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Counsel to **Citigroup Global Markets Limited** in the Chapter 15 proceedings of **Basis Yield Alpha Fund (Master)** pending in the Bankruptcy Court for the Southern District of New York

Counsel to **The Dow Chemical Company** in the successful restructuring of its relationship in Pittsburg, California with **Calpine Corporation**.

Counsel to **UBS Securities** in connection with its equity investment and rights offering backstop commitment under **Delphi Automotive**'s proposed plan of reorganization.

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Ninth Circuit Court of Appeals Joins Sister Circuits in Adopting Standards for Injunction of Non-Debtor Proceedings

By Juliet A. Drake *Page 2*

On September 7, 2007, the United States Court of Appeals for the Ninth Circuit issued a decision setting forth the appropriate standard by which bankruptcy courts must evaluate requests for preliminary injunctions staying proceedings where the debtor is not a party.

Project 688: The Restructuring of Iraq's Saddam-Era Debt

By Hadi Nicholas Deeb *Page 3*

Among the less visible consequences of Saddam Hussein's invasion of Kuwait one summer night in 1990 was the disruption of tens of thousands of contracts between Iraqi public sector entities and foreign counterparties. No one predicted then that the ensuing staring match between Saddam and the international community would, after almost fifteen years, leave his successors saddled with the largest tangle of sovereign debt in modern history.

Delaware Supreme Court Rejects Creditor's Claim of Breach of Fiduciary Duty Against Corporation's Directors

By Lisa M. Schweitzer and Neil P. Forrest *Page 11*

In an important corporate governance decision, the Delaware Supreme Court has refused to recognize a claim by a creditor of a Delaware corporation for breach of fiduciary duty against the corporation's directors where it was alleged that the corporation was insolvent or in the "zone of insolvency." In *North American Catholic Educ. Programming Found., Inc. v. Gheewalla*, the Court not only reaffirmed the protection of the "business judgment rule" for corporate directors, but expressly limited the rights of creditors to pursue actions against a debtor corporation's directors, even where the corporation is nearing insolvency or actually insolvent.

Amendments to German Insolvency Code Facilitate Restructurings

By Werner Meier and Michael Kern *Page 14*

On July 1, 2007, the Law on the Simplification of Insolvency Proceedings (*Gesetz zur Vereinfachung des Insolvenzverfahrens*) (the "2007 Law") became effective. The 2007 Law includes, among other things, changes to the German Insolvency Code relating to the enforcement of security interests during preliminary insolvency proceedings and the sale of the debtor's business prior to the first creditors' meeting.

Good Faith Exception to Fraudulent Transfer Statute Held Not to Apply to Prime Broker With Notice of Fraud of Customer of Introducing Broker

By Jane Kim *Page 16*

The Bankruptcy Court for the Southern District of New York has held that margin payments made to a broker can subsequently be recovered from the broker as a fraudulent transfer when the broker was on inquiry notice of the debtor's improprieties when it accepted the payments.

Settlement Distributions And The Absolute Priority Rule In Light Of *In Re Iridium*

By George A. Bongartz *Page 22*

The United States Court of Appeals for the Second Circuit has ruled that, in deciding whether to approve a pre-plan settlement agreement entered into by a debtor, a bankruptcy court must consider, as the most important factor, whether payments made pursuant to the settlement comply with the Bankruptcy Code's absolute priority rule.

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Ninth Circuit Court of Appeals Joins Sister Circuits in Adopting Standards for Injunction of Non-Debtor Proceedings

By Juliet A. Drake
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On September 7, 2007, the United States Court of Appeals for the Ninth Circuit issued a decision setting forth the appropriate standard by which bankruptcy courts must evaluate requests for preliminary injunctions staying proceedings where the debtor is not a party. *In re Excel Innovations, Inc.*, 502 F.3d 1086 (9th Cir. 2007).

In *Excel*, the debtor sought declaratory and injunctive relief from the Bankruptcy Court to prevent arbitration between two non-debtors (one of which was the former CEO of the debtor) from moving forward by staying that arbitration pursuant to section 105(a) of the Bankruptcy Code.[1] The debtor argued that information subject to the attorney-client privilege could be revealed by the debtor's former CEO during the arbitration, adversely affecting the debtor.[2] The Bankruptcy Court granted a temporary restraining order and then later granted an injunction, staying the arbitration until confirmation of Excel's plan of reorganization. The Bankruptcy Appellate Court upheld this decision, which was then appealed to the Ninth Circuit.

The Ninth Circuit reversed the Bankruptcy Appellate Court, holding that the courts below had applied an incorrect legal standard and that the debtor's request for a preliminary injunction should be evaluated in the same way as every request for a preliminary injunction is evaluated in the Ninth Circuit — by balancing the likelihood of success in reorganization against the relative hardship of the parties, while also considering the public interest, if warranted.[3] In reaching this decision, the Ninth Circuit joins a majority of other circuit courts that have reached the same conclusion, leaving only the United States Court of Appeals for the Seventh Circuit holding that a debtor need not show irreparable harm when seeking to enjoin proceedings between non-debtors under section 105(a) of the Bankruptcy Code.[4] The Ninth Circuit relied on the legislative history of section 105(a) and also on the fact that because stays are generally disfavored in cases involving only non-debtors, requiring the debtor to fulfill the standard prerequisites for a preliminary injunction will "help to ensure that stays would not be granted lightly."[5]

The Ninth Circuit remanded the proceedings to the Bankruptcy Court, to allow for fact finding and for the Bankruptcy Court to apply the correct legal standard.

* * *

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1 *Excel*, 502 F.3d 1086 at 1089.

2 *Id.* at 1091.

3 *Id.* at 1089.

4 *Id.* at 1094.

5 *Id.* at 1095.

Project 688: The Restructuring of Iraq's Saddam-Era Debt[1]

By Hadi Nicholas Deeb
Mr. Deeb is an associate in the New York office.

I. *"What is at stake here is whether the Republic of Iraq will be able quickly to recover from the horrors of three wars, the corruption and brutality of the Saddam regime and the social instability that has followed the overthrow of Saddam. If Iraq* **can** *recover — quickly and convincingly — great benefits will flow to the Middle East region and to the rest of the world. But if Iraq remains paralyzed by continuing social and political instability, the cost to all of us will be unimaginably high."*[2]

A. 661 to 688

Among the less visible consequences of Saddam Hussein's invasion of Kuwait one summer night in 1990 was the disruption of tens of thousands of contracts between Iraqi public sector entities and foreign counterparties. No one predicted then that the ensuing staring match between Saddam and the international community would, after almost fifteen years, leave his successors saddled with the largest tangle of sovereign debt in modern history.

Saddam took full power in Iraq in 1979. To finance his war with Iran and the extravagance of his regime, he first squandered the $40 billion of reserves Iraq had stored during the years of high oil prices, then accumulated debt to foreign governments and companies ranging from the largest European banks and Asian construction firms to mom-and-pop trade suppliers from the Middle East and India. Foreign governments with geopolitical motivations — whether Cold War competition, antipathy towards the neighboring Islamic Republic or older interests in the region — encouraged their petrodollar-hungry nationals to lend to, build in and supply Iraq.

On August 6, 1990, four days after the invasion of Kuwait, the United Nations Security Council imposed blanket economic and financial sanctions on Iraq through Resolution 661. It prevented not only new deals with Iraq (with humanitarian exceptions), but also payments out of Iraq under existing contracts. Those sanctions were not lifted until the passage of Resolution 1483 on May 22, 2003, after the US-led coalition removed the Saddam regime.

In 1483 and subsequent resolutions, the Council also called on all Member States to assist Iraq in reducing its debt stock. Ernst & Young ("E&Y"), the accounting firm appointed by the Iraqi authorities in conjunction with the Coalition Provisional Authority as Iraq's debt reconciliation agent in the spring of 2004, undertook the arduous — and dangerous — task of collecting what Iraqi records remained after years of war and neglect. E&Y also put out a call for the submission of debt claims against Iraq and its state-controlled institutions held by foreign governments, export credit agencies and, eventually, private creditors. Other data calls were issued by the Paris Club group of official creditors and the International Monetary Fund ("IMF").

The results were formidable. The new Government faced a mountain of claims estimated at well over $140 billion.[3] The plurality, just over $50 billion, was held by 18

members of the Paris Club.[4] Another $25-30 billion lay with as many as 55 other governments, excluding the 6 members of the Gulf Cooperation Council ("GCC").[5] A further $20 billion was registered with E&Y by over 600 commercial claimants and arose out of more than 13,000 separate contracts. Project 688 did not address either war reparations claims or those amounts awarded by the United Nations Compensation Commission as damages resulting directly from the invasion of Kuwait and paid through a UN-mandated 5% debit from Iraq's oil proceeds, which together may have rivaled the debt claims in size.

A $140 billion (or greater) debt stock for a middle-income nation ravaged by three wars and mismanagement over twenty years is, in the antiseptic terminology of the field, unsustainable. A World Bank assessment in January 2004 reported that, after years of negative growth (including a 31% decline in 2003), even a projected 33% growth in 2004 would leave Iraq with a debt-to-GDP (gross domestic product) ratio of 600-900% that year.[6] By comparison, the ratios of other middle-income countries such as Argentina and Russia during recent debt crises became no worse than about 140%.[7]

In Iraq's case, new investment is essential to developing its only significant near-term source of revenue, petroleum. But governments are loath to lend money that might simply be snatched by pre-existing creditors. The private sector shares that concern and would be nervous about prospects for repayment under new contracts. Iraq, in turn, would be unable to deploy oil revenues for public investment if a huge proportion was earmarked for debt service payments. Furthermore, a massive external financial burden can be politically destabilizing when a traumatized people views creditors as rapacious devourers of its resources. The cost of continuing instability in Iraq compared to the benefit of retaining stale Saddam-era claims on the books was self-evident. With the security situation precarious, time was of the essence. A total collapse of Iraq triggered by financial shambles could have reverberated violently across the globe. That combination of facts placed Iraq in a category by itself when it came to debt relief.[8]

Most creditors could not be expected to accept this grim logic immediately. Therefore, one of the first acts of the Interim Government of Iraq following the resumption of sovereignty at the end of June 2004 was to hire legal advisors to shape the most complicated sovereign debt restructuring in history. So began Cleary Gottlieb's involvement in Project 688.

B. A Unique Challenge

Besides its extraordinary size, the unusual nature of the debt claims asserted against Iraq further complicated the task at hand. Unlike many other countries, Iraq had no traded paper but rather tens of thousands of direct loans (often syndicated), letters of credit, promissory notes, guarantees, banking arrangements, in-kind supply contracts and virtually every other type of financial arrangement imaginable, written in many languages and payable in various currencies.

The claims were also old, pre-dating sanctions. After the imposition of Resolution 661 in 1990, the only legitimate contractual payments made out of Iraq were pursuant to programs supervised by the so-called 661 Committee (including Oil-For-Food, which had a designated payment mechanism). One effect of this thirteen year *de facto* moratorium was to magnify the difference between contracts that

provided for past due interest ("PDI") and those that did not. Some creditors even had PDI claims that significantly exceeded the principal value of the underlying contracts. Another effect was to focus reconciliation efforts on matching accounting points with the Iraqi records rather than a magisterial inquiry into each claim.

In addition, by virtue of the nature of the Saddamist state, the Iraqi obligors or guarantors of its "sovereign" debt were not only ministries and state enterprises, but quasi-governmental institutions, in particular two banks, Rafidain and Rasheed, through which most external financial relations were conducted. Therefore, a wider group had to be coordinated than is normally the case in sovereign debt restructurings. The location of many of these institutions, including the Central Bank, outside the relative safety of the Baghdad Green Zone (home to the central US base in Iraq) increased the difficulty by an additional order of magnitude.

Finally, the existence of the contracts themselves threatened to become a flashpoint. Even before the war was underway, organizations such as Jubilee Iraq clamored for a revival of the imprecise and untested "doctrine of odious debts," or "debts incurred by a despotic regime that do not benefit the people bound to repay the loans."[9] To a victim of Saddam, any trade that propped him up for one minute longer could be anathema, even an instrument of direct oppression. Iraqi officials often pointed out that large domestic constituencies held this view. Other observers noted that the brewing Oil-For-Food controversy made painfully clear the Saddam regime's pervasive corruption and skill in corrupting others. On the other hand, many claimants wrote plaintive or angry letters arguing that moral principles demanded payment in full of their particular claims because they built a hospital or sold hungry Iraqis food.

Thus, the size, complexity, age and nature of the obligors and claims confronted an Iraqi Government that was under intense political and financial pressure to reach a quick resolution. Iraq took the pragmatic view that a significant write-down of claims — what eventually amounted to 90% in net present value terms — washed away a great many sins. As long as a claim met basic criteria (in particular, if it was an outstanding credit, balance or purchase price arising from a non-dinar contract entered into before the imposition of sanctions in 1990) and could be reconciled by E&Y to Iraqi records, it would be eligible for payment. However, existing Paris Club precedents for debt restructurings did not quite hit the mark in terms of the relief required or the restructuring terms. Moreover, a straightforward debt-for-debt exchange for commercial creditors was impossible (and appropriate market benchmarks for cash buyback terms were difficult to come by).

While Iraq and Cleary Gottlieb began thinking about these structural issues in the second half of 2004, they faced the threshold question of which group of creditors to address first.

II. "I do not for a moment want to suggest that debt relief is a sufficient condition for social and political stability to return to Iraq. But it is certainly a necessary condition. …If a destabilized Iraq adds, on average, only $2 to the price of a barrel of oil, then more than $1 billion is being paid every week by the oil-importing countries of the world as the price of Iraq's instability. These were the considerations that influenced Iraq's

> *compromise settlement with its Paris Club creditors last November. That settlement calls for a comparable treatment of all other creditor groups, including both non-Paris Club bilateral creditors and commercial creditors. Iraq is, on this basis, vigorously tackling the gargantuan debt stock left by the Saddam regime."*[10]

A. The Paris Club Agreed Minute

The Paris Club was a natural first stop for four related reasons. First, as noted above, the Club's members held the plurality of claims. Second, several Paris Club members had been vocal supporters of significant debt relief for Iraq. Third, the Paris Club operates by consensus. While this fact meant Iraq and its supporters had to expend much time and political capital lobbying a few countries that initially preferred a smaller debt haircut, once an accord was reached it would require unanimity to backtrack.

Finally, Paris Club accords typically include a "comparability of treatment" clause that obliges the debtor to seek terms from non-Paris Club creditors that are no less favorable to the debtor than those received from the Club. Once a deal was secured with the Paris Club, Iraq's hands were tied to a minimum level of relief.

From an initial bid-ask spread of a 50-95% haircut to the Paris Club debt stock, with the Iraqi position supported by a debt sustainability analysis produced by the IMF, Iraq and the Paris Club settled on an 80% write-off. The Agreed Minute signed on November 21, 2004 called for an immediate cancellation of 30% of debts. A further 30% would be cancelled when Iraq and the IMF signed a standby arrangement, which was accomplished in December 2005. The final 20% would be cancelled after the standby arrangements had been in place for three years. Iraq avoided means-testing, whereby debt relief would have been calibrated to some measure of economic output and even clawed back if that output crossed a certain threshold. Iraq also won six years of principal payment grace, three years of interest payment grace and a further three years of partial interest payment grace.

One additional benefit to Iraq came from reaching out to the Paris Club. One of the Club's quirks is that it assumes that the discount rate will equal interest rates over time. In reality, both borrowers and lenders feel the effect of the time value of money. In net present value terms, therefore, Iraq achieved almost a 90% haircut. In addition, the United States set a helpful alternative precedent by canceling 100% of the $4.1 billion owed to it. It was later followed by a number of non-Paris Club countries.

B. The Bilateral Creditors

The Agreed Minute with the Paris Club became the touchstone of Project 688. But it was an agreement in principle. Three major tasks confronted the team: negotiating bilateral agreements with each of the 18 members of the Paris Club to implement the Minute, negotiating comparable agreements with non-Club countries and devising a simple, efficient solution for the 600 commercial claimants.

Iraq hired financial advisors to assist in these tasks. A Lazard Frères team from Paris took on the Paris Club agreements, while the London office of Houlihan Lokey Howard & Zukin tackled the non-Paris Club group. Citigroup and JPMorgan in New York signed on as joint advisors and dealer managers for the commercial debt restructuring.

While most Paris Club countries had experience with bilateral debt restructuring agreements, it fell to Iraq's advisors to draft a model agreement that could be presented to Club members as well as the other governments holding claims against Iraq. The main open point in bilateral negotiations was the interest rate that would apply on the restructured debt going forward (and often the PDI rate as well). Governments also had different ways to address matters such as prepayment, late interest and dispute resolution.

Embracing the notion of Paris Club consensus, Iraq rejected proposals that would have given countries acceleration or unqualified enforcement rights outside the Club context or permitted fracturing assignments to third parties. Judgments or arbitral awards were discharged as the underlying claims were brought into each restructuring agreement. In its non-Paris Club agreements, Iraq also insisted on amendment provisions in case the Paris Club granted further debt relief.

An important feature in light of the complex nature of Iraq's debt stock was the "evidence of indebtedness" clause. Each new agreement replaced and superseded the obligations under the old contracts. The benefit to Iraq was that it knew its old obligations — those that may have existed towards a given creditor even if lost to history and memory — were forever extinguished.[11] The benefit to the creditor was that it knew it had a clean set of credits acknowledged by the debtor and encapsulating a streamlined repayment schedule.

That schedule was included as a numerical illustrative example that assumed a certain amount of initial debt, an average fixed interest rate and effective dates for the conditional reductions. The non-lawyers who will have to implement the agreements during the next quarter century thus have another way to understand the mechanics.

C. The Commercial Offer

In December 2004, Iraq launched a Request For Information concerning privately held, commercial claims on a specially designated website managed by E&Y as the debt reconciliation agent. Claimants registered by filling out forms to identify their claims. Supplemental information was requested as needed, minimizing the aggregate documentation required to assess thousands of claims.

If a claimant's information could be reconciled to Iraqi records according to a uniform Reconciliation Methodology[12] that took into account the various currencies, interest regimes and set-offs, among other things, the claimant received an invitation to exchange its claims for either cash or a new Iraqi debt instrument.

By number, most claimants held claims for amounts less than $35 million[13] and were eligible to receive 10.25 cents in cash for each dollar of claims. Three-quarters of the debt stock by amount, however, consisted of larger claims. Holders of the larger claims could opt for either new Iraqi notes with a par value equal to 20% of the initial claim and a 5.8% coupon, or an interest in a multicurrency loan with the same financial terms as a bilateral agreement. To maintain speed and efficiency, the new notes were issued in a Rule 144A / Regulation S private placement, eliminating the need to address the full panoply of securities registration rules in the United States and 54 other jurisdictions or for roadshows beyond two explanatory meetings in Dubai and Singapore.

Because the long period of payment default could have resulted in a PDI windfall for some creditors and a huge disadvantage for others, and because it would have been extremely difficult to calculate contractual and late interest on each separate item, the Reconciliation Methodology applied a uniform rate to the principal amount of all contracts beginning from the earlier of their maturity date, last interest payment date or August 6, 1990.

The suddenness of sanctions had resulted in a tangle of set-offs against Iraqi assets and frozen Iraqi funds. The Reconciliation Methodology gave claimants a choice of two alternatives consistent with Security Council Resolution 1483: Iraqi assets under their control could be set off against their claims or could be returned to the Development Fund for Iraq (DFI), an account set up by that Resolution to which Iraqi revenues and previously frozen assets were to be transferred. Using these options, Iraq recovered approximately $500 million in funds it might otherwise have lost.

The long period of sanctions, as well as the Saddam regime's contempt for procedural rules, also resulted in an enormous number of default judgments and opaque ongoing litigation against various Iraqi state entities around the world. As with the bilateral creditors, Iraq therefore required any participating claimant to agree that the 688 settlement discharged or dismissed in its entirety any judgment, arbitral award or litigation relating to a tendered claim. Over $5 billion of claims tied up in legal proceedings were cleared. As sovereigns typically do, Iraq announced early, often and loudly that it would vigorously defend lawsuits brought by non-participants on the basis of statute of limitations and unclean hands defenses (in this case, both quite realistic) or any other defenses available to it.

Many of the contracts had run through Rafidain and Rasheed Banks as well as the Central Bank and claimants felt exposed to potential counterclaims that may not have been dismissed or, in the case of performance bonds, cancelled by the Iraqi banks during the intervening years. Because the Ministry of Finance and the Central Bank obtained authority to act for the entire public sector, these guarantees could be released simultaneously with closing on the tenders. Before Project 688, Rafidain and Rasheed Banks were hopelessly insolvent. The cancellation of billions of dollars' worth of claims against them through Project 688 made it possible to conceive of their eventual rehabilitation. That mere possibility was seen as psychologically important because of their dominance of the domestic banking sector.

The large volume of claims necessitated a series of rolling closings. As each batch of claims was reconciled, an invitation was sent to the holders, resulting in four cash buyback and two debt-for-debt exchange rounds.

Inevitably, however, a number of claims — though only about 5% of the total — could not be reconciled by E&Y. The long passage of time and its effect on both Iraqi and creditor records prompted one of the most innovative features of the commercial offer, its arbitration mechanism. Claimants were promised this: if they tendered all of their claims, reconciled and unreconciled, the unreconciled ones would be sent to one member of a panel of independent arbitrators who would determine if credible documentary evidence supplied by the claimant supported the claim. Absent signs of fraud, Iraq declined to submit responsive papers.

If an arbitrator found credible documentary evidence in support of the claim in a certain principal amount (which was the case for 84% of the claims), it was deemed reconciled and E&Y calculated the interest due. If not, it was rejected. What otherwise would have been a prohibitively expensive and time-consuming process of contesting claims instead permitted four arbitrators to dispose of over 800 claims in the space of four months.

With each closing, claims that had been registered and reconciled were paid out at the discounted amount and cancelled in full. Unregistered or unreconciled claims were deemed "unasserted" and discharged and cancelled in full. This *in situ* cancellation procedure ensured that Iraq henceforth knew not only that specific contracts were cancelled, but that specific creditors — generally a simpler thing to track — no longer held valid claims.

The debt relief that Iraq required of its commercial creditors was bound to be unpopular. But at the end of the day, 96% of the claimants who received invitations accepted the offer. From the initial data call to the last closing, the commercial debt restructuring of $20 billion and almost 12,000 claims cost Iraq just under $500 million in cash and $3 billion in new debt obligations. It was all completed in about nineteen months.

III. "The enormous and unsustainable debt stock accumulated by the Saddam regime has now been reduced to the point that it will not deter the new investment needed to finance Iraq's economic reconstruction. This was one of the major objectives that the Government of Iraq identified in June, 2004. It is an objective that has now been accomplished."[14]

Forgotten now is that in 2003, articles in the press about Iraq hit on two themes: the security crisis and the debt crisis. Against the odds, reports on the latter rapidly transformed into the primary source of good news out of Iraq. In design and execution, Project 688 was as much a product of financial as political imperatives. The streamlining of techniques such as the uniform interest accrual and the arbitration mechanism was conscious and deliberate. There has been criticism in the past from some quarters that sovereign debt restructurings get bogged down, to the regret of both the sovereign and the creditors. Perhaps the successes of Iraq's case may devolve upon future restructurings.

* * *

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1 "688" was part of an identification number generated automatically by a Cleary Gottlieb computer. The team adopted it because at the outset the mountain of prickly Saddam-era debt loomed something like the reputedly impregnable fortress facing RAF pilots in the 1964 film "633 Squadron" (or 617 Squadron of "The Dam Busters").

2 Adil Abdul Mahdi, Minister of Finance of Iraq, Opening Remarks to the Paris Club (Nov. 17, 2004). Dr. Mahdi is currently Vice President of Iraq.

3 Figures for debts denominated in currencies other than US dollars have been translated as of the date of the Paris Club Agreed Minute for bilateral debts and as of the relevant closing date for commercial debts.

4 Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom, the United States and *ad hoc* member Korea. (Ireland and Norway are standing members but held no governmental claims against Iraq.) Paris Club members acted also on behalf of their export credit agencies, which by this time typically had been subrogated to the claims of the insured exporters.

5 Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates. Some of these countries supplied funds during the 1980s primarily to support Iraq during its war with Iran.

6 Middle East and North Africa Region, Middle East Department, MNCO2, *Interim Strategy Note of the World Bank Group for Iraq*, 4-5, World Bank Report No. 27602 (Jan. 14, 2004), http://siteresources.worldbank.org/INTIRAQ/Overview/20193777/Iraq%20Interim%20Strategy.pdf.

7 International Monetary Fund, Independent Evaluation Office, *The IMF and Argentina, 1991-2001*, 88, (2004), http://www.imf.org/External/NP/ieo/2004/arg/eng/index.htm; Nikolay I. Tabachkov, Auditor of the Accounts Chamber of the Russian Federation, *The Current Problems of Contingent Debt in Russia*, Speech at the International Organization of Supreme Audit Institutions Public Debt Committee Hearing (June 6, 2006), 2, http://www.intosaipdc.org.mx/Anexos/Meetings/06RusContDebP_i.pdf.

8 *See*, *e.g.*, Daniel Cohen, *War, Debt and Settlement: A Background Paper on Iraqi Debt*, Memorandum for the Iraq Ministry of Finance (Aug. 23, 2004) (available from the author). Dr. Cohen was at the time an economist at the social sciences department of the Ecole Normale Supérieure in Paris. The memorandum contrasted the consequences of the failure to address sovereign debts after World War I with the successes after World War II and responded to various arguments that had been voiced against granting Iraq significant debt relief.

9 Lee C. Buchheit, Mitu Gulati and Robert M. Thompson, *The Dilemma of Odious Debts*, 56 Duke L.J. 1201 (2007). The article discusses alternatives to the odious debt doctrine that nonetheless could shield countries from paying morally repugnant dues. It also notes how the regime change in Iraq triggered new interest in the concept.

10 Ali A. Allawi, "*Why Iraq's Debt Deal Makes Sense*," Euromoney, September 2005. At the time, Dr. Allawi was the Minister of Finance of Iraq.

11 The High Court of Justice in London recently reiterated the principle that a lender can reserve the right to the original amount owed in the event of a payment default regardless of a rescheduling. *Donegal International Limited v. Republic of Zambia and Anr.*, 2007 EWHC 197 (Q.B. Comm.) ¶¶502-524.

12 Posted on www.eyidro.com and available to registered claimants.

13 The threshold was determined in part by sensitivity analyses of Iraq's ability to budget the necessary cash to buy back small claims and pay the coupon on new notes.

14 Sinan Al-Shabibi, Governor of the Central Bank of Iraq, in a press release of the Republic of Iraq, "*Iraq Announces Conclusion of Commercial Debt Settlement*," (July 18, 2006) (available on www.eyidro.com).

Delaware Supreme Court Rejects Creditor's Claim of Breach of Fiduciary Duty Against Corporation's Directors

By Lisa M. Schweitzer and Neil P. Forrest

Ms Schweitzer is a partner and Mr. Forrest is a senior attorney in the New York office.

In an important corporate governance decision, the Delaware Supreme Court has refused to recognize a claim by a creditor of a Delaware corporation for breach of fiduciary duty against the corporation's directors where it was alleged that the corporation was insolvent or in the "zone of insolvency." In *North American Catholic Educ. Programming Found., Inc. v. Gheewalla* ("*Gheewalla*"),[1] the Court not only reaffirmed the protection of the "business judgment rule" for corporate directors, but expressly limited the rights of creditors to pursue actions against a debtor corporation's directors, even where the corporation is nearing insolvency or actually insolvent.

The *Gheewalla* case arose after the failure of Clearwire Holdings, Inc. ("Clearwire") to create a national system of wireless internet connections. The plaintiff in *Gheewalla*, North American Catholic Educational Programming Foundation, Inc. ("NACEPF"), which held a license on certain FCC approved microwave signal rights transmissions, had entered into a master royalty agreement with Clearwire, in alliance with other license holders. The agreement required Clearwire to acquire the holders' licenses when they became available. When, in a collapsing market, Clearwire became financially unable to purchase the NACEPF licenses, NACEPF blamed Clearwire's directors, and filed its action in the Delaware Court of Chancery against them. In the action, NACEPF alleged, *inter alia*, that the directors had breached a fiduciary duty owed directly to NACEPF as a creditor of Clearwire in (i) failing to preserve Clearwire's assets for the benefit of the company and its creditors once the need to liquidate became apparent, and (ii) continuing to retain the license rights for the purported benefit of an investor during that time. The Chancery Court dismissed the action for failure to state a fiduciary duty claim, and the Delaware Supreme Court affirmed.[2]

While it is black letter law that a corporation's directors generally owe a fiduciary duty only to the corporation and its shareholders, the premise for NACEPF's action was that because Clearwire was allegedly either insolvent or in the "zone of insolvency," the directors' fiduciary duty was also owed to the corporation's creditors and Clearwire could directly assert claims for breach of that duty. The Delaware Supreme Court rejected this premise. First, as to a circumstance in which a solvent corporation is in the "zone of insolvency," the Court considered the question NACEPF presented to be one of first impression under Delaware law: "can the *creditor* of a corporation that is operating within the *zone of insolvency* bring a *direct action* against its directors for an alleged *breach of fiduciary* duty?"[3] Citing lower court decisions and numerous journal articles,[4] the Court agreed with the Chancery Court that, regardless of whether a corporation is financially strong or in the "zone of insolvency,"[5] its creditors' interests are adequately protected by "contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights."[6] Accordingly, the Court declined to expand existing fiduciary duty law to create a new direct claim for creditors, deeming such an expansion

unnecessary. Moreover, such a new claim would run counter to Delaware's general reluctance to enlarge existing fiduciary duties.[7]

Further, the Court concluded that from the perspective of the corporation's directors, there is nothing about the "zone of insolvency" that requires an expansion or shifting of existing fiduciary duties, and to the contrary, it was important to provide directors with "definitive guidance" regarding their duties in such circumstances. Accordingly, the Court announced:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[8]

In particular, the Court recognized that directors must have more freedom to lead and negotiate with creditors when a corporation is in the "zone," and that freedom would be undermined and uncertainty created if the directors faced potential liability to creditors for the exercise of their business judgment and their decision-making.

The Court similarly found no reason to permit a creditor to bring a direct claim for breach of fiduciary duty when a corporation was actually insolvent. Although the Chancery Court had left open the possibility that such a direct claim would be viable under Delaware law, the Supreme Court in *Gheewalla* flatly rejected such a possibility. In the insolvency situation, the Court held, creditors do have standing, similar to shareholders of a solvent corporation, to bring a *derivative* action on behalf of the corporation against the directors for breach of fiduciary duty, because they, not the shareholders, are the "residual beneficiaries of any increase in [the corporation's] value."[9] However, the Court did not see the need or basis for also allowing creditors to file direct claims for individual injuries arising from such breaches. As with the "zone of insolvency" situation, to grant creditors a claim for alleged direct injury when the corporation is insolvent, the Court ruled, would not only add unnecessarily to the protections already provided by the creditors' contracts and existing law, but would create uncertainty for the directors and hinder their ability to freely exercise their business judgment in the corporation's best interests:

> To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.[10]

The *Gheewalla* decision is significant in at least two respects. First, it provides bright line guidance to directors by making clear that even in the "zone of insolvency," directors' fiduciary duties are owed to the corporation and its shareholders, and do not shift to the company's creditors. Second, while it leaves open the possibility that creditors can bring derivative suits against an insolvent company's directors, *Gheewalla* rejects the notion that directors of an insolvent corporation are liable to individual creditors (rather than the company) for any breaches of fiduciary duties. The details of what showing would be required to succeed in such a derivative suit are left for another day.

* * *

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1 930 A. 2d 92 (Del. Supr. 2007).

2 NACEPF also asserted claims for fraudulent inducement and tortious interference with a prospective business opportunity. Under the applicable Delaware statute, personal jurisdiction over defendant directors on these claims depended on the sufficiency of plaintiff's allegations of breach of fiduciary duty. *Id.* at 93-94.

3 *Id.* at 99.

4 *Id.*

5 Neither the Chancery Court nor the Supreme Court defined the "zone of insolvency," but the Supreme Court strongly implied that a corporation enters the "zone" when it suffers a significant degree of financial distress.

6 *Id.* at 99.

7 *Id.*

8 *Id.* at 101.

9 *Id.* The Court did not address the issue whether creditors have standing to bring a derivative claim for breach of fiduciary duty against the directors of a corporation that is solvent but in the "zone of insolvency."

10 *Id.* at 103.

Amendments to German Insolvency Code Facilitate Restructurings

By Werner Meier and Michael Kern

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On July 1, 2007, the Law on the Simplification of Insolvency Proceedings (*Gesetz zur Vereinfachung des Insolvenzverfahrens*) (the "2007 Law") became effective. The 2007 Law includes, among other things, changes to the German Insolvency Code (*Insolvenzordnung*) relating to the enforcement of security interests during preliminary insolvency proceedings and the sale of the debtor's business prior to the first creditors' meeting.

Enforcement of Security Interests During Preliminary Insolvency Proceedings

Under prior law, secured creditors were generally entitled to enforce their security interests during the period of the preliminary insolvency proceedings, *i.e.*, between the insolvency filing and the opening of insolvency proceedings by the bankruptcy court. This period typically lasts three months. As a practical matter, however, preliminary insolvency receivers and bankruptcy courts frequently took steps to prevent such enforcement, in spite of the lack of express legal discretion to do so.

The 2007 Law codifies this informal practice by explicitly authorizing the bankruptcy court to order a stay on (i) the enforcement of security interests during the preliminary insolvency proceedings with respect to collateral that the insolvency receiver would be entitled to dispose of after the opening of the insolvency proceedings (*i.e.*, mainly security interests in inventory and receivables), and (ii) the release of assets that do not belong to the estate and that could be segregated in insolvency proceedings (such as assets leased by the insolvent debtor or, arguably, receivables assigned in a true sale). The 2007 Law also permits the continued use of such assets for the debtor's business, provided that the relevant assets are of "major importance" to the continuation of the debtor's business. (From the wording of the 2007 Law, it is not entirely clear whether such requirement also applies to the stay order itself.) Although the debtor is entitled to continue to use its assets, if the continued use of such assets results in deterioration in value of the assets concerned and thereby adversely affects the secured creditor's position such that it is undersecured, the preliminary receiver will be required to compensate the secured party for such loss. Finally, if based upon a court order prohibiting a secured creditor from collecting an assigned receivable, a preliminary insolvency receiver instead collects such receivable, the insolvency receiver is entitled to withhold from the collection proceeds payable to the lienholder a haircut of, generally, 9% for the benefit of the estate.

Sale of Debtor's Business Prior to First Creditors' Meeting

Under prior law, during preliminary proceedings, and between the opening of insolvency proceedings and the date of the first creditors' meeting (which is supposed to take place within six weeks to three months from the opening of insolvency proceedings), neither the preliminary insolvency receiver nor the insolvency receiver, as applicable, were permitted to sell the debtor's entire business or substantial parts thereof (although bankruptcy courts have, with an uncertain legal basis, allowed exceptions from this general rule in rare

circumstances). These restrictions proved to be serious impediments to successful restructurings that required a quick sale of all or part of the debtor's business.

The 2007 Law therefore allows the insolvency receiver, with the consent of the creditors' committee (if one is established), to dispose of the debtor's entire business or substantial parts thereof before the first creditors' meeting. The 2007 Law does not, however, grant the preliminary insolvency receiver similar rights. As a result, the sale of a debtor's entire business or substantial parts thereof during preliminary insolvency proceedings will remain generally impermissible, on the theory that interference with the debtor's rights at a point in time where insolvency proceedings have not been opened is unjustified and that potential purchasers' interests in such a disposal should be limited at this early stage because of the potentially significant risks that might result from a purchase of the debtor's assets from the preliminary insolvency receiver (*e.g.*, assumption of employee and tax liabilities).

* * *

It is expected that the changes embodied in the 2007 Law will facilitate restructurings by clarifying the insolvency receiver's rights to manage and dispose of a debtor's property in the early stages of an insolvency proceeding. That said, a preliminary insolvency receiver's powers are still somewhat limited since the German legislature did not expressly authorize the preliminary insolvency receiver to dispose of the debtor's entire business (absent an express court order), even though such sale or other disposition is frequently required during preliminary proceedings to avoid a deterioration of value.

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Good Faith Exception to Fraudulent Transfer Statute Held Not to Apply to Prime Broker With Notice of Fraud of Customer of Introducing Broker

By Jane Kim
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A decision by the Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), if upheld, could impose heightened duties on prime brokers and other broker-dealers to investigate suggestions of wrongdoing in accounts managed by introducing brokers. On February 15, 2007, Judge Burton Lifland of the Bankruptcy Court entered a judgment against Bear Stearns Securities Corp. ("Bear Stearns") in the Manhattan Investment Fund (the "Fund") chapter 11 case.[1] The judgment arose from an earlier decision that held that $141.4 million in margin payments received by Bear Stearns, the Fund's prime broker, were avoidable transfers recoverable from Bear Stearns, given that the Fund's principal was operating a Ponzi scheme and that Bear Stearns was at least on inquiry notice of the Fund's improprieties at the time it accepted such payments.[2]

Under section 548(a)(1)(A) of the Bankruptcy Code, certain transfers of property made by the debtor in the two years before the beginning of its bankruptcy case (or one year for bankruptcies filed before October 17, 2005, including the case at hand), including margin payments made to a stockbroker, can be reversed if the transfers were made with the actual fraudulent intent of the debtor. Section 550(a) of the Bankruptcy Code clarifies that "the trustee may recover . . . the property transferred, or, if the court so orders, the value of such property, from (1) the *initial transferee* of such transfer or the entity for whose benefit such transfer was made …" (emphasis added). Section 548(c) of the Bankruptcy Code, however, provides that a transferee may retain the transferred property if the transfer was taken for value and in good faith. The Manhattan Investment Fund decision focuses on whether Bear Stearns was an initial transferee of the margins payments (rather than a mere conduit) and whether it acted in good faith in accepting such payments.

Background

The Fund — created in 1996 by Michael Berger — had already lost almost $400 million of its investors' money by the beginning of 2000. Berger hid the Fund's investment losses during this period by falsifying his investors' account statements to give the appearance that the Fund was performing well and by paying early investors with new investor money.

In December 1998, Fredrik Schilling, a senior Bear Stearns employee, had a conversation at a holiday party with a person affiliated with an investor in the Fund. That individual told Schilling that the Fund was reporting a 20% profit for the year, a statement that did not "sound right" to Schilling, who had been under the impression based on his participation in internal risk-related conference calls that the Fund was losing money.[3]

Following that conversation, Schilling spoke with other Bear Stearns employees, and received confirmation that the Fund was losing money in its account at Bear Stearns. Schilling then met with a member of Bear Stearns' legal department and discussed the situation with other members of Bear Stearns' senior management. Eventually, two managers in Bear

Stearns' relationship management department spoke with the Fund's introducing broker and Berger, who explained that the discrepancy between the investor's description of the Fund's performance and the performance of the Fund's account at Bear Stearns was due to the fact that Bear Stearns was one of eight or nine prime brokers used by the Fund.

Bear Stearns did not have the Fund's financial statements or correspondence with its investors and thus did not verify Berger's explanation, but Schilling spoke with two partners at Deloitte & Touche, the Fund's auditor, to describe Bear Stearns' efforts and Berger's explanation, and asked that Deloitte & Touche be "keen and careful" during the Fund's upcoming audit.[4] Several months later, in the spring of 1999, Deloitte & Touche apparently informed Schilling that the Fund's audit had been completed without issue.[5]

In December 1999, Schilling learned that the Fund had been sued by one of its terminated marketers for a substantial amount of money owed for past marketing efforts. This conversation — which Bear Stearns contends was the first information it had that raised questions about Berger's integrity and honesty — led to further inquiries and ultimately to Bear Stearns obtaining a set of the Fund's confidential audited financial statements, which included a footnote that stated that "the activity of the [Fund] was predominantly or primarily exclusive at one prime broker," and stated a substantially greater year-end equity than reflected on Bear Stearns' records.[6] Shortly thereafter, after receiving a call from Deloitte & Touche informing Bear Stearns that it could no longer discuss the Fund, Bear Stearns notified the SEC that there was a potential problem with the Fund, even though it still had no specific proof that Berger was engaging in wrongdoing.[7] By December 22, 1999, the Fund was put on "closing only" status and asked to leave Bear Stearns.[8]

During the year before the Fund filed for bankruptcy relief, the Fund deposited a total of $141.4 million into its account at Bear Stearns, through eighteen separate transfers, to satisfy Bear Stearns' margin level requirements. By late 1999, Bear Stearns had raised its margin requirement from 35% to 50%.[9] On December 23, 1999, Bear Stearns covered all of the Fund's remaining open short positions at a realized loss to the Fund of more than $22 million.[10]

On January 14, 2000, the SEC filed a complaint alleging securities fraud against the Fund, Berger, and Berger's wholly-owned company, Manhattan Capital Management. On March 7, 2000, after the SEC had obtained an asset freeze and the appointment of a Trustee, the Fund filed a voluntary petition for relief under chapter 11 of the Bankruptcy Code. Berger pleaded guilty to securities fraud in November 2000, but failed to appear at his sentencing hearing in March 2002 and remained a fugitive until recently, when news reports indicate that Berger was arrested by authorities in Austria.

On April 24, 2000, the Trustee commenced an adversary proceeding against Bear Stearns. Among other things, pursuant to section 548(a)(1)(A) of the Bankruptcy Code, the Trustee sought to avoid the $141.4 million in margin payments made by the Fund to Bear Stearns prior to the filing of the Fund's chapter 11 case, arguing that (1) the transfers were made by Berger with actual intent to hinder, delay, or defraud the Fund's creditors and without which the Fund could not have continued to operate and further perpetrate its fraud; (2) Bear Stearns was not a mere conduit but rather an initial "transferee" under section

550(a) of the Bankruptcy Code; and (3) Bear Stearns could not prove that it accepted the transfers in good faith under section 548(c) of the Bankruptcy Code.[11]

On January 9, 2007, the Bankruptcy Court granted the Trustee's motion for summary judgment, holding that Berger's transfers were margin payments, that the margin payments were made with actual intent to defraud, that Bear Stearns was an initial transferee, and that Bear Stearns did not act in good faith by accepting the margin payments given it was on inquiry notice of the Fund's principal's fraudulent actions at the time it accepted such payments. Accordingly, the Bankruptcy Court entered judgment against Bear Stearns in the amount of approximately $160 million, representing the margin payments, plus interest, that the Fund had transferred to Bear Stearns and that Bear Stearns had used following the Fund's bankruptcy to settle positions in the Fund's account. The judgment dwarfs the approximately $2.4 million in revenue that Bear Stearns earned from the Fund's account at Bear Stearns.

The Bankruptcy Court's Decision

In attempting to defend against the grant of summary judgment, Bear Stearns raised three principal arguments, all of which were ultimately rejected by the Bankruptcy Court.

No Fraudulent Intent: In challenging whether a *prima facie* case had been shown as to whether the margin loan payments constituted fraudulent transfers, Bear Stearns argued that the Trustee could not merely rely on the fact that the Fund was generally operated as a "Ponzi scheme" and that the Trustee did not otherwise meet her burden of establishing that Berger acted with actual intent to hinder, delay, or defraud the Fund's creditors in making the transfers at issue. In support of this argument, Bear Stearns pointed to evidence showing that Berger deposited money into the brokerage account with the intent to make profitable investments for the benefit of the Fund and its investors. Berger indisputably committed fraud in falsifying the Fund's investors' account statements, lying to investors about the Fund's performance, and selling shares to investors based upon the Fund's inflated net asset value. But, Bear Stearns contended, that did not prove that the deposits into the brokerage account were made with an intent to defraud. Bear Stearns secondarily argued that there was a factual dispute as to whether the Fund was a Ponzi scheme, and referred to conflicting expert testimony on that topic.

Judge Lifland flatly rejected these arguments, noting that both the Bankruptcy Court and the District Court for the Southern District of New York had previously determined in the context of earlier motions to dismiss that Berger operated a Ponzi scheme, and that prior caselaw established that all payments made by a debtor operating a Ponzi scheme in order to keep the scheme going are made with an actual intent to defraud.[12]

Mere Conduit, Not Transferee: Bear Stearns next argued that it was not a "transferee" under section 550(a) of the Bankruptcy Code because it lacked legal dominion and control over the margin payments it received, which were placed in the Fund's securities trading account. In support, Bear Stearns argued that SEC Rule 15c3-3 prohibited it from using the transfers at issue for its own proprietary purposes (or any purposes not specified in the account agreement) and required that the transfers be maintained in an account for the exclusive benefit of the Fund.

In connection with this argument, Bear Stearns urged that because the only rights it had with respect to the funds transferred were those limited ones granted in its standard account agreement and permitted under SEC Rule 15c3-3, and were standard in the securities industry, a finding that those limited contractual rights were sufficient to constitute dominion and control "would expose broker-dealers to massive amounts of liability, including *strict liability*, for money that customers deposited into their own accounts that the broker-dealers do not own."[13]

Judge Lifland rejected the theory that Bear Stearns was a mere conduit for the margin payments and instead held that no question existed that Bear Stearns was an initial transferee of the margin payments. Judge Lifland adopted a broad interpretation of the "dominion and control" test, and found the test to be met by the boilerplate provisions in the Fund's account agreement with Bear Stearns that gave Bear Stearns a security interest in any monies transferred into the account, the right to hold the monies transferred as collateral for short sales, the right to use the monies transferred to purchase covering securities, with or without the Fund's consent (which right Bear Stearns exercised in December 1999), and the right to prohibit the Fund from withdrawing any of the monies transferred as long as any short position remained open (which right Bear Stearns exercised in January 2000).[14] The Bankruptcy Court concluded that these rights gave Bear Stearns the ability to use the transfers at issue to protect its own economic well-being.[15] Judge Lifland further found it significant that Bear Stearns made a $2.4 million profit on the Fund's transactions during the period in which it acted as the Fund's prime broker.[16]

Good Faith Defense: Finally, Bear Stearns contended that the good faith defense would be available to it at a jury trial. Bear Stearns argued that because the Fund was a customer of an introducing broker that cleared trades through Bear Stearns rather than a direct customer, Bear Stearns had access to very limited information about the Fund and did not owe any fiduciary duties to the Fund, its investors, or the introducing broker. Bear Stearns asserted that it "not only acted in good faith but acted in an exemplary fashion." (A good faith showing would have been a dispositive defense to the fraudulent conveyance claim, given that the Bankruptcy Court agreed that the transfers were clearly margin payments.)[17]

In particular, Bear Stearns argued that Schilling's casual holiday party conversation in December 1998 did not put Bear Stearns on inquiry notice of Berger's fraud, and in any event, the actions taken by Bear Stearns in response — including discussing the issue with the Fund's introducing broker and manager and contacting Deloitte & Touche — more than constituted a diligent inquiry that would preserve the good faith defense. As to whether Bear Stearns should have accepted Berger's explanation that the Fund had multiple prime brokers without further probing, Bear Stearns pointed to the testimony of eight non-party fact witnesses and three experts (including the Trustee's own expert) supporting the proposition that Berger's explanation was a reasonable one, that the use of multiple prime brokers by hedge funds was common at the time, and that the Fund's use of multiple prime brokers could have reasonably accounted for the Fund's apparent discrepancy in performance.

The Bankruptcy Court found these facts insufficient as a matter of law to sustain a good

faith defense. The Bankruptcy Court concluded that Bear Stearns was on inquiry notice of Berger's fraud beginning in December 1998, and that "[b]ased upon the information it had, Bear Stearns was required to do more than simply ask the wrongdoer if he was doing wrong."[18] Judge Lifland rested his decision that Bear Stearns did not conduct an adequate inquiry on the fact that, one year later, Bear Stearns performed several "simple steps," including, primarily, signing a confidentiality agreement and thereby obtaining the Fund's financial statements, which, upon "a ten-minute review" by Bear Stearns, revealed that Berger's multiple-broker explanation was false.[19] The Bankruptcy Court's ruling is most significant in that it rejected the existence of a good faith defense at the summary judgment phase, thereby concluding that there was no question that the facts supporting Bear Stearns' defense, even if accepted as true, could not show that Bear Stearns acted in good faith in accepting the margin payments.

Implications

Bear Stearns has appealed the Bankruptcy Court's judgment and posted a $159,233,437.12 bond in support of its appeal. Two trade associations, the Securities Industry and Financial Markets Association (SIFMA) and the International Swaps and Derivatives Association, Inc. (ISDA), have filed amicus briefs in support of Bear Stearns' appeal, arguing that the Fund's deposits into its own account were not transfers, that Bear Stearns was not an "initial transferee" of the payments because it did not exercise dominion and control over the assets in the Fund's account, and that to hold otherwise would effectively cause prime brokers to become guarantors of the losses incurred by it's account holders, thereby disrupting the country's prime brokerage and clearing system. If the decision were upheld on appeal, prime brokers and other broker-dealers would want to review and consider the sufficiency of their standard practices in monitoring their hedge fund customers, particularly where there is any question as to whether the customer is in financial distress or the broker becomes aware of information suggesting that the customer is engaging in fraudulent conduct. As shown by this decision, the availability of the good faith defense to fraudulent conveyance claims is even more important for cases involving Ponzi schemes, to the extent courts are willing to view all transfers and transactions that further such a scheme as fraudulent conveyances, regardless of whether such transfers also had valid business purposes.

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1 *Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, Nos. 00-10922 (BRL), 00-10921 (BRL), 2007 WL 534547 (Bankr. S.D.N.Y. Feb. 15, 2007).

2 *Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, 359 B.R. 510 (Bankr. S.D.N.Y. 2007) ("*Gredd*").

3 *Gredd*, 359 B.R. at 524.

4 *Id.* at 525.

5 While the Manhattan Investment Fund Trustee disputed that this conversation occurred, it was accepted for the purposes of the decision. *Id.* at 525 n.11.

6 *Id.* at 526.

7 *Id.*

8 *Id.*

9 *Id.* at 525.

10 *Id.* at 526.

11 By Opinion and Order dated March 22, 2002, the District Court for the Southern District of New York, which had withdrawn the reference on a limited basis, dismissed the Trustee's claims to recover from Bear Stearns $1.7 billion in short sale proceeds from stock borrowed by the Fund from Bear Stearns, and $1.9 billion in securities purchased with the short sale proceeds and delivered to Bear Stearns. *Gredd v. Bear, Stearns Secs. Corp. (In re Manhattan Inv. Fund Ltd.)*, 275 B.R. 190 (S.D.N.Y. 2002).

12 *Gredd*, 359 B.R. at 515. In so ruling, Judge Lifland did not address the argument made by Bear Stearns that both his earlier decision and the District Court's decision were decisions on Bear Stearns' motions to dismiss (for which the Trustee's allegations must be assumed to be true), and therefore based on less stringent standards than apply to the Trustee's motion for summary judgment (for which there must be no genuine issues of fact and no reasonable jury could find in favor of Bear Stearns when viewing the facts in the light most favorable to Bear Stearns).

13 Memorandum Of Law Of Bear, Stearns Securities Corp. In Opposition To The Chapter 11 Trustee's Motion For Summary Judgment On Count I Of The Complaint at 16-17, *Gredd*, 359 B.R. 510 (Bankr. S.D.N.Y. 2007) (No. 115).

14 *Id.* at 521-22.

15 *Id.* at 522.

16 *Id.* at 521.

17 Bear Stearns had argued that the transfers at issue were cash deposits transferred from the Fund's bank account at the Bank of Bermuda to its brokerage account at Bear Stearns that were fully credited to the Fund's account. The Bankruptcy Court held that the transfers were made to comply with the account's margin requirements and were therefore margin payments under the Bankruptcy Code.

18 *Gredd*, 359 B.R. at 526.

19 *Id.*

Settlement Distributions and The Absolute Priority Rule In Light of *In Re Iridium*

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In March, the United States Court of Appeals for the Second Circuit (the "Second Circuit") ruled that, in deciding whether to approve pre-plan settlement agreements entered into by a debtor, a bankruptcy court must consider whether payments made pursuant to the settlement comply with the absolute priority rule. *See In re Iridium Operation LLC, et al.*[1] ("*In re Iridium*").

Generally, Rule 9019 of the Federal Rules of Bankruptcy Procedure and interpreting case law have limited a bankruptcy court's role in evaluating the fairness of a settlement entered into by the debtor.[2] To that end, the bankruptcy court "must make an informed judgment whether the settlement is fair and equitable and in the best interests of the estate."[3] In making this determination, the court will typically weigh a range of factors including:

> (1) the balance between the likelihood of success in the litigation compared to the present and future benefits offered by the settlement, (2) the prospect of complex and protracted litigation with its attendant expense, inconvenience, and delay, and the difficulties associated with collection of any judgment, (3) the paramount interests of the creditors, which includes the relative benefits to be received by members of any affected class and the degree to which creditors either do not object to or affirmatively support the proposed settlement, (4) the degree to which the settlement is supported by other parties in interest and the competency and experience of counsel who support the settlement, (5) the nature and breadth of releases to be obtained by officers and directors, and (6) the extent to which the settlement is the product of arm's length bargaining.[4]

The Second Circuit clarified in *In re Iridium*, however, that where the settlement contemplates a *distribution* of estate property to the estate's stakeholders (rather than the allowance of a claim against an estate), the bankruptcy court also must consider, as the most important factor, whether the proposed distribution scheme complies with the Bankruptcy Code's absolute priority rule. The absolute priority rule in the Bankruptcy Code governs the distribution of estate property under a plan of reorganization and generally requires that secured creditors be paid in full before any payments are made to unsecured creditors. Historically, the rule of absolute priority has not been applied to pre-plan settlement agreements entered into by a debtor; rather, its application has been limited to bankruptcy court approval of plans of reorganization. Therefore, *In re Iridium* imposes an important new requirement on pre-plan settlement payments by the debtors.

Background

The relevant facts of *In re Iridium* are as follows: Iridium Operating LLC ("Iridium"), a former subsidiary of Motorola, Inc. ("Motorola"), was a provider of global satellite-based telecommunications services. Soon after it launched commercial operations in November 1998, however, it was forced into bankruptcy,

due to little demand for its services and a burgeoning debt burden of about $4 billion. On August 13, 1999, Iridium and its affiliates filed for Chapter 11 protection in the United States Bankruptcy Court for the District of Delaware. The cases later were transferred to the United States Bankruptcy Court for the Southern District of New York (the "Bankruptcy Court"), where involuntary petitions had been filed on the same day.

A few months before the filing of the bankruptcy petition, Iridium had entered into a series of loan agreements with a consortium of lenders represented by JPMorgan Chase Bank, N.A. (the "Lenders") who asserted liens on all the debtor's assets, including some $156 million in cash deposits. During the course of the bankruptcy proceeding, the Lenders, Iridium and former parent Motorola entered into various cash collateral stipulations that permitted Iridium to use some of the cash to fund its operations. The official committee of unsecured creditors (the "Committee"), however, contested the validity of the liens on the cash deposits under a variety of theories, including as avoidable preferences. Concurrently, the Committee pressed claims for billions of dollars against Motorola for breach of contract, breach of fiduciary duty, and fraudulent conveyance. Since the debtor could not afford protracted and complex litigation on both these issues, the Committee entered into a settlement with the Lenders that would resolve the question of the liens on the cash deposits and at the same time provide for the resources to pursue litigation against Motorola (the "Settlement").

As part of the Settlement, the Committee conceded the validity of the Lenders' liens on Iridium's cash, subject to the Bankruptcy Court's approval of the Settlement. In return, the Lenders agreed to the division of the remaining cash into three cash funds. Cash Fund Number One would split $130 million two-ways: the Lenders would receive $92.5 million and a newly created entity, the Iridium Litigation LLC, would receive $37.5 million. Cash Fund Number Two would receive $5 million for professional expenses, and Cash Fund Number Three would divide income from accounts receivable between Iridium Litigation LLC and the Lenders. Iridium Litigation LLC was to be controlled by the Committee and serve as a funding vehicle for all Motorola-related litigation, including the Lenders' own claims against Motorola. The Settlement further provided that 37.5% of the recovery from the litigation was to go to the Lenders and 62.5% was to go to the debtor's estate. Any surplus from the initial $37.5 million in Cash Fund Number One, however, was to be distributed directly to unsecured creditors.

The Bankruptcy Court approved the Settlement on the ground that it was fair, reasonable and in the best interest of the debtors' estates because it provided significant benefits to the debtors while avoiding significant costs and risks involved in establishing the validity of Lenders' liens.[5] Motorola, who was an administrative creditor as well as a defendant in the Committee's lawsuit, appealed, arguing that the Settlement violated the Bankruptcy Code's priority scheme, as it would distribute estate property to unsecured creditors before payments were made to more senior creditors. The District Court for the Southern District of New York (the "District Court") affirmed the Bankruptcy Court ruling.[6] Relying on the First Circuit decision *In re SPM Mfg. Corp.*,[7] the District Court reasoned that a secured creditor with a valid lien may share some of the proceeds from its collateral with junior creditors even though a priority creditor will go unpaid,

because such sharing does not involve a distribution of property of the *estate* but only of the secured lender.[8] Moreover, the District Court emphasized that because Motorola had signed a series of cash collateral stipulations during the bankruptcy that permitted Iridium to use some of its cash deposits to fund operations and did not specifically reserve the right to later challenge the validity of the liens, but instead stated that the liens were valid, enforceable and perfected,[9] Motorola had in fact conceded that the Lenders' liens were valid and the cash belonged to the Lenders. It was therefore judicially estopped from arguing that the settlement was an improper distribution of estate property.[10]

The Second Circuit Ruling

The Second Circuit reversed the decisions below. As a preliminary matter, it distinguished *In re SPM Mfg. Corp.* on the ground that that decision concerned perfected, valid liens, while the Lenders' liens in *In re Iridium* were contested by the Committee and would only become perfected upon entry of an order approving the Settlement. The Second Circuit also rejected the District Court's estoppel argument on the ground that "Motorola's position does not rest on a contention that the liens are *in fact* invalid, but rather that right up until (and indeed dependent on approval of) the Settlement, there remained significant doubts as to whether the liens were avoidable."[11]

As to the scope and application of Rule 9019, the Second Circuit reemphasized that a settlement generally may be approved by the court if it is fair and equitable. In those instances where a settlement contemplates a *distribution* to the debtor's stakeholders, however, the standard multi-factor test must be extended. In particular, the most important factor for the Bankruptcy Court to consider is "whether a pre-plan settlement's distribution plan complies with the Bankruptcy Code's priority scheme."[12] The Second Circuit expressly disavowed a rigid per se rule that would require all settlement distributions to fully comply with the absolute priority rule (such as the one the Fifth Circuit had adopted in *In re AWECO, Inc.*).[13] Because the absolute priority rule is difficult to employ "when the nature and extent of the Estate and the claims against it are not yet fully resolved,"[14] the Second Circuit adhered to a more flexible approach that would give settling parties the opportunity to demonstrate that a minor deviation from the priority scheme could be justified in their individual circumstances. In particular, the Second Circuit noted that

> "[i]n the Chapter 11 context, whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor. However, where the remaining factors weigh heavily in favor of approving a settlement, 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."[15]

Reviewing the facts in light of the "most important factor," the Second Circuit noted that the distribution of money from the estates to the Iridium Litigation LLC was clearly justified by the record in light of the risks and costs of litigating the validity of the Lenders' liens. However, the court found no explanation in the record as to why the residual of the $37.5 million in Cash Fund Number One at the conclusion of the

Motorola-related litigation should go directly to unsecured creditors in violation of the absolute priority rule. Since the Second Circuit did not want to speculate as to possible justifications for such a deviation from the absolute priority rule, it remanded to the Bankruptcy Court for clarification with the specific instruction that the Committee "must come before the bankruptcy court with specific and credible grounds to justify that deviation and the court must carefully articulate its reasons for approval of the agreement."[15]

The Second Circuit also rejected Motorola's contention that the proposed Settlement constituted a *sub rosa* plan of reorganization, i.e., an attempt to circumvent the requirements of a Chapter 11 confirmation, because the Bankruptcy Court had identified a proper business justification for the Settlement.

Conclusion

In re Iridium imposes a new requirement on pre-plan settlements that contemplate a distribution to the debtor's stakeholders. A bankruptcy court must now also consider, as the most important factor, whether the distribution complies with the Bankruptcy Code's absolute priority scheme. Minor deviations from the absolute priority rule are permissible, but must be justified by the parties and articulated by the court.

It is important to note that the Second Circuit relied on the fact that the liens were contested and subject to significant doubt, and would not have become perfected until approval of the Settlement. One is left wondering whether the outcome would have been different if the Committee had never openly challenged the liens or the Settlement itself had been phrased differently to recognize that the liens had already been perfected. Similarly, had the funds gone to the Lenders directly, who had then funded the three Cash Funds directly, the Second Circuit would likely have ruled that the absolute priority rule was satisfied.

* * *

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1 478 F.3d 452 (2nd Cir. 2007).

2 *See, e.g.*, *Protective Comm. For Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968).

3 *In re WorldCom, Inc.*, 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006). *See also In re Drexel Burnham Lambert Group, Inc.*, 134 B.R. 493, 496 (Bankr. S.D.N.Y. 1991).

4 *See In re WorldCom, Inc.*, 347 B.R. at 137.

5 *See* Order Pursuant to Sections 105, 362 and 363 of the Bankruptcy Code and Bankruptcy Rule 9019 Approving a Settlement Agreement with the Debtors' Prepetition Secured Lenders at 3, *In re Iridium Operating LLC*, No. 99-45005, (Bankr. S.D.N.Y. March 30, 2001).

6 *See In re Iridium Operating LLC*, 2005 U.S. Dist. LEXIS 5483 (S.D.N.Y. 2005).

7 984 F.2d 1305 (1st Cir. 1993).

8 *See In re Iridium Operating LLC*, 2005 U.S. Dist. LEXIS 5483 at *25-*26.

9 *Id.* at *6, fn.4.

10 *See id.* at *17-*20.

11 *In re Iridium Operating LLC*, 2007 U.S. App. LEXIS 5134, at *18 n.11.

12 *Id.* at *2.

13 725 F.2d 293, 298 (5th Cir. 1984) ("[A] bankruptcy court abuses its discretion in approving a settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors.")

14 *In re Iridium Operating LLC*, 2007 U.S. App. LEXIS 5134, at *28.

15 *Id.* at *29.

16 *Id.* at *33.

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