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STRAUSS HAUER & FELD LLP
Attorneys at Law

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BANKRUPTCY UPDATE

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SECOND LIEN FINANCING: APPELLATE COURT UPHOLDS FIRST LIENHOLDERS' INTERESTS

What happens when an impasse is reached between first and second lienholders in restructuring negotiations? Considering the number of second lien financings that have closed over the past few years, this question is being asked more and more often these days. One example of what can happen is illustrated by the *WestPoint Stevens* Chapter 11 case in which the second lienholders sought to force non-cash securities on the first lienholders in satisfaction of claims and security interests.

WestPoint Stevens sold substantially all of its assets to an entity controlled by a majority holder of second lien debt over the objection of a steering committee composed of a majority of first lienholders. An appeal followed, and in *Contrarian Funds LLC v. WestPoint Stevens, Inc. (In re WestPoint Stevens, Inc.)*, 333 B.R. 30 (S.D.N.Y. 2005), the district court for the Southern District of New York considered whether the bankruptcy court committed an error by ordering the objecting first lienholders to accept unregistered minority equity securities (the Common Stock) and related subscription rights in the parent company of the purchaser as replacement collateral (the Subscription Rights, collectively referred to with the Common Stock as the Securities) in full payment and satisfaction of the outstanding first lien indebtedness.

For two years, WestPoint Stevens unsuccessfully attempted to negotiate a consensual plan of reorganization or liquidation with its major creditor constituencies. Its primary creditors included its DIP lenders, holders of approximately $488 million in first lien debt and holders of $167 million in second lien debt. Running out of cash and lacking the ability to refinance their outstanding DIP financing obligations, the debtors commenced an auction process designed to culminate in the sale of substantially all of the debtors' assets. The auction attracted two competing purchasing groups:

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one led by the majority first lienholders, and the second led by the majority second lienholder. Following a competitive auction process, the debtors declared the bid submitted by the majority second lienholder the winner.

The winning bid did not provide for the payment in full in cash of the first lien debt, but instead provided the first lienholders with a direct in-kind distribution of Securities of the newly formed parent company. The bankruptcy court found, based on valuation testimony at the sale hearing, that the value of the Securities available for distribution to first and second lienholders exceeded the first lienholders' aggregate secured claim by approximately $95 million, warranting distribution of the surplus Subscription Rights to the second lienholders. The first lienholders objected to the sale on those terms and, in particular, the provisions authorizing the in-kind distribution of Securities to the first lienholders in lieu of cash, and provisions of the sale order addressing claim satisfaction and lien termination. The first lienholders also argued that, by virtue of the credit bid provisions of section 363(k) of the Bankruptcy Code, a competing bidder was required to bid sufficient *cash* to pay the first lienholders in full, and that first lienholders could only be forced to accept securities in satisfaction of their claims in a cram-down under a confirmed Chapter 11 plan. The bankruptcy court overruled the objections of the first lienholders and held that the direct in-kind distribution of the Securities to the first and second lienholders was permissible under the intercreditor agreement among the debtors, the first lienholders and the second lienholders, and was authorized under sections 105(a), 361 and 363 of the Bankruptcy Code.

After the first lienholders sought a stay of the sale order, an agreement was reached permitting the transaction to close, but preserving the issue concerning allocation of the surplus Subscription Rights among the first and second lienholders. On appeal, the district court concluded that neither the intercreditor agreement nor adequate protection provisions of the Bankruptcy Code authorized the distribution of Securities to the first lienholders in satisfaction of their claims and security interests, nor authorized the distribution of the surplus Subscription Rights to the second lienholders. The fact that the debtors were unable to consensually confirm a Chapter 11 plan incorporating the challenged sale transaction due to the first lienholders' insistence on cash satisfaction of their claims was not lost on the district court. The district court was disturbed that the sales process resulted in a material alteration of the first lienholders' rights without satisfaction of the cram-down requirements of the Bankruptcy Code. The bankruptcy court's reliance on section 363 and section 105(a) of the Bankruptcy Code to permanently impair the first lienholders' contractual rights was an error according to the district court because Chapter 11 authorizes the alteration of a secured creditor's rights solely through the plan confirmation process. The district court explained:

> Taken to its logical extreme, the Bankruptcy Court's notion of adequate protection would allow a powerful creditor and a debtor anxious to achieve some value for its favored constituencies to run roughshod over disfavored creditors' rights, so long as a section 363(b) asset sale transaction could be defended as an exercise of reasonable business judgment in the context of dire economic circumstances. No such expansive interpretation of the Bankruptcy Code's adequate protection provisions is supportable, particularly in light of the fact that the Bankruptcy Code provisions specifically providing for impairment of objecting creditors' rights — the plan confirmation provisions of Chapter 11 — also provide for enfranchisement and procedural and

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substantive protections for adversely affected creditors.

Though the district court decision currently is on appeal before the 2nd Circuit, *WestPoint* illustrates certain legal and practical considerations relevant in intercreditor disputes between first and second lienholders. As a legal matter, *WestPoint* affirms the bankruptcy principle that the contractual rights of senior secured creditors cannot be altered absent satisfaction of the cram-down provisions under Chapter 11. The district court makes clear that surplus non-cash sales proceeds (i.e., equity interests/rights) cannot, absent authority under an intercreditor agreement, be distributed to a junior creditor until satisfaction of the first lienholders' claims in full and in cash.

As a practical matter, *WestPoint* also illustrates the extent to which ambiguities in an intercreditor agreement can be exploited to the advantage of second lienholders. The second lienholders prevailed upon the bankruptcy court to accept their interpretation of the intercreditor agreement, which resulted, essentially, in the imposition of a non-consensual equity-based arrangement upon objecting first lienholders. Fortunately for WestPoint Stevens' first lienholders, the appellate court disagreed.

To view the Contrarian Funds LLC v WestPoint Stevens Inc. opinion, please visit www.akingump.com/docs/pdf/FRN_200605_6.pdf.

For further information, please contact:

James R. Savin
202.887.4417
jsavin@akingump.com
Financial Restructuring Group

Scott L. Alberino
202.887.4027
salberino@akingump.com
Financial Restructuring Group

RE-EVALUATING KERPS: *REFCO* COURT ANSWERS THE QUESTION "IS THAT EMPLOYEE REALLY 'KEY'?"

For anyone familiar with the Chapter 11 process, the term KERP is well-known. KERPs or **K**ey-**E**mployee-**R**etention-**P**lans, have been a critical part of a Chapter 11 debtor's arsenal to induce certain key personnel, typically officers and other senior management, to remain with a troubled company through the reorganization process. KERPs require the approval of the bankruptcy court, and if approved generally provide significant extra compensation (sometimes tied to results) for those employees covered by the plan. The theory behind KERPs is that rewarding key employees of a troubled company will offset their temptation to jump ship and prevent the migration of talent to competitors. However, it is not unusual for KERPs to provide the greatest benefit to the debtor's insiders.

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Prior to enactment of new Bankruptcy Code section 503(c)(1), bankruptcy courts evaluated KERPs under the standard set forth in Bankruptcy Code section 363, which deals with the use of estate property. Under this standard, a KERP would typically be approved if the Bankruptcy Court found that a sound business purpose justified the plan, or that the debtor properly exercised its business judgment. While KERPs have not been without controversy, particularly for a debtor's shareholders and its creditors, they have become common in many of the larger Chapter 11 cases. However, KERPs are certain to undergo greater scrutiny under new Bankruptcy Code section 503(c)(1), which became effective in October 2005.

On its face, section 503(c)(1) appears to impose significant hurdles to the successful implementation of a KERP. Specifically, section 503 prohibits a debtor from incurring obligations to an "insider" for the purpose of inducing that person to remain with the debtor's business, absent evidence that, among other things —

- the "insider" has a bona fide job offer from another business at the same or greater rate of compensation
- the services provided by the "insider" are essential to the survival of the business
- the amount of the KERP is not more than 10 times the mean of a similar compensation package the debtor has provided to nonmanagement employees during the same calendar year in which the KERP is proposed. If the debtor has not made a similar bonus payment to a nonmanagement employee, the KERP cannot be greater than 25 percent of the amount of any similar transfer made or incurred for the benefit of an insider within the calendar year before the enactment of the KERP.

The standard imposed on KERPs by section 503(c)(1) appears to be a direct attempt by Congress to curb the magnitude of retention and severance payments made to "insiders" during a Chapter 11 case. The legislative history of this section confirms this. What impact this section will have on a bankruptcy judge's discretion to approve KERPs largely remains unknown. Surprisingly, while there have been very few cases to address section 503(c)(1) in the context of a reorganization, it appears that *liquidating debtors* may have an easier burden satisfying the requirements of section 503(c)(1).

In *In re Refco Inc.*, No. 05-60006 (Bankr. S.D.N.Y. Jan. 10, 2006), a liquidating Chapter 11 case,[1] the debtor's first-day motions included a proposed KERP. In an effort to implement the KERP, Refco argued that section 503(c)(1) did not apply because none of the employees in the proposed program were "insiders" of the debtors. U.S. Bankruptcy Judge Robert D. Drain agreed, commenting at the hearing that the employees covered by the proposed plan were included in the KERP not because they were insiders, but because they were productive employees necessary to the efficient and economic administration of the debtors' estates. Significantly, in approving the KERP, Judge Drain noted that the employees covered by the KERP were essentially working themselves out of a job by facilitating an orderly liquidation and thereby providing added value to the process.

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[1] Akin Gump currently represents the co-chair of the Creditors' Committee in the *Refco* case.

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While largely untested, restructuring professionals have already suggested the following "fixes" to work within the requirements of section 503(c)(1):

- pre-bankruptcy incentive-based compensation tied to well-defined future performance that is assumed by the debtor post-bankruptcy
- the resignation of executives at the inception of the bankruptcy case, which executives are then hired by a turnaround firm, retained by the debtor, which turnaround firm then deploys the former executive in a like role, at compensation reflective of retention-type terms
- the formation of pre-bankruptcy compensation trusts, and
- delay of implementing or payment of KERPs until confirmation of a plan of reorganization.

Whether these "fixes" pass judicial muster remains to be seen. In any event, it would appear to be premature to relegate KERPs to the bankruptcy closet. In light of the new level of scrutiny imposed under section 503(c)(1), creativity and ingenuity will likely be seen when debtors seek to implement a KERP in the wake of the new legislation.

To view the Refco 1-10-06 KERP hearing transcript, please visit www.akingump.com/docs/pdf/FRN_200605_2.pdf.

To view the Refco-KERP Order, please visit www.akingump.com/docs/pdf/FRN_200605_3.pdf.

For further information, please contact:

Fred S. Hodara
212.872.8040
fhodara@akingump.com
Financial Restructuring Group

ADELPHIA COURT RULES: UNSECURED CREDITORS ARE ENTITLED TO POST-PETITION INTEREST — BUT AT WHAT RATE?

On April 27, 2006, Bankruptcy Judge Robert Gerber approved the payment of post-petition interest to unsecured creditors under Adelphia Communications' proposed Chapter 11 plan of reorganization. (*In re Adelphia Communications*, Case No. 02-41729 REG, S.D.N.Y.) The ruling came as part of the court's resolution of a handful of issues in advance of the hearing on Adelphia's disclosure statement. Although not a novel decision, in his comments from the bench, Judge Gerber did shed some light on an important issue for unsecured creditors in large and complex Chapter 11 cases: What is the proper rate to be applied to pendency interest, that is, interest on general unsecured claims from the commencement of the Chapter 11 case until the effective date of a plan of reorganization?

Section 502(b)(2) of the Bankruptcy Code provides for the allowance of claims except to the extent that they are "for unmatured interest." As a practical matter, this means that unsecured claims are not entitled to interest which accrues after the commencement of a Chapter 11 case. Courts have carved out two

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exceptions, however, to the general rule disallowing post-petition interest on unsecured claims. Both apply only when a debtor is solvent.

The first exception is based on Bankruptcy Code section 726(a)(5), made relevant to Chapter 11 cases by the best-interests-of-creditors rule of section 1129(a)(7). The best-interests rule is triggered when a member of an impaired class of creditors rejects a plan of reorganization. It requires courts to examine what dissenting creditors would receive in a hypothetical Chapter 7 liquidation. Section 726(a)(5) provides that unsecured creditors in a Chapter 7 liquidation must receive interest at the "legal rate" from the date of the filing of the petition. Courts differ as to the appropriate interpretation of "the legal rate," and the 2nd Circuit has not decided the issue. Judge Gerber ruled, consistent with a majority of cases, that the legal rate is the federal judgment rate for purposes of Bankruptcy Code section 726(a)(5), and not the contract rate to which secured creditors may be entitled under Bankruptcy Code section 506(b). But, the best-interest test does not end the inquiry.

The second exception is based on the "fair and equitable" standard of Bankruptcy Code section 1129(b). In order for a plan of reorganization to satisfy the "fair and equitable" standard, a rejecting class of impaired creditors must be "paid in full" before junior creditors or equity may receive any distribution under a plan. It is settled that payment in full to unsecured creditors requires payment of some amount of post-petition interest when an estate is solvent. But at what rate? That was the issue before Bankruptcy Judge Gerber: what interest rate must be paid to Adelphia's solvent subsidiaries' general unsecured creditors in order for creditors to be "paid in full"?

Following published case law outside of the 2nd Circuit and Judge Robert Drain's recent bench decision in the *Loral* Chapter 11 cases, Judge Gerber noted that bankruptcy courts have a substantial degree of discretion, subject to the equities in each case, to decide what the appropriate rate of interest should be under a Chapter 11 plan for a solvent debtor. Because of this discretion, the best interests rule could be satisfied by application of the federal judgment rate, the contract rate set forth in the debtor's agreements with its creditors, or at a rate close to the contract rate (which is what the Adelphia debtors proposed in their plan and the court referred to as the "Adjusted Contract Rate"), depending upon the equities of the case.

Judge Gerber noted that "the touchstone of each decision on allowance of interest in bankruptcy . . . has been a balance between creditor and creditor and creditors and the debtor," quoting *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 67 S. Ct. 237, 241 (1946). After balancing the interests in the Adelphia case, Judge Gerber rejected the default and/or compound rate of interest as too high, and rejected the federal judgment rate as too low based upon the facts before him. He decided, instead, to apply the Adjusted Contract Rate because that most accurately reflected what the debtors had told their creditors to expect in their business dealings and public offerings.

The court explained that "in a multi-debtor, parent/subsidiary, case . . . 'structural seniority' of subsidiaries and subsidiary creditors' rights of priority to subsidiary assets was something that senior creditors know about, or should have when they bought their bonds." The court concluded that "when we're talking about what's fair and equitable to creditors of the subsidiaries on the one hand, and of the parent on the other, the debtors' pendency interest proposal - which comports with what the parent bondholders were

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told in the prospectuses covering their bonds, and which is consistent with the fact that higher-level debtors are equity holders of their subsidiaries - is, despite the fact that all creditors are victims in the Adelphia cases, 'fair and equitable.'"

The court went out of its way to note that there were equities to be weighed in favor and against all sides, and that a careful balancing was required to arrive at what would be equitable in this case. Judge Gerber's guidance on this issue is important for an understanding of the balancing of equities employed by the court in rendering its decision. In rejecting application of the higher default and/or compound rate of interest, Judge Gerber specifically limited his comments to pendent interest payable to general unsecured creditors. Secured creditors, he noted, have statutory rights to their contractual entitlements under Code section 506(b). Thus, the results might be different if secured creditors were seeking application of a contractual right, such as default interest.

Although this was a bench ruling, Judge Gerber reiterated his view that the interests of predictability in the Southern District of New York (and in the 2nd Circuit) are of considerable importance to the financial community, and thus most bankruptcy judges in the Southern District of New York would likely follow his lead on this vexing issue.

To view the transcript of Judge Gerber's decision, please visit www.akingump.com/docs/pdf/FRN_200605_8.pdf.

For further information, please contact:

Ira S. Dizengoff
212.872.1096
idizengoff@akingump.com
Financial Restructuring Group

KMART CRITICAL VENDORS LOSE — AGAIN

The roller coaster continues for Kmart's critical vendors — one day on top of the world, getting paid pre-petition claims as "critical vendors," only to have the appellate court overturn the order authorizing their payment. The Bankruptcy Court for the Northern District of Illinois recently issued an opinion in the continuing post-confirmation saga of Kmart bankruptcy cases that shows that the critical vendors are still getting short shrift. *See In re Kmart Corp.*, 02-02474-SPS, Ad. 04-00126, #38 (Bankr. N.D. Ill. April 11, 2006).

When Kmart filed for Chapter 11, the bankruptcy court granted a particularly broad "first day order" authorizing the debtor to pay in full the prepetition claims of certain "critical vendors." Bankruptcy courts have granted this relief in several large, high-profile Chapter 11 cases on the theory that unless these critical vendors are paid they might stop providing goods to the debtors, which would inflict great harm on the debtors' estates. One of Kmart's creditors timely appealed the critical vendor order and, just

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two business days prior to Kmart's plan confirmation hearing, won reversal of the Critical Vendor Order in the district court.

Kmart's plan of reorganization had provided that Kmart would waive most avoidance actions, but, sensing an opportunity to recover hundreds of millions of dollars in critical vendor payments if the district court's order were to stand, Kmart moved to amend its plan of reorganization to preserve the right to recover the critical vendor payments (the Modification). Several critical vendors (the Objecting Venders) objected and requested additional time to consider Kmart's plan in light of the Modification.

At the confirmation hearing, the bankruptcy court overruled the Objecting Vendors. Noting that a plan modification requires a hearing on notice to the debtor, any statutory committees and "any other entity designated by the court . . ." Fed. R. Bankr. P. 3019, the Bankruptcy Court declined to designate Kmart's critical vendors for notice because it found that the Modification did not adversely change the plan's treatment of their claims. The critical vendors had already been paid in full and, therefore, no longer held "claims" for purposes of the plan. The bankruptcy court acknowledged that if Kmart succeeded in avoiding the critical vendor payments, the critical vendors would receive new claims in exchange for Kmart's now-unpaid (again) debts, but held that these contingent claims were irrelevant because they had not been allowed and could not be voted for or against the plan. After noting that the Modification did not change the treatment of the critical vendors' other claims, the bankruptcy court confirmed Kmart's plan, as modified.

Later, in a now famous (infamous?) decision, the 7th Circuit affirmed the district court's reversal of the critical vendor order. *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004). Kmart had by then filed recovery actions against all the critical vendors, and these actions began moving forward in the bankruptcy court. In its recent opinion, the bankruptcy court issued an omnibus opinion disposing of certain common defenses raised by the critical vendors, including objections based on the efficacy of the notice (and the lack thereof) of the Modification.

In their objections, the critical vendors argued that because they received no notice of the Modification and its hearing, they were not bound by it. The bankruptcy court rejected these arguments, stating that the critical vendors received no notice because the bankruptcy court had not designated them to receive notice, nor had they been entitled to it. The bankruptcy court also noted that the critical vendors had received notice of the confirmation hearing and implied that the critical vendors should have known that a plan modification shortly before confirmation was a possibility. Additionally, the bankruptcy court reaffirmed its holding that the Modification did not adversely affect the plan's treatment of the critical vendors' claims. Thus, the bankruptcy court held that, although the Modification meant that the reorganized debtors could recover up to approximately $300 million in critical vendor payments from the critical vendors if the 7th Circuit affirmed, this change did not "adversely" change the plans' treatment of the critical vendors' claims.

The take-home message: if you receive a critical vendor payment where the critical vendor order is on appeal, stay alert, attend the plan confirmation hearing and, if necessary, timely appeal any adverse rulings

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at confirmation. Unlike the creditor who immediately appealed Kmart's critical vendor order, the Objecting Vendors did not appeal the bankruptcy court's disposition of their notice arguments at the confirmation hearing, and that may have been a "critical" error by them.

For further information, please contact:

David P. Simonds
310.552.6692
dsimonds@akingump.com
Financial Restructuring Group

ELEVENTH CIRCUIT APPLIES *IN PARI DELICTO* DEFENSE TO TRUSTEE CLAIMS

The 11th Circuit has joined a growing list of jurisdictions that have made the equitable defense of *in pari delicto* [2] available to defendants who are defending against causes of action brought on behalf of a bankruptcy estate if such defense would have been available against the debtor outside of bankruptcy. In *Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards (In re PSA, Inc.)*, 437 F.3d 1145 (11 Cir. 2006) (*In re PSA*), the court permitted assertion of this defense notwithstanding that the plaintiff was not PSA or its affiliated debtors (collectively, PSA) but was a trustee who was not involved in the pre-petition misconduct that gave rise to the causes of action.

PSA's sole shareholder used PSA to operate a massive Ponzi scheme involving the sale and lease-back of payphones as investment opportunities. This scheme defrauded thousands of investors of over $300 million. PSA's confirmed joint Chapter 11 plan of liquidation established a litigation trust (the Trust) to liquidate certain estate causes of action, with the proceeds to go to general unsecured creditors and certain payphone fraud victims under the terms of the plan and the trust documents. The court appointed a trustee (the Trustee) to oversee the litigation trust. The Trustee sued several defendants, including PSA's banks, for (i) aiding and abetting a breach of fiduciary duties under state law, (ii) violations of the Racketeer Influenced and Corrupt Organizations Act (18 U.S.C. §§ 1962(c), (d))(RICO) and (iii) avoidance claims.

The banks (collectively, the IRA Custodians) allegedly aided in the fraud by funneling investor IRA funds into payphone investments. The IRA Custodians moved to dismiss the complaint, arguing, among other things, that the doctrine of *in pari delicto* barred the Trustee's action. The district court concluded that, under applicable state law, the wrongdoing of PSA's sole shareholder was imputed to PSA under the "sole actor" rule. Insofar as the legal and equitable interests of the Trustee are only as strong as PSA's claims against the defendants, the doctrine of *in pari delicto* barred the Trustee's claims. On appeal, the court of appeals upheld the district court's ruling on this issue and affirmed the dismissal of the Trustee's suit.

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[2] *In pari delicto* is an abbreviation of the Latin phrase *in pari delicto potior est conditio defendentis* (meaning, where the wrong of both parties is equal, the position of the defendant is the stronger). The defense is premised on the equitable principle that "[n]o Court will lend its aid to a man who founds his cause of action upon an immoral or illegal act." *In re Dublin Securities, Inc.*, 133 F.3d 377, 380 (6th Cir. 1998).

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In arriving at its decision, the court in *In re PSA* strictly construed the nature of a bankruptcy trustee's claims under 11 U.S.C. § 541(a) (Section 541), which provides that property of the bankruptcy estate consists of all legal or equitable interests of the debtor, including causes of action, as of the commencement of the bankruptcy case.[3] A bankruptcy estate's causes of action, therefore, as well as the attendant defenses thereto, transfer to the bankruptcy trustee frozen and fixed as they existed at the commencement of the bankruptcy case. As a result, an "innocent" bankruptcy trustee "stands in the shoes" of the pre-petition debtor and may be unable to prevail on estate causes of action where the pre-bankruptcy debtor participated or was complicit in the wrongful acts upon which the estate attempts to sue.[4] To the court in *In re PSA*, there was no sidestepping the explicit language of section 541.

Commentators have taken serious issue with this line of reasoning. The purpose of the *in pari delicto* defense, they argue, is to prevent a party who is complicit in wrongdoing from prevailing against their joint actors. In their view, the intercession of an innocent trustee whose duty it is to maximize the value of the estate for the debtor's creditors purges the taint of the debtor's wrongdoing, and that to hold otherwise would simply elevate the legal fiction of section 541 over the purpose of the *in pari delicto* defense. Once a bankruptcy trustee is put into place, the bad actor — the pre-petition debtor — is removed from the equation, in the case of a Chapter 7 trustee, and at least theoretically removed in the case of a Chapter 11 debtor in possession, and the purpose of the defense is no longer satisfied by its application against the bankruptcy trustee. Commentators find support for this logic in a line of receivership cases that have held that a receiver is not barred from recovery by the bad acts of the company in receivership. *See, e.g., Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995). Although these cases analogize to Section 541, they are not governed by it, and are distinguished out of hand on that basis by courts such as the 11th Circuit.

More troubling for commentators is the result of the application of the defense to bankruptcy trustees. For example, if directors and officers are allowed to prevail against fraud and breach of fiduciary duty claims based on a debtor-corporation's pre-bankruptcy complicity in such conduct, creditors will be required to pursue claims individually or as a class against the directors and officers, a costly and cumbersome process that may not result in an equitable distribution of proceeds. The court in *In re PSA* was not moved by this policy argument, stating that an individual creditor's right to bring suit independent of the bankruptcy case protects such creditor's interests. Furthermore, unlike in recoveries from estate causes of action, creditors pursuing their remedies outside of bankruptcy would not risk dilution through apportionment to senior estate creditors or unharmed creditors of equal priority.

Although commentators have vociferously argued against decisions such as that in *In re PSA*, the text of Section 541 is clear, and that clarity appears to have held greater sway with the 11th Circuit than the murky back and forth of policy arguments. As stated by the 10th Circuit in the case of *In re Hedged-*

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[3] The court's rationale is similar to that of other circuit courts that have recognized application of the *in pari delicto* defense against claims brought by a trustee in bankruptcy, including the 2nd, 3rd, 6th, 8th and 10th Circuits.

[4] Of course, this would not impact a bankruptcy trustee's right to bring bankruptcy-specific causes of action that do not rely for their existence upon section 541, such as claims for the avoidance and recovery of preferential or fraudulent transfers under Chapter 5 of the Bankruptcy Code. This distinction was recognized by the court in *In re PSA*.

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Investments Associates, Inc., "the issue is not whether such an exception [freeing Section 541 claims from the *in pari delicto* defense] would make good policy, but whether the exception can be found in the Bankruptcy Code." 84 F.3d 1281, 1285-86 (10th Cir. 1996). The 11th Circuit now has stated that the Bankruptcy Code does not contain any such exception that would insulate a trustee from the *in pari dilecto* defense.

In valuing potential recoveries by litigation trusts in plans of liquidation, creditors would do well to consider whether the claims to be pursued would be subject to the defense of *in pari delicto*.

To view the Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards opinion of the court, please visit www.akingump.com/docs/pdf/FRN_200605_1.pdf.

For further information, please contact:

Peter J. Gurfein
310.552.6696
pgurfein@akingump.com
Financial Restructuring Group

SUPREME COURT RULES: BINDING ARBITRATION CLAUSES MUST BE HONORED

Challenges to a contract that requires binding arbitration must be heard by an arbitrator, even if such challenges go to the validity of the contract as a whole. In a 7-1 decision,[5] the U.S. Supreme Court, in *Buckeye Check Cashing, Inc. v. Cardegna*, 2006 WL 386362 (2006), reaffirmed the national policy favoring arbitration.

Respondents had entered into various deferred payment transactions with petitioner Buckeye Check Cashing. Each of the deferred payment agreements contained a provision whereby the parties agreed to submit to binding arbitration for the resolution of any disputes arising out of the agreement. Notwithstanding the binding arbitration provision, respondents brought an action in Florida state court alleging that Buckeye charged usurious interest rates which rendered the deferred payment agreements illegal and void in entirety.

Buckeye moved to compel arbitration, and the trial court denied the motion. The District Court of Appeals of Florida (4th District) reversed, holding that because respondents did not challenge the arbitration provision itself, but rather the contract as a whole, the arbitration provision was enforceable and the question of the entire contract's validity should go to the arbitrator. The Florida Supreme Court reversed again, holding that it would violate state law and policy to enforce an agreement to arbitrate in a contract challenged as illegal. The U.S. Supreme Court granted certiorari and readily agreed with the district court of appeals, upholding the primacy of the arbitration provision.

[5] Justice Alito took no part in the consideration or decision of the case.

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The *Buckeye* opinion is straightforward and relies heavily on prior Supreme Court cases *Southland Corp. v. Keating*, 465 U.S. 1 (1984) and *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967). The Court stated that Congress enacted the Federal Arbitration Act — which embodies "the national policy favoring arbitration" — to overcome judicial resistance to arbitration.[6] The Court then stated that challenges to the validity of arbitration agreements come in two forms: (1) challenges specifically to the validity of the agreement to arbitrate (e.g. fraud in the inducement of the arbitration clause itself) and (2) challenges to the contract as a whole. Respondents' claim fell into the second category.

Accordingly, precedent determined that an arbitrator must hear the respondents' claims. The Court stated that *Prima Paint* and *Southland* established three propositions:

- First, as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract.
- Second, unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance.
- Third, this arbitration law applies in state as well as federal courts.

Applying these propositions to the *Buckeye* facts, the Court determined that, because respondents challenged the contract as a whole, rather than specifically challenged the arbitration provision of the contract, the dispute must be heard by an arbitrator rather than a court. The Court stated: "We reaffirm today that, regardless of whether the challenge is brought in federal or state court, a challenge to the validity of the contract as a whole, and not specifically to the arbitration clause, must go to the arbitrator."[7]

In the bankruptcy context, the result is likely to be the same. Because the Federal Arbitration Act establishes a federal policy favoring arbitration, in order to override an otherwise enforceable agreement to arbitrate, one must show that Congress intended to supersede the parties' agreement to arbitrate the particular statutory right at issue.[8] Accordingly, to defeat application of the Federal Arbitration Act, the party opposing arbitration must demonstrate, by pointing to the text, legislative history or purpose of a particular statute (e.g., a provision of the Bankruptcy Code), that Congress intended to make an exception to the Federal Arbitration Act for the dispute at issue. Core bankruptcy proceedings **might** be capable of showing such congressional intent to vary from the Federal Arbitration Act provisions.[9] However, the 2nd Circuit recently determined that even core proceedings, such as disputes regarding violations of the automatic stay, are arbitrable in certain circumstances.[10] Non-core proceedings, which consist of everything except the proceedings delineated in 28 U.S.C. § 157, should be arbitrable, since congressional silence does not demonstrate intent to deviate from the Federal Arbitration Act.

[6] 2006 WL 386362 at *3.

[7] *Buckeye Check Cashing, Inc.*, 2006 WL 386362 at *8.

[8] *See Hays & Company v. Merrill Lynch, et al.*, 885 F.2d 1149, 1156 (3d Cir. 1989).

[9] *Id.* at 1157 ("[The Chapter 11 Trustee] has pointed to no provision in the text of the bankruptcy laws, and we know of none, suggesting that arbitration clauses are unenforceable in a ***non-core*** adversary proceeding in a district court to enforce a claim of the estate." (emphasis added)

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In general, the text of the Bankruptcy Code supports enforcement of pre-petition non-executory contract rights.[11] Accordingly, if one party to an agreement containing a broad arbitration provision seeks to compel arbitration of a dispute under such agreement pursuant to the Federal Arbitration Act, the court — whether it is a U.S. district court or a bankruptcy court — is likely to order the parties to arbitrate. Unless the party opposing arbitration specifically alleges that the agreement to arbitrate is at issue rather than the contract containing such agreement to arbitrate or demonstrates specific congressional intent to supersede the application of the Federal Arbitration Act to the issue in the case, the court would be hard-pressed to do otherwise.

To view the Buckeye Check Cashing v Cardegna opinion, please visit www.akingump.com/docs/pdf/FRN_200605_7.pdf.

For further information, please contact:
Sara J.L. Wahl
214.969.2845
swahl@akingump.com
Financial Restructuring Group

[10] *MBNA America Bank, N.A. v. Hill*, 436 F.3d 104 (2d Cir. 2006).
[11] *Id.* at 1153.

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IN-THE-NEWS

Akin Gump represented the creditors' committees in four of the 10 largest restructurings and two of the 10 largest reemergences of 2005. (*The American Lawyer*, Corporate Scorecard, April 2006)

In a League Table of "top shareholder law firms" (ranked by active assignments), Akin Gump is tied for third with three active cases (as of April 3, 2006). In addition, Peter J. Gurfein (Los Angeles), with three active assignments, is tied for "top shareholder lawyer." ("Dire Stats," *The Deal's Bankruptcy Insider*, April 10, 2006)

In a League Table of "top bankruptcy lender lawyers" (ranked by active assignments), Charles R. Gibbs (Dallas), is tied for third with six active cases (as of April 19, 2006). In addition, Akin Gump, with 11 active cases, is ranked ninth for "top bankruptcy lender law firms." ("Dire Stats," *The Deal's Bankruptcy Insider*, April 24, 2006)

Congratulations to Brian A. Kilmer and Sara J.L. Wahl, members of the Akin Gump Financial Restructuring team, who were honored as "Rising Stars" of the Texas Bar in the March 2006 issue of *Texas Monthly*.

Congratulations to David P. Simonds for being named by *Turnaround & Workouts* magazine as an "Outstanding Young Restructuring Lawyer." David was recognized for his work on behalf of the Delta Airlines Creditors Committee, the Ad Hoc Bondholders Committee for Tom's Foods, and the Bondholders Committee for Horizon PCS.

LOS ANGELES SYMPOSIUM:

On Thursday, May 18, Akin Gump Strauss Hauer & Feld LLP hosted a symposium designed for members of the distressed and private equity investment community followed by cocktails overlooking the beach in Santa Monica.

The program covered the following topics:

- hot topics in current high-profile Chapter 11 cases
- tax issues in distressed investing
- convergence of hedge and private equity and activist investing issues
- pre- and post-reorganization control issues
- indenture provisions relevant to distressed situations and second lien lending
- critical issues in bankruptcies — OPEB, pension and 363 sales

Time: 11:00 a.m. – 5:30 p.m. – Symposium; 5:30 – 7:30 p.m. – Sunset Reception
Where: Shutters Hotel on the Beach, One Pico Boulevard, Santa Monica, CA

For more information, please visit: www.akingump.com/larsvp

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CONTACT INFORMATION

If you have any questions, please contact any of the lawyers listed below:

Editor-in-Chief

Peter J. Gurfein.............................310.552.6696 ....pgurfein@akingump.com ....Los Angeles

Managing Editor

Scott L. Alberino ....202.887.4027 ....salberino@akingump.com ....Washington, D.C.

Contributing Editors

Patrick Ivie...................................310.728.3326 ....pivie@akingump.com.....................................Los Angeles
Sara J. L. Wahl.............................214.969.2845 ....swahl@akingump.com ....Dallas
Drake Foster.................................310.552.6450 ....dfoster@akingump.com ....Los Angeles
David W. Nelson ....310.728.3020 ....dnelson@akingump.com ....Los Angeles
James A. Wright III ....212.872.8182 ....jawright@akingump.com ....New York

Austin Brussels Dallas Dubai Houston London Los Angeles Moscow
New York Philadelphia San Antonio San Francisco Silicon Valley Taipei Washington, D.C.

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