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TO OUR READERS

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THE SUPREME COURT CONFIRMS THAT SECURED CREDITORS HAVE THE RIGHT TO CREDIT BID IN PLAN SALES

By Douglas Deutsch and Jessica Marrero

In the 2010 decision of In re Philadelphia Newspapers, 599 F.3d 298 (3d. Cir. 2010), the Third Circuit Court of Appeals concluded that a plan proponent could deny a secured creditor the right to credit bid on its collateral when the sale was made pursuant to a plan of reorganization. That holding was a surprise to many given that secured creditors were specifically authorized to credit bid in stand-alone sales under section 363 of the Bankruptcy Code. A year or so later, another circuit court, the Seventh Circuit Court of Appeals, came to the opposite conclusion. See River Road Hotel Partners v. Amalgamated Bank, 651 F.3d 642 (7th Cir. 2011). As a result of the split among the circuit courts, the Supreme Court agreed to hear the appeal of the latter case late last year.

On May 29, 2012, the Supreme Court issued an 8-0 decision in the RadLAX Gateway Hotel, LLC v. Amalgamated Bank case. Penned by Justice Scalia, the decision held that a secured lender cannot be denied the right to credit bid if its collateral is to be sold free and clear of all liens pursuant to a Chapter 11 plan of reorganization. The decision summarily disposed of what appeared to be a difficult interpretative issue.

The Legal Issue
A debtor may sell its assets under section 363 of the Bankruptcy Code, which permits a stand-alone sale of an asset, or it may sell its assets as part of a chapter 11 plan. Where a debtor seeks to sell an asset pursuant to section 363, the sale terms must allow for a secured creditor to credit bid. However, where a debtor seeks to sell an asset pursuant to the terms of a plan, the relevant statute, section 1129(b), is not (seemingly) as clear.

Section 1129(b)(2) of the Bankruptcy Code provides that a plan that proposes to sell an encumbered asset may be confirmed notwithstanding the objection of a secured creditor if one of three “cram down” criteria is satisfied. One relevant option is to sell the property pursuant to section 363(k), thus providing a secured creditor the right to credit bid. Another relevant option is provided in section 1129(b)(2)(A)(iii). This subsection, which does not reference section 363 at all, provides that a secured creditor must receive the “indubitable equivalent” of its claim as part of plan confirmation. This “indubitable equivalent” provision was interpreted by the Third Circuit in the Philadelphia Newspaper case and in the prior Fifth Circuit decision of In re Pacific Lumber Co., 584 F.3d 229 (5th Cir. 2009) to mean that a plan may provide for the sale of an asset that secures a claim without allowing the secured creditor to credit bid. As mentioned above, in River Road Hotel Partners, the Seventh Circuit reached a different conclusion. That decision was subsequently appealed to the Supreme Court under the case name of RadLAX Gateway Hotel.

The Background Facts of RadLAX Gateway Hotel
In 2007, the debtors purchased the Radisson Hotel at Los Angeles International Airport and an adjacent lot on which they planned to build a parking garage. In order to finance the purchase, renovation and development of the property, they obtained a $142 million loan, secured by all of the debtors’ assets. Ultimately, the debtors, unable to continue with construction due to unanticipated expenses, filed for protection under Chapter 11 of the Bankruptcy Code.

The debtors proposed a plan of reorganization that entailed selling substantially all of the debtors’ property at an auction and using the sale proceeds to repay the
secured lender. However, under the debtors’ proposed bid procedures, the lender was not permitted to credit bid for the property. Despite the lender’s objection to this provision, the debtors sought to confirm the plan by “cramdown” pursuant to section 1129(b)(2)(A). The bankruptcy court denied confirmation of the debtors’ plan on the grounds that the plan did not comply with section 1129(b)(2)(A)’s requirements for “cramdown” on a dissenting secured lender. On appeal, the Seventh Circuit affirmed.

The Supreme Court’s Legal Analysis
The Supreme Court began its analysis with a review of the requirements for cramdown under section 1129(b)(2)(A) of the Bankruptcy Code. The Supreme Court explained that in order to be “fair and equitable” with respect to non-consenting secured creditors, a plan must meet one of the three requirements set forth in section 1129(b)(2)(A), including the previously referenced (and most relevant) section 363(k) sale option or the “indubitable equivalent” option. The debtors argued that section 1129(b)(2)(A) provides three distinct options for confirming a plan over a secured creditor’s objection. Thus, the debtors asserted, the plan could properly prohibit credit bidding (under the section 363(k) option) where, as was the case here, the cash generated by an auction would be remitted to the secured lender, thus providing the secured lender with the “indubitable equivalent” of its claim.

The Supreme Court found the debtors’ argument to be “hyperliteral and contrary to common sense.” Citing the “well-established canon of statutory interpretation” that the specific governs the general, the Court contrasted the detailed provision regarding the requirements of selling collateral free and clear of all liens (the section 363(k) provision) with the broadly worded indubitable equivalent provision which says nothing about such a sale. The Court reasoned that although the general language clause is broad enough to include these types of sales, it will not be held to apply to section 363(k) sales, which are specifically addressed in another provision. While noting that the general-specific canon is not an absolute rule, the Court explained that the debtors had not presented any textual indications that would overcome the canon. Accordingly, the Court held that because the rule allowing for credit bidding in sales of collateral free and clear of all liens was specific to these types of sales, the debtors could not sell their property free and clear without allowing the secured creditor the option to credit bid.

The Supreme Court’s decision is welcome news to secured creditors.

Interestingly, the Supreme Court characterized the issues it addressed as an “easy case” and found “no textual ambiguity” in the statute. It noted that an outright prohibition on credit bidding would produce absurd results. Moreover, as the Supreme Court explained, an advantage of credit bidding is that it helps to protect creditors against the risk that the collateral securing the debt will be sold at a depressed price. The Court also noted that the practice of credit bidding is particularly important for the federal government which often lacks appropriations authority to “throw good money after bad in a cash-only bankruptcy auction.”

What the Supreme Court’s Decision Means
Confirming what had been the accepted interpretation of the law prior to the In re Philadelphia Newspapers decision, the RadLAX decision confirmed that a Chapter 11 plan may not prohibit credit bidding when a debtor proposes to sell its assets free and clear pursuant to section 1129(b)(2)(A). The result should be welcome news to secured creditors.

Douglas Deutsch is a partner in Chadbourne & Parke’s New York office in the firm’s bankruptcy and financial restructuring group. Jessica Marrero is also located in New York and is an associate in Chadbourne’s bankruptcy and financial restructuring group.
On May 1, 2012, John Verrill joined Chadbourne as a restructuring partner in Chadbourne’s London Office. We caught up with John to ask him about his practice, his decision to join Chadbourne and his recent argument before Great Britain’s highest court. This Q & A is the result of that dialogue.

**Background**

**How long have you been practicing law?**
I have been practicing for 31 years this June. I obtained a special Insolvency Practitioners License in 1990.

**How did you get involved in practicing bankruptcy law?**
I started as essentially a corporate lawyer. In 1984/5, the United Kingdom embarked upon a wholesale reform of bankruptcy law, personal and corporate. The changes were such that everyone was almost back to “square one.” Having monitored the progress of the legislation, I decided to run seminars to explain the changes to bankers and accountants. Work flowed from that.

**Why did you come to Chadbourne?**
My deal flow has an increasingly (60%+) international flavor and I needed to be in a firm where such work is better supported. Interestingly, as I was in the process of joining Chadbourne, I had an opportunity to work on both the United Kingdom and United States sides of the *Hellas II* case. At my old firm, we acted for the Hellas United Kingdom Liquidators who needed Chapter 15 recognition to stay proceedings against the company in New York so we instructed Howard Seife. Now that I have moved to Chadbourne, we act on both the United Kingdom and United States sides of the case. Oh, by the way, the Chadbourne people are great!

**Football League**

**What is the “The Football League”?**
The Football League is the oldest football league (of course, I am referring to what you call “soccer” in the United States) in the world with its origins in the nineteenth century. The League itself was actually formed in 1904. It now organizes the competition among the 72 clubs in the flight below the FA Premier League (the Premier League is the home of Manchester United, Chelsea and eighteen other teams). The League has three divisions of twenty-four clubs and each club plays the others in its league twice per season and the ladder produces a ranking from 1 to 24 based on points awarded (3 for a win, 1 for a draw, 0 for a loss). At the end of each season, there are promotions and relegations. From division 1, three clubs became elevated to the Premier League and three teams are demoted, two are automatically promoted and those just below (the next four) have a play off. The playoff is the richest game in world soccer with an estimated £45 million windfall (over $US 70 million) going to the winner as a result of the increased cash flow arising from promotion!

**What work do you do for the League?**
I write the League’s bankruptcy rules and policies. When a club goes into Administration (the United Kingdom’s equivalent of Chapter 11), I handle the legal aspects of what is usually a pre-pack of the old club and the accession of the buyer to the League (membership of the League is by share ownership which is controlled by the League). The League imposes financial and other conditions on new entrants to ensure (at least, as much as possible) that they will not default on their credit obligations. If a club ceases to exist, then its playing record is expunged. This is important because if there are too many defaults, the competition becomes meaningless.
and television broadcast rights lose value. This month, I successfully defended a challenge to the League’s bankruptcy rules by Her Majesty’s Revenue and Customs. They argued unsuccessfully that the rules are a fraud on the bankruptcy of insolvent clubs.

**How long have you represented the League?**
Ten years. I started when ITV Digital pulled the plug on its broadcasting deal with the League, resulting in a loss of revenue of over £178 million. I acted in an attempt to re-negotiate the deal and in the related subsequent litigation.

**Do you attend many League games?**
No. Ironically, I do not particularly like football.

**What was your most interesting Madoff issue?**
In order to release Madoff’s boat from a series of maritime arrests by a determined French victim of the fraud (who invested via a Luxembourg fund!), our litigation team was required to take three trips to the Court of Appeal in France and participate in three related hearings in London. The French ended up having to pay us $500,000 to avoid being in contempt of the automatic stay in the United States and to avoid being dragged into court to apologize in London.

**Your Recent Appeal to the Highest English Court**

**What is the highest court in the United Kingdom?**
The Supreme Court of the United Kingdom. There are twelve justices on the Supreme Court although panels who hear cases typically consist of five justices. The Supreme Court was created in October 2009. It replaced the House of Lords Judicial Committee (after hundreds of years).

**In what case were you before the Supreme Court in late May of 2012?**
The case was *Rubin and Lan v. Eurofinance & Others*. The facts of the case are very relevant to the underlying issues. In 2002, the “Sponsors” created a trust named The Consumers Trust or “TCT”. TCT operated under English law, for the benefit of consumers who participated in sales promotions in the USA and Canada (the Court of Appeal called these promotions a “scam”). By 2005, the sales promotions were identified as what was essentially a Ponzi scheme. The scheme was brought to a halt as a result of legal proceedings against TCT in Missouri. These legal proceedings led to TCT filing for bankruptcy protection in New York. Immediately prior to that, our clients were appointed by the High Court as the receivers of TCT in England. We brought adversary proceedings in New York against the Sponsors to recover sums on behalf of TCT. The Sponsors did not submit to the jurisdiction of the New York court and a default judgment was entered against them. We then made an application to the High Court for an order recognizing the US bankruptcy proceedings as a “foreign main proceeding” and seeking the enforcement against the Sponsors of the orders made by the New York Bankruptcy Court.

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**John’s deal flow has significant international flavor necessitating his joining a firm with significant cross-border experience — namely Chadbourne & Parke.**

**Madoff**

**What is the nature of your involvement in the Madoff case?**
We act for the liquidators appointed by the High Court of Justice’s Companies Court. We gather assets and investigate the fraud.

**How are the London courts involved in the Madoff matter?**
The London courts are winding up Madoff’s private hedge fund, Madoff Securities International Limited. At one time, that entity warehoused around $180 million of stolen cash, some of which was used to buy cars (including a rare Aston Martin), a boat, an apartment in Antibes in France, Rolexes and other baubles.
What was the main legal issue in the case and why is the case important?
Should the New York actions: (1) be recognised as “foreign main proceedings” under the Model Law (our equivalent to Chapter 15) and/or at common law; and (2) be enforced as a judgment of the English court without any further process. The outcome of the case is very important because the decisions of the United Kingdom’s Supreme Court are followed throughout the Commonwealth (New Zealand, Canada, Australia and most of the Anglophone Caribbean). Accordingly, if we win, United States Bankruptcy Courts will be able to “reach” almost automatically into those “dark places” to enforce fraudulent conveyance and preference judgments (actions central to and dependant on the bankruptcy) with almost no formalities being required.

Was there anything special about the Rubin case for you personally?
My wife, Louise, is also a bankruptcy lawyer and is on the opposing side of the Rubin appeal. Accordingly, the outcome should result in even more interesting discussions on the home front!

Other
Are you looking forward to the Olympics this summer?
I am. My rowing club, of which I am on the “committee” (a director), is the Leander Club. The Club is providing 22 of the 45 or so of the Great Britain rowers (many of whom are already world champions) who will participate in this summer’s games. I will certainly be rooting them on! 😊

The outcome of the case is very important because the decisions of the United Kingdom’s Supreme Court are followed throughout the Commonwealth (New Zealand, Canada, Australia and most of the Anglophone Caribbean).

To speak to John and learn more about his practice, please contact him at +44 (0) 20-7337-8055 or jverrill@chadbourne.com
Can a Claims Purchaser Acquire Claims Free of Defects?

By Christy Rivera

The Delaware bankruptcy court in the *KB Toys, Inc.* cases recently held that a claims purchaser takes a claim subject to certain disabilities of the claim as held by the seller, regardless of whether the claim transfer is deemed a “sale” or an “assignment.” See *In re KB Toys, Inc.*, Case No. 04-10120 (KJC) (Bankr. Del. May 4, 2012). In so ruling, the Delaware court’s decision is somewhat at odds with the decision issued by the District Court for the Southern District of New York in the *Enron* bankruptcy cases. See *Enron Corp. v. Springfield Associates, LLC (In re Enron Corp.)*, 379 B.R. 425, 443 (S.D.N.Y. 2007). In the *Enron* decision, the district court held that whether a disability travels with a claim to the purchaser depends on whether the transfer is a “sale” (in which case there is no transfer of any disability) or an “assignment” (in which case any disability transfers to the assignee).

When issued, the *Enron* decision created some uncertainty for claims purchasers. As noted by the *KB Toys* court, whether the transfer of a claim constitutes a sale or an assignment was not something market participants had focused on and, in fact, many buyers and sellers used the terms interchangeably. While the *Enron* decision arguably provided claims purchasers with more protection in connection with purchased claims, whether that “protection” applied to any particular transferred claim was not a straightforward issue. This ambiguity was criticized by many in the market. The *KB Toys* decision should provide some clarity, at least in Delaware bankruptcy cases, for claims purchasers.

**Facts**

During the *KB Toys* bankruptcy case, ASM Capital, L.P. and ASM Capital II, LLP (together, “ASM”) purchased several trade claims filed against *KB Toys*. Nine of these claims were subject to an objection filed by the trustee of the *KB Toys* residual trust. In the objection, the trustee asserted the claims should be disallowed on the basis that the original claimant had not repaid certain “preferential” payments received from *KB Toys* shortly before it filed for bankruptcy. (The original claimants were defendants in preference actions. The trustee had obtained judgments against each claimant, and none had to date disgorged to the trust those “preferential” payments.)

In its objection, the trustee relied on Bankruptcy Code section 502(d), which provides in relevant part that “the court shall disallow any claim of any entity … that is a transferee of a transfer avoidable under [the Bankruptcy Code] unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under [the Bankruptcy Code]” Absent payment on the judgment in the preference action, the trustee asserted the trade claims were not entitled to participate in distributions.

ASM filed a response to the objection, arguing that the claims could be not disallowed pursuant to section 502(d) when they were no longer held by the original claimant/preference defendant.

**The Parties’ Arguments**

Citing to the *Enron* decision, ASM asserted that the claims at issue were transferred to ASM by “sales,” not “assignments,” and therefore ASM held the claims free of any of the seller’s disabilities. ASM asserted that the trustee’s basis for the objection — Bankruptcy Code section 502(d) — was intended to focus on the claimant subject to the preference action, not the claim itself. Finally, ASM argued that it had purchased the claims in “good faith,” and therefore the claims could not
A claims purchaser takes a claim subject to certain disabilities of the claim as held by the seller, regardless of whether the claim transfer is deemed a “sale” or an “assignment.”

be disallowed because the Bankruptcy Code protects “good faith” purchasers.

By contrast, the trustee asserted that the claims had been transferred to ASM by “assignment,” so that the taint of the preference judgments traveled with them. The trustee also argued that KB Toys’ statement of financial affairs noted the original claimants had received payments during the 90-day period prior to the bankruptcy case, which gave ASM at least constructive knowledge of the preferential transfers and the risks related to the claimants’ claims. Such knowledge, the trustee argued, precluded a finding of “good faith.” The trustee also questioned the reasoning of the Enron decision.

The Court’s Analysis

Agreeing with the trustee, the KB Toys court found that the plain language of Bankruptcy Code section 502(d), the legislative history, and related case law all support the view “that a claim in the hands of a transferee has the same rights and disabilities as the claim had in the original claimant. Disabilities attach to and travel with the claim.”

Starting with a review of the legislative history supporting section 502(d), the KB Toys court noted that section 502(d) was derived from section 57g of the Bankruptcy Act of 1898, which established the basis for allowance or disallowance of particular claims. Prior cases considering the application of section 57g held that the rights of a transferee of a claim were subject to the equities and burdens of the transferor. The KB Toys court stated that after the enactment of the Bankruptcy Code, courts continued to find that transferees held claims subject to personal disabilities of the transferor, and it highlighted two decisions — In re Metiom, Inc., 301 B.R. 634 (Bankr. S.D.N.Y. 2003) and Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.), 340 B.R. 180 (Bankr. S.D.N.Y. 2006). The Metiom court held that “[t]he assignment [of a claim] should not, and does not, affect the

Awards

Chadbourne’s Bankruptcy and Restructuring Department was recognized in the 2012 edition of Chambers USA: The World’s Leading Lawyers for Business. The Department was recognized as “a highly respected player in the bankruptcy market, with a team that brings specific expertise in international and cross-border restructurings.” Chambers also noted that the Department was principally known for representing senior lenders and creditor committees. Chambers specifically highlighted two Chadbourne partners in this year’s edition. Practice chair Howard Seife was recognized as key to the firm’s reputation for cross-border restructurings and representing creditor committees. Howard was specifically praised by sources cited by Chambers as “good in all facets of bankruptcy; intelligent, creative and good at gaining consensus and looking for common ground.” In addition, Chadbourne partner David LeMay’s work for various parties in the ongoing Lehman Brothers bankruptcy cases was cited. Chambers reported that clients recommend David for his “technical knowledge, efficiency and responsiveness.”

Legal 500 USA also recently released its 2012 annual survey results. The survey, based on recommendations from clients and peers as well as research conducted by the Legal 500 staff, recognized that the firm’s profile had risen steadily in recent years, “marked by its ability to secure major roles on some of the market’s headline mandates, such as advising the creditors’ committee in the Tribune Company Chapter 11 reorganization.” The publication singled out Department co-chair Howard Seife as a “leader in the field” and also recommended David LeMay based on his work in the Lehman bankruptcy cases.
Buyers of debt tend to be “highly sophisticated entities fully capable of performing due diligence” before purchasing claims and, even without any due diligence, claims purchasers are aware of “the ever-present possibility of avoidance actions based on preference liability or fraudulent conveyances.”

debtor’s rights vis-à-vis the claim; it is incumbent, instead, on prospective assignees to take into account possible claim defenses when they negotiate the terms of their assignments.” *See In re Metiom, Inc.*, 301 B.R. at 642-43. This sentiment was also expressed by the bankruptcy court in the *Enron* decision, stating “participants in the claims-transfer market are aware of, or should be aware of, the risks and uncertainties inherent in the purchase of claims against the debtors, including the possibility of claims being temporarily disallowed under section 502(d) unless and until their predecessors turn over the avoidance transfers. . . .” *See In re Enron Corp.*, 340 B.R. at 202. This *Enron* bankruptcy court decision, however, was vacated by the district court case discussed above.

Turning to the *Enron* district court decision, the *KB Toys* court first noted that the “assignment/sale” distinction stressed by the *Enron* court is not easily applied when considering the treatment of claims in the hands of a purchaser. As noted above, the markets had used the terms interchangeably and neither word is defined by the Bankruptcy Code. Indeed, the *Enron* court stressed that the nomenclature used by parties was not dispositive, but rather the legal effect of its provisions was to be considered.

The *KB Toys* court disagreed with the *Enron* court’s statement that burdening the transferee of a claim with a disability imposed on a claim by the transferor would “wreak havoc on the markets for distressed debt.” The *KB Toys* court noted that buyers of debt tend to be “highly sophisticated entities fully capable of performing due diligence” before purchasing claims and, even without any due diligence, claims purchasers are aware of “the ever-present possibility of avoidance actions based on preference liability or fraudulent conveyances.”

Finally, the court dismissed ASM’s argument that it was a “good faith” purchaser of the claims such that the claims could not be disallowed. The *KB Toys* court noted that purchasers of claims in bankruptcy are well aware (or should be aware) that they are “entering an arena in which claims are allowed and disallowed in accordance with the Bankruptcy Code and decisional law interpreting those provisions” and in such conditions, claims purchaser are not entitled to the benefits afforded to “good faith” purchasers under the Bankruptcy Code.

**Conclusion**

The *KB Toys* court concluded that claims purchasers hold claims subject to the same rights and disabilities under Bankruptcy Code section 502(d) as does the original trade claimant. While the decision is less protective to claims purchasers than the *Enron* decision, the risks related to Bankruptcy Code section 502(d) are of the type that are arguably easier to identify by claims purchasers. A claim purchaser can review the seller’s records and debtor’s statement of financial affairs and schedules to ascertain what the seller may have received from the debtor within the months immediately preceding a bankruptcy filing. In the *Enron* decision, the debtor asserted the claims purchasers’ claims should be equitably subordinated based on inequitable conduct of the sellers. Such “inequitable conduct” is not as easily discernible by a review of the books of and records and, accordingly, the *Enron* court’s “assignment/sale” distinction to protect claims purchasers may be more defensible. Claims purchasers may mitigate equitable subordination risk by negotiating for a right to recourse against the claims seller if the transferred claim is later subject to challenge based on conduct of the original claim holder/transferor.

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BEYOND MERE SUBORDINATION: ARE YOUR WAIVERS WORTH THE PAPER THEY ARE PRINTED ON?

By Eric Daucher

After several years of unusually few corporate defaults, there has recently been an uptick in corporations failing to satisfy their bond and loan obligations. In a number of cases, the debts in question are part of multiple-lien or multi-tranche financing structures that incorporate complex subordination packages. The agreements at issue often go beyond merely subordinating rights to payments. Instead, such agreements often also entail waivers by the junior creditors of various bankruptcy protections that they would otherwise possess, including the right to vote on plans of reorganization or to object to such plans. But are such waivers actually enforceable? Frustratingly, the answer is “sometimes.”

510(a) of the Bankruptcy Code
Section 510(a) of the Bankruptcy Code states that a “subordination agreement is enforceable . . . to the same extent that such agreement is enforceable under applicable non-bankruptcy law,” meaning state contract law. The Bankruptcy Code is silent, however, as to the enforceability of agreements that contain not only a subordination clause (i.e., a clause that alters priority of payment rights as between two parties), but also other provisions that affect the parties’ respective rights in bankruptcy. Remarkably, very few cases have addressed whether such agreements constitute enforceable “subordination agreements.” Instead, when a dispute arises, courts usually begin their analysis with a citation to section 510(a), and then simply discuss whether a particular provision is enforceable. Unfortunately, such decisions are splintered and provide little certainty that a subordination agreement that goes beyond mere subordination of payment rights will be enforced in full.

Certain Decisions Have Found Such “Broad Subordination” Provisions Unenforceable
Some courts have concluded that subordination agreements are only enforceable insofar as they address the relative priority of payments. These courts hold that provisions of subordination agreements that purport to waive other bankruptcy rights, such as the right to vote a claim or object to a plan of reorganization, are unenforceable in bankruptcy. For example, in In re 203 North LaSalle Street Partnership, 246 B.R. 325 (Bankr. N.D. Ill. 2000), the court was asked to consider whether an agreement that granted a senior lender the right to vote the junior lender’s claims in bankruptcy should be enforced. The court concluded that it should not be enforced, reasoning that “[s]ubordination . . . has a common understanding in the law [as] [t]he act or process by which a person’s rights or claims are ranked below those of others. . . . Subordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights.” Previously, the court in In re Hart Ski Mfg. Co., Inc., 5 B.R. 734 (Bankr. D. Minn. 1980) reached a similar conclusion, reasoning “[t]he intent of § 510(a) (subordination) is to allow the consensual and contractual priority of payments to be maintained between creditors . . . . There is no indication that Congress intended to allow creditors to alter . . . the bankruptcy laws unrelated to distribution of assets.”

General Trend Towards Enforcement of Broad Subordination
Despite the 203 North LaSalle and Hart Ski decisions, most courts have enforced broad subordination agreements. For example, in Blue Ridge Investors, II, LP v. Wachovia Bank, N.A.
(In re Aerosol Packaging LLC), 362 B.R. 43 (Bankr. N.D. Ga. 2006), the court was asked, as in 203 North LaSalle, whether a subordination agreement that contained an assignment of voting rights was enforceable. The Aerosol Packaging court explicitly rejected 203 North LaSalle and concluded that the voting rights assignment provision was enforceable, noting that bankruptcy rules 3018 and 9010 explicitly permit agents and other representatives to act on behalf of creditors.

Under very different facts, the court in In re Erickson Retirement Communities, LLC, 425 B.R. 309 (Bankr. N.D. Tex. 2010) also enforced a broad subordination agreement. In that case, certain subordinated creditors sought the appointment of an examiner despite having entered into a subordination agreement in which they agreed, among other things, not to exercise any of their remedies or take any action to collect on their claims without the prior consent of the senior lenders’ agent unless the claims of the senior lenders had already been satisfied in full. In that case, the agent refused to give his consent to the appointment of an examiner, and contended that the subordinated creditors’ request for the appointment of an examiner was an indirect request for payment. The court reasoned that a reasonable person would understand that, pursuant to the subordination agreement, subordinated parties were required to “stand still” until senior obligations were satisfied. The subordinated creditors’ violation of that principle was thus “the very type of obstructionist behavior that [subordination agreements] are intended to suppress.” Accordingly, the court enforced the stand still provisions and refused to appoint an examiner.

Other courts have reached similar results after concluding that subordination agreements are intended to prevent obstructionist behavior by junior creditors. See, e.g., Ion Media Networks, Inc. v. Cyrus Select Opportunities Master Fund (In re Ion Media Networks, Inc.), 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

Recent Anti-Enforcement Decisions
Although some commentators have observed a growing trend towards enforcement of broad subordination agreements, two recent decisions have called that trend into question. In In re Croatian Surf Club, LLC, No. 11-00194-8, 2011 WL 5989199 (Bankr. E.D.N.C. Oct. 25, 2011), the court faced almost exactly the same issue as that raised in 203 North LaSalle and Aerosol Packaging. Prepetition, the debtor and two of its creditors entered into a subordination agreement under which, among other things, the junior creditor assigned to the senior creditor its right to file and vote its claims in the event the debtor filed for bankruptcy. However, when the debtor filed for chapter 11 protection and proposed a plan of reorganization, both the senior and the junior creditor attempted to vote the junior creditors’ claim.

In deciding which vote to accept, the bankruptcy court explicitly adopted the reasoning of 203 North LaSalle and found that only the junior creditor possessed the right to vote its claim. According to the court, “there is no reason to deviate from the plain language of § 1126(a),” which empowers the holder of a claim to vote that claim. When faced with the argument that bankruptcy rules 3018 and 9010 permitted the senior creditor, as the junior creditor’s appointed agent, to vote on the junior creditor’s behalf, the court held that no such agency existed because “agency involves action at the direction of a principal,” whereas the senior creditor voted the junior creditor’s claim at its own discretion.

Mere days after the Croatian Surf Club decision, the court in In re SW Boston Hotel Venture LLC, 460 B.R. 38 (Bankr. D. Mass. 2011) issued a virtually identical decision under similar facts. As in Croatian Surf Club, the court was asked to decide whether a senior creditor could vote a junior creditor’s claim in accordance with a subordination agreement when the junior creditor cast a competing ballot in violation of the agreement. Although the SW Boston Hotel Venture court did not cite Croatian Surf Club, it similarly adopted the reasoning of Hart Ski and 203 North LaSalle in concluding that a subordination agreement “cannot nullify provisions of the Bankruptcy Code.” In the face of contrary authority, including the Aerosol Packaging decision, the court held that 203 North LaSalle and Hart Ski were more persuasive.

Is Your Subordination Agreement Enforceable?
Unfortunately, under current law, there is no practical way to determine whether a particular subordination agreement that goes beyond mere subordination of payment rights is enforceable. Prior to the SW Boston Hotel Venture and Croatian Surf Club decisions, it was safe to say that a court would generally enforce a broad subordination agreement
containing waivers of voting or other bankruptcy rights by the junior creditor. In light of those rulings, however, the picture is more mixed. Decisions by bankruptcy courts in the Second, Third, Fifth and Eleventh Circuits have favored enforcement of subordination agreements that go beyond mere subordination of payment rights. Meanwhile, decisions from bankruptcy courts in the First, Fourth and Seventh circuits have reached a contrary conclusion. Worse, there is a distinct lack of authority from appellate courts on this issue. As a result, bankruptcy courts are likely to continue to address the enforceability of such provisions on an ad hoc basis.

Creditors who are parties to subordination agreements that contain waivers of bankruptcy rights should approach bankruptcy with the unsettled state of the law in mind. Senior creditors should be aware that while a broad subordination agreement may provide some leverage over a junior creditor that might not otherwise be available, it does not give senior lenders a bullet-proof method for excluding dissident junior creditors from the decision-making process. Likewise, junior creditors should be aware that if cooperation with a senior creditor becomes untenable, they may have more room to maneuver than a plain reading of a subordination agreement might suggest. ☮

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Speeches, Events and Announcements

- **Howard Seife** was chair of a panel at INSOL International’s Annual Regional Conference in Miami for a program titled “Government Regulations and Their Impact on Preventing or Increasing the Chance of Insolvency” (May 21, 2012).

- **Seven Rivera** is scheduled to speak with Chadbourne litigation partners Thomas Hall and Thomas McCormack in a webinar sponsored by Stafford Publications titled “Fraudulent Conveyance Actions: Responding to TOUSA III” (July 11, 2012).

- **Howard Seife** will be co-chairing INSOL International’s seminar in Cartagena, Colombia on October 4, 2012.

- **Douglas Deutsch** was selected as co-chair of a joint Bloomberg News/American Bankruptcy Institute conference for secured lenders scheduled to be held in New York City on October 16, 2012.

- **Howard Seife** was re-elected to the Board of Directors of INSOL International.

- **Douglas Deutsch** will be co-chairing the American Bankruptcy Institute’s Mid-Level Professional Development Program, a one-day seminar held in New York City (November 9, 2012).

Publications


- **Howard Seife** and **Frank Vazquez** co-wrote “Insurers Accorded Standing to Challenge Asbestos Bankruptcy Plan that Potentially Limit Insurers’ Reinsurance Recoveries,” Insurance and Reinsurance Newswire (May 2012).

- **Douglas Deutsch** and **Jessica Marrero** co-wrote “A Recap Of Bankruptcy Rule 2019,” Law360 (March 5, 2012).
AN OVERSECURED LENDER’S RIGHT TO DEFAULT INTEREST AND LATE PAYMENT PENALTIES

By Marc Roitman

It is common for lenders to require borrowers to agree to pay a higher interest rate, known as the default rate, following an event of default under a loan. Some loan agreements also require the borrower to pay a fee in the event of a late payment. If the borrower files for bankruptcy protection, the Bankruptcy Code affords special protection to secured creditors with respect to collecting interest.

In general, an oversecured creditor (a creditor whose collateral is valued at more than its claim) is entitled to collect interest until such time as the sum of the principal and interest equals the value of its collateral. However, the Bankruptcy Code does not specify the rate at which the oversecured creditor may collect interest. In a recent decision, the Bankruptcy Court for the Southern District of New York held that an oversecured creditor is generally entitled to collect both pre-petition and post-petition interest at the default rate, but not late payment fees. See In re 785 Partners LLC, 2012 WL 1154282 (Bankr. S.D.N.Y. Apr. 9, 2012).

Disputed Issues

The debtor challenged First Manhattan’s claim with respect to (i) payment of pre-petition interest at the default rate, (ii) payment of post-petition interest at the default rate, and (iii) the late payment premium, arguing that the default rate interest and late payment premium were unenforceable penalties, inequitable and unreasonable.

The Bankruptcy Court’s Analysis

Pre-Petition Default Rate

The debtor argued that a bankruptcy court may reduce the default interest rate applicable to the pre-petition portion of a secured claim on equitable considerations. The court disagreed. The court first noted that pre-petition interest is generally allowed to the extent and at the rate permitted under state law. Under New York law, an agreement to pay a higher interest rate in the event of default is an agreement that “reflects the allocation of risk as part of the bargain struck between the parties,” and is not considered a penalty. A court cannot adjust the pre-petition portion of a claim (thereby rewriting the parties’ bargain) based on its own notions of fairness and equity. The court stressed that this was especially true in the context of real property transactions “where commercial certainty is a paramount concern” and the agreement was negotiated at arm’s length between sophisticated, counseled parties.
The debtor also argued that First Manhattan should be precluded from collecting interest at the default rate because it had already factored the debtor’s existing default into the price it paid for the loan. However, the court quickly dismissed that argument, noting that First Manhattan was the assignee of the original lenders and therefore stood in the shoes of the original lenders vis-à-vis the debtor. Accordingly, the court held there was no basis to disturb the parties’ bargained-for pre-petition interest rate.

Post-Petition Default Rate
Unlike pre-petition interest (which, as noted above, is determined under state law and may not be adjusted by a bankruptcy court), post-petition interest that an oversecured creditor may collect as part of its claim can be modified pursuant to Section 506(b) of the Bankruptcy Code at the “limited discretion” of a bankruptcy judge. The court noted that there is a rebuttable presumption that an oversecured creditor is entitled to collect interest at the contractual default rate. That presumption can be rebutted by showing that the interest rate should be modified on equitable grounds.

However, the court stated that, “the power to modify the contract rate based on notions of equity should be exercised sparingly.” Such judicial intervention is only appropriate in certain limited situations, such as where (a) the secured creditor is guilty of misconduct, (b) the application of the contractual interest rate would harm the unsecured creditors or impair the debtor’s fresh start, or (c) the contractual interest rate constitutes a penalty.

In the case of 785 Partners, the court determined that none of those factors were present. Moreover, the debtor was solvent and proposed to pay unsecured creditors in full. As the court explained, the reluctance to modify the contract interest rate is especially strong where the debtor is solvent and reducing the interest rate would only serve to increase the distribution to equity.

With respect to whether the default rate constituted a penalty, the issue turned on New York law and, as noted above, an increase in the interest rate after an event of default is not a penalty under New York law. Although the court agreed with the debtor that a higher default rate of interest has some penal effect in that it compels timely compliance with payment requirements under a loan, it concluded that the default rate was designed to compensate the secured party “for the increased risk of non-payment and the costs associated with the debtor’s default.” As such, the court allowed First Manhattan’s claim for post-petition default interest.

Late Payment Premium
Although the court determined that interest at the default rate was permissible, the court refused to permit First Manhattan to collect the late payment premium for two separate reasons.

First, the court noted that Section 506(b) limits the secured creditor to recovery of “reasonable” fees. Allowing a lender to recover default interest and late payment fees would result in double recovery because both payments are designed to compensate the lender for the same injury. Accordingly, case law on the matter “is uniform that oversecured creditors may receive payment of either default interest or late charges, but not both.”

Second, the court determined that the late payment premium was contemplated specifically to compensate the original lenders for incurring the additional costs of handling late payments made pursuant to the loan agreement. However, no payments would be made pursuant to the loan agreement. Instead, the debtor’s plan provided that First Manhattan would receive payments pursuant to an amended note and amended mortgage. Accordingly, First Manhattan would not incur any costs handling late payments under the loan agreement and the late payment premium would never become due.

Conclusion and Takeaways
From the In re 785 Partners decision, lenders should take some comfort that, at least with respect to pre-petition interest, they will be entitled to collect at the default rate if the agreement is governed by New York law. However, lenders should be wary of loans governed by other (non-New York) law. For example, the Bankruptcy Court in In re 785 Partners referred to a decision by the Bankruptcy Court for the Eastern District of Pennsylvania, In re 400 Walnut Assocs., L.P., 461 B.R. 308 (Bankr. E.D. Pa. 2011), in which the court relied on the Section 506(b) factors in disallowing a claim for pre-petition default interest under a contract governed by Pennsylvania law.

With respect to post-petition interest, the 785 Partners decision suggests that courts will take equitable concerns into account but will rarely modify or disallow an oversecured lender’s claim for default interest at the contract rate. However, if a creditor is awarded post-petition interest at the default rate, that creditor will most likely not be permitted to collect any late payment fees.

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The Challenge of Resolving Future Claims in Bankruptcy

By Michael Distefano

It is common knowledge that the Bankruptcy Code provides a debtor with a “fresh start” by allowing it to discharge prepetition claims. Similarly, section 363 of the Bankruptcy Code allows a trustee or debtor in possession to sell property of the estate “free and clear” of prior claims. These two concepts, while relatively straightforward, raise a fundamental question — when does a creditor hold a “claim” for purposes of the Bankruptcy Code? This question is particularly relevant in the case of future claims, that is, where a debtor’s pre-bankruptcy conduct results in post-bankruptcy injuries. This article discusses two recent cases that grappled with this issue and ultimately hold that certain future claims were not discharged by a bankruptcy case.

Section 101(5)(A) of the Bankruptcy Code defines a claim as a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” Congress intended this definition to be broad so that all legal obligations of a debtor — no matter how remote or contingent — would be resolved during a bankruptcy case. “Future tort claims” exist where (i) the claimant has had pre-petition contact with the debtor or its product but has not yet discovered the injury (e.g., asbestos cases); or (ii) where a product manufactured or sold by the debtor before the bankruptcy injures a claimant after the debtor has emerged from bankruptcy. See In re Chateaugay Corp., 944 F.2d 997 (2d Cir. 1991). The second category poses a number of challenges, because the claimants are typically unidentifiable at the time of the bankruptcy and cannot be given notice of the proceedings or their effect on the claimants’ rights. To address this problem, most courts hold that a claimant has a “claim,” within the meaning of the Bankruptcy Code, only if: “(i) events occurring before the confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor’s product; and (ii) the basis for liability is the debtor’s prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product.” In re Piper Aircraft, Corp., 58 F.3d 1573 (11th Cir. 1995). This relationship must be between an “identifiable claimant or group of claimants” and the debtor’s prepetition conduct.

In re Grumman Olson Industries
Grumman Olson Industries, Inc. was a designer and manufacturer of truck body parts that filed for bankruptcy in 2002. No. 11-2291, 2012 WL 1038672 (S.D.N.Y. 2012). Before its filing, Grumman’s products were routinely incorporated into Ford and General Motors vehicles. During its bankruptcy proceeding, Grumman sold certain of its assets to a predecessor of Morgan Olson LLC pursuant to section 363 of the Bankruptcy Code. The sale order provided, among other things, that Morgan was free of liability for claims against Grumman arising prior to the sale or related to the purchased assets. Following confirmation of Grumman’s liquidating plan in 2006, Morgan continued to produce and market the product line as that of Grumman.

In 2009, John and Denise Frederico commenced a lawsuit against Morgan in New Jersey state court, alleging that they were injured by a product manufactured, designed and/or sold by Grumman in 1994 — years before the commencement of Grumman’s bankruptcy case. In particular, Ms. Frederico alleged that she was seriously injured in 2008 when her truck hit a telephone pole, and that Morgan was responsible for her injuries under the theory of successor liability. In response, Morgan commenced an adversary proceeding
against the Fredericos in bankruptcy court, arguing that the sale order absolved Morgan of any liability for Grumman products manufactured or sold prior to the sale. The bankruptcy court held that the Fredericos’ did not hold a “claim” within the meaning of section 101(5), because at the time of the sale, the Fredericos were not identifiable claimants and therefore they could not have been notified of the release of their claims as required by due process. (For a more detailed discussion of the Grumman bankruptcy court decision, see “A Sale ‘Free and Clear’ is Not Necessarily Free and Clear of All Future Tort Liability,” International Restructuring Newswire, May 2011.)

On appeal, the bankruptcy court’s decision was affirmed by the District Court for the Southern District of New York. The district court stressed that sufficient notice is the “cornerstone underpinning of Bankruptcy Code procedure,” and that for due process reasons, a party that does not receive adequate notice of a bankruptcy proceeding cannot be bound by orders issued during that proceeding. In the case of future tort claims, the claimant is, for all practical purposes, unidentifiable and cannot be provided with appropriate notice of the bankruptcy filing. The court thus held that “[e]nforcing the Sale Order against the Fredericos to take away their right to seek redress . . . when they did not have notice or an opportunity to participate in the proceedings that resulted in that order would deprive them of due process.”

Morgan’s primary argument against imposing successor liability was that allowing this type of claim to survive section 363’s “free and clear” provisions would reduce the amount that potential purchasers are willing to pay for a debtor’s assets in a bankruptcy sale. According to Morgan, this would violate the Bankruptcy Code’s policy of maximizing the value of the estate. The district court summarily dismissed this contention, explaining that “to whatever extent maximizing the value of the estate is an important policy of the Bankruptcy Code, it is no more fundamental than giving claimants proper notice and opportunity to be heard before their rights are affected, to say nothing of constitutional requirements of due process.”

**In re Lear Corporation**

Though Grumman dealt with complicated issues of contingent liability, the facts of the case were relatively straightforward — a product created before the bankruptcy resulted in an injury occurring after the bankruptcy. In In re Lear Corp., No. 09-14326, 2012 WL 443951 (Bankr. S.D.N.Y. 2012), by contrast, the debtor’s alleged wrongful conduct and the resulting injury spanned before and after the bankruptcy. Such facts present a substantially more complex question of when claims arise for purposes of the Bankruptcy Code.

Lear Corporation was a manufacturer of auto parts that filed for chapter 11 in 2009 due to a weak automotive industry. The company underwent a relatively quick restructuring and in late 2009 it received a discharge of claims pursuant to a confirmed plan of reorganization. Two years later, Lear became the subject of several class action antitrust lawsuits alleging that it had engaged in a continuous price-fixing conspiracy since January 2000.

In response to the antitrust complaints, Lear filed a motion in the bankruptcy court to enforce the discharge and injunction provisions contained in its confirmed plan. Lear argued that the antitrust causes of action were claims that had been discharged and that the plaintiffs were therefore barred from bringing suit. The antitrust plaintiffs responded by arguing that it was post-confirmation conduct that gave rise to Lear’s liability and therefore the claims had not been discharged.

Similar to Grumman, the central question for the bankruptcy court was whether the causes of action asserted by the antitrust plaintiffs were “claims” within the meaning of the Bankruptcy Code at the time the discharge was granted. The court began its analysis with the principle that a contingent claim may be discharged if the underlying acts occurred before the bankruptcy petition. The court then examined two cases where this principle had been applied to antitrust violations. In both cases, all of the acts giving rise to liability had occurred prepetition, and thus the courts held that the antitrust claims had been discharged.

The Lear court agreed with these prior rulings and held that to the extent the causes of action asserted by the antitrust plaintiffs arose prepetition, the antitrust plaintiffs

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**To whatever extent maximizing the value of the estate is an important policy of the Bankruptcy Code, it is no more fundamental than giving claimants proper notice and opportunity to be heard before their rights are affected, to say nothing of constitutional requirements of due process.**
held “claims” that had been discharged. The court also held that to the extent the debtor’s conduct gave rise to antitrust liability after the bankruptcy, the plaintiffs were not enjoined from bringing suit. While bankruptcy may offer a debtor a fresh start, a “debtor is responsible for the consequences of its actions after it emerges from chapter 11.” In this instance, the plaintiffs asserted that after its bankruptcy, Lear had committed overt acts in furtherance of the antitrust conspiracy and such acts gave rise to liability for the entire life of the conspiracy. By contrast, Lear argued that only the original conspiratorial agreement should give rise to liability, since future anticompetitive sales were only a “rippling effect” of the original conspiratorial agreement.

Recognizing that application of antitrust principals will be “intensely factual,” the bankruptcy court declined to decide when the antitrust “claims” came into being, and deferred the issue to the trial court. This procedural aspect signals that in some cases bankruptcy courts may decline to rule on complex factual issues with respect to when claims arise. Interestingly, the Lear court seemed to dismiss the due process concerns raised in Grumman, holding that notice was a “separate issue” and that the plaintiffs’ due process arguments were “not ripe for decision.”

**Conclusion**

The Lear and Grumman decisions demonstrate that there is continuing uncertainty as to the effect of bankruptcy proceedings on future claims. There is at least one company, however, that has partially succeeded in avoiding this type of future liability.

In 2009, Chrysler underwent a government-backed restructuring whereby the company’s assets were sold to “New Chrysler” pursuant to a section 363 sale. The sale order immunized New Chrysler from punitive damages claims resulting from manufacturing defaults in vehicles sold before the restructuring. Thus, individuals who purchased vehicles before Chrysler’s bankruptcy were precluded from bringing punitive damages claims against Chrysler if they were subsequently injured by the vehicle after Chrysler’s restructuring (the same fact scenario as Grumman). Chrysler remained liable for future lawsuits, but only with respect to compensatory (actual) damages. While punitive damages can be excessive and unpredictable, they provide a powerful incentive for recalls and subsequent safety modifications.

Following Chrysler’s bankruptcy, several individuals injured by Chrysler vehicles have been precluded from bringing punitive damage claims against Chrysler. Understandably, these individuals have been surprised to learn that their claims were essentially discharged by a bankruptcy proceeding in which they were not involved. Now retired U.S. Bankruptcy Judge Arthur Gonzalez, who approved the Chrysler sale, was recently quoted in a Wall Street Journal article observing that “[w]ithin the parameters of ‘due process,’ it appears that bankruptcy law allows for the cutting off of liability and thereby protecting the purchaser who has paid for value.” Judge Gonzalez’s comments suggest that even though these future claimants were unidentifiable at the time of the bankruptcy sale, their due process rights were not harmed.

General Motors, which also went through a government-backed restructuring, attempted to include similar language in its sale order, but was unsuccessful. Because General Motors is a larger company than Chrysler and has far more older cars on the roads, various states opposed GM’s attempt to abandon future liability. Wary of a potential public backlash and hesitant to delay the sale, GM agreed to retain future liability, including punitive damages claims. In this regard, it was politics — not law — that thwarted GM’s attempt to discharge future liability.

Chrysler offers an attractive model for debtors looking to limit future liability. The success of such efforts will depend on careful drafting of the appropriate orders and may ultimately still be called into question by the courts. For now, however, debtors and asset purchasers should continue to carefully investigate the existence and nature of potential future claims when implementing a reorganization or liquidation strategy.

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