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Hot Topics in Bankruptcy

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Bankruptcy, The Financial Tool

Bankruptcy can be an important financial tool. Through the Chapter 11 process, bankruptcy can allow a company to restructure its debt and become a more efficient and profitable business, without the threat of looming creditors.

There are many benefits to a Chapter 11 proceeding. For example a corporation's existing management can stay in control of the business as a Debtor in Possession (DIP) as long as it continues to exercise reasonable business judgment and does not act in an incompetent or fraudulent manner. The DIP can continue to operate its business in the ordinary course while in Chapter 11 and use its regular professionals, such as accountants and attorneys: Although specialized bankruptcy professionals are needed to navigate the company through the process, a company should, and often will, continue to use the professionals it has previously relied upon for its business operations.

In addition to debt restructuring, Chapter 11 also allows a company to restructure its business operations and increase its going concern value. With court approval, a company can sell or lease property, incur additional debt and reject, assume, or assign executory contracts and leases. Another advantage of Chapter 11 is the automatic stay: Once a company has filed for Chapter 11, there is an immediate suspension of creditor collections or any acts which would affect the debtor's assets. Although secured creditors or other parties in interest can request relief from the stay, it requires judicial analysis and court approval. If Chapter 11 is used properly, many companies can emerge from bankruptcy much healthier than they were before.

Included below are some recent developments to help further understand Chapter 11 proceedings.

Anna Nicole Smith Case Alters Purview of Bankruptcy Courts

In 2011, the *Stern v. Marshall case* made headlines for denying Anna Nicole Smith's claim for her deceased husband's fortune and redefined the boundary of issues that can be decided by bankruptcy courts. Prior to this case, bankruptcy judges had authority under 28 USC section 157(b) 28 to enter final orders on "core proceedings" and to propose orders on "noncore" matters. In the midst of the dispute with her stepson, Pierce, Smith filed a counterclaim in the bankruptcy court for tortious interference, alleging Pierce had acted to prevent his father from establishing a trust for her. The bankruptcy court later found that Pierce had indeed interfered with his father's creation of a trust and awarded Smith $474 million. The case moved on appeal to the U.S. Supreme Court.

The U.S. Supreme Court granted certiorari to determine whether the bankruptcy court had constitutional authority to enter a final judgment on a counterclaim for tortious interference, a non-core cause of action, and framed the question as a separation of powers issue. The majority held that Congress could not constitutionally authorize non-Article III bankruptcy judges to enter a final judgment on a state law counterclaim because it is not in Congress's authority to delegate this power away from Article III courts.

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Interpretation of this decision has varied amongst district courts. Some courts have treated the holding narrowly, finding for instance that bankruptcy courts may continue to enter final orders concerning fraudulent conveyances. Other courts, however, including the Southern District of New York, seem to have adopted a broader view precluding bankruptcy courts from issuing final judgments on fraudulent conveyance claims, as noted below.

District Court Decision Cuts Madoff Trustee's Claims by over $600 Million

U.S. District Court Judge Rakoff embraced a broad interpretation of *Stern v. Marshall* in a recent Madoff litigation decision. In May, the court held that bankruptcy judges do not have the power to make final judgments on claims for fraudulent transfers or unjust enrichment (*Kirschner v. Agoglia).* This decision guided Judge Rakoff's action in removing the Madoff trustee's lawsuit against the owners of the New York Mets, Katz and Wilpon, to the district court from the bankruptcy court to determine the fraudulent conveyance claims.

In a subsequent holding, Judge Rakoff held that section 546(e) of the Bankruptcy Codes , which provides a safe harbor for certain financial entities, applies to Madoff Securities. The safe harbor resulted in the disallowance of claims for constructive and actual fraudulent transfers that occurred beyond the Bankruptcy Code's two year look-back period. The holding reduced the trustee's claims from over $1 billion to $380 million.

Section 503(b)(9): A Back Door to the New Value Defense?

The Bankruptcy Code provides that a creditor's claim will be disallowed under section 502(d) if said creditor is the transferee of an avoidable transfer. Such avoidable transfers include preference payments under section 547(b), which are transfers generally made for the benefit of a creditor on account of an antecedent debt while the debtor was insolvent in the 90 days prior to the bankruptcy filing. Section 547(c) of the Bankruptcy Code contains certain defenses to preference claims, including new value or ordinary course of business.

A 2005 amendment to the Bankruptcy Code has given rise to differing opinions among courts. In 2005, section 503(b)(9) was added to the Bankruptcy Code and provides creditors with an administrative expense claim for the value of any goods received by the debtor within 20 days prior to the bankruptcy filing where such goods were sold to the debtor in the ordinary course of business. Section 503(b)(9) is intended to protect creditors who sell goods to the debtor shortly before it files for bankruptcy.

The interplay between sections503(b)(9) and 547(c) has produced differing opinions. For example, in a recent Tennessee case, *In re Commissary Operations, Inc.*, the court ruled that trade creditors could assert their section503(b)(9) priority claims as additional new value to reduce preferential liability. In *In re Circuit City Stores, Inc.*, however, a Virginia court temporarily disallowed trade creditors these priority claims up to the amounts potentially recoverable on preference claims asserted against them. The court wanted to ensure 503(b)(9) claimants would not receive an improper benefit by obtaining relief on priority claims and using such amounts as new value to offset preference liability. Therefore the debate among the courts continues as to whether 503(b)(9) claims can be used as new value to reduce preference liability.

Increased Security for Creditors: Credit Bidding In the Plan

Finally, a recent decision affirms a secured creditor's opportunity to credit bid on its collateral under a plan of reorganization. Credit bidding occurs when a lender uses the debt it is owed to offset the purchase price of an asset. The U.S. Supreme Court held, in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, that when a debtor sells substantially all of its assets free and clear of liens, a creditor with a lien on the

assets must be permitted to credit bid at the sale.

A debtor may confirm a plan over the objections of a class of creditors if it can "cramdown" that particular class of creditors. (A cramdown occurs when the debtor meets certain statutory requirements that allow it to pass a plan through, even though a class of creditors voted against it.)

There are three options for a debtor's treatment of secured creditors under section1129(b)(2)(A) of the Bankruptcy Code:

- The secured creditor may retain its lien on the property and receive deferred cash payments, (section1129(b)(2)(A)(i);
- The debtor may sell the property free and clear of the lien, subject to section 363(k)—which permits the creditor to credit-bid at the sale—and provides the creditor with a lien on the sale proceeds (section 1129(b)(2)(A)(ii); or
- The plan may provide the secured creditor with the "indubitable equivalent" of its claim, (section1129(b)(2)(A)(iii).

The debtor in *RadLAX* submitted a reorganization plan that provided for the sale of substantially all the debtor's property free and clear of liens, but did not allow for credit bidding. The debtor argued that the Bankruptcy Code provided a choice of any of the three provisions and the proposed plan fulfilled the third option, providing the creditor with the "indubitable equivalent"of its claim.

The U.S. Supreme Court disagreed and held that "the debtors may not obtain confirmation of a Chapter 11 cramdown plan that provides for the sale of collateral free and clear of the [creditor's] lien, but does not permit the [creditor] to credit-bid at the sale."The Court reasoned that permitting a reorganization plan, which allows the sale of secured property free and clear of any liens without providing the lender the option to credit bid, would make section1129(b)(2)(A)(ii) irrelevant in a manner contrary to traditional statutory construction. This decision has provided comfort to many secured lenders by providing them with the security of knowing they would be entitled to credit bid on their collateral under a plan as they have always been able to do as part of a sale pursuant to section 363 of the Bankruptcy Code.

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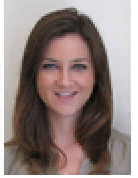

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