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Buying Debt and Taking Control of Distressed Companies

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With credit markets tightening, credit defaults rising and debt trading prices falling, some investors are considering or pursuing "loan to own" acquisition strategies where they purchase existing debt in (or extend new debt to) distressed or bankrupt companies with a view to converting their debt positions into controlling equity positions. Such strategies require careful planning and legal analysis, but may represent innovative M&A opportunities, if properly executed.

Supreme Court to Resolve Scope of Bankruptcy Code's Transfer-Tax Exemption

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The ability of Chapter 11 debtors to sell assets outside of a plan of reorganization and claim the transfer-tax exemption set forth in section 1146 of the Bankruptcy Code has long been a matter of dispute among the circuit courts. In those circuits that have applied the transfer-tax exemption to asset sales other than under a plan of reorganization, debtors have been able to more easily obtain valuable tax savings. Now, the United States Supreme Court has granted *certiorari* in an Eleventh Circuit case to resolve a division among the lower courts about whether the Bankruptcy Court's transfer-tax exemption applies to asset sales completed during bankruptcy, but prior to plan confirmation.

Payments Made Pursuant to Private Leveraged Buyout Transactions are Settlement Payments that are Protected from Avoidance Actions Under Section 546(e) of the Bankruptcy Code

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On December 21, 2007, the United States District Court for the Western District of Michigan issued an opinion holding that transfers of cash and stock to shareholders to effectuate a private leveraged buyout were protected transfers that under section 546(e) of the Bankruptcy Code could not be voided as fraudulent transfers. This decision is the first to address the question in the Sixth Circuit of whether section 546(e)'s protections apply to leveraged buyouts involving privately held shares of stock, and aligns the Sixth Circuit, at least at the District Court level, with the broad interpretation of 546(e) adopted by the Third, Ninth and Tenth Circuit Courts of Appeals.

Ninth Circuit Bankruptcy Appellate Panel Weighs in on Rights of Unsecured Creditors to Receive Contractual Postpetition Attorneys' Fees

BY JANE KIM 11

On December 19, 2007, the United States Bankruptcy Appellate Panel of the Ninth Circuit Court of Appeals issued an important ruling addressing the question left open by a recent Supreme Court decision of whether an unsecured creditor may include attorneys' fees incurred postpetition as part of its unsecured claim. The Bankruptcy Appellate Panel held that unsecured creditors can recover postpetition attorney's fees, as provided by contract, on their claims.

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Buying Debt And Taking Control Of Distressed Companies[1]

BY SEAN A. O'NEAL

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This year promises increased activity in distressed M&A. Credit markets are tight, credit defaults are up and debt trading prices are down. Investors will have opportunities to pursue a variety of distressed M&A transactions.

This article focuses on "loan to own" strategies where investors purchase existing debt in (or extend new debt to) distressed or bankrupt companies with a view to converting their debt positions into controlling equity positions.

Developing an Acquisition Strategy

Typically, the investor's goal is to convert all or a portion of the debt into equity, pay off secured creditors (and other creditors to the extent valuation permits) and cram down junior creditors and equityholders. Although these acquisition strategies frequently involve second-lien secured debt, the goal can be accomplished through the acquisition of unsecured debt or even equity in some circumstances.

The first step is determining the fulcrum security – the security that will be converted into equity in the distressed company's reorganization efforts. By acquiring a controlling position in the fulcrum security (or joining an ad hoc group of other fulcrum security holders), the investor gains a seat at the negotiating table and the opportunity to help direct the restructuring.

The most important step in selecting the fulcrum security is determining the value of the target company and identifying the class of debt that will be impaired but still receive some recovery in the restructuring based on that valuation. An investor who buys debt that is too senior runs the risk of reinstatement or cash payouts (with no equity upside) and an investor who buys debt that is too junior runs the risk of significantly reduced or zero recovery. To hedge these risks, investors frequently buy at different levels of the capital structure.

Factors to be considered when identifying the fulcrum security include:

- The company's cash flow and liquidity position in view of pending maturity and interest payment dates;
- The existence of potential, arguable or actual defaults under the relevant indentures or credit agreements;
- The rights of debt holders to call defaults, accelerate debt, waive defaults and take other actions (usually requiring 25% of the outstanding principal);
- The scope of any guarantees of debt by affiliated companies, especially operating companies;
- The relative rights of junior and senior creditors under intercreditor agreements (e.g., whether junior creditors have given pre-bankruptcy consents to bankruptcy sales or debtor-in-possession financing);
- Whether the debt is widely held or held only by a few sophisticated investors and whether those holders purchased the debt at par or at discounted prices;
- Whether current holders are interested in participating in a potential restructuring;
- If the debt is secured, the nature of the collateral and the validity of the security interest in that collateral; and
- The amount and nature of pending claims against the company and other parties (e.g., preference or fraudulent conveyance claims).

In many instances, the distressed company will need an injection of new money, which can involve extensions of credit, rights offerings, preferred stock purchases, or other mechanisms. Existing debt instruments may impose limitations on how new money is injected and will need to be carefully reviewed.

Potential Mechanisms for Converting Debt to Equity

An investor pursuing this acquisition strategy should consider the best options for effectuating the conversion of debt to equity, which may include:

Out-of-Court Exchange Offers

An exchange offer, which can be registered or unregistered, permits consenting creditors to exchange their debt for equity. In distressed situations, an exchange offer can be backed-up by a

prepackaged bankruptcy plan solicitation in the event that the requisite threshold of creditors does not consent to the exchange offer. Exchange offers can be difficult in public company situations where the company may be required to generally solicit votes of shareholders through a proxy statement.

Prepackaged Chapter 11 Bankruptcy Plans

In a prepackaged plan, creditors agree in advance of a bankruptcy filing to convert their debt to equity pursuant to a plan of reorganization that is solicited and approved by creditors before the bankruptcy filing. A prepackaged bankruptcy can be faster and cheaper than a traditional bankruptcy. Unlike an out-of-court exchange offer, a prepackaged bankruptcy can bind non-consenting creditors, as long as the requisite voting thresholds (two-third in amount and a majority in number) are satisfied.

Prenegotiated Chapter 11 Plans

In a prenegotiated plan, impaired classes agree to the basic terms of a chapter 11 reorganization plan in advance of the bankruptcy filing by signing “lock-up” agreements. However, votes are not solicited until after the bankruptcy is filed. This process takes more time and may involve more post-bankruptcy risks than a prepackaged bankruptcy, but can be much shorter than a traditional bankruptcy.

Post-Bankruptcy Debt Acquisitions

Under this scenario, existing creditors and other investors acquire claims after the bankruptcy filing in order to gain some control over the plan process (including voting rights) with a view to converting the newly acquired debt into equity in the company that emerges from bankruptcy.

Issues in Chapter 11 Bankruptcies

Once a distressed company enters bankruptcy, special issues arise.

Negotiation Dynamics

In a bankruptcy case, creditors and equityholders will have significant influence and rights to object to and guide the proposed reorganization. They may initiate litigation and discovery. The bankruptcy court also has tremendous influence on the reorganization and must approve any proposed transaction involving the debtor. Investor concessions may be necessary to get past creditor or court opposition.

Obligation of Good Faith

A bankruptcy court cannot approve a plan proposed in bad faith.[2]

In several cases, objecting creditors have argued that a proposed reorganization plan is a bad faith, “sweetheart” deal for the proposed acquirer to the disadvantage of other creditors. They may seek the appointment of an examiner to look into pre-bankruptcy negotiations.[3] Proving bad faith is not easy. For example, in the recent *Granite Broadcasting Corp.* case, the court rejected bad faith arguments, even though it acknowledged that the plan negotiation process was problematic.[4]

Valuation Disputes

Litigation can erupt over valuation and other issues, with dissident creditors arguing that the proposed plan provides too much value (i.e., too much equity upside) to the proposed acquirer at the expense of other stakeholders. In the *Granite Broadcasting Corp.* case, the court rejected such arguments, relying on a market check and ruling that the objecting parties had effectively conceded the debtor’s proposed valuation by failing to fund a feasible plan that would completely take out existing senior debt.[5]

Voting Rights

Except as provided by the admittedly broad “cram-down” exception,[6] the U.S. Bankruptcy Code requires a reorganization plan to be approved by a majority in the number of claims in each class entitled to vote (the “numerosity requirement”) and two-thirds in amount of the claims in such class.[7] Thus, a creditor may have a blocking position and significantly influence the plan process by holding or acquiring either (a) a majority in the number of claims in a class or (b) one-third of the amount of claims in a class.

Although the U.S. Bankruptcy Code does not bar creditors from taking blocking positions, it does permit a court to “designate” (i.e., disqualify) votes that are not cast in good faith.[8] Courts generally recognize that creditors can act in their own “enlightened self interest” in voting their claims. However, they tend to scrutinize more carefully votes cast by fiduciaries, insiders and persons who were not creditors before the bankruptcy filing.

Courts may disqualify votes where the creditor had an “ulterior motive” unrelated to protecting its interests as a creditor. Examples of ulterior motives include purchases of bankruptcy claims in order to (a) harm another creditor in an unrelated dispute, (b) destroy a competitor’s business, (c) block a higher or better sale offer in an auction process, (d) frustrate the debtor’s attempt to litigate claims against the purchaser, and (e) block a reorganization plan where the purchaser has purchased the claims at a premium above the amount to be distributed under the plan.[9]

Post-Bankruptcy Management and Governance

Investors pursuing distressed acquisition strategies frequently require operational and management changes (and perhaps board seats) in connection with any restructuring or new investment. Board members and compensation for key insiders must be disclosed in connection with approval of the plan.[10] Conflicts between stakeholders regarding post-emergence corporate governance and related issues also may need to be addressed.[11]

DIP Financing / Credit Bid

An investor can strengthen its position by also extending debtor-in-possession ("DIP") financing in bankruptcy. For example, to keep the plan process moving, a DIP credit agreement can be structured to terminate upon the debtor's failure to meet certain milestones by specific dates or upon approval of an alternative transaction. In addition, a DIP lender (like any allowed secured creditor) may be able to credit bid its claim in a bankruptcy sale.[12] DIP lending facilities must be approved by the court, which may scrutinize arrangements that unduly benefit the potential acquirer.[13]

Equitable Subordination and Recharacterization

Bankruptcy courts have authority to equitably subordinate a claim to other claims of the same class.[14] To be equitably subordinated, some courts have found that the creditor must have engaged in inequitable conduct that results in injury to other creditors (or confers an unfair advantage to the creditor).[15] A claim that is equitably subordinated will receive a distribution from the bankruptcy estate only after the other creditors in that class are paid in full.

In some cases, objecting creditors have argued that claims held by a controlling creditor should be equitably subordinated because of such creditor's bad faith conduct. Similarly, objecting creditors may attempt to recharacterize debt as equity where the creditor is also a shareholder, especially if the creditor-shareholder extended new debt immediately before the bankruptcy filing with minimal documentation. In considering such allegations, facts that courts have considered include the intent of the parties, the documentation of the transaction and other relevant facts and circumstances.[16]

Satisfying the elements for equitable subordination and recharacterization is not easy. Even so, it involves a factual analysis that can require significant discovery and litigation and, as such, is often used as a threat to encourage settlement.

Tax Attributes

Any investment should attempt to maximize any favorable tax attributes of the company. In many situations, companies experiencing financial distress may have valuable tax attributes such as federal net operating losses ("NOL") to offset future earnings. These attributes can be seriously impaired depending on how a control investment is undertaken.

In many large bankruptcy cases, the debtor will obtain an order from the bankruptcy court preserving the company's ability to utilize NOLs after emerging from bankruptcy. These NOL orders may impose restrictions on the ability of large creditors or shareholders to buy or sell claims or stock during a bankruptcy case without prior approval of the company or the court. In less draconian instances, the court does not impose such restrictions but instead requires (in limited circumstances) a sell-down of claims above a given threshold at the end of the case in order to preserve the NOLs.

* * *

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1 This article was also featured in the firm's Merger's & Acquisitions and Corporate Governance Report.

2 11 U.S.C. § 1129(a)(3).

3 *Id.* § 1104(c).

4 *In re Granite Broadcasting Corp.*, 369 B.R. 120 (Bankr. S.D.N.Y. 2007).

5 *Id.*

6 A bankruptcy court can use the "cram-down" provisions of the U.S. Bankruptcy Code to approve a plan even if not all impaired classes have voted in favor of the plan, as long as the court determines that the plan does not discriminate unfairly and is fair and equitable with respect to the rejecting classes. 11 U.S.C. § 1129(b).

7 *Id.* § 1126(c), (d). Only creditors and shareholders who are impaired by the plan and would receive a distribution under the plan are entitled to vote on the plan. Creditors and shareholders who are not impaired by the plan are presumed to accept the plan, and those who would receive no distributions are presumed to reject the plan. *Id.* § 1126(f), (g).

8 11 U.S.C. § 1126(e).

9 *See*, *e.g.*, *In re Figter Ltd.*, 118 F.3d 635 (9th Cir. 1997).

10 11 U.S.C. § 1129(a)(5).

11 *In re Fibermark, Inc.*, Case No. 04-10463, 2005 WL 859270 (Bankr. D. Vt. April 13, 2005) (discussing intercreditor disputes regarding governance).

12 11 U.S.C. § 363(k); *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006) (court permitted a secured creditor to bid the face amount of its claim, not just the secured amount).

13 11 U.S.C. § 364.

14 *Id.* § 510(c).

15 *See*, *e.g.*, *In re Papercraft Corp.*, 160 F.3d 982 (3d Cir. 1998).

16 *See*, *e.g.*, *In re Radnor Holdings Corp.*, 353 B.R. 820 (Bankr. D. Del. 2006) (denying recharacterization).

Supreme Court to Resolve Scope of Bankruptcy Code's Transfer-Tax Exemption

BY DEBORAH M. BUELL AND LUKE A. BAREFOOT

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The ability of Chapter 11 debtors to sell assets outside of a plan of reorganization and claim the transfer-tax exemption set forth in section 1146 of the Bankruptcy Code has long been a matter of dispute among the circuit courts. In those circuits that have applied the transfer tax exemption to asset sales other than under a plan of reorganization, debtors have been able to more easily obtain valuable tax savings. Now, the United States Supreme Court has granted *certiorari* in *Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 484 F.3d 1299, 1301 (11th Cir. 2007), to resolve a division among lower courts on whether the Bankruptcy Code's transfer-tax exemption applies to asset sales completed during bankruptcy, but prior to plan confirmation, commonly referred to as "363 sales", as they occur pursuant to section 363 of the Bankruptcy Code.[1] As the ability to sell assets without incurring transfer-taxes can result in significant savings, the Supreme Court's decision will figure prominently in strategic planning for both debtors and acquirers of distressed assets.

Background: Tax-Free Transfers Under Section 1146(a)

Section 1146(a) of the Bankruptcy Code provides that "the issuance, transfer or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1129 of this title, may not be taxed under any law imposing a stamp tax or similar tax."[2] Although debtors have sought to apply this provision to a variety of taxes, it principally applies to real estate transfer taxes imposed on the recording of deeds, leases or mortgages.[3] The exemption thus limits the tax consequences of bankruptcy asset sales, both facilitating the debtors' restructuring and preserving a greater share of the sale proceeds for distribution to creditors.

Some lower courts have held that the availability of this tax exemption depends on whether the asset sale occurs under a plan of reorganization. Specifically, the Bankruptcy Code offers Chapter 11 debtors two avenues for pursuing significant asset sales. Debtors can incorporate approval for asset sales (or even the sale of their entire business) into their Chapter 11 plans of reorganization pursuant to section 1123(b)(4).[4] Alternatively, subject to court authorization, debtors may sell assets at any time during their bankruptcy case under section 363.[5] Unlike plans of reorganization, 363 sales do not require solicitation of creditor votes, or resolution of the inter-creditor issues necessary to confirm a plan of reorganization, and instead are subject only to a showing of good business judgment. This 363 sale route is particularly attractive where a particular asset continues to drain resources from the estate, is a "wasting asset" that is depreciating in value, or is an asset not needed for the reorganized entity's expected business strategy. Pursuing piecemeal asset sales prior to confirmation may also enable a debtor to build the necessary funds and support from creditor constituencies to proceed with a reorganization plan.

However, whether pre-confirmation 363 sales are entitled to 1146(a)'s tax benefit remains an open question. State attorneys general – eager to preserve transfer tax revenues – have taken the firm position that under the plain text of the Bankruptcy Code, an asset sale must be authorized by a confirmed plan of reorganization to qualify for the 1146 exemption.[6] Under this interpretation, any transfers made pursuant to a confirmed plan would qualify for the exemption, regardless of their centrality to the debtors' reorganization efforts. By contrast, parties to distressed asset sales have advocated a broader position, under which 1146(a) applies whenever the asset sale is somehow necessary to plan confirmation. By redirecting the focus to the role the asset transfer plays in enabling the debtor's reorganization, this more expansive reading would eliminate any focus on the temporal relationship between the sale and confirmation.[7] To date, neither position has garnered a clear majority among courts.

The Piccadilly Case

The narrow issue before the Supreme Court focuses on the meaning of the statutory phrase "under a plan confirmed" – in particular, whether it extends to pre-confirmation asset sales made in contemplation of a plan that is later confirmed.

In *Piccadilly*, the debtor executed an agreement for the sale of substantially all of its assets, and the following day, filed its Chapter 11 petition along with a motion requesting authorization to consummate the sale under section 363(b), subject to a higher and better offer. The sale motion sought to apply the transfer-tax exemption in section 1146. The Bankruptcy Court for the Southern District of Florida established an auction process, at which a substantially higher bidder prevailed. Over an objection from state taxing authorities, the Bankruptcy Court approved the resulting sale, with the requested section 1146 exemption. Approximately one week after the sale closed, the debtor then filed its Chapter 11 plan of liquidation. The state taxing authorities objected to that plan and commenced an adversary proceeding seeking a declaration that the debtor's asset sale was not exempt from approximately $40,000 in stamp taxes. The Bankruptcy Court confirmed the plan and granted summary judgment to the debtor, holding that because the sale was necessary to later consummate the plan, it qualified for the transfer tax exemption.[8] The District Court affirmed, agreeing with the Bankruptcy Court's analysis.[9]

The three federal circuit courts to have squarely addressed the question are divided. While the Third and Fourth Circuits have rejected application of section 1146(a) to pre-confirmation transfers, in *Piccadilly*, the Eleventh Circuit held that the exemption can apply where the transfer is necessary to confirmation of a plan.[10] This division among authorities is hardly limited to the circuit courts, as lower courts also have reached contrary conclusions on section 1146's application to pre-confirmation transfers.[11]

The first appeals court to squarely address the issue, the Fourth Circuit in *In re NVR, L.P.*, 189 F.3d 442, 457 (4th Cir. 1999), employed a textual approach, relying on dictionary definitions to conclude that pre-confirmation transfers could not be "under" (e.g., subordinate to, or authorized by) "something that did not exist at the date of the transfer – a plan confirmed by the court." In a similar vein, while the Third Circuit did find some ambiguity in the statutory text, it also held that the most natural reading required that the plan provide authorization for the asset transfers to benefit from the tax exemption. *See In re Hechinger Inv. Co. of Del., Inc.*, 335 F.3d 243, 253 (3d Cir. 2003). Both the Third and Fourth Circuit decisions also relied upon the canons of statutory construction that favor narrow interpretation of tax exemptions and of federal laws that interfere with state taxation schemes. *See NVR*, 189 F.3d at 457; *Hechinger*, 335 F.3d at 254.

The Eleventh Circuit's decision flatly rejects the reasoning of its sister circuits, holding that section 1146 may apply to pre-confirmation transfers where there is a sufficient nexus between the pre-confirmation sale and the confirmed plan. Finding the statutory text ambiguous, the *Piccadilly* decision reasoned that elsewhere when Congress intended to place temporal restrictions in the Bankruptcy Code, it did so expressly. The Court interpreted the absence of such express "post-confirmation" language in section 1146 as intentional.[12] The *Piccadilly* panel agreed with lower court decisions that distinguishing between pre- and post-confirmation transfers fails to account for the practical realities of a debtor's reorganization.

Notably, the *Piccadilly* decision did not decide whether section 1146 was properly applied by the bankruptcy court to the facts of the case, but decided instead only the narrow issue of whether the exemption *could* apply to pre-confirmation transfers generally. The Eleventh Circuit thus left "for another day an attempt to set forth a framework for determining the circumstances under which section 1146(c)'s tax exemption may apply to pre-confirmation transfers." *Piccadilly*, 484 F.3d at 1305. Nonetheless, on petition by state taxing authorities, the Supreme Court granted review in December 2007.

Prospects Going Forward

On March 26, 2008, the Supreme Court heard oral arguments in the *Picadilly* case. The Supreme Court's decision will almost certainly resolve the present split in authorities and eliminate 1146(a) as a factor in debtors' venue-selection analysis. If the Supreme Court adopts the Eleventh Circuit's position, it could provide debtors with the flexibility to sell assets at the most financially advantageous time, while preserving the benefit of the section 1146 tax exemptions. Should the Court instead hold that the exemption applies only to sales provided for and consummated through plan confirmation, debtors and their advisors will need to weigh the financial benefits of building significant asset sales into a plan of reorganization (where such tax savings may be passed on to the debtor) against the need to sell assets pre-confirmation to maximize creditor recoveries.

* * *

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1 *See Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 128 S. Ct. 741 (2007) (granting petition for writ of certiorari).

2 Now codified at 11 U.S.C. § 1146(a), this section – in its present textual form – was designated as section 1146(c) prior to effectiveness of the 2005 Bankruptcy Code amendments.

3 While beyond the scope of this article, it is worth noting that the scope of the exemption is itself often the subject of litigation. *See generally*, Karen Cordry, *The Incredible Expanding Section 1146(c)*, 21 Am. Bankr. Inst. J. 10 (Dec/Jan. 2003) (noting that while courts have not endorsed this expanded scope, debtors commonly file proposed sales motions that apply section 1146 to sales, use and gains taxes).

4 *See* 11 U.S.C. §1123(b).

5 *See* 11 U.S.C. §363(b).

6 Indeed, attorneys general from twenty states and Puerto Rico submitted an *amicus* brief to the Supreme Court in support of *certiorari*, arguing that the Eleventh Circuit's decision jeopardized billions of dollars in local and state tax revenue.

7 *See, e.g.*, *In re Webster Classic Auctions, Inc.*, 318 B.R. 216, 219 (Bankr. M.D. Fla. 2004) (adopting broader interpretation of the 1146 exemption, reasoning that "inserting an artificial preconfirmation v. postconfirmation line of demarcation into the §1146(c) analysis fails to recognize the complexities the reorganizing debtor often faces").

8 Though the Bankruptcy Court's decision is unreported, the Eleventh Circuit's opinion explains the course of proceedings below. *See generally*, *Piccadilly*, 484 F.3d at 1301.

9 *Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 379 B.R. 215 (S.D. Fla. 2006).

10 In a related decision, the Second Circuit held that the section 1146 tax exemption applied to an asset sale that took place *after* confirmation of a plan, where the plan did not specifically provide for the sale. *See In re Jacoby-Bender*, 758 F.2d 840 (2d. Cir. 1985). While the Eleventh Circuit relied on *Jacoby-Bender* in support of its broad reading of section 1146, *Jacoby-Bender* involved a transfer made subsequent to plan confirmation, and thus does not squarely address section 1146's application to pre-confirmation transfers.

11 *Compare, e.g.*, *In re Beulah Church of God in Christ Jesus, Inc.*, 316 B.R. 41 (Bankr. S.D.N.Y. 2004) (sale qualifies for tax exemption where the sale is in view of and integral to a plan) *with States of Wash. & Ill. v. Nat'l Steel Corp. (In re Nat'l Steel Corp.)*, No. 03-3932, 2003 U.S. Dist. LEXIS 15695 (N.D. Ill. Sept. 8, 2003) (unambiguous statutory text dictates that plan must be officially confirmed at the time of sale in order for section 1146 tax exemption to apply) *and N.Y. City Dep't of Fin. V. 310 Assocs., L.P. (In re 310 Assocs., L.P.)*, 282 B.R. 295, 300-01 (S.D.N.Y. 2002) (transfer completed when plan had not even been drafted was not exempt).

12 *Piccadilly*, 484 F.3d at 1303.

Payments Made Pursuant to Private Leveraged Buyout Transactions are Settlement Payments that are Protected from Avoidance Actions Under Section 546(e) of the Bankruptcy Code

BY JULIET A. DRAKE

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On December 21, 2007, the United States District Court for the Western District of Michigan issued an opinion holding that transfers of cash and stock to shareholders to effectuate a private leveraged buyout were protected transfers that under section 546(e) of the Bankruptcy Code could not be voided as fraudulent transfers. *QSI Holdings, Inc. v. Alford*, 382 B.R. 731 (W.D. Mich. 2007). This decision is the first to address the question in the Sixth Circuit of whether section 546(e)'s protections apply to leveraged buyouts involving privately held shares of stock, and aligns the Sixth Circuit, at least at the District Court level, with the broad interpretation of 546(e) adopted by the Third, Ninth and Tenth Circuit Courts of Appeals.

The facts of the *QSI Holdings* case are straightforward. In 1999, Quality Stores, Inc. and certain of its principal shareholders entered into a merger agreement with Central Tractor Farm and Country, Inc. and its parent, CT Holdings, Inc. (collectively the "CT Parties").[1] Under the merger agreement, Quality Stores merged into Central Tractor and its shareholders were paid for their equity interests in Quality Stores in cash or CT Holding's stock.[2] The cash and shares were transferred by CT Holdings to HSBC Bank USA, as exchange agent.[3] HSBC collected stock from individual shareholders and then transferred the stock to the CT Parties and the cash or shares in CT Holdings to the individual shareholders.[4]

Some of the shareholders who were bought out in the leveraged buyout were employees of Quality Stores (including many lesser paid and mid-level employees) who owned Quality Stores' shares under an Employee Stock Ownership Trust (the "ESOT").[5] The ESOT stock was held for the most part by LaSalle Bank.[6] Therefore, for these shareholders, to achieve the leveraged buyout, LaSalle transferred the stock to HSBC and received cash consideration from HSBC.[7] The ESOT was eventually terminated and the cash distributed to the employees.[8]

The merged company did not thrive, however, and filed for bankruptcy on November 1, 2001, along with an affiliate, QSI Holdings, Inc.[9] On October 31, 2003, the debtors sued 170 of the former shareholders, alleging that the monies and stock paid to the shareholders as consideration for the leveraged buyout were fraudulent conveyances that should be voided and repaid to the debtors.[10] Various shareholders moved for summary judgment, arguing that the consideration paid to them could not be recovered by the debtors because section 546(e) of the Bankruptcy Code exempts such transactions from avoidance.[11] The United States Bankruptcy Court for the Western District of Michigan granted the shareholders' motion for summary judgment on those grounds. *QSI Holdings, Inc. v. Alford* (*In re Quality Stores, Inc.*), 355 B.R. 629 (Bankr. W.D. Mich. 2006). The debtors subsequently appealed to the District Court.

Section 546(e) of the Bankruptcy Code states, in relevant part, that "the trustee may not avoid a transfer that is a . . . settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a . . . financial institution . . . except under section 548(a)(1)(A) of this title." 11 U.S.C. § 546(e).[12] The key issue in the *QSI Holdings* case, therefore, was whether the payments of cash and stock to Quality Stores' shareholders were settlement payments under section 546(e). Two other arguments were made by the debtors, namely that the transfers were not made "by" a "financial institution" and thus did not quality for protection under section 546(e) and that the potential for abuse mandated that the District Court limit the application of 546(e) to transactions involving publicly traded securities only.

A. Settlement Payments

The term "settlement payment" is defined under section 741 of the Bankruptcy Code to mean "a preliminary settlement payment, a partial settlement payment, an interim settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. § 741(8).[13] While

the definition is facially broad, parties have disputed the scope of transactions covered and, as a result, there have been several decisions addressing whether the transfer of shares and cash pursuant to private securities transactions such as leveraged buyouts constitutes a settlement payment that falls within the statutory safe harbor. *See, e.g., Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.)*, 366 B.R. 318 (Bankr. D. Del. 2007) (holding that the protections of 546(e) extended to shares of privately held corporations purchased pre-petition by debtor) (on appeal to the United States District Court for the District of Delaware), *but see Official Comm. of Unsecured Creditors of Norstan Apparel Shops, Inc. v. Lattman (In re Norstan Apparel Shops, Inc.)*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007). In the *QSI Holdings* case, the District Court affirmed the Bankruptcy Court's ruling and held that the term "settlement payment" is defined broadly enough to include payments made pursuant to private leveraged buyouts.

In reaching this decision, the District Court relied primarily upon the plain language of the statute. While concluding that the language "lacked sufficient definition to determine precisely what constitutes a 'settlement payment' in any specific context,"[14] the District Court noted that the purpose of section 546(e) was "to protect the nation's financial markets from the instability caused by the reversal of settlement securities transactions"[15] and that this purpose was facilitated when private transactions such as the leveraged buyout at issue in the *QSI Holdings* case were protected by section 546(e).

The debtors argued that the 546(e) exemption for settlement payments is limited to publicly traded securities and that the payment for privately held stock transferred as part of a leveraged buyout is not a settlement payment "commonly used in the securities trade," as required by section 546(e). The debtors also argued that the statutory definition of "settlement payment" is inherently ambiguous, and thus the court should look beyond the language of the statute to determine legislative intent. Finally, the debtors argued that even if the language is not ambiguous, the application of section 546(e) to private leveraged buyouts would lead to an absurd result. Therefore, the debtors reasoned, section 546(e) should not apply to the transaction at hand. The District Court rejected all of these arguments.

First, the District Court noted that the plain language of the statute does not limit the exemption to transactions involving only publicly traded securities.[16] Second, the District Court held that "[b]ecause the securities industry generally defines settlement as 'the completion of a securities transaction,' interpreting 'settlement payment' to include the transfer of consideration in an LBO is consistent with the securities industry definition of 'settlement.'"[17] Third, the District Court held that the statutory language was not ambiguous, but rather was simply broad, noting that "Congress chose an inclusive, rather than exclusive, definition" of settlement payments.[18] Finally, the District Court disagreed with the debtors' conclusion that application of section 546(e) to the circumstances of the case at hand would lead to an absurd result, suggesting that the equities favored the 170 Quality Stores' shareholders, "many of whom were mid- and lower-level ESOT employee-shareholders, whose stock payments would be voided in favor of the creditors."[19]

B. Transfers Made by a Financial Institution

The District Court also rejected the debtors' argument that the settlement payments were not protected under section 546(e) as transfers made "by" a "financial institution" because HSBC, the disbursing agent, never acquired a beneficial interest in the leveraged buyout consideration.[20] The District Court relied again on the plain language of the statute, which contains no such requirement, as the basis for its rejection of this argument. The District Court disagreed with an Eleventh Circuit decision cited by the debtors, *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996), in which a divided court required that a financial institution acquire a beneficial interest in the leveraged buyout consideration for the 546(e) exemption to apply. The District Court instead adopted the reasoning of the Bankruptcy Court that "courts may not impose policy limitations not expressly stated in the statute."[21]

C. Potential for Abuse Unpersuasive

Finally, the debtors argued that section 546(e) would be abused if the District Court were to hold that payments made pursuant to private leveraged buyouts were protected by its safe harbor. The District Court was unpersuaded and noted that "a statutory safety valve" existed to prevent troubled companies from "[cashing]-out their shareholders before bankruptcy, to the detriment of [creditors]."[22] Specifically, the District Court relied on the fact that a settlement payment must be "commonly used in the securities trade" to qualify for protection under section 546(e),[23] and that it is unlikely that "a transaction that is a clear abuse of the exemption could be said to be commonly used in the securities trade."[24]

The *QSI Holdings* case therefore is an interesting addition to the case law on the scope of the "settlement payment" exception,

codified in section 546(e) of the Bankruptcy Code, to the bankruptcy trustee's general powers to void pre-bankruptcy transfers by a debtor to third parties. Consistent with decisions in other contexts, it reaffirms a broad reading of the Bankruptcy Code safe harbor and the protections afforded thereunder to counterparties engaging in transactions with distressed companies. Quality Stores, Inc. and QSI Holdings, Inc. have appealed the District Court decision to the United States Court of Appeals for the Sixth Circuit, where briefing is expected to be completed by June 9, 2008.

* * *

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1 *QSI Holdings* at 734.

2 *Id.*

3 *Id.* at 735.

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.*

12 Both the 2005 and 2006 amendments to the Bankruptcy Code amended section 546(e). Although the amendments did not alter the language at issue in the *QSI Holdings* case, the application of section 546(e), as amended, to the facts of this case is outside the scope of this article and was specifically reserved by the District Court. In addition, the section 548(a)(1)(A) exception referred to in section 546(e) applies to intentional fraudulent transfers, which were not at issue in this case.

13 The definition of the term "settlement payment" under section 101 of the Bankruptcy Code relates only to forward contracts and thus was not at issue in the *QSI Holdings* case. 11 U.S.C. § 101(51A).

14 *QSI Holdings* at 739.

15 *Id.* at 737 (citing *Enron Corp. v. Credit Suisse First Boston Int'l (In re Enron Corp.)*, 328 B.R. 58, 66 (Bankr. S.D.N.Y. 2005)).

16 *QSI Holdings* at 741.

17 *Id.* (internal citations omitted)

18 *Id.*

19 *Id.* at 742.

20 *Id.*

21 *Id.*

22 *Id.* at 743.

23 *Id.*

24 *Id.*

Ninth Circuit Bankruptcy Appellate Panel Weighs in on Rights of Unsecured Creditors to Receive Contractual Postpetition Attorneys' Fees

BY JANE KIM

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On December 19, 2007, the United States Bankruptcy Appellate Panel of the Ninth Circuit Court of Appeals (the "Bankruptcy Appellate Panel" or the "Panel") issued an important ruling addressing the question left open by the recent Supreme Court decision in *Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Elec. Co.*, 127 S.Ct. 1199 (2007) of whether an unsecured creditor may include attorneys' fees incurred postpetition as part of its unsecured claim. The Bankruptcy Appellate Panel held that unsecured creditors can recover postpetition attorneys' fees, as provided by contract, on their claims. This question is also pending before the Ninth Circuit Court of Appeals in the *Travelers* proceeding, where the Supreme Court remanded it for resolution.

In *Centre Insurance Company v. SNTL Corp. (In re SNTL Corp.)*, 380 B.R. 204 (B.A.P. 9th Cir. 2007), Centre Insurance Company ("Centre"), an unsecured creditor, asserted a claim for $110 million (plus postpetition attorneys' fees) against debtor SNTL Corporation (f/k/a Superior National Insurance Group) ("SNIG") relating to SNIG's guarantees of obligations of SNIG's affiliates under certain reinsurance and other agreements.

Prior to SNIG's bankruptcy proceedings, in 1999, SNIG's affiliates defaulted on certain of their obligations under various agreements with Centre guaranteed by SNIG, and Centre asserted a claim for $180 million. On December 31, 1999, Centre, SNIG and the relevant affiliates entered into the Partial Commutation and Settlement Agreement (the "PCSA") under which Centre's claim was resolved. Under the PCSA, SNIG's affiliates made a $163.4 million payment to Centre and Centre released the affiliates as well as SNIG as guarantor, for amounts up to $180,000,000. The PCSA also provided that Centre's release of SNIG could be revoked in the event that a court "enters a final order, judgment, or other finding that . . . the [payment] of $163,400,000 . . . constitutes a voidable or preferential transfer . . . or the payment is otherwise in violation of law or subject to a claim or [sic] preference."[1]

Three months later, the Insurance Commissioner for the State of California (the "Commissioner") placed certain of SNIG's insurance affiliates into conservation, followed by liquidation. The next month, SNIG and certain of its non-insurance affiliates filed for relief under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the Central District of California (the "Bankruptcy Court"). Centre filed a proof of claim in the SNIG bankruptcy on November 13, 2000. In the proof of claim, which sought a total of $294,488,911, Centre stated that "SNIG's liability as guarantor was for amounts 'in excess of $180,000,000' and reserved the right to seek additional amounts if any portion of the [$163,400,000] was 'deemed void or avoidable'."[2]

In January 2002, the Commissioner filed a complaint in state court against Centre seeking the return of the $163.4 million payment as a voidable preference under state law. Centre ultimately agreed to settle the state court action by returning $110 million of the payment it had received from SNIG's affiliates to the Commissioner. The settlement agreement with the Commissioner, which was approved by the state court on February 17, 2005, made clear that the payments made thereunder were on account of the Commissioner's claims challenging the prior settlement payment as a preferential transfer.[3]

Approximately one month after settling with the Commissioner, Centre amended its proof of claim against SNIG. Although the amended claim did not specifically mention the avoidance action that had just settled, Centre asserted that the amended claim could include the $110 million payment as well as postpetition attorneys' fees.[4] The litigation trustee, who was appointed pursuant to the debtors' confirmed plan of reorganization to prosecute certain claims and objections to proofs of claim, objected to Centre's claim in four respects: (1) Centre's claim arising from SNIG's guaranty had been released prepetiton and could not be revived because Centre had not obtained a judicial finding or judgment that the $163.4 million payment constituted a preferential transfer as required under the PCSA, (2) Centre's claim could not be revived under the terms of the PCSA because Centre's subsequent payment to the Commissioner of the $110 million had been voluntary, (3) Centre's claim was not contingent but instead was extinguished prepetition under the release, and any revival

based on the settlement with the Commissioner would give rise to a claim based on a postpetition event that was disallowed under section 502(b) of the Bankruptcy Code, and (4) Centre was an unsecured creditor and, as such, could not assert a claim for attorneys' fees incurred postpetition.

On a motion by the trustee for partial summary judgment, the Bankruptcy Court held that Centre's release of SNIG became effective prepetition and that any attempt by Centre to revive its claim under the guaranty pursuant to its settlement agreement with SNIG occurred postpetition and therefore was not allowable under Bankruptcy Code section 502(b). The Bankruptcy Court also disallowed Centre's claim for postpetition attorneys' fees. On appeal, the Bankruptcy Appellate Panel reversed the Bankruptcy Court's order and remanded the case for a determination of the amount of attorney's fees to which Centre was entitled under the relevant contracts and state law.

Attorneys' Fees

The most notable issue addressed by the Bankruptcy Appellate Panel in the *Centre* decision was whether unsecured creditors are entitled to postpetition attorneys' fees under the Bankruptcy Code, if the relevant contracts allow it. This issue was left undecided by the recent Supreme Court *Travelers* case, and was remanded to the Ninth Circuit Court of Appeals for resolution.[5] The Bankruptcy Appellate Panel identified four primary arguments made by the trustee: (1) whether section 506(b) of the Bankruptcy Code disallows such claims, (2) whether section 502(b) of the Bankruptcy Code disallows such claims because they were not fixed as of the petition date, (3) whether the Supreme Court's decision in *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988), precludes allowance of such claims, and (4) whether public policy favors disallowance of such claims.

First, the Bankruptcy Appellate Panel found that section 506(b) of the Bankruptcy Code, which expressly permits oversecured creditors to make claims for postpetition attorneys' fees,[6] does not specifically limit the entities who can seek postpetition attorneys' fees to those holding oversecured claims, but rather leaves open the possibility that unsecured creditors may seek to include postpetition fees in their claims.[7]

Second, the Panel found that nothing in the Bankruptcy Code precluded an unsecured creditor from seeking postpetition fees, and that the postpetition fees at issue here were fairly and reasonably contemplated (since they were based on a prepetition contract that provided for attorneys' fees), satisfied the Ninth Circuit's "fair contemplation" test under section 502(b), and therefore were an allowable contingent claim under section 502(b) of the Bankruptcy Code.[8]

Third, the court determined that the rationale adopted in *Timbers*, in which the Supreme Court concluded that undersecured creditors could not receive postpetition interest on the unsecured portion of their debt, *Timbers*, 484 U.S. at 380, was not applicable to the issue of whether unsecured creditors were permitted to assert claims for postpetition attorneys' fees. The court found instead that the holding of *Timbers* was consistent with section 502(b)(2) of the Bankruptcy Code, which disallows claims for unmatured interest, but that "[i]nasmuch as section 502(b) does not contain a similar prohibition against attorneys' fees, the comparison between the current issue and that presented in *Timbers* is not persuasive."[9]

Finally, the Bankruptcy Appellate Panel did not address the public policy arguments of the parties as to whether such fees should be allowable, since it concluded that the Bankruptcy Code answered the question at hand by not specifically disallowing postpetition attorneys' fees of unsecured creditors.[10] The Panel therefore remanded the case to the Bankruptcy Court to determine whether Centre had satisfied the requirements of the relevant contracts and state law for allowance of its claim for postpetition attorneys' fees.

SNIG's Guaranty

The Bankruptcy Appellate Court also reversed the Bankruptcy Court decision by allowing Centre's guaranty claim against SNIG to be revived. In its ruling, the Bankruptcy Appellate Panel differed from the Bankruptcy Court in its reading of the contract as well as its interpretation of the relevant Bankruptcy Code provisions and precedents involving the settlement of preference claims.

First, the Bankruptcy Appellate Panel focused on the particular language of the PCSA to determine whether a contractual triggering event had occurred that would permit the revival of Centre's claims against SNIG under SNIG's guaranty. The Bankruptcy Appellate Panel agreed with Centre that the state court order approving the settlement between Centre and the Commissioner constituted a "final order, judgment, or other finding" that the $163.4 million payment at issue was "subject to" a preference claim, and thus triggered the provision in the PCSA that permitted Centre to revive its claims, even though the settlement agreement that the state court approved did not contain an express finding of liability on the preference claim.[11]

Second, the Bankruptcy Appellate Panel found that the payment to the Commissioner of $110 million by Centre constituted a return of a preferential payment that revived Centre's claim against SNIG as guarantor. The Bankruptcy Appellate Panel relied on the general principle set forth in caselaw and other secondary materials that when a creditor is forced to refund a preferential payment, a guarantor's liability is revived. Specifically, the Bankruptcy Appellate Panel relied on a case from the Tenth Circuit Court of Appeals, *Lowrey v. Mfrs. Hanover Leasing Corp. (In re Robinson Drilling, Inc.,)*, 6 F.3d 701, 704 (10th Cir. 1993), for the proposition that "guarantors must make good on their guaranties following avoidance of payments previously made by their principal debtors."[12] The Bankruptcy Appellate Panel also cited to the *Restatement (Third) of Suretyship and Guaranty* and the *Corpus Juris Secundum* on *Principal and Surety*. It then rejected the trustee's contention that the repayment of the preference must be involuntary or "forced" for the principle to apply, and instead agreed with a decision from the Sixth Circuit Court of Appeals, *Wallace Hardware Co. v. Abrams*, 223 F.3d 382, 408-09 (6th Cir. 2000), which held that when an obligee returns a payment as part of a settlement of a preference avoidance action, the guarantor is not discharged of its obligation to pay the debt.[13] The Panel noted that this result allowed a creditor to avoid the costs of litigating a preference action to conclusion (and potentially being found liable for the full amount of a payment, as opposed to settling for partial payment) before receiving the benefit of a guaranty.[14]

Third, the Bankruptcy Appellate Panel held that the postpetition revival of Centre's guaranty claim against SNIG gave rise to a prepetition claim allowable under section 502(b) of the Bankruptcy Code. The Panel found that as of the petition date, Centre held a contingent claim against SNIG because its claim under the guaranty was subject to revival once the conservation action by the Commissioner was filed prepetition by SNIG's affiliates. Once the conservation action was filed, the Panel reasoned, the potential preference action later brought by the Commissioner was possible.[15] The Bankruptcy Appellate Panel noted that before the petition date, the parties to the PCSA had provided that Centre could revoke the release contained in the PCSA in the event of a finding that the $163.4 million payment was subject to a preference claim.[16] The Bankruptcy Appellate Panel held that under section 502(b)(1) of the Bankruptcy Code, "those contingent claims cannot be disallowed simply because the contingency occurred postpetition."[17] Noting that under the Ninth Circuit's "fair contemplation test," a claim arises under section 502(b) "when a claimant can fairly or reasonably contemplate the claim's existence even if a cause of action has not yet accrued under nonbankruptcy law,"[18] the Bankruptcy Appellate Panel found that in light of the prepetition commencement of the conservation action, a preference action by the Commissioner could have been fairly and reasonably contemplated by SNIG and Centre.

This case is noteworthy because the Bankruptcy Appellate Panel decision concerning attorneys' fees may be predictive of the position taken by the Ninth Circuit Court of Appeals, and also because of the scarcity of decisions addressing whether guarantees can be revived postpetition. The *Centre* decision has been appealed by SNIG and its affiliates to the Ninth Circuit Court of Appeals.

* * *

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1 *Centre*, 380 B.R. at 209.

2 *Id.* at 210.

3 *Id.*

4 The underlying agreements between Centre and SNIG and its affiliates provided for recovery of all reasonable expenses, including attorneys' fees, incurred by Centre in the enforcement of SNIG's guaranty. *Id.* at 208.

5 Although the Panel noted that that issue was currently before the Ninth Circuit in a separate matter, having been remanded from the Supreme Court, *Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Elec. Co.*, __ U.S. __, 127 S.Ct. 1199, 1207-08 (2007), the Panel determined that it would answer the question itself rather than delay the appeal at hand. *Centre* at 217. The Panel gave the following three reasons for not waiting for the Ninth Circuit's decision in *Travelers*: "First, we owe it to the parties to decide cases before us promptly. Second, our decision is subject to review by the Ninth Circuit. Third, we believe the Ninth Circuit values the views of the Bankruptcy Appellate Panel on bankruptcy issues." *Id.* at 217, n.14 (citing *Sigma Micro Corp. v. Healthcentral.com (In re Healthcentral.com)*, 504 F.3d 775, 784 n.3 (9th Cir. 2007)).

6 11 U.S.C. § 506(b).

7 *Centre* at 219 (citing *Joseph F. Sanson Inv. Co. v. 268 Ltd. (In re 268 Ltd.)*, 789 F.2d 674, 678 (9th Cir. 1986)).

8 *Centre* at 221.

9 *Id.* at 222 (citing *New Power*, 313 B.R. at 510; *Gencardelli*, 501 F.3d at 6, n.2).

10 *Centre* at 222.

11 *Id.* at 212.

12 *Id.* at 213.

13 *Id.* at 215.

14 *Id.*

15 *Id.*

16 *Id.* at 216.

17 *Id.* Section 502(b)(1) provides that a claim is not allowable if it is unenforceable under applicable agreement or law "for a reason other than because such claim is contingent or unmatured." 11 U.S.C. § 520(b)(1).

18 *Centre* at 216-217 (citing *Cool Fuel, Inc. v. Bd. Of Equalization (In re Cool Fuel, Inc.)*, 210 F.3d 999, 1007 (9th Cir. 2000)).

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Iida

On September 26, 2007, the United States Bankruptcy Appellate Panel for the Ninth Circuit issued a decision in the Chapter 15 case of *Iida v. Kitahara* (*In re Iida*), 377 B.R. 243 (B.A.P. 9th Cir. 2007) clarifying the rights and duties of foreign bankruptcy trustees acting as shareholders in the United States outside of the parameters of Chapter 15.

In *Iida*, a Japanese citizen, Katsumi Iida, filed for bankruptcy in Japan and a trustee was appointed by the Japanese court. The Japanese debtor indirectly owned three Hawaiian corporations, which in turn owned several luxury hotels in Hawaii. The Japanese trustee, acting as sole shareholder of the Hawaiian corporations, restructured their management and sought to sell one of the luxury hotels. Mr. Iida, now a former director of the Hawaiian corporations, filed a declaratory judgment lawsuit in Hawaiian state court against the Japanese trustee, seeking reinstatement as director and to enjoin the distribution of the proceeds from sales of assets of the Hawaiian corporations.

In response, the Japanese trustee filed a chapter 15 proceeding seeking recognition of the Japanese bankruptcy proceeding, removing the declaratory judgment proceeding to the bankruptcy court and seeking to dismiss the declaratory judgment proceeding. In the chapter 15 proceeding, Mr. Iida contended that the Japanese trustee did not have the authority to act as the sole shareholder of the Hawaiian corporations in the restructuring of management and sale of the hotel because the trustee did not first obtain an order from a United States Court permitting him to act in that capacity. The Bankruptcy Appellate Panel held that neither the Bankruptcy Code nor Hawaiian state law required the trustee to seek a U.S. Court order before exercising ownership rights over the Hawaiian corporations, when the trustee was acting pursuant to valid Japanese court orders.

Premier

On June 15, 2007, the United States Court of Appeals for the Fourth Circuit issued a decision in *Maryland Port Admin. v. Premier Auto. Servs., Inc.* (*In re Premier Auto. Servs., Inc.*), 492 F.3d 274 (4th Cir. 2007) concerning bad faith bankruptcy filings. In *Premier*, the Fourth Circuit concluded that a bankruptcy petition had been filed in bad faith and should be dismissed when the debtor filed the petition just before it was to be evicted from a six and one half acre plot of waterfront land that it had leased pursuant to an expired commercial lease. Specifically, the Fourth Circuit noted that Premier leased the waterfront property in Baltimore, Maryland from a Maryland state agency. Premier had leased the property for its import-export business for over forty years and had built a 27,500 square foot building on the property. Premier's lease expired in June 2002 and, despite extensive negotiations, the parties were unable to agree on the terms of a new lease over the next several years. The Maryland agency therefore leased the property to another entity and notified Premier that its month-to-month tenancy would terminate May 1, 2005. On April 29, 2005, Premier filed a chapter 11 petition, invoking the automatic stay to prevent the eviction.

The Bankruptcy Court found that the petition had been filed in bad faith, for the sole purpose of halting or delaying Premier's eviction, and dismissed the petition. The Fourth Circuit affirmed the Bankruptcy Court's decision, finding substantial evidence supporting the Bankruptcy Court's ruling. First, the Fourth Circuit agreed that Premier had no realistic possibility of an effective reorganization, since it had no property interest in the expired lease that could be addressed by the Bankruptcy Court. Second, the Fourth Circuit found that Premier was not motivated by an honest intent to reorganize and was not even experiencing financial difficulties.

Capitol Food

On June 6, 2007, the United States Court of Appeals for the First Circuit issued a decision in *Fields Station LLC v. Capitol Food Corp. of Fields Corner* (*In re Capitol Food Corp. of Fields Corner*), 490 F.3d 21 (1st Cir. 2007) also concerning bad faith bankruptcy filings, although reaching a different result. In *Capitol Food*, the First Circuit examined facts similar to the facts of *Premier*, and concluded that no prima facie showing had been made that the chapter 11 petition submitted by Capital Food was filed in bad faith. Specifically, according to the First Circuit, Capitol Food filed its bankruptcy petition the day before it would have been required to forfeit its leasehold in order to obtain time within which to obtain necessary permits so that it could cure a non-monetary default under the lease for a food market in which it was a lessee paying well below prevailing market rates. Within two weeks of its chapter 11 filing, Capitol Food had obtained the necessary permits and reopened the food market, thereby preserving its lucrative leasehold. The First Circuit refused to consider what would otherwise have been an issue of first impression in the Circuit: whether the Bankruptcy Code contains a requirement that bankruptcy petitions be filed in good faith.

However, even though the First Circuit refused to decide whether a review of the good faith nature of a bankruptcy filing is required under section 1121(b) of the Bankruptcy Code, the First Circuit did find that were such a review required, the facts at hand did not establish a prima facie showing that Capitol Foods filed in bad faith. The First Circuit primarily based its conclusion on the rationale that debtors do not need to be insolvent at the time of a filing of a chapter 11 petition. Rather, according to the First Circuit, a debtor need only be experiencing some kind of imminent financial distress, in this case the threatened foreclosure on the debtor's interests in real property. The First Circuit also noted that Capitol Food's unsecured creditors were likely to have benefited from Capitol Food's successful reorganization.

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