AKIN GUMP
STRAUSS HAUER & FELD LLP
Attorneys at Law

November 2007

BANKRUPTCY UPDATE

BUYERS OF DISTRESSED DEBT BENEFIT FROM ENRON RULING ON CLAIMS TRADING:

PURCHASERS OF SECONDARY DEBT NOT SUBJECT TO TAINT ON ACCOUNT OF SELLER'S ALLEGED IMPROPER CONDUCT

IN RE ENRON CORP.

Alleged misconduct by a claimant asserting a claim against a bankruptcy estate could subject the claim to disallowance under Code section 502(b) or subordination under Code section 510(c). That is, unless the claim has been sold to a good faith purchaser on the open market. In that event, the "personal disabilities" of the initial holder of the claim do not transfer with claims. That was the holding of the U.S. District Court for the Southern District of New York in *Springfield Associates, L.L.C. v. Enron Corp. (In re Enron Corp.)*.[1] In issuing its opinion the court recognized that its decision would have substantial consequences on the claims trading community.

Springfield Associates, LLC purchased on the secondary market $5 million of Enron bank debt that had been held originally by Citibank. Thereafter, Enron filed an action against Citibank for equitable subordination, disallowance, and compensatory and punitive damages based on allegations that Citibank had aided and abetted fraud and breach of fiduciary duty by Enron insiders. Enron also filed an adversary proceeding against Springfield seeking equitable subordination and disallowance of the claim that it had purchased from Citibank, based upon the alleged misconduct by Citibank, but did not allege misconduct by Springfield itself. Springfield moved to dismiss on the grounds that equitable subordination and disallowance cannot be applied to claims held by transferees, based solely on the misconduct of the transferors of such claims. Although Enron did not accuse Springfield of acting inequitably or receiving any preference that could subject its claims to equitable subordination or disallowance, the bankruptcy court ordered that Springfield's claims be subordinated and disallowed, based on the conduct of Citibank, its transferor.

On appeal, the district court reversed the bankruptcy court's ruling, recognizing that a purchaser of a claim may take more rights than those held by the seller of that claim. Specifically, while a seller of a claim may be subject to personal disabilities that impede the seller's ability to collect its claim, a purchaser buys the claim free of those personal disabilities. The district court then proceeded to determine whether

[1] No. 06-7828, slip op., 2007 WL 2446849 (S.D.N.Y. August 27, 2007).

equitable subordination and disallowance based on receipt of an avoidable transfer were personal disabilities of the seller that did not travel with the claim to the purchaser.

With regard to equitable subordination, the district court determined that, while the plain language of the Bankruptcy Code did not directly address the question, both the case law and the legislative history demonstrated that Congress intended to create a disability personal to the claim holder. First, the legislative history refers to misconduct on the part of a "holder" of the claim, showing that Congress intended equitable subordination to be specific to the bad actor. Second, at the time of enactment of section 510(c) of the Bankruptcy Code, the section that incorporates principles of equitable subordination, courts required misconduct on the part of the creditor asserting the claim before they would apply equitable subordination. The district court thus held that equitable subordination does not apply to a transferee of a claim who has not acted inequitably "merely because that claim was transferred, directly or indirectly, by a bad actor."

With respect to disallowance, the district court focused on the plain language of the relevant provision of the Bankruptcy Code. Section 502(d) requires "that the entity that is asserting the claim be the same entity . . . that is liable for receipt of and failure to return property." Because the language at issue focuses on the claimant as opposed to the claim, disallowance under Section 502(d) creates "a personal disability of the claimant, not an attribute of the claim."

For the reasons described above, the district court held that when the holder of a claim sells that claim to a third party, the buyer of the claim is not subject to the personal disabilities that would have run against the seller. At the same time, however, the district court distinguished a "sale" from an "assignment" stating that if a claim is assigned, a personal disability of the claimant transfers from the claimant to the transferee.

The transfers from Citibank to Springfield were effectuated by four documents, including a purchase and sale agreement and an assignment. Because the bankruptcy court did not address the issue of the nature of the transfers between Citibank and Springfield, the district court remanded the issue back to the bankruptcy court to determine whether the transfers were sales or assignments.

In addition, the district court explained that a purchaser with "actual notice" of the seller's receipt of an avoidable transfer may be subject to equitable subordination for its own misconduct. The court again looked to state law in reaching its decision, noting that "all defenses of an issuer of a security with enumerated exceptions are ineffective against a purchaser for value who has taken the security without notice of the particular defense," quoting NY UCC 8-202(d). To be a holder in due course under the NY UCC, the purchaser must take the security (a) for value, (b) in good faith and (c) without notice that it is overdue or has been dishonored or of any defense to it or claim against it. The court reasoned, however, that one cannot be a holder in due course if the transfer occurred post-petition, "because they cannot take the instrument 'without notice that it is overdue' as required by the N.Y. U.C.C."

Springfield sought leave of the court to file an interlocutory appeal on the issue whether potential equitable subordination or disallowance of a claim should turn on the distinction between a claim transferred by sale and a claim transferred by assignment. *Amicus* briefs in support of Springfield were filed by the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association, and the Loan Syndications and Trade Association, all parties interested in the free trading of claims. But the district court did not agree that there was substantial ground for difference of opinion whether sales and assignments are distinct and should be treated as such, and refused to certify the appeal.[2] In its ruling, the district court noted that the issue had been remanded to the bankruptcy court to determine whether, among other things, Springfield obtained its claims by way of assignment or sale, and that may require a factual inquiry at trial.

The opinion suggests that third-party purchasers with knowledge of the infirmity may not acquire claims free of personal defenses. There exists a thriving secondary market for claims against bankruptcy debtors. Claims purchased by innocent third parties on the open market may be asserted by the purchaser even if the claim could

[2] No. 06-7828, slip op., 2007 WL 2780394 (S.D.N.Y. September 24, 2007).

be subject to disallowance or subordination in the hands of the original holder. The outcome depends upon whether the claim was acquired prepetition or postpetition, and whether by sale or assignment.

To view *In re Enron Corp.* opinion, please visit www.akingump.com/docs/publication/1044.pdf

To view *In re Enron Corp.* August 27 opinion and order, please visit www.akingump.com/docs/publication/1045.pdf

For further information, please contact:

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

THE EMERGENCE OF THE MARKET CAPITALIZATION APPROACH IN THE DETERMINATION OF INSOLVENCY/INADEQUATE CAPITALIZATION

IN RE IRIDIUM OPERATING, LLC

Hindsight may be 20/20 – but not when you are determining the solvency of a corporation, according to the district court in the matter of *In re Iridium Operating, LLC*.[3] The court ruled that public market data available as of the time of the solvency determination controls over knowledge gleaned after the fact. In order "to justify disregarding values placed on [Iridium's] securities in an efficient public trading market, the court needs a substantial reason to depart from that standard and find that the value implied by an efficient market is not a trustworthy benchmark."[4] The fact that "the market was plainly wrong as an indicator of future value and badly misjudged the likelihood of Iridium's success" did not provide a reason to look beyond the market for valuation.[5]

Background

In the early 1990s, Motorola, Inc. developed a global telecommunications system, called the Iridium System, that was designed to provide voice communication and paging services anywhere in the world so long as the antenna of a subscriber's portable telephone handset or paging unit could be positioned to make radio contact with one of Iridium's 66 earth-orbiting satellites. In 1993 Motorola spun-off the Iridium System into a separate entity called Iridium, Inc., which was owned by private investors. Subsequent to this spin-off, Motorola entered into a contract with Iridium to serve as Iridium's prime contractor for the development of certain portions of the Iridium System and for the development, licensing and sale of certain equipment. Between 1995 and 1999 Iridium made payments under this contract to Motorola totaling $3.7 billion in the aggregate.

Launched in November of 1998, the Iridium System was a monumental failure, which led Iridium to file for chapter 11 bankruptcy nine months later. The unsecured creditors' committee in the Iridium bankruptcy subsequently brought an action to recover the $3.7 billion in payments to Motorola under the contract, alleging that such payments were fraudulent conveyances. As a finding of insolvency or unreasonably small capital is needed to satisfy certain statutory prerequisites under section 548 of the Bankruptcy Code for recovery of fraudulent transfers, the court was forced to address the issue whether Iridium was insolvent or had unreasonably small capital. First, the court had to determine what methodology to employ in its valuation of Iridium.[6]

---

[3] *In re Iridium LLC* (S.D.N.Y., No. 99-45758).
[4] *Id.*
[5] *Id.*
[6] *Statutory Comm. of Unsecured Creditors on behalf of Iridium Operating, LLC, et al. v. Motorola, Inc. (In re Iridium Operating LLC*, Adv. Pro. no. 01-02952, ___ B.R. ____, 2007 WL 2471798 (Bankr. S.D.N.Y. Aug. 31, 2007).

Determination of Insolvency or Unreasonably Small Capital: Competing Methodologies

Motorola and the creditors committee each presented the court with a different methodology by which to determine Iridium's value during the four years prior to its bankruptcy filing. Motorola asserted that, in the absence of evidence of a superior method, market capitalization is the best indicator of value, and maintained that the market in which Iridium's securities were traded was well-informed and that Iridium's substantial value was confirmed by the collective judgment of market participants.[7] The committee, by contrast, maintained that the market could not have been a reliable reference point, given that the market had made gross errors in overvaluing Iridium prior to Iridium's bankruptcy. Accordingly, the committee requested that the court ignore historical market data as unreliable and rely instead on the committee's expert valuations based on discounted cash flows and restated cash flow projections.[8]

The court sided with Motorola's methodology and based its valuation analysis on the assumption that public market data is the best indicator of value (as opposed to the data provided by the committee's valuation experts). In holding that the committee had failed to meet its burden to show insolvency or inadequate capitalization, the court stated that in order "to justify disregarding values placed on [Iridium's] securities in an efficient public trading market, the court needs a substantial reason to depart from that standard and find that the value implied by an efficient market is not a trustworthy benchmark."[9] Disregarding the committee's arguments that occasional valuation errors by the market should render it unreliable as a source of valuation, the court held that the fact that "the market was plainly wrong as an indicator of future value and badly misjudged the likelihood of Iridium's success" did not provide a reason to look beyond the market for valuation.[10]

In relying on the market as its primary source of valuation and disregarding the valuation experts brought forth by the committee, the court relied heavily on the 3rd Circuit's ruling in *VFB LLC v. Campbell Soup Co.*,[11] which the court felt "validate[s] the use of market data for purposes of valuing a public company for fraudulent conveyance purposes and makes clear that the public markets constitute a better guide to fair value than the opinions of hired litigation experts whose valuation work is performed after the fact and from an advocate's point of view."[12] The court also analyzed a variety of factors, including management's projections of future cash flows, Iridium's market capitalization, the valuations prepared by various third-party analysts and investors, and expert testimony by both sides, in finding that the market was well-informed as to Iridium's financial situation and business plan, and that market capitalization was a reliable benchmark for value.[13]

To view *In Re Iridium Operating, LLC* opinion, please visit www.akingump.com/docs/publication/1046.pdf

For further information, please contact:

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

[7] *Id.* at *14.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] 482 F.3d 624 (3d Cir. 2007). In *VFB*, the issue was whether reasonably equivalent value was provided to VFB for the $500 million it provided to Campbell for the purchase of Campbell's Specialty Foods Division. In analyzing the market capitalization of the Specialty Foods Division after its spin-off from Campbell, and finding such capitalization to be positive, the district court ruled that equivalent value had been provided. VFB appealed, arguing that market capitalization could not accurately value Campbell's assets because Campbell manipulated the Specialty Foods Division's sales and earnings prior to the spinoff. The 3rd Circuit upheld the district court's ruling, validated the district court's use of market data for valuation purposes, and found that "[a]bsent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'" *VFB*, 482 F.3d at 636.
[12] *Iridium* at *2.
[13] *Id.* at *53-55.

PREFERENCE UPDATE: EXISTING OBLIGATIONS DO NOT QUALIFY AS A SUBSEQUENT ADVANCE FOR "NEW VALUE"

IN RE GLOBE BUILDING MATERIALS, INC.

Does delivery by a supplier of component parts it was contractually obligated to furnish, after receipt of an otherwise avoidable preference, constitute "new value" that would permit the supplier to defeat a preference claim and keep that payment? Not according to a recent decision by the U.S. Court of Appeals for the 7th Circuit. In its 2007 decision in *Gouveia v. The RDI Group* (*In re Globe Building Materials Inc*.),[14] the 7th Circuit held that a party does not provide "new value" sufficient to offset a preference, when it furnishes something of value to a debtor under a **pre-existing** contractual obligation.

Bankruptcy Code section 547(b) provides that a trustee may avoid a transfer: (1) made to a creditor, (2) on account of an antecedent debt, (3) made while the debtor was insolvent, (4) made within the period 90 days preceding the debtor's bankruptcy filing, and (5) that left the creditor better off than it would have been if the transfer had not been made and it had asserted its claim in a chapter 7 liquidation case. Payments otherwise qualifying as a preference, however, may not be avoided by the debtor if, among other things, the payment was followed by subsequent advances of "new value" by the creditor in an amount equal to or exceeding the amount of the preference (the "New Value Defense").[15] The Bankruptcy Code defines "new value" as

> money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation.[16]

Globe Building Materials Inc. (GBM) contracted with the The RDI Group, Inc. (RDI) to supply certain equipment for use in GBM's manufacture of roofing products. When the contract was almost complete, GBM filed for bankruptcy protection. The chapter 7 trustee appointed in GBM's bankruptcy case commenced an action against RDI seeking to recover GBM's last payment to RDI on the grounds that it was made during the 90-day preference period before GBM's bankruptcy filing. RDI resisted, claiming that its postpetition shipment of component parts under an existing agreement with the debtor qualified as a subsequent advance for "new value" sufficient to offset the subject preference payment.

The bankruptcy court held that RDI's delivery of components during the preference period was not enough to entitle it to the benefit of the New Value Defense. The district court affirmed the bankruptcy court's decision, and RDI appealed to the 7th Circuit. On appeal, RDI argued that Congress chose not to exclude existing contractual obligations from its definition of "new value" in the Bankruptcy Code. The 7th Circuit disagreed, finding that Congress intended the definition of "new value" to codify the principle of consideration from contract law, which principle requires consideration to be something that the promisor is not already obliged to give to the promisee – that is, something additional or new.[17] The 7th Circuit concluded that under the terms of the parties' agreement, RDI had a pre-existing obligation to deliver the component parts that were the subject of the controversy. The fact the parties had structured both payment and delivery obligations under the contract to extend over a period of time – including through bankruptcy – did not transform each payment by the debtor, or delivery of goods by RDI, into an independent transaction.[18] Accordingly, the 7th Circuit ruled that RDI's delivery of the goods after receipt of the preference payments was anything but "new," and RDI could not avail itself of the New Value Defense.

---

[14] 484 F.3d 946 (7th Cir. 2007).
[15] 11 U.S.C. § 547(c)(4).
[16] 11 U.S.C. § 547(c)(4).
[17] *Globe Building Materials* at 949.
[18] *Globe Building Materials* at 950.

The New Value Defense is intended to encourage creditors to continue to work with troubled companies and to remove the unfairness of allowing a debtor to avoid all transfers made by the debtor to a creditor during the preference period without giving any corresponding credit for subsequent advances of new value to the debtor for which the preference creditor remains unpaid. The 7th Circuit's decision in *Globe Building Materials* reminds preference defendants of the limitations on the "new value" defense to preference payments and reinforces the notion that only value furnished outside the confines of an existing obligation will qualify as "new value."

To view *In re Globe Building Materials Inc.,* please visit www.akingump.com/docs/publication/1047.pdf

For further information, please contact:

Charles R. Gibbs
214.969.4710
cgibbs@akingump.com
Financial Restructuring Practice

DEFENDING DIRECTORS: AFFIRMATIVE DEFENSES CANNOT SUPPORT SUMMARY JUDGMENT

MILLER V. MCCOWN DE LEEUW & CO., INC.

The bankruptcy court for the District of Delaware, in *Miller v. McCown De Leeuw & Co., Inc. (In re The Brown Schools, et al.*),[19] recently restated the principle that defendants (in this case – company directors) may not rely on affirmative defenses as a basis to summarily dismiss a complaint, even under circumstances in which the affirmative defenses can be asserted successfully at later stages in the proceeding.

The history leading up to the 2005 chapter 7 bankruptcy filing of The Brown Schools and its related affiliates (the "Debtors") is not unique for financially troubled companies. In the eight years leading up to the bankruptcy filing, the Debtors engaged in various corporate actions – they recapitalized debt, raised additional working capital through the sale of stock, issued PIK notes and warrants, and, on several occasions, restructured their debt. During the initial debt recapitalization in 1997-1998, a private equity investment firm, McCown De Leeuw & Co., Inc. (MDC), acquired more than 65% of the stock of the parent debtor, The Brown Schools. By April 2003 the Debtors owed approximately (i) $47 million on the secured bank debt, (ii) $18.4 million in principal and interest on notes issued to the Teachers Insurance and Annuity Association of America, (iii) $12.5 million plus interest on pay-in-kind notes issued to various parties, including MDC and (iv) $22 million to other creditors. In April 2003 the Debtors sold certain of their assets to third parties. A portion of the proceeds were used to satisfy in full the secured bank debt. Two months later, the Debtors restructured their debt yet again.

One and a half years after filing for bankruptcy, the Trustee filed a complaint against several parties, including MDC and Naples, as director of The Brown Schools. The Trustee asserted various counts against MDC and Naples, including breach of fiduciary duty.

MDC and Naples each filed a motion seeking to dismiss the breach of fiduciary duty count on the grounds, among others, that (i) their actions were protected by the business judgment rule and (ii) they were protected by a certain exculpation clause contained in the Debtors' corporate charter. With little discussion, the bankruptcy court unequivocally held that the defenses of exculpation and the application of the business judgment rule are affirmative defenses and that it was not proper to determine the viability of those defenses on a motion to dismiss. Ultimately, the bankruptcy court denied MDC's and Naples' motions to dismiss the count for breach of fiduciary.

[19] 368 B.R. 394 (Bankr. D. Del. 2007).

This decision underscores that parties may not rely upon exculpation clauses or the business judgment rule as a basis for dismissing a breach of fiduciary duty claims in the first instance (i.e., on a summary judgment motion). While directors can still take comfort in the fact that they may assert these ordinary course defenses at later stages, their application cannot be considered at the early stages in the proceeding.

To view the *Miller* opinion, please visit: www.akingump.com/docs/publication/1049.pdf

For further information, please contact:

Lisa G. Beckerman
212.872.8012
lbeckerman@akingump.com
Financial Restructuring Practice

CONTACT INFORMATION

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

Editor in Chief

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

Managing Editor

Philip C. Dublin .... 212.872.8083 .... pdublin@akingump.com.......................... New York

Contributing Editors

J. Meritt Crosby Jr......................... 214.969.4255 .... mcrosby@akingump.com .... Dallas
Patrick J. Ivie .... 310.728.3326 .... pivie@akingump.com .... Los Angeles
Ryan C. Jacobs.............................. 212.872.7434 .... rjacobs@akingump.com .... New York
Christina M. Moore .... 310.229.1082 .... cmoore@akingump.com .... Los Angeles
Joanna F. Newdeck .... 202.887.4549 .... jnewdeck@akingump.com........... Washington, D.C.
Tracey Southwell, *Paralegal* .... 310.728.3029 .... tsouthwell@akingump.com .... Los Angeles

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