

2011: A Reminder to Secured Creditors to Take Nothing for Granted

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2011 taught us that secured creditors should expect the unexpected. A number of key court decisions issued in 2011 illustrate that parties cannot completely rely on existing precedent, as it is subject to constant change, particularly in the bankruptcy arena, where innovative practices are always at least one step ahead of the law. When the courts finally do weigh in, they sometimes make bold, unanticipated holdings that fundamentally change existing assumptions. Other times, they make their decisions incrementally, in cases that leave significant questions unanswered and room for additional developments.

The cases discussed in this article, which interpret the rights, options, and liabilities of secured creditors in bankruptcy cases, put a twist on the expectations of secured creditors and reflect the inherent uncertainty in insolvency law. This past year, creditors saw that, at the whim of one individual judge or another, their liability can be either increased, as in the *TOUSA* bankruptcy court's famous fraudulent conveyance decision, or decreased, as in the *TOUSA* district court's reversal of that decision, or the *Enron* split (2-1) decision broadly construing one of the Bankruptcy Code's safe harbors against fraudulent conveyance actions. When the Court of Appeals for the Second Circuit issued its anti-gifting opinion in *DBSD*, and when a bankruptcy court upheld the involuntary bankruptcy of a CDO in *Zais*, they also saw that seemingly well-settled assumptions can be upended. Even tried and true rights, recognized and relied-upon for years, can be taken away or given back. In 2010, secured creditors were stunned when the Court of Appeals for the Third Circuit found an exception to the long presumed right of secured creditors to credit bid on their collateral when it is sold in bankruptcy. Just one year later, the Court of Appeals for the Seventh Circuit issued an opinion to the contrary, and the United States Supreme Court granted certiorari to consider the question.

Change is the only constant in this collection of cases, and the coming year will surely bring more of the same. Secured creditors will continue to live on the edge, creating new structures,

thinking up new, untested protections, and taking chances by dealing with distressed companies to maximize profits and recoveries. In so doing, they also risk falling over the edge when the limits are tested and a judge interprets the law differently than expected. This article considers the import of these cases for secured creditors and highlights where the courts have left open questions for future surprises.

TOUSA – NOW WE'RE LIABLE, NOW WE'RE NOT. OR ARE WE?

Last February, the United States District Court for the Southern District of Florida quashed the judgment of the bankruptcy court in one part of the *TOUSA* fraudulent conveyance litigation. The bankruptcy court's opinion finding *TOUSA*'s former and existing lenders liable for fraudulent conveyance had sent shivers through the lending community, and the district court's decision was greeted with some relief. Consistent with the *TOUSA* case's meandering style, however, that decision itself now sits on appeal before the Court of Appeals for the Eleventh Circuit.

This litigation has drawn considerable scrutiny in the lending community because each court's analysis reveals tensions between modern lending practices in the context of large, multi-entity enterprises, where debt structures are designed for the enterprise as a whole, with the entity-by-entity legal analysis that occurs in fraudulent conveyance litigation and bankruptcy. With the bankruptcy court taking a narrow view of how transactions can benefit various entities in a corporate enterprise, and the district court taking a wider view, the Eleventh Circuit is now presented with deciding among a range of outcomes on issues that could affect many loan structures, particularly where a borrower may be in financial distress. Given all the attention that the case has received, the Eleventh Circuit's decision will be closely watched and will help define how lenders analyze and take into account fraudulent conveyance risk for loan structures with co-borrowing, guarantees, and cross-collateralization.

Background and Lower Court Decisions

While famously intricate, a few key elements of the *TOUSA* litigation have received most of the attention because of their bearing on modern lending practices. The *TOUSA* litigation arose out of the failure of *TOUSA, Inc.* (“*TOUSA*”) and its various affiliates and subsidiaries, which operated the thirteenth largest home-building enterprise in the United States.¹ As “the national housing market went to hell in a handcart beginning in August 2007,” *TOUSA* rapidly collapsed, and it filed for chapter 11 on January 29, 2008.²

The Transeastern Litigation – In June 2005, *TOUSA*, through its wholly-owned subsidiary *Tousa Homes LP* (“*Homes LP*”), formed a joint venture called *TE/TOUSA LLC* (the “*Transeastern Joint Venture*”) to acquire home-building assets from a leading developer in Florida.³ The *Transeastern Joint Venture* was funded, in large part, by a \$675 million secured credit facility from a group of lenders (the “*Transeastern Lenders*”).⁴ *TOUSA* and *Homes LP* guaranteed repayment of this credit facility, and, when the joint venture defaulted, the *Transeastern Lenders* sued *TOUSA* and *Homes LP* for repayment. *TOUSA* settled this litigation by agreeing to pay the *Transeastern Lenders* approximately \$421 million plus interest.⁵

The July 31, 2007 Transaction – To fund the settlement, on July 31, 2007, *TOUSA* entered into two new credit agreements for approximately \$500 million, with *TOUSA* and certain of its subsidiaries as co-borrowers pledging their assets as security to the new lenders (the “*New Lenders*”). Notably, these “*Conveying Subsidiaries*,” were not involved in the *Transeastern Joint Venture* and were not liable to the *Transeastern Lenders*. Upon funding of the \$500 million facility, *TOUSA* transferred approximately \$476 million to the *Transeastern Lenders*.⁶

BANKRUPTCY COURT PROCEEDINGS

In the *TOUSA* bankruptcy, the official committee of unsecured creditors (the “*Creditors’ Committee*”) filed an adversary proceeding against the *New Lenders* and the *Transeastern Lenders*

on behalf of the *Conveying Subsidiaries’* estates, arguing, among other things, that the July 31, 2007 transaction constituted a fraudulent transfer under section 548 of the Bankruptcy Code, and seeking avoidance of the liens granted to the *New Lenders* and recovery of the settlement funds paid to the *Transeastern Lenders* pursuant to section 550 of the Bankruptcy Code.⁷

Even without evidence of “actual intent” to defraud, a transaction can be avoided as constructively fraudulent under section 548 of the Bankruptcy Code if the debtor “received less than a reasonably equivalent value in exchange for such transfer” and was “insolvent on the date that such transfer was made.”⁸ Section 550 of the Bankruptcy Code provides that, if a transfer is avoided under section 548, the debtor may recover the property transferred (or the value of such property) from either the initial transferee, the entity “for whose benefit such transfer was made,” or a subsequent transferee (unless the subsequent transferee provided value for the transfer in good faith and without knowledge of the voidability of the transfer avoided).⁹

The bankruptcy court agreed with the *Creditors’ Committee*, holding that the *Conveying Subsidiaries* “did not receive reasonably equivalent value in exchange for the obligations they incurred by pledging their assets to the *New Lenders*,”¹⁰ and that “each of the *Conveying Subsidiaries* was insolvent both before and after the July 31 transaction.”¹¹ In its insolvency analysis, the bankruptcy court rejected the defendants’ argument that solvency should be evaluated on a “common enterprise” basis, and instead evaluated the solvency of each *Conveying Subsidiary* as a separate entity.¹² Finally, the bankruptcy court ordered the *Transeastern Lenders* to disgorge the settlement funds as “entities ‘for whose benefit the transfer was made’ under 11 U.S.C. § 550(a)(1).”¹³

The *New Lenders* and the *Transeastern Lenders* both appealed the bankruptcy court’s ruling. The *New Lenders’* appeal was assigned to Judge Adalberto Jordan of the United States District Court for the Southern District of Florida. Judge Jordan stayed

¹ *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of Tousa, Inc. (In re TOUSA, Inc.)*, 444 B.R. 613, 621 (S.D. Fla. 2011).

² *Id.* at 637 (internal citations omitted).

³ *Id.* at 629.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.* at 636.

⁷ *Id.* at 637, 640.

⁸ 11 U.S.C. § 548(a)-(b).

⁹ 11 U.S.C. § 550(a)(1).

¹⁰ *TOUSA*, 444 B.R. 613 at 640-41.

¹¹ *Official Comm. of Unsecured Creditors of Tousa, Inc. v. Citicorp N. Am., Inc. (In re TOUSA, Inc.)*, 422 B.R. 783, 801 (Bankr. S.D. Fla. 2009).

¹² *Id.* at 834-35.

¹³ *TOUSA*, 444 B.R. 613 at 640-41.

the New Lenders' appeal pending the ultimate resolution of the Transeastern Lenders' appeal, which was heard, in the first instance, by Judge Alan Gold of the United States District Court for the Southern District of Florida.¹⁴

DISTRICT COURT DECISION

In a scathing rebuke of the bankruptcy court's decision with regard to the Transeastern Lenders, Judge Gold reversed without remand, holding that "the Bankruptcy Court erred as a matter of law and fact in refusing to recognize as reasonably equivalent value the indirect benefits to the Conveying Subsidiaries from the July 31 Transaction."¹⁵ Specifically, Judge Gold focused on three indirect benefits to the Conveying Subsidiaries in incurring the obligations to the New Lenders: (i) TOUSA and the Conveying Subsidiaries avoided having to file for bankruptcy and were able to continue as going concerns, (ii) the Conveying Subsidiaries were able to maintain their existing source of funding (in the form of a revolving credit facility), and (iii) as a result of the settlement with the Transeastern Lenders, the Conveying Subsidiaries avoided becoming liable for more than \$1 billion in guaranty obligations enforceable against them by existing lenders and holders of TOUSA bond debt (which would have become due if the Transeastern Lenders had obtained a judgment against TOUSA in excess of \$10 million).

Judge Gold stressed that the bankruptcy court's failure to recognize these indirect benefits as reasonably equivalent value was contrary to well-established case law throughout the country, and risked unduly inhibiting "contemporary financing practice."¹⁶ Judge Gold noted that subsidiaries often guaranty debts of their parent, or engage in co-borrowing practices like those employed in TOUSA, and requiring a direct flow of money to such subsidiaries in order to establish reasonably equivalent value would result in the unwarranted avoidance of "legitimate

business transactions" that were "not made to frustrate creditors."¹⁷

Judge Gold also stressed that "whether a debtor received reasonably equivalent value must be evaluated as of the date of the transaction" and criticized the bankruptcy court for viewing the July 31 transaction "through the lens of retrospection to point out that bankruptcy ultimately was not avoided."¹⁸ Other courts have similarly rejected such Monday morning quarterbacking.¹⁹ While TOUSA ultimately collapsed, along with the rest of the United States real estate market, for purposes of determining reasonably equivalent value, Judge Gold held, "it is enough that the July 31 Transaction left the Conveying Subsidiaries in a better position to remain as going concerns than they would have been without the settlement."²⁰

Finally, recognizing the inevitability of an appeal to the Eleventh Circuit, Judge Gold held that even if the bankruptcy court's reasonably equivalent value finding was sustained, reversal would still be required as a matter of law because the Conveying Subsidiaries could not recover from the Transeastern Lenders pursuant to section 550 of the Bankruptcy Code.²¹ The Creditors' Committee argued that the Transeastern Lenders were entities "for whose benefit" the liens were transferred to the New Lenders because "the new loans and the liens securing those loans, were undertaken for the express purpose of resolving the [litigation with the Transeastern Lenders]."²² Judge Gold rejected that argument and was highly critical of the Creditors' Committee's attempt to "lump all transactions into a 'single integrated transaction'" for section 550 purposes, when the "overwhelming record of evidence" reveals that three distinct asset transfers took place: (i) the Conveying Subsidiaries transferred liens to the New Lenders, (ii) the New Lenders loaned funds to TOUSA, and (iii) TOUSA used those funds to settle the litigation with the Transeastern Lenders.²³ Judge Gold also noted that because the

¹⁴ See *3V Capital Master Fund Ltd. v. Official Comm. of Unsecured Creditors of Touse, Inc. (In re TOUSA, Inc.)*, Case No. 10-60017-cv-GOLD (S.D. Fla. Apr. 26, 2011) [Docket No. 160] (explaining that Judge Jordan issued an Order staying the TOUSA appeal proceedings before him involving the [New Lenders] until the Eleventh Circuit issues a mandate concerning the Transeastern Opinion," and authorizing the New Lenders to intervene in the Transeastern appeal to the Eleventh Circuit). The Creditors' Committee had also filed an adversary proceeding against TOUSA's pre-petition lenders seeking to avoid as fraudulent transfers certain amendments made to their revolving credit facility as part of the July 31 transaction. The bankruptcy court dismissed these claims, and Judge Jordan affirmed the dismissal. *Official Comm. of Unsecured Creditors of Touse, Inc. v. Citicorp N. Am., Inc. (In re TOUSA, Inc.)*, 2011 WL 1627129 (Bankr. S.D. Fla. Mar. 4, 2011). The Creditors' Committee did not appeal this decision to the Eleventh Circuit.

¹⁵ TOUSA, 444 B.R. at 653 (emphasis added).

¹⁶ *Id.* at 657, 659.

¹⁷ *Id.* at 659; see also *Leibowitz v. Parkway Bank & Trust Co. (In Re Image Worldwide, Ltd.)*, 139 F.3d 574, 578 (7th Cir. 1998) ("...requiring a direct flow of capital to a cross-guarantor to avoid a finding of fraudulent transfer is inhibitory of contemporary financing practices, which recognize that cross-guarantees are often needed because of the unequal abilities of inter-related corporate entities to collateralize loans.").

¹⁸ TOUSA, 444 B.R. 613 at 666 (emphasis added).

¹⁹ See e.g. *Daley v. Chang (In re Joy Recovery Tech. Corp.)*, 286 B.R. 54, 75 (Bankr. N.D. Ill. 2002) ("Courts will not look with hindsight at a transaction because such an approach could transform fraudulent conveyance law into an insurance policy for creditors"); *In re R.M.L.*, 92 F.3d at 151 (rejecting a "hindsight" test, noting that such a test would mean that "only successful investments can confer value. . . . Such an unduly restrictive approach to reasonably equivalent value has been soundly rejected by other courts, and with good reason. Presumably the creditors whom § 548 was designed to protect want a debtor to take some risks that could generate value . . .").

²⁰ TOUSA, 444 B.R. at 663.

²¹ *Id.* at 670.

²² *Id.*

²³ *Id.* at 673.

Conveying Subsidiaries transferred liens to the New Lenders, and “the liens remained at all times *with the New Lenders*,” the bankruptcy court could not find that the Transeastern Lenders were liable for the transfer of liens as either “initial” or “subsequent” transferees.²⁴ Even if the Transeastern Lenders could be considered subsequent transferees within the meaning of section 550 (as subsequent transferees of the proceeds backed by the liens, for example), Judge Gold implied that they would be protected as good faith purchasers.²⁵

Although Judge Gold noted that the bankruptcy court spent significant time considering arguments concerning the solvency of TOUSA and its subsidiaries, he did not address the insolvency prong of the fraudulent conveyance analysis because he found that the Conveying Subsidiaries received reasonably equivalent value.²⁶

ANALYSIS AND SIGNIFICANCE OF THE APPEAL

On appeal from the district court’s decision, the Eleventh Circuit will consider, among other things, the district court’s application of indirect benefits as reasonably equivalent value, the application of hindsight to value those benefits, and whether the Transeastern Lenders are subject to disgorgement as a result of a transaction where the debtor transferred liens not to the Transeastern Lenders themselves, but to the New Lenders. Judge Jordan and the New Lenders will be on high alert for the Eleventh Circuit’s decision as well.

REASONABLE EQUIVALENCE

Most important for parties structuring credit arrangements, particularly in a distress context, will be the Eleventh Circuit’s findings on what constitutes reasonably equivalent value. The district court and other courts²⁷ have already articulated rationales based on modern lending and cash management practices whereby liens, obligations, and cash circulate in an enterprise, and the benefits that flow from a transaction for each legal entity cannot always be isolated from the functioning of the system as a whole. The district court was satisfied that indirect economic benefits for the Conveying Subsidiaries as a result of the July 31 transaction were sufficient to establish reasonably equivalent

value, holding that “the record establishes beyond dispute that the Conveying Subsidiaries themselves, as compared to only the TOUSA Parent, received indirect economic benefits.”²⁸

Because of these indirect benefits, the district court found it unnecessary to consider, in the alternative, the “identity of interest” doctrine, which provides that, where “a corporate group has purposely availed itself of the benefits of an enterprise, it may be appropriate to treat the enterprise as a single borrowing unit.”²⁹ It did however, hold that the bankruptcy court erred in failing to consider whether an “identity of interest existed sufficient to establish reasonably equivalent value.”³⁰ Thus the “identity of interest doctrine,” while not applied by either of the lower courts, provides the Eleventh Circuit with an alternative basis for affirming or denying the district court’s reasonably equivalent value findings.³¹

SOLVENCY

If the Eleventh Circuit does make an “identity of interest” finding, this could impact the solvency prong of fraudulent conveyance analysis as well. If the Eleventh Circuit addresses the insolvency issue, it will have to consider whether to assess the solvency of each Conveying Subsidiary as a separate entity, like the bankruptcy court, or to examine solvency on a “common enterprise” basis. If the Eleventh Circuit explicitly rejects the “identity of interest” doctrine, it would likely also reject the “common enterprise” approach to solvency analysis. As a result, instead of considering solvency on an enterprise basis, as is customary in modern lending practices, lenders would need to consider the solvency of each entity within the larger corporate group before agreeing to provide financing, placing much more of a burden on lenders.

The concept of considering indirect benefits to, and the solvency of, the enterprise as a whole is a more flexible concept and lenders may view this as a preferable approach. Lenders would argue that parties should be able to structure transactions in good faith to accomplish a range of benefits, direct and indirect, tangible and intangible, that courts and commentators are not in a position to identify in advance. Any legal test that requires

²⁴ *Id.* at 672 (emphasis in original).

²⁵ *Id.* at 675.

²⁶ *Id.* at 639.

²⁷ *In re Renaissance Hosp.*, 2011 WL 5240265 (Bankr. N.D. Tex. Nov. 1, 2011) (finding reasonably equivalent value was provided by transferee who provided services to an entity with operations that generated funds benefiting the transferor of the allegedly fraudulent transfer).

²⁸ TOUSA, 444 B.R. at 654.

²⁹ *Id.* at n. 43.

³⁰ *Id.* at 653.

³¹ *Id.* at n. 43.

more than conveying some benefit to the enterprise as a whole, roughly commensurate with the value conveyed, may limit the possibilities for parties trying to find creative transactional solutions to rescue a distressed company from the brink of failure. Indeed, lenders may decide that trying to assess with any degree of accuracy how a bankruptcy court would value each particular legal entity may be too risky, difficult, and burdensome to be worth the effort to provide financing to a distressed company. Companies in distress, and their stakeholders, could suffer as a result.

DISGORGEMENT LIABILITY

Also important for lenders to distressed borrowers is the Creditors' Committee's appeal of the district court's alternative holding that the Conveying Subsidiaries could not recover funds from the Transeastern Lenders under section 550 of the Bankruptcy Code.

The district court commented that sustaining the bankruptcy court's finding that the Transeastern Lenders were entities "for whose benefit" the Conveying Subsidiaries transferred liens would have a "profoundly chilling effect on acceptance of payment by lenders of valid antecedent debts."³² Given the bankruptcy court's emphasis on viewing the relevant transfers as one integrated transaction, one might also expect parties to attempt to break up refinancing transactions into steps so that the incurrence of new liens is not linked to the payment of old debts. It remains to be seen, however, whether any new transactional forms will persuade courts that later-questioned debt pay-downs are truly unrelated to transfers supporting the incurrence of new debt.

If the Eleventh Circuit considers the district court's alternative suggestion that the Transeastern Lenders could be considered "subsequent" transferees under section 550, it will have to consider whether the Transeastern Lenders are protected from liability as good faith purchasers. The bankruptcy court found that the Transeastern Lenders "acted in bad faith and were grossly negligent because they knew or should have known on the basis of publicly available information that TOUSA and the Conveying Subsidiaries were insolvent on July 31, 2007, or were precariously close to insolvency."³³ The district court warned that this view would "place an impossible burden on holders

of antecedent debt that would undermine their ability to settle valid debts . . . and . . . would encourage the proliferation of wasteful debt-resolution litigation."³⁴

TOUSA CONCLUSION

The Eleventh Circuit's holding will be important to defining the scope of liability for parties engaging in complex, multi-lateral transactions, particularly refinancing transactions for distressed entities. Whether the Eleventh Circuit focuses on if the July 31 transaction, essentially a refinancing transaction, consisted of multiple, separate transactions, or instead focuses on whether a holder of antecedent debt has an obligation to consider the financial condition of a borrower before it accepts repayment, its ruling will surely influence how lenders approach refinancing transactions with distressed borrowers. Ultimately, if the Eleventh Circuit departs from the district court's refusal to hold the Transeastern Lenders liable, it risks increasing unpredictability in the distressed lending world and discouraging rescue financing. Lenders that provide financing for distressed companies or enter into settlements with distressed companies need a clear understanding of the risks they are agreeing to take on. If the Eleventh Circuit makes it harder for such lenders to assess fraudulent transfer liability risk, sources of rescue financing and opportunities to enter into advantageous settlements outside of chapter 11 may dry up, leaving distressed companies with no one to save them from failure.

FINANCIAL INSTITUTIONS FEELING SAFE UNDER SECTION 546(E), THANKS TO ENRON

In a gift to secured creditors, the year brought several decisions in the Second Circuit expanding the scope of the safe harbor for "settlement payments" under section 546(e) of the Bankruptcy Code. Section 546(e) provides a safe harbor from avoidance for any transfer that is otherwise preferential or constructively fraudulent (but not actually fraudulent) under the Bankruptcy Code, if it is a "settlement payment" made by or to (or for the benefit of) a stockbroker, "financial institution," financial participant, or securities clearing agency.³⁵ Section 741(a) of the Bankruptcy Code defines "settlement payments" in a circular manner to include partial, interim, and final settlement payments, settlement payments on accounts, and "any other similar payment commonly used in the securities trade."³⁶

³² *Id.* at 677.

³³ *Id.* at 671, 675.

³⁴ *Id.* at 677-78.

³⁵ 11 U.S.C. § 546(e).

³⁶ 11 U.S.C. § 741(a)(8).

Avoidance powers in bankruptcy allow a debtor (or trustee) to claw back certain payments made prior to the bankruptcy case that, among other things, enabled a creditor to receive more than other creditors (generally preference claims under section 547 of the Bankruptcy Code) or were made while the debtor was insolvent and were not made for reasonably equivalent value (generally constructively fraudulent transfer claims under section 544 or 548 of the Bankruptcy Code). These powers are designed to prevent a race to the court house while a company is teetering, maximize the value of the estate, and ensure the fair treatment of similarly situated creditors. Each of these “avoidance powers” is subject to certain conditions and exceptions, as well as certain safe harbors.

After the enactment of section 546(e) in 1982, many believed that, consistent with its legislative history, it was a narrow safe harbor designed to protect the clearing and settlement system, in which clearing agencies, brokers, and other intermediaries guarantee the completion of both sides of securities transactions. The reasoning behind section 546(e) was that if these financial intermediaries were subject to liability for their role in clearing transactions, the result might be market destabilization and systemic risk. It turned out, however, that while the legislative history of the safe harbor suggested a narrow purpose of protecting against a particular risk, the language Congress used in drafting the safe harbor was quite broad.

First, some courts began applying section 546(e) to avoidance actions involving payments to shareholders in small, private LBOs that clearly did not pose a systemic risk to the market.³⁷ Other courts disagreed, finding the language of section 546(e) ambiguous and, therefore, they looked to legislative history.³⁸ Then, in a series of decisions, courts broadened the definition of 546(e) to encompass large payoffs of debt even in the absence of a clearing agency that took title to the payments. The courts pointed to the broad language of the statute that protects any payment made to a financial institution settling a transaction involving securities. Given that the Bankruptcy Code defines securities more broadly than the securities laws, to include, for example a “note” or “bond” or “stock” (but not “debt or evidence of indebtedness for

goods sold and delivered or services rendered”),³⁹ then it follows, these courts hold, that any payment by a debtor to any financial institution (whether it is an intermediary or not) to complete a transaction for a note or stock is protected by section 546(e).

THE ENRON DECISION

In the most notable of these decisions, the Second Circuit issued a divided 2-1 opinion in *Enron* in June of 2011 that adopted a broad reading of section 546(e). In the months before it filed for chapter 11 in December 2001, under pressure from noteholders as its financial condition was deteriorating, *Enron* agreed to pay out more than \$1.1 billion to retire certain of its commercial paper prior to maturity at considerably higher than the paper’s market price at the time.⁴⁰ Although the Depository Clearing Agency tracked ownership of *Enron*’s commercial paper and was involved in the transaction, it did not, and neither did any other financial intermediary, take title to the securities in the course of the transaction.

In November 2003, *Enron* brought adversary proceedings against approximately two hundred financial institutions, including Alfa, S.A.B. de C.V. (“Alfa”) and ING VP Balanced Portfolio, Inc. and ING VP Bond Portfolio, Inc. (together, “ING”), seeking to avoid and recover the redemption payments as preferences and constructively fraudulent transfers.⁴¹ Alfa and ING moved to dismiss, arguing that the redemption payments were protected from avoidance as “settlement payments” pursuant to section 546(e)’s safe harbor.⁴²

The Bankruptcy Court for the Southern District of New York denied Alfa and ING’s motion to dismiss and subsequent summary judgment motion, holding that the redemption payments were not “settlement payments” within the meaning of section 546(e)’s safe harbor. The district court reversed, and *Enron* appealed.

The Second Circuit ultimately held that *Enron*’s redemption payments fell within the plain language of the section and were thus protected from avoidance under section 546(e).⁴³ The court noted that the parties agreed that the definition of settlement

³⁷ *Brandt v. B.A. Capital Co. LP (In re Plassein Int’l Corp.)*, 590 F.3d 252, 257-59 (3d Cir. 2009); *QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545, 549-50 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 985-86 (8th Cir. 2009).

³⁸ *Geltzer v. Mooney (In re MacMenamin’s Grill Ltd.)*, 450 B.R. 414, 418-26 (Bankr. S.D.N.Y. 2011).

³⁹ 11 U.S.C. § 101(49).

⁴⁰ *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, 651 F.3d 329, 331 (2d Cir. 2011).

⁴¹ *Id.* at 332.

⁴² *Id.*

⁴³ *Id.* at 335.

payment should be interpreted “in the context of the securities industry” to mean “the transfer of cash or securities made to complete [a] securities transaction.”⁴⁴ According to the Second Circuit’s opinion, any payment made to complete a transaction involving securities is a settlement payment, and the Second Circuit rejected each of the three limitations *Enron* (and the bankruptcy court) applied to the definition of “settlement payment,” each of which would arguably have excluded the redemption payments at issue in the case.

First, the Second Circuit rejected *Enron*’s argument that payments, such as the early redemption of its commercial paper, that are not “commonly used in the securities industry” fall outside of section 741(8)’s definition of “settlement payment,” and thus outside of the scope of the safe harbor. The Second Circuit held that the phrase “commonly used in the securities industry” is not a limitation, but rather “a catchall phrase intended to underscore the *breadth* of the § 546(e) exemption.”⁴⁵ As long as a payment constitutes “the transfer of cash or securities . . . to complete [a] securities transaction,” it does not have to be a payment “commonly used in the securities trade.”⁴⁶

Second, the court disagreed with *Enron*’s contention that the redemption payments were not “settlement payments” because they involved the retirement of debt rather than the purchase of a security. The Second Circuit found no basis in bankruptcy or securities law for the requirement that title to securities must change hands in the context of a settlement payment.

Finally, the Second Circuit found unpersuasive *Enron*’s argument that the redemption payments were not “settlement payments” within the meaning of the safe harbor because they “did not involve a financial intermediary that took a beneficial interest in the securities during the course of the transaction,” and thus “did not implicate the systemic risks that motivated Congress’s enactment of the safe harbor.”⁴⁷ The court held that resort to legislative history was not permissible in light of the plain language of the statute.⁴⁸ In any case, the Second Circuit saw “no reason to think undoing *Enron*’s redemption payments,

which involved over a billion dollars and approximately two hundred noteholders, would not also have a substantial and similarly negative effect on the financial markets.”⁴⁹

The majority’s decision was accompanied by a harshly worded dissent by Judge Koeltel, sitting by designation. He saw the decision as inconsistent with legislative history, dangerous, and not required by the “opaque” definition of “settlement payment.” The dissent argued that, as it is commonly understood in the securities industry, a settlement payment necessarily involves the purchase or sale of a security and does not encompass the redemption of commercial paper. The dissent warned that, notwithstanding the majority’s claims to the contrary, its holding would necessarily apply to standard bank loans and therefore “imperil[s] decades of cases that allow the avoidance of debt-related payments.”⁵⁰

THE QUEBECOR DECISION

Just one month after *Enron*, Judge James M. Peck, a bankruptcy judge in the Southern District of New York, issued a decision in the *Quebecor World (USA) Inc.* bankruptcy case that simultaneously applied and criticized the Second Circuit’s broad interpretation of “settlement payments.” Several months before *Quebecor* filed for chapter 11, in response to demands from holders of unsecured notes it had issued through a private placement in July 2000, and in a last ditch effort to avoid bankruptcy, the company agreed to redeem/repurchase the notes by wiring approximately \$376 million to the noteholders’ trustee, which included the payment of a \$53 million make-whole payment.⁵¹

Understandably, the creditors’ committee commenced an adversary proceeding seeking to avoid and recover the payment as a preferential transfer. Judge Peck sympathized with the committee’s efforts to restore the \$376 million to the estate given that the creditors represented by the committee were “relegated to percentage distributions from *Quebecor* . . . amounting to only a fraction of their allowed claims while the Noteholders have reaped the benefits of unimpaired total return.”⁵² This situation was seemingly a prototypical example of the type of unfair behavior that the preference laws were intended to remedy.⁵³

⁴⁴ *Id.* at 334 quoting *Contemporary Indus.*, 564 F.3d at 985.

⁴⁵ *Enron*, 651 F.3d at 336 (quoting *QSI Holdings, Inc.*, 571 F.3d at 550 (8th Cir. 2009) (emphasis in original)).

⁴⁶ *Enron*, 651 F.3d at 334.

⁴⁷ *Id.* at 338.

⁴⁸ *Id.* at 339.

⁴⁹ *Id.*

⁵⁰ *Id.* at 347.

⁵¹ *Official Comm. of Unsecured Creditors of Quebecor World (USA) Inc. v. Am. United Life Ins. Co. (In re Quebecor World (USA) Inc.)*, 453 B.R. 201, 206, 209 (2011).

⁵² *Id.* at 205.

⁵³ See *Id.* (“Thus, the situation presented here is an example of behavior that the law generally would seek to discourage (ganging up on a vulnerable borrower to obtain clearly preferential treatment in the months leading up to a bankruptcy) . . .”).

⁵⁴ *Id.* at 203.

The noteholders filed a motion for summary judgment arguing that the payment was exempt from avoidance as a “settlement payment” within the meaning of section 546(e)’s safe harbor.⁵⁴ Judge Peck granted the motion, noting that “the direction given by the *Enron* majority with respect to [the definition of ‘settlement payment’] is both uncomplicated and crystal clear – a settlement payment, quite simply, is a transfer of cash made to complete a securities transaction.”⁵⁵ Under this “easy-to-apply” definition, Judge Peck held that the \$376 million redemption transaction clearly qualified as a “settlement payment” within the scope of section 546(e)’s safe harbor.⁵⁶ This was so not withstanding that in *Quebecor*, unlike in *Enron*, there was no formal settlement process involved in the payment; rather, the transfers were unilateral payments by the debtor to the noteholders in exchange for the return of the noteholders’ securities sometime in the future.

Although *Enron* made Judge Peck’s decision easier, he was seemingly critical of the *Enron* decision. He noted that the Second Circuit’s overly broad interpretation of “settlement payment” could reach “relatively small private transactions having no foreseeable impact on the securities market,” and which “Congress never intended to immunize.”⁵⁷ Judge Peck noted that “Congress enacted section 546(e) . . . to prevent the ripple effect created by the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected industry.”⁵⁸ Although the large transactions at issue in both *Enron* and *Quebecor* may have been sufficiently “systemically significant” to be consistent with the legislative intent behind section 546(e)’s safe harbor, Judge Peck noted that “not all transfers that fit the *Enron* definition of a settlement payment involve this much money or a business enterprise of such obvious importance in its relevant market.”⁵⁹ Because *Enron* defined settlement payment broadly without regard to the size, systemic importance, or public nature of the transaction, Judge Peck warned that “the impact of the decision on avoidance actions may be quite far reaching.”⁶⁰

THE MADOFF CASES

It remains to be seen whether *Enron* will have the far-reaching impact Judge Peck warned of in *Quebecor* or imperil the avoidance of repayments of standard loans as Judge Koeltel warned in his *Enron* dissent. The litigations surrounding the unraveling of the Madoff ponzi scheme may, in the near future, provide the Second Circuit with the opportunity to shed further light on the scope of section 546(e)’s safe harbor post-*Enron*. In *Picard v. Katz*, Judge Jed S. Rakoff of the United States District Court for the Southern District of New York considered whether section 546(e)’s safe harbor prohibited the trustee of the estate of Bernard L. Madoff Investment Securities LLC from recovering over a billion dollars paid to Madoff Securities’ customers as constructively fraudulent transfers or preferences.⁶¹ Without providing extensive analysis, the district court held that section 741(8)’s definition of “settlement payment” and section 546(e)’s safe harbor clearly encompass all payments made by Madoff Securities to its customers.⁶² The court disagreed with the argument that using section 546(e) to protect transfers that were made in the context of a fraudulent ponzi scheme could not be consistent with the statute’s purpose. Citing *Enron*, Judge Rakoff stated that it was inappropriate to resort to legislative history when the language of the statute is clear.⁶³ This decision did not address Judge Peck’s concern that the *Enron* definition would, contrary to Congressional intent, apply to smaller, inconsequential private transactions, as the Madoff Securities ponzi scheme, which involved approximately \$68 billion and 4,900 customers,” was clearly systemically significant.⁶⁴

Interestingly, Judge Rakoff’s decision directly contradicts other Madoff decisions addressing the same issue. In two decisions, one preceding *Enron* and one following it, Judge Burton Lifland, a bankruptcy judge in the Southern District of New York, held that section 546(e)’s safe harbor did not provide a basis for dismissing constructive fraudulent transfer claims against an investor with Madoff Securities⁶⁵ or Madoff’s sons, who were both customers and senior employees of Madoff Securities.⁶⁶ In both

⁵⁴ *Id.* 215 (internal citations omitted).

⁵⁵ *Id.*

⁵⁷ *Id.* at 217.

⁵⁸ *Id.* at 216 quoting *Official Comm. of Unsecured Creditors v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68, 76 (Bankr. E.D.N.Y. 2007); see also *MacMenamin’s Grill*, 450 B.R. at 426-25 (noting that the legislative history demonstrates that Congress intended to shield from avoidance transfers that involve “an entity in its capacity as a participant in the securities market” or that “pose any danger to the functioning of the securities markets.”).

⁵⁹ *Id.* at 217.

⁶⁰ *Quebecor*, 435 B.R. at 214.

⁶¹ *Picard v. Katz*, 2011 WL 4448638 (S.D.N.Y. 2011).

⁶² *Id.* at *5.

⁶³ *Id.* at *3.

⁶⁴ *Id.*

⁶⁵ *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec LLC)*, 440 B.R. 243 (Bankr. S.D.N.Y. 2010).

⁶⁶ *Picard v. Madoff (In re Bernard L. Madoff Inv. Sec LLC)*, 458 B.R. 87 (Bankr. S.D.N.Y. 2011).

decisions, Judge Lifland noted that the defendants' 546(e) safe harbor arguments were premature at best because they did not, on their face, prohibit the trustee from meeting the relatively low burden of making out an initial, or *prima facie*, case of constructive fraud.⁶⁷ Nevertheless, Judge Lifland went on to outline several reasons section 546(e) did not apply to the transactions at issue, as a matter of law, including that it was doubtful that the payments from Madoff Securities to Madoff's sons were "settlement payments" given that Madoff "never in fact purchased any of the securities he claimed to have purchased for customer accounts."⁶⁸ Notwithstanding *Enron's* broad definition of settlement payments, "it suggest[s] that 'settlement payments' must be made in relation to an actual securities transaction."⁶⁹ Finally, contrary to Judge Rakoff's opinion, Judge Lifland found that the application of section 546(e) in the context of a fraudulent ponzi scheme was "contrary to the purpose of the safe harbor provision." The United States District Court for the Southern District of New York agreed with Judge Lifland's refusal to dismiss the claims against the *Merkin* defendants based on section 546(e)'s safe harbor.⁷⁰ Investors should keep watch for how the Second Circuit resolves these conflicting interpretations of section 546(e)'s safe harbor in the context of the Madoff ponzi scheme litigations.

SECTION 546(E) SAFE HARBOR CONCLUSION

Post-*Enron*, application of the section 546(e) safe harbor, at least in the Second Circuit, became a lot more straightforward. No longer do courts have to hear conflicting evidence over whether something is a "redemption" or "purchase," what "settlement payment" means in the context of the securities industry, or the effect of a particular transaction on the securities market. Courts will likely now apply a much simpler test – was the payment made to or for the benefit of a financial institution on account of a note, a bond, stock, or another security? This means those financial institutions that beat down the doors of a failing company, and are successful in getting paid before a filing, are able to win the proverbial race to the courthouse without risk of preference exposure. Given the stakes, will this mean more lenders demanding payments from a company in distress, thereby causing a further deterioration in the company's financial condition?

How broad is *Enron*? Probably very. Applied literally, the expansive definition of settlement payment could be applied to encompass any payment on any non-trade debt owed to any financial institution or paid through any financial institutions. The majority stated that its decision does not cover payments on ordinary loans as the definition of settlement payment must be considered "in the context of the securities industry," but as the dissent notes, the majority's decision does not offer a basis for distinguishing such loans, as all notes are securities under the Bankruptcy Code. It is likely that this issue will be tested sometime soon.

How do these decisions impact lenders? For those that are financial institutions (or use financial institutions to broker their transactions) and get paid out prior to the petition date on their securities in situations that might otherwise be viewed as a fraudulent transfers or preference payments, these decisions are welcome news. Where such lenders may have received pennies on the dollar if their payments had been clawed back, they now get to keep their payments in full while others may be left sharing peanuts. Good news, right? Maybe not. Those same lenders might in other cases be on the other side of the fence. Perhaps they were not paid out prior to the petition date but other similarly situated creditors (or even junior creditors) were. In those cases, the lenders' recoveries would be negatively impacted by the inability of the estate to claw back the recoveries received by the other financial institutions. *Enron* is a good example. While Alfa and ING were beneficiaries of the broad safe harbor, bondholders and banks that were left with claims when the music stopped were victims of the same statute.

One thing that lenders can smile about is that, as a whole, they will come out ahead in the 546(e) battle; although they may find themselves on either side of the fence, depending on the particular situation, trade creditors will always be on the wrong side. Trade claims are specifically excluded from the definition of security, so trade creditors will always be losers when someone gets to benefit from section 546(e).

DBSD: NO GIFTING, JUST SECOND GUESSING

2011 began with a blow to secured creditors when the Court of Appeals for the Second Circuit in the *DBSD* case⁷¹ issued an

⁶⁷ *Merkin*, 440 B.R. 243 at 266; *Madoff*, 458 B.R. at 115.

⁶⁸ *Merkin*, 440 B.R. 243 at 267; *Madoff*, 458 B.R. at 116.

⁶⁹ *Madoff*, 458 B.R. at 116 (emphasis added).

⁷⁰ *Picard v. Merkin (In re Bernard L. Madoff Inv. Sec LLC)*, 2011 WL 3897970, at *12 (S.D.N.Y. Aug. 31, 2011).

⁷¹ *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011).

unexpected opinion that severely restricts the longstanding “gifting” doctrine. Interestingly, distressed investors and restructuring professionals had closely watched the appeals in the *DSBD* case because of a different issue – the bankruptcy court’s designation of the votes of first lien creditors in the case. Little attention was paid to the “gifting” issue, because most people sophisticated in restructuring believed the Second Circuit would agree with the two lower courts in the case and uphold the conventional wisdom that a secured creditor is free to do what it wants with its bankruptcy proceeds, including gift them to equity. Eyes popped all over the restructuring community, therefore, when the Second Circuit held that the *DSBD* plan violated the absolute priority rule by allowing old equity to receive shares and warrants when an intermediate unsecured creditor class rejected the plan. The Second Circuit’s strict view of the absolute priority rule will have a lasting effect on how courts in the Second Circuit, and likely elsewhere, construe the absolute priority rule, and on how debtors and senior creditors strategize to secure the support of junior creditors and equity.⁷²

BACKGROUND: GIFTING AND THE ABSOLUTE PRIORITY RULE

Under the absolute priority rule, embodied in section 1129(b) of the Bankruptcy Code, to confirm a plan when an impaired class of unsecured creditors has voted to reject it, equity holders may not receive or retain “any property” under the plan “on account of such [equity] interest.” Under the gifting doctrine, a creditor agrees to forego a portion of the distribution to which it is otherwise entitled and allows that distribution to go to a junior class. Until recently, most courts had held that such a distribution (essentially a gift from one or more creditors to another party in the case) did not violate the absolute priority rule or the prohibition against unfair discrimination against a class that does not accept the plan. Some recent cases held that distributions by an unsecured class to another class are not protected by the gifting doctrine (most notably the Third Circuit in *Armstrong*),⁷³ but until *DBSD*, it seemed fairly well-established that a secured creditor could “do whatever it wanted” with its plan distribution, including agree that old equity can get a piece of the recovery.

The justification was that the amounts distributed to the junior classes belonged to the secured creditor, and the intermediate class had no entitlement to those amounts in the absence of the gift. “No one is hurt by the gift” was the refrain.

THE SECOND CIRCUIT’S HOLDING

In *DBSD*, a class of unsecured creditors, which was getting only a small recovery, rejected the *DBSD* plan. The bankruptcy court nevertheless confirmed the plan, and its distributions to equity, under the gifting doctrine. After a contested valuation hearing, the bankruptcy court determined that the value of the company was less than the value of the secured debt. As a result, the secured creditors were entitled to all of the value of the company, and there was insufficient value to provide a recovery to unsecured creditors. The distribution to equity, therefore, was a proper gift from the secured creditors out of their plan recovery and did not violate the absolute priority rule. The bankruptcy court held that gifting is permitted “at least where . . . the gift comes from secured creditors . . . where there are understandable reasons for the gift, where there are no ulterior, improper ends . . . and where the *complaining creditor would get no more if the gift had not been made.*”⁷⁴ Sprint Nextel Corporation, a creditor with an unsecured, unliquidated claim, appealed the decision, and the district court affirmed it.

The Second Circuit, however, disagreed with the notion that secured creditors could direct the application of their forgone distributions, and reversed on the ground that the gift violated the absolute priority rule. The Second Circuit’s opinion was based on two foundations: statutory construction and policy. First, it read the language of the absolute priority rule strictly and applied precedent from the *North LaSalle* case,⁷⁵ in which the United States Supreme Court found that where equity receives an interest “because of” its prior interest, its distribution is “on account of” that interest and is subject to the strictures of the absolute priority rule. Like the *North LaSalle* Court, the Second Circuit found no exception where there are good reasons to offer a distribution to equity, and it held that where

⁷² The *DBSD* decision is important for another issue as well—designation of votes under section 1126(e) of the Bankruptcy Code (essentially a disregard of the vote) of a party “whose acceptance or rejection of [the] plan was not in good faith.” In *DBSD*, the bankruptcy court designated the votes of a creditor, DISH Network Corporation, that purchased its debt to facilitate a strategic transaction with the debtor. After the debtor proposed a plan under which first-lien debt would be satisfied with a modified promissory note, DISH bought all of the debt in that class at par and voted its claims to reject the plan. The debtor sought the designation of DISH’s votes, and the bankruptcy court granted the request because of DISH’s strategic motives. Moreover, because there were no voting members of the first-lien debt class after the designation, the court deemed the class to accept. Therefore, the plan did not have to meet the cram-down standard with respect to the first-lien debt class. *In re DBSD North America, Inc. et al.*, 421 B.R. 133 (Bankr. S.D.N.Y. 2009); *In re DBSD North America, Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009). On appeal, the Second Circuit affirmed both holdings, finding that “DISH purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring *DBSD*’s spectrum rights . . .” *DBSD*, 634 F.3d at 104-06. This decision is also important to secured creditors, as prior to *DBSD*, designation did not appear to be as a likely consequence to aggressive actions.

⁷³ *In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005).

⁷⁴ *DBSD*, 634 F.3d at 87 (emphasis added).

⁷⁵ *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434 (1999).

the distribution is at least “partly” because of the recipient’s prior equity interest, as it was in *DBSD*, the distribution must satisfy the absolute priority rule.

Second, in a sharp rebuke of the gifting doctrine, the Second Circuit used history and precedent to find that the purpose of the absolute priority rule is precisely to prevent gifting-type arrangements, which may allow senior creditors and equity holders to cooperate to squeeze out intermediate interests. The Court pointed to the 1868 *Howard* case, where the Supreme Court rejected an argument similar to those made by gifting proponents to put a stop to mischief it believed was being perpetuated in numerous railroad equity receiverships. In *Howard*, stockholders and secured creditors of a railroad agreed to a foreclosure on the railroad, coupled with a transfer of the railroad’s assets to a new entity in which the old stockholders would share in the equity. Junior creditors would receive nothing. The Supreme Court held that secured creditors “may exact the whole amount of the [debt] . . . or they may, if they see fit, accept a percentage as a compromise in full discharge of their respective claims, but whenever their lien is legally discharged, the property embraced in the mortgage, or whatever remains of it, belongs to the corporation.”⁷⁶ In other words, if secured creditors decline to take all the property to which they are entitled in a strict waterfall, they cannot direct the distribution of property remaining with the debtor. Later cases followed this reasoning until the Supreme Court articulated the concept now codified in the absolute priority rule, “with the aim,” the Second Circuit stated, “of stopping the very sort of transaction” proposed by *DBSD*. Viewed from this perspective, the absolute priority rule is meant to prevent cooperation between junior and senior interests at the expense of creditors in the middle.

EFFECT OF *DBSD*

How does the decision affect parties structuring plans in chapter 11 cases in the Second Circuit? The Second Circuit’s view of *DBSD* removes one useful tool of secured creditors in constructing a plan that will gain the support of junior interest holders. The Second Circuit acknowledged that the compromise inherent in a gifting plan could be beneficial in facilitating consensual chapter 11 plans and that a strict application of absolute priority rule gives hold-up value to intermediate creditors that may be entitled to nothing under a strict waterfall. Yet, it concluded that these concerns were outweighed by the good policy behind a strict application of the absolute priority rule. After *DBSD*, if a

secured creditor wishes to provide a “tip” to a junior class, it will have to consider whether any intermediate classes will oppose the plan, and possibly provide additional value to those classes to achieve their support for the plan as well. In that way, *DBSD* increases the leverage of intermediate, out-of-the-money creditors in situations where cooperation of junior interest holders is needed, as it may be in many pre-arranged cases.

The result is that a consensual restructuring is now more difficult in scenarios where equity’s cooperation is valuable, such as where avoiding changes of control preserves contractual rights or tax advantages, where equity has valuable expertise necessary to maintain the value of the business, or where cooperation of equity enables a quicker restructuring before a company’s distress becomes acute. Where equity knows it can provide value, it will capitalize on its position, and the cost of tipping will simply increase if it is necessary to satisfy an intermediate class as well.

In the view of the Second Circuit, however, a regime where gifting is permitted provides junior interest holders leverage to extract improper recoveries, whereas a strict application of the absolute priority rule helps prevent equity from using its control of the company to enrich itself “at the expense of creditors.”⁷⁷ By prohibiting distributions to out-of-the-money equity when impaired classes of creditors do not support a plan, *DBSD* makes it more difficult for equity to hold out for a tip and aligns the interests of equity more closely with those of intermediate creditor classes. Without gifting, both have an incentive to argue that the value of the company is higher than what the secured creditor is advocating, while the secured creditor has the incentive to argue for a lower valuation so that it can take 100% of the value of the company for itself.

ALTERNATIVES TO GIFTING

In light of *DBSD*’s clear prohibition on traditional gifting, creative restructuring professionals have been scratching their heads to come up with alternatives. The most commonly discussed is the one that *DBSD* expressly left undecided: whether the Bankruptcy Code prohibits gifts from senior creditors to junior creditors or interest holders outside of a plan. In other words, can secured creditors and old equity sign a side agreement that provides that the secured creditors will transfer a portion of their recovery to old equity after the plan is confirmed and goes effective? Such transfers raise a host of issues, however, including questions about what kinds of arrangements

⁷⁶ *Chi., Rock Island & Pac. R.R. v. Howard*, 74 U.S. 392 (1868).

⁷⁷ *DBSD*, 634 F.3d at 100.

would have to be disclosed and whether they would be enforceable. Furthermore, even if these issues are favorably resolved, if there are many dispersed stakeholders, the practical obstacles of effecting such an agreement outside of a plan may be immense. In particular, if the debt or equity is widely held, it may be difficult to coordinate a gifting agreement and opportunities for hold-outs create additional challenges. For this reason, and because parties may be unwilling to gamble on whether they can avoid the *DBSD* result through gifting outside of a plan, this option may not be tested in court for some time.

Another option restructuring professionals are considering is whether secured creditors and old equity can agree to accomplish the restructuring through a sale of the debtor's assets under section 363 of the Bankruptcy Code instead of through a plan of reorganization. Under this scenario, secured creditors would agree to credit bid for the assets and agree to give a portion of the assets they purchase to equity. There is a line of cases (most recently in the context of the automotive bankruptcies) that suggest that a purchaser of assets is free to do as it wishes with the assets it purchases notwithstanding the absolute priority rule.⁷⁸ This alternative presents uncertainties and practical difficulties similar to those in the side agreement option. In addition, the secured creditor is subject to being outbid at the section 363 auction, and thus cannot be certain that it will end up with the company in exchange for its claim.

Other possibilities include enabling recoveries to equity in the context of a consensual foreclosure on the assets of the company, getting relief from the automatic stay, or filing a chapter 7 case. While none of these options is as clean as gifting, they do not, on their face, run afoul of the *DBSD* holding. One cannot be certain, however, whether a court with *DBSD* on its mind would sanction something it views as seeking to circumvent the *DBSD* holding.

Furthermore, *DBSD* is only binding in the Second Circuit. While the Third Circuit in *Armstrong* held that gifting by unsecured creditors may violate the absolute priority rule, it suggested that gifting by a secured creditor might be permissible.

No other court of appeals has held that gifting may run afoul of the Bankruptcy Code. Debtors and secured creditors may press their luck on a gifting plan by filing in a jurisdiction outside of the Second Circuit.

DBSD CONCLUSION

Was the Second Circuit correct in its *DBSD* holding? Some would say it stifles creative restructuring and rewards hold up behavior. One of the authors of this article made those same arguments after the Third Circuit's *Armstrong* holding.⁷⁹ However, others may look to the results of the *DBSD* bankruptcy case as proof that the Second Circuit had it right. With their plan unable to be confirmed, the debtors in *DBSD* ended up proposing a sale under section 363 of the Bankruptcy Code. The secured creditors were outbid, with the successful bidder ultimately paying consideration sufficient to provide the unsecured creditors with a full recovery on their claims, as well as provide a recovery to equity holders.⁸⁰ Sprint would surely argue that it was proven correct that by not permitting a gifting deal between secured creditors and equity, the debtor is incentivized to try to maximize value in a way that is beneficial for unsecured creditors. Moreover, while bankruptcy courts commonly hear valuation disputes and do their best based on evidence from valuation experts, they are subject to getting it wrong. In *DBSD*, the market demonstrated that the assets were worth much more than the bankruptcy court found them to be worth. Others would say that, in *DBSD*, the bankruptcy court was correct about value given the down market, but that the timing of the asset sale over a year after the bankruptcy court's initial confirmation of the plan is what changed the result.⁸¹

The Second Circuit's *DBSD* opinion is no gift for secured creditors. While gifts skipping intermediate classes are not an everyday occurrence in reorganization plans, they are one tool secured creditors have historically used to facilitate consensual plans and preserve value. Without this tool, secured creditors will be exposed to additional leverage of out-of-the-money junior creditors whenever the cooperation of equity is needed. That is, unless they can successfully take advantage of one of the other tools in the creative restructuring toolbox.

⁷⁸ *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009); *In re Gen. Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009); Official, Unsecured Creditors' Comm. v. Stern (*In re SPM Mfg. Corp.*), 984 F.2d 1305 (1st Cir. 1993); but see *Roaming LLC v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 462 (2d Cir. 2007) (noting that SPM was a chapter 7 liquidation, and expressly declining to decide whether SPM could ever apply to chapter 11 settlements).

⁷⁹ Harvey R. Miller & Ronit J. Berkovich, *The Implications of the Third Circuit's Armstrong Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?*, 55 Am. U. L. Rev. 1345 (2006).

⁸⁰ See *Disclosure Statement for the Debtors' Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, In re DBSD N. Am., Inc.*, Case No. 09-13061 (REG) (Bankr. S.D.N.Y. May 23, 2011) [Docket No. 111].

⁸¹ Interestingly, in most cases, Sprint would have been out of luck given that the debtor would have consummated the plan (absent a stay pending appeal, which is not common) mooted the appeal before it was heard). In this case, the only reason Sprint's appeal was not mooted out by consummation was because the plan required regulatory approval from the Federal Communications Commission. This gave Sprint the time necessary to pursue its appeal.

SO ZAIS THE SECURED CREDITOR TO THE CDO: “C U N BANKRUPTCY COURT”

The opinion in *In re Zais Investment Grade Limited VII* initially caused a stir among those in the lending community, as it challenged the longstanding assumption that a special purpose vehicle holding collateralized debt obligations (a “CDO”) could not be a debtor in a bankruptcy.⁸² Upon a closer reading, however, lenders can take comfort in the fact that certain circumstances in *Zais* make it unique. In other situations, a filing by or against a CDO may not be approved.

In *Zais* certain senior noteholders commenced an involuntary chapter 11 case against a distressed CDO that had defaulted on a covenant and been placed into runoff mode, with all income being applied to satisfy the claims of senior noteholders.⁸³ The senior noteholders sought an orderly liquidation of the CDO instead of a runoff of the securities over time because they believed their overall recovery would be higher from an actively managed liquidation than from a slower runoff of the CDO over time. They resorted to an involuntary chapter 11 filing because the indenture would have required the consent of two-thirds of all noteholders to force the liquidation. The junior noteholders, on the other hand, seemed to believe that they would receive a better recovery in a runoff than in an orderly liquidation because the assets might increase in value over time. Therefore, they challenged the propriety of the filing and sought to have the bankruptcy court dismiss the case or abstain from hearing it. The debtor took no position in the dispute.

THE COURT’S HOLDING

In a straight-forward analysis, the United States Bankruptcy Court for the District of New Jersey rejected the junior noteholders’ challenge to the filing. While the decision is a good reminder that “bankruptcy remote” does not mean “bankruptcy proof,” it has limited utility in assessing the likelihood that other structures may be successfully placed into bankruptcy proceedings because of certain facts that may be unique to the *Zais* situation: (i) the debtor itself did not submit an answer challenging the petition, (ii) the junior noteholders (which bought their claims postpetition) did not bring their challenge until after the court had already entered an order for relief (making the involuntary petition effective), and (iii) the court did not have the opportunity to address the enforceability of covenants against

commencing an involuntary bankruptcy case. Had any of these facts been different (or more typical), the results of the case might have been different. Therefore, although *Zais* may have been a wake up call for anyone assuming that CDOs will never file bankruptcy cases, parties are still in much the same world as before, with serious questions about the efficacy of contractual barriers to bankruptcy remaining.

ELIGIBILITY

The court found that the CDO qualified as a debtor under the Bankruptcy Code, even though it was registered in, and therefore “domiciled” in, the Cayman Islands. Section 109(a) of the Bankruptcy Code provides that to be an eligible debtor, an entity must reside in, or have a domicile, place of business or property in the United States. *Zais* owned property in the United States (the collateral securities it used to generate income and which were to be liquidated in the bankruptcy) and its business was conducted primarily in the United States, albeit by various managers and administrators and not by the debtor itself. Both of these factors were sufficient to establish eligibility as a chapter 11 debtor notwithstanding the Cayman Islands business registration, as the court found that *Zais* could be “characterized as a letterbox company” and that the only real function that took place in the Cayman Islands was maintaining *Zais*’s corporate status there.

ABSTENTION

Similarly, the court rejected the junior noteholders’ request that the court abstain from hearing the case. Under section 305(a) of the Bankruptcy Code (entitled “abstention”), a court may dismiss a bankruptcy case (or suspend all proceedings in a case) if “the interests of creditors and the debtor would be better served by such dismissal or suspension.” In refusing to abstain, the court found that there was no alternate forum that could grant relief and “no prospect for an out-of-court work out or a settlement among noteholders that could overcome the super majority voting requirement of the indenture.”⁸⁴ It also determined that liquidation of the securities was a valid chapter 11 purpose, and characterized the noteholders’ objections to the transfer and liquidation of the debtor’s securities as more appropriate to consider in the context of confirmation. Accordingly, it declined to abstain from hearing the case.

⁸² In *Zais*, the debtor was a Cayman Islands corporation and special purpose vehicle that issued secured and unsecured notes and used the proceeds to purchase securities. The *Zais* debtor was a “CDO squared,” meaning that many of the securities it purchased were issued by other CDOs. Those securities were ultimately secured by residential mortgages and other forms of debt obligations. *In re Zais Investment Grade Limited VII*, 455 B.R. 839 (Bankr. D. N.J. 2011).

⁸³ *Id.*

⁸⁴ *Id.* at 847.

DISMISSAL FOR CAUSE

The court also declined to dismiss the case under section 1112 of the Bankruptcy Code, which provides that, upon the request of a party in interest, a bankruptcy court may dismiss a chapter 11 case “for cause.” The court noted that although lack of good faith would be cause to dismiss, it rejected the junior noteholders’ arguments that the senior noteholders had not acted in good faith. The court held that the junior holders’ arguments that they are in-the-money are more properly considered as objections to confirmation based on sections 1129(a)(7) (best interest of creditors) and 1129(b) (cramdown) of the Bankruptcy Code. The court also rejected the argument that filing a bankruptcy to get around the limitations in the indenture was an improper purpose, as the Bankruptcy Code specifically permits the rejection of contracts and the impairment of claims. Similarly, the court rejected the argument that the indenture, which required the runoff, was a subordination agreement that must be enforced under section 510(a) of the Bankruptcy Code. The court noted that section 1129(b)(1) of the Bankruptcy Code explicitly permits confirmation of a plan “notwithstanding” section 510(a). Overall, the court found that the petitioning creditors showed good faith in their desire to realize the greatest present value for their securities.

IF THE FACTS HAD BEEN DIFFERENT**CAN SECURED NOTEHOLDERS IN A CDO FILE AN INVOLUNTARY PETITION?**

As noted, some of the more interesting issues involving the filing of CDOs are the ones the *Zais* court did not consider. For example, the court declined to consider an argument that the creditors that commenced the involuntary case were ineligible to do so because their claims were non-recourse and secured by collateral, while only unsecured creditors may commence an involuntary bankruptcy case. Under section 303(b) of the Bankruptcy Code, creditors petitioning to file an involuntary petition must have non-contingent claims that are not subject to a bona fide dispute, and the claims must aggregate to a threshold amount (currently \$14,425) over “the value of any lien on property of the debtor securing such claims held by the holders of such claims.” If there are less than twelve creditors with qualifying claims, a single creditor may commence the involuntary case; otherwise, three are required. Section 303(d) of the Bankruptcy Code allows the debtor to file an answer to an involuntary petition challenging, among other things, the qualifications of the petitioning creditors. The court rejected the junior noteholders’ challenges to the senior noteholders’

qualifications as petitioning creditors, holding that those types of challenges could only be asserted by the debtor, not by other creditors. Here, the debtor did not file an answer and so the order for relief was entered. Had the debtor opposed the filing, it would have had standing to make a range of arguments opposing entry of the order for relief commencing the involuntary chapter 11 case that were not available to creditors.

On the issue of the qualification of the senior noteholders, it is not clear what the result in *Zais* would have been had the debtor made the challenge. Case law suggests that a secured creditor with recourse (and in the chapter 11 context, also a nonrecourse secured creditor, although there is not much case law on this point) may be able to waive a portion of its claim to qualify as an unsecured petitioning creditor.

IS A CDO IN RUNOFF NOT PAYING ITS DEBTS AS THEY COME DUE?

Even assuming that the petitioning creditors are qualified, in some circumstances a vehicle that is winding down through a runoff may have arguments that the petition should be dismissed. Section 303(h) of the Bankruptcy Code provides that a timely controverted petition “shall” be sustained “only if” the debtor is generally not paying its undisputed debts as they become due, or if a custodian was appointed within 120 days before the petition was filed (subject to certain exceptions). One view is that a CDO in runoff is no longer making debt payments as they become due, and, therefore, the petition should be sustained. One might argue, however, particularly in circumstances where the CDO has been operating in runoff for a long time, or where parties opposing bankruptcy can demonstrate that a runoff is the bargained-for remedy post-default, that creditors have elected runoff as a remedy, and a CDO in a runoff mode is paying debt holders in accordance with the terms of their contract, and is therefore paying its debts as they come due.

ARE PROVISIONS REQUIRING A DEBTOR TO CONTROVERT AN INVOLUNTARY FILING ENFORCEABLE?

If the junior noteholders had protected themselves with a provision in the governing documents for the CDO that required the debtor (or its manager) to controvert timely any involuntary filing, would they have been able to enforce the provision and force the debtor to oppose the filing? This was not tested in the *Zais* case. Some argue that covenants against filing a bankruptcy case should be void as against public policy when they are made by the debtor, or parties controlling a debtor, because a

bankruptcy case may be the best way to satisfy fiduciary duties to creditors as a whole.⁸⁵ Under this critique, enforcing such a promise is tantamount to allowing a debtor to contract to act, in some circumstances, contrary to its fiduciary duties. This concern is most salient for large enterprises with many types of creditors, including employees and trade creditors, but may be less persuasive when applied to bankruptcy-remote investment vehicles, where the universe of creditors is presumably small, sophisticated, and understands the risks associated with covenants against commencing a bankruptcy case. In *Zais*, just as the court did not view using bankruptcy to liquidate securities in violation of the indenture as improper, it may have similarly found that any agreements by the debtor to refrain from filing a bankruptcy case, or to contest an involuntary filing, were unenforceable against the debtor once the filing occurred.

The *Zais* court's analysis does not tell us anything, however, about how the court might view covenants not to file a bankruptcy, or to resist a petition, by a party controlling or managing the debtor. Such an agreement would not be an obligation of the debtor itself, and so the *Zais* court's comments on the ability to reject obligations post-filing would not apply. Moreover, courts have been more willing to accept anti-bankruptcy covenants made by entities other than the debtor.⁸⁶

ARE PROVISIONS PREVENTING CREDITORS IN CDOs FROM FILING INVOLUNTARY PETITIONS ENFORCEABLE?

It is less clear how courts would view covenants made by creditors against commencing an involuntary case. The court found that *Zais*' governing documents prevented junior noteholders from commencing a case until after senior noteholders are paid in full, but contained no such limitation on commencing a case for senior noteholders. One possible explanation is that the parties did not bother restraining the senior noteholders' right to commence an involuntary filing because they were presumed to be secured creditors ineligible to commence such a case. As such, the opinion did not address how the court would view the violation of a covenant not to commence an involuntary case. When it comes to *creditors* promising not to commence a case, it is easier to argue that any negative impact from such a promise will be borne by the party making it and that the covenant should therefore be enforceable. On the other hand,

courts may view such covenants as undermining the rights of third-party creditors by making it more difficult or impossible to reach the threshold number of creditors required to commence an involuntary case, and may therefore be reluctant to enforce them. Even if a bankruptcy court accepts the enforceability of the covenant, however, it may not dismiss the bankruptcy case. Instead, a bankruptcy court may leave enforcement for a breach of contract action in another forum. Moreover, it is not clear that the covenant is enforceable by specific performance, or what sort of damages out-of-the-money noteholders can demonstrate, and, therefore, it is not clear how helpful such covenants will be when they are tested in practice.

ZAIS SUMMED UP

In sum, the simple analysis in the *Zais* case makes plain that it is possible to put a CDO into bankruptcy. That is about all the insight that the case provides, however, as it dodged treatment of common bankruptcy defenses in structured vehicles, and left those questions for another day. Ultimately, the court approved a liquidation plan that incorporated a settlement providing for a cash payment of \$4.375 million to the junior noteholders, and approximately \$152.5 million to the senior noteholders. After *Zais*, more CDOs and other bankruptcy-remote entities may be filed in time, and eventually these questions will have to be addressed.

ON THE RIVER ROAD TO THE COMEBACK OF CREDIT BIDDING UNDER PLANS

2011 saw secured lenders breathe a sigh of relief when the Seventh Circuit Court of Appeals issued an opinion in the *River Road Hotel Partners* case⁸⁷ disagreeing with the much-hated 2010 *Philadelphia Newspapers* case, in which the Third Circuit Court of Appeals had found no automatic right for secured creditors to credit bid on their collateral when it is sold under a chapter 11 plan.⁸⁸ The news got even better when the United States Supreme Court granted certiorari to hear an appeal in the *River Road* case. In ruling on *River Road*, the Supreme Court will likely resolve the circuit split and decide the issue of whether secured creditors are entitled to credit bid in the context of plan sales of collateral once and for all.

⁸⁵ Some courts have stated that bankruptcy waivers are unenforceable against a debtor. See *Fallick v. Kehr*, 369 F.2d 899, 904 (2d Cir. 1966) ("We agree, as the dissent points out, that an advance agreement to waive the benefits of the [Bankruptcy] Act would be void."); *In re Trans World Airlines, Inc.*, 261 B.R. 103, 113 (Bankr. D. Del. 2001) ("It has long been true that contractual provisions prohibiting the filing of a bankruptcy case are not enforceable.")

⁸⁶ For example, some courts have been willing to enforce anti-filing covenants made between members of an LLC. See *In re DB Capital Holdings, LLC*, Nos. CO-10-046, 10-23242, 2010 WL 4925811 (B.A.P. 10th Cir. Dec. 6, 2010) (court stated that it knew of no case law "standing for the proposition that members of an LLC cannot agree among themselves not to file bankruptcy, and that if they do, such agreement is void as against public policy").

⁸⁷ *River Road Expansion Partners v. Amalgamated Bank* (*In re River Road Hotel Partners, LLC*), 651 F.3d 642 (7th Cir. 2011).

⁸⁸ *In re Philadelphia Newspapers*, 599 F.3d 298 (3d Cir. 2010).

THE PHILADELPHIA NEWSPAPERS CONTROVERSY

In the *Philadelphia Newspapers* bankruptcy case, the debtors proposed a plan under which all of their assets would be sold in a public auction. The lenders holding a first-priority lien on substantially all of the debtors' assets objected to the fact that the proposed bidding procedures did not permit credit bidding, and the Bankruptcy Court for the Eastern District of Pennsylvania upheld the objection. On appeal, the district court overturned the bankruptcy court decision, and the Third Circuit agreed with the district court. The Third Circuit held that credit bidding is not required when collateral is sold under a plan if the debtor can prove that the secured lenders' plan treatment is the "indubitable equivalent" of their claim.

The Third Circuit's holding in the *Philadelphia Newspapers* case turned on the court's reading of the Bankruptcy Code's absolute priority rule as offering three methods for treatment of dissenting secured creditors in a cram-down plan under section 1129(b)(2)(A), any one of which is sufficient to allow confirmation of a plan over the dissent of secured creditors. These include (i) leaving the secured creditor's lien in place and providing for deferred cash payments, (ii) a sale of the secured creditor's collateral, subject to credit bidding, and (iii) the "realization . . . of the indubitable equivalent" of the secured creditor's claim.⁸⁹ Under the Third Circuit's interpretation of the statute, a sale of collateral under a plan without credit bidding is permissible when proceeding under the "indubitable equivalent" prong, which the Third Circuit read as a catch-all provision allowing for any type of treatment that meets the "indubitable equivalent" standard. The Third Circuit disagreed with the lenders' argument that a sale under a plan must necessarily comply with (ii) and that (iii) was not applicable when collateral was being sold.

The dissent, written by Judge Ambro, who was an accomplished bankruptcy attorney before he joined the bench, articulated clearly the views and concerns of secured creditors. He argued that a better reading of the statute is that the indubitable equivalent standard is only applicable in situations where the other two standards do not apply (for example, where a lender is given replacement liens on alternate collateral). Thus, any time a cram-down plan contains a sale of collateral, it is required to satisfy the provision of the absolute priority rule applying to sales, which incorporates a right to credit bid. Judge Ambro focused on the importance of credit bidding to protect secured creditors from

undervaluation of their collateral in a sale context, and argued that the very facts of the *Philadelphia Newspapers* case, where the alleged purpose of the prohibition on credit bidding was to steer the sale to a stalking horse bidder that was related to old equity, demonstrated the type of situation where the protection provided by a right to credit bid was necessary.

ALONG COMES RIVER ROAD

There was an outcry following *Philadelphia Newspapers*, with critics echoing Judge Ambro's dissent and arguing that the holding compromised the interests and expectations of secured creditors, which, before *Philadelphia Newspapers*, thought that a right to credit bid protected them from having collateral sold over their objection in all bankruptcy sales, including sales under a plan. In *River Road*, the debtors capitalized on the *Philadelphia Newspapers* logic, and proposed a plan under which they would sell substantially all of their assets at auction, with no right to credit bid for their large secured lenders. The lenders rejected the plan and objected to its confirmation, as well as to the bidding procedures governing the auction. The bankruptcy court found that indeed the debtors' plan could not be confirmed because it violated the absolute priority rule, and indicated that its decision was premised on the statutory reading presented in Judge Ambro's dissent in *Philadelphia Newspapers*. On direct appeal, the Seventh Circuit agreed.

Like the Third Circuit, the Seventh Circuit undertook a detailed textual analysis in deciding what the absolute priority rule requires and found that the text of the statute is ambiguous, both as to the scope of what falls within the indubitable equivalent prong, and "what constitutes the 'indubitable equivalent' of a secured creditor's claim."⁹⁰ It further noted that the "indubitable equivalent" subsection does not, by itself, indicate that a plan sale of collateral without credit bid rights can provide indubitably equivalent value to secured creditors. Instead, it saw a need for credit bidding to protect against flawed auction results. It said, "[b]ecause the Debtors' proposed auctions would deny secured lenders the ability to credit bid, they lack a crucial check against undervaluation. Consequently, there is an increased risk that the winning bids in these auctions would not provide the Lenders with the current market value of the encumbered assets."⁹¹ The Seventh Circuit found that "nothing in the text" of section 1129(b)(2)(A) "indicates that plans that *might* provide secured lenders with the indubitable equivalent of their claims can be

⁸⁹ 11 U.S.C. § 1129(b)(2)(A).

⁹⁰ *River Road*, 651 F.3d at 648.

⁹¹ *Id.* at 651.

⁹² *Id.*

confirmed under Subsection (iii).⁹² Thus, it concluded that the plain language of the statute did not clearly authorize a plan sale that deprived the lenders of a right to credit bid.

The Seventh Circuit sided with the dissent in *Philadelphia Newspapers* and found that a right to credit bid at a plan sale is incorporated into section 1129(b)(2)(A) for two reasons. First, it thought the contrary interpretation made the creditor bidding protection in subsection (ii) of the statute superfluous.⁹³ It also pointed out that the first subsection of the statute, prescribing the standards for providing lenders with a lien and deferred cash payments under a cram-down plan, could be circumvented by an interpretation of the statute that allows debtors to proceed under the indubitable equivalent standard even when a plan proposes treatment covered by the other two subsections.

Second, it found that the debtors' interpretation of section 1129(b)(2)(A) "sharply conflicts with the way that these interests are treated in other parts of the Code."⁹⁴ It found that the general scheme of the Bankruptcy Code is to offer hefty protections to secured creditors when it comes to the disposition of their collateral, including the credit bidding rights under section 363(k) of the Bankruptcy Code and the absolute priority rule, and the recourse claims given to nonrecourse lenders under section 1111(b) of the Bankruptcy Code. It found the debtors' interpretation of the Bankruptcy Code implausible because that interpretation did not accord with the credit bid protections afforded to secured creditors under other provisions in the Bankruptcy Code.

The decision, and its adoption of the views expressed in the *Philadelphia Newspapers* dissent, garnered significant attention in the bankruptcy world as a counterweight to *Philadelphia Newspapers*. When the debtor appealed to the Supreme Court, commentators were gleeful because a ruling upholding *River Road* would be a rejection of the statutory interpretation in *Philadelphia Newspapers*, and would have the effect of overturning the *Philadelphia Newspapers* precedent as applied to future cases.

WHAT TO EXPECT FROM THE SUPREME COURT

Considering the consternation in the bankruptcy and lending communities inspired by the *Philadelphia Newspapers* case, it may be tempting to assume that the Supreme Court will side

with the Seventh Circuit. Given the language of the statute, the Court could side with the Third Circuit instead, however, as the language of the statute can support a reading that Congress allows a plan proponent the flexibility to provide any form of treatment, including plan sales with no credit bid rights, so long as it gives the secured creditor the indubitable equivalent of its claim. As Judge Ambro himself commented, "[m]y colleagues' reading of § 1129(b)(2)(A) is not a trip to the twilight zone. Neither is mine. We must choose between two plausible readings of § 1129(b)(2)(A)" Moreover, the Third Circuit's reading of the absolute priority rule is consistent with a reading by the Fifth Circuit in the *Pacific Lumber* case.⁹⁵ Therefore, it is far from certain how the Court will rule.

HOW CAN SECURED CREDITORS PROTECT THEMSELVES IF PHILADELPHIA NEWSPAPERS BECOMES THE LAW OF THE LAND?

In a world where the Supreme Court overturns the Seventh Circuit, and upholds the interpretation of the absolute priority rule articulated in *Philadelphia Newspapers*, what is a secured lender to do? Even if the *Philadelphia Newspapers* precedent is upheld, its impact may be softened in practice by the valuation requirements implicit in the indubitable equivalent standard. Establishing indubitable equivalent value requires establishing that the plan treatment undoubtedly provides the equivalent value of a secured creditor's secured claim to the creditor. As the *River Road* court explained, the two mechanisms for valuing collateral in bankruptcy are auction and judicial determination. An auction produces a value by creating a market and selecting the highest price that any counterparty is willing to pay. Where a lender prefers to credit bid and take its collateral rather than the cash offered at auction, it is establishing a higher price for the collateral because it is deciding that the collateral is worth more than the cash offered by other bidders. Therefore, how often can a plan proponent that excludes a credit bid from an auction show that its auction produced a value that meets the indubitable equivalent standard?

The *Philadelphia Newspapers* court considered similar arguments and expressly rejected any notion that a right to credit bid is implicit in any plan sales proceeding under subsection (iii) of the statute, but the Third Circuit did acknowledge that, at plan confirmation, the debtor would have to demonstrate that it

⁹² *Id.* at 652.

⁹³ *Id.* at 653.

⁹⁵ *Bank of New York Trust Co. v. Official Unsecured Creditors' Comm. (In re The Pacific Lumber Co.)*, 584 F.3d 229 (5th Cir. 2009).

provided the lenders with the “indubitable equivalent” of their claims. Accordingly, even though the court refused to find that credit bidding was required as a procedural matter under the statute, it acknowledged that the auction it was approving might not produce a result consistent with the “indubitable equivalent” standard, and left open the possibility that secured creditors could successfully argue that a plan sale without credit bidding failed to deliver to them indubitably equivalent value. Where auctions produce values insufficient to pay secured creditors in full, and absent some special circumstances, it may be difficult for plan proponents to meet the indubitable equivalent standard after depriving objecting secured creditors of an opportunity to credit bid.

Moreover, where credit bidding is restricted, there may be other infirmities with a bid process, and bankruptcy courts do have wide discretion to administer the estate and regulate the procedures governing bankruptcy sales. In *Philadelphia Newspapers* for example, the bankruptcy court said that it could “discern no plausible business justification” for the credit bidding restrictions in the debtor’s bid procedures, and that there were concerns that the credit bid was restricted for the purpose of steering the auction to the stalking horse bidder.⁹⁶ The Third Circuit approved the bid procedures notwithstanding these infirmities. In another case, where the bankruptcy court’s refusal to approve bid procedures is premised simply on a finding that the procedures are not designed to maximize value, and not on a construction of provisions of the Bankruptcy Code, the result could be different.

In addition to the difficulty in demonstrating indubitable equivalence for plan sales that forbid credit bidding, secured lenders can take some comfort in the fact that even if they can be denied the right to credit bid, they likely cannot be denied the right to bid. As such, sufficient lenders can agree to put up cash to make a cash bid with the result that the cash will be round-tripped back to them as payments under a plan. This protection is not complete, however, as in large, diverse lending groups, not all lenders will have the desire or constitutional ability to make a cash bid. In such cases, the other lenders will have to decide whether to come out of pocket and take the asset for themselves.

CREDIT BIDDING CONCLUSION

The resounding verdict from secured creditors is that they view credit bidding as a key protection. The Supreme Court’s decision in the *River Road* case should provide a final word on the scope of this protection under cram-down plans. Yet, if plan proponents are permitted by the Supreme Court to sell collateral in plan sales without a right to credit bid, the long-term effects of such a decision may not be as bad as feared, as plan proponents may have an uphill battle in demonstrating that secured creditors are receiving the indubitable equivalent of their claims under such plans.

CONCLUSION

As you can see, 2011 was an active year for judges deciding key issues that will shape the rights and risks associated with lending to distressed entities for years to come. Unfortunately, as 2011 came and went, more questions were raised than answers decided. In light of *TOUSA*, how can a lender successfully structure a transaction or settlement with a multi-entity enterprise to limit its risk of constructive fraudulent transfer liability? When can lenders confidently invoke section 546(e)’s safe harbor provision after *Enron*, *Quebecor*, and the Madoff rulings? Is any form of gifting still permissible after *DBSD*? Is it possible to structure a CDO or other type of entity that is truly bankruptcy remote after *Zais*? Can a debtor sell substantially all of its assets pursuant to a chapter 11 plan without allowing a prepetition secured creditor the right to credit bid, in light of *River Road* and *Philadelphia Newspapers*? Perhaps 2012 will shed light on these burning questions.

⁹⁶ *Philadelphia Newspapers*, 2009 WL 3242292 at *11.