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BANKRUPTCY UPDATE

BANKRUPTCY BARGAINS JUST GOT MORE EXPENSIVE: EXEMPTION FROM TRANSFER TAX ONLY APPLICABLE TO POST-CONFIRMATION TRANSFERS

IN RE PICCADILLY CAFETERIAS, INC.

In *Florida Dept. of Revenue v. Piccadilly Cafeterias* (*In re Piccadilly Cafeterias, Inc.)*,[1] the Supreme Court has ruled that, in order for a debtor's asset sale to qualify for the Bankruptcy Code's exemption from state sales or transfer taxes, the sale must be made post-confirmation and pursuant to a confirmed reorganization plan.

Asset sales under Bankruptcy Code Section 363 can be attractive to buyers and sellers. Among other things, the debtor can maximize value by selling assets quickly, efficiently and often as a going concern; buyers can purchase assets free and clear of liens and other claims and encumbrances. All of this makes asset sales under the Bankruptcy Code more attractive to buyers, and, theoretically, increases the price such buyers may be willing to pay. An additional attraction has been the ability to sell assets without either buyer or seller paying a sales or transfer tax in connection with the transaction, pursuant Section 1146 of the Bankruptcy Code, which provides that:

> The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax.[2]

The ability to avoid having to pay a transfer tax may add substantial value to a buyer, at no cost to the selling debtor, since the sales tax would go to the state, and would not be paid for the benefit of the bankruptcy estate. There was a split among the Circuits, however, on the interpretation of Code Section 1146, with certain courts (including the Third and Fourth Circuits) holding that the exemption is only available for transfers occurring post-confirmation,[3] and other courts (including the Eleventh Circuit) holding that the exemption

[1] 555 U.S. ___ (2008) Slip. Op 07-312 (June 16, 2008).
[2] 11 U.S.C. § 1146(a).
[3] *In re Hechinger Inv. Co. of Del.*, 335 F.3d 243, 246 (3d Cir. 2003) (holding that Section 1146 "does not apply to…transactions that occur prior to the confirmation of a plan under Chapter 11 of the Bankruptcy Code"; *see also In re NVR, LP*, 189 F.3d 442, 458 (4th Cir. 1999) (holding that Section 1146 "appl[ies] only to transfers under the Plan occurring after the date of confirmation").

remains valid if the plan is subsequently confirmed after the transfer.[4] Debtors preferred the expansive application of the exemption, which made their assets more attractive. States, however, opposed their loss of revenue.

In *In re Piccadilly Cafeterias, Inc.*,[5] the debtor, in preparation for a sale of its assets as a going concern, had sought from the Bankruptcy Court an exemption from any stamp taxes under Section 1146 of the Bankruptcy Code. The Bankruptcy Court initially granted the exception. However, prior to confirmation, the Florida Department of Revenue filed an objection, seeking a declaration that certain stamp taxes it had assessed on the debtor's transferred assets fell outside Section 1146's exemption due to the fact that the transfer had not occurred "under a plan confirmed" under Chapter 11. On cross-motions for summary judgment on the exemption issue, the Bankruptcy Court granted summary judgment in favor of the debtor, with the District Court[6] and Court of Appeals for the Eleventh Circuit[7] upholding on successive appeals.

In *Piccadilly Cafeterias,* the Supreme Court sided with the Third and Fourth Circuits, and the interests of states, (i) holding that the Code Section 1146 exemption only applies to transfers made after a plan has been confirmed, (ii) rejecting the debtor's argument that the sale of the debtor's assets was a transfer "under" its confirmed plan because the sale was necessary to consummate the plan and (iii) embracing the state of Florida's assertion that Section 1146 unambiguously limits exemptions to post-confirmation transfers.[8] Holding that the statute required more than a mere "nexus between the pre-confirmation transfer and the confirmed plan" for Section 1146 to apply, the court found Florida's straightforward interpretation of Section 1146 to place less strain on the statutory text.[9]

As a result of the *Piccadilly Cafeterias* decision, parties to Code Section 363 sales may be more inclined to effect such a sale pursuant to a plan of reorganization rather than in advance of one where the sales tax saving would be significant.

To view the *In re Piccadilly Cafeterias, Inc.* opinion, please visit http://www.akingump.com/files/upload/07-312.pdf.

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[4] *In re Piccadilly* 379 B.R. at 226 ("1146's tax exemption may apply to those pre-confirmation transfers that are necessary to the consummation of a confirmed plan of reorganization, which, at the very least, requires that there be some nexus between the pre-confirmation transfer and the confirmed plan").
[5] Bankr. S.D. Fla., No. 03-27976.
[6] *In re Piccadilly Cafeterias, Inc.*, 379 B.R. 215 (S.D. Fla. 2006).
[7] *In re Piccadilly Cafeterias, Inc.*, 484 F.3d 1299 (11th Cir. 2007).
[8] 552 U.S. at *6.
[9] *Id.* at *7.

DIRECTORS MAY BE LIABLE FOR BREACH OF DUTY OF LOYALTY DESPITE EXONERATION CLAUSE IN CORPORATE CHARTER

BRIDGEPORT HOLDINGS INC. LIQUIDATING TRUST V. BOYER, ET AL.

The duty of loyalty requires that directors not act out of self-interest or in situations where they are not independent. But even when they are disinterested, a director's duty of loyalty requires that they act in good faith. The conscious abdication of a director's duty of care can form the basis for breach of loyalty claims. So held the United States Bankruptcy Court for the District of Delaware in *Bridgeport Holdings Inc. Liquidating Trust v. Boyer, et al.*[10]

In a story that is becoming all too familiar, Bridgeport Holdings, Inc. was confronted with financial pressures when it lost credit support from its major suppliers and suffered in the downturn in the technology sector. Bridgeport may have waited too long to take action, and the board ultimately determined that liquidation of its North American business was its only viable option. Bridgeport hired a chief restructuring officer. Within three days of starting work, the CRO determined to sell the North American business. No competitive bidding process took place and no investment banker was hired to "shop" the deal. Within a week, an offer had been received, and a "handshake" deal was soon entered. The sale closed within one week thereafter, and the company filed its Chapter 11 petition the next day.

In its complaint, a post-confirmation liquidating trust (the "Trust") alleged that the directors had abdicated their directorial duties by allowing a newly appointed restructuring officer to sell off substantially all of the company's assets in a hasty private sale without "shopping" the deal, without hiring an investment banker, without getting a fairness opinion and without contacting known potential buyers. In other words, it was a flawed sale process. The directors argued that the duty of loyalty claim should be dismissed because the Trust did not allege that the directors acted out of any self-interest or that they lacked independence in connection with the asset sale. Moreover, the corporation's charter contained a typical "exoneration clause," including provisions holding no personal liability on the part of directors except for breach of their duty of loyalty, intentional misconduct, receipt of unlawful dividends and self-dealing. The directors filed a motion to dismiss the complaint, relying upon the exoneration clause and other grounds.

In the *Bridgeport* decision, the court denied, in relevant part, the motions of the former directors of Bridgeport Holdings Inc. to dismiss breach of fiduciary claims filed against them, holding: "The Trust has alleged sufficient facts to support the claim that the D&O Defendants breached their duty of loyalty and acted in bad faith by consciously disregarding, i.e., abdicating, their duties to the Company. Fiduciaries breach their duty of loyalty by intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard for their duties."[11]

Regarding the duty of care, the court critiqued the Delaware District Court's decision in *IT Group*,[12] in which that court purportedly applied the Delaware Supreme Court's decision in *Malpiede*[13] and held that duty of care claims cannot survive in the face of Delaware Corporations Code § 102(b)(7) exculpatory provisions in the corporate bylaws. The *Bridgeport* court said that *Malpiede* had not gone that far. *Malpiede* had held that where the *only* claim was a due care claim, the exculpatory provisions would be sufficient to defeat the claim. But, where, as here, there were surviving loyalty and bad faith claims, the exculpatory provisions are not sufficient to defeat the duty of care claims.

[10] Case No. 03-12825(PJW), Adv. Proc. No. 07-51798 (PJW) (Bankr. D. Del. May 30, 2008).
[11] Citing, *inter alia, Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006).
[12] *IT Litig. Trust v. D'Aniello (In re IT Group Inc.)*, No. 04-1268, 2005 WL 3050611 (D. Del. Nov. 15, 2005).
[13] *Malpiede v. Townson*, 780 A.2d 1075 (Del. 2001).

An exoneration clause in a corporation's charter will not support dismissal of claims alleging breach of the duty of loyalty, especially where the conduct gives rise to numerous claims. When the "entire fairness" of a transaction is placed at issue, the court is unlikely to summarily dismiss claims, notwithstanding the presence of an exoneration clause.

To view the *Bridgeport Holdings Inc. Liquidating Trust v. Boyer, et al.* opinion, please visit http://www.akingump.com/files/upload/Bridgeport Opinion.pdf.

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DEEPENING INSOLVENCY? – YES, COURTS STILL CARE

MILLER V. MCCOWN DE LEEUW & CO. (IN RE THE BROWN SCHOOLS)

The Delaware Bankruptcy Court has visited again with the officers and directors of The Brown Schools. Last time, you may recall, the court ruled that the directors could not rely on affirmative defenses as a basis to summarily dismiss a complaint, even under circumstances in which the affirmative defenses could be asserted successfully at later stages in the proceeding.[14] The Bankruptcy Court now has considered the defendants' motions to dismiss the trustee's claims, including deepening insolvency, breach of fiduciary duty, corporate waste, civil conspiracy and fraudulent transfer. Consistent with its prior rulings, the Delaware Bankruptcy Court confirmed that deepening insolvency constitutes a viable damages theory, despite the fact that deepening insolvency is not an independent cause of action in Delaware.[15]

In 2005, The Brown Schools filed voluntary Chapter 7 bankruptcy petitions. The trustee filed complaints against The Brown Schools' directors and the equity sponsor based on their involvement in a pre-petition restructuring of the debtors. The defendants filed motions to dismiss. The Bankruptcy Court first considered the Delaware Supreme Court's *Trenwick* decision.[16] In *Trenwick*, the Delaware Supreme Court unequivocally held that deepening insolvency does not constitute an independent cause of action. Relying on this holding, the Bankruptcy Court dismissed the trustee's claim for deepening insolvency.

The court turned next to the trustee's allegations regarding breach of fiduciary duty. Specifically, the trustee asserted that the equity sponsor used its control as majority shareholder to stack the boards of directors and extend the life of the debtors for its own financial gain. In support of this contention, the trustee cited a transaction in which the debtors sold certain assets for $64 million. The debtors used the proceeds to pay down debt and also paid $1.7 million to the equity sponsor. In response, the defendants maintained that the trustee's claims relating to breach of fiduciary duty improperly relied on the principal of "deepening insolvency." The trustee, however, argued that his claims for breach of fiduciary duty, corporate waste, and civil conspiracy were not disguised claims of deepening insolvency. The trustee distinguished this case from *Trenwick* by pointing out that the *Trenwick* plaintiff had not asserted claims for breach of

[14] 368 B.R. 394 (Bankr. D. Del. 2007); see, also, *Bankruptcy Update*, November 2007.
[15] *Miller v. McCown de Leeuw & Co.* (*In re The Brown Schools*), Case. No. 05-10841, Adv. No. 06-50861, __ B.R. __, 2008 WL 1849790 (Bankr. D. Del. Apr. 24, 2008).
[16] Citing *Trenwick Am. Litig. Trust v. Billet*, 2007 Del. LEXIS 357, at *1 (Del. 2007), *aff'g Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006)

distinguished this case from *Trenwick* by pointing out that the *Trenwick* plaintiff had not asserted claims for breach of fiduciary duty and self-dealing and had failed to plead adequately that the debtor was insolvent when the challenged transactions occurred. The Bankruptcy Court agreed with the trustee and refused to dismiss claims relating to breach of fiduciary duty.

Finally, the Bankruptcy Court analyzed the trustee's claim for damages. The defendants argued again that the trustee relied on the theory of "deepening insolvency" as a basis for damages for breach of fiduciary duty, aiding and abetting breach of fiduciary, corporate waste and civil conspiracy. The defendants asserted that deepening insolvency cannot serve as a measure of damages because it is not an independent cause of action and that the trustee failed to identify adequately the wrongful acts which proximately caused damage. The trustee cited the *Tuft* opinion for the proposition that deepening insolvency is a valid measure of damages caused by a breach of fiduciary duty and related claims.[17] In the *Tuft* case, the court had ruled that deepening insolvency served as a theory of damages for breach of the fiduciary duties of care and loyalty. *Id.* The trustee further alleged that he was entitled to claim damages in excess of the amount of increased insolvency based on the defendants' self-dealing and breach of fiduciary duty. The Bankruptcy Court followed the *Tuft* decision and denied the motion to dismiss trustee's claims on the grounds that deepening insolvency was not a valid damages theory.

The Brown Schools decision demonstrates that deepening insolvency, disfavored through it may be as a cause of action, remains viable as a measure of damages. Defendants should not expect courts to dismiss causes of action on the grounds that the claims are just deepening insolvency claims in disguise, as long as viable claims *are* alleged. Corporate fiduciaries must exercise great caution in balancing constituents' interests when a company enters the zone of insolvency.

To view the *In re The Brown Schools* opinion, please visit http://www.akingump.com/files/upload/Miller v McCown Opinion.pdf.

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FINDING THAT CHAPTER 11 PETITION WAS FILED IN GOOD FAITH PRECLUDES BREACH OF FIDUCIARY DUTY CLAIMS

NELSON V. EMERSON

The directors of a company do not breach their fiduciary duties when they file a bankruptcy petition in good faith, even where the strategy later proves unsuccessful and the case is dismissed. In *Nelson v. Emerson*, [18] the Delaware Chancery Court concluded that a Bankruptcy Court finding that the bankruptcy filing was nonfrivolous and filed in good faith precluded breach of fiduciary duty liability under state law. The case provides an interesting example of interplay between the application of federal good faith standard and Delaware fiduciary duty law.

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[17] Citing *Alberts v. Tuft* (*In re Greater Se. Cmty. Hosp. Corp. I*), 353 B.R. 324, 333 (Bankr. D.C. 2006).
[18] Not Reported in A.2d, 2008 WL 1961150 (Del. Ch., May 6, 2008) *(Unpublished opinion. Check court rules before citing.)*

Nelson had been a minority shareholder and director of Repository Technologies, Inc. (RTI) for ten years, including two years as its chief executive officer, and had loaned the company some $1,740,000 of his personal funds. RTI's bankruptcy filing was precipitated by Nelson's notice of default, on the same day he resigned from RTI's board, together with the demand that past due interest of over $500,000 be paid in fifteen days. Financially unable to meet this demand, RTI filed a Chapter 11 bankruptcy petition. Nelson moved to dismiss the bankruptcy case, arguing that the filing was made in bad faith.

In response to Nelson's motion to dismiss, RTI filed an adversary proceeding seeking recharacterization of Nelson's loans from debt to equity and equitable subordination. These two causes of action are distinct, but have similar practical effects on a party's indebtedness. Recharacterization looks at whether the debt is really an equity contribution disguised as a loan, while equitable subordination is a doctrine that, based on a creditor's inequitable conduct and its effect on other creditors, allows his debt to be subordinated to other claims, or his liens transferred to the bankruptcy estate.

The Bankruptcy Court dismissed RTI's Chapter 11 case, albeit not for a lack of good faith, but on the grounds of RTI's inability to reorganize under Chapter 11.[19] The court specifically found that bad faith on the part of directors was not present, since the bankruptcy filing was "a rational reaction to Nelson's actions, and was partially successful." The court ordered recharacterization of Nelson's claims to equity only as to advances exceeding $1,500,000, which was the amount approved by the board. RTI's equitable subordination claim was rejected, because even though Nelson was a fiduciary and an insider, his conduct was not clearly inequitable as to constitute harm to the company. RTI would have needed to prove "a terrible wrong" to justify ousting Nelson from his rights to collect the debt due him, whereas in this case his cash advances to the company actually benefited the business.

Unhappy with the ruling that the bankruptcy had not been filed in bad faith, Nelson appealed to the District Court for the Northern District of Illinois. Among other things, he argued that the Bankruptcy Court's language regarding RTI's good faith was *dicta*, since it was not necessary to resolve the issues before the court. By doing so, Nelson tried to preserve his ability to again bring his bad faith argument to another tribunal, hoping that it would find the argument more substantial.

The District Court rejected Nelson's claim.[20] The District Court held that not only was the good faith language an essential part of the Bankruptcy Court's holding, but Nelson had himself invited it by basing his motion to dismiss on RTI's bad faith. Therefore, he could not argue that the ruling on an argument he made in support of his own motion for relief was *dicta*. The court affirmed all remaining Bankruptcy Court's conclusions of law, since none of them was so clearly erroneous as to "strike [the court] as wrong with the force of a five-week-old, unrefrigerated dead fish."

Undeterred by the District Court's decision, Nelson filed a petition in the Chancery Court of Delaware, this time arguing that two of the RTI's directors and majority shareholders had breached their fiduciary duties to the company by causing it to file for bankruptcy and by paying themselves excessive compensation during the time RTI was insolvent.[21] The Chancery Court rejected both arguments.

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[19] *In re Repository Tech., Inc*., 363 B.R. 868 (Bankr. N.D. Ill. 2007).
[20] *In re Repository Tech., Inc*., 381 B.R. 852 (N.D. Ill. 2008).
[21] Nelson had also filed a direct action in his capacity as a creditor against the directors, alleging breach of their fiduciary duties to him. However, in light of a recent decision by the Delaware Supreme Court in *N. Am. Catholic Educ. Programming Found., Inc., v. Gheewalla*, 930 A.2d 92 (Del. 2007), which held that creditors cannot bring direct actions for breaches of fiduciary duties, Nelson agreed that this claim should be dismissed. See *Akin Gump Corporate Alert*, June 13, 2007.

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Citing its previous decision in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,[22] the court reiterated that Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and liquidate. Even where the business is insolvent, directors have a significant discretion in their business judgment to pursue alternatives to liquidation in good faith. Chapter 11 recognizes that the fundamental purpose of reorganization is to maximize the value of a company, and expresses a view that "an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around."

In this case, the bankruptcy filing was RTI's rational reaction to Nelson's demand for payment and implied threat to foreclose on its business assets. Thus, it was a legitimate exercise of business judgment, and not a breach of fiduciary duty. Moreover, since the Bankruptcy Court, after a full trial, determined that RTI used that strategy in good faith, and the District Court affirmed, Nelson was collaterally estopped from yet again bringing the bad faith argument. The Bankruptcy Court's explicit finding that RTI's directors filed the bankruptcy case in good faith precluded any liability under Delaware fiduciary duty law.

Directors of a company cannot be held liable just because their good-faith strategy in seeking to protect the interests of the company's equity holders fails. Such nonfrivolous decisions are protected by the business judgment rule, and holding directors liable for breach of fiduciary duty whenever the company loses in Bankruptcy Court would "discourage directors from exercising their business judgment by subjecting them to a judicially invented English Rule that makes them personally liable for the winner's costs and damages simply because of an adverse judgment."

To view the *Nelson v. Emerson* opinion, please visit http://www.akingump.com/files/upload/Nelson Opinion.pdf.

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APPELLATE COURT UPHOLDS DECISION DENYING CHAPTER 15 RECOGNITION

IN RE BEAR STEARNS HIGH-GRADE STRUCTURED CREDIT STRATEGIES MASTER FUND, LTD. (IN PROVISIONAL LIQUIDATION)[23]

IN RE BEAR STEARNS HIGH-GRADE STRUCTURED CREDIT STRATEGIES ENHANCED LEVERAGE MASTER FUND, LTD. (IN PROVISIONAL LIQUIDATION)[24]

The extent to which the principle of comity should be considered by courts in interpreting the provisions of Chapter 15 of the Bankruptcy Code (Chapter 15) became the subject of a recently issued appellate decision by the U.S. District Court for the Southern District of New York. On May 22, 2008, the District Court affirmed a Bankruptcy Court decision denying the petitions for recognition of winding-up proceedings pending in the Cayman Islands (the Foreign Proceedings) of the official liquidators of Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and

[22] 906 A.2d 168 (Del. Ch. 2006), *aff'd,* 931 A2d 438 (Del. 2007).
[23] Case No. 07-8730 (RWS).
[24] Case No. 07-8746 (RWS).

Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd. (the Foreign Debtors). The question on appeal was whether the Bankruptcy Court erroneously determined that the Foreign Proceedings did not qualify as either "foreign main proceedings" or "foreign nonmain proceedings" pursuant to Chapter 15. Neither the Chapter 15 petitions nor the Foreign Proceedings were contested by any creditors, investors or other parties in interest. Amici curiae, however, appeared in opposition to the appeal.

Chapter 15 largely incorporates the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law, which was designed to implement a modern mechanism to deal effectively with cross-border insolvencies. Chapter 15 replaced Section 304 of the Bankruptcy Code (Section 304), which was the previous statutory mechanism for the commencement of a proceeding ancillary to a foreign insolvency proceeding. Under Chapter 15, a Bankruptcy Court must afford "main recognition" to a foreign proceeding if the debtor's "center of main interest" (COMI) is in the same country as the foreign insolvency proceeding, or "nonmain recognition" if the debtor's COMI is elsewhere but the debtor has an "establishment" in that country.

Although "COMI" is left undefined by Chapter 15, there is a statutory presumption that the COMI is the place where the debtor has its registered office. An "establishment," on the other hand, is defined to be "any place of operations where the debtor carries out nontransitory economic activity."[25] Whether a petitioner attains main or nonmain recognition dictates whether certain injunctive relief is available as a matter of right or is discretionary based on the facts of the case.

Following the well-publicized volatility in capital markets arising from defaults on mortgages by subprime borrowers in the United States, the Foreign Debtors commenced liquidation proceedings in the Cayman Islands. On the same day, provisional liquidators were appointed (later becoming official liquidators) by the Grand Court of the Cayman Islands.[26] The official liquidators immediately filed petitions in the United States Bankruptcy Court seeking recognition of the Foreign Proceedings as foreign main proceedings or, in the alternative, as foreign nonmain proceedings, under Chapter 15.

The Foreign Debtors are two hedge funds incorporated and registered in the Cayman Islands. Both entities are "exempted" companies under Section 193 of the Companies Law of the Cayman Islands, which allows qualifying companies to trade in the Cayman Islands provided that activities performed in the Cayman Islands are primarily to further business outside of the Cayman Islands and not to compete with business establishments conducting local business within the Cayman Islands.

On September 5, 2007, the Bankruptcy Court denied main recognition on the grounds that each of the Foreign Debtors' COMIs was in the United States, not the Cayman Islands, where the primary liquidation proceedings are pending. The Bankruptcy Court based its decision in large part on the fact that the Foreign Debtors' investment manager and all or substantially all of the Foreign Debtors' liquid assets were located in New York.[27]

The Bankruptcy Court also denied nonmain recognition as a matter of first impression. The court held that the Foreign Debtors do not have an "establishment" in the Cayman Islands primarily because of the Foreign Debtors' status as "exempted" companies.[28]

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[25] 11 U.S.C. § 1502(2).

[26] Akin Gump Strauss Hauer & Feld LLP is engaged as counsel to the official liquidators in respect of the subject Chapter 15 petitions and issues related to the Foreign Proceedings.

[27] *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (in Provisional Liquidation) and In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, 374 B.R. 122, 130 (Bankr. S.D.N.Y. 2007).

[28] *Id.* at 131.

On May 22, 2008, the District Court affirmed the Bankruptcy Court's decision in full. The District Court acknowledged that Chapter 15 is designed to further comity by "optimiz[ing] disposition of international insolvencies by facilitating appropriate access to the court system of a host country."[29] It nevertheless held that comity does not come into play in determining a foreign debtor's eligibility for recognition. Instead, recognition should be viewed as "a condition to granting comity" under Chapter 15, and is based on objective criteria. Under former Section 304, by contrast, "all relief … was discretionary and based on subjective, comity-influenced factors."[30]

The District Court further held that the statutory COMI presumption was rebuttable and that, even absent a challenge to the petitions for recognition, the Bankruptcy Court has an independent duty to examine the evidence of the Foreign Debtors' contacts with the Cayman Islands. In affirming the Bankruptcy Court's decision, the District Court agreed with the Bankruptcy Court that the Foreign Debtors' COMI was New York.

With respect to nonmain recognition, the District Court summarily held that the official liquidators failed to present facts that the Cayman Islands was a "place of operations" where the Foreign Debtors carried out "nontransitory economic activity." The court provided no criteria by which to evaluate the issue of whether an establishment exists in a foreign jurisdiction, but clarified that nonmain recognition is limited to relief related to assets located in the nonmain jurisdiction.

In our view, the decision undermines the longstanding pre-eminence of comity in international insolvency jurisprudence, and may have far-reaching effects in the financial marketplace and significant implications for hedge funds and other financial vehicles doing business in the United States that have elected to incorporate in the Cayman Islands or other non-US. jurisdictions. Because a District Court decision is not binding on other courts, interpretation of Chapter 15 remains a work in progress.

To view the *In re Bear Stearns High-Grade Structured Credit* opinion, please visit http://www.akingump.com/files/upload/Bear Opinion.pdf.

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SO CLAIMS AGAINST YOU WERE SETTLED AND RELEASED UNDER THE PLAN? SO WHAT!

HIGHLAND CAPITAL MANAGEMENT LP VS. CHESAPEAKE ENERGY CORPORATION

The trustee agrees to settle the estate's claims and to release you under the confirmed plan of reorganization. You then are sued by a dissident creditor group, and you defend based upon the court-ordered release. Case closed. Or is it? Not so fast, says the Fifth Circuit Court of Appeals in *Highland Capital Management LP v. Chesapeake Energy*

[29] *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. (in Provisional Liquidation) and In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Civil Case No. 07-8730, 2008 U.S. Dist. LEXIS 41456 at *21 (S.D.N.Y. May 22, 2008).
[30] *Id.* (citations omitted.)

Corporation.[31] Though the facts leading up to the appeal in *Highland Capital* are complex, the issue on appeal was straightforward. Specifically, resolution of the appeal hinged on whether certain claims belonged to the bankruptcy estate or to certain bondholders.

In *Highland Capital*, a group of investment funds (the "bondholders") held $30 million in unsecured notes issued by Seven Seas Petroleum, Inc. as part of a $110 million debt offering. The bondholders did not purchase the unsecured notes directly from Seven Seas, but instead purchased the unsecured notes either in private transactions or on the secondary market throughout 1999, 2000 and 2002. In July 2001, Seven Seas issued $45 million in secured debt, which was secured by substantially all of Seven Seas' property. A group of investors, which was led by the chairman and CEO of Seven Seas, purchased one half of the secured notes. Chesapeake Energy Corporation purchased the remaining half of the secured notes. Seven Seas' ability to issue the secured debt was governed by the terms of the unsecured notes and was tied, in part, to the estimated oil reserves held by the company, which number was calculated by Ryder Scott Company, a reservoir-evaluation consulting firm. As of December 31, 2000, Ryder Scott estimated the oil reserve to be 47.9 million barrels. In August 2002, Seven Seas revised its reserve estimate downward *significantly* – to 16.3 million barrels. The next month, Seven Seas' management informed holders of the unsecured notes that the Company's assets were worth $49 million, but that the liabilities on the secured notes alone were $52 million. This caused a number of holders of the unsecured notes, including some of the bondholders, to file an involuntary Chapter 7 bankruptcy petition against Seven Seas in the Bankruptcy Court for the Southern District of Texas, which Seven Seas subsequently converted to a Chapter 11 reorganization case in which a trustee was appointed.

In the bankruptcy cases, the trustee filed an adversary proceeding against Chesapeake, among others, seeking to recharacterize the secured debt transaction. The trustee and Chesapeake eventually reached a settlement whereby Chesapeake agreed to give up some of its collateral in exchange for a complete release of claims by the bankruptcy estate. The settlement was incorporated into the trustee's plan of reorganization, which was confirmed in August 2007.

Shortly after the bankruptcy filing, the bondholders sued Ryder Scott in state court for, among other things, negligent misrepresentation and fraud. Two months after the Seven Seas plan was confirmed, the bondholders amended their state-court complaint to add Chesapeake, among others, as a defendant, bringing claims of conspiracy to defraud and aiding and abetting fraud. Chesapeake removed the claims against it to the District Court on the basis that the claims were property of the bankruptcy estate and had been released as a result of the confirmed plan of reorganization. The claims were eventually removed to Bankruptcy Court, where the Bankruptcy Court determined that the claims were property of the bankruptcy estate and that the bondholders did not have a right to assert these claims. As such, the Bankruptcy Court dismissed the bondholders' claims. The District Court affirmed this decision and the bondholders appealed.

On appeal to the Fifth Circuit, the court noted that whether a particular state-law claim belongs to the bankruptcy estate will depend on (i) whether, under applicable state law, the debtor could have raised the claims as of the commencement of the case, and (ii) the nature of the injury for which relief is sought. As to the first issue, the Fifth Circuit expressed its doubt that, under applicable state law, Seven Seas could have raised the claims asserted by the bondholders as of the commencement of the bankruptcy case since the underlying wrong complained of was fraud in connection with the purchase of bonds in the secondary market; Seven Seas would not have been in a position to assert the bondholders' reliance on any alleged misrepresentations or to claim to have suffered damages on account of, such reliance. As to the second issue, the Fifth Circuit found that if Chesapeake knew that the reserve estimates were false and used them to induce the bondholders to purchase or refrain from selling the unsecured notes, then there was a

[31] 522 F.3d 575 (5th Cir. 2008).

direct injury to the bondholders that was independent of any injury to Seven Seas. As such, the Fifth Circuit determined that the claims brought by the bondholders were not property of the estate and thus had not been released pursuant to the plan of reorganization. In addition, the Fifth Circuit found that the bondholders' involvement in the bankruptcy proceeding did not preclude them from asserting their own claims against a third party based on discrete wrongs that caused direct damages to them. Accordingly, the Fifth Circuit vacated the order of the Bankruptcy Court and instructed that the case be remanded to state court.

To view the *Highland Capital* opinion, please visit http://www.akingump.com/files/upload/Highland Opinion.pdf.

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NON-DEBTOR CONTRACTING PARTY CANNOT DEPRIVE DEBTOR OF ITS RIGHT TO REJECT CONTRACT

THE PENN TRAFFIC CO. V. COR ROUTE 5 CO., LLC (IN RE THE PENN TRAFFIC CO.)

Everyone knows that a debtor can reject an executory contract, that is, a contract in which material performance remains due on both sides. If one side has fully performed, does that mean that the contract is not executory and the debtor cannot reject it? And if that were the case, could the non-debtor party to the contract prevent the debtor from rejecting the contract by tendering full performance post petition so that the contract is no longer executory? Not according to the Second Circuit Court of Appeals in *The Penn Traffic Co. v. COR Route 5 Co., LLC (In re The Penn Traffic Co.).* [32]

A non-debtor party to a contract that is executory at the time of the bankruptcy filing cannot unilaterally, by postpetition tender of performance of its obligations under the contract, deprive the debtor of the right to reject the contract, the Second Circuit recently held in the bankruptcy case of *The Penn Traffic Company.*

In *The Penn Traffic Company* case, the debtor sought to reject a project agreement into which it had entered prepetition with a commercial real estate developer. The project agreement was fairly complex and involved the exchange of certain parcels of land, the site preparation and construction of a supermarket, reimbursement by the developer of a specified portion of the construction costs, the debtor's conveyance of the improved parcel of land to the developer and the developer's leaseback of the improved supermarket parcel to the debtor. At the time of the debtor's bankruptcy filing, the developer had performed all of its obligations under the project agreement save two – the reimbursement of the construction costs (approximately $3.5 million) and the tender of the lease to the debtor. The debtor had not conveyed the improved supermarket parcel to the developer.[33] Several months after the debtor had filed its bankruptcy petition, the developer sent the debtor a letter with the $3.5 million reimbursement and a signed lease, as required under the project agreement. However, the debtor declined to accept the developer's tender, and, several months later, moved to reject the project agreement pursuant to Section 365 of the Bankruptcy Code.

[32] 524 F.3d 373 (2d Cir. 2008).
[33] *Id.*

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The Bankruptcy Court denied the motion to reject, holding that, though the project agreement was executory on the petition date, the developer's post-petition tender of the payment and the lease had "rendered the project agreement non-executory and thus incapable of rejection."[34] The debtor appealed the Bankruptcy Court's order, and the District Court reversed, holding that "post-petition performance cannot alter the executoriness of a contract" and remanded the matter to the Bankruptcy Court for further proceedings consistent with its opinion. Thereafter, the Bankruptcy Court entered the rejection order, and the developer appealed the rejection order to the District Court, which affirmed, and then to the Second Circuit Court of Appeals.

Relying on both the plain language of section 365 and the policy of the Bankruptcy Code, the Second Circuit determined that a non-debtor party to an executory contract could not unilaterally, by its post-petition actions, deprive a debtor of its statutory right to reject the contract as disadvantageous to the estate. After first addressing the question of what determines whether a particular contract is executory, e.g., material performance due on both sides,[35] the court noted that the executoriness of a contract and the debtor's rights with respect to assumption or rejection of the contract are normally assessed as of the petition date. The court acknowledged that some courts have denied debtors' post-petition attempts to assume or reject contracts that were executory as of the petition date in light of post-petition events that rendered such contracts non-executory, as when a contract expires by its terms post petition or the debtor takes steps to terminate obligations.[36] However, the Second Circuit observed that it would be against both the plain language of the Bankruptcy Code and against policy to find that unilateral post-petition performance by a non-debtor party could deprive a debtor of its right to reject executory contracts.[37]

In light of the plain language of section 365 and the policy behind it, the Second Circuit found that a non-debtor's actions with respect to a contract which was executory on the petition date cannot serve to deprive the debtor of the power to later assume or reject such contract. Accordingly, the Second Circuit affirmed the order granting the debtor's motion to reject the contract with the developer, notwithstanding the developer's post-petition tender of all of its obligations under the contract.

The Penn Traffic Co. case is likely to be limited in its application to the peculiar circumstances of executory contracts. Rejection of a contract, after all, does not affect the enforceability of the contract or serve to create claims. Rather, assumption or rejection of a contract simply determines whether damage claims arising from the breach of the contract will be afforded administrative priority or treated as general unsecured prepetition claims. The Bankruptcy Code gives the debtor the right to make that decision, not the creditor/non-debtor party to the contract.

To view the *In re The Penn Traffic Co.* opinion, please visit http://www.akingump.com/files/upload/Penn Opinion.pdf.

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[34] *Id.* at *2.
[35] *Id.* at *3 (relying on the Countryman definition, "that an executory contract is one 'under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.'").
[36] *Id.* at *5.
[37] *Id.* at *6.

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