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Caveat Emptor: Emerging Issues for Buyers of Bankruptcy Claims

In a large Chapter 11 bankruptcy case, claims against the debtor are actively traded in the secondary markets. A debtor's original creditors may lack the liquidity to wait for uncertain payment at the end of the bankruptcy case (which could be years from the commencement date) and are often inclined to promptly "cash out" by selling their positions, even at a discount. Purchasers of claims, usually hedge funds and other seasoned participants in the bankruptcy process, are rewarded if the ultimate recovery on the transferred claims is greater than the purchase price. Moreover, the acquisitions of claims can, if purchased in sufficient quantities, give the buyer a meaningful voice in the strategic direction of the underlying Chapter 11 case.

These investments, however, are not without legal risk. A number of recent judicial decisions addressed (i) whether a taint that could render a claim worthless in the hands of the original creditor continues to travel to a buyer and (ii) the circumstances under which a court may disregard the votes of a claim purchaser in connection with the balloting on the debtor's plan of reorganization.

Does a Taint Travel to a Buyer?

Section 502(d) of the Bankruptcy Code prohibits distributions by the estate on account of "any claim of any entity" that has failed to return a voidable transfer to the estate. 11 U.S.C. § 502(d). The United States Bankruptcy Court for the Southern District of New York considered the "statutory reference [in section 502(d) applicable] ... to any claim." *Enron Corp. v. Avenue Special Situations Fund II, LP* (*In re Enron Corp.*) ("*Enron I*"), 340 B.R. 180, 194 (Bankr. S.D.N.Y. 2006). "[T]he transfer of a claim subject to section 502(d) disallowance in the hands of the transferor remains subject to disallowance in the hands of a transferee. A claim in the hands of a transferee, either as an initial transferee or subsequent transferee, remains subject to a section 502(d) disallowance defense, just as if such claim was still held by the transferor. The claim and the section 502(d) disallowance defense are linked, and such relationship is not severed by a transfer." *Id.* at 183-84.

On appeal, the United States District Court for the Southern District of New York took the opposing

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Quinn Emanuel Named a 2012 "Top Firm for Diversity" by *The American Lawyer* and *Corporate Counsel*

Quinn Emanuel was named a 2012 "Top Firm for Diversity" by *The American Lawyer* and *Corporate Counsel.* This year, the firm ranked in the top 15% on *The American Lawyer*'s Diversity Scorecard, an annual review of 233 law firms based on firms' percentage of minority attorneys and partners. Diversity Scorecard rankings were used as the basis for the firm's selection as a "Top Firm for Diversity." Quinn Emanuel has been ranked in the top tier of *The American Lawyer*'s Diversity Scorecard for several years running. Q

Quinn Emanuel Scores Unclean Hands Victory Against Rambus

Quinn Emanuel obtained a ruling holding unenforceable all twelve patents that plaintiff Rambus Inc. asserted against Micron Technology, Inc. and Micron Semiconductor Products, Inc. After a five-day bench trial regarding Micron's unclean hands defense and multiple rounds of post-trial briefing, Judge Robinson of the United States District Court for the District of Delaware found Rambus' patents unenforceable due to unclean hands based on Rambus' bad-faith spoliation. Rambus appealed and the case was remanded by the Federal Circuit in *Micron Technology, Inc. v. Rambus Inc.*, 645 F.3d 1311 (2011), a seminal decision

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position, finding instead that "[t]he plain language of section 502(d) focuses on the claimant as opposed to the claim and leads to the inexorable conclusion that the disallowance is a personal disability of a claimant not an attribute of the claim." *Enron Corp. v. Springfield Assocs., LLC* (*In re Enron Corp.*) ("*Enron II*"), 379 B.R. 425, 443 (S.D.N.Y. 2007). The District Court also drew a distinction between "sale" and "assignment" of claims, noting that "[a]n assignment is a contractual transfer of a right, interest, or claim from one person to another. The word 'assignment' is not synonymous with 'sale,' although each is a type of transfer …. " *Id.* at 435-36. From there, the District Court deduced that

> [T]he outcome of this case depends on whether the principle that an assignee has no greater rights than its assignor applies to equitable subordination and disallowance. That issue raises a threshold question of law[:]… are equitable subordination [and disallowance] … attributes of a claim or are they personal disabilities of particular claimants. If they are attributes of the claim, they will travel with the claim regardless of the method of transfer, whereas if they are personal disabilities, their application to transferees depends on whether the transfer was by way of a sale or assignment . . . . [E]quitable subordination and disallowance are both personal disabilities that do not inhere in the claim. Thus, unless there was a pure assignment (or other basis for the transferee to step in the shoes of the transferor), as opposed to a sale of the claim, the claim in the hands of the transferee is not subject to equitable subordination or disallowance based solely on the conduct of the transferor."

Id. at 439. *See also id.* at 436-37 (suggesting "holder in due course" status may provide assignee with defense).

In *In re KB Toys, Inc.,* 470 B.R. 331 (Bankr. D. Del. 2012), the United States Bankruptcy Court for the District of Delaware considered whether a claim would still be subject to disallowance upon its purchase by a third party which does not have an obligation to return a voidable transfer. The *KB Toys* court ultimately sided with the New York Bankruptcy Court's decision in *Enron I* (*i.e.,* not the decision of the United States District Court for the Southern District of New York in *Enron II)*, concluding that the bar imposed by section 502(d) follows a claim to its new owner. *Id.* at 343.

KB Toys and its affiliates filed Chapter 11 petitions in 2004 and liquidated substantially all of their assets under court supervision. The plan established a litigation trust to, among other things, prosecute avoidance actions on behalf of the estate. The trust commenced preference lawsuits against a host of targets, including parties set forth in the debtor's Statement of Financial Affairs (the "SOFA") as having received payments during the 90-day preference window that preceded the bankruptcy filing. However, at least nine defendants, which were trade creditors of the debtor, had sold their claims to an investor (the "Investor") and defaulted on the trust's preference actions. Invoking section 502(d), the trust eventually sought to disallow each of the Investor's claims where the trust had a corresponding judgment against the original trade creditor. *Id.* at 332-34.

The Investor argued that the plain language of section 502(d) linked disallowance to the **claimant**, such that only claims that are still in the hands of the entity that received, but did not return, a voidable transfer at the time of distribution by the estate, would be subject to the section 502(d) bar. In response, the trust contended that the statute disallowed **any claim** originally held by the voidable transfer recipient, even if that claim had been transferred to an "innocent" third party. *Id.* at 335.

The *KB Toys* court did not dwell on the plain meaning of section 502(d). It instead focused on section 57(g) of the Bankruptcy Act of 1898, the predecessor to section 502(d). In the view of the *KB Toys* court, section 57(g) clearly stated that disallowance followed claims by identifying "the claims of creditors" which had made voidable transfers and mandating disallowance unless the creditors returned the voidable transfers. *Id.* at 335-36. The *KB Toys* court also examined case-law that interpreted section 57(g). Those cases generally held that assignees and sureties could collect payment only if the original claimant could as well. *Id.* at 336-37.

The *KB Toys* court analyzed section 502(d) from the vantage point of the estate as opposed to that of the affected creditor. The court read the statute as giving the estate an affirmative defense to an otherwise valid claim, and held this defense cannot be rendered moot by a transfer of the claim from one creditor to another. *Id.* at 338. The transferring of a claim merely substitutes one party for another and does not confer any right upon the transferee that was not originally available to the transferor. *Id.* at 339. According to the *KB Toys* court, the long-standing Congressional policy goal of preventing the recipient of a voidable transfer from collecting a distribution unless the recipient returns the voidable transfer, as articulated in both section 57(g) and section 502(d), would be seriously undermined if such creditor could circumvent the statutory restriction by simply selling a tainted claim, and thereby cleanse it. *Id.* In a footnote, the *KB Toys* court arguably limited the scope of its decision by observing that it was making "no determination about whether the same result should ensue in circumstances involving other types of transferred claims [other than trade claims]. It seems the

drafters of the Bankruptcy Code also recognized when public markets might be effected." *Id.* at 342 n.14.

As part of its legal analysis, the *KB Toys* court declined to adopt the sale vs. assignment distinction espoused by the *Enron II* court. According to the *KB Toys* court, as had been recognized by numerous commentators, these two terms are not easily distinguishable and are not defined in the Bankruptcy Code. *Id.* at 340-41. The *KB Toys* court also dismissed the argument that its ruling could unleash chaos in the distressed debt markets, describing that possibility as a "hobgoblin without a house to haunt" because buyers of claims are highly sophisticated entities capable of performing due diligence and are presumed to appreciate the risk that a purchased claim may be disallowed in whole or in part by a bankruptcy court. *Id.* at 341-42.

The *KB Toys* court further observed that the SOFA put the Investor on notice of the potential disallowance of the claims it bought. *Id.* at 342. In addition, the presence of indemnity provisions in four of the nine sales contracts in the event the claims acquired were disallowed demonstrated that the Investor understood the risk of disallowance and knew how to bargain with the sellers of claims for contractual protection against prospective disallowance. *Id.* The court would not force the estate to be the Investor's insurer where the Investor elected not to obtain indemnification from a seller. Finally, the *KB Toys* court rejected the Investor's argument that their purchases were made in "good faith," finding that the "good faith" defense was not applicable where the purchaser knew that the claims being purchased could be disallowed as part of the bankruptcy process. *Id.* at 343.

The Second Circuit declined in *Longacre Master Fund Ltd. v. ATS Automation Tooling Systems, Inc.*, No. 11–3413–cv, 2012 WL 4040176 (2d Cir. September 14, 2012), an opportunity to definitely determine whether the bar to payment set forth in section 502(d) travels to a new owner of the claim. In its decision, the court sustained broad contractual remedies granted to a purchaser/assignee (the "Purchaser") against the seller/assignor (the "Seller") in a claim transfer agreement (the "Agreement"). *Id.* at *2-*3.

Under the Agreement, the Seller agreed to transfer to the Purchaser claims against Delphi Automotive Services, LLC ("Delphi"), a Chapter 11 debtor (the "Claim"). The Agreement required the Seller to repurchase the Claim with interest if (1) "all or any part of the Claim is . . .objected to, disallowed, . . . in whole or in part, in the Case for any reason whatsoever," or (2) the Purchaser received notice of a possible impairment against the Claim, and such possible impairment was not fully resolved within 180 days. The Agreement also contained a representation (the "Representation") that "to the best of [the Seller]'s knowledge, the Claim is not subject to any defense, claim or right of setoff, reduction, impairment, avoidance, disallowance, subordination or preference action. . . ." *Id.* at *2.

Delphi sued the Seller following the execution of the Agreement, alleging that the Seller had received approximately $17.3 million in preferential transfers from Delphi within the 90 days before bankruptcy and that such amounts were avoidable under the Bankruptcy Code. Invoking section 502(d) of the Bankruptcy Code, Delphi also filed an objection to the Claim. Delphi and the Seller eventually reached a global settlement and the objection to the Claim was withdrawn. *Id.* at *1. However, the withdrawal occurred more than 180 days after the filing of the objection. *Id.* at *2.

The Purchaser commenced an action seeking a determination that the Seller was obligated to pay it over $800,000 in interest because (i) Delphi's objection was an impairment of the Claim under the Agreement and (ii) the Seller breached the Representation. *Id.* The United States District Court for the Southern District of New York ruled against the Purchaser, holding that Delphi's objection to the Claim did not constitute under the Agreement an impairment. In the District Court's view, the objection to the Claim merely "preserved the Debtor's right to object " and did not constitute a formal objection under section 502(d). *Longacre Master Fund, Ltd. v. ATS Automation Tooling Sys. Inc.*, 456 B.R. 633, 640 (S.D.N.Y. 2011). After the withdrawal of the objection, "no vehicle exist[ed] through which such an objection could be raised, filed, or formally commenced in the future." *Id.*

The District Court further observed that the language of the Agreement evidenced a sale, not an assignment, of the Claim. Relying upon the distinction drawn between sales and assignments by the *Enron II* court, the District Court observed that "no section 502(d) objection (even if one were to have been made) would have constituted an Impairment in the first instance." *Id.*

On appeal, the Second Circuit vacated the District Court's decision. It determined that the objection filed by Delphi against the Claim constituted an Impairment and a Possible Impairment as those terms were defined under the Agreement because:

> Delphi stated that it was "objecting to" the claim, and the Bankruptcy Court issued an order stating that the "Objection" was preserved. These steps are all that the purchase agreement requires in order to trigger [the Seller]'s obligations under Paragraphs 7 and 16. These paragraphs do not exclude objections intended to be withdrawn after the resolution

> of some other pending issue. Thus, even if the objection was in effect only a reservation of rights rather than an objection they intended to pursue immediately, it still constituted an objection under the purchase agreement. And the parties had good reason to draft the contract in this way, because the pendency of the objection limited [the Purchaser]'s ability to transfer or obtain payment on the claim.

2012 WL 4040176 at *2.

The Second Circuit also addressed the sale vs. assignment distinction in the context of the alleged breach of the Representation. The District Court had dismissed that claim based on the Purchaser's concession that the transaction was a sale, which would have, in the District Court's view and consistent with *Enron II*, "negat[ed] the possibility that the claim could be impaired by a preference action." *Id.* at *3. But the Second Circuit observed that the Seller "had no reason at the time of the transfer to anticipate [the Purchaser]'s litigating position that the transfer was a 'sale' rather than an 'assignment.'" *Id.* Moreover, the Agreement repeatedly referenced the transaction as an "assignment." *Id.* The Second Circuit ruled that because "language in the agreement strongly suggests that it was an assignment, we conclude that [the Purchaser] has shown a material issue of fact as to [the Seller]'s knowledge of a possible preference action and related objection." *Id.*

The Acquisition of Claims Does Not Ensure the Unfettered Right to Vote Them

Holders of claims or interests that are impaired by a plan (and that are slated to receive a distribution) are eligible to cast a vote on that plan. This is one of the most important statutory rights a creditor has in a Chapter 11 case. However, section 1126(e) of the Bankruptcy Code empowers a court to designate, *i.e.,* disregard, the votes of "any entity whose acceptance of rejection of such plan was not in good faith." The Bankruptcy Code provides no guidance as to how good faith should be defined, but the purpose of section 1126(e) is to deter a creditor from extracting an undue or inequitable advantage for itself in the Chapter 11 process.

In *In re DBSD North America, Inc.,* 634 F.3d 79 (2d Cir. 2011), the Second Circuit affirmed the decision of the bankruptcy court to designate the votes of DISH Network Corporation ("DISH"). DISH was an indirect competitor of the debtor and a part-owner of a direct competitor of the debtor. DISH was not a pre-existing creditor of the debtor. The bad faith finding appeared to stem from the purchase by DISH of an **entire class** of claims **at par** after the debtor had proposed their plan and while solicitation for the plan's acceptance was ongoing. *Id.* at 87. DISH had a keen interest in acquiring DBSD's spectrum rights. *Id.* The court found that the purpose of the purchase of the claims was not to obtain maximum recovery on the debt, but to "obtain a blocking position" to defeat the debtor's plan and to propose its own competing plan. *Id.* at 104. DISH ultimately voted against confirmation and DBSD moved to designate DISH's votes under the theory that DISH did not vote in good faith. *Id.* at 87. In its opinion, the Second Circuit held that votes are subject to designation if creditors attempt to receive "more than the ratable equivalent of their proportionate part of the bankruptcy assets," or act with an "ulterior motive," that is, with "an interest other than interest as a creditor." *Id.* at 102.

The Second Circuit zeroed in on DISH's motives. DISH was a competitor of the debtor and decided to purchase a blocking position in a class of claims after a plan had been proposed with the intention of "us[ing] [its] status as a creditor to provide advantages over proposing a plan as an outsider, or making a traditional bid for the company or its assets." *Id.* at 104. "In effect, DISH purchased the claims as votes it could use as levers to bend the bankruptcy process toward its own strategic objective of acquiring DBSD's spectrum rights, not towards protecting its claim." *Id.*

The Second Circuit emphasized that its decision imposed "no categorical prohibition on purchasing claims with acquisitive or other strategic intentions." *Id.* at 105. Moreover, the court also noted that it was not addressing the situation where a preexisting creditor voted with strategic intentions. The court specifically noted two situations in which designation would generally be inappropriate. First, trade creditors could vote in such a way that would allow them to continue doing business with the reorganized debtor. *Id.* at 102. Second, a fully secured creditor could vote to seek liquidation to allow its funds to be invested more favorably elsewhere. *Id.*

Three post-DBSD decisions vividly illustrate that the concept of bad faith for purposes of section 1126(e) is a dynamic one that requires an examination of the totality of the circumstances, and not just a single set of factors.

In *In re Circus & Eldorado Joint Venture*, No. 12-51156, (Bankr. D. Nev. Sept. 20, 2012), the United States Bankruptcy Court for the District of Nevada designated the plan votes of a noteholder after finding that the noteholder acted in bad faith when it lobbied other creditors to vote against the debtor's plan by filing a motion to terminate exclusivity. That motion critiqued the purported defects of the debtor's plan of

reorganization and described in detail the noteholder's alternative plan structure. The court was troubled by the failure of the noteholder to (i) obtain court approval to disseminate information pertaining to its prospective competing plan during the debtor's exclusive solicitation period and (ii) notice its own motion for hearing. Accordingly, the court concluded that the noteholder's true intention in filing the exclusivity termination motion was to acquire operating ownership of the debtor. That conduct fell squarely within the range of "bad faith" conduct that required designation of the noteholder's plan votes.

In *In re Windmill Durango Office LLC*, 473 B.R. 762, 767 (9th Cir. B.A.P. 2012), Beal Bank was the only secured creditor of the debtor. The debtor solicited votes on a "cramdown" plan that provided for the repayment of Beal Bank's claim over time. It was evident that Beal Bank would vote to reject the plan, while the only two remaining holders of unsecured claims had voted to accept the plan. The plan would be confirmable with the support of these creditors. Attempting to preclude confirmation, Beal Bank bought one of the two unsecured claims for about 82 percent of its face value, or $1,250. Beal Bank then sought, pursuant to Bankruptcy Rule 3018(a), to withdraw the vote that had been cast on account of the unsecured creditor's claim and submit a substitute ballot rejecting the plan. If the motion was successful, the debtor's plan would not have been confirmable. *Id.* at 769-770. The bankruptcy court denied the bank's motion to change the vote. The bankruptcy court held that a new creditor could only change its vote upon a showing of "cause" and it was not appropriate for creditors "to wait 'til the plans [were] balloted and then decide what claims [they were] going to buy" and that Beal Bank's attempt to change its vote so as to block confirmation was improperly motivated and "did the [bankruptcy] process violence." *Id.* at 770.

On appeal, the Bankruptcy Appellate Panel affirmed the bankruptcy court's denial of Beal Bank's motion. The appellate panel specifically noted its decision was a "close" one and limited its ruling to the issue of whether the bankruptcy court had "abuse[d] its discretion." *Id.* at 777.

At least one case expressly refused to designate the votes of a competitor of the debtor pursuant to section 1126(e). In *In re Trikeenan Tileworks, Inc.*, 2011 WL 2898955 at *3, *7 (Bankr. D.N.H. July 14, 2011), the debtor's competitor purchased a claim. By virtue of that purchase, the competitor obtained standing and proposed a plan that would (i) restructure the debtor's secured debt, (ii) provide a meaningful recovery to unsecured creditors, and (iii) invest additional capital into the reorganized debtor. The court found that the competitor "intend[ed] to maintain the [debtor] as viable entities that w[ould] create a going concern value for creditors." *Id.* at *7. The court noted the amount of the purchased debt was small and the competitor's alternative plan enjoyed significant creditor support. *Id.* In declining to designate the votes of the competitor, the court explained that:

> Being a competitor who proposes a competing plan to take over the debtor does not equal bad faith per se. To the contrary, the Supreme Court has noted that lifting exclusivity to propose a competing plan opens the door for other parties to bid for the equity of the company . . . . There is no requirement that a competing plan must be friendly to the existing management or ownership of a debtor.

Id. (citing *Bank of America v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457-58 (1999)).

Conclusion

"Claims trading markets are as old as our nation." *KB Toys*, 470 B.R. at 341. The importance of these markets to the Chapter 11 process has grown by leaps and bounds in recent years. However, as discussed herein, market participants need to be mindful of the potential legal risk. Whether the bar to payment set forth in section 502(d) travels with a new owner of the claim is an unsettled question of law. As a result, it behooves potential buyers of bankruptcy claims to conduct due diligence by at least reviewing the SOFA filed by a debtor and to, whenever possible, obtain indemnification protection from the seller. In a development that could strengthen the hand of buyers of bankruptcy claims, the *Longacre Master Fund* court broadly read a contractual indemnification clause to require the seller to take back the claim upon an objection to the claim by the estate. And given that court's oblique reliance on the sale vs. assignment distinction in which a defense to payment of a claim in bankruptcy travels with the claim to an assignee, but not to a purchaser, a claim buyer should, at least for a bankruptcy case in New York, document a transfer agreement as a purchase agreement, rather than as an assignment.

It is also clear that while good faith under section 1126(e) is not synonymous with selfless disinterest, *see, e.g., In re Figter Ltd.,* 118 F.3d 635, 639 (9th Cir. 1997), buyers of claims who are competitors of the debtor are vulnerable to losing their voting right, especially if they are not pre-petition creditors and their goal in purchasing claims is to carry out a hostile takeover of a debtor or to use the assets of the debtor for their own benefit. Q

Entertainment Litigation Update

Second Circuit Steers Away from Strict Copyright Protection in the Photography Arena. According to well-known photographer Janine Gordon, rival photographer Ryan McGinley copied more than 150 of Ms. Gordon's contemporary images in a series of advertising campaigns in violation of copyright law. The U.S. District Court for the Southern District of New York disagreed. *See Gordon v. McGinley, et al.*, 2012 U.S. App. LEXIS 23273, *2-4 (2d Cir. Nov. 13, 2012). Ms. Gordon has established herself as a major photographer in the art world, with exhibitions at prominent venues, including the Whitney and Hammer museums. Mr. McGinley also has received critical and commercial acclaim in recent years, particularly with respect to a series of advertising campaigns for fellow defendant Levi Strauss. According to Ms. Gordon, the images used in Mr. McGinley's Levi Strauss campaigns, and exhibited at various defendant galleries, were substantially similar to her copyrighted photographs. Ms. Gordon pointed to examples such as an arm gesture at a right angle in one photograph, and a naked, tattooed body laying at a similar angle in another. Mr. McGinley countered by stressing the differences between his and Gordon's photographs—such as the use of different colors, clothing and physical appearances. The District Court agreed with Mr. McGinley, finding that there was no substantial similarity as a matter of law because the differences in the works outweighed the similarities. Accordingly, it granted Mr. McGinley's motion to dismiss. The Second Circuit concurred, holding after a *de novo* review that the District Court's dismissal of Ms. Gordon's federal copyright claims was proper.

The *Gordon* ruling has special resonance within the arts community, where artists must calibrate new works based on the degree to which those works can contain or reflect content from other artists' works. The Second Circuit has now indicated a willingness not only to protect visual artists from copyright claims regarding tangentially similar works, but also to dispose of such claims at an early stage in the litigation process.

Trial Practice Update

Court Rules Jury Voir Dire Must Be Public. The Second Circuit recently reversed a criminal conviction because the public had been excluded from the courtroom during jury selection. In the case of *United States v. Gupta*, the courtroom deputy had asked the defendant's brother and girlfriend to leave the courtroom because there were insufficient seats for them in the gallery along with the jury venire of 70 people. The deputy informed the two that they would be welcome back in the courtroom after jury selection was complete. The defense did not lodge an objection. Voir dire was uneventful, and the defendant's brother and girlfriend watched the balance of the trial. Mr. Gupta was convicted of immigration fraud and sentenced to more than four years in prison.

After the trial, Mr. Gupta objected to the exclusion of his brother and girlfriend. The Court of Appeals, following the Supreme Court decisions in *Waller v. Georgia*, 467 U.S. 39 (1984) and *Pressley v. Georgia*, 558 U.S. 209 (2010) held that a courtroom cannot be closed simply to accommodate a large panel of prospective jurors, nor can a courtroom be closed to protect the panel from contact with the public. The court also rejected the Government's argument that the closure was trivial because voir dire was not contentious. The court wrote that "it is the openness of the proceeding itself, regardless of what actually transpires," that imparts public confidence in our system of justice.

The Court of Appeals also rejected the Government's argument that Mr. Gupta forfeited his challenge to the courtroom closure by not raising it contemporaneously with the exclusion of his brother and girlfriend. The court rejected this argument for two reasons: first, the evidence was not clear that Mr. Gupta had been aware of the exclusion at the time. Second, the record was clear that Mr. Gupta's trial counsel was unaware of the exclusion of the brother and girlfriend. The court refused to find waiver if counsel was ignorant of the basis for the need to object. The Second Circuit therefore vacated Mr. Gupta's conviction and sentence. Regardless of courtroom space, criminal trials in the federal courts must remain open to the public.

Deprivation of Rebuttal Summation Leads to Reversal. In *Wagner v. County of Maricopa*, decided late last year, the Ninth Circuit reversed a civil case after trial because the judge refused to allow the plaintiff to do a rebuttal summation. The plaintiff in *Wagner* sued the county after an inmate died in custody. The case proceeded to trial in the District of Arizona. After the plaintiff delivered its principal summation, which lasted an hour, the trial court informed the plaintiff that there would be no rebuttal summation despite the practice in the District of Arizona for the plaintiff to speak last. The county delivered its summation and then the jury returned a defense verdict. The Ninth Circuit held that while a court may manage

a trial in its discretion, the trial court cannot deprive a plaintiff of a rebuttal summation without notice. One dissenting judge noted that a party is only entitled to principal closing argument, and no rule requires that a plaintiff be given the opportunity for a rebuttal summation. But that view did not carry the day, and the rest of the Ninth Circuit rejected the county's motion for rehearing *en banc*. So the rule in the federal courts of the Ninth Circuit is that a plaintiff cannot be deprived of a rebuttal summation without notice.

Japan Litigation Update

Japanese Court's Ruling Limits Scope of Contributory Infringement in Pharmaceutical Patents. The Osaka District Court recently addressed the application of the Japanese counterpart to "contributory infringement" in the pharmaceutical context. Specifically, in *Takeda Pharmaceutical Company Limited v. Sawai Pharmaceutical Co., Ltd., et al*, the court assessed whether infringement of a pharmaceutical patent could be found where the alleged infringer sells only a non-patented medicine that can then be combined with another product to infringe the patent.

Takeda, which produces a product named ACTOS that treats Type 2 Diabetes, owns patents covering a product that combines the ACTOS treatment with other medicine(s). The defendant companies manufacture and sell generic products akin to ACTOS that may be used with other oral anti-diabetic products. Takeda sought a provisional injunction and damages against the defendants under Article 101, Item 2 of the Patent Act. Analogous to contributory infringement in the United States under 35 USC § 271(c), Article 101 covers infringement where the accused infringer makes a product that is knowingly used with another component or product that together fall within the scope of the patent claims, and where the accused infringer's contribution is indispensable to the resolution of the problem of the invention.

The Osaka District Court rejected the contributory infringement theories on numerous grounds. The court first held that the defendants' generic products are independent medical products themselves and are not intended to be used with other products or medicines, even if they ultimately are used as such. The court specifically rejected Takeda's argument that the doctor's prescriptions, which prescribed that the generic be used with other medicines, constituted producing a product to be used with another. The court further found that giving a patient those medicines together, such as when they are given in the same bag under a common prescription, cannot constitute production of an infringing product. The court similarly found that a patient's active ingestion of the defendants' medicines with other medicines did not constitute production of an infringing product. Accordingly, the court held that the generic medicines could not be liable for infringement pursuant to Article 101, item 2 even when their medication was combined with other medication so as to fall within the scope of the claims.

Takeda appealed the decision by the Osaka District Court to the Intellectual Property High Court.

Criminalization of Illegal Music and Video Downloads. The Revised Japanese Copyright Act that criminalizes illegal downloads of music and video files came into effect on October 1, 2012. The revised act now imposes penalties of up to two years in prison and fines of up to two million yen (around $25,000) on those who illegally download infringing files. To institute criminal prosecution, the copyright title holder must file a complaint.

Before the amendment, although prohibited, downloading files that infringed copyrights was not criminalized—only uploading infringing files was considered a crime. As a result, before the amendment, the only recourse for a copyright title holder against an infringing downloader was a civil suit seeking damages. Time will tell how this criminal penalty will be enforced in practice.

Libor Litigation Update

UBS and Barclays Acknowledge Making False Libor Submissions. Investigations into misconduct at UBS and Barclays have revealed pervasive corruption of the London Interbank Offered Rate ("Libor"), which provides a benchmark for more than $350 trillion in financial instruments. The British Bankers' Association ("BBA") calculates Libor in several currencies and maturities based on banks' reported borrowing costs in the London interbank lending market. This reliance on self-reporting makes Libor vulnerable to manipulation if banks misreport their true cost of borrowing. With numerous government probes ongoing, regulators are expected to ensnare more global banks and uncover new evidence of Libor manipulation that will influence already-filed and potential litigation.

UBS became the second bank to admit to Libor-related wrongdoing late last year, when it agreed to pay $1.5 billion to resolve investigations by U.S., British, and Swiss authorities. The UBS settlement—

following the $453 million fine imposed on Barclays in June—includes a rare admission of criminal wrongdoing by UBS's Japanese subsidiary. The Justice Department is also pursuing wire fraud charges and antitrust violations against two Tokyo-based UBS traders accused of conspiring to manipulate Yen Libor.

Regulators have identified three main categories of Libor-related wrongdoing at UBS and Barclays.

First, both banks systematically suppressed their Libor submissions in an effort to protect their reputations during the global financial crisis. Managers at UBS and Barclays directed their respective submissions desks to adjust their USD Libor and other submissions downward to avoid being perceived as a high outlier relative to other panel banks.

Second, traders manipulated their own banks' rate submissions in order to benefit their trading positions. In Barclays' case, traders in New York, London, and Europe sought to influence the bank's USD Libor and Euro Interbank Offered Rate ("Euribor") submissions. The allegations against UBS focus on traders in Tokyo, London, and Zurich, and relate primarily to the bank's Yen Libor, Sterling Libor, and Swiss Franc Libor submissions.

Third, some of this trader-driven misconduct involved coordination with other banks. The most damaging revelations concern UBS's Japanese subsidiary, where traders colluded with interdealer brokers and other panel banks to manipulate Yen Libor. This scheme reportedly involved traders at Citigroup, Deutsche Bank, HSBC, JPMorgan, and other institutions. The Barclays probe also found that traders colluded with peers at other banks to manipulate USD Libor and Euribor submissions.

More revelations are certainly forthcoming. Royal Bank of Scotland ("RBS") is widely expected to be the next panel bank to reach a settlement with authorities, who have reportedly unearthed evidence of improper USD and Yen Libor submissions. Many other banks are under investigation or are facing litigation, including JPMorgan, Bank of America, and Citibank. These probes will likely lead to further acknowledgements of misconduct.

Quantifying Crisis-Era Libor Suppression. UBS and Barclays have both admitted to systematically understating their Libor submissions beginning in 2007, and it is now clear that Libor was abnormally low during the same period. By late 2007, emerging discrepancies between Libor and comparable interest rates attracted the attention of officials at the Federal Reserve Bank of New York. Concerns about the reliability of Libor spilled into public view in April 2008, when the *Wall Street Journal* published articles questioning whether banks' submissions accurately reflected their borrowing costs. A Citigroup analyst estimated at the time that Libor "may understate actual interbank lending costs by 20-30 bps." In addition, submissions by Citigroup, Bank of America, and JPMorgan Chase often clustered, suspiciously, around the lowest rate that could be submitted without being discarded as an outlier.

A growing body of statistical research has attempted to quantify the degree of Libor distortion during the crisis period. According to one study comparing Libor submissions with comparable funding transactions, Libor understated banks' borrowing costs by 10 basis points between August 2007 and March 2008, and by up to 30 basis points for the remainder of the year. The Federal Housing Finance Agency and other investors have estimated much larger spreads, finding that Libor diverged from comparable Federal Reserve Eurodollar Deposit rates by as much as 300 basis points at the peak of the financial crisis. This misreporting could have damaged large investors by substantially reducing the interest paid on Libor-indexed financial products.

The Existing Litigation Does Not Cover Potential Investments and Causes of Action. Investors have filed numerous actions based on rate-setting misconduct at panel banks, including an individual investor claim by Charles Schwab and a number of class actions. All of the current Libor cases are part of the multi-district litigation before Judge Naomi Buchwald in the Southern District of New York: *In re: Libor-Based Financial Instruments Antitrust Litigation*, No. 1:11-md-02262-NRB. The class cases have been consolidated into two main actions, the "direct purchaser" case and the "over-the-counter" action. Judge Buchwald recently imposed a stay on any action that is not the subject of pending motions to dismiss filed in June 2012.

The current class complaints assert antitrust violations, unjust enrichment claims, and violations of the Commodity Exchange Act on behalf of investors who purchased or held Libor-linked assets. Members of these classes may receive the benefit of *American Pipe* tolling, but the existing actions only cover a small subset of potential investments and causes of action. For example, the main class actions do not assert securities fraud, RICO, or common-law fraud claims, which may prove to be the most viable causes of action. The statutes of limitations on these claims are generally not tolled by the class actions and they continue to run. For claims brought under the

Securities Exchange Act of 1934, which are governed by a five-year statute of repose, this means that claims relating to investments made in late 2007 are already barred, with more claims being barred daily.

The primary hurdle facing antitrust claims is pleading an agreement among the panel banks. Government investigations have unearthed evidence of collusion among individual traders seeking favorable rate submissions, and the consistency of the banks' Libor submissions (especially their departure from historical norms) suggests that the banks may have been acting in concert. But neither the Barclays nor the UBS settlement has produced any direct evidence of a high-level agreement between the banks systematically to suppress Libor. Thus, while the current facts may be sufficient to overcome a motion to dismiss under the *Twombly* plausibility standard, the antitrust claims may face tougher scrutiny at the summary judgment stage.

For this reason and others, investors considering opt-out suits should not limit themselves to antitrust claims, but rather should consider claims that do not require proof of collusion among the panel banks. For example, RICO claims do not require an industry-wide conspiracy, and carry potential treble damages. Claims brought under the 1934 Act likewise do not require a conspiracy, although such claims are only available for investors who purchased Libor-linked "securities" (not loans, swaps, or other non-security instruments).

Notably, RICO and 1934 Act claims are likely mutually exclusive because securities fraud cannot be a predicate act for a federal RICO claim. Whether to allege securities fraud or RICO will depend largely on the makeup of the particular investor's portfolio. Investors asserting fraud-based claims will have strong arguments that the Libor panel banks committed fraud when they offered instruments whose returns were benchmarked to Libor, without disclosing that Libor was being manipulated.

Common-law fraud claims have a number of advantages that will make them particularly attractive to opt-out claimants. For instance, common-law fraud: (1) does not require a conspiracy among the panel banks; (2) can be brought with respect to all types of Libor-based financial instruments; (3) should not be subject to the heightened standards of the PSLRA; and (4) depending on the jurisdiction, may have longer statute of limitations than other claims.

The Libor scandal is almost certain to grow. Due to the potential size of the banks' fraud, and the fast-approaching expiration of the statute of limitations for certain causes of action not included as part of the class actions, investors should perform a detailed analysis of their portfolios as soon as possible. Only those investors who have analyzed their portfolios in advance will be well positioned to respond to any changes in this fast-unfolding scandal. Q

Stephen Neuwirth and Susheel Kirpalani Selected as *Law360* "MVPs" for 2012

Quinn Emanuel partners Stephen Neuwirth and Susheel Kirpalani were named legal "MVPs" of 2012 by *Law360* in the areas of competition and bankruptcy, respectively. *Law360* recognized attorneys whose legal successes "set a new standard for accomplishment." Mr. Neuwirth, one of only eight antitrust MVPs nationwide, and Mr. Kirpalani, one of only five bankruptcy MVPs nationwide, were selected from a pool of nearly 500 nominees.

Stephen Neuwirth, Chair of the firm's Antitrust and Competition Law practice, was recognized for his successes on the "front line of high-stakes antitrust litigation" representing an "impressive roster of clients." *Law360* commended Mr. Neuwirth not only for his class action successes against "corporate giants," but also for his work defending major corporations against antitrust suits. *Law360* noted, among other things, Mr. Neuwirth's role in securing certification of a nationwide class of rail freight shippers in *In re Rail Freight Fuel Surcharge Antitrust Litigation*; his representation of The Home Depot as an objector to the settlement of class action antitrust claims concerning interchange fees charged to merchants by Visa and MasterCard; and his success in achieving voluntary dismissal of all claims against client Rabobank in the antitrust class action litigation concerning bid rigging in the market for municipal derivatives.

Susheel Kirpalani, Chair of the firm's Bankruptcy and Restructuring Group, was praised for his "remarkable" role as examiner in Dynegy's controversial Chapter 11, in which he exemplified "thorough examination and deft mediation." Overall, *Law360* lauded Mr. Kirpalani for his "impressive case file of large bankruptcy cases" in 2012 and named him one of the "bankruptcy world's most formidable players." Q

VICTORIES

$18 Million Mid-Trial Settlement Victory Against Real Estate Developer

The firm recently secured a mid-trial $18 million settlement for two brothers, Neil and Ian Reinhard, against their father and partner, successful San Jose, California real estate developer Eli Reinhard. Eli built a multimillion dollar real estate empire using what he and his accountant called "The System." The System consisted of myriad interlocking real estate companies and partnerships, largely controlled by Eli. Over the years, Eli made his sons limited partners and members in the various entities, and on paper, those holdings had appreciated tremendously.

But there was a problem. Money in the system was "circular money." Instead of distributions going to Neil and Ian directly, money would be re-circulated into The System for other projects. The brothers sued in 2009, claiming that Eli converted their distributions. They also brought claims for breach of fiduciary duty based on Eli's use of partnership assets as collateral to fund personal investments. During two weeks of hearings in San Jose Superior Court, Quinn Emanuel defeated all of the defendants' major pretrial motions. After a week in front of the jury and with Eli on tap to be cross examined next, the case settled for $18 million.

Victory in Ground-Breaking Mammoth Lakes Chapter 9 Case

On behalf of Mammoth Lakes Land Acquisition ("MLLA"), the firm recently obtained the dismissal of the *In re Town of Mammoth Lakes, California* Chapter 9 case commenced by the Town of Mammoth Lakes ("Mammoth Lakes") in the United States Bankruptcy Court for the Eastern District of California. The dismissal, as a condition to a successful mediation between Mammoth Lakes and MLLA commenced at MLLA's suggestion, results in a 90% recovery for the firm's client.

The Mammoth Lakes Chapter 9 bankruptcy case is one of three closely watched California municipal bankruptcies implicating a California statute enacted in late 2011; while the Mammoth Lakes case has been dismissed at MLLA's urging, the *City of Stockton* and *City of San Bernardino* remain in protracted litigation.

In 2008, the firm obtained a $30 million verdict on behalf of MLLA against Mammoth Lakes, the location of a world renowned ski resort. By 2012, following appeals, the amount Mammoth Lakes owed was $43 million. However, under California law, Mammoth Lakes had the option to pay the judgment over 10 years, with minimal interest, such that the present value of the judgment was approximately $33 million.

Chapter 9 is the chapter of the United States Bankruptcy Code applicable to municipalities. In order to be eligible under Chapter 9, a municipality must show state law permits it to seek bankruptcy, that it is insolvent, and that the municipality tried to negotiate in good faith before filing for bankruptcy. In 2011, California enacted AB 506, a law intended to make it more difficult for California municipalities to seek bankruptcy protection by requiring municipalities to either mediate with their creditors or declare fiscal emergencies. Mammoth Lakes invoked the mediation option and invited MLLA, along with dozens of other creditors, to participate. MLLA was concerned that Mammoth Lakes was using the mediation process, as required by California, as a pretext to satisfy the "good faith negotiation" requirement. MLLA declined to participate in the mediation, and, through Quinn Emanuel, invited the town to participate in direct negotiations. Mammoth Lakes refused; in July 2012, Mammoth Lakes filed its Chapter 9, presenting expert testimony that the most the Town could ever pay MLLA was $500,000 for 10 years, interest-free. Mammoth Lakes also requested an expedited schedule on determining its eligibility as a debtor under Chapter 9.

The firm was able to convince the bankruptcy court to delay the schedule and instead order Mammoth Lakes to participate in a mediation, supervised by Bankruptcy Judge Elizabeth Perris, directly with MLLA. Within weeks that mediation produced a settlement pursuant to which the Town is obligated to pay MLLA the present value of $29.5 million, equaling a 90% recovery. In addition, Mammoth Lakes agreed to accept the issuance of a writ of mandate as security in the event that Mammoth Lakes were default under the settlement agreement. Further, Mammoth Lakes agreed as part of the settlement to dismiss its Chapter 9 case, as opposed to seeking confirmation of a Chapter 9 plan of adjustment (with its attendant costs and risks).

The *Mammoth Lakes* case provides an important roadmap for any creditor of a California municipality in financial distress, demonstrating the importance of understanding, and planning to address, the requirements of California's AB 506 statute and Chapter 9 eligibility requirements <u>before</u> the municipality files its bankruptcy case.

Dismissal for United Guaranty Residential Insurance Company

Quinn Emanuel recently obtained a dismissal for its client United Guaranty Residential Insurance Company in a case in federal court in the Eastern District of California.

Plaintiff brought a putative class action against United Guaranty, a mortgage insurer, along with other mortgage insurers and the lender HSBC, contending that captive reinsurance—purchasing mortgage reinsurance from the same bank that issued the underlying loan—violated the anti-kickback prohibition of the Real Estate Settlement Procedures Act of 1974 ("RESPA"). While United Guaranty disputed all of Plaintiff's theories of liability, the firm brought a motion to dismiss on the basis that RESPA's one-year statute of limitations had expired, because Plaintiff's loan closed in November 2006, and the lawsuit was filed on March 12, 2012, more than five years later.

United Guaranty sought dismissal because, among other reasons, Plaintiff showed no diligence at all in the five-year period between when his loan closed and when he retained counsel. In an attempt to explain his lack of diligence, Plaintiff asserted that diligence would have been futile because defendants had fraudulently concealed his claims, and that the failure to disclose the specifics of the alleged "scheme" meant that the statute of limitations should have been tolled. Plaintiff further asserted that since his claims were not discoverable without the aid of an attorney, they had to be tolled until he retained counsel.

The Court (O'Neill, J) rejected Plaintiff's theories, noting that Plaintiff had alleged no diligence over the course of five years other than a single phone call in 2012. The Court also rejected Plaintiff's claim that the need for counsel to understand a claim necessitates tolling, because the result would be "any plaintiff who requires the assistance of counsel to discover the existence of a claim, including plaintiffs who conduct virtually no diligence, would be automatically entitled to equitable tolling of the statute of limitations for an indefinite period of time until that plaintiff retains counsel." The court also rejected Plaintiff's claim of fraudulent concealment, finding it had not been plead with particularity.

Plaintiff did not appeal the court's decision, and despite being granted leave to amend, instead voluntarily dismissed his claims. Plaintiff's counsel has asserted nearly identical claims in multiple other class actions, and this decision is significant as it is the first to fully resolve the motions to dismiss. Q

(Quinn Emanuel Scores Unclean Hands Victory Against Rambus continued from cover)

regarding spoliation of evidence. The Federal Circuit held that Judge Robinson's finding that Rambus "knew or should have known" its conduct was in bad faith was not adequate. *Id.* at 1327. Instead, the Federal Circuit held that bad faith requires a showing that Rambus intended to impair the ability of potential defendants to defend themselves. *Id.* at 1327. The Federal Circuit also remanded the question of whether Micron was prejudiced by the spoliation and pointed out that resolution of the question of prejudice hinged on whether Rambus acted in bad faith. *Id.* at 1328. And the Federal Circuit provided specific instructions about what factors needed to be considered in assessing an appropriate sanction. *Id.* at 1328-1329.

On remand, after hearing additional argument, Judge Robinson held that the only appropriate sanction was to hold the twelve asserted patents unenforceable. She held that: "Rambus' destruction of evidence was of the worst type: intentional, widespread, advantage-seeking, and concealed." She concluded that: "This bad faith underlies the entire [document destruction] policy and permeates any action taken pursuant to the policy." Judge Robinson also found that Micron was prejudiced. She held that Rambus prejudiced Micron's claims and defenses related to Rambus' conduct before the standard-setting body JEDEC, including patent misuse and violations of the antitrust and unfair competition laws. She also found prejudice to Micron's inequitable conduct defense. She held that: "The wide range and sheer amount of materials destroyed, along with Rambus' bad faith, make it almost certain that the misconduct interfered with the rightful resolution of the case." As a result, she concluded that "[a]ny lesser sanction would, in effect, reward Rambus for the gamble it took by spoliating and tempt others to do the same." Q

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