FOR CHAPTER 11 PRACTITIONERS –

SOME INTERESTING CASES

THAT HAVE NOTHING TO DO WITH BAPCPA[1]

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[1] Also not included are cases reported prior to April 1, 2005 (with one exception), or cases in areas covered in other 2006 SBLI presentations.

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Central Virginia Community College v. Katz, 126 S. Ct. 990 (Jan. 23, 2006)

States surrendered sovereign immunity in the Bankruptcy Clause of the U.S. Constitution

This case involves an adversary proceeding by the bankruptcy trustee of a bookstore against Virginia state colleges to avoid and recover alleged preferences under sections 547(b) and 550(a).[2] In a 5-4 decision (penned by Justice Stevens and joined by Justices O'Connor, Souter, Ginsburg and Breyer), the United States Supreme Court held that "a proceeding initiated by a bankruptcy trustee to set aside preferential transfers by the debtor to state agencies is not barred by sovereign immunity." Id. at 994. Even more broadly, the Supreme Court determined that "[i]n ratifying the Bankruptcy Clause [of Article I of the U.S. Constitution], the States acquiesced in a subordination of whatever sovereign immunity they might otherwise have asserted in proceedings necessary to effectuate the in rem jurisdiction of the bankruptcy courts." Id. at 1005. Thus, the Court reached its conclusion based on the effect of the Bankruptcy Clause and not on whether Congress validly abrogated state sovereign immunity in section 106(a). In making its determination, the Court reviewed the history of the Bankruptcy Clause, including English law, early American cases and the Bankruptcy Act of 1800 (which granted "federal courts the authority to release debtors from state prisons"). Id. at 1004. The Court also acknowledged the error in its assumption, articulated in both the majority and dissenting opinions in Seminole Tribe v. Florida, 517 U.S. 44, 117 S. Ct. 1114 (1996), that its holding in that case with respect to sovereign immunity and the [Interstate and Indian Commerce Clauses of Article I of the U.S. Constitution] applies to the Bankruptcy Clause, as follows: "Careful study and reflection have convinced us . . . that that assumption was erroneous." 126 S. Ct. at 996.

The dissent (written by Justice Thomas and joined by Chief Justice Roberts and Justices Scalia and Kennedy) asserts that the majority "casts aside . . . long-established principles" of sovereign immunity – that "the States are not subject to suit by private parties for monetary relief absent their consent or a valid congressional abrogation" – without justification "by the text, structure, or history of our Constitution" (id. at 1005-06), and that its "decision . . . cannot be reconciled with our established sovereign immunity jurisprudence, which the majority does not purport to overturn" (id. at 1007).

[2] References herein to a "section" or "sections" are to a section or sections of the Bankruptcy Code, 11 U.S.C. § 101 et seq. (referred to herein as the "Code").

Howard Delivery Service, Inc. v. Zurich American Insurance Co. (In re Howard Delivery Service, Inc.), 403 F.3d 228 (4th Cir. March 24, 2005), cert. granted, 126 S. Ct. 621 (Nov. 7, 2005) (oral argument set for Mar. 21, 2006)[3]

Supreme Court grants certiorari to determine whether an unsecured claim for unpaid prepetition workers compensation policy premiums is entitled to priority under section 507(a)(4)[4]

The Fourth Circuit, in a per curiam decision, follows the Ninth Circuit, and disagrees with the Sixth, Eighth, and Tenth Circuits,[5] in ruling that unpaid workers compensation insurance premiums incurred in the 180-day period before bankruptcy are entitled to the "contribution to an employee benefit plan" priority of section 507(a)(4). The 2-1 decision produced three opinions. One concludes that the phrase "contribution to an employee benefit plan" unambiguously includes workers compensation insurance premiums because the insurance is for the benefit of employees. The other two conclude that the phrase is ambiguous and criticize the first opinion for selective review of dictionaries to find otherwise. They both review the legislative history, but reach opposite conclusions on whether the premiums are included. One relies in part on an analogy to ERISA to conclude that workers compensation insurance is an employee benefit plan. The other argues that priorities are to be narrowly construed and that the insurance protects employers from statutory workers compensation liability, not employees.

The Supreme Court granted certiorari, and oral argument is set for March 21, 2006.

Ivey v. Great-West Life & Annuity Insurance Co. (In re J.G. Furniture Group, Inc.), 405 F.3d 191 (4th Cir. April 20, 2005)[6]

Unpaid health insurance premiums for COBRA are entitled to section 507(a)(4) priority[7]

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[3] The description of this case is adapted from Richard B. Levin, Recent Developments in Bankruptcy Law 6-7 (July 2005), with permission.

[4] In the Code as amended by BAPCPA, this is section 507(a)(5).

[5] The Ninth Circuit opinion is Employers Insurance of Wausau, Inc. v. Plaid Pantries, Inc., 10 F.3d 605 (9th Cir. 1993); the Sixth Circuit opinion is Travelers Property Casualty Corp. v. Birmingham-Nashville Express, Inc. (In re Birmingham-Nashville Express, Inc.), 224 F.3d 511 (6th Cir. 2000); the Eighth Circuit opinion is Employers Insurance of Wausau, Inc. v. Ramette (In re HLM Corp.), 62 F.3d 224 (8th Cir. 1995); and the Tenth Circuit opinion is State Insurance Fund v. Southern Star Foods, Inc. (In re Southern Star Foods, Inc.), 144 F.3d 712 (10th Cir. 1998).

[6] The description of this case is adapted from Richard B. Levin, Recent Developments in Bankruptcy Law 7 (July 2005), with permission.

[7] See n. 4, supra.

The debtor terminated numerous employees well before bankruptcy. Many of them maintained COBRA coverage after termination through the debtor's health insurance provider and paid the debtor for their coverage. The health insurance provider was unpaid at the time of the debtor's bankruptcy for coverage provided during the 180 days before bankruptcy. Based on its decision in Howard Delivery Service (discussed above), the Fourth Circuit granted priority to the health insurance provider's claim. The court construed "for services provides within 180 days before" bankruptcy as applying to the insurance provider's, not just the employees', services.

In re Owens Corning, 419 F.3d 195 (3d Cir. October 12, 2005), petitions for cert. filed, 74 U.S.L.W. 3395 (U.S. Dec. 23, 2005) (No. 05-877) and __ U.S.L.W. __ (U.S. Jan. 26, 2006) (No. 05-941)

Court denied "deemed" substantive consolidation and articulated standards for substantive consolidation

A parent operating company and its operating company subsidiaries – "a multinational corporate group" (id. at 200) – were borrowers and guarantors under a bank credit line. The parent managed and controlled all of the subsidiaries and their finances on a product line basis and provided funding for all the subsidiaries. The companies, not the banks, determined which entities would borrow funds. Financial reporting was done on a consolidated basis, and the banks obtained guaranties based on the book values of subsidiaries' assets, not their net worth. The debtors and asbestos plaintiffs, who had claims only against the parent, sought substantive consolidation only for chapter 11 plan voting and distribution purposes, preserving the corporate structure unchanged for all other purposes.[8] Their motion to substantively consolidate was granted by the district court,[9] over the objection of the banks, whose guaranties and structural seniority to the creditors of the parent would be eliminated.

The Third Circuit reversed and remanded. It articulated five fundamental principles regarding substantive consolidation. First, because it is a "general expectation of state law and of the Bankruptcy Code, and thus of commercial markets," courts should "respect entity separateness absent compelling circumstances . . . ." Id. at 211. Second, "[t]he harms substantive consolidation addresses are nearly always those caused by debtors . . . who disregard separateness." Id. (footnote omitted; emphasis in original). Third, "[m]ere benefit to the administration of the case . . . is hardly a harm calling substantive consolidation into play." Id. Fourth, because substantive consolidation is an extreme remedy, it should be used rarely and only when other remedies are inadequate. Fifth, substantive consolidation may not be used offensively, e.g., "to disadvantage tactically a group of creditors." Id. Based on those principles, the court ruled that, to support substantive consolidation (absent consent), the moving party must prove that either:

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8 The foregoing portion of the description of this case is adapted from Richard B. Levin, Recent Developments in Bankruptcy Law 15-16 (January 2006), with permission.

9 The district court's opinion is reported at 316 B.R. 168 (D. Del. 2004).

> (i) prepetition [the debtor entities] disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors.

Id. (footnotes omitted).[10] The court explained the first test as follows:

> A prima facie case for [substantive consolidation] typically exists when, based on the parties' prepetition dealings, a proponent proves corporate disregard creating contractual expectations of creditors that they were dealing with debtors as one indistinguishable entity. . . . Proponents who are creditors must also show that, in their prepetition course of dealing, they actually and reasonably relied on debtors' supposed unity. . . . Creditor opponents of consolidation can nonetheless defeat a prima facie showing . . . if they can prove they are adversely affected and actually relied on debtors' separate existence.

Id. at 212 (citations and footnotes omitted). The court explained the second test as follows:

> [C]ommingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of every creditor – this is, when every creditor will benefit from the consolidation. Moreover, the benefit to creditors should be from cost savings that

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[10] The Third Circuit noted that most courts had adopted either the Augie/Restivo test (articulated by the Second Circuit in Union Savings Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.), 860 F.2d 515 (2d Cir. 1988), or the Auto-Train test (established by the D.C. Circuit in Drabkin v. Midland-Ross Corp. (In re Auto-Train Corp.), 810 F.2d 270 (D.C. Cir. 1987). The court stated that, in prior cases, it "left little doubt that, if presented with a choice of analytical avenues, [it] favor[ed] essentially that of Augie/Restivo." 419 F.3d at 210.

The court dispatched the argument that, under the reasoning of Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc., 527 U.S. 308, 119 S. Ct. 1961 (1999), substantive consolidation is not an available equitable remedy. It reasoned that Grupo Mexicano is not applicable to bankruptcy cases because "[t]he extensive history of bankruptcy law and judicial precedent renders the issue of equity authority in the bankruptcy context different to such a degree as to make it different in kind." 419 F.3d at 208-09 n.14. Further, section 1123(a)(5)(C) permits "'consolidation of debtor with one or more persons pursuant to a plan '[n]otwithstanding any otherwise applicable non-bankruptcy law.'" Id.

> make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another. Mere benefit to some creditors, or administrative benefit to the Court, falls short.

Id. at 214. The court also advised that substantive consolidation should not be used "offensively to achieve advantage over one group in the plan negotiation process . . . nor a 'free pass' to spare Debtors or any other group from proving challenges, like fraudulent transfer claims, that are liberally brandished to scare yet are hard to show." Id.

Applying these alternative tests to the case, the court found that there was no prepetition disregard of corporate separateness. Rather, both the debtors and the banks treated the parent and subsidiaries as separate entities, and the banks specifically negotiated for and relied on the structural seniority the subsidiary guaranties provided them. The court also found no "hopeless commingling" because "there is no question which entity owns which principal assets and has which material liabilities" (id. at 214), even if there may be some imperfections (a situation "assuredly not atypical in large, complex company structures" (id. at 215)).

However, the court seemed most offended by the type of substantive consolidation provided for in the debtors' plan, i.e., "deemed" consolidation, which it called "a pretend consolidation" and described as "the flaw most fatal to the Plan Proponents' proposal." Id. at 216. The court said:

> If Debtors' corporate and financial structure was such a sham before the filing of the motion to consolidate, then how is it that post the Plan's effective date this structure stays largely undisturbed, with the Debtors reaping all the liability-limiting, tax and regulatory benefits achieved by forming subsidiaries in the first place?

Id.

Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.), 402 F.3d 416 (3d Cir. May 17, 2005)

> **U.S. trustee's quarterly fees are to be calculated on a debtor-by-debtor basis notwithstanding either an approved cash management procedure that centralized actual disbursements or confirmation of a plan based on "deemed" substantive consolidation**

In this case, 350 affiliated debtors commenced chapter 11 cases, which were jointly administered. The bankruptcy court permitted the debtors to maintain a centralized cash management system under which each debtor's revenues were deposited into a separate account that was periodically "swept" into a handful of concentration accounts. From there, funds were transferred into several disbursing accounts held only by Paying Debtors. The Paying Debtors used the funds in the disbursing accounts to pay the financial obligations of each of the debtors. Inter-company balances were kept so that each debtor could account for its own revenues and expenditures.

The first issue faced by the Third Circuit was how the U.S. trustee's quarterly fee, payable under 28 U.S.C. § 1930(a)(6), was to be calculated. This fee begins at $250 per quarter if "disbursements" for that quarter total less than $15,000, and steps up to $10,000 if "disbursements" total $5 million or more. The debtors treated "disbursements" as pertaining only to the Paying Debtors who held the disbursing accounts from which payments were made. Therefore, they collectively paid $691,250 in U.S. trustee's fees prior to the effective date of their plan. The U.S. trustee contended that the fee should be calculated on a debtor-by-debtor basis attributing "disbursements" to the debtors whose obligations were paid. On that basis, fees of almost $4.4 million should have been paid.

The bankruptcy court, district court and Third Circuit agreed with the U.S. trustee that "[p]ayments made on behalf of a debtor, whether made directly or indirectly through centralized disbursing accounts, constitute that particular debtor's disbursements for the purpose of quarterly fee calculations under § 1930(a)(6)." Id. at 422. The court did not believe that the permissive use of cash management procedures should change the amount of fees payable.

The second issue was how fees for the period after the effective date of the plan should be calculated. The U.S. Trustee's Manual provided that cases that are substantively consolidated are subject to only one fee. In this case, the plan provided for "deemed" substantive consolidation, i.e.,

> [f]or a temporary period, claims against separate Debtors were "deemed filed against the deemed consolidated . . . Debtors" and the handling of inter-Debtor claims and cross-Debtor guaranties was simplified. Put colloquially, per the Plan voting and distribution were streamlined. But for "funding distributions under the Plan," deemed consolidation left no effect on the Debtors (including their legal and organizational structures) and the rights of claimholders (including holders of intercompany claims).

Id. at 423.

The court found that, even though the bankruptcy court at confirmation found justification for substantive consolidation, "the Debtors proposed a Reorganization Plan several zip (if not area) codes away from anything resembling substantive consolidation." Id. at 424. Therefore, it was still incumbent on each of the debtors individually to pay its quarterly fees after the effective date.

Chicago Truck Drivers, Helpers & Warehouse Workers Union Pension Fund v. Brotherhood Labor Leasing, 406 F.3d 955 (8th Cir. May 4, 2005), cert. denied sub nom. Dysart, Taylor, Lay, Cotter & McGonigle v. Chicago Truck Dricers, Helpers & Warehouse Workers Pension Fund, 125 S. Ct. 1143 (Jan. 17, 2006)

Court affirmed contempt sanction against lawyers for advice to financially-troubled client

The Fund had sued certain corporations for ERISA withdrawal liability and the district court entered a judgment ordering (a) the corporations to make the interim payments requested by the Fund within 60 days and (b) that further disputes be submitted to arbitration. The corporations were in financial distress and did not make the payments to the Fund, but did pay other creditors, including their lawyers, apparently on the advice of those lawyers. The Fund sought to have the corporations and their officers and lawyers held in contempt of the district court's order to pay. The lawyers were cited for aiding and abetting. The district court held the lawyers in contempt and ordered them to pay the Fund the amount of compensation they had received from the corporations.

On appeal, the Eighth Circuit affirmed. It held that the district court's order to pay was an injunction and agreed with the district court's determinations that (a) the attorneys knew what the order required and that the corporations were in precarious financial condition, and (b) the lawyers "should have known, if they did not, that advising [the corporations] to pay other bills (including [the lawyer's] own bills) before paying the Fund was the same as advising [the corporations] to disregard the order." Id. at 958. The court also held that, even if the order were not an injunction, the statutory requirement that interim payments be made despite the fact that withdrawal liability is contested (citing 29 U.S.C. § 1399(c)(2)) provided sufficient basis for contempt under the circumstances. The court also held that it was not necessary to a finding of contempt that the law firm acted in bad faith.

The dissent pointed out that, at the time the judgment ordering payment was entered, there was uncertainty in the case law whether such an order actually constituted an injunction, and that lawyers cannot be subject to contempt as aiders and abettors if they give legal advice in good faith. Thus, the dissent argued, the clear and convincing evidence standard for contempt had not been met. The dissent also criticized the majority's determination that the contempt finding was appropriate, even if there were no injunction, because "the withdrawal liability was a legal obligation of the compan[ies]." Id. at 962. It expressed concern about the effect of this ruling on lawyers that advise financially distressed clients, which generally are delinquent in paying a number of legal obligations:

> Under the majority's ruling, a lawyer advising a financially distressed client as to how to deal with competing legal obligations is at risk of a contempt citation for providing such advice and receiving payment for those services . . . . [T]o

> expose attorneys to a possible contempt in this situation will temper attorney advocacy and impede clients' ability to obtain advice when it is most needed.

Id. at 962.

Smart World Technologies, LLC v. Juno Online Services, Inc. (In re Smart World Technologies, LLC), 423 F.3d 166 (2d Cir. Sept. 12, 2005)

Except in rare circumstances, only DIP/trustee may seek approval of settlement under Rule 9019

The debtor in possession sued the purchaser of the estate's assets. The bankruptcy court encouraged settlement and stayed discovery for over two years, over the debtor's objection, to accommodate settlement discussions (from which the debtor was excluded) between the purchaser and an allegedly secured creditor (WorldCom) and the creditors' committee (collectively, the "creditors"). Ultimately, the creditors, with WorldCom taking the lead, reached a settlement with the purchaser under which the estate's claims would be settled and released for the purchaser's payment of $5.5 million to WorldCom. The creditors then moved for approval of the settlement under Rule 9019, which the debtor in possession opposed.

At the hearing on the motion, the bankruptcy court was "openly hostile to [the debtor's] claim that it had not been able to conduct meaningful discovery because of the repeated stays imposed by the bankruptcy court and thus could not properly evaluate the proposed settlement . . . ." Id. at 173. In approving the settlement, the bankruptcy court found that the debtor's estate was insolvent, that the debtor's refusal to join the settlement was unreasonable, and that continuing the litigation would amount to allowing equity to gamble with the creditors' recovery; and it concluded that the settlement was in the best interests of the debtor, its estate and its creditors and equity holders. The court also determined that the creditors had standing to pursue the settlement. The district court affirmed.

The Second Circuit framed the issue on appeal as follows: "Did the bankruptcy court err in granting . . . creditors standing to settle the adversary proceeding . . ."? Id. at 174-75. First, the court determined that Rule 9019 authorizes only the debtor in possession (or a trustee) to bring a motion to approve a settlement, and that this limitation is appropriate in light of the duties and responsibilities of a debtor in possession. Then, the court considered whether and under what circumstances other parties, such as the creditors, could be granted "derivative standing" to seek approval of a settlement. Based on its decision in Unsecured Creditors' Committee v. Noyes (In re STN Enterprises), 779 F.2d 901 (2d Cir. 1985), the court concluded that derivative standing could be appropriate, but decided that "a party who seeks to displace the debtor" in settling claims of the estate "faces a heavier burden" than a party who seeks to pursue estate claims. 423 F.3d at 177. The court reasoned as follows:

> [T]here is an important difference between pursuing an otherwise neglected claim and settling a claim that the estate is trying to pursue. The former usually involves a claim against the debtor's principals themselves, who refuse to litigate out of self interest. . . . Derivative standing in such a case may be necessary to avoid the inherent conflict of interest that exists when those with the power to pursue a claim are those who may be the target of such a claim. In the Rule 9019 context, by contrast, it is the debtor and its principals who seek to pursue a claim on behalf of the estate, which is precisely the role of the debtor-in-possession envisioned by the Code. In such circumstances, we think it is less likely that the debtor's principals will be motivated by reasons that conflict with the best interests of the estate. On the contrary, it is more likely that allowing creditors and other parties to bring Rule 9019 motions over a debtor's objection will encourage parties against whom the estate has a valid claim to delay and obstruct litigation, in the hopes that a creditor with a small interest in the estate will eventually propose a settlement disposing of the estate's valuable causes of action at a low price. The possibility of such perverse dynamics suggests that derivative standing will be appropriate much less frequently in the Rule 9019 context than in the usual case (i.e., where the would-be derivative plaintiff wishes to pursue a claim).

Id.

The Second Circuit then determined that the creditors had not met even the lesser standard for derivative standing. In fact, the court characterized the case as "a poster child for why the Code and Rule 9019 authorize only the debtor-in-possession to pursue or settle the estate's legal claims and why the derivative-standing exception to the policy is narrow." Id. at 179-80. Principally, this was because (a) there was no showing as to the "'probabilities of legal success and financial recovery in the event of success'" (id. at 178 (citing STN Enterprises, supra at 905)) and (b) WorldCom's interests conflicted with those of the estate. With respect to the former, the Second Circuit noted that the bankruptcy court eschewed any inquiry regarding the merits of the estate's claims, and considered its findings regarding the unreasonableness of and motivation for the debtor's opposition to the settlement to be "bald and unsupported assertions." 423 F.3d at 179. Further, the Second Circuit indicated that the bankruptcy court's action in staying discovery in the underlying action and expressed preference for settlement suggested that its "evaluation of [the debtor's] claims may have been colored by his own desire to 'get this matter out of [its] hair' and to 'eliminate the litigation.'" Id.

The Second Circuit also noted that WorldCom was to receive the proceeds of the settlement, even though the priority of its claim had been challenged. Further, WorldCom's counsel "candidly admitted that WorldCom did not view the settlement as a fiduciary, that it was primarily concerned with getting money from [the purchaser] quickly, and that it had not evaluated the merits of [the debtor's] claims . . . ." Id. The Second Circuit also considered it significant that the debtor had retained counsel to pursue the litigation against the purchaser on a contingent fee basis. This was analogous to the willingness of a party seeking derivative standing to pursue litigation agreeing to absorb the costs of litigation.

The Second Circuit also determined that section 1109(b), under which creditors have an unconditional right to intervene in adversary proceedings,[11] did not implicitly grant creditors standing to bring a Rule 9019 motion. The court read Hartford Underwriters Insurance Co. v. Union Planters Bank, N.A., 530 U.S. 1, 120 S. Ct. 1942 (2000), "to stand for the proposition that § 1109(b) does not entitle parties in interest . . . to usurp the debtor-in-possession's role as legal representative of the estate." 423 F.3d at 182. It also held that a right to intervene does not include control of the estate's claims for relief, citing Official Unsecured Creditors' Committee v. Michaels (In re Marin Motor Oil, Inc.), 689 F.2d 445 (3d Cir. 1982); Official Committee of Unsecured Creditors v. Morgan Stanley & Co. (In re Sunbeam Corp.), 287 B.R. 861, 862 (S.D.N.Y. 2003); and Adelphia Communications Corp. v. Rigas (In re Adelphia Communications Corp.), 285 B.R. 848, 850-51 (Bankr. S.D.N.Y. 2002). The Second Circuit also held that section 105(a) "does not provide an independent basis" on which a bankruptcy court could grant standing to the creditors to pursue the settlement. Id. at 184 (citing New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.), 351 F.3d 86, 91-92 (2d Cir. 2003) (exercise of power under section 105(a) must be tied to another provision of the Code and "not merely to a general bankruptcy concept or objective")).

Robert M. Hallmark & Associates, Inc. v. Athens/Alpha Gas Corp. (In re Athens/Alpha Gas Corp.), 332 B.R. 578 (B.A.P. 8th Cir. Nov. 4, 2005)

Administrative expense may arise from postpetition use of funds belonging to claimant under a prepetition agreement

Prepetition the debtor and the appellants each owned a working interest in an oil well, which the debtor operated. After bankruptcy, the debtor in possession used the appellants' portion of well receipts "to pay operating expenses and debts unrelated to the well instead of distributing the appellants' share of the funds to them." Id. at 579. The appellants sought allowance of an administrative claim under section 503(b)(1)(A) for their share of the postpetition revenues.

The bankruptcy court denied the request because, among other things, the appellants' claim "did not involve a post-petition transaction with the estate" and was

[11] See Term Loan Holder Comm. v. Ozer Group, LLC (In re Caldor Corp.), 303 F.3d 161 (2d Cir. 2002).

"based on their pre-petition ownership rights," and because "the appellants did not incur any expense or provide an outlay of costs to the bankruptcy estate." Id. at 580.

The Eighth Circuit Bankruptcy Appellate Panel reversed, holding that the appellants were entitled to an administrative expense. It reasoned that, even though the parties' agreement regarding revenue distribution was a prepetition agreement, the "transaction" (defined as "an act between the parties which alters their legal relationship") giving rise to the claim occurred postpetition, when the debtor in possession "exercis[ed] control of all the profits, thereby depriving the appellants of their revenue." Id. at 580-81. Essentially, the appellants made "an involuntary infusion of cash" to the estate. Id. at 581. There was also tangible benefit to the estate, because the debtor used the profits in the postpetition operation of its business. Therefore, the appellants were entitled to an administrative expense claim.

Volvo Commercial Finance LLC the Americas v. Gasel Transportation Lines, Inc. (In re Gasel Transportation Lines, Inc.), 326 B.R. 683 (B.A.P. 6th Cir. June 9, 2005)

Secured creditor not entitled to administrative expense for use of its non-cash collateral

Secured creditor, with a security interest in eleven tractors, promptly moved for relief from the automatic stay and ultimately obtained an agreed order that provided for adequate protection prospectively. Thereafter, secured creditor sought an administrative expense claim for the period from the filing of the debtor's chapter 11 petition to the entry of the agreed order.

The bankruptcy court denied the request, and the Bankruptcy Appellate Panel affirmed. The Panel found that, while there was benefit to the estate from use of the tractors, the essential element of "a transaction with the bankruptcy estate" was missing. "In determining whether there was a 'transaction with the bankruptcy estate,' the proper focus [is] on the inducement involved in causing the creditor to part with its goods or services," and such inducement must come from the debtor in possession. Id. at 687 (citations omitted). "Normally, merely continuing to possess equipment pursuant to a prepetition contract does not constitute 'inducement' by the debtor in possession." Id. at 688 (citation omitted). The panel found no action prior to the agreed order that amounted to such inducement. Rather, "[t]he debtor in possession was able to retain and use [the] collateral during the first fifteen weeks of the chapter 11 case solely by virtue of the automatic stay." Id.

In a concurring opinion, Judge Gregg noted that the panel reached the correct result for the wrong reason because it analyzed a secured transaction as if it were a personal property lease. Rather, "[a]s a secured creditor, the only compensation Volvo is entitled to for the Debtor's postpetition 'use' of the tractors is adequate protection against a decrease in the value of the tractors." Id. at 693 (emphasis in original). Further, a secured creditor is not entitled to adequate protection until it is both requested and granted. Therefore, having entered into the agreed order for prospective adequate protection, without even reserving the issue of retrospective adequate protection, secured creditor was precluded by res judicata from subsequently requesting it.

Insurance Co. of North America v. Sullivan, 333 B.R. 55 (D. Md. Sept. 29, 2005)

Postpetition attorneys' fees and costs payable under a prepetition indemnification agreement can be allowed as an unsecured claim

INA was debtor's surety on a performance bond for the Union Station Contract, and had an indemnity agreement with the debtor requiring the debtor to indemnify INA for certain costs in relation to any bonds on which it was surety. The District of Columbia ("D.C.") terminated the Contract prepetition based on debtor's alleged default. Pursuant to an agreement between INA and D.C., with a full reservation of rights, INA as surety made provisional payment to D.C. of approximately $13 million under the performance bond and obtained a release. The debtor and INA then filed claims against DC which were litigated through appeal, with INA bearing most of the legal fees and costs. Ultimately, it was determined that the termination for default was improper, so D.C. paid almost $14 million to the debtor.

The issue in the case was whether INA had a claim against the debtor's estate for the attorneys' fees and related costs that it incurred in pursuing the litigation with DC postpetition. The bankruptcy court ruled against INA.

On appeal, the district court agreed with that bankruptcy court that, reading together section 506(b) (which allows postpetition fees and expenses only to oversecured creditors) and section 502(b) (which requires claims to be determined "as of the petition date"), a court generally cannot allow attorneys' fees and expenses incurred postpetition to unsecured creditors. However, the court held that, to the extent that INA's attorneys' fees and related costs were payable under the parties' prepetition indemnity agreement, they constituted a general unsecured claim that was contingent and unliquidated as of the petition date, but nonetheless allowable. However, the court determined that the prepetition indemnity agreement at issue did not cover INA's attorneys' fees and expenses under the circumstances of the case.

The court also held that INA did not have an administrative expense claim for attorneys' fees and expenses under section 503(B)(1)(A) because, even through the expenditure did benefit the estate through success in the litigation, INA incurred the fees and expenses not "to preserve the estate, but rather 'to preserve its own interest in the estate.'" Id. at 67-68 (citation omitted). Section 503(b)(3)(D) was not at issue because the debtor's chapter 11 case had been converted to chapter 7.

Merrimac Paper Co., Inc. v. Harrison (In re Merrimac Paper Co., Inc.), 420 F.3d 53 (1st Cir. Aug. 25, 2005)

ESOP stock redemption note may not be equitably subordinated

Harrison, who worked as an executive for the debtor for 36 years, elected on retirement to exercise his "put option" with respect to the debtor's stock in which he had a vested interest as a participant in the debtor's ESOP. The "put option" is an ERISA-mandated choice a retiree has if the employer's securities in the plan are not readily traded on an established market, i.e., the retiree may either demand the shares themselves or require the employer to repurchase the securities under a fair valuation formula. If the "put option" is exercised, the employer can elect to pay the repurchase price over a period not to exceed five years and post adequate security. Thus, when Harrison exercised his "put option," "[i]n simultaneous transactions, he constructively received the shares and sold them back to the debtor, which gave him a promissory note," which bore interest and was to be paid in three equal annual installments. Id. at 56. The debtor paid the first installment, but failed to pay the next two prior to filing its chapter 11 petition.

The debtor sought to subordinate both Harrison's claim on the note and his claim that the debtor had failed to perform its duties under ERISA (the "ERISA claim"). The bankruptcy court granted the debtor summary judgment.[12] It subordinated Harrison's claims under section 510(c) based on equitable subordination, and it subordinated Harrison's ERISA claim under section 510(b) as a claim arising out of a sale of stock. However, it refused to subordinate Harrison's claim on the note under section 510(b) because it "arose from the enforcement of a debt, not the sale of a security." Id. at 58. The district court affirmed.[13]

The First Circuit considered only equitable subordination of Harrison's claim on the note under section 510(c), and reversed. First, the court abrogated the "categorical rule" that it had established in Matthews Bros. v. Pullen, 268 F. 827 (1st Cir. 1920), and Keith v. Kiolmer (In re National Piano Co.), 261 F. 733 (1st Cir. 1919), that stock redemption claims, as a class, are automatically subject to equitable subordination. The court concluded that these cases were inconsistent with United States v. Noland, 517 U.S. 535, 116 S. Ct. 1524 (1996), and United States v. Reorganized CF & I Fabricators of Utah, Inc., 518 U.S. 213, 116 S. Ct. 2106 (1996), which held that categories of claims cannot be equitably subordinated, but rather, claims may be equitably subordinated only after particularized inquiry regarding the equities of the situation.

The court then considered whether the Harrison claim on the note should be equitably subordinated and decided that it should not. This was because the rationale

12 The bankruptcy court's opinion is reported at 303 B.R. 710 (Bankr. D. Mass. 2003).

13 The district court's opinion is reported at 317 B.R. 215 (D. Mass. 2004).

for subordinating stock redemption claims did not apply. The court quoted the Seventh Circuit's statement of that rationale, as follows:

> "[Stock redemption] claims are, in substance, based on equity interests. When [the holders of those claims] invested in [the corporation], they positioned themselves to benefit if the company performed well, but they also accepted the risk that the company might perform poorly. Thus [they] accepted risks and benefits that . . . unsecured creditors did not, and as such their equity interests were legally subordinate to possible claims of unsecured creditors."

420 F.3d at 64 (quoting In re Envirodyne Indus., Inc., 79 F.3d 579, 583 (7th Cir. 1996). The court determined that this rationale did not apply to the case at hand because of the ERISA framework in which the stock redemption occurred and the note was issued. Because Harrison, when he retired, had the statutory option not to take the debtor's stock, but to take a note instead, he did not assume the same kind of risk that an equity holder has. "[A]lthough the employee's position entails market risk during the period of employment . . . , ERISA seeks to eliminate that risk once retirement occurs." 420 F.3d at 64. Thus, the note did not actually result from a stock redemption, but from a statutory choice between "continued stock ownership and a pecuniary retirement benefit." Id. Because of this, the court decided that Harrison's claim on the note should not be treated like "claims arising from stock redemption notes that have a more conventional genesis." Id. Rather, Harrison's election "made manifest his intention to refrain from becoming an equity investor (with all the risks attendant thereto). Under these circumstances, there is a strong policy argument that the Note should be viewed for what it is: a note received in partial payment of retirement plan benefits." Id. at 64-65.

American Wagering, Inc v. Racusin (In re American Wagering, Inc.), 326 B.R. 449 (B.A.P. 9th Cir. April 14, 2005)

Damage claim arising from failure to deliver stock under employment agreement is subordinated under section 510(b)

In 1994, claimant was retained as a financial consultant in connection with debtor's IPO. His compensation included "'4.5 percent of the final valuation in the form of [debtor's] common stock.'" Id. at 451. While the IPO was pending, the debtor sued claimant to determine that the contract was unenforceable, and claimant countersued for damages for breach of contract, breach of the covenant of good faith and fair dealing, and unjust enrichment. After several appeals, claimant was awarded damages equal to "the value of the [debtor's stock] when [claimant] could have legally sold it." Id. In 2003, a few days after the judgment, debtor filed its chapter 11 petition. The debtor sought to subordinate the consultant's claim pursuant to section 510(b) as "[a] claim . . .

for damages arising from the purchase or sale of . . . a security." The bankruptcy court declined to subordinate the claim, but the Bankruptcy Appellate Panel reversed.

Claimant contended that his claim was not subject to subordination under section 510(b) because (a) his claim was based on a money judgment, (b) his claim was based on an employment contract, and (c) he was more like a creditor than an equity holder because he promptly sought money damages based on the value of the stock at the completion of the IPO, approximately eight years before the petition date.

The court rejected each of these contentions. It focused on the purpose served by section 510(b), based on the rationale articulated in John J. Slain & Homer Kripke, The Interface Between Securities Regulation and Bankruptcy – Allocating Risk of Illegal Security Issuance Between Security Holders and the Issuer's Creditors, 48 N.Y.U. L. Rev. 261 (1973), on which "Congress heavily relied in crafting § 510(b)," as follows:

> "According to Slain and Kripke, the dissimilar expectation of investors and creditors should be taken into account in setting a standard for mandatory subordination. Shareholders expect to take more risk than creditors in return for the right to participate in firm profits. The creditor only expects repayment of a fixed debt. It is unfair to shift all of the risk to the creditor class since the creditors extend credit in reliance on the cushion of investment provided by the shareholders."

326 B.R. at 454 (quoting American Broadcasting Sys., Inc. v. Nugent (In re Betacom of Phoenix, Inc.), 240 F.3d 823 (9th Cir. 2001)). The court then determined that, by agreeing to accept part of his compensation in stock, the claimant "chose to cast his lot with the shareholders and to share with them the expected increase in the value of [the debtor's] stock." 326 B.R. at 457. The court also determined that "at least some creditors in this case extended credit to the debtors after the contract was made, presumptively in partial reliance on the equity cushion as augmented by [claimant's] contribution." Id. The court also found a causal nexus, satisfying the "arising from" requirement in section 510(b) because "the non-delivery of stock was the sole cause or [claimant's] damages." Id. at 548.

The court also reviewed case law applying section 510(b), finding that it generally supported subordination of claimant's claim.[14] However, in Official Committee of Unsecured Creditors v. American Capital Financial Services, Inc. (In re Mobile Tool International, Inc.), 306 B.R. 778 (Bankr. D. Del. 2004), the Delaware bankruptcy court

[14] Among the cases cited as supporting is In re NAL Financial Group, Inc., 237 B.R. 225 (Bankr. S.D. Fla. 1999), which the court in American Wagering described as "subordinating an investor's claim for damages resulting from an issuer's failure properly to register debentures because the registration failure was a causal link in the damage claim." 326 B.R. at 456.

had determined that section 510(b) did not apply to claims based on notes given to former officers in exchange for their stock under agreements that the debtor would repurchase the stock. There, the court found that the claims were based on the notes, not on the sale or purchase of securities and "held that the claimants had been converted from shareholders into creditors and the variable nature of their investment had disappeared." 326 B.R. at 456. The Mobile Tool court distinguished another case that it had decided, In re Alta+Cast, LLC, 301 B.R. 150 (Bankr. D. Del. 2003), in which it had subordinated under section 510(b) the claim of a former employee based on an employment agreement that provided that the debtor would repurchase the employee's stock on termination of employment. The Mobile Tool court distinguished Alta+Cast on the basis that, in the latter case, there was no separate debt instrument.

The Bankruptcy Appellate Panel distinguished Mobile Tool on the basis that the claimant in the case at issue "never bargained for, and [the debtor] never issued, any sort of separate debt instrument to him." 326 B.R. at 456. It also criticized Mobile Tool as inconsistent with the Supreme Court's decision in Archer v. Warner, 538 U.S. 314, 123 S. Ct. 1462 (2003), where the Court determined that a claim based on a note could be nondischargeable based on fraud, even though the underlying fraud claim had been settled, with mutual releases and issuance of the new promissory note.

Contrarian Funds, LLC v. WestPoint Stevens, Inc. (In re WestPoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005)

> **Other than under a confirmed plan, the Code does not permit distribution to objecting secured creditor of noncash proceeds of a sale free and clear in full satisfaction of secured creditor's claim and security interest**

The debtor in possession sold all of its assets to a new entity, which paid for the purchase in securities of the new entity (the "securities"). The debtor's assets were subject to liens in favor of first and second lien creditors. The sale order provided not only for sale of the assets fee and clear with the liens to apply to the proceeds (i.e., the securities), but also for (a) the immediate distribution of the securities to the first lien creditors "in a quantity valued by the Bankruptcy Court as of the closing date to equal the accrued amount of [the creditors'] claims, and termination of the [creditors'] liens in the replacement collateral," and (b) distribution of the remaining securities in partial satisfaction of the second lien creditor's claim. Id. at 36-37. The purchaser insisted on the distributions as part of the purchase transaction.

The first lien creditors objected to the sale on those terms, particularly the in-kind distribution, claim satisfaction and lien termination provisions. The bankruptcy court approved the terms of the sale, holding that the challenged provisions of the order were permissible under the first lien creditors' credit agreement, their intercreditor agreement with the second lien creditor, and/or sections 361, 363 and 105(a).

The district court reversed. First, the court considered whether the first lien creditors had waived their objection because they had proposed a sale to a different purchaser on the same terms, i.e., that their claims would be satisfied by an immediate in kind distribution of the securities of the purchaser. It determined that there was no waiver because "a party's willingness voluntarily to negotiate away rights for particular consideration constitutes neither a blanket waiver of those rights nor an agreement to accept different consideration." Id. at 42. The court noted that, in the sale the first lien creditors supported, they would have obtained control of the purchaser, which they would not have in the sale that was approved.

Second, the district court found that the credit agreement did not permit non-cash distributions after default. It also found that the "adequate protection" clause of the intercreditor agreement – which permitted the second lien creditor to receive adequate protection in accordance with sections 361-64 of the Code – was inapplicable because "[t]he challenged provisions of the Sale Order are . . . beyond the scope of the adequate protection authority provided to bankruptcy courts by the cited Bankruptcy Code provisions." Id. at 47. The court held that nothing in section 361 authorizes impairment of the first lien creditors' rights to cash payment of its claim and retention of its liens on the estate's assets either to adequately protect the first lien creditors or a junior creditor. The court was concerned that

> [t]aken to its logical extreme, the Bankruptcy Court's notion of adequate protection would allow a powerful creditor and a debtor anxious to achieve some value for its favored constituencies to run roughshod over disfavored creditors' rights, so long as a section 363(b) asset sale transaction could be defended as an exercise of reasonable business judgment in the context of dire economic circumstances.

Id. at 49-50.

The district court then determined that, while the sale free and clear and attachment of the liens to the proceeds was authorized by section 363, the challenged provisions of the sale order were not authorized by the Code – even though they were required by the purchaser and the alternative may have been forced liquidation or piecemeal asset sales. "Nothing in . . . Section 363 . . . provides the Bankruptcy Court with authority to impair the claim satisfaction rights of objecting creditors or to eliminate the replacement liens granted by the court in connection with the section 363(b) sale." Id. at 51. Rather, the challenged provisions constituted an impermissible effort to circumvent the plan process, since the first lien creditors' right to cash payment and retention of its lien rights in the securities could be altered, over their objection, only by cramdown in a plan. The court stated:

> [T]he [first lien creditors'] insistence on cash satisfaction of their claim would have rendered the Debtors unable to confirm consensually a plan incorporating the challenged features of the . . . transaction. . . . The Bankruptcy Court's utilization of sections 363(b) and 105(a) to overcome [the

> first lien creditors'] anticipated objections to an attempt to cram down an equity-based plan of reorganization must be rejected.

Id. at 54.

In re FiberMark, Inc., 330 B.R. 480 (Bankr. D. Vt. Aug. 16, 2005)

> **Examiner's report made public under section 107 after redactions to protect material subject to attorney-client privilege and work product protection and affixing of appropriate legends**

On the bankruptcy court's initiation, with the agreement of all interested parties, an examiner was appointed after disputes among members of the creditors' committee, which had undertaken to prepare the corporate governance documentation for the reorganized debtor, resulted in withdrawal by the debtor of what had been a consensual plan. Apparently,[15] the dispute involved three of the four members of the committee: A (which was chair of the committee), B and C. A and B were originally the largest note holders in the case. However, postpetition, C acquired a majority of the outstanding claims, including claims of various officers and managers of the debtor and the claim of a former committee member. As a result, under the previously-negotiated plan, C (not A and B, as originally envisioned) would be the majority shareholder of the reorganized debtor; A and B would be minority shareholders. A and B insisted that the governance documents for the reorganized debtor include certain protections for minority shareholders, while C rejected such terms. In addition, the committee members accused one another of violating the court's "trading order," which delineated the information barriers prerequisite to committee member's trading in claims, and other breaches of fiduciary duty.

Pursuant to court order, the examiner's report was initially filed under seal and made available only to certain parties in interest. In his report, the examiner concluded that A, B and committee counsel had breached their fiduciary duties. C, with the support of the debtors and the U.S. trustee, asked the bankruptcy court to unseal the report, while A, B and committee counsel (collectively, the "Seal Proponents") sought to keep the examiner's report under seal. They contended that certain information in the report was protected by the committee's attorney-client privilege and committee counsel's work product privilege, and that the report contained "erroneous, scandalous, or defamatory conclusions." Id. at 504.

The court first determined that the protections of the attorney-client privilege and the work product doctrine are distinct from the issues raised by section 107, which generally governs public access to bankruptcy court filings. Nevertheless, the court

[15] This description of the underlying dispute derives from two other opinions in In re FiberMark, Inc.: No. 04-10463, 2005 WL 859269 (Bankr. D. Vt. Apr. 13, 2005), and 2005 WL 859270 (Bankr. D. Vt. Apr. 13, 2005).

determined that such protections were to be respected. The court also determined that, while the attorney-client privilege and work product protection had been waived for purposes of the examiner's investigation, they had not been waived as to third parties. Thus, publication in the report of quotes from, or direct disclosure of, protected information would not be permitted. Therefore, the court had to determine the extent of the committee's attorney-client privilege and committee counsel's work product.

In this regard, the court noted that

> [m]any of the provisions of the Report which [A] asserts to be protected by the [Committee's] privilege relate to conflicts among members of the Committee, strategy for maneuvering other members to one's perspective and the various governance issues. These matters are not protected from disclosure by the privilege because (a) they are not communications with the Committee, which is [committee counsel's] only client in this proceeding; and (b) they are not directed at protecting the interests of the Committee or its constituents, but rather at advancing or reconciling the needs of individual Committee members.

Id. at 499.[16] Thus, the court held that "[w]here [committee counsel] was conferring with co-counsel, the Committee's advisors,[17] or individual Committee members about the divergence of opinions regarding corporate governance issues," the committee's attorney-client privilege did not apply because committee counsel "was not advising its client and/or not pursuing legal issues on behalf of its client." Id. at 500. "By contrast,

[16] The FiberMark court also determined that the corporate governance issue about which the committee members were in dispute (i.e., the protections to be afforded minority shareholders of the reorganized debtor) was a business decision, not a legal issue, so that communications about it were not protected by attorney-client privilege. See 330 BR at 499-500.

[17] Separately, the FiberMark court held that the privilege was not negated by the involvement of the committee's financial advisor in otherwise privileged communications. Citing U.S. v. Kovel, 296 F.2d 918, 922 (2d Cir. 1961), the court stated that

> the presence of an accountant or financial advisor, whether hired by the lawyer or the clients, does not destroy the privilege, any more than would the presence of a linguist when needed to translate legal papers in a foreign language. If the financial advisor's presence is necessary, or at least highly useful, for the effective consultation between the client and the lawyer which the privilege was designed to permit, . . . then the presence of the financial advisor in the communication loop does not negate the protection.

330 B.R. at 499.

where [committee counsel] was communicating with the Committee chair or co-counsel with regard to the obligation of the Committee to disclose suspicions of violation of the trading order, that activity was a duty of the Committee and hence . . . privileged communication . . . ." Id.

The FiberMark court made a similar determination with respect to committee counsel's work product protection under Fed. R. Civ. P. 26(b)(3). It held that, since "the Committee exists to represent the interests of all creditors in the case, not just to represent its members' own interests," work product done for the benefit of individual members of the Committee would not be protected. Id. at 502. The court found it difficult to apply this standard because A was "both the chair of the Committee and at the center of disputes with other members of the Committee regarding . . . corporate governance issues." Id. Therefore, the court required redaction of the portions of the examiner's report that "would lead an objective party to conclude that the disclosure is: (1) legal advice; (2) related to a topic that might be the subject of litigation (e.g., plan confirmation or breach of the trading wall); and (3) involves [A] in what appears to be its capacity as chair of the Committee." Id. However, it refused to require redaction of legal advice that did not "appear to be on behalf of or for the benefit of all creditors or the Committee as a representative of the estate's interests, or to address topics that would appear to be reasonably expected to be the subject of litigation by the Committee." Id.

Having dealt with attorney-client privilege and work product, the court addressed whether the report, as redacted, should remain under seal under section 107. Even though the report had been filed under an order that it be temporarily sealed, the court imposed on the seal proponents the burden to "demonstrate grounds for deviating from the general rule of public access under § 107(a)." Id. at 504. This was because the court was considering the issue under section 107 for the first time.[18]

The court noted that section 107(a) "evidences Congress's strong desire to preserve the public's right of access to judicial records in bankruptcy." Id. at 505. Further, it determined that an examiner's report is subject to section 107 because section 1106(a) (3), (4) and (6) requires the report to be "filed." Thus, unless an exception in section 107(b) applies, the report must be made public.

[18] In a lengthy footnote, the court explained that, even if the parties seeking to have the report unsealed had the burden of proof, they "have demonstrated extraordinary circumstance[s] and compelling need for having the Report available to the public." 330 B.R. at 504 n.11. C demonstrated a compelling need to clear its name of the public accusations of wrongdoing made by A, B and committee counsel. The debtor demonstrated a compelling need because of its obligation to provide all material information in the disclosure statement for its plan. The U.S. trustee demonstrated a compelling need to enable those participating in this and other bankruptcy cases "to decide how to conduct themselves and to draw their own conclusions from the Report, in the interest of promoting transparency in judicial proceedings, in general, and integrity of the bankruptcy system, in particular." Id. at 505 n.11.

The court considered whether the report contained "scandalous or defamatory matter," which would be protected by section 107(b)(2). The Seal Proponents argued that the examiner's language was "inflammatory, defamatory, and intemperate." Id. at 507. The court disagreed. It reasoned that, because the examiner was investigating alleged breaches of fiduciary duty, "it was clear that the Report might be negative and strongly worded." Id. Further, "the Examiner was not appointed to determine the truth," but to investigate and report his conclusions and recommendations. Id. Therefore, it was not relevant to the court's inquiry under section 107(b) whether the examiner's conclusions were correct. "[T]he parties in interest will have an opportunity to refute the Examiner's opinions and conclusions." Id. at 508. The court recognized that "those opinions and conclusions may cause some embarrassment to certain individuals or entities," but concluded that section 107(b)(2) does not protect sophisticated parties from embarrassment. Id. Further, the court found no evidence that "the Examiner's choice of words was malicious or capricious," and, because all of the parties supported the appointment of the examiner and raised no objection to the person chosen, the court refused to "entertain . . . allegations . . . that the Examiner is biased." Id. at 508-09.

Nevertheless, the court was "not unmindful or unsympathetic to the concerns raised by the Seal Proponents that: (a) the Report may be mischaracterized, (b) information in the Report may be misconstrued, and (c) the Report may be interpreted as having the imprimatur of [the] Court." Id. at 509. Therefore, the court required the following legend on every page of the report available to the public:

> The statements and conclusions in this report have not been adopted or accepted by the Court, and constitute only the opinions of the Examiner. No portion of this report has been admitted into evidence. Several parties dispute the accuracy of the contents of this report. The publication of this report is without prejudice to the right of any party to challenge the statements contained in the report.

Id. at 509-10.

Gitto v. Worcester Telegram & Gazette Corp. (In re Gitto Global Corp.), 422 F.3d 1 (1st Cir. Aug. 31, 2005)

Articulated standards for determining whether material is "defamatory" and entitled to protection under section 107(b)

Debtor filed its chapter 11 case "amid allegations of financial distress and accounting irregularities." Id. at 5. An examiner was appointed to investigate "'pre[-]petition fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management and business affairs of the Debtor.'" Id. Per court order, the examiner filed his report under seal and served relevant portions of the report on persons named therein. The bankruptcy court then entertained requests to make the report public and keep it under seal. The debtor's part-owner and former CEO and his father, who held himself out as chairman (collectively, the "Gittos"), moved to keep the report under seal. Two news organizations opposed the motion. The bankruptcy court ruled that the report should be made public under section 107, the district court affirmed, and the First Circuit agreed.

The First Circuit initially determined that section 107 supplants in bankruptcy the common law regarding access to judicial records. Thus, while "common law requires the court to determine whether the document at issue is a 'judicial record' subject to the presumption of public access, and, if so, to 'balance the public interest in the information against privacy interests'" (id. at 9 (citing In re Boston Herald, Inc., 321 F.3d 174, 190 (1st Cir. 2003)), in bankruptcy under section 107, any paper filed in the bankruptcy case must be publicly available unless it comes within one of the exceptions in section 107(b). Further, if the material is within a section 107(b) exception, then the court is required to act at the request of an interested party and is permitted to act sua sponte.

The court then considered the meaning of "defamatory" in section 107(b) (since the Gittos did not contend that the report contained "scandalous" material). It determined that papers are not "defamatory" "merely because they would have a detrimental impact on an interested party's reputation." 422 F.3d at 11. More is required. Based on a review of scarce case law interpreting section 107, Fed. R. Civ. P. 12(f) and the common law of public access, the court developed the following test:

> To qualify for protection under the § 107(b)(2) exception for defamatory material, an interested party must show (1) that the material at issue would alter his reputation in the eyes of a reasonable person, and (2) that the material is untrue or that it is potentially untrue and irrelevant or included for an improper end.

Id. at 16. The court indicated that protection would be provided if "untruthfulness is readily apparent." Id. at 11.

Applying this standard to the examiner's report, the court found that the Gittos demonstrated that some of the material in the report was potentially untrue. However, it was nonetheless relevant to the purpose for the report, and there was no indication that the examiner, whose disinterested status was not questioned, "drafted the Report in bad faith or otherwise included the allegedly defamatory material for an improper purpose." Id. at 16. Therefore, the examiner's report should be made public.[19]

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[19] The court did order redaction of all bank account numbers in the report, pursuant to section 107(b)(1)'s exception for confidential information.

In re UAL Corp., 412 F.3d 775 (7th Cir. June 21, 2005) (opinion by Judge Easterbrook)

Stock sales that may impair NOLs do not violate the automatic stay

Early in the case, the bankruptcy court issued, and continued at a hearing two months later, an injunction under sections 362(a)(3) and 105(a) forbidding sale of the debtor's shares by the ESOP that owned slightly more than half of the debtor's stock, in order to avoid a change of control that would substantially limit the reorganized debtor's ability to use its net operating loss carryforwards under the Internal Revenue Code. The ESOP trustee appealed. While the appeal was pending, the IRS issued a regulation that permitted the ESOP to pass shares through to the employees, who could then sell them without jeopardizing the debtor's NOLs. This was done: the ESOP was terminated and the shares were distributed.

Notwithstanding these developments, the district court declined the debtor's motion to dismiss the appeal as moot and affirmed the injunction. The ESOP trustee then appealed to the Seventh Circuit. The ESOP trustee argued that the appeal was not moot because "the investors deserve compensation for the loss they suffered between the time of the bankruptcy court's order (when United's stock traded for $1.06 per share) and the dissolution of the ESOP (when the market price had fallen to 76 [cents] per share)." Id. at 777. The Seventh Circuit noted that "'a person injured by the issuance of an injunction later determined to be erroneous has no action for damages in the absence of a bond,'" and, after finding that certain exceptions to that rule did not apply, ruled that the appeal was moot. Id. at 779 (citations omitted). Therefore, the court vacated the judgment of the district court and ordered it to remand the case to the bankruptcy court to vacate the injunction as moot.

Notwithstanding that determination, the court indicated that neither section 362(a)(3) nor section 105 could support the injunction issued by the bankruptcy court. Although the NOLs may be property of the estate, "an ESOP's sale of stock does not 'obtain possession . . . or exercise control' . . . over that interest." Id. at 778 (emphasis in original). Any effect on the debtor's NOLs "would not occur because of anything the ESOP possessed or controlled." Id. Accordingly, section 362(a)(3) does not apply. The court distinguished In re Prudential Lines Inc., 928 F.2d 565 (2d Cir. 1991), as follows:

> [There], one non-bankruptcy member of the group [of related corporations, including the debtor, that filed consolidated tax returns] . . . proposed to take a worthless-stock deduction on account of its investment in the bankrupt entity; that tax benefit would have come in lieu of the corporate family's accumulated operating losses. Prudential Lines holds that taking the deduction would have exercised control over the debtor's operating losses; there is no equivalent example of

control (or consumption) of a loss carry-forward in an investor's simple sale of stock.

412 F.3d at 779.

The court also indicated that, since section 105(a) permits only implementation of other Code provisions, it could not be used to enjoin a stock sale that is not subject to the automatic stay. See id. at 778. However, the court also indicated that, if United had posted a bond or entered into an adequate protection agreement, the injunction could have been granted. See id.

Schilling v. Heavrin (In re Triple S Restaurants, Inc.), No. 04-5330, 2005 WL 1109615 (6th Cir. May 10, 2005) (unpublished), cert. denied, 126 S. Ct. 1143 (Jan. 17, 2006)

Section 329 applies to prepetition counsel even though he does not represent the debtor during bankruptcy

When the debtor commenced its chapter 11 case (September 1994), Heavrin was acting as general counsel for the debtor pursuant to a retainer agreement that had been signed more than a year before bankruptcy. The retainer agreement provided for Heavrin to receive $10,000 per month. In 1992, Heavrin assisted the debtor to avoid bankruptcy proceedings by negotiating arrangements with its creditors. In 1993 and 1994, Heavrin defended the debtor in litigation commenced by creditors seeking payment. Heavrin did not act as counsel for the debtor during the bankruptcy case.

After the debtor's case was converted to a chapter 7 case, the trustee filed an adversary proceeding against Heavrin seeking disgorgement of the fees the debtor had paid to him prepetition because Heavrin had not filed the statement required by section 329 and Bankruptcy Rule 2016[20]. The debtor's bankruptcy attorney had, however, submitted a schedule of "Payments to Insiders" which showed that, in the year prior to bankruptcy, the debtor had paid Heavrin $153,177.71.

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[20] Section 329(a) provides: "Any attorney representing a debtor in a case under this title, or in connection with such a case, whether or not such attorney applies for compensation under this title, shall file with the court a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation."

Rule 2016(b) provides, in relevant part: "Every attorney for a debtor, whether or not the attorney applies for compensation, shall file and transmit to the United States trustee within 15 days after the order for relief, or at another time as the court may direct, the statement required by § 319 of the Code including whether the attorney has shared or agreed to share the compensation with any other entity. . . ."

The bankruptcy court determined that the services Heavrin provided prepetition were covered by section 329 because they were in contemplation of the bankruptcy case. Although it initially ordered Heavrin to disgorge all of the fees at issue, ultimately it ordered him to disgorge only $46,043.32 (about 30% of his fees).[21] The bankruptcy court sanctioned Heavrin because of his initial failure and continuing refusal to comply with the disclosure requirements of section 329 and Rule 2016 and to deter noncompliance by others; however, the court also took into account that Heavrin had provided substantial services to the debtor during the year prior to bankruptcy.

While the district court in two prior appeals had agreed that Heavrin was subject to the requirements of section 329, in this last appeal, it reversed itself and ruled that "'Section 329 applies only to attorneys for the debtor and does not apply to counsel generally who provided services for a corporation prior to bankruptcy. . . . [T]he words seem so clear that the Court is uncertain how one could state a view so confidently to the contrary.'" Id. at 770-71.

The Sixth Circuit reversed the district court. It concluded that Heavrin was subject to section 329(a) because it applies to attorneys who render services "in contemplation of the case." Further, Heavrin's services were "in contemplation of the case" because he "was defending the encroaching claims of creditors to 'keep [the company] out of chapter 11.'" Id. at 772. The court also held that the bankruptcy court did not abuse its discretion in ordering partial disgorgement of Heavrin's fees, concluding that "the final order was, if anything, unduly generous to Heavrin." Id. at 773.

In re Armstrong World Industries, Inc., 432 F.3d 507 (3d Cir. Dec. 29, 2005)

A plan under which one impaired class of unsecured creditors shares its distribution with equity cannot be crammed down over the objection of another impaired class of unsecured creditors

The plan in this asbestos case provided that Class 6, a class of unsecured creditors, would recover about 59.5% of its $1.651 billion in claims; Class 7, a class of present and future asbestos-related personal injury claimants, would be paid from a section 524(g) trust into which the debtor would place approximately $1.8 billion in assets; and Class 12, its equity holders, would receive new warrants to purchase the debtor's common stock (the "warrants"), estimated to be worth $35-40 million. The plan also provided that, if Class 6 rejected the plan, Class 7 would receive the warrants, but automatically waive receipt, and that the warrants would be issued to Class 12. Class 6 rejected the plan because a majority in amount voted against it. The official committee of unsecured creditors ("UCC") initially endorsed the plan, but subsequently objected to confirmation "based on (1) the greater potential distribution to creditors that would result if the federal asbestos legislation was passed . . . and (2) the possible applicability of

[21] The original judge ultimately recused himself and another judge entered the order from which this appeal was taken.

the absolute priority rule, as codified in 11 U.S.C. § 1129(b), if the Plan was not accepted by all classes." Id. at 510.

The bankruptcy court recommended confirmation of the plan, finding that the section 1129(b)(2) "was satisfied because the warrants were distributed to the holder of equity interests because of the waiver of Class 7, citing In re Genesis Health Ventures, Inc., 266 B.R. 591 (Bankr. D. Del. 2001), and In re SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993)." 432 F.3d at 510. The district court disagreed. In re Armstrong World Indus., Inc., 320 B.R. 523 (D. Del. 2005).

On appeal, the Third Circuit agreed with the district court's reading of the cases creating the so-called "MCorp-Genesis" rule, e.g., SPM, Genesis Health and In re MCorp. Financial, Inc., 160 B.R. 941 (S.D. Tex. 1993), which it described as follows:

> The District Court differentiated SPM from the current case in three ways: (1) SPM involved a distribution under Chapter 7, which did not trigger 11 U.S.C. § 1129(b)(2)(B)(ii); (2) the senior creditor had a perfected security interest, meaning that the property was not subject to distribution under the Bankruptcy Code's priority scheme; and (3) the distribution was a "carve out," a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others. . . . Similarly, Genesis Health involved property subject to the senior creditors' liens that was "carved out" for the junior claimants. . . . In addition, the District Court found MCorp distinguishable on its facts because the senior unsecured creditor transferred funds to the FDIC to settle pre-petition litigation.

432 F.3d at 514 (citations omitted).[22]

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[22] The district court also distinguished In re WorldCom, Inc., No. 02-13533, 2003 WL 23861928 (Bankr. S.D.N.Y. Oct. 31, 2003), as a case that "did not involve the distribution of the debtor's property to any class of interests junior to the unsecured creditors on account of the junior creditors' equity interests in the debtor." 320 B.R. at 539. The district court also stated:

> [T]o the extent that In re WorldCom, In re Genesis Health Ventures, and In re MCorp Financial read SPM to stand for the unconditional proposition that "[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors, so long as recoveries received under the [p]lan by other creditors are not impacted," In re WorldCom, 2003 WL 23861928, at *61, . . . without adherence to the strictures of

(footnote continued…)

The court also declined to find that, based on floor statements by Rep. Don Edwards and Senator Dennis DeConcini, Congress intended to prevent only the squeezing out of an intermediate, intervening class, not the sharing of consideration by another class of the same priority. It found the "plain meaning" of the statute to cover any situation where a junior class is given property over the objection of a more senior class, and that this interpretation did not conflict with Congressional intent reflected in the legislative history. The court also noted that the plan was structured so that Class 12 would get the warrants whether or not Class 6 objected, and expressed its concern that "[a]llowing this particular type of transfer would encourage parties to impermissibly sidestep the carefully crafted strictures of the Bankruptcy Code, and would undermine Congress's intention to give unsecured creditors bargaining power in this context." Id. at 514-15.

The court also deflected the debtor's argument that the warrants were not given to Class 12 "on account of" their equity interests, but rather as part of an overall settlement including the release of intercompany claims. The court noted that the intercompany claims were approximately $12 million, while the warrants were worth $35-40 million, and that equity was getting other consideration in the plan as well. Since the debtor "gives no adequate explanation for this difference in value," the court was led "to conclude that . . . Class 12 . . . would receive the warrants on account of their status as equity interest holders." Id. at 516. The court also declined the debtor's invitation to find a general equitable exception to the absolute priority rule as codified.

Lastly, the court dealt with the debtor's argument that "UCC waived its right to object to the Plan because of its conduct during the reorganization process, specifically referring to UCC's role in shaping the Plan, its initial endorsement of the Plan, and then its subsequent objections to the Plan based on the possible passage of the FAIR Act." Id. at 517. The bankruptcy court had agreed with the debtor, finding UCC's conduct "too sharp even for a bankruptcy case." Id. But the district court disagreed, and so did the Third Circuit. Considering the issue one of judicial estoppel, rather than waiver, the court determined that UCC had a right to change its position as part of the plan confirmation process.

(footnote continued…)

> 11 U.S.C. § 1129(b)(2)(B)(ii), that contention is flatly rejected here.

320 B.R. at 539-40.

MBNA America Bank, N.A. v. Hill, No. 04-2086-BK, 2006 WL 172213 (2d Cir. Jan. 25, 2006)

Bankruptcy court did not have discretion to deny arbitration of claim for damages under section 362(h) [23]

After debtor filed her chapter 7 petition, bank continued to withdraw funds from her bank account to pay down a balance she owed on a prepetition consumer loan. Debtor filed a class action against bank in the bankruptcy court under section 362(h) seeking damages for willful violation of the automatic stay. Bank moved to stay or dismiss the adversary proceeding in favor of arbitration under a provision in the account agreement that mandated binding arbitration of "'[a]ny claim or dispute . . . arising from or relating in any way to this Account Agreement or . . . your account (whether under a statute, in contract, tort, or otherwise and whether for money damages, penalties or declaratory or equitable relief.'" Id. at *2.

The bankruptcy court denied the motion, concluding it was the most appropriate forum for the debtor's claim because (a) "a section 362(h) cause of action is strictly a product of the Bankruptcy Code," (b) it derives "from the rights of a debtor and recovery under it inures to the debtor," (c) the debtor's case was still open and "she continued to require the protection of the automatic stay," and (d) the automatic stay is "the equivalent of an injunctive order of the bankruptcy court." Id. at *4. The district court affirmed, "persuaded by the fact that a ruling on Hill's claim did not require the bankruptcy court to address the terms of the agreement between Hill and MBNA," and impelled by "the fact that the automatic stay serves the same function as an injunction." Id.

The Second Circuit reversed, holding that the bankruptcy court did not have discretion to deny the motion for arbitration. After conceding that the adversary proceeding was "core" – because it "derive[s] directly from the Bankruptcy Code and can be brought only in the context of a bankruptcy case" – the court determined that "arbitration . . . would not seriously jeopardize the objectives of the Bankruptcy Code." Id. This was because: (a) the debtor's case had been fully administered so she no longer needed the protection of the automatic stay; (b) resolution of the claim would not affect the bankruptcy estate as the debtor personally would receive any damage award and the bank had already restored the funds to her account; (c) her filing of a class action demonstrated that the claim for relief was "not integral to her individual bankruptcy proceeding"; and (d) "a stay is not so closely related to an injunction that the bankruptcy court is uniquely able to interpret and enforce its provisions." Id. at *4, *6. As to the last point, the court also said that since, under 28 U.S.C. § 1334(b), district courts as well as bankruptcy courts can hear automatic stay litigation, "this is not a matter within the excusive jurisdiction of the bankruptcy courts." Id. "While the automatic stay is surely an important provision of the Bankruptcy Code, there is no

[23] In the Code as amended by BAPCPA, this is section 362(k)(1).

indication from the statute that any dispute relating to an automatic stay should categorically be exempt from resolution by arbitration." Id.

Madison Foods, Inc. v. Fleming Cos., Inc. (In re Fleming Cos., Inc.), 325 B.R. 687 (Bankr. D. Del. June 2, 2005)

Debtor can enforce arbitration clause in contract it rejects

Prepetition, the debtor sold a grocery store to plaintiffs, in connection with which they executed a facility standby agreement (the "FSA"), a lease agreement, promissory notes and related agreements. Postpetition, the debtor rejected the FSA. The debtor also sought authority to sell substantially all of its wholesale distribution assets to Buyer. A dispute arose over the assumption and assignment of plaintiffs' notes as part of the sale. The plaintiffs then filed a complaint against the debtor and Buyer alleging that the notes were unenforceable as a result of fraud, breach of contract and promissory estoppel; they also sought a declaration that they had the right to use certain real estate pursuant to section 365(h), to offset obligations pursuant to section 552, and to deny the discharge of the debtor's obligations under section 523.

The FSA contained an arbitration clause covering "'[a]ll disputes between [the Debtor] and [plaintiff], including any matter relating to this Agreement.'" Id. at 691. The debtor moved to compel arbitration and to stay any nonarbitrable claims pending completion of the arbitration.

The bankruptcy court granted the motion. After determining that the arbitration clause covered all disputes between the parties, not simply those under the FSA, that the debtor had not waived its right to arbitrate, and that the arbitration provision was not unconscionable, the court considered whether, as plaintiffs argued, the debtor's rejection of the FSA meant that it could not enforce the arbitration agreement. The court held that a party can still be compelled to arbitrate even though it has rejected or breached the underlying agreement, citing principally Southeastern Pennsylvania Transportation Authority v. AWS Remediation, Inc., No. Civ. A 03-695, 2003 WL 21994811 (E.D. Pa. Aug. 18, 2003). In Southeastern, the court opined that "[a] rejection in bankruptcy does not alter the substantive rights of the parties that formed pre-petition. . . . While a debtor may reject a contract in its 'entirety.' it may not invalidate freely negotiated methods of dispute resolution [such as arbitration provisions] as they apply to pre-petition acts." Id. at *3. The bankruptcy court applied this reasoning even though, in Southeastern and similar cases, the nondebtor party, not the debtor, sought arbitration. It considered the distinction "immaterial." 325 B.R. at 694. "Both parties agreed to the method of dispute resolution and both parties should be able to take advantage of it." Id. Because the plaintiffs' claims under the Bankruptcy Code depended on whether plaintiffs succeeded on their fraud and contract claims, the court stayed proceedings on the nonarbitrable claims.

<u>In re MSI Marketing, Inc.</u>, No. 03-35822-SAF-11, 2005 WL 2589177 (Bankr. N.D. Tex. Sept. 9, 2005)

Bankruptcy claim procedure was superior to a class action in determining claims against debtor

Claimant filed a "class claim" against debtors for violating the Telephone Consumer Protection Act by sending unauthorized facsimile communications. The bankruptcy court allowed claimant an unsecured claim of $3000 (including treble damages), but refused to certify the class. Although the court assumed that the claimant raised claims typical of other class members and that there were common questions for adjudication, the court determined that the alternative "claims allowance process under the federal bankruptcy rules provided a fair and efficient opportunity to adjudicate those claims." <u>Id.</u> at *4. To assure that potential claimants had notice of the requirement that they file claims, the court had

> appointed a representative for claimants to assist the court in developing a procedure for the filing of claims. With the input of the representative, the court established a process to easily access claim forms. At the court's direction, [the debtors] placed claims notices in national newspapers, on various web sites and at other locations. . . . [That] process has resulted in numerous claims filed in the case.

<u>Id.</u> The court also noted that "the handling of a large number of claims is not impractical for this court," and that "[t]he number of potential claims . . . pales in comparison to the claims have been filed in other cases." <u>Id.</u> at 5. Thus, "[a] class action is not a superior method to determine claims against the bankruptcy estate." <u>Id.</u>