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RESTRUCTURING & INSOLVENCY UPDATE

Spring 2011

* PRIOR RESULTS DO NOT GUARANTEE OR PREDICT A SIMILAR OUTCOME IN ANY FUTURE CASE. RESULTS DEPEND UPON A VARIETY OF FACTORS UNIQUE TO EACH CASE.

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Dear Clients and Friends,

Welcome to the Spring 2011 issue of the Restructuring & Insolvency Update. You will notice a few changes in this issue, most noticeably the change of the publication's name from Bankruptcy & Restructuring. This restatement of our practice name is intended to reflect the greater scope and diversity of services that we now provide as a result of Squire Sanders' January 1 combination with UK-based Hammonds. Together, we offer additional cross-border resources, deepened thought leadership and a wider breadth of experience across the globe. Our 90 restructuring and insolvency lawyers are located in 27 offices across 15 countries in the United States, UK, Europe, Asia, and Central and South America. We are confident that no firm has greater capabilities and resources to serve the restructuring needs of sophisticated clients across as many borders.

This issue of the Update offers a wealth of information that we hope is of interest. Among other items, we provide analyses of recent significant cases, a discussion on how the common interest privilege was extended to a restructuring case and case summaries reviewing pitfalls for reclaiming sellers and substantive consolidation.

With our new, expanded focus, we plan to publish articles and newsletters that will provide valuable insight to the restructuring and insolvency process in the UK and throughout Europe, and case studies that analyze the unique representations in which we have been involved.

We invite you to visit the news, events and publications sections of our website practice page at http://www.ssd.com/restructuring_insolvency/ for updates throughout the year. As always, we welcome your feedback and appreciate your ongoing friendship and business.

– Stephen D. Lerner
Chair, Squire Sanders Restructuring & Insolvency Practice Group

ARTICLES

Frenemies – Extending the Common Interest Privilege to the Restructuring Context

– *Bradley A. Cosman, Phoenix*

The term "frenemy" – a combination of the words friend and enemy – has emerged from modern vernacular to describe someone who is simultaneously a partner and an adversary. The term is perhaps perfectly emblematic of the restructuring process where various constituents make and break alliances in an effort to steer the restructuring process. In so doing, the lines between friend and enemy are often blurred or altered during the course of the restructuring.

Collaboration amongst frenemies in the restructuring context is often dependent upon the ability to employ the common interest privilege. The common interest privilege allows attorneys representing different clients with similar legal interests to share information without waiving attorney-client privileges. The party invoking the protection of the common interest privilege must establish: (1) the communication was made by separate parties in the course of a matter of common interest; (2) the communication was designed to further that effort; and (3) the privilege has not otherwise been waived. The common interest privilege requires that the parties share at least a substantially similar legal interest; but the parties need not be in complete accord.

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Application of the common interest privilege amongst bankruptcy frenemies was recently challenged and upheld in *In re Leslie Controls, Inc.*, 2010 Bankr. LEXIS 3177 (Bankr. D. Del. 2010). In *Leslie Controls,* the court held that the common interest privilege may be invoked by parties in a bankruptcy discovery dispute that share substantially similar legal interests, even if they had adversarial interests on other issues. The debtor in *Leslie Controls* determined that a bankruptcy filing was necessary to deal with its mounting asbestos-related liabilities. Prior to filing bankruptcy, the debtor began negotiating with an ad hoc committee of asbestos plaintiffs (the Ad Hoc Committee) and the debtor's proposed future claimants' representative (the FCR). During those negotiations the debtor shared with the Ad Hoc Committee and the FCR a legal memorandum prepared by the debtor's insurance coverage counsel that analyzed potential insurance recoveries for asbestos claims under various bankruptcy scenarios. In this regard, the debtor, the Ad Hoc Committee and FCR were functioning as frenemies because they were partnering in an effort to maximize the estate's assets, but had adversarial interests in how those assets would be allocated.

In the debtor's subsequent bankruptcy, the debtor's insurers (the Insurers) moved to compel production of the insurance memorandum while the debtor invoked the protection of the common interest doctrine. In upholding the debtor's invocation of the common interest doctrine, the court first found that the debtor, the Ad Hoc Committee and the FCR shared a legal interest, not merely a commercial interest. The court found that the parties shared an interest in preserving and maximizing the insurance available to pay asbestos claims, and such interest was an "inherently legal question" because it involved analysis of the insurance documents, contracts, insurance and bankruptcy law, and required involvement of the bankruptcy court.

To the extent the estate's pool of assets can be considered a pie, the size of the pie and the size of the pieces are two separate issues.

The court then confirmed that the common interest privilege does not require complete unity of interest among participants. The Insurers argued that the debtor, the Ad Hoc Committee and the FCR did not share a common interest in connection with the insurance proceeds because they had competing interests in allocating such proceeds. The court acknowledged the parties had competing interests in the allocation of proceeds, but rejected the Insurer's argument by analogizing the situation to sharing a pie. To the extent the estate's pool of assets can be considered a pie, the size of the pie and the size of the pieces are two separate issues. The court found that the debtor, the Ad Hoc Committee and FCR were in accord as to the former and adversaries as to the latter. Said another way, the parties shared a common interest in increasing the size of the estate's pool of available assets even though they had competing interests in how to allocate such assets. The court, therefore, upheld the debtor's invocation of the common interest privilege.

Leslie Controls affirms extension of the common interest privilege to the restructuring context, even when the parties asserting it are engaged in adversarial negotiations at the time the communications were made. In so doing, *Leslie Controls* is welcome comfort to parties negotiating consensual restructuring strategies. Moreover, *Leslie Controls* fosters the critical frenemy restructuring partnerships that often lead to increased creditor recoveries, even where future conflict amongst the parties to such partnerships is foreseeable.

Avoidable Transfer Laws Under Chapter 15

– Peter A. Zisser, *New York*

Introduction

The world is an international marketplace, so it is not uncommon for a US company's non-US trade partner to have a financial meltdown and become subject to an insolvency proceeding in its domicile country. Obviously, this can have a significant adverse impact on the US company. It might not get paid and/or may be the target of an avoidance and recovery action. Prior to 2005, representatives of foreign debtors were able to utilize section 304[1] of title 11 of the Bankruptcy Code[2] to seek the assistance of the US courts in protecting the foreign debtor's assets in the United States. In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Act), which repealed section 304 and replaced it with chapter 15,[3] a more comprehensive cross-border bankruptcy statute, primarily intended to foster cooperation between and among US courts, trustees and debtors, and the courts of foreign jurisdictions involved in cross-border insolvency cases.[4]

One issue that had been raised under section 304, however, remained unresolved under chapter 15: Does a foreign representative[5] have the right to bring avoidance actions in a US bankruptcy court as part of an ancillary chapter 15 bankruptcy case and, if so, what avoidance law is applicable? In

[1] 11 U.S.C. §§ 304 *et seq.* (repealed).
[2] 11 U.S.C. §§ 101 *et seq.*
[3] 11 U.S.C. §§ 1501-1532.
[4] 11 U.S.C. § 1501(a).
[5] A "foreign representative" is defined as a person "authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding." 11 U.S.C. § 101(24). Such "person or body" does not necessarily have to be one appointed by the insolvency court if the relevant insolvency scheme provides otherwise. *See, e.g., In re Betcorp Ltd. (In Liquidation),* 400 B.R. 266 (Bankr. D. Nev. 2009) (Australian debtor in a "voluntary winding up," as provided under Australian insolvency law, using a liquidator appointed by the shareholders, not a court, and who was registered as a liquidator with the Australian Securities and Investments Commission).

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applying section 304, courts were split on whether the foreign representative could utilize the avoidance powers provided by the Bankruptcy Code. Some courts agreed that he/she could, while others held that the foreign representative was limited to avoidance powers granted under the laws of the foreign domiciliary. Chapter 15 partially answered the question. Under chapter 15, the Bankruptcy Code's avoidance powers, by statute, were rendered unavailable to foreign representatives, but chapter 15 was silent on whether the foreign representative could utilize foreign avoidance laws in the chapter 15 case.

In March 2010, the Fifth Circuit unequivocally held that a foreign representative could indeed utilize foreign avoidance law in a chapter 15 case. *See In re Condor Ins. Ltd.,* 601 F.3d 319 (5th Cir. 2010) (hereinafter, *Condor*). While this result may seem anti-climactic, it could, depending on the foreign law, have a significant impact on the US trading partner who might have been the recipient of an alleged preferential or fraudulent transfer by a foreign insolvent company. As discussed below, with the Fifth Circuit's decision, it has become imperative that every company doing business with a non-US company at least be aware of the insolvency statutory regime in the relevant country.

Section 304

Under section 304, a foreign representative in a foreign insolvency proceeding could seek recognition in the bankruptcy court and, if recognition was granted, obtain injunctive and other relief designed to assist the foreign representative in protecting the foreign debtor's assets in the United States.

By way of brief background, under section 304, a foreign representative in a foreign insolvency proceeding could seek recognition in the bankruptcy court and, if recognition was granted, obtain injunctive and other relief designed to assist the foreign representative in protecting the foreign debtor's assets in the United States.[6] In making such assistance available, the bankruptcy court could order whatever relief it deemed "appropriate," leading one court to suggest that "section 304(b) conferred authority on a bankruptcy court to 'broadly mold appropriate relief in near blank check fashion.'"[7] In determining the parameters

[6] Under Section 304, the court could (1) enjoin the commencement or continuation of any action against the debtor in the foreign proceeding or any property involved in that proceeding; (2) enjoin the enforcement of any judgment against the debtor or its property or any act or proceeding to enforce a lien against the debtor's property; (3) order the turnover of the debtor's property to the foreign representative for administration in the foreign proceeding; and/or (4) order whatever additional relief it deems "appropriate." See 11 U.S.C. § 304(b).
[7] *In re Culmer,* 25 B.R. 621, 624 (Bankr. S.D.N.Y. 1982).

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of appropriate relief, the court was to be guided by "what will best assure an economical and expeditious administration of such estate."[8] In doing so, courts were to consider:

> (1) just treatment of all holders of claims against or interests in such estate; (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding; (3) prevention of preferential or fraudulent dispositions of property of such estate; (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by this title; (5) comity; and (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.[9]

Notwithstanding such lofty principles, one issue continued to split the courts: Can a foreign representative in a section 304 proceeding utilize chapter 5 avoidance powers, such as section 547 (preferential transfers)[10] or section 548 (fraudulent transfers)?[11] While the Bankruptcy Code offered no explicit guidance, a number of bankruptcy courts looked to the language of section 304 and other sections of the Bankruptcy Code to reach the conclusion that the foreign representative was permitted to utilize the chapter 5 avoidance powers.[12]

At least one court, however, bucked that trend. In *In re Metzeler,* 78 B.R. 674 (Bankr. S.D.N.Y. 1987), the court rejected the earlier decisions, instead holding that a foreign representative was prohibited from using section 304 as a vehicle to bring avoidance actions under sections 547 or 548, but could utilize the avoiding powers "vested in him by the law applicable to the foreign estate."[13] In reaching this decision, the *Metzeler* court pointed out that the language of sections 547 and 548 referred only to

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[8] *See* 11 U.S.C. § 304(c).
[9] *Id.*
[10] *See* 11 U.S.C. § 547.
[11] *See* 11 U.S.C. § 548.
[12] *See, e.g., In re Comstat Consulting Services Ltd.,* 10 B.R. 134, 135 (Bankr. S.D. Fla. 1981) (finding that the word "petition" in sections 547 and 548 included a petition filed under Section 304); *In re Egeria Societa Per Azioni Di Navigazione,* 26 B.R. 494, 497 (Bankr. E.D. Va. 1983) (the language of section 304(c)(3) specifically allows the use of chapter 5 avoidance powers in a section 304 proceeding).
[13] *Id.* at 677. It should be noted that the decision was written in the negative (i.e., you *may not* use sections 547 or 548, not *you may* use foreign law).

a "trustee" (and, by reference, a debtor-in-possession), not a "foreign representative."[14] Further, the *Metzeler* court determined that:

> The section 304 court's tasks should be to assist implementation of the foreign court's decrees (when not contrary to fundamental domestic policies), not to provide the foreign representative with the benefit of American avoidance powers, which may be better (from a debtor's perspective) than those available in the foreign court.[15]

The reason is unclear, but the issue of avoidance actions based on foreign law virtually dropped off the radar between 1987 and 2005, the year the Act was enacted.[16]

Chapter 15

In Condor, the Fifth Circuit Court of Appeals explicitly held that a duly recognized foreign representative could use chapter 15 as a vehicle to prosecute an avoidance action based on the laws of the debtor's domiciliary country, notwithstanding chapter 15's preclusion of a foreign representative's use of the avoidance powers granted under the Bankruptcy Code.

As part of the Act, Congress partially clarified the avoidance power exception by codifying the *Metzeler* ruling. Now, upon recognition of the foreign proceeding, the court can grant certain relief *except* for relief available under, *inter alia,* Bankruptcy Code sections 547 and 548.[17] What the Act did not do, however, was address what avoidance law the foreign representative was permitted to use. Nevertheless, in *Condor,* the first (and, currently, the only) Circuit Court decision on this issue, the Fifth Circuit Court of Appeals explicitly held that a duly recognized foreign representative could use

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[14] *Id.*

[15] *Id.* (quoting R. A. Gitlin and E.D. Flaschen, "The International Void in the Law of Multinational Bankruptcies," 42 Business Lawyer, 307, 319 (1987)).

[16] The only pre-Act case the author has been able to identify that relied on *Metzeler* to reach a similar holding was *In re Tarricone, Inc.,* 80 B.R. 21, 23-24 (Bankr. S.D.N.Y. 1987) (court rejected foreign representative's attempt to bring action under Bankruptcy Code sections 547 and 548). Citations to *Metzeler,* however, continued to appear regularly in unrelated *dicta. See, e.g., In re Koreag,* 961 F.2d 341, 357 (2d Cir. 1992) (*dicta*) (section 304 proceeding does not give rise to a full-scale bankruptcy case with avoidance powers); *In re Loy,* 2010 U.S. Dist. LEXIS 71693 (E.D. Va. June 23, 2010) (same); *In re Wachsmuth,* 272 B.R. 766 (Bankr. M.D. Fla. 2001) (dismissing attempt to use state fraudulent transfer law); *In the Matter of Axona Int'l Credit & Commerce Ltd.,* 88 B.R. 597, 607 n.17 (Bankr. S.D.N.Y. 1988) (*dicta*) ("[C]ases and the commentators have concluded that the avoiding powers under the Code are not available in an ancillary proceeding").

[17] *See* 11 U.S.C. § 1521(a)(7) ("Upon recognition of a foreign proceeding, whether main or nonmain, where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interest of creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including – (7) granting any additional relief that may be available to a trustee except for relief available under sections 522, 544, 545, 547, 548, 550 and 724(a).").

chapter 15 as a vehicle to prosecute an avoidance action based on the laws of the debtor's domiciliary country, notwithstanding chapter 15's preclusion of a foreign representative's use of the avoidance powers granted under the Bankruptcy Code.

Condor Insurance Ltd., an insurance and surety company, was subject to a winding-up proceeding in Nevis, its domiciliary country. The Nevis insolvency court appointed Richard Fogerty and William Tacon as Joint Official Liquidators (the Liquidators). The Liquidators filed a chapter 15 case in Mississippi for the purpose of recovering approximately $313 million the Liquidators alleged was fraudulently transferred to Condor's US subsidiary, Condor Guaranty, Inc. (CGI). The Liquidators then filed an adversary proceeding in the chapter 15 case against CGI, seeking recovery of the $313 million based on the fraudulent transfer laws of Nevis. CGI moved to dismiss, arguing that (1) avoidance actions are available to only chapter 7 or chapter 11 debtors and (2) because Condor was a foreign insurance company, it was prohibited from filing under either of those chapters.[18] The bankruptcy court agreed with CGI, dismissing the adversary proceedings, and the dismissal was affirmed by the district court.[19] The result of these two lower-court decisions was that the Liquidators could not bring any avoidance actions under any jurisdiction's laws in the chapter 15. An appeal was then taken to the Fifth Circuit.

The Fifth Circuit began its analysis by looking at the restrictive language in section 1521(a)(7) of the Bankruptcy Code. The court noted that while the section contains an exclusive list of exceptions, there is no indication that other forms of relief were also to be excluded.[20] Thus, while sections 547 and 548 may not be available, "it does not necessarily follow that Congress intended to deny the foreign representative powers of avoidance as supplied by applicable foreign law. If Congress wished to bar all avoidance actions whatever their source, it could have stated so; it did not."[21]

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[18] Pursuant to Bankruptcy Code section 109, foreign insurance companies engaged in the insurance business in the United States are prohibited from being debtors under chapter 7 or 11. *See* 11 U.S.C. § 109(b)(3)(A) and (d). The history behind this prohibition, while fascinating, is beyond the scope of this article.
[19] *See In the Matter of Condor Ins. Ltd.,* 2008 WL 2858943 (Bankr. S.D. Miss. 2008), *aff'd,* 411 B.R. 314 (S.D. Miss. 2009).
[20] *Condor,* 601 F.3d at 324 ("Generally, where there are enumerated exceptions 'additional exceptions are not to be implied, in the absence of a contrary legislative intent.'") (quoting *Andrus v. Glover Const. Co.,* 446 U.S. 608, 616-617 (1980)).
[21] *Id.*

The court also looked at the purpose of chapter 15 as embodied in section 1501, particularly the idea that chapter 15 was intended to provide “effective mechanisms” for dealing with cross-border insolvencies, to promote cooperation between US and foreign courts, “fair and efficient administration” of such cases so as to protect the interests of all creditors and protect and maximize the value of the debtor’s assets.[22] This goal “suggests a broad reading of the powers granted to the district court in order to advance the goals of comity to foreign jurisdictions.”[23] Allowing application of foreign law also denies the foreign representative an opportunity to use the avoidance laws of the United States when no such authority exists in the representative’s domicile jurisdiction. This will eliminate the threat that the foreign representative may commence a chapter 15 simply to gain access to such laws.[24]

The Fifth Circuit apparently recognized that cross-border cooperation is an integral part of the United States’ commercial future, cogently noting that:

> Providing access to domestic federal courts to proceedings ancillary to foreign main proceedings springs from distinct impulses of providing protection to domestic business and its creditors as they develop foreign markets. Settled expectations of the rules that will govern their efforts on distant shores is an important ingredient to the risk calculations of lenders and corporate management. In short, Chapter 15 is a congressional implementation of efforts to achieve the cooperative relationships with other countries essential to this objective. The hubris attending growth of the country’s share of international commerce rests on a nourishing of its exceptionalism not its diminishment.[25]

Notwithstanding the requirement that only foreign law be used, there remain a number of good reasons why it is preferable for an insolvent foreign entity to seek recognition under chapter 15 and thereupon seek recovery of allegedly avoidable transfers in the United States, even if it may only take advantage of the foreign jurisdiction’s avoidance laws:

- **The bankruptcy court has nationwide jurisdiction:** It is possible, if not likely, that the foreign insolvency court will not have *in personam* jurisdiction over a US defendant, making

[22] *See* 11 U.S.C. § 1501.
[23] 601 F.3d at 325.
[24] *Id.* at 327.
[25] *Id.* at 329.

any decision in an avoidance action before that court unenforceable.[26] In a chapter 15, however, the bankruptcy court, in whatever federal district it may be situated, is granted automatic *in personam* jurisdiction over any entity located anywhere in the United States for purposes of an avoidance action.[27] This can be especially beneficial to the foreign representative if there are multiple recipients of alleged avoidable transfers.[28]

- **The summons and complaint can be served by mail:** Even if the foreign court believes it has jurisdiction over the defendant, under nonbankruptcy federal law, the foreign plaintiff would have to deliver the summons and complaint directly into the defendant's hands.[29] This can be difficult and sometimes costly, particularly if there are multiple defendants. Under the bankruptcy rules, which are applicable in a chapter 15 case, service of a summons and

[26] *See, e.g.,* 601 F.3d at 327 ("Congress did not intend to restrict the powers of the U.S. court to apply the laws of the country where the main proceeding pends. Refusing to do so would lend a measure of protection to debtors to hide assets in the United States out of the reach of the foreign jurisdiction, forcing foreign representatives to initiate much more expansive proceedings to recover assets fraudulently conveyed, the scenario Chapter 15 was designed to prevent. Nor is the suggestion that the representatives need only render their claim in Nevis an answer. Not all defendants are necessarily within the jurisdictional reach of the Nevis court.").

[27] Nationwide jurisdiction is granted under section 1334 of the judicial code, not the Bankruptcy Code. *See* 28 U.S.C. § 1334. Under section 1334, the district court (and, by automatic reference in most jurisdictions, the bankruptcy court) has exclusive jurisdiction over all cases arising under title 11 (including chapter 15) as well as exclusive jurisdiction of property of the debtor "wherever located." 28 U.S.C. § 1334(a), (e). *See also, e.g., Bakst v. Lester (In re Amelung),* 2010 Bankr. LEXIS 1220, *26 (Bankr. S.D. Fla., West Palm Beach Div., April 7, 2010) (Congress has expressly provided bankruptcy courts with federal question jurisdiction over all bankruptcy cases and proceedings. The legislative history of 28 U.S.C. § 1334 shows Congress' intention that "bankruptcy courts will exercise *in personam* jurisdiction as well as *in rem* jurisdiction in order that they may handle everything that arises in the bankruptcy case. [T]he bankruptcy courts can exercise personal jurisdiction without applying a minimum contacts analysis and remain in constitutional harmony with the Due Process Clause of the Fifth Amendment.") (citations omitted).

[28] It should also be noted that enforcing a foreign judgment in the United States would require the US court to grant comity to the foreign proceeding. A court in the United States (which appears to include state or federal courts) is not permitted to grant comity or cooperate with the foreign tribunal unless the foreign proceeding has been recognized under chapter 15. *See* 11 U.S.C. 1509(c) ("A request for comity or cooperation by a foreign representative in a court in the United States other than the court which granted recognition shall be accompanied by a certified copy of an order granting recognition under section 1517."). As noted in the legislative history to this section, "chapter 15 is intended to be the exclusive door to ancillary assistance to foreign proceedings. The goal is to concentrate control of these questions in one court." H.R. No. 109-31, Pt. 1, 109th Cong. 1st Sess. 100-111 (2005).

[29] *See* Fed. R. Civ. P. 4(h). Serving a summons and complaint can be done either (1) by delivering a copy of the summons and of the complaint to an officer, a managing or general agent, or any other agent authorized to accept service or (2) in a manner provided by state law. Under New York law, for example, personal service is required. *See* N.Y.C.P.L.R. 311(a)(1).

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complaint is generally accomplished simply by sending copies by first-class mail to the defendant,[30] wherever he/she may be located.[31]

- **Compelling discovery requires no court involvement:** In order to compel production of documents or depose a defendant domiciled in the United States, a foreign non-insolvency tribunal must seek an order of the district court in the district in which the defendant resides.[32] The district court has wide discretion to decide whether to grant discovery.[33] Further, application for a discovery order generally must be made on notice to the target.[34] Again, this can be extremely burdensome if there are multiple targets. In a chapter 15 case, however, the foreign representative of a recognized foreign proceeding[35] simply issues a subpoena (or subpoenas) and serves it on the target(s).[36] No prior court authorization is needed.

What Does This All Mean?

It is well established that US trade partners are well advised to know about their non-US counterpart's financial condition, the laws governing cross-border business transactions, the laws on taxation and other laws governing the business itself. The caveat here is that the foregoing may be meaningless if the non-US trading partner becomes subject to a foreign insolvency proceeding in its domicile country. If that happens, you or your client, as a US trade partner, may become subject to that jurisdiction's

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30 *See* Fed. R. Bankr. P. 7004(b)(3).
31 *Id.* at 7004(d) ("The summons and complaint and all other process except a subpoena may be served anywhere in the United States.").
32 *See* 28 U.S.C. § 1782.
33 *See Esses v. Hanania (In re Application of David Esses for Assistance Before a Foreign Tribunal),* 101 F.3d 873, 876 (2d Cir. 1996) ("Section 1782 grants district courts wide discretion to determine whether to grant discovery and equally wide discretion to tailor such discovery to avoid attendant problems. Substantively, so long as the district court fashions its order in accordance with the twin aims of § 1782, providing efficient means of assistance to participants in international litigation in our federal courts and encouraging foreign countries by example to provide similar means of assistance to our courts, it acts within its discretion.") (internal citations omitted).
34 *See, e.g., In re Application of Merck & Co., Inc.,* 197 F.R.D. 267, 270 (M.D.N.C. 2000) ("Nothing in *Section 1782* states that the application is to be made *ex parte,* much less that the Court must entertain the application *ex parte.* Moreover, such a reading would seem to be contrary to the purpose of the statute, which is to help promote evenhanded justice and a sense of fair treatment.") (emphasis in original).
35 *See supra* note 28.
36 *See* Fed. R. Civ. P. 45, made applicable to bankruptcy by Bankruptcy Rule 9016. Rule 45 provides, in pertinent part, that "[s]erving a subpoena requires delivering a copy to a named person." Fed. R. Civ. P. 45(b)(1). A growing number of courts have determined that Rule 45(b)(1) does not require personal service, but only service "reasonably designed to ensure actual receipt of a subpoena by a witness." *Cadlerock Joint Venture, L.P. v. Adon Fruits & Vegetables, Inc.,* 2010 U.S. Dist. LEXIS 65978, *8 (E.D.N.Y. April 21, 2010) (citations omitted). Although first-class mail may be sufficient, it is generally prudent for the subpoena to be sent certified mail or overnight courier so a record of delivery can be submitted with the affidavit of service.

substantive avoidance law, not the Bankruptcy Code. While in certain instances, the foreign law may favor the US trading partner by burdening the foreign representative with more onerous standards of proof, shorter statutes of limitation and limits on liability of subsequent transferees,[37] in others, the foreign law may favor the foreign representative with longer statutes of limitation or lesser burdens of proof.[38] The individual differences are unimportant; it is the particular laws in the country in which you plan to trade that are crucial. It would be prudent for the US trading partner to examine those laws when entering into business relationships with a non-US trading partner.

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CASE SUMMARIES

River Road Court Certifies Direct Appeal to the Seventh Circuit Court of Appeals on Credit Bid Issue

– *Christine Murphy Pierpont, Cleveland*

On November 4, 2010, the United States Bankruptcy Court for the Northern District of Illinois certified the appeal of debtors *River Road Hotel Partners, LLC, et al*. of the court's Order Denying Debtors' Bid Procedures Motion (the Order) entered October 5, 2010. In its Order, the bankruptcy court expressly denied the debtors' attempts to prevent their secured creditors from credit bidding in a proposed sale of assets under a chapter 11 plan. In certifying the appeal, the bankruptcy court cited the need to resolve recent conflicting decisions among courts on this crucial issue of whether a secured creditor has the absolute right to credit bid at a plan sale. Earlier in the year, in *In re Philadelphia Newspapers, LLC*., No. 09-4266 (3d Cir. Mar. 22, 2010), the Third Circuit had determined that a plan that provides secured lenders with the "indubitable equivalent" of their secured interest in an asset is not required to permit credit bidding when that asset is sold. The *Philadelphia Newspapers* decision followed a similar ruling by the Fifth Circuit *in In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009).

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[37] *See generally* Jeffrey A. Schoenbaum, *Multistate and Multinational Estate Planning 2009,* p. 18-190, § 18.23[B][3] (CCH 2009 ed.).
[38] *Id.*

However, the *River Road* court was not persuaded by the *Philadelphia Newspapers* reasoning and denied the debtors' attempts to block their secured creditors from credit bidding. The debtors proposed a chapter 11 plan, which, among other things, contemplated the auction sale of all of their assets. In conjunction with the plan, the debtors filed a motion seeking approval of procedures to govern the sale. The motion sought an order precluding the debtors' secured creditors from credit bidding, both as a matter of law under section 1129(b)(2)(iii) of the Bankruptcy Code and for cause under section 363(k) (as incorporated in section 1129(b)(2)(ii)). The bankruptcy court summarily dismissed the debtors' argument, derived from the majority opinion in the *Philadelphia Newspapers* case, that a sale under section 1129(b)(2)(iii) permitted them to sell their assets free and clear of the secured liens. Rather, the bankruptcy court specifically found that Judge Ambro's dissent in *Philadelphia Newspapers* was the more persuasive view. Judge Ambro had argued that subsection 1129(b)(2)(A)(ii) (which includes a secured creditor's right to credit bid) is the exclusive subsection of 1129(b)(2)(A) applicable to sales under plans of reorganization. Further, Judge Ambro emphasized the importance of a secured creditor's right to credit bid at any sale, including a sale under a plan of reorganization, as a means to permit secured creditors to protect against the undervaluation of secured assets at a sale. He pointed out that such undervaluation in this case likely benefited only the buyer who has substantial insider and equity ties. He was troubled by other practical concerns as well, such as the potential for the increased cost of credit as secured creditors were denied the benefit of their bargain.

The River Run *court was not persuaded by the* Philadelphia Newspapers *reasoning and denied the debtors' attempts to block their secured creditors from credit bidding.*

Finally, after conducting an evidentiary hearing, the *River Road* bankruptcy court also denied the debtors their alternative relief, holding that the debtors failed to show sufficient cause to deny credit bidding under sections 1129(b)(2)(A)(ii) and 363(k).

As the bankruptcy court noted in certifying the direct appeal of its Order, the issue of a secured creditor's right to credit bid at plan auction sales is receiving significant attention among bankruptcy commentators. If the Seventh Circuit Court of Appeals upholds the *River Road* decision, it could well set the stage for a showdown on this issue in the Supreme Court. Briefing by the parties in the appeal has been completed, and an amicus brief has been submitted by the Loan Syndications and Trading Association. The court is scheduled to hear oral argument on April 7, 2011.

A Statutory Basis for Substantive Consolidation? *In re Cyberco Holdings, Inc.*, 431 B.R. 404 (Bankr. W.D. Mich. 2010)

– *Andrew M. Simon, Cincinnati*

A popular line of thinking among bankruptcy practitioners and commentators holds that substantive consolidation – the combining of assets and liabilities of a debtor and another debtor or non-debtor entity to satisfy creditor claims against both entities ratably from the resulting pool – is an equitable remedy of judicial invention with no specific foundation in the Bankruptcy Code. Many courts seem to agree with this view, with few even attempting to find a statutory basis for substantive consolidation outside of the court's broad authority to issue orders under section 105(a) of the Bankruptcy Code.

However, a recent Michigan bankruptcy court decision upsets this conventional thinking, finding statutory authority for substantive consolidation by combining provisions found in sections 542(a) and 502(j) of the Bankruptcy Code. Judge Jeffrey R. Hughes' decision in *In re Cyberco Holdings, Inc.*, 431 B.R. 404 (Bankr. W.D. Mich. 2010), is potentially groundbreaking in its attempt to "legitimize" substantive consolidation by removing the substantive consolidation analysis from, in the court's words, "amorphous notions of equity and dubious interpretations of Section 105" and placing it within a statutory framework. But its reasoning may ultimately lead to fewer estates being substantively consolidated because it also holds that only trustees have standing under section 542(a). This may significantly limit availability of the remedy to creditors seeking substantive consolidation.

Facts and Procedural History

Cyberco involved Huntington National Bank's motions seeking substantive consolidation of two related chapter 7 debtors. Cyberco Holdings, Inc. was an information technology infrastructure company that began as a legitimate enterprise but ultimately engaged in a massive fraud that led banks, leasing companies and other lenders to lend money for the purchase of fictitious computer equipment from Cyberco's affiliate through common ownership, Teleservices Group, Inc. After receiving funds directly from the financing companies, Teleservices channelled money to Cyberco in order to extend the scheme and finance the lavish lifestyles of the entities' owners.

Huntington had been a prepetition lender to Cyberco, which was able to significantly reduce its exposure during the months leading up to the collapse of the scheme and the subsequent chapter 7 filings of both Cyberco and Teleservices. Ultimately, the chapter 7 trustees for both entities filed avoidance actions against Huntington related to its receipt of allegedly preferential and fraudulent transfers.

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In response, Huntington sought to have the two estates substantively consolidated because they had been under common ownership and control and had acted in concert to perpetuate the fraud. Substantive consolidation was attractive to Huntington in part because a combination of the two estates would have resulted in the netting out of some of the allegedly avoidable transfers it had received.

Analysis and Statutory Authority for Substantive Consolidation

The *Cyberco* court noted the modern "liberal" approach among courts toward allowing substantive consolidation under section 105(a), but discarded it, ultimately finding a statutory basis for the remedy in the Bankruptcy Code and common law support among cases decided under the old Bankruptcy Act of 1898 and the Bankruptcy Code. Section 105(a) has long been a source of controversy under the Bankruptcy Code, with some disputing whether the key language of the section – ("[t]he court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.") – permits the court broad discretion to fashion whatever remedies it sees fit. Some believe that interpreting section 105(a) so broadly opens the door for inconsistent adjudication and abuse, and they argue that the section cannot be used to fashion remedies that are not rooted in other substantive sections of the Bankruptcy Code. The court quoted a widely followed Second Circuit case, *In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988), which refers to substantive consolidation as having "no express statutory basis but is a product of judicial gloss," to summarize the popular position that substantive consolidation is a remedy of judicial invention under section 105(a).

The court then analyzed prominent Bankruptcy Act substantive consolidation cases, including *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 216-217, 61 S. Ct. 904, 906 (1941). But instead of agreeing with the approach of the Third Circuit in *In re Owens Corning*, 419 F.3d 195, 206 (3rd Cir. 2005), and similar cases, which seem to view *Sampsell* as the genesis for substantive consolidation as an equitable remedy, Judge Hughes found the beginning of his statutory support for substantive consolidation in *Sampsell*. He noted that under the Bankruptcy Act, "property of the estate" included property that had been fraudulently transferred out of the estate. This broad definition of property effectively extended the bankruptcy court's reach beyond the boundaries of the estate, sometimes allowing it to exercise jurisdiction over the property of non-debtors via turnover proceedings.

In other words, prior to the enactment of the Bankruptcy Code, substantively consolidating a non-debtor with a debtor was actually accomplished by turnover actions and was not simply the "product of judicial gloss." The court found similar support in other Bankruptcy Act cases. This history provided an informative backdrop for section 542(a) of the Bankruptcy Code, which provides in relevant part:

> … an entity … in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title … shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate. 11 U.S.C. § 542(a).

Under the Bankruptcy Code, section 541(a)(1) broadly defines property of the estate: "Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case." The *Cyberco* decision argued that section 541(a)(1)'s broad scope renders section 542(a) unnecessary unless it is read to provide "broader authority to reach out and take control of the estate's property in the possession of others." *Cyberco*, 431 B.R at 420, citing *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 206-07 nn.13, 15, 103 S. Ct. 2309, 2314-15 nn. 13, 15 (1983).

Combining the assets of a non-debtor with a debtor remedies unfair treatment of the debtor's creditors whose property has been bled out of the estate, but it does not address any new inequities suffered by creditors of the non-debtor.

Assuming one accepts this reasoning, this only accounts for half of the substantive consolidation equation. Combining the assets of a non-debtor with a debtor remedies unfair treatment of the debtor's creditors whose property has been bled out of the estate, but it does not address any new inequities suffered by creditors of the non-debtor. *Cyberco* remedied this by relying on reconsideration of claims under section 502(j), which provides in relevant part:

> A claim that has been allowed or disallowed may be reconsidered for cause. A reconsidered claim may be allowed or disallowed according to the equities of the case. 11 U.S.C. § 502(j).

The court reasoned that through 502(j), creditors of the non-debtor would be guaranteed an opportunity to assert claims against the enlarged estate.

Outcome: Only Trustees Have Standing to Seek Substantive Consolidation

Through the combination of two distinct Bankruptcy Code sections, Judge Hughes found statutory authority for allowing substantive consolidation. However, he denied Huntington's two motions seeking substantive consolidation for lack of standing. Under section 542(a), it is clear that only the trustee has

The Cyberco court may have significantly restricted the availability of the remedy by limiting its availability only to trustees and debtors in possession.

standing to seek turnover of estate property. So rather than encourage the spread of substantive consolidation by “legitimizing” it with what may be viewed as a more solid statutory foundation, the *Cyberco* court may have significantly restricted the availability of the remedy by limiting its availability only to trustees and debtors in possession.

Sellers of Goods Beware! A Written Reclamation Demand May Not Be Enough

– *Sherri L. Dahl, Cleveland*

In September 2010, the District Court for the Eastern District of Virginia denied a reclaiming seller rights despite the claimant’s service of a timely written reclamation demand and compliance with a reclamation procedures order and section 546(c) of the Bankruptcy Code.

Section 546(c) of the Bankruptcy Code provides that:

> . . . subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of the trustee . . . are subject to the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller’s business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but such seller may not reclaim such goods unless such seller demands in writing reclamation of such goods – (A) not later than 45 days after the date of receipt of such goods by the debtor; or (B) not later than 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.

In *Paramount Home Entertainment Inc. v. Circuit City Stores, Inc. (In re Circuit City Stores, Inc.)*, 2010 U.S. Dist. LEXIS 92103, 3:10-CV-316, (Dist. Ct. E.D. Va. Sept. 3, 2010), Paramount complied with section 546(c) of the Bankruptcy Code. One day after Circuit City sought chapter 11 relief, Paramount served its written reclamation demand, seeking the return of $11,600,840.04 worth of goods delivered to and accepted by Circuit City while insolvent in the ordinary course of business within the 45-day period preceding Circuit City's bankruptcy filing.

Pursuant to the reclamation procedures order entered by the Bankruptcy Court, Circuit City was permitted to reject rights asserted by reclamation claimants by doing nothing. The reclamation procedures order required a timely written reclamation demand from each creditor asserting a reclamation claim and, in turn, Circuit City was required to advise each reclamation claimant of the allowed amount, if any, of its reclamation demand. If no notice of allowed reclamation amount was given by Circuit City by the prescribed deadline, then Circuit City was deemed to have rejected the reclamation demand. Paramount was not sent a notice setting forth an allowed reclamation amount; accordingly, Paramount's reclamation demand was deemed rejected by Circuit City.

The bankruptcy court ruled in favor of Circuit City on summary judgment, and the district court affirmed the bankruptcy court on appeal. Specifically, the district court concluded that a reclamation claimant must actively assert its rights in any proceeding where its rights may be affected. The district court explained the importance of actively asserting rights and pointed to motions to which Paramount failed to object, that were filed by Circuit City seeking approval of: (a) debtor-in-possession financing involving the award of post-bankruptcy collateral to the lender; and (b) "going out of business" sales. The district court determined that "a reclaiming seller must diligently assert its rights while bankruptcy proceedings progress, particularly in the context of the bankruptcy of such a large company with numerous creditors, such as Circuit City" and that a creditor may lose "whatever reclamation rights it might have … through lack of diligence in asserting those rights."

In light of the Paramount *decision in the* Circuit City *bankruptcy, and similar decisions cited in Paramount, the cost of monitoring bankruptcy proceedings and asserting a seller's interest should be weighed against rights that may be lost.*

In light of the *Paramount* decision in the *Circuit City* bankruptcy, and similar decisions cited in *Paramount*, the cost of monitoring bankruptcy proceedings and asserting a seller's interest should be weighed against rights that may be lost. If the benefit outweighs the cost, then a reclamation claimant should carefully monitor all bankruptcy proceedings and file objections any time the goods sold are at issue, or risk losing reclamation rights. Careful cost-benefit analysis is required, because, even if a reclamation claimant provides a timely written demand and complies with a reclamation procedures order and section 546(c) of the Bankruptcy Code, valuable reclamation rights may be lost if rights are not also asserted in other non-reclamation related proceedings.

New York Court of Appeals Maintains Status Quo on Imputation, *In Pari Delicto* Defenses

– Kristin E. Richner, Columbus

On October 21, 2010, the New York Court of Appeals (the Appeals Court), New York's highest appellate court, addressed two appeals, and then issued an important ruling regarding the parameters of the affirmative defense of *in pari delicto* in suits against outside auditors, holding that the doctrines of *in pari delicto* and imputation are a complete bar to recovery when the corporate wrongdoer's actions are imputed to the company.

The Doctrines of *In Pari Delicto* and Imputation

The doctrine of *in pari delicto* has been a part of New York common law for over two hundred years, and prevents courts from interceding to resolve a dispute between two wrongdoers (i.e., a corporation and a third party). Since a corporation acts only through its agents, the availability of the *in pari delicto* defense revolves around the scope of the imputation doctrine; i.e., the presumption that a corporation must be generally responsible for the acts of its authorized agents, regardless of whether the actions are unauthorized. Only in instances where the agent has totally abandoned the corporation's interests and is acting entirely for his own purpose does an exception to imputation arise: the "adverse interest" exception. This exception is designed to avoid ambiguity where there is a benefit to both the insider and the corporation, and reserves this exception for those cases where the insider's misconduct benefits only himself or a third party.

In recent years, there has been much debate over the parameters of imputation, and whether the in pari delicto *defense should be available to outside professionals, such as auditors, that are alleged to have been negligent or even to have participated in the fraud.*

In recent years, there has been much debate over the parameters of imputation, and whether the *in pari delicto* defense should be available to outside professionals, such as auditors, that are alleged to have been negligent or even to have participated in the fraud.

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The Appeals

Kirschner v. KPMG, LLP

The *Kirschner* lawsuit resulted from the 2005 collapse of Refco, a leading provider of brokerage and clearing services. In October 2005, Refco disclosed that, as early as 1998, its president and chief executive officer had orchestrated a series of loans that ultimately hid millions of dollars of uncollectible debt from public and regulator view. These maneuvers, of course, created a falsely positive picture of Refco's financial condition, and as a result of the disclosure, Refco was required to file for bankruptcy protection.

When Refco's plan of reorganization was confirmed in December 2006, a Litigation Trust was established. The Litigation Trust, through the Litigation Trustee (Mr. Kirschner), was authorized to pursue claims and causes of action possessed by Refco prior to the bankruptcy filing. In August 2007, the Litigation Trustee filed a complaint in Illinois state court asserting fraud, breach of fiduciary duty and malpractice against not only Refco's president and CEO and other managers and owners (collectively, the Refco Insiders), but also against investment banks that served as underwriters for the 2004 leveraged buyout and two accounting firms that provided services to Refco. The Litigation Trustee asserted that these defendants either aided and abetted the Refco Insiders in carrying out the fraud, or were negligent in failing to discover the fraud. A year later, the Litigation Trustee filed a similar complaint in Massachusetts state court, asserting similar claims against KPMG LLP. Both lawsuits were removed to federal court and transferred to the Southern District of New York for consolidated proceedings.

The defendants moved to dismiss the Litigation Trustee's claims, and the court identified the threshold issue as whether the claims were subject to dismissal pursuant to the Second Circuit's Wagoner rule, which essentially states that a bankruptcy trustee does not possess standing to seek recovery from third parties alleged to have joined with the debtor corporation in defrauding creditors. Further, if the Wagoner rule applied, then the issue was solely whether the narrow exception to the Wagoner rule – the "adverse interest" exception – was applicable. The district court noted that the adverse interest exception applied only if the corporate wrongdoer had totally abandoned the company's interests and had acted entirely for his own or another's purpose (because only in those circumstances could the officer's misconduct not be imputed to the corporation). The district court concluded that, because the complaint was filled with allegations regarding the substantial benefits that Refco received from the Refco Insiders' alleged wrongdoing, case law precedent foreclosed the claims of the Litigation Trustee against the defendants. In so doing, the district court declined to expand the adverse interest exception to require an inquiry solely into the insiders' claimed motivations, without regard to the nature and effect of their misconduct, as advocated by the Litigation Trustee: "the Trustee must allege, not that the [Refco] insiders intended to, or to some extent did, benefit from their scheme, but that the corporation was harmed by the scheme, rather than being one of its beneficiaries" (2009 WL 1286326, *7, 2009 US Dist LEXIS 32581, *27).

The Litigation Trustee appealed to the Second Circuit Court of Appeals, which certified certain questions to the Appeals Court, including "whether the adverse interest exception is satisfied by showing that the insiders intended to benefit themselves by their misconduct"; and "whether the exception is available only where the insiders' misconduct has harmed the corporation."

Teachers' Retirement System of Louisiana and City of New Orleans Retirement System v. PricewaterhouseCoopers LLP (PwC)

This lawsuit was a derivative action brought on behalf of American International Group, Inc. (AIG) by the Teachers' Retirement System of Louisiana and the City of New Orleans Employees' Retirement System. The complaint alleged that senior officers of AIG set up a fraudulent scheme to misstate AIG's financial performance in order to deceive investors. The derivative plaintiffs also alleged that PwC, as independent auditor, did not perform its auditing responsibilities in accordance with professional standards, and failed to detect or report the fraud.

PwC moved to dismiss the action, and in February 2009 the Delaware Court of Chancery granted the motion, on the grounds that under New York law, the claims were barred. Specifically, the court found that the wrongdoing of AIG's senior officers was imputed to AIG, and that, based on the allegations in the complaint, these officers did not totally abandon AIG's interests such that the adverse interest exception to imputation would apply. Thus, once the wrongdoing was imputed to AIG, the claims against PwC were barred by New York's *in pari delicto* doctrine and the Wagoner rule. The derivative plaintiffs appealed, and upon the determination that the appeal's resolution depended on unsettled questions of New York law, the Delaware Supreme Court certified the question to the appeals court.

Plaintiffs' Arguments

Subjective Intent and Illusory Benefits

The Litigation Trustee first advocated that the insiders' intent be the primary consideration, and that short-term benefit to the company would not defeat the adverse interest exception, based on his reading of the Second Circuit's opinion in *In re CBI Holding Co. v. Ernst & Young*, 529 F.3d 432 (2d Cir. 2008).

In the *CBI* case, the Second Circuit found that the plaintiff had standing via the adverse interest exception to assert claims against the corporation's accountants arising from prepetition audits, as the fraud was perpetrated by the wrongdoers in order to obtain bigger bonuses and preserve the status quo regarding management of the company. Thus, the Litigation Trustee argued, the adverse interest exception should depend upon whether the insiders intended to benefit themselves, to the detriment of the company, which is to be proven by showing that the wrongdoers received personal benefits and/or that the company received only short-term benefits but suffered long-term damages.

The Court of Appeals noted that… "fraudsters are presumably not, as a general rule, motivated by charitable impulses, and a company victimized by fraud is always likely to suffer long-term harm once the fraud becomes known."

Succinctly considering this argument, the Court of Appeals noted that the Litigation Trustee's proposed rule would essentially render the adverse interest exception available in all corporate fraud cases, stating that: "fraudsters are presumably not, as a general rule, motivated by charitable impulses, and a company victimized by fraud is always likely to suffer long-term harm once the fraud becomes known."

The Rules of NCP and AHERF

Alternatively, the Litigation Trustee argued that the Court of Appeals should approach *in pari delicto* and imputation in the manner of the New Jersey Supreme Court in 2006 or the Pennsylvania Supreme Court in 2010.

In the cases of *NCP Litig. Trust v. KPMG LLP*, 187 N.J. 353 (N.J. 2006) and *Official Comm. of Unsecured Creditors of Allegheny Health Educ. and Research Found. v. PricewaterhouseCoopers LLP*, 989 A.2d 313 (Pa. 2010), both New Jersey and Pennsylvania developed carve-outs from agency law in cases of corporate fraud, in order to deny the defense of *in pari delicto* to negligent auditors (NCP) and collusive outside professionals (AHERF).

In the *NCP* case, two corporate officers intentionally misrepresented the publicly traded company's financial status to investors and to KPMG. When KPMG uncovered and reported the fraud, the company filed for bankruptcy, resulting in significant losses for investors. Ultimately, the litigation trust brought suit against KPMG for negligence in failing to exercise due care in performing the audits and preparing financial statements. KPMG argued *in pari delicto* as an affirmative defense, but the New Jersey Supreme Court held that the doctrine of imputation does not prevent the shareholder from seeking to recover against a negligent auditor, though the shareholders must have been innocent to avoid the imputation defense. Thus, the resulting New Jersey rule requires an analysis of comparative fault and apportionment of responsibility.

In the *AHERF* case, the chief executive and financial officers of a nonprofit operator of health care facilities allegedly intentionally misstated the company's financials to PwC, its outside auditors, in order to cover up substantial operating losses. After bankruptcy was filed, the creditors' committee, acting on the debtor's behalf, sued PwC and alleged negligence, aiding and abetting and breach of contract. The district court granted PwC's motion for summary judgment, finding that the doctrine of *in pari delicto* applied. On appeal, the Third Circuit certified questions to the Pennsylvania Supreme Court regarding the test for determining when imputation was appropriate. The Pennsylvania Supreme Court found that imputation (and therefore the *in pari delicto* defense) was not available where the auditor did not proceed in material good faith. In light of this opinion, the Third Circuit held that when a third party, such as an auditor, colludes with agents to defraud the principal, Pennsylvania law requires an inquiry as to whether the third party dealt with the principal in good faith.

The Pennsylvania Supreme Court found that imputation (and therefore the in pari delicto *defense) was not available where the auditor did not proceed in material good faith.*

Noting that the rulings in both cases were motivated by equitable considerations, the Court of Appeals nonetheless found that such carve-outs essentially render moot the adverse interest exception.

Comparative Negligence

Finally, the Litigation Trustee argued that the *in pari delicto* defense should not be a total bar to recovery, but instead should serve as the basis for apportionment of fault and damages. However, the Court of Appeals held that the application of a standard of comparative fault contradicts the public policy purpose behind *in pari delicto.*

Implications

With this ruling, the appeals court stood firm in its application of *in pari delicto* and imputation, reaffirming that in New York, responsibility for fraudulent or other wrongful actions of corporate agents falls squarely on the corporation, except in circumstances where the agents act in a manner that immediately and directly harms the corporation (such that imputation does not apply). Thus, in situations where the fraud or other misconduct has benefited the corporation, at least in the immediate aftermath, the corporation and other derivative plaintiffs (such as bankruptcy trustees or litigation trusts) will be barred from recovering against outside professionals.

Putting the Brakes on Derivative Standing for Lenders and Other Creditors of Delaware Limited Liability Companies

– *Elliot M. Smith, Cincinnati*

As the Delaware Court of Chancery recently made clear, there is a big difference between Delaware limited liability companies (LLCs) and their corporate cousins.

In 2007, the Delaware Supreme Court issued an important ruling for creditors of insolvent corporations. It held that such creditors had standing to assert derivative claims for breaches of fiduciary duties against directors of an insolvent corporation.[1] But, as the Delaware Court of Chancery recently made clear, there is a big difference between Delaware limited liability companies (LLCs) and their corporate cousins.

[1] *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla et al.*, 920 A.2d 92, 101 (Del. 2007).

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On November 3, 2010, the Delaware Chancery Court issued an opinion that should cause lenders and other creditors of Delaware LLCs to sit up and take notice. The opinion challenges popular beliefs and assumptions regarding creditor derivative standing in the context of Delaware LLCs and highlights what was, perhaps, a legislative blunder. From the creditor's perspective, the opinion is disruptive to say the least, and possibly game changing if upheld on appeal.

The Facts and Issues

The case is *CML V, LLC v. Bax et al.*, Case No. 5373-VCL, and the relevant facts are simple enough. A lender asserted a direct claim against its borrower (a Delaware LLC) for breaching certain of its loan obligations and derivative breach of fiduciary duty and similar claims against certain individual members and managers of the borrower. The individual defendants moved to dismiss the derivative claims against them on various grounds, including that the lender lacked standing as a creditor to sue derivatively under section 18-1002 of the Delaware Limited Liability Company Act (LLC Act). The lender countered that, just as with insolvent corporations, creditors are the principal constituency injured by any fiduciary breaches that diminish the value of the insolvent LLC. As such, the holding of the Delaware Supreme Court in the *Gheewalla* case should extend to creditors of an insolvent LLC so as to confer derivative standing upon them.

The Statutory Language Controls

The Chancery Court agreed with the defendants, however, explaining that "the literal terms of the LLC Act control, and they bar a creditor of an insolvent LLC from suing derivatively. Although this Court may depart from the literal reading of a statute where such a reading is so inconsistent with the statutory purpose as to produce an absurd result, this is not such a case."[2]

Section 18-1002 of the LLC Act, entitled "Proper Plaintiff," provides as follows:

> In a derivative action, ***the plaintiff must be a member or an assignee of a limited liability company*** interest at the time of bringing the action and: (1) at the time of the transaction of which the plaintiff complains; or (2) the plaintiff's status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by

[2] *CML V, LLC v. Bax et al.*, 6 A.3d 238, *7 (Del. Ch. Nov. 3, 2010).

> operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transaction. 6 Del. C. § 18-1002 (emphasis added)

Referring to this language as "exclusive language," the court contrasted it with an example of "non-exclusive language" appearing in the section of the Delaware General Corporation Law that addresses derivative actions.[3] "Section 327 demonstrates that the General Assembly can readily adopt a non-exclusive limitation on derivative standing. Section 18-1002, by contrast, uses exclusive language."[4]

Because the plain language of the statute appears to be exceedingly clear and dispositive of the issue, the Chancery Court took note of the "awkward fact" that "virtually no one has construed the derivative standing provisions as barring creditors of an insolvent LLC from filing suit.[5] … If practitioners widely understood the derivative standing provisions to have this effect, one would expect treatises, articles, and commentaries to call attention to that fact."[6] And yet, that has not been the case. Indeed, at the very outset of the opinion, the Chancery Court acknowledged that its ruling might "surprise wizened veterans of the debates over corporate creditor standing…[.]"[7] Many commentators have simply assumed that creditors of an insolvent LLC can sue derivatively.[8] Nonetheless, constrained by what it perceives to be clear statutory language, the Chancery Court held fast to its conclusions.

Further Support for Its Conclusions

The Chancery Court further supported its conclusions by considering "(i) how parallel provisions of other alternative entity statutes have been interpreted, (ii) the source and development of the alternative entity derivative standing provisions, and (iii) whether enforcing the plain meaning of Section 18-1002 would create an absurd result at odds with the overarching purpose and framework of the LLC Act."[9]

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[3] 8 Del. C. § 327
[4] *CML V, LLC v. Bax*, 6 A.3d at *10-11.
[5] *Id*. at *11-12.
[6] *Id*.
[7] *Id*. at *3.
[8] *Id*. at *13.
[9] *Id*. at *19.

The court noted that the LLC Act was modeled on the Delaware Limited Partnership Act (LP Act) which contains nearly identical derivative standing provisions as the LLC Act. "Like the derivative standing provisions in the LLC Act, the comparable derivative standing provisions in the LP Act facially bar any party other than a limited partner or assignee from suing derivatively. Read literally, the provisions prevent creditors from suing, and the Delaware courts historically have interpreted them as exclusive. This treatment strongly supports a similarly exclusive reading of the LLC Act."[10]

The court then engaged in a thorough historical review of the adoption of both the LLC Act and the current version of the LP Act. Following the development of various statutory schemes, the court noted that the drafters of the current LP Act had had a "clear choice" in deciding whether to adopt a new uniform statutory scheme known as the "Revised Uniform Limited Partnership Act of 1976," which contained facially exclusive language in its derivative action standing provisions, or to retain the non-exclusive language contained in the existing LP Act. The drafters chose the former, which suggests "a conscious intent to make statutory standing exclusive."[11]

On What Basis Would LLCs Differ from Corporations?

Finally, the court considered whether its adhering to the plain meaning of section 18-1002 of the LLC Act would result in "an absurd distinction between insolvent corporations, where creditors can sue derivatively, and insolvent LLCs, where they cannot."[12] In other words, the court turned to the question "why?" Why would the Delaware legislature permit derivative standing for creditors of insolvent corporations, but not for insolvent LLCs? What about the "equitable considerations" articulated in the *Gheewalla* case that would seem to apply equally to creditors of LLCs?

While the answer may very well be that such a distinction was not intended by the drafters of the LLC Act – i.e., it was a legislative blunder – the Chancery Court saw a clear basis for making such a distinction. "[T]here is nothing absurd about different legal principles applying to corporations and LLCs."[13] By their very nature, LLCs are "creatures of contract, 'designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved.' Creditors

[10] *Id*. at *23.
[11] *Id*. at *33.
[12] *Id*. at *34.
[13] *Id*.

generally are presumed to be 'capable of protecting themselves through the contractual agreements that govern their relationships with firms.' 'Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections.' To limit creditors to their bargained-for rights and deny them the additional right to sue derivatively on behalf of an insolvent entity comports with the contractarian environment created by the LLC Act."[14]

In addition, the court notes that the LLC Act provides creditors with various forms of statutory protections that further obviate the need for derivative standing. Such protections include, among others, the ability of an LLC agreement to provide express contractual rights to creditors (e.g., provisions requiring prior lender consent before certain acts may be taken or provisions subjecting members to specific penalties or consequences for breaching the LLC agreement or upon the occurrence of specific events) (see 6 Del. C. §§ 18-101(7) and 18-306). It would also include the ability to expand fiduciary duties owed by members to the LLC in the LLC agreement (see 6 Del. C. § 18-1101).[15]

In sum, "[i]n light of the expansive contractual and statutory remedies that creditors of an LLC possess, it does not create an absurd or unreasonable result to deny derivative standing to creditors of an insolvent LLC. The outcome does not frustrate any legislative purpose of the LLC Act; it rather fulfills the statute's contractarian spirit."[16]

In neutralizing the threat of derivative actions by creditors, the Chancery Court has greatly expanded the protections afforded to members and managers of Delaware LLCs.

Practical Effects

In neutralizing the threat of derivative actions by creditors, the Chancery Court has greatly expanded the protections afforded to members and managers of Delaware LLCs. If affirmed on appeal, and absent legislative intervention, the popularity of Delaware LLCs as business vehicles may very well increase. As such, lenders transacting with Delaware LLCs must be cognizant of their inability to assert derivative claims and seek greater contractual protections for themselves at the outset of the lending relationship.

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[14] *Id*. at *36.
[15] See *Id*. at *37-*42 for additional examples.
[16] *Id*. at *48.

The opinion was appealed on November 30, 2010 to the Delaware Supreme Court, Case No. 735,2010. The matter has been fully briefed, and the court is scheduled to hear oral arguments on June 22, 2011. In the meantime, the lending and legal communities are waiting with bated breath.

IN THE NEWS

Distinctions

U.S. News & World Report, in conjunction with Best Lawyers, released the results of its "Best Law Firms" survey in which our Bankruptcy and Creditor-Debtor Rights/Insolvency and Reorganization Law practices in the Cincinnati, Cleveland and Phoenix offices received Tier 1 rankings.

Craig D. Hansen (Phoenix), **Jordan A. Kroop** (Phoenix/New York), **Stephen D. Lerner** (Cincinnati/New York), **Jeffrey A. Marks** (Cincinnati), **G. Christopher Meyer** (Cleveland) and **Thomas J. Salerno** (Phoenix) have been listed in *The Best Lawyers in America 2011,* with **G. Christopher Meyer** named **Lawyer of the Year** for his practice in Bankruptcy and Creditor-Debtor Rights in the Cleveland market.

Kevin T. Connor (Riyadh/Beirut), **Ákos Erős** (Budapest), **Stephen D. Lerner** and **G. Christopher Meyer** have been listed as Recommended and **Sandra E. Mayerson** (New York) has been listed as Recognized by *PLC Which Lawyer?*

Stephen D. Lerner, Jeffrey A. Marks and **G. Christopher Meyer** were recognized as "leaders in their field" by *Chambers USA.*

Craig D. Hansen, Jordan A. Kroop and **Thomas J. Salerno** have been named Southwest Super Lawyers in a survey distributed by *Law & Politics* magazine. **Stephen D. Lerner, Jeffrey A. Marks** and **G. Christopher Meyer** have been named Ohio Super Lawyers.

Jeffrey A. Marks has been elected president of The TriState Association for Corporate Renewal, a regional organization consisting of turnaround consultants, lenders, accountants, attorneys and other professionals engaged in business restructurings in Ohio, Kentucky and Indiana.

Upcoming and Recent Speaking Engagements

G. Christopher Meyer will be moderating a panel on October 14, 2011 for IRA on “Financial Advisors in the Court Room” at the National Conference of Bankruptcy Judges’ annual conference in Tampa.

On June 21, 2011, **Paul Muscutt** (London) will be presenting to members of the R3 Association of Business Recovery Professionals as well as insolvency professionals in London on “Taking and Enforcement Security.”

Jordan A. Kroop will speak during a live webcast, “The Bankruptcy Code Section 363 Explored,” presented by The Knowledge Congress on June 2, 2011.

Jeffrey A. Marks will be participating in the panel discussion “Complex Chapter 11 Issues” at the Columbus Bar Association Bankruptcy Law Institute in Columbus, Ohio on May 13, 2011.

Jordan A. Kroop will speak at a regional conference held by Chicago Title on “Bankruptcy Code Section 363 Sales” on May 4, 2011 in Phoenix.

Thomas J. Salerno and **Jordan A. Kroop** will return as faculty for the week-long bankruptcy litigation skills workshop jointly held by the American Bankruptcy Institute and the Turnaround Management Association at SMU Dedman School of Law in Dallas in May 2011.

Beginning in May 2011, **Amy Taylor** (Birmingham) will be participating in the “Introductory Courses on Insolvency” for the R3 Association of Business Recovery Professionals.

Squire Sanders Hammonds is sponsoring the eighth Business Money All-Asset Finance Conference in London on April 7, 2011. **Andrew J. Knight** (London) and **Graeme D. Levy** (London) will present “Insolvency Law in Flux,” which addresses challenges arising from evolving insolvency law, as well as “Reports from the Coalface,” a discussion of legal issues and anecdotes from recent new deals, restructurings and enforcements.

Stephen D. Lerner spoke on a panel on April 1, 2011 at the 29th Annual Spring Meeting of the American Bankruptcy Institute in Maryland on “Plan Sales Revisited: Plan Sale vs. Section 363 Sale.”

Sean T. Cork (Phoenix) spoke at *The Bond Buyer's* Southeast Public Finance Conference in Miami on March 30, 2011 during a panel discussion entitled "Development Districts, Lessons Learned."

Sandra E. Mayerson served on the panel "Recession Lessons Learned: The Managerial and Legal Duties of Equity Investors in Times of Crisis and Strategies for Keeping You and Your Fund Out of Hot Water" at the American Conference Institute's 18th Private Equity Summit, "Benchmarking Compliance Issues, Fund-Raising Strategies and Deal-Making Opportunities in a Time of Economic Recovery and Enhanced Government Regulation," on February 24-25, 2011 in New York.

On February 24, 2011, **Daniel French** (Birmingham) presented to the Royal Institution of Chartered Surveyors on "Remedies Against the Insolvent Tenant."

Thomas J. Salerno spoke at the "Hot Topics in Bankruptcy for Attorneys" live webcast presented by The Knowledge Congress on January 6, 2011.

On November 29, 2010, **Sandra E. Mayerson** presented "Late Breaking News" at the 17th Annual Distressed Investing Conference in New York.

On November 25, 2010, **Daniel French** presented at the Squire Sanders Hammonds Birmingham office's real estate conference for landlords and tenants on "Property and Insolvency Issues."

On November 17, 2010, **Noriyuki Shimoda** (San Francisco) presented the seminar "Collection, Bankruptcy and Security" at the Palo Alto office. This seminar was presented again on February 16, 2011 at the same location.

Stephen D. Lerner, Thomas J. Salerno, G. Christopher Meyer and **Sandra E. Mayerson** served as panelists for various discussions at the 84th Annual National Conference of Bankruptcy Judges in New Orleans on October 13-16, 2010.

Sandra E. Mayerson participated in the panel discussion "Introduction to New Loan Level Products and Re-Engineering Old Products for Today's Market" at the IQPC's 6th Annual Global Forum on Investing in Distressed Debt in New York on September 22-24, 2010.

Publications

Devinder Singh co-authored with **Susan Kelly, Graeme Levy, Cathryn Williams** and **John Alderton** an article, "Super Aguri," in the *Restructuring & Insolvency Review* (Lexology, March 14, 2011) on the successful administrators' remuneration proceedings brought by Squire Sanders Hammonds in the administration of the former Formula 1 motor racing team Super Aguri F1 Ltd. The article also appeared in *Insolvency Intelligence.*

James J. Barresi (Cincinnati), **Stephen D. Lerner** and **Andrew M. Simon** (Cincinnati) co-authored "Options for Selling Distressed Assets," published in the March 2011 issue of *Financial Worldwide Magazine.* Their article addresses several asset sale vehicles including out of court sales and secured party sales, bankruptcy sales, receivership sales and assignments for the benefits of creditors, which are becoming increasingly popular for facilitating financial restructurings.

Daniel French authored "Landlords Rejoice as High Court Overturns 'Unfair' CVA" (Lexology, February 25, 2011), commenting on recent UK case law on the claims of landlords in administrations and company voluntary arrangements.

Thomas J. Salerno, Jordan A. Kroop and **Craig D. Hansen** authored the second edition of *The Executive Guide to Corporate Bankruptcy,* released in 2010. This resource-intensive guide provides the business professional, including the executive of a troubled company, credit manager, workout professional and investor in distressed debt or equity, with a guided tour through the intricacies of the bankruptcy process in a concise and readily understood manner.

Dr. Andreas Fillmann (Frankfurt) published an article, "Financial Stabilization Measures for Endangered Germany-Based Credit Institutions" (IPBA, September 2010), which covers new regulatory measures to stabilize the German banking industry.

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