of" 29 U.S.C. § 1368(c) – (e) shall apply with respect to such Funding Lien. 29 U.S.C. § 1082(f)(4)(C); 26 U.S.C. § 412(n)(4)(C).

[231] Daniel L. Keating, moderator; Laurie Ashton & Martin Bienenstock, panelists; *Bankruptcy Meets ERISA: Enron, et al.*, Presented at National Conference of Bankruptcy Judges Annual Meeting, § VIII, F (Oct. 16, 2003) ("*Bankruptcy Meets ERISA*").

[232] *Id.*; *see* 11 U.S.C. § 362; *see, e.g., PBGC v. Skeen* (In re Bayly Corp.), 163 F.3d 1205, 1207 (10th Cir. 1998) (PBGC did not demand payment for unfunded, guaranteed benefit liabilities prior to petition date and automatic stay prevented attachment of liens post-petition.). However, the PBGC could seek to assert, perfect and enforce a lien on controlled groups members that are not under bankruptcy protection.

[233] *Bankruptcy Meets ERISA*, *supra* note 221, § VIII, F; *see* 11 U.S.C. § 545.

[234] 29 U.S.C. § 1362(b)(1)(A).

equals the present value of all accrued future benefit obligations of the plan less any plan assets.[235]

The PBGC, on the one hand, and the debtors and their stakeholders, on the other hand, often disagree over the method for determining the present value of the future liabilities that will not be covered by the terminated plan's assets. Two competing methodologies have been developed and adopted by various courts: (i) the PBGC's valuation regulation, codified at 29 C.F.R. § 4044.41 and 4044.75, and (ii) the "prudent investor" discount rate.[236] The PBGC regulation uses the 1983 Group Annuity Mortality Table (the "1983 GAM") to calculate the expected lifespan and retirement ages for plan participants to estimate the sum of future benefit payments. This sum is then discounted according to a discount factor generated by the PBGC after considering annuity pricing levels in private industry in light of the 1983 GAM.[237] This discounted figure is the level of funding necessary to purchase an annuity that would pay the guaranteed benefits.[238]

On the other hand, many debtors have argued, and a number of courts have held, that a bankruptcy court can reject the PBGC's valuation regulation in favor of the prudent investor rate based on the bankruptcy court's authority to determine the amount of claims in bankruptcy proceedings and to treat creditors in the same class equally.[239] The prudent investor rate is the rate of return achievable by a reasonable, prudent, long-term pension fund portfolio investor who seeks the best long-term return on investment consistent with preserving capital and minimizing risk.[240] The "prudent investor rate" often is a higher discount rate, which results in a lower present value for the PBGC's claim than if the PBGC's valuation regulation is approved.[241]

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235 29 U.S.C. § 1362(b)(2).

236 *See* 29 C.F.R. §§ 4044.41, 4044.75 (codifying PBGC's valuation regulation).

237 To determine the cost of the annuity contracts, the PBGC relies on the American Council of Life Insurers (the "ACLI") to conduct "double-blind" quarterly surveys of current prices charged by insurance companies for single-premium annuities. John Wm. Butler, Jr., *Undoing the Benefits of the Bargain: Pension and Other Legacy Obligations in Bankruptcy*, Presented at National Conference of Bankruptcy Judges, at 11-20 (Nov. 3, 2006). ACLI voluntarily sends approximately twenty surveys out to insurance companies in order to collect pricing information and typically receives 9-12 responses. *Id.* Some have noted that the PBGC's survey method is wrought with inherent limitations. *See, e.g., id.* This was noted by Judge Stephen Mitchell in *US Airways*, where he stated that "[a]s the General Accounting Office has recently observed in a report to Congress, the anonymous nature of the survey necessarily creates ambiguity about the extent to which the PBGC interest rate factors reflect the current broad market for group annuities." *In re US Airways Group, Inc.*, 303 B.R. 784, 797 (Bankr. E.D. Va. 2003).

238 Butler, *supra* note 237, at 11-19.

239 *See PBGC v. Belfance* (In re CSC Indus., Inc.), 232 F.3d 505, 509 (6th Cir. 2000); *PBGC v. Reorganized CF & I Fabricators of Utah, Inc.* (In re CF & I Fabricators of Utah, Inc.),179 B.R. 704 (D. Utah 1994); *LTV Corp. v. PBGC* (In re Chateaugay Corp.), 126 B.R. 165, 171, 175-77 (Bankr. S.D.N.Y. 1991), *vacated, op. withdrawn pursuant to settlement*, No. 89 Civ. 6012, 1993 WL 388809 (S.D.N.Y. June 16, 1993).

240 *Chateaugay Corp.*, 126 B.R. at 177; *accord CSC Indus., Inc.*, 232 F.3d at 508, 509.

241 For instance, in *Law Debenture Trust Co. v. Kaiser Aluminum Corp.* (In re Kaiser Aluminum Corp.), 339 B.R. 91 (D. Del. 2006), the PBGC's claim would have been $168 million using the prudent investor rate, but $616 million using the PBGC's valuation regulation. *See id.* at 96-97 (approving settlement providing for PBGC to receive $268 million claim for unfunded benefit liability).

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Presentation Topics

> **This presentation will cover selected topics in distressed investing:**

- Disclosure Issues
  - Ad Hoc Committee Disclosure Obligations
  - Disclosure Issues Arising from Credit Derivatives
- Selected Claim Enforceability Issues
  - Equitable Subordination in Light of Enron Decision
  - Recharacterization
  - Section 363(k) Credit Bidding
  - Makewhole Premiums
- Pension Claims and Related Matters

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Ad Hoc Committees and Disclosure Obligations

> Why the Increase in Ad Hoc Committees?

- The increase in distressed investing by hedge funds has resulted in the proliferation of ad hoc committees.
- Ad hoc committees can confer many benefits on their members:
  - Membership on committees is unregulated;
  - Provides unified voice during the Chapter 11 process;
  - Can diffuse and defray costs stemming from participation in Chapter 11 process; and
  - Affords opportunity to appear and be heard on any issue that arises in the bankruptcy case.

Ad Hoc Committees and Disclosure Obligations

> **What Does Bankruptcy Rule 2019 Require?**

- Requires every entity or committee representing more than one creditor or equity security holder to file a verified statement setting forth:
  - Names and addresses of the creditors or equity security holders represented;
  - The nature and amount of the claims or interests held and the time of acquisition, unless acquired more than one year before the petition date;
  - The amounts paid for the claims and interests; and
  - Any sales or other disposition of the claims or interests.
- Can be severe consequences for failing to comply with the disclosure requirements.

Ad Hoc Committees and Disclosure Obligations

> **How Have Courts Interpreted The Disclosure Requirements of Bankruptcy Rule 2019?**

- In re Owens Corning, Case No. 00-03837 (JFK) (Bankr. D. Del)
  - Ad hoc bondholder committee was required to comply with disclosure requirements. Exhibits containing sensitive materials were submitted to the Clerk's Office on compact disk.
- In re Mirant Corp., Case No. 03-46590 (DML) (Bankr. N.D. Tex.)
  - Ad hoc bondholder committee was required to comply with disclosure requirements.
    - Disclosure was filed under seal.
    - Disclosure relating to time of acquisition or sale: month-of-trade was sufficient.
    - Disclosure on an aggregate versus individual creditor basis was sufficient.

Ad Hoc Committees and Disclosure Obligations

> And then matters got interesting . . .

- In re Northwest Airlines Corp., 363 B.R. 701 (Bankr. S.D.N.Y. 2007)
  - Members of ad hoc committee of equity security holders were mostly hedge funds. Ad hoc committee members sought to form official equity committee.
  - Court required ad hoc committee to comply with disclosure requirements.
    - Court required disclosure of date of investment and price paid for claims against, or interests in, the debtors.
    - Court rejected request of ad hoc committee to file the disclosure under seal.
  - Decision has caused concern in distressed investor community.
  - Is the concern justified?

Ad Hoc Committees and Disclosure Obligations

- In re Scotia Development, LLC, Case No. 07-20027-C-11 (Bankr. S.D. Tex.)
  - Noteholder group successfully distinguished itself from the ad hoc equity committee in Northwest.
    - Did not seek to represent any other holders of debt, unlike the Northwest ad hoc equity committee members, who announced their "desire to serve in a representative and fiduciary capacity on behalf of other equity holders."
    - The group had no need to represent other creditors' interests, as they owned 95% of the bonds; in Northwest, ad hoc equity committee members only held 27% of Northwest's equity.
    - The group's members only held one series of notes; the Northwest ad hoc equity committee members held equity in and claims against the debtors.
  - Court found that bondholders were "not a committee . . . just one law firm representing a bunch of creditors."
  - Is a "bunch of creditors" an entity?
  - Is their counsel an entity for the purposes of Rule 2019?

Ad Hoc Committees and Disclosure Obligations

> **Does the Applicability of Rule 2019 Turn On What the Group of Creditors Decides to Call Itself?**

- Creditors have referred to themselves as "consortiums" or "groups" in an attempt to mitigate the risk of subjecting themselves to Bankruptcy Rule 2019 disclosure requirements.
- In Scotia Development, the bondholders initially called themselves an ad hoc committee, but later referred to themselves as a "noteholder group."
- Does this approach make any sense?

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Ad Hoc Committees and Disclosure Obligations

> **Is Bankruptcy Rule 2019 Limited to Committees Acting As Fiduciaries?**

- Predecessor to Bankruptcy Rule 2019 was adopted as a result of abusive practices in certain aspects of 1930s reorganization practice.
- If the ad hoc committee only speaks for its members, is it true that it has no fiduciary responsibilities to other creditors, and, therefore, that Bankruptcy Rule 2019 is inapplicable?
- Does the applicability of Bankruptcy Rule 2019 turn on whether the ad hoc committee sought, unsuccessfully, its appointment as a formal committee?
- What if the ad hoc committee members do not control voting in the class of stakeholders of which they are members?

> Credit Derivatives

- A “credit derivative” is an instrument that allows parties to isolate and transfer credit risk from one party to another (without transferring the underlying claim or security) by providing for payment keyed to a credit event such as a company defaulting on its debts or filing for bankruptcy.
- Generally sold by dealers over the counter with little or no transparency.
- Credit derivatives can cause a party’s economic incentives to be different (or even the reverse) of what their “paper position” may indicate.
    - E.g., a creditor might have a greater interest in the debtor’s failure than its success.

Credit Derivatives – Disclosure Issues

> **Impact of Credit Derivative Disclosure in Distressed Situations**

- Slowly increasing, but expected to be very significant in the next round.
- The law has not kept up with the market for credit derivatives (or their economics).
  - Currently, no explicit disclosure obligations.
  - Neither the court, nor other parties, can ascertain a party's true incentives.
  - What is the proper response? By whom (debtor, committee, US Trustee or other parties)?
  - May raise "empty voting" concerns in the plan confirmation context as parties vote against their interest as a "creditor" to increase the value of credit derivative positions.

Selected Claim Enforceability Issues

Equitable Subordination

> **Under § 510(c), creditors who have acted inequitably may have their claims equitably subordinated to the claims of other creditors.**
>
> - Equitable subordination is a remedial doctrine and should only be applied to the extent necessary to offset specific harm to creditors from inequitable conduct.

> **If a bad actor sells a claim to an distressed investor, can/should equitable subordination still apply?**

> **<u>In re Enron Corp.</u>, 333 B.R. 205 (Bankr. S.D.N.Y. 2005)**
>
> - Equitable subordination survives transfer of a claim to innocent transferee.
> - Good faith purchaser defense is not available to transferee.

> **On appeal, District Court reversed.**
>
> - Although subordination may apply to claim transferred by assignment, "[w]here a claimant has purchased its claim . . . assignment law principles have no application . . . ."
> - Bankruptcy Court improperly assumed that assignment law principles applied without determining whether assignment occurred.
> - Distinction between assignment and sale is "particularly imperative in the distressed debt market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller . . . has acted inequitably."

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Selected Claim Enforceability Issues

Equitable Subordination (cont.)

> **How is an assignment distinguished from a sale?**

- Not clear from Enron decision, but state law principles may provide some guidance.
- In re Metiom, Inc., 301 B.R. 634 (Bankr. S.D.N.Y. 2003)
  - Divine sought to enforce against Metiom claim obtained from Intira through § 363 sale of certain of Intira's assets.
  - Intira had received preference from Metiom, but Divine did not receive the benefit of this preference.
  - Metiom's trustee objected to Intira's claim requesting that it be:
    - (i) disallowed under § 502(d) because Intira had never returned preference or
    - (ii) equitably subordinated on basis of misconduct by Intira.
  - Motion to dismiss claim objection denied in Metiom because Divine as "assignee of non-negotiable instrument . . . receives no more than the assignor possessed."
- One basis for Metiom decision is N.Y. Gen. Oblig. Law § 13-105, which provides that a claim is transferred "subject to any defense or counter-claim, existing against the transferor, before notice of the transfer, or against the transferee."

Selected Claim Enforceability Issues

Equitable Subordination (cont.)

- N.Y. Gen. Oblig. Law § 13-105 does not apply (i) if a "special provision of law" covers the defenses that may be asserted or (ii) to negotiable instruments.
- For instance, N.Y. U.C.C. § 8-202 provides that, generally, a security issuer's defenses against a transferor are ineffective against a purchaser for value who has taken the security without notice of the particular defense.
  - The definition of "security" under N.Y. U.C.C. is broad, albeit different from the federal securities law definition. See Highland Capital Mgmt. LP v. Schneider, 8 N.Y.3d 406 (N.Y. 2007) (finding N.Y. U.C.C. § 8-102(a)(15) definition of "security" covers a wide variety of obligations).
  - N.Y. U.C.C. § 8-202 excludes "securities" from the general rule of N.Y. Gen. Oblig. Law § 13-105 regarding the defenses that can be asserted against a transferee.
    - However, post-petition transferees may be at higher risk.
- Enron suggests, however, that N.Y. U.C.C. § 8-202 may not protect a transferee of a "security" if that transfer takes the form of an assignment (even for value).

Selected Claim Enforceability Issues

Equitable Subordination (cont.)

> How would the assignment/sale dichotomy be interpreted by courts (and markets) in the future?

- Recently, Springfield Associates, LLC sought an interlocutory appeal of the Enron decision by the Second Circuit, emphasizing the question of whether equitable subordination or disallowance can "turn on the distinction between a claim transferred by sale and a claim transferred by assignment."
- The District Court denied the request for an interlocutory appeal on the basis that:
  - The District Court's opinion "significantly scaled back the Bankruptcy Court's rulings, and [the District Court's] . . . narrow holdings took care to ensure that the markets would not be disturbed."
  - Concern over uncertainty in the market, absent an appeal to the Second Circuit, is "not significant" because the District Court's "narrow holdings took care to ensure that the markets would not be disturbed" in resolved the uncertainty caused by the bankruptcy court's ruling.

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Selected Claim Enforceability Issues

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Equitable Subordination (cont.)

> Some have suggested that transferees bring direct actions against transferors and/or bad actors.
  - Harbinger Capital Partners Master Fund I, Ltd. v. Wachovia Capital Markets, LLC, No. 07-Civ.-8139-DC (S.D.N.Y. filed Sept. 17, 2007) provides an example of such a suit arising out of In re Le Nature's, Inc., No. 06-25454-MBM (Bankr. W.D. Pa.).
    - Although their claims have not been subordinated, lenders are suing the debtor's management, the credit facility agent and accounting firm for RICO act violations, fraud and civil conspiracy.
      - RICO violations can result in treble damages.

Selected Claim Enforceability Issues

Recharacterization Risk

> **Distressed investor's claim could be recharacterized as equity.**

> **In re SubMicron Sys. Corp., 432 F.3d 448 (3d Cir. 2006): Court declined to recharacterize loan to distressed company as equity.**
- Contractual language important; and
- Borrower's distress and lender's participation on borrower's board not dispositive.

> **In re Dornier Aviation, 453 F.3d 225 (4th Cir. 2006): Court invoked equitable power to recharacterize loan as equity. Fact that lender was parent of debtor was significant, as was:**
- Lack of fixed maturity date;
- Debtor did not have to repay loan until it became profitable;
- Debtor's long history of unprofitability;
- Debtor's insolvency at time of loan; and
- Lender/parent's assumption of debtor's losses.

Selected Claim Enforceability Issues

Recharacterization Risk (cont.)

> **<u>In re Radnor Holdings Corp.</u>, 353 B.R. 820 (Bankr. D.Del. 2006)**

- Court reviewed the loan documentation and found the parties intended the transaction to be a debt obligation and not an equity investment because:
  - Documentation consistently referred to loans as "debt";
  - Loans had fixed maturity date and required interest payments; and
  - It was reasonable for lender to provide emergency loan to keep company afloat as this protected lender's existing loans.

Selected Claim Enforceability Issues

Credit Bidding

> **Common method for distressed investors to acquire troubled companies: purchase secured debt and credit bid their debt at sale of company's assets under § 363(k).**

- **§ 363(k):** "At a sale . . . of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."

> **Ability to use this strategy will be jeopardized to the extent the bidder's claim is recharacterized, subordinated or disallowed (e.g., makewhole premiums).**

> **<u>SubMicron</u> court ruled that § 363(k) allows secured creditor to bid the entire amount of its claim, not merely the value of the lien.**

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Selected Claim Enforceability Issues

"No-Call" & "Makewhole" Provisions

> **"No call" provisions prohibit the prepayment of debt. They are generally not enforceable in bankruptcy.**

> **"Makewhole" provisions require payment of premiums in event of loan prepayment; designed to mitigate lender's loss of interest payments.**

- Premiums may be included in oversecured lender's claim under § 506(b).
- Voluntary vs. involuntary prepayment.
- Characterization as interest vs. fees or charges.

Pension Claims and Related Matters

> **Two Methods of Calculating a Company's Future Pension Liabilities**

- PBGC's Valuation Regulation: calculates expected lifespan and retirement ages for plan participants to estimate the sum of future benefit payments.
  - This sum is then discounted according to a discount factor generated based on annuity pricing levels in private industry.
- Prudent Investor Discount Rate: rate of return achievable by a reasonable, prudent, long-term pension fund portfolio investor who seeks the best long-term return consistent with preserving capital and minimizing risk.
  - This is often a higher discount rate, which results in a lower present value for the PBGC's claim than if the PBGC's valuation regulation is utilized.