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In This Issue

When Tribal Gaming Goes Sour . . . Rights & Remedies in an Unclear Legal Environment

By Scott J. Greenberg & Jeffrey Taub

Introduction

Although the steep downturn in the U.S. gaming industry that began in 2008 appears to be easing for the time being, many mid-market gaming companies are still encountering difficulties servicing their debt as consumer spending slowly creeps back. In 2009, the Restructuring Review ran a two-part series on the strategies available to gaming companies seeking to restructure their debts and the challenges facing creditors who must choose between writing down their investments or attempting to foreclose on their collateral. This article examines additional and unique challenges facing creditors attempting to restructure debt issued by tribal gaming entities.

Creditors negotiating with their borrowers often use several leverage points to influence a borrower who is either in, or is facing a, default. Creditors can use the threat of foreclosure to influence negotiations if they are secured by the borrower's collateral. Creditors can also use the threat of an involuntary bankruptcy petition filed against the borrower in order to strengthen their negotiating position.[1] These creditor/borrower negotiations typically lead to a "sharing of the pain," whereby creditors often agree to de-lever the company by writing down a piece of its debt and in exchange take equity in the reorganized company with the hope that the borrower will better be able to service its healthy balance sheet.

These creditor leverage points, however, are often not available in the context of tribal-owned gaming entities, limiting the options for borrowers and lenders/creditors. Creditors cannot threaten an involuntary bankruptcy with respect to sovereign tribal entities. The ability of a creditor to take an equity stake in a tribal entity or to foreclose on all or some of a tribal entity's property may be severely constrained by federal law. This article discusses these constraints. Additionally, we examine the regulatory schemes governing tribal entities and the leverage points that remain for lenders to tribal entities, such as the potential for reducing access to credit if the entities do not work closely with lenders to consensually restructure debt.

The Indian Gaming Regulatory Act

Tribal gaming activities are governed by the Indian Gaming Regulatory Act ("IGRA").[2] Under IGRA, the National Indian Gaming Commission (the "NIGC") is charged with regulating the tribal gaming industry. Several IGRA provisions directly affect creditors' rights. First, IGRA provides that tribal casinos can only operate on land owned by the tribe.[3] Second, the entity responsible for gaming operations must be wholly owned by the tribe and must be approved by the chairman of the NIGC. Finally, no party can enter into a management contract with a tribe to manage its casinos unless the chairman of the NIGC approves the contract.[4] When evaluating a contract, the chairman of the NIGC evaluates the proposed counterparty's background, experience in the gaming industry and with other tribes, and financial resources. Any management contract cannot extend for more than seven years and must provide minimum payments to the tribe.

Consequently, creditors attempting to obtain leverage in their negotiations with distressed tribes — by threatening to foreclose on tribal property securing their loans, or offering to take equity in the borrower in exchange for a reduction in the amount of outstanding debt — may be unable to take these actions without violating IGRA. Similarly, creditors wishing to take control of gaming operations to enhance operational efficiency may be required to seek approval from the chairman of the NIGC. In many of these situations, the proverbial stick has been removed from the hand of the creditors before the parties even sit down to negotiate.

Involuntary Bankruptcy

Another tool available to creditors when a borrower has defaulted on its debt is the ability to file an involuntary bankruptcy petition against the borrower. Under section 303 of the Bankruptcy Code, an entity that is not paying its debts as they become due can be forced into chapter 11 or chapter 7 by three creditors holding, on an individual basis, unsecured, non-contingent claims of at least $14,425. Although involuntary petitions are much less common than voluntary filings, the threat of such a petition and the associated effect on the borrower's perceived creditworthiness can force a distressed debtor to the negotiating table.

However, the threat of involuntary bankruptcy appears to be unavailable to creditors of tribal gaming entities. Section 109 of the Bankruptcy Code provides that only a "person" or a "municipality" may be a debtor under the Bankruptcy Code.[5] Although cases on the issue are in conflict, recent commentary[6] on the subject suggests that tribal entities are neither persons nor municipalities for purposes of the Bankruptcy Code and therefore cannot be a voluntary or involuntary debtor.

Even if a tribal gaming entity were eligible to be a debtor under the Bankruptcy Code, it is unclear how much leverage this would provide to creditors. Many of the remedies and sources of leverage available to creditors under the Bankruptcy Code, such as moving to appoint a trustee, or threatening to object to a plan on the basis that it violates the absolute priority rule, are in apparent conflict with provisions in IGRA requiring that the management of tribal gaming entities be approved by NIGC, and ownership to be held by the tribe. Furthermore, it is unclear whether any of the proceeds of gaming assets can be distributed to creditors under a plan, because IGRA only allows proceeds from gaming interests to be distributed for tribal initiatives or other charitable causes.[7]

Sovereign Immunity

Another significant obstacle facing creditors seeking to enforce their rights against tribal entities is sovereign immunity. Under the "Marshall Trilogy,"[8] Indian tribes are recognized as sovereign entities and can therefore invoke the doctrine of sovereign immunity to counter legal actions brought against the tribe. In recognition of this status, many lenders will negotiate language in the applicable credit documents requiring the tribal entity to waive its sovereign immunity. However, the recent case of *Wells Fargo Bank N.A. v. Lake of the Torches Economic Development Corp.*,[9] raises doubts regarding the efficacy of these waivers.

In *Wells Fargo*, the Lake of the Torches Economic Development Corporation, a chartered corporation of the Lac du Flambeau Band of Lake Superior Chippewa Indians, issued $50 million of bonds in 2008 to finance a new riverboat casino operation. In conjunction with the bond issuance, the Corporation executed a Trust Indenture with Wells Fargo Bank N.A. as the Indenture Trustee. The bonds were secured by substantially all of the Corporation's revenues, accounts, deposits and casino equipment. Additionally, under the language of the Trust Indenture, the Corporation waived its sovereign immunity. In 2009, the Corporation, in violation of the indenture, transferred $4.75 million to the Tribe. Pursuant to its rights under the indenture, Wells Fargo accelerated the loan and initiated a lawsuit against the Corporation seeking the appointment of a receiver.

The district court dismissed the lawsuit, holding that the indenture was a management contract under IGRA, and was therefore void *ab initio* because it was not approved by the chairman of the NIGC.[10] The court pointed to several provisions in the indenture to support its finding that the indenture was a management contract. First, the indenture required approval of 51% of bondholders for the Corporation to replace key executives or to incur certain capital expenditures. Second, bondholders could appoint a management consultant if the Corporation failed to meet certain debt service ratios. Finally, upon an event of default, the bondholders could force the Corporation to hire new management and Wells Fargo could appoint a receiver for all of the assets that were pledged as collateral.

The court further held that because the indenture was void under IGRA, the court lacked jurisdiction over the dispute due to the Corporation's sovereign immunity. The court reasoned that even though the Corporation had purported to waive its sovereign immunity in the indenture, because the indenture was void *ab initio*, the indenture never came into effect and the waiver included in the indenture was therefore void as well. Furthermore, even if the waiver provision was severable, such that it could be given effect separate and apart from the rest of the indenture, the court held that there would be no remaining obligations to enforce under the contract.

Foreclosure Issues

In addition to the apparent conflict with IGRA created by foreclosure proceedings, even collateral that is not subject to NIGC approval may be out side the reach of creditors attempting to foreclose. A recent decision from the U.S. Court of Appeals for the Second Circuit creates uncertainty with respect to creditors' rights to foreclose on tribal property, even if the borrower cannot claim sovereign immunity with respect to the underlying debt.

In *Oneida Indian Nation of N.Y. v. Madison County & Oneida County N.Y.*,[11] Madison and Oneida Counties (the "Counties") appealed a district court decision prohibiting the Counties from foreclosing on tribal property in order to satisfy a tax lien issued by the counties due to the non-payment of county taxes by the Oneida tribe. The Counties' authority to levy the property tax in question was decided in *City of Sherrill v. Oneida Indian Nation.*[12] In *Sherrill*, the United States Supreme Court held that the Oneida Indian Nation could not regain sovereignty over its ancient lands by repurchasing them on the open market. Therefore, even after the Oneidas regained title to the land, the local government remained responsible for regulating the land. Accordingly, the local government could levy and collect taxes on the property.

Notwithstanding the holding in *Sherrill*, the Second Circuit held that the Counties could not foreclose on the tribe's property for failing to pay property taxes. In reaching this conclusion, the court distinguished between jurisdiction over the land and jurisdiction to enforce the lien. The Second Circuit held that although under *Sherrill* a tribe could not recover its sovereignty over the land and was therefore required to pay property taxes, the tribe did not waive its sovereignty with respect to immunity against a foreclosure action. The court held that although the Counties had the right to assess taxes, "the remedy of foreclosure is not available to the Counties unless and until Congress authorizes such suits or [the Oneidas] consent[] to such suits."[13]

Accordingly, even if a tribe waives its sovereign immunity with respect to actions related to the interpretation of its rights and obligations under credit agreements, the tribe may still argue that it maintained its sovereign immunity with respect to the enforcement of the same agreements. Tribes have embraced this ruling. In a recent Form 10-K filing,[14] the Mohegan Tribal Gaming Authority, operator of the Mohegan Sun casinos, stated that even though it has waived sovereign immunity with respect to its credit agreements, "[i]f an event of default occurs in connection with our indebtedness, no assurance can be given that a forum will be available to creditors other than [the tribal court]." Additionally, Mohegan noted that, as a practical matter, a creditor's ability to foreclose successfully will depend on the willingness and ability of tribal officials to carry out the tribal court's orders.

When a lender is faced with a defaulting or nearly defaulting borrower and that borrower is a tribal entity, the traditional tools in a creditor's toolkit are extremely limited.

Negotiations with Tribes

In summary, when a lender is faced with a defaulting or nearly defaulting borrower and that borrower is a tribal entity, the traditional tools in a creditor's toolkit are extremely limited. Nevertheless, lenders retain some leverage. If a tribal entity were to default on its obligations and refuse to negotiate with lenders on the grounds that sovereign immunity protects the tribal entity from the lenders' exercise of the typical rights and remedies, the entity could potentially freeze the credit markets for all tribal gaming entities on a go-forward basis. In an industry as reliant on credit as the gaming industry (whether it be for capital expenditures, to deal with market dips like those recently experienced, or simply to build a new facility), it is an exceedingly risky strategy for any tribal entity to walk away from its existing debt obligations by declaring sovereign immunity or claiming a violation of IGRA.

This may shed light on the protracted negotiations between the Mashantucket (Western) Pequot Tribal Nation, operator of the Foxwoods Resort and Casino, and its bank lenders. In February 2011, lenders of a $700 million revolving loan originally due in July 2010, further extended a forbearance agreement with the Pequot until April 7, 2011. In addition to the revolving loan, the Pequot also have $1.43 billion of outstanding bonds. Although it is clear that the Pequot's cash generated from gaming operations cannot service this debt, bondholders and the Pequot have not come to a global consensual resolution to date – although this does not mean that they will be unable to do so eventually.

Similarly, several news outlets reported recently that Mohegan Sun has hired restructuring professionals to engage its lenders in what will likely be similar protracted discussions. Mohegan has $925 million in revolving loans and senior subordinated bonds due in the first half of 2012. Additionally, Mohegan's maximum leverage ratios are set to step-down on March 31, 2011, and analysts believe that Mohegan may be in violation of these financial covenants.[15] Although Mohegan's actions indicate that it intends to negotiate in good faith with its creditors, creditors may find themselves in protracted negotiations lacking their usual leverage at the negotiating table.

Conclusion

Restructuring tribal gaming debt presents creditors with unique challenges. However, some of the larger tribal gaming borrowers have thus far shown that they intend to negotiate in good faith with their creditors. Lenders seeking to extend credit to tribal gaming entities should consider protecting themselves by submitting their credit agreements to the NIGC before closing on the loan. They should request a determination that the agreement is not deemed a management agreement under IGRA. This will help ensure that sovereign immunity waivers included in the agreements are enforceable. However, to achieve this determination, creditors may not be able to include provisions granting them control over management in an event of default setting.

Additionally, lenders should insist on a comprehensive waiver of sovereign immunity that specifically waives immunity with respect to foreclosure as well as any other dispute that arises under the credit agreement.

Endnotes

1 Pursuant to 11 U.S.C. § 303(b)(1), three creditors holding, on an individual basis, unsecured, non-contingent claims of at least $14,425 may file an involuntary case against an alleged debtor. Section 303(h) of the Bankruptcy Code provides that the petition will be granted if the alleged debtor is not paying its debts as they become due.

2 25 U.S.C. § 2701 *et seq.*

3 *See* 25 U.S.C. § 2710.

4 25 U.S.C. § 2711.

5 *See* 11 U.S.C. § 109(b)-(c).

6 *See*, *e.g.*, Steven T. Waterman, *Tribal Troubles — Without Bankruptcy Relief*, XXVIII ABI Journal 10, 44-45, 87 (Jan. 2010); Shmuel Vasser & Janet Bollinger, *Casino Creditors, Heads-Up: American Indian tribes may be ineligible for bankruptcy*, N.Y.L.J. (Dec. 13, 2010).

7 *See* 25 U.S.C. § 2710(b)(2)(B).

8 *See Johnson v. McIntosh*, 21 U.S. 543 (1823); *Cherokee Nation v. Georgia*, 30 U.S. 1 (1831); *Worcester v. Georgia*, 31 U.S. 515 (1832).

9 677 F. Supp. 2d 1056 (W.D. Wis. 2010). Wells Fargo has appealed this decision to the Seventh Circuit Court of Appeals. The Seventh Circuit heard arguments in the case on October 20, 2010. To date, the Seventh Circuit has not issued a ruling.

10 Notably, the Corporation's counsel had issued an opinion letter stating that the indenture was not a management contract.

11 605 F.3d 149 (2d Cir.), *cert. granted*, 131 S. Ct. 459 (2010), *vacated & remanded*, 131 S. Ct. 704 (2011).

12 544 U.S. 197 (2005).

13 605 F.3d at 159. While on appeal at the Supreme Court, the Oneida tribe passed a tribal ordinance waiving its sovereign immunity with respect to a foreclosure action based on unpaid real estate taxes. Accordingly, the Court vacated the decision and remanded the case back to the Second Circuit. Although the new tribal ordinance apparently moots the question of the Counties' ability to foreclose, it is likely that the Second Circuit would still prohibit foreclosure if the same question would arise in another case.

14 *See* Mohegan Tribal Gaming Authority, Annual Report (Form 10-K), at 35 (Dec. 29, 2010).

15 *See* Jon Berke & Hema Oza, *Mohegan Restructuring Stalled by Hurdles to Clearing Debt Clutter for Future Growth*, Debtwire.com, Mar. 14, 2011.

S.D.N.Y. Bankruptcy Court Continues to Construe Bankruptcy Code's Safe Harbor Provisions Narrowly

By Mark C. Ellenberg, Douglas S. Mintz and Stephen M. Johnson

In two recent decisions, the United States Bankruptcy Court for the Southern District of New York has interpreted narrowly certain of the Bankruptcy Code's safe harbor provisions.

Last month, Judge James M. Peck ruled that a payment subordination provision in a swap agreement triggered by a bankruptcy constituted an unenforceable *ipso facto* clause and was not protected by the safe harbors. This resolved uncertainty related to a similar 2010 decision. *See Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings Inc.)*, Adv. Pro. No. 09-01032, 2011 WL 1831779 (Bankr. S.D.N.Y. May 12, 2011).

Several weeks earlier, Judge Robert D. Drain ruled that the safe harbor provided by section 546(e) of the Bankruptcy Code, which insulates certain "settlement payments" from avoidance actions, does not apply to transfers made or obligations incurred in the context of a leveraged buyout of a privately-held company. The Court, in applying its holding, voided both the payments made to the company's former shareholders in exchange for their equity interests and the obligations incurred by the company on account of the loan that financed the LBO. *See Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, Adv. Pro. No. 09–8266 (RDD), 2011 WL 1549056 (Bankr. S.D.N.Y. Apr. 21, 2011).

Ballyrock: A Second Look at Payment Subordination Provisions

Background

In July 2007, Lehman Brothers Special Financing Inc. ("LBSF") entered into an ISDA master agreement with Ballyrock ABS CDO 2007-1 Ltd. Lehman Brothers Holdings Inc. ("LBHI") issued a guarantee in connection with the master agreement and served as "Credit Support Provider" to LBSF under a credit support annex. Ballyrock entered into an indenture pursuant to which it issued several classes of notes to investors. The indenture established a waterfall distribution system under which the holders of senior notes must be paid in full before holders of more junior notes could receive any distributions. Under the terms of the ISDA Master Agreement and the Ballyrock Indenture, LBSF purchased and Ballyrock sold loss protection with respect to certain CDOs and mortgage-backed securities.

The Ballyrock Master Agreement identified a number of Events of Default, including a bankruptcy filing by either of the parties (LBSF or Ballyrock) or by the credit support provider (LBHI). Upon an Event of Default, the non-defaulting party could "designate a day not earlier than the day such notice is effective as an Early Termination Date in respect of all outstanding transactions" under the swap.[1] On the Early Termination Date, the swap required the out-of-the-money party to make a termination payment to the in-the-money party. The parties agreed that "any termination payment would be calculated using a recognized industry methodology referred to as the 'Second Method', which calls for payment to the in-the-money counterparty regardless of whether it was the defaulting party.[2]

Generally, a termination payment is given higher priority under a waterfall distribution scheme and would receive payment before senior noteholders. However, the Indenture "singled out for particularly harsh treatment" under the waterfall, a payment due upon an Event of Default triggered by LBSF or LBHI. The Indenture subordinated this payment – a so-called Defaulted Synthetic Termination Payment – further down the waterfall distribution scheme. Therefore, if either LBSF or LBHI triggered an event of default while LBSF was in-the-money, the Defaulted Synthetic Termination Payment would be subordinated to distributions owing to senior noteholders and, additionally, capped at $30,000.

LBHI filed for bankruptcy on September 15, 2008. Ballyrock then gave notice to LBSF that LBHI's bankruptcy filing constituted an Event of Default, and designated September 16, 2008, as the Early Termination Date. Wells Fargo Bank, N.A., the trustee under the Ballyrock Indenture, then gave notice that LBSF was in-the-money on the underlying transactions – to the tune of approximately $404 million. Ballyrock liquidated its assets, generating a total of approximately $326 million for distribution. The trustee made the first distribution of $189 million to the senior noteholders in accordance with the waterfall distribution scheme. The trustee also stated, however, that the remaining $137 million, which the trustee would have paid LBSF pursuant to the waterfall distribution scheme, constituted a Defaulted Synthetic Termination Payment and would be distributed to the senior noteholders rather than LBSF.

In response, LBSF commenced an adversary proceeding in the bankruptcy court seeking: (i) a declaratory judgment that the proposed distribution of the remaining $137 million violated applicable law; (ii) a declaratory judgment that the relevant credit default swap agreement was improperly terminated; and (iii) a temporary restraining order and permanent injunction preventing the trustee from distributing the remaining funds to the senior noteholders. Ballyrock, with the support of the senior noteholders, moved to dismiss the complaint.

The Perpetual Decision

The Court addressed a similar contract provision in a 2010 decision issued in another Lehman adversary proceeding. *See Lehman Bros. Special Fin. Inc. v. BNY Corp. Trust Servs. Ltd. (In re Lehman Bros. Holdings Inc.*), 422 B.R. 407 (Bankr. S.D.N.Y. 2010) ("*Perpetual*"). In *Perpetual*, the Court addressed the enforceability of a priority "flip" provision, which reversed the payment priorities in a terminated swap transaction if either the swap counterparty or its credit support provider (again, LBSF and LBHI, respectively) triggered the relevant event of default. Judge Peck held that the flip provision in *Perpetual* was an unenforceable *ipso facto* clause, and that the bankruptcy of LBHI (as credit support provider, a non-party to the swap) triggered the flip provision.

As detailed in sections 365(e)(1) and 541(c)(1)(b) of the Bankruptcy Code, contract provisions that prohibit the modification of a debtor's right solely because of a provision in an agreement conditioned on "the commencement of a case under this title" are unenforceable. In *Perpetual*, Judge Peck held that the Bankruptcy Code's *ipso facto* provisions applied to contract terms that modified a debtor's rights based on the filing of "presumably any case that is related in some appropriate manner to the contracting parties,"[3] and not solely upon the commencement of the debtor's case. Applying this logic to the facts before it, the Court concluded that the flip provision was unenforceable because it was triggered by the commencement of LBHI's chapter 11 case.

The judge limited the safe harbor to "preserving the right to liquidate, terminate and accelerate a qualifying financial contract."

Analysis

Here, the Court applied similar reasoning and held that "the analysis from the *Perpetual* decision would render ineffective the changes in the Waterfall that would result from activation of the Defaulted Synthetic Termination Payment Clause."[4] The Court therefore found that "the Complaint brought by LBSF is sufficient to state claims against Ballyrock based on the allegations that the clause in question constitutes an unenforceable *ipso facto* provision."[5]

The Court next considered whether the Defaulted Synthetic Termination Payment clause was protected by the safe harbor provisions of the Bankruptcy Code – an issue arguably not addressed in *Perpetual* (where the Court held that the safe harbor did not apply because the "flip" provision was not contained within the four corners of the swap agreement itself). Section 560 of the Bankruptcy Code protects a non-defaulting swap participant's contractual right to (i) liquidate, terminate or accelerate "one or more swap agreements because of a condition of the kind specified in section 365(e)(1)" of the Bankruptcy Code (the insolvency of the debtor, or commencement of a bankruptcy case) or (ii) "offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation or acceleration of one or more swap agreements."[6] The Court found that the Defaulted Synthetic Termination Payment clause "would change the flow of funds in a manner that would deprive LBSF of pre-existing distribution rights" and that such a deprivation of payment rights "should not be entitled to any protection under safe harbor provisions that, by their express terms, are limited exclusively to preserving the right to liquidate, terminate and accelerate a qualifying financial contract."[7]

Finally, the Court considered whether Ballyrock improperly terminated the credit default swap, and that, as a result, the underlying transactions remained in effect. LBSF argued that, pursuant to the Indenture, Ballyrock could only have terminated the swap if no transactions remained outstanding under the Master Agreement or Ballyrock had entered into a replacement Master Agreement. The Court held that this argument "confuses and obscures the distinction between the Ballyrock Master Agreement and the Transactions that may be entered into pursuant to that agreement."[8] Concluding that Ballyrock "did all that was necessary to designate an Early Termination Date, terminate all outstanding transactions and establish the obligation of the out-of-the-money party to pay the termination payment,"[9] the Court dismissed Count II of the Complaint.

In *Ballyrock*, Judge Peck again interpreted the Bankruptcy Code's safe harbor provisions in a light favorable to debtors. Following the *Perpetual* decision, which was limited to the particular facts of that case, there was uncertainty as to whether the Court would find similar priority-altering provisions that were expressly incorporated in the safe-harbored agreement protected by the Bankruptcy Code's safe harbors. *Ballyrock* does away with that uncertainty.

MacMenamin's Grill: Limiting Section 546(e)'s "Settlement Payment" Exception

Background

Each of three defendants owned 31 percent of the outstanding common stock of MacMenamin's Grill Ltd., a privately-held bar and grill. In July of 2007, the shareholders agreed to sell their ownership interests back to MacMenamin's in a typical, though relatively small, LBO transaction. Pursuant to a Loan and Security Agreement, Commerce Bank, N.A., extended a $1,150,000 loan to MacMenamin's to finance the transaction. As security for the loan, MacMenamin's granted the lender a security interest in substantially all of MacMenamin's assets. MacMenamin's directed the lender to pay the loan proceeds directly to the three shareholders as consideration for their stock. The transaction closed on August 31, 2007. MacMenamin's filed for bankruptcy on November 18, 2008.

During the pendency of the bankruptcy case, a chapter 11 trustee was appointed. The trustee subsequently filed a complaint seeking to avoid the transfers made and obligations incurred in connection with the LBO as constructively fraudulent transfers pursuant to sections 544 and 548 of the Bankruptcy Code, and to recover for the benefit of the estate the value of the proceeds paid out to the shareholders under section 550 of the Bankruptcy Code.

Analysis

The dispute in this case did not revolve around whether the transfers themselves were avoidable under sections 544 and 548 of the Bankruptcy Code. Rather, the shareholders conceded that the transfers were constructively fraudulent and subject to avoidance by the trustee. The shareholders and the lender contended that the transfers at issue were exempt from the trustee's avoidance powers by nature of section 546(e) of the Bankruptcy Code – a so-called "safe harbor" provision that insulates certain transactions from the avoidance provisions of chapter 5 of the Bankruptcy Code – and sought summary judgment in their favor.

Section 546(e) provides, in relevant part:

> Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a . . . settlement payment as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or. . . that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7). . . .

Section 741(8) of the Bankruptcy Code defines "settlement payment" as:

> a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade . . . .

The shareholders argued that the transfers in question – the payment of the loan proceeds to them in exchange for their shares in MacMenamin's – constituted "settlement payments" for purposes of section 546(e), or, in the alternative, were transfers made by and to financial institutions in connection with a securities contract. Thus, they argued, the transfers fit squarely within the safe harbor of section 546(e) pursuant to the plain language of the statute.

Having considered the text of section 546(e), along with its various cross-references and definitions, the Court found the section to be ambiguous. The Court therefore turned to the relevant legislative history in an attempt to uncover the purpose and scope that Congress had intended for section 546(e). The Court held:

> That legislative history . . . makes it clear that Congress intended section 546(e) to address risks that the movants have failed to show conclusively are implicated by the avoidance of the transaction at issue here. The Court should not, therefore, impose a result contrary to Congressional intent.[10]

The Court challenged the prevailing view of the circuit courts that the safe harbor provided by section 546(e) of the Bankruptcy Code applies to transfers made in connection with private securities transactions, as well as those involving publicly traded stock.

The Court also ruled that the obligations incurred by MacMenamin's in connection with the lender's financing of the transaction were outside of the scope of section

546(e) and therefore subject to avoidance. The Court's reasoning was twofold. First, the Court's analysis of section 546(e)'s legislative history did not differentiate between transfers made and obligations incurred, and thus the same reasoning applied. And second, while sections 544 and 548 of the Bankruptcy Code provide a trustee with the power to avoid transfers made and obligations incurred by the debtor, section 546(e) only provides that "the trustee may not avoid a transfer," but imposes no express limitation on the avoidance of obligations incurred. Therefore, the Court held that section 546(e)'s exemption is inapplicable to actions seeking to avoid obligations incurred by a debtor, regardless of whether the relevant transaction involves private or publicly traded securities.[11]

While a number of circuit courts have held that LBO-related transfers are protected by the safe harbors of section 546(e) of the Bankruptcy Code,[12] in the last year, courts in both the Southern District of New York and the District of Delaware have narrowed the scope of the safe harbor and generally read them in a manner most favorable to debtors and their estates.[13] Participants in private LBOs should be aware that the transfers made and obligations incurred in connection with an LBO may be susceptible to avoidance as fraudulent transfers. And all non-debtor parties should be aware that courts in recent years have given debtor-friendly views of various safe harbor provisions.

Endnotes

1 Ballyrock Master Agreement, § 5(a).

2 *Ballyrock*, 2011 WL 1831779, *2.

3 *Perpetual*, 422 B.R. at 419.

4 *Ballyrock* at *5.

5 *Id.*

6 11 U.S.C. § 560.

7 *Ballyrock* at *6.

8 *Id.* at *7.

9 *Id.* at *8.

10 *MacMenamin's* at *10.

11 *Id.* at *15.

12 *See, e.g.*, *QSI Holdings v. Alford (In re QSI Holdings, Inc.)*, 571 F.3d 545 (6th Cir. 2009), *cert. denied* 130 S.Ct. 1141 (2010); Brandt v. B.A. Capital Co. LP (In re Plassein Int'l Corp.), 590 F.3d 252 (3d Cir. 2010), *cert. denied*, 130 S.Ct. 2389 (2010); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009).

13 *See, e.g.*, *Chevron Prods. Co. v. SemCrude, L.P.* (In re SemCrude, L.P.), 428 B.R. 590 (D. Del. 2010) (affirming bankruptcy court decision holding that contractual provision allowing for triangular setoff violates mutuality requirement of section 553); *Swedbank AB (PUBL) v. Lehman Bros. Holdings Inc. (In re Lehman Bros. Holdings Inc.)*, 445 B.R. 130 (S.D.N.Y. 2011) (affirming bankruptcy court decision holding that safe harbor provisions allow for exercise of contractual right to setoff notwithstanding automatic stay, but that other prerequisites for setoff, such as mutuality, must be satisfied); *Bank of Am., N.A. v. Lehman Bros.* Holdings Inc., 439 B.R. 811 (Bankr. S.D.N.Y. 2010) (holding that lender's seizure of debtor's account funds, which were unrelated to any safe harbored transaction, absent court approval was impermissible setoff in violation of automatic stay).

Second Circuit Clarifies Rules On Gifting, Designation, in DBSD[1]

By Douglas S. Mintz & Michael A. Stevens

Earlier this year, the U.S. Court of Appeals for the Second Circuit held that a proposed "gifting" plan distributing value from the second lien lenders to the prepetition equity holder violated the absolute priority rule and was confirmed in error.[2] This decision, by a 2-1 panel vote,[3] reversed the decisions of the Bankruptcy and District Courts for the Southern District of New York. The Second Circuit also affirmed unanimously the designation of the vote of an indirect competitor of the debtor that held no claims prior to the petition date. The Second Circuit held that this entity did not vote on the plan in good faith because it purchased an entire class of claims with the goal of blocking plan confirmation in an effort to acquire DBSD's assets.[4] This opinion prohibits class-skipping gifting plans in the Second Circuit and raises a host of questions about the applicability of gifting in bankruptcy. The ruling also curtails a competitor's ability to purchase bankruptcy claims for strategic purposes.

Background

On May 15, 2009, DBSD filed for Chapter 11 relief in the U.S. Bankruptcy Court for the Southern District of New York. Following negotiations, DBSD filed a "gifting" plan of reorganization, pursuant to which the unsecured creditors would receive an estimated recovery ranging from four percent to nearly 50 percent. Holders of DBSD's second lien debt would receive the majority of the reorganized company's equity and then "gift" portions of that equity to DBSD's pre-bankruptcy shareholder, ICO Global Communications, and the unsecured creditors.[5]

Sprint Nextel Corporation objected to the plan. Sprint argued that the plan violated the absolute priority rule of section 1129(b)(2)(B) of the Bankruptcy Code by distributing equity to ICO, whose prepetition equity interest was junior in priority to Sprint's prepetition unsecured claim, while failing to pay the unsecured creditors' claims in full. The Bankruptcy Court overruled Sprint's objection, holding that the undersecured second lien lenders were allowed to "gift" a portion of their recovery to ICO.[6]

After DBSD filed its disclosure statement, DISH Network Corporation, a competitor of DBSD that was not a prepetition creditor, purchased all of the first lien debt at face value and a portion of the second lien debt with the intention of blocking confirmation and seizing control of certain DBSD assets. DISH voted against the plan and objected to confirmation, arguing that the plan was not feasible and that DISH did not receive the indubitable equivalent of its claims. In response, DBSD moved to designate DISH's vote pursuant to section 1126(e) of the Bankruptcy Code as not being made in good faith. The Bankruptcy Court granted DBSD's motion, designated DISH's vote, disregarded the first lien lender class for voting purposes, and confirmed the plan on October 26, 2009.[7] After the

District Court affirmed the Bankruptcy Court's decision, both Sprint and DISH appealed to the Second Circuit.[8]

Second Circuit Rejects Gifting

Sprint argued that the plan violated the absolute priority rule by distributing property to ICO on account of its prepetition equity interests although the more senior class of unsecured creditors did not receive complete satisfaction of its claims. The Second Circuit looked first to the text of the absolute priority rule in section 1129(b)(2)(B) of the Bankruptcy Code, which requires that, to be fair and equitable to unsecured creditors

> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property . . . .

The Second Circuit stated that the plan, which did not satisfy Sprint's claim, would comply with the absolute priority rule "only if the existing shareholder, whose interest is junior to Sprint's, does 'not receive or retain' 'any property' 'under the plan on account of such junior . . . interest.'"[9]

Reviewing the plan, the Second Circuit concluded that ICO received "property" because the meaning of "any property" includes the equity the second lien lenders granted to ICO. ICO received this property "under the plan" because the plan expressly stated that ICO was to receive this equity. Finally, ICO received its new equity "on account of" its prepetition interest because it received the shares in exchange for its old shares pursuant to the terms of the plan. Although the disclosure statement articulated additional reasons why ICO received this gift, namely ICO's "continued cooperation and assistance," the Second Circuit found that ICO's cooperation was only necessary and possible because of its prior interest. In addition, the Second Circuit found that even if ICO had made a capital contribution to the reorganized debtor, which it had not, ICO's "receipt of property partly on account of the existing interest [would be] enough for the absolute priority rule to bar confirmation of the plan."[10]

The Second Circuit rejected DBSD's argument that the so-called "gifting doctrine" allowed the undersecured second lien lenders to gift shares of new equity to ICO. The Second Circuit found that the text of the Bankruptcy Code, Supreme Court jurisprudence, and the distinguishing facts of the landmark gifting doctrine case, *Official, Unsecured Creditors' Committee v. Stern (In re SPM Manufacturing Corp.),*[11] offered ample support for its determination that any gifting exception to the absolute priority rule did not apply in this case.[12]

The Second Circuit also addressed the policy arguments against a strict interpretation of the absolute priority rule, noting that "[g]ifting may be a 'powerful tool in accelerating an efficient and non-adversarial . . . chapter 11 proceeding' . . . and no doubt the parties intended the gift to have such an effect here." Regardless of the policy merits of the absolute priority rule, the Second Circuit concluded that "Congress was well aware of both [the absolute priority rule's] benefits and disadvantages when it codified the rule in the Bankruptcy Code. . . . [A]lthough Congress did soften the absolute priority rule in some ways [in the 1978 Bankruptcy Code], it did not create any exception for 'gifts' like the one at issue here."[13]

"Congress was well aware of both [the absolute priority rule's] benefits and disadvantages when it codified the rule in the Bankruptcy Code. . . . [A]lthough Congress did soften the absolute priority rule in some ways [in the 1978 Bankruptcy Code], it did not create any exception for 'gifts' like the one at issue here."

Second Circuit Permits Designation of Votes for Bad Faith Actions

The Second Circuit also held unanimously that the Bankruptcy Court did not err in designating DISH's vote for not being made in good faith.[14] Section 1126(e) of the Bankruptcy Code provides that "[o]n request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith . . . ."

The Second Circuit found that DISH was a competitor of DBSD that had purchased the entire class of first lien debt "not to maximize its return on the debt but to . . . use [the votes] as levers to bend the bankruptcy process toward its own strategic objective . . . ." Based on these facts, and in light of the history behind section 1126(e) of the Bankruptcy Code and its modern interpretation in bankruptcy courts, the Second Circuit ruled that DISH acted on the type of "ulterior motive" that constitutes bad faith. Accordingly, the Second Circuit held that the Bankruptcy Court correctly designated DISH's vote as not having been made in good faith.[15]

The Second Circuit limited its decision, however, stating that the ruling "should deter only attempts to 'obtain a blocking position' and thereby 'control the bankruptcy process for [a] potentially strategic asset,'" as opposed to when a "preexisting creditor votes with strategic intentions."[16] In addition, the Second Circuit emphasized that its decision is not a "categorical ban" on the strategic purchasing of claims, which may be appropriate in other contexts, but was instead a "fact-intensive" analysis "based on the totality of the circumstances."[17]

DBSD Likely To Have Extensive Impact

In *DBSD*, the Second Circuit's strict application of the absolute priority rule virtually prohibits any class-skipping gift under a plan, and the plain meaning of section 1129(b)(2) of the Bankruptcy Code clearly supports the Second Circuit's conclusion. Under a cramdown plan, a junior class may not be paid unless a dissenting senior class is paid in full. This limitation applies even to those plans where the recipient also contributes new value to the reorganized debtor. Indeed, the Second Circuit found that "a transfer partly on account of factors other than the prior interest is still partly 'on account of' that interest . . . [which is] enough for the absolute priority rule to bar confirmation of the plan."[18] However, to the extent a debtor can demonstrate that a gift under a plan was not made on account of the beneficiary's prior interest, the gift may be permitted under the Second Circuit's analysis.

Although this decision may be correct from a purely legal perspective, the analysis creates practical problems. First, the Second Circuit recognized explicitly that the absolute priority rule does not exist in chapter 7 and is inapplicable to gifting mechanisms akin to that employed in *SPM*, where a senior secured creditor agreed with unsecured creditors to seek liquidation of the debtor in chapter 7 and to share in the proceeds of the liquidation.[19] Thus, the permissibility of gifting in chapter 7 could steer debtors toward chapter 7 in situations where parties cannot reach a consensual plan—contrary to the Bankruptcy Code's general policy favoring reorganization.

Additionally, plan proponents can effectuate a gift through means outside of chapter 7 or a plan. For example, parties could implement a settlement under Federal Rule of Bankruptcy Procedure 9019 or through a private agreement subsequent to the effective date of the plan.[20] It is unclear how gifting outside the chapter 11 plan, while continuing to pursue the plan process, is consistent with the absolute priority rule as interpreted by the Second Circuit's decision in *DBSD*. It is also uncertain whether and to what extent parties would be required to disclose a private agreement, though greater disclosure to a bankruptcy court is generally preferred.

The vote designation ruling is also significant. The Second Circuit endorses the Bankruptcy Court's ruling that a purchaser cannot acquire claims with a strategic, rather than financial, motivation. It is, of course, difficult to draw the line between a strategic versus a financial motivation. Can a financial player acquire claims and use them to takeover a company? Can an existing creditor use its claims to act strategically? Those questions remain unanswered and both the Bankruptcy Court and the Second Circuit clearly limit the reach of their respective holdings. Specifically, the Second Circuit held that "purchasing claims with acquisitive or other strategic intentions" may be proper in some circumstances. This leaves future courts flexibility in applying designation.[21] For this reason, the designation portion of the opinion should be read narrowly.

Endnotes

1 This article is modified from a version printed in the New York Law Journal. *See* John J. Rapisardi, *Second Circuit Disapproves of Gifting, Affirms Designation in 'DBSD'*, N.Y.L.J., May 5, 2011.

2 *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79 (2d Cir. 2011).

3 Judge Pooler dissented from the majority's determination that Sprint had standing to appeal, reasoning that "[u]nder no reasonable understanding of Sprint's [unsupported and unliquidated] claim can [Sprint] show that it suffered a pecuniary injury as a result of the confirmation plan." *Id.* at 111 (Pooler, J., dissenting). As a result, Judge Pooler did not consider the merits of Sprint's appeal or address its absolute priority rule argument. Id. at 109.

4 *Id.* at 104 (majority opinion).

5 *Id.* at 85-86. ICO owned 99.8% of DBSD. *Id.*

6 *Id.* at 86-87 (citing *In re DBSD N. Am., Inc.*, 419 B.R. 179, 210, 212 (Bankr. S.D.N.Y. 2009) ("*DBSD I*").

7 *Id.* at 87-88 (citing *In re DBSD N. Am., Inc.*, 421 B.R. 133, 137, 143(Bankr. SD.N.Y. 2009); DBSD I, 419 B.R. at 137, 143, 203, 208-09).

8 *Id.* at 88.

9 *Id.* at 88, 95 (quoting 11 U.S.C. § 1129(b)(2)(B)).

10 *Id.* at 96 (citing *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 456-58 (1999)).

11 984 F.2d 1305 (1st Cir. 1993).

12 634 F.3d at 96-98 (citing *203 N. LaSalle*, 526 U.S. at 437, 458; *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 199, 206 (1988); SPM, 984 F.2d at 1309, 1312, 1313, 1313-14).

13 *Id.* at 100.

14 *Id.* at 104. The Second Circuit also rejected DISH's argument that the bankruptcy court erred in ruling the plan feasible. Id. at 107-08.

15 *Id.* at 103-05 (citing *In re Applegate Prop., Ltd.*, 133 B.R. 827, 833-35 (Bankr. W.D. Tex. 1991); *In re Allegheny Int'l, Inc.*, 118 B.R. 282, 289-90 (Bankr. W.D. Pa. 1990); *In re MacLeod Co.*, 63 B.R. 654, 655-56 (Bankr. S.D. Ohio 1986)). The Second Circuit likewise found that the bankruptcy court properly disregarded DISH's first lien lender class, of which DISH was the sole claimholder, reasoning that "just as a bankruptcy court properly ignores designated claims when calculating the vote of a class, so should it ignore a wholly designated class when deciding to confirm a plan under § 1129(a)(8)." *Id.* at 106.

16 *Id.* at 105 (quoting DISH's own internal presentation materials).

17 *Id.* Following the Second Circuit's decision, and after filing a modified plan, the DBSD debtors accepted an alternative purchase proposal from DISH whereby DISH would purchase the 100% of the reorganized debtors and fund an alternative plan that would result in substantially greater distributions to unsecured creditors. *See* Debtors' Motion for Entry of an Order Authorizing and Approving the Investment Agreement, *In re DBSD N. Am., Inc.*, Case No. 09-13061 (REG) (Bankr. S.D.N.Y. Feb 1, 2011), ECF No. 899. On March 15, 2011, the Bankruptcy Court entered an order approving the transaction with DISH. See Order Authorizing and Approving the Investment Agreement, *In re DBSD N. Am., Inc.*, Case No. 09-13061 (REG) (Bankr. S.D.N.Y. Mar. 15, 2011), ECF No. 1028.

18 *Id.* at 96 (citing *203 N. LaSalle*, 526 U.S. at 456-58).

19 *Id.* at 97-98 (citing SPM, 984 F.2d at 1307-08).

20 In *Motorola, Inc. v. Official Committee of Unsecured Creditors (In re Iridium Operating LLC)*, the Second Circuit held that where the applicable factors weigh heavily in favor of approving a settlement under Rule 9019, "the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule." 478 F.3d 452, 464-65 (2d Cir. 2007). The Second Circuit in *DBSD* did not address the continued viability of *Iridium* as it relates to gifting in the pre-plan settlement context, although the Second Circuit's strict application of the absolute priority rule in DBSD may, as a practical matter, preclude the effectiveness of such agreements if their terms are effectuated through a plan.

21 634 F.3d at 104-05.

Champion Enterprises Bankruptcy Court Dismisses Equitable Subordination and Fraudulent Transfer Claims

By Joe Zujkowski and Kathryn Borgeson

The United States Bankruptcy Court for the District of Delaware dismissed equitable subordination and fraudulent transfer claims filed by the Official Committee of Unsecured Creditors of Champion Enterprises, Inc. ("Champion") against more than 100 prepetition lenders to Champion (collectively, the "Defendants")[1]. The Committee alleged that in the years preceding the bankruptcy, the Defendants acted inequitably by authorizing amendments to a credit agreement that allowed for the issuance of certain unsecured notes, the proceeds of which were used to repay amounts owed to the Defendants under the credit agreement.

In dismissing the equitable subordination claim, the Court found that the Defendants were not insiders of the Debtors and had not otherwise acted inequitably prior to the petition date. The Court also dismissed the fraudulent conveyance claim, finding that the transfers at issue discharged an antecedent debt and thus were made in exchange for fair consideration.

Background

On April 7, 2006, Champion Home Builders Co. ("Champion Opco"), a producer of manufactured and modular housing, and Champion's principal operating subsidiary, executed a credit agreement (the "Credit Agreement") which provided for two term loans maturing on October 31, 2012 (the "Senior Term Loans").[2] Champion Opco's obligations under the Credit Agreement were secured by a pledge of all its assets.[3]

By early 2007, Champion Opco was on the verge of defaulting on the Senior Term Loans and sought to amend the terms of the Credit Agreement.[4] Pursuant to October 2007 amendments, Champion was permitted to issue unsecured 2.75% Convertible Senior Notes due in 2037 (the "Subordinated Notes"), and to use the proceeds from the Subordinated Notes to pay down the Senior Term Loans and redeem other secured notes previously issued by Champion due in 2009 (the "2009 Notes").[5] Champion raised $180 million through issuance of the Subordinated Notes, and ultimately used $86.4 million of the proceeds to redeem the 2009 Notes, $8 million to prepay the Senior Term Loans, and $14.5 million to prepay other obligations under the Credit Agreement.[6] Despite the issuance, Champion's financial condition continued to decline through 2008 and 2009, and on November 15, 2009, the Debtors filed for bankruptcy in the United States Bankruptcy Court for the District of Delaware.[7]

The Adversary Proceeding

On February 18, 2010, the Committee brought an adversary proceeding on behalf of the Debtors' estates against the Defendants to recover damages arising out of the Credit Agreement amendments and the issuance of the Subordinated Notes.[8] In response to the complaint, the Defendants filed motions to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6).[9] In particular, the Defendants argued that they were not insiders of the Debtors, and thus the heightened equitable subordination standard applicable to claims against insiders should not apply. With respect to the fraudulent transfer claims, the Defendants argued that the transactions at issue were made in exchange for fair consideration and thus were not fraudulent.

On September 1, 2010, the Bankruptcy Court granted, almost entirely, the Defendants' motions to dismiss.[10] The Court dismissed all thirteen counts with respect to the Defendants, except Credit Suisse. With respect to Credit Suisse, the Court dismissed all but two counts seeking breach of contract damages for improper assignments of certain debt obligations under the Credit Agreement and disallowance of certain claims.[11] Most notably, the Court dismissed the Committee's equitable subordination and fraudulent transfer claims in their entirety. This article details the parties' arguments and the Court's rulings on these two issues.[12]

Equitable Subordination of Defendants' Secured Claims

In Count I of the complaint, the Committee alleged that the Defendants' claims should be equitably subordinated to the claims of the Debtors' unsecured creditors.[13] The Committee argued that the Defendants exploited Champion's distressed situation, and their resulting leverage over Champion, to improperly shift their risk to other creditors and to advance their own position through the Credit Agreement amendments and the issuance of the Subordinated Notes.[14] The Committee also argued that the Defendants failed to correct allegedly materially false and misleading disclosures in the Subordinated Notes prospectuses.

A court may equitably subordinate a claim when a creditor has improved its position relative to other creditors through unjust or unfair means.[15] The claim of the offending creditor is subordinated to the claims of the injured creditors, to the extent necessary to remedy the harm caused by the offending creditor's conduct. In requesting equitable subordination, the moving party must demonstrate "(i) inequitable conduct; (ii) resulting in injury to creditors or unfair advantage to the claimant; and (iii) an outcome that is not otherwise inconsistent with the Bankruptcy Code."[16]

In analyzing equitable subordination claims, courts "typically differentiate between insider and non-insider claimants and apply special scrutiny to the conduct of insiders."[17] Specifically, "[w]hile the general standard for non-insider creditors is egregiousness and severe unfairness in relation to other creditors, insider claims have been equitably subordinated in cases involving (1) fraud, illegality or breach of fiduciary duty, (2) undercapitalization, and (3) control or use of the debtor as an alter ego for the benefit of the claimant."[18]

Insider Status

The Committee alleged that the Defendants were "insiders" of Champion and thus their role in the amendments to the Credit Agreement required a higher degree of scrutiny. Specifically, the Committee alleged that the Defendants were insiders under (i) section 101(31) of the Bankruptcy Code, which defines insiders to include persons in control of a debtor,[19] and (ii) applicable case law related to "non-statutory insiders." Summarizing these allegations, the Court observed that "[t]he Committee's theory is that the [Defendants] were able to coerce Champion's actions and, therefore, had sufficient control over Champion to merit statutory and non-statutory insider status."[20]

In addressing the Committee's argument, the Court first observed that in the context of equitable subordination claims against lenders, "courts have refused to apply insider status absent a showing of a high level of control by the lender."[21] The Court added that "control sufficient to merit insider status may be established by facts showing that the lender dictated day-to-day management and operation of the debtor or made decisions for the debtor regarding replacement of management or filing for bankruptcy."[22]

In analyzing the allegations in the complaint, the Court devoted significant attention to a recent Third Circuit decision, *Schubert v. Lucent Technologies, Inc. (In re Winstar Communications, Inc.)*.[23] In that case, the Third Circuit held that the claims of Lucent, a vendor and prepetition lender, should be equitably subordinated – even though Lucent did not meet the definition of an insider under section 101(31) of the Bankruptcy Code – because Lucent was a non-statutory insider able to coerce the debtors into taking actions that were only in Lucent's best interests.[24] The Third Circuit stated that when addressing non-statutory insider status, courts should focus on "whether there is a close relationship [between the debtor and creditor] and . . . anything other than closeness to suggest that any transactions were not conducted at arm's length."[25] Finally, the Third Circuit found that the transactions at issue in *Winstar* were not conducted at arm's length because Lucent had used "Winstar as a mere instrumentality to inflate Lucent's own revenues" and the transactions at issue clearly were not in the debtors' best interest.[26]

The *Champion* Court distinguished *Winstar*, and dismissed the Committee's argument that the lenders were subject to stricter scrutiny as non-statutory insiders. The Court first noted that, unlike in *Winstar*, where Lucent was the debtor's primary supplier, the Defendants here were "traditional lenders."[27] Specifically, in distinguishing *Winstar* the Court stressed that Lucent's "economic survival" as a supplier depended on Winstar's inventory purchases and business development.[28] Here, although the Defendants had access to Champion's financial information and successfully negotiated amendments to the Credit Agreement, the Court stressed that "where a lender's influence on a debtor's actions merely arises by [operation] of bargained-for rights under a credit agreement, those 'reasonable financial controls negotiated at arms' length between a lender and a borrower do not transform a lender into an insider.'"[29] The Court concluded that "the Complaint's allegations are indicative of nothing more than a normal distressed-borrower/lender relationship and do not provide a basis from which the Court could infer that Defendants' relationship or dealings with Champion merit applying insider status to Defendants pursuant to 11 U.S.C. § 101(31)(B)(iii) or non-statutory insider law."[30] The Court, thus, found that the Defendants were either "statutory" nor "non-statutory" insiders, and their actions were not subject to heightened scrutiny.

Inequitable Conduct of Non-Insiders

Because the Court determined that the Defendants were non-insiders, the Committee needed to prove that the Defendants engaged in "egregious conduct, such as fraud, spoliation or overreaching" in order to equitably subordinate their claims.[31] In the complaint, the Committee alleged that (i) the Defendants generally abused the Credit Agreement amendment process to shift the credit risk from themselves to others, (ii) the Defendants failed to correct allegedly materially false and misleading disclosures in the Subordinated Notes prospectuses, and (iii) the Defendants acted egregiously in assigning certain obligations under the Credit Agreement to MAK Capital Fund, LP.[32]

The Court dismissed each of the Committee's arguments regarding egregious conduct. With respect to the Committee's first argument that the Defendants "abused" the Credit Agreement amendment process, the Court stated that the Defendants had acted as normal lenders and that "[n]ormal lender conduct does not amount to inequitable conduct for equitable subordination purposes."[33] The Court further stressed that "[a]lthough the [Defendants] may have forcefully negotiated, the fact that one party to a contract has more leverage does not indicate that the dealings are not at arm's length."[34]

With respect to the Committee's second argument that the Defendants failed to correct statements in the prospectus, the Court held that "the Complaint's allegations regarding these Defendants' specific actions consist solely of factually unsupported conclusory statements."[35] Accordingly, the Complaint did not meet the applicable Rule 12(b)(6) standard which required "sufficient facts from which the Court could draw the inference" that the Defendants "assisted Champion in making materially misleading disclosures or that these Defendants had an independent disclosure duty."[36]

Finally, the Court rejected the Committee's arguments with respect to the prepetition assignment of Credit Agreement obligations from the Defendants to MAK Capital Fund, LP. The Committee argued that the Defendants "actively supported and furthered MAK's efforts to forc[e] Champion into bankruptcy so that MAK could acquire all or a controlling interest in Champion's assets at a fire sale price."[37] In dismissing these arguments, the Court found that although Credit Suisse, as agent under the Credit Agreement, may have breached its contractual obligations by allowing for the prepetition transfer of obligations to MAK Capital Fund, LP without Champion's consent, this "conduct does not rise to the level of inequitable behavior necessary for equitable subordination."[38] The Court added that "the remainder of the allegations regarding Credit Suisse's motivations and MAK's long-term plan are factually-unsupported conclusions" and concluded that the complaint's equitable subordination claims should be dismissed against all Defendants.[39]

Avoidance of Constructively Fraudulent Transfers

The Committee also alleged that it could avoid the $86.4 million paid to redeem the 2009 Notes, the $8 million prepayment of the Senior Term Loans, and the approximately $14.5 million in prepayments of other portions of the Credit Agreement, as constructively fraudulent transfers under section 544(b) of the Bankruptcy Code and section 274 of the New York fraudulent conveyance statute.[40] Section 274 of the New York fraudulent conveyance statute states that "[e]very conveyance made without fair consideration when the person making it is engaged or about to engage in a business or transaction for which the property remaining in his hands after the conveyance is unreasonably small capital, is fraudulent as to creditors . . . ."[41] "Fair consideration" is provided when, in good faith, the conveyance is an exchange of fairly equivalent interests, the conveyance satisfies an antecedent debt, or the conveyance is to secure an advance or an antecedent debt.[42] Section 544 of the Bankruptcy Code incorporates applicable non-bankruptcy fraudulent transfer law (including the New York fraudulent transfer law) into the Bankruptcy Code.

"[a]lthough the [Defendants] may have forcefully negotiated, the fact that one party to a contract has more leverage does not indicate that the dealings are not at arm's length."

The Committee premised its fraudulent transfer allegations on the notion that the redemption of the 2009 Notes, the pay-down of the Senior Term Loans, and other payments under the Credit Agreement, all of which were funded by the issuance of the Subordinated Notes, were not made in exchange for fair consideration. In response, the Defendants argued that the transfers were made for fair consideration because the transfers resulted in the repayment of outstanding indebtedness. The Court agreed, citing a recent Second Circuit case, *In re Sharp International,* which it described as "factually and procedurally on-point."[43]

In *Sharp*, the chapter 11 trustee alleged that State Street Bank and Trust Company, a lender to the debtor, discovered that the controlling shareholders of the debtor were committing fraud.[44] Instead of revealing the fraud to the public, State Street requested that the debtor incur additional debt to pay off its loan.[45] The chapter 11 trustee argued that the repayment of State Street's loan by incurring new debt was a constructively fraudulent transfer.[46] The *Sharp* court found that the transfers were supported by fair consideration because they discharged an antecedent debt, noting that "bad faith does not appear to be an articulable exception to the broad principle that 'the satisfaction of a preexisting debt qualifies as fair consideration for a transfer of property.'"[47]

The *Champion* Court stated that the Defendants, like the Sharp defendants, "were alleged to have orchestrated the issuance of new debt to better position [themselves] and to quietly shift risk to other creditors," and that the Defendants, like State Street, did not violate the law or the terms of any financing agreements.[48] Accordingly, the Court held "that the Complaint fails to allege that the Transfers in satisfaction of the [Credit Agreement] lacked fair consideration," because although the transfers may have been preferential, they were made on account of an antecedent debt and thus were not fraudulent under applicable New York law.[49] As a result, the Court dismissed this count of the complaint.

Conclusion

The Court's dismissal of the equitable subordination and fraudulent transfer claims in *Champion* is instructive for a number of reasons. First, the Court emphasized that the exercise of remedies under a prepetition loan agreement is not a sufficient basis for concluding that a lender has sufficient control of or influence over the debtor to be a non-statutory insider. The Court stressed that even where the exercise of lender remedies gives the lender increased leverage, this conduct does not rise (or sink) to the inequitable or egregious level necessary for equitable subordination. Moreover, the Court held unequivocally that where a prepetition payment extinguishes an existing debt, the payment is made in exchange for fair consideration and thus is not a fraudulent transfer. The Court's willingness to knock out these counts of the complaint on a motion to dismiss should provide comfort to lenders that the robust exercise of their remedies and use of their leverage when dealing with distressed borrowers is unlikely to subject them to equitable subordination or fraudulent transfer liability.

Endnotes

1 *Official Comm. of Unsecured Creditors of Champion Enters., Inc. v. Credit Suisse (In re Champion Enters., Inc.)*, No. 10-50514 (K.G.), 2010 WL 3522132 (Bankr. D. Del. Sept. 1, 2010).

2 *Id.* at *2.

3 *Id.*

4 *Id.*

5 *Id.*

6 *Id.* at *17 n.15.

7 *Id.* at *4.

8 *Id.* at *1.

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.* at *1.

14 *Id.* at *8.

15 11 U.S.C. § 510(c)(1). Section 510(c)(1) also allows a court to subordinate the interests of an equity holder to the interests of another equity holder.

16 *In re Champion Enters.*, 2010 WL 3522132, at *5.

17 Id. at *6 (citing *Waslow v. MNC Commercial Corp. (In Re M. Paoella & Sons, Inc.)*, 161 B.R. 107, 117-18 (E.D. Pa. 1993)).

18 *Official Comm. of Unsecured Creditors v. Austin Fin. Servs., Inc. (In re KDI Holdings, Inc.)*, 277 B.R. 493, 511 (Bankr. S.D.N.Y. 1999)

19 11 U.S.C. § 101(31) defines an insider of a corporation as a director, officer, person in control, or general partner of the debtor, a partnership in which the debtor is a general partner, or a relative of a director, officer, person in control or general partner of the debtor.

20 *In re Champion Enters.*, 2010 WL 3522132, at *6.

21 *Id.*

22 *Id.*

23 554 F.3d 382, 395 (3d. Cir. 2009).

24 *Id.* at 397 (quoting *Anstine v. Carl Zeiss Meditec AG (In re U.S. Med. Inc.)*, 531 F.3d 1272, 1277 (10th Cir. 2008)).

25 *Id.* at 396-97.

26 *Id.* at 399.

27 *In re Champion Enters.*, 2010 WL 3522132, at *7.

28 *Id.* at *6-7.

29 *Id.* at *7.

30 *Id.* at *8.

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.* at *9.

35 *Id.*

36 *Id.*

37 *Id.* at *12-13.

38 *Id.* at *13.

39 *Id.*

40 *Id.* at *17.

41 N.Y. Debt. & Cred. § 274 (2010).

42 *Id.*

43 403 F.3d 43 (2d Cir. 2005).

44 *Id.* at 47.

45 *Id.*

46 *Id.*

47 *Id.* at 54 (quoting *Pashaian v. Eccelstron Props., Ltd.*, 88 F.3d 77, 85 (2d Cir. 1996)).

48 *In re Champion Enters.*, 2010 WL 35522132, at *19.

49 *Id.*

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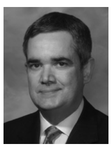

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