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Restructuring and Reorganization Report

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Dechert LLP

Welcome

By **H. Jeffrey Schwartz** and **Charles I. Weissman**

"The present combination of consumer distress, including consumers' loss of net worth and high debt, together with the structural opacity of the credit markets is unprecedented during the post-World War II era and could well engender a tsunami of defaults and insolvencies. During my three decades of law practice, I've witnessed a number of corrections and recessions, but nothing akin to this perfect storm of economic disturbance."

– H. Jeffrey Schwartz, Partner at Dechert LLP, March 20, 2008

Dechert has built up a fully integrated business restructuring and reorganization practice of approximately 30 lawyers with a broad range of experience. We are committed to providing our clients with world-class expertise and exceptional service. Given current market conditions, we are aware of the economic challenges and opportunities that our clients may face in this rapidly changing environment. We understand that new and unique issues will be raised and look forward to the opportunity to assist our clients in their endeavors.

Dechert helps clients with diverse interests in restructuring matters to achieve their specific financial and business goals, including preserving value, capitalizing on investment opportunities, managing complex restructurings, and protecting their rights and interests. We serve as powerful advocates at every phase of the restructuring lifecycle, from the early stages where preventing bankruptcy is the primary objective, through negotiations among stakeholders with competing interests, to the strategic use of litigation, as necessary. We respond to our clients' needs for expediency while maximizing their recovery.

We are pleased to present the inaugural issue of Dechert's *Restructuring and Reorganization Report*. This publication will bring you our insights and guidance on topical issues relevant to your business interests.

Dechert Obtains Compensation in Exchange for Forbearance from Stock Transfer or Taking Worthless Stock Deduction

By **H. Jeffrey Schwartz**

In *Remy Worldwide Holdings, Inc.*[1] ("Remy"), the Dechert team represented certain funds controlled by Court Square Capital Limited ("Court Square"), Remy's former majority equity holders, in connection with Remy's prepackaged chapter 11 cases. To preserve Remy's net operating losses ("NOLs"), Remy agreed to pay Court Square an unprecedented $4 million and provide Court Square with a full release under Remy's chapter 11 plan in exchange for Court Square's forbearance of its right to transfer its equity interests in Remy or to take a worthless stock deduction and its waiver of certain management fees.

The compensation provided to equity in *Remy* is in sharp contrast to past cases where all out-of-the-money equity could hope for was some combination of the following: (i) a smooth and efficient bankruptcy case, (ii) no lawsuits against former equity during or following the bankruptcy case, and (iii) full releases under a confirmed chapter 11 plan.

Preservation of NOLs

NOLs are typically a significant asset of a chapter 11 debtor. The preservation of NOLs upon emergence from chapter 11 is critical to the reorganized debtor so that any cancellation of debt income ("COD") resulting from the discharge of liabilities under the debtor's confirmed chapter 11 plan can be offset by the NOLs. If there are insufficient NOLs to offset the COD income, the debtor will be required to write-down certain tax attributes on other assets. Depending on the extent and severity of the write-down of tax attributes, the reorganized debtor could face significant tax liabilities upon emergence from chapter 11.

Remy

Court Square was the majority equity holder of Remy. Given Remy's capital structure and insolvency, Court Square was unlikely to recover any distributions on account of its equity interests in Remy. To accelerate its loss from its equity investment in Remy for estimated tax purposes, Court Square either could have sold its equity interests in Remy or taken a worthless tax deduction prior to the commencement of the bankruptcy cases. However, taking such actions would have caused the extinguishment of all or a portion of Remy's estimated $300 million-plus of NOLs.

Specifically, section 382 of the Internal Revenue Code provides, among other things, that a chapter 11 debtor's NOLs can be significantly limited if an ownership change occurs outside of a confirmed chapter 11 plan. For example, an ownership change can occur for the purposes of section 382 if a 50% or greater shareholder elects to take a worthless stock deduction before the debtor's emergence from chapter 11.

Given Remy's significant estimated NOLs, Remy entered into negotiations with Court Square and the Dechert team to obtain a forbearance of Court Square's right to transfer its equity interests or to take a worthless stock deduction before the commencement of Remy's chapter 11 cases. Those negotiations concluded with an executed prepetition agreement to preserve Remy's NOLs providing, among other things, that:

- Remy would pay $4 million to Court Square and provide Court Square with a full release of claims and causes of action from Remy and the ad hoc noteholders committee;
- Court Square would not cause an ownership change or take a worthless stock deduction; and
- Court Square would waive certain management fees.

To ensure that Court Square would be able to capture the $4 million payment, Dechert, on behalf of Court Square, negotiated an agreement that provided for its assumption in the chapter 11 cases and the treatment of the $4 million settlement payment as an administrative expense under Remy's prepackaged plan. In addition, the $4 million payment was a condition to the effectiveness of the plan, which the Bankruptcy Court confirmed on November 20, 2007. The plan went effective on December 6, 2007, and $4 million was paid to Court Square on that date.

Trading Injunctions

It remains to be seen whether a debt or equity holder will be able to establish that it is entitled to an administrative expense claim in a conventional (i.e., not prepackaged) chapter 11 case in exchange for a forbearance of the right to transfer interests in the debtor or to take a worthless stock deduction. In large chapter 11 cases, trading injunctions are routinely obtained by chapter 11 debtors, which preclude certain debt and equity holders from transferring their interests in the debtor or taking a worthless stock deduction if such actions would result in any erosion of the debtor's NOLs. Generally, compensation has not been awarded to enjoined debt or equity holders.

To be sure, trading injunctions have been challenged. As a result of one such challenge, the U.S. Court of Appeals for the Seventh Circuit in *In re UAL Corp.*[2] found that trading injunctions could harm enjoined shareholders and that mitigation of that harm may be appropriate. Following the reasoning of *UAL*, in *In re Wellman, Inc.*, a shareholder of Wellman objected to the proposed trading injunction and argued, among other things, that Wellman should post a bond or other adequate protection for the benefit of enjoined shareholders.[3]

In *In re Dana Corp.*,[4] the ad hoc committee of certain noteholders questioned the evidentiary basis for the injunctions, arguing that the debtors should be required to prove the value of the NOLs. After several months of litigation, the debtors' proposed form of order was entered by the court with modifications including: (i) an increase in the threshold ownership required for holders to be implicated by the trading injunction (from 4.5% to 4.75%); (ii) a narrower window for the debtors to object to a proposed transfer (15 days instead of 30 days); and (iii) a requirement that a hearing be held within 15 days of any objection to a proposed transfer.

Conclusion

Remy demonstrates that, with strong advocacy by counsel, a debt or equity holder may be able to obtain compensation in exchange for any forbearance of its right to transfer its interests in the debtor or to take a worthless stock deduction in certain circumstances. In addition, the *Remy* Order, together with the *UAL Corp.* decision, may serve as support for a debt or equity holder to seek compensation if there is an involuntary forbearance imposed under a trading injunction in a conventional chapter 11 case under appropriate facts.

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1 Jointly administered under the lead case of *Remy Worldwide Holdings, Inc., et al.* Del. Bankr. Ct. 07-11481 (KJC).

[2] 412 F.3d 775 (7th Cir. 2005).

[3] Case No. 08-10595 (SMB) (Bankr. S.D.N.Y.). At the time this article was prepared, a decision from the Bankruptcy Court was unavailable.

[4] Jointly administered under the lead of *In re Dana Corp.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.).

The author would like to thank Richard Stieglitz for his substantial assistance in preparing this article.

The Treatment of Mortgage Loan Repurchase Agreements in Chapter 11 Bankruptcy

By **Katherine A. Burroughs**

In a recent case of first impression, a Bankruptcy Court held that a contract for the sale and repurchase of mortgage loans was a "repurchase agreement" as defined in section 101(47) of the Bankruptcy Code and that the amended "safe harbor" provisions of sections 555 and 559 of the Bankruptcy Code were applicable; however, the safe harbor provisions did not apply to the servicing rights for the mortgage loans. *See Calyon N.Y. Branch v. Am. Home Mortgage Corp. (In re Am. Home Mortgage, Inc.)*, 379 B.R. 503 (Bankr. D. Del. 2008).

Background

In November 2006, a number of financial institutions (the "Repo Buyers") entered into a repurchase agreement (the "Repo Agreement") with American Home Mortgage Corp. and certain of its affiliates (the "Repo Seller"). A mortgage loan repurchase agreement commonly provides a means by which a finance provider or a group of finance providers can supply a loan originator with the funds necessary to originate mortgage loans. In this case, the Repo Agreement provided for the transfer of mortgage loans from the Repo Seller to the Repo Buyers in exchange for a payment from the Repo Buyers. The Repo Buyers were then to re-transfer the mortgage loans to the Repo Seller no later than 180 days after the initial transfer, upon payment of a repurchase price equal to the original price paid to the Repo Sellers plus the "pricing differential," a *per diem* "pricing rate" multiplied by the number of days the mortgage loans were held by the Repo Buyers. The Repo Agreement also provided that the mortgage loans were sold to the Repo Buyers on a "servicing retained" basis in which the Repo Sellers retained the right to designate the mortgage loan servicer.

In August 2007, the Repo Seller filed a chapter 11 bankruptcy petition. Subsequently, the Repo Buyers filed a complaint against the Repo Seller seeking, among other things, (i) a declaratory judgment that the Repo Agreement was a "repurchase agreement" as defined in the Bankruptcy Code and that, pursuant to sections 362(B)(7), 555, and 559 of the Bankruptcy Code, the rights of the Repo Buyers to sell the mortgage loans under the Repo Agreement were not stayed and (ii) injunctive relief compelling the Repo Seller to transfer the servicing rights to the mortgage loans to the Repo Buyers.

The Contract Qualified for the Repo Agreement Safe Harbor under Section 559

In reaching a decision, the court articulated five specific factors that characterize repurchase agreements entitled to the "safe harbor" provisions of the Bankruptcy Code, which exempt the exercise of certain contractual rights to liquidate, terminate, and accelerate repurchase agreements from the bankruptcy automatic stay and avoidance powers. The court established the definition of a repurchase agreement, which:

- provides for the transfer of one or more mortgage loans or interests in mortgage related securities or mortgage loans;
- against the transfer of funds by the transferee of such mortgage loans or interests in mortgage related securities or mortgage loans;
- with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests in mortgage related securities or mortgage loans;
- at a date certain not later than one year after such transfer or on demand; and
- against the transfer of funds.[1]

The court found that the first factor was fulfilled since the Repo Agreement provided for the transfer of multiple mortgage loans or interests in mortgage loans. The court noted that even if the Repo Agreement provided for the creation of a lien on the mortgage loans, it would still constitute a "transfer" under subsection 101(54) of the Bankruptcy Code. With respect to the second factor, the court determined that the transfer from the Repo Seller to the Repo Buyers was against the transfer of funds from the Repo Buyers to the Repo Seller. Additionally, the Repo

Agreement contained a concurrent agreement by the Repo Buyers to transfer the mortgage loans to the Repo Seller that, according to the court, fulfilled the third factor. The court concluded that the fourth factor was satisfied as the re-transfer of the mortgage loans from the Repo Buyers to the Repo Seller was to occur within 180 days of the original transfer—well before the one-year deadline articulated by section 101(47) of the Bankruptcy Code. Finally, as the transfer of the mortgage loans from the Repo Buyers to the Repo Seller was against the transfer of funds by the Repo Seller to the Repo Buyers, the final factor was fulfilled. Thus, the court held that the sale and repurchase of the mortgage loans under the Repo Agreement was a repurchase agreement entitled to the "safe harbor" provisions of the Bankruptcy Code.

The Safe Harbor Did Not Apply to the Servicing Rights

With respect to the transfer of the servicing of the mortgage loans under the Repo Agreement, however, the court found that the safe harbor provisions were inapplicable. Applying New York law, the court reached this decision for two reasons:

- the portion of the Repo Agreement that provided for the servicing of the mortgage loans was severable from the portion of the Repo Agreement providing for the sale and repurchase of the mortgage loans; and
- the portion of the Repo Agreement providing for the servicing of the mortgage loans was neither a "repurchase agreement" (under subsection 101(47) of the Bankruptcy Code) nor a "securities contract" (under subsection 741(7)(a)(i) of the Bankruptcy Code).

Based on this finding, the court held that the provisions of the Repo Agreement relating to servicing the mortgage loans were severable from the rest of the agreement and were thus not entitled to the protections of the "safe harbor" provisions of the Bankruptcy Code.

Significance

American Home is significant in that it is a case of first impression regarding the applicability of the amended "safe harbor" provisions of sections 555 and 559 of the Bankruptcy Code to a repurchase agreement involving mortgage loans. Participants in a repurchase agreement should take some comfort from the court's holding that the portion of the agreement providing for the sale and repurchase of mortgage loans fell within the plain meaning of the Bankruptcy Code's definitions of a "repurchase agreement" and a "securities contract." This enables repo participants to receive the protections for which they bargained through the application of the amended "safe harbor" provisions.

Of note, however, is the court's finding that the portion of the agreement providing for the servicing of the mortgage loans was not protected under the amended "safe harbor" provisions of the Bankruptcy Code because that portion of the agreement was neither a repurchase agreement nor a securities contract. As a bankrupt repo seller is unlikely to have the funds necessary to buy back its loans, a repo buyer may have to liquidate collateral loans by sales to third-party buyers. The price a repo buyer could realize from such a sale, however, may be reduced if the repo buyer must sell the mortgage loans subject to the bankrupt repo seller's servicing rights.

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[1] *See also* 11 U.S.C. § 101(47) (defining a repurchase agreement).

The author would like to thank Jonathan F. Tross for his substantial assistance in preparing this article.

> ***"Both initial and continuing jobless claims surged.*** *The large upward moves of both in tandem are very consistent with an economy moving into a recession … Apart from two weeks immediately following [Hurricane] Katrina, initial claims are the highest since the aftermath of the last recession. Meanwhile, the increase in continuing claims was an extremely large move for this series."*
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> – Goldman Sachs U.S. Economics Research

Current Loan-to-Own Strategies

By **H. Jeffrey Schwartz**

The U.S. economy is currently in a severe credit crunch as a result of the sub-prime mortgage crisis. While the downward trend of the credit markets poses a serious threat to the U.S. economy and existing investors in troubled companies, substantial opportunity exists for investors to acquire good businesses with bad balance sheets at distressed prices by executing a loan-to-own strategy.

The Dechert team routinely advises its clients with respect to loan-to-own transactions. Generally, loan-to-own transactions involve one or more of the following:

- the purchase or provision of prepetition secured debt;
- the provision of debtor-in-possession financing;
- rights offerings or plan funding agreements; and/or
- the purchase of the fulcrum security.

Executing a Loan-to-Own Strategy

Secured Debt

The first strategy that a distressed investor can use to acquire a troubled business is to provide senior secured debt or to purchase the company's senior secured debt. By holding a perfected first lien position, the distressed investor will have powerful leverage to influence a restructuring. If the company commences a chapter 11 case, a secured creditor can participate in an auction of the company's assets by credit bidding the full face value of its allowed secured claim as opposed to the discounted purchase amount of the claim.[1] In addition, the secured creditor will have a leg up over other potential bidders for a company's assets because the secured creditor will have superior information about the company and its assets.

The secured creditor will have significant leverage with respect to the ultimate formulation of the debtor's chapter 11 plan. The secured creditor will either be able to control the reorganization or receive payment for the full amount of the allowed claim. Specifically, to cram-down a plan on an objecting secured creditor, the company will be required to make deferred payments under its plan of reorganization whose face value equals the amount of the allowed claim and whose present value equals the value of the collateral.

In *In re Granite Broadcasting Corp.*,[2] the court was faced with two competing distressed investors at different levels of the capital structure. One investor was a secured creditor of the company and the other was a preferred stockholder of the company. The company proposed a chapter 11 plan that provided the secured creditor with an 85% recovery including most of the new equity of the company. The preferred stockholders offered an alternative package that would have given the secured lender a 100% recovery in debt and cash and provided the new equity to the preferred stockholders.

In support of the alternative plan, the preferred stockholders argued that because the secured lender preferred an 85% package including the new equity to a 100% package of cash and debt, the secured lender could not possibly believe the valuation proffered by its expert. The court rejected this argument because the issue is not whether the secured lender believes that there may be upside to its investment in the debtor but whether the plan gives the secured creditors value that is more than 100% of their debt. Accordingly, the court confirmed the plan proposed by the company and in favor of the secured lender.

The *Granite* decision demonstrates, among other things, that a distressed investor using a secured debt strategy has a leg-up on other constituencies at lower levels of the capital structure.

DIP Financing

A distressed investor can provide debtor in possession financing ("DIP financing") to the company once it commences a chapter 11 case. While the Bankruptcy Code provides that a new lender can prime a prepetition secured lender, i.e., by taking a security interest in collateral ahead of the security interest of the prepetition secured lender, priming can only be accomplished if the debtor is able to provide the prepetition secured lender with adequate protection for the diminution of value of its collateral as a result of the priming loan. Accordingly, in most situations, the prepetition secured lender provides the DIP financing. As a result, if a distressed investor desires to provide DIP financing, holding a position in the prepetition secured debt will make it more likely that the DIP financing is approved by the Bankruptcy Court because the DIP lender can consent to the priming of its prepetition liens.

There are several advantages to providing DIP financing for the distressed investor. The DIP financing will be subject to approval by the Bankruptcy Court. Once the DIP financing is approved by final order, the DIP lender will have superpriority claims and liens that are not subject to challenge. The ability to obtain a court order and certainty of legal rights in the DIP financing should provide a distressed investor with substantially more comfort than if it was providing a secured bridge loan before the commencement of a bankruptcy case.

A distressed investor also can use DIP financing to take control of the negotiations concerning the company's chapter 11 plan or to control the sale of assets to the DIP lender. In *Official Committee of Unsecured Creditors v. New World Pasta*,[3] both the District Court and Bankruptcy Court held that a DIP financing agreement may provide that any chapter 11 plan of reorganization must be satisfactory to the DIP lender. In addition, Bankruptcy Courts have repeatedly approved DIP financing agreements providing that the terms of an asset sale under section 363 of the Bankruptcy Code must be satisfactory to the DIP lender.[4]

Fulcrum Security

An alternative strategy for a distressed investor is to determine which layer of a company's capital structure is the "fulcrum security." The fulcrum security is the security that is most likely to receive equity in the reorganized company after confirmation of a chapter 11 plan. Whether a particular security will be entitled to equity will be determined by the enterprise value of the company. For example, if a company has an enterprise value of $150 million, $100 million in secured debt, and $100 million in unsecured bond debt, the holders of the secured debt will be paid in full, and the holders of the bond debt will receive equity in the reorganized company. Existing equity will be cancelled. In this example, the bond debt is the fulcrum security.

If the fulcrum security is an unsecured obligation of the company, the distressed investor can band together with other similarly situated investors to form an ad hoc committee and pursue restructuring negotiations with the company. In addition, the distressed investor also may be able to serve on an official creditors committee once the company commences a chapter 11 case. By serving on either an ad hoc or official committee, the distressed investor will be able to obtain material non-public information from the company. However, receiving such information may significantly limit the distressed investor's ability to trade its securities in the company.

Rights Offerings and Plan Funding Agreements

To increase its holdings in the new equity of a reorganized company, a distressed investor may participate in a rights offering to purchase the new equity either as part of the chapter 11 process or before the commencement of a chapter 11 case in the context of a prepackaged bankruptcy. For example, in *Curative Health Services, Inc.*,[5] the company permitted certain large bondholders to participate in a rights offering for additional equity in the reorganized company in connection with the formulation of its prepackaged chapter 11 plan. By participating in the rights offering, large bondholders were able to obtain additional equity in the reorganized company at a discount in exchange for making the cash available to the company during the chapter 11 case to cash-out smaller bondholders.

Similarly, a distressed investor can choose to be a plan sponsor. In this capacity, the distressed investor agrees to contribute liquidity to enable the company to make distributions under its chapter 11 plan. In the *Loral Space* bankruptcy,[6] for example, MHR Fund Management supported a plan of reorganization that rendered MHR the reorganized debtor's controlling stockholder by, among other things, backstopping a substantial rights offering of senior secured notes by a Loral subsidiary.

Flexible Approach

Distressed investors can invest in various parts of a company's capital structure. For example, a distressed investor can have both debt and equity positions in a company. In this instance, the distressed investor must be careful to distinguish between its role as equity holder and its role as debt holder. This means not only executing separate documents respecting debt and equity investments but also acting like a debt holder when the investor monitors the loan and responds to a default. In addition, if the distressed investor has representatives on the company's board of directors, those directors should avoid any conflicts of interest that may arise if the investor enters into negotiations with the company to refinance its debt obligations.

Win Board Support

To maximize a loan-to-own strategy, the distressed investor should work with the company's board of directors. A company's board of directors has significant flexibility in choosing the course of a restructuring or a preferred bidder for the company's assets whether or not the company commences a chapter 11 case. If the directors believe that the proposal from the distressed investor will maximize the value of the corporation, the distressed investor will have a greater chance of effectuating its strategy.

If the directors do not support the proposal from the distressed investor, recent changes in fiduciary duty law provide directors with a shield to resist activist distressed investors. In *North American Catholic Educational Programming, Inc. v. Gheewalla*,[7] Delaware's highest court held that (a) a creditor cannot assert a direct claim for breach of fiduciary duty against the directors of a solvent or insolvent company, and (b) a creditor cannot assert a derivative claim for breach of fiduciary duty against the directors of a solvent company. It remains unclear whether a creditor can assert a derivative claim for breach of fiduciary duty against the directors of a company in the zone of insolvency.

The inability of a creditor to pursue a direct claim against the company's board of directors for breach of fiduciary duty when the company is insolvent (and potentially a derivative claim when the company is in the zone of insolvency) provides directors with a basis to resist activist distressed investors.

Risks of a Loan-to-Own Strategy

Litigation Risk

Distressed investors may face litigation from other constituencies seeking control or greater recoveries from a bankrupt company. Some of the claims that can be asserted against a distressed investor include:

- aiding and abetting breach of fiduciary duty;
- equitable subordination of the investors' claims;
- recharacterization of the investor's claims; and
- preference or fraudulent transfer claims.

However, a well-advised investor can structure the investment and related course of conduct to minimize the risk of such litigation.

In *Official Committee of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.)*,[8] a distressed investor successfully thwarted claims asserting recharacterization, equitable subordination, and aiding and abetting breach of fiduciary duty with respect to secured loans made to the company before the commencement of its bankruptcy case. The Radnor decision provides some guiding principles:

- it is reasonable for a lender to provide additional credit to a distressed borrower before the commencement of a bankruptcy to protect its existing loans;
- an investor is not an insider even if the investor controls some, but not all, of a company's board seats, has the right to acquire additional board seats, and has access to non-public information; and
- a board of a highly distressed company may incur additional debt in an effort to rehabilitate the business.

Competing Investors

To ensure the success of a loan-to-own strategy, the distressed investor should be prepared to offer a superior apples-to-apples offer when confronted with competing investors at different levels of the capital structure. Competition, and any associated legal fight between investors, may produce a variety of benefits: (a) the competing bid may prevail, (b) the secured lender may make a significantly better offer that provides more value to distressed investors at lower levels of the capital structure, and (c) the value of the securities at different levels of the capital structure may temporarily spike because of perceived upside.

Conclusion

The current credit markets have created a wealth of opportunity for distressed investors to obtain strong returns. Before making a loan-to-own play, the distressed investor should carefully determine which strategy to implement, determine the value of the company, properly document the transaction, and act in good faith.

1 *See Cohen v. KB Mezzanine Fund II, LP v. Cohen (In re Submicron Sys. Corp)*, 432 F.3d 448, 459-60 (2d Cir. 2006).

2 369 B.R. 120 (Bankr. S.D.N.Y. 2007).

3 322 B.R. 560 (M.D. Pa. 2005).

4 See, for example, the court-approved DIP agreement in *In re Phoenix Information Systems Corp.*, Case No. 97-02498 (Bankr. D. Del.).

5 *In re Curative Health Servs., Inc.,* Case No. 06-10552 (Bankr. S.D.N.Y.).

6 *In re Loral Space & Commc'ns Ltd.,* Case No. 03-41710 (Bankr. S.D.N.Y.).

7 930 A.2d 92 (Del. 2007).

8 353 B.R. 820 (Bankr. D. Del. 2006).

The author would like to thank Brian E. Greer for his substantial assistance in preparing this article.

> *"Credit market problems persist and if anything have gotten worse. We're looking to 2009 before we see much of an improvement."*
>
> – Tony James, President of The Blackstone Group, March 10, 2008

Dechert Wins Compound Interest on Post-Maturity Debt for Noteholders

By **Glenn E. Siegel**

In *Bank of New York v. Foamex Int'l Inc. (In re Foamex Int'l Inc.)*,[1] the Dechert team won an appeal in the U.S. District Court for the District of Delaware in which the court held that unsecured noteholders characterized as "unimpaired" under a chapter 11 plan should receive compound interest on post-maturity debt in accordance with the terms of the underlying indenture.

Background

Foamex Int'l Inc. and its affiliates (collectively, "Foamex") are leading producers of cushioning for furniture and automobiles. Prior to the commencement of Foamex's chapter 11 cases, Foamex issued $98 million of 13.5% unsecured

notes due in 2005 (the "Notes"). The Notes provided for semi-annual interest payments (compounded) and established a higher default rate (14.5% per year) on overdue installments of interest and principal. As of the petition date, the Notes had matured, but the Debtors had not paid the principal or the last scheduled interest payment.

In 2006, Foamex filed its chapter 11 plan, which provided, among other things, that unsecured creditors (including holders of the Notes (the "Noteholders")) were to be unimpaired. The effect of such classification was that the plan could not alter the "legal, equitable, and contractual rights" of the unimpaired creditors in accordance with section 1124 of the Bankruptcy Code. Under the plan, the Debtors proposed to pay to the Noteholders all outstanding amounts owed under the Notes and default rate simple interest (as opposed to compounded interest) on such amounts.

The indenture trustee, on behalf of the Noteholders, argued that such treatment did not leave the Noteholders unimpaired. The indenture trustee asserted that New York law provides that if a debt instrument provides for interest to accrue until principal is "paid," then the interest continues to accrue post-maturity in the manner provided for in that instrument (which in this case was on a compound basis). The U.S. Bankruptcy Court for the District of Delaware disagreed, because as Foamex argued, the indenture for the Notes did not expressly provide for post-maturity compounding of interest.

The Appeal

The indenture trustee filed an appeal of the Bankruptcy Court's decision with the Delaware District Court. On appeal, the District Court reversed the Bankruptcy Court and held that compound interest was required under the indenture. Specifically, the District Court found that because the Noteholders were unimpaired under Foamex's plan, the Noteholders were entitled to their full claims under the indenture. Under New York law, where a debt instrument provides for interest to accrue "until principal is paid," the provision remains operative after the maturity date. In addition, because the indenture provided for compound interest, the District Court found that the interest payable to the Noteholders continued to accrue on a compound basis.

The *Foamex* decision follows Dechert's recent victory in settling the right of Portrait Corporation of America's oversecured second lien noteholders to receive a contractual prepayment premium in exchange for a *de minimis* payment to the estate and Dechert's earlier victory in the *Dow Corning* case finding that a solvent debtor must pay in full contractually mandated interest and fees.

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[1] Case No. 07-00212 (JJF) (D. Del. Feb. 28, 2008).

The author would like to thank Davin J. Hall for his substantial assistance in preparing this article.

Growth in Emerging Markets and Increase in Multinational Corporations Highlight Concerns over the Scope of Section 365(n)

By **Shalom Jacob**

In recent years, emerging markets, such as the BRIC countries—Brazil, Russia, India, and China—have grown dramatically, and multinational corporations continue to expand. While this growth has led to significant investment activity and greater opportunities to do business outside the United States, it is critical that parties involved in foreign transactions carefully structure each transaction to protect their economic interests.

Dechert routinely represents clients in connection with the licensing of intellectual property owned by foreign or multinational companies. When engaging in transactions with foreign companies, parties may find it much more difficult to perform comprehensive due diligence, especially when the foreign company is a newly-formed entity or privately owned enterprise. As a result, U.S. entities must ensure that they are receiving adequate and accurate financial information about the foreign company. While obtaining such information is critical in most transactions, it is particularly important with respect to intellectual property.

In addition, in most of these cases, the foreign or multinational company has a nexus with the United States as a result of the presence of affiliate companies incorporated in the United States. Thus, there is a risk that the licensor may be subject to a U.S. bankruptcy case. In that event, the licensee's rights under a license agreement with either a U.S. or multinational company can be dramatically impacted by the U.S. bankruptcy of the licensor, particularly if the debtor licensor elects to reject the license.

While there are inherent risks in any intellectual property transaction, section 365(n) of the Bankruptcy Code provides valuable protection to licensees of intellectual property. However, certain significant areas that section 365(n) does not explicitly address are even more pressing in the context of multinational companies. Accordingly, licensees are potentially vulnerable in the event of a U.S. bankruptcy filing by the licensor.

Section 365 of the Bankruptcy Code

Section 365 of the Bankruptcy Code provides that a debtor may assume (i.e., accept) an executory contract, reject it, or assume it and then assign it to a third party. However, a debtor will be prohibited from assuming an executory contract if applicable law excuses the non-debtor party from accepting performance from, or rendering performance to, anyone other than the debtor—regardless of whether such contract restricts or prohibits assignments—unless the non-debtor party consents to the assumption or assignment. In chapter 11 reorganization cases, the debtor may reject or assume most executory contracts at any time before the confirmation of a plan of reorganization or as part of a plan.

Generally, a license agreement will be deemed an executory contract if material performance remains due by both parties to the agreement. If the debtor assumes the license agreement, the relations of the licensor and licensee remain generally unchanged after the bankruptcy case is commenced. However, before a debtor can assume an executory contract, it must (a) cure all defaults and compensate the licensee for actual pecuniary losses due to the default and (b) provide adequate assurance of future performance under the license.

Consequences of Rejection by the Debtor

If the debtor rejects a license agreement, the effect of the rejection could be devastating to a licensee if the licensee is deprived of the technology that it needs to operate its business. To mitigate the potential adverse consequences to licensees, section 365 of the Bankruptcy Code was amended in 1988 to add section 365(n). Section 365(n) was enacted to "make clear that the rights of an intellectual property licensee to use the licensed property cannot be unilaterally cut off as a result of the rejection of the license pursuant to section 365 in the event of the licensor's bankruptcy." S. Rep. No. 505, 100th Cong., 2d Sess. 1 (1988).

Upon rejection of the license agreement, the licensee has two options: terminate the license agreement or elect to retain its rights under the license agreement. If the licensee terminates the agreement, the licensee forfeits its rights to the intellectual property under the agreement. In that event, rejection is treated as a breach of the agreement and the licensee's only recourse would be to assert a general unsecured claim for rejection damages under section 502(g) of the Bankruptcy Code. Depending on the enterprise value of the debtor, the recovery on such claim may be minimal.

If the licensee elects to retain its rights to the license, section 365(n)(3) requires the debtor, upon the licensee's written request, to (A) "[p]rovide the licensee with the licensed intellectual property to the extent provided for in the license agreement or any supplemental agreement" and (B) refrain from interfering with the rights of the licensee under the license or any supplement thereto, "including any right to obtain such intellectual property (or such embodiment) from another entity."

Once the licensee elects to retain its rights to the license, the licensee can benefit from the license for the length of the license with any extensions that the license may allow and enforce the exclusivity of the license against third parties to prevent infringement.

Limitations on the Licensee's Rights

While the rights and remedies of a licensee that elects to retain the license are broad, there are significant limitations under section 365(n).

Not All Intellectual Property is Protected

Section 365(n) protects licensees only with respect to certain types of intellectual property. Intellectual property is defined by the Bankruptcy Code as "(A) trade secret; (B) invention, process, design, or plant protected under title 35; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17; or (F) mask work protected under chapter 9 of title 17."[1]

Notably absent from this definition are trademarks. Consequently, trademarks—and licensees thereof—are not protected by section 365(n).

Foreign Patents

Although the Bankruptcy Code deems patent applications to be intellectual property regardless of where they are issued, some commentators have cautioned that foreign patents may not constitute intellectual property under the Bankruptcy Code. The issue of foreign patent eligibility results from an ambiguity in the bankruptcy definition of intellectual property set forth above. Specifically, it is not clear whether the phrase "title 35" in clause (B) modifies only "plant," or "invention, process, design, [and] plant."

If "title 35" modifies the entire clause as opposed to just "plant," then foreign patents may not be protected as title 35 concerns only patents registered in the United States. This issue is avoided if the patent application is filed in both the United States and in a foreign jurisdiction.

Royalty Payments

To retain the rights to a license under section 365(n), the licensee must make all royalty payments due under the license agreement for the duration of the agreement. The term "royalty payments" will be construed broadly by courts, and it is possible that any payment required under the licensing agreement will be deemed to be a required royalty payment.

Once the licensee elects to make royalty payments and retain its licensing rights, it will be deemed to have waived all setoff rights it may have in connection with its licensing agreement. However, a licensee may be able to exercise a right of recoupment, an equitable doctrine that is permitted in the discretion of the Bankruptcy Court.

Limitation on Improvements

Section 365(n) permits a licensee to retain rights to a license only as such rights existed immediately before the bankruptcy case commenced. If the license grants the licensee rights in improvements to the intellectual property or intellectual property created in the future, such grants may not be enforceable.

Supplemental Agreements and Embodiments

Section 365(n) permits a licensee to retain its rights under a license agreement and any agreement supplementary thereto with respect to intellectual property and any embodiment thereof. However, the Bankruptcy Code does not define the terms "supplemental agreement" and "embodiment."

With respect to supplemental agreements, some commentators suggest that the term refers to separate agreements that relate to and enable the functionality of intellectual property, such as separate development agreements, escrow agreements, maintenance, technical services, and updating agreements. However, it remains unclear whether other types of agreements and contractual rights, such as rights of first refusal, could be deemed to be supplementary to a license agreement and thus protected under the statute.

As to embodiments, some commentators suggest that the term includes written protocols, prototypes, genetic material necessary to produce biotechnological products, and computer program source codes. But again, the precise scope of the term—and therefore the statute—remains unclear.

Automatic Stay and Ipso Facto Clauses

When a licensor commences a bankruptcy case, the automatic stay extant under section 362 of the Bankruptcy Code will preclude the licensee from taking action against the debtor licensor or its property. As long as the automatic stay is in effect, the licensee cannot unilaterally terminate the license without the authorization of the Bankruptcy Court. In addition, any provision in a license agreement that purports to terminate the agreement if one of the parties enters into bankruptcy or becomes insolvent is an unenforceable "ipso facto" clause under section 365(e)(1).

Conclusion

Although the Bankruptcy Code provides substantial protection for a licensee when the licensor of intellectual property becomes a debtor in a bankruptcy proceeding, the scope of protection is not perfectly clear and may not be comprehensive. This is particularly the case where the intellectual property is licensed from a multinational company. Accordingly, licensees are cautioned to carefully structure their licensing agreements to obtain the best possible protection in the event the licensor commences a U.S. bankruptcy case.

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1 11 U.S.C. § 101(35).

The author would like to thank Lorri E. Staal for her substantial assistance in preparing this article.

"It is now very clear that the fat lady has sung for the economic expansion. The country has slipped into a recession."

– Stuart Hoffman, chief economist at PNC Financial Services Group

Developments in Fraudulent Transfer Law in the Context of a Fraudulent Investment Scheme

By **H. Jeffrey Schwartz**

The Dechert team represents Bayou Group, LLC and its affiliates ("Bayou") in connection with their chapter 11 cases.[1] The Bayou hedge funds operated

prepetition as a fraudulent investment scheme and engaged in a series of fraudulent actions and transactions in furtherance of their criminal scheme. Dechert, on behalf of Bayou, commenced more than 120 adversary proceedings to recover investment principal as well as fictitious profits from investors who sought and obtained redemption of their investments in the two years prior to the bankruptcy filing (the "Fraudulent Transfer Actions"). To date, Bayou has recovered approximately $30 million through settlements.

Background

The Fraudulent Transfer Actions alleged that: Bayou was operated as a fraudulent investment scheme and that, in the course of this fraud, Bayou attracted more than $450 million of investments for its hedge funds. After suffering millions of dollars in trading losses, Bayou attempted to stay afloat, and indeed prolonged the scheme, by disclosing false investment performance and creating false financial statements. Bayou also attempted to conceal its losses through a series of fraudulent transfers to certain of its investor creditors. In essence, Bayou used its depleted capital and capital from new investors to pay redemption proceeds to investor creditors seeking to exit the funds. These redemption proceeds were paid based on inflated statements of what the investments were worth and were made with fraudulent intent by the transferors, i.e., Bayou. Each of the investors was induced to invest in the funds and was a victim of the fraudulent investment scheme. Ultimately, Bayou's fraudulent investment scheme collapsed with approximately $250 million in principal unpaid to hundreds of creditors.

Rulings

The Fraudulent Transfer Actions engendered a series of rulings and settlements providing substantial guidance to parties-in-interest in fraud-driven bankruptcies and hedge fund bankruptcies. Specifically, the Bankruptcy Court set forth the following principles in the context of a denial of a motion to dismiss and a motion for summary judgment in the Bayou cases:[2]

- Fraudulent transfer claims based on actual fraud under Bankruptcy Code § 548(a)(1)(A) may avoid the entire amount of any transfer made with the actual intent to hinder, delay, or defraud whether or not the debtor received value in exchange for the transfer, unless the transferee can prove its affirmative defense of good faith under Bankruptcy Code § 548(c).
- The presumption of actual intent to hinder, delay, or defraud is "intuitive" and "inescapable" from the facts alleged in the complaint where the debtor intentionally overpaid redemptions of entirely fictitious profits and overstated principal amounts to earlier investors by using funds obtained from new investors.
- Tort claims for rescission of invested principal constitute value for purposes of Bankruptcy Code § 548(a)(1)(B). Accordingly, claims based on constructive fraud are limited to any fictitious profits paid to investors.
- Non-redeeming investors are creditors of the debtor by virtue of their tort claims for rescission or damages for fraudulent inducement in the amount of their principal investment.
- A non-redeeming investor creditor's claim is subordinated under Bankruptcy Code § 510(b), but subordination does not affect the issue of allowance or disallowance of the claim.
- The plaintiff is not obligated to plead a lack of good faith on the part of the transferee. The defendant must plead good faith as an affirmative defense in the first instance.

Conclusion

The *Bayou* case is one of the first heavily litigated hedge fund bankruptcies in the current credit cycle. Given the sheer number of hedge funds controlling substantial capital and the downward turn of the credit markets, there will likely be several more hedge funds that unwind or seek protection under the Bankruptcy Code over the next few years. The *Bayou* decisions provide guidance as to how a Bankruptcy Court will analyze fraudulent transfers in the context of a fraudulent investment scheme.

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1 *The Bayou* bankruptcy cases are jointly administered under the lead case of *Bayou Group, LLC*, Bankr. S.D.N.Y. 06-22306 (ASH).

2 These principles are set forth in *Bayou Superfund, LLC v. WAM Long/Short Fund II, L.P. (In re Bayou Group, LLC)*, 362 B.R. 624 (Bankr. S.D.N.Y. 2007) and *Bayou Accredited Fund, LLC v. Redwood Growth Partners, L.P. (In re Bayou Group, LLC)*, 372 B.R. 661 (Bankr. S.D.N.Y. 2007).

The author would like to thank Elise Scherr Frejka for her substantial assistance in preparing this article.

In the News

Recent Practice Highlights

Plainfield Specialty Holdings II Inc., an affiliate of Plainfield Asset Management LLC, as plan sponsor, construction lender, and DIP lender in the successful reorganization of Kara Homes, Inc., a privately owned builder and developer in New Jersey. With Dechert's assistance, Plainfield executed a multi-step loan-to-own strategy resulting in the successful reorganization of profitable construction projects and the liquidation of the remaining assets. The Kara Homes bankruptcy represents one of the first instances of a hedge fund underwriting the reorganization of a large scale builder.

Complete Retreats, LLC, d/b/a Tanner and Haley Resorts, a market leader of the "destination club" industry, with approximately $350 million in debt, in the sale of assets and confirmation of a plan of reorganization in the U.S. Bankruptcy Court for the District of Connecticut. Dechert was instrumental in negotiating and effectuating a going-concern sale transaction that enabled the club's members, with no upfront deposit, to become members of a new club and travel to most of the same locations and properties.

The senior lenders and equity holders (led by Candlewood Capital Partners and including GSC Partners and the Royal Bank of Scotland) of **APW Ltd.** and its affiliates with respect to the orderly liquidation of this global manufacturing conglomerate. This engagement has entailed the initiation of or participation in insolvency proceedings in France, Germany, Italy, Poland, the United Kingdom, and the United States—as well as dispositions of assets in China, India, Ireland, and elsewhere.

Anvil Knitwear, Inc., one of the world's largest manufacturers of activewear apparel, in restructuring $200 million in bank and public bond debt, along with significant preferred stock, in connection with its chapter 11 case. Dechert was instrumental in negotiating and effectuating a pre-arranged plan of reorganization, which enabled the client to come out of bankruptcy with a new and manageable capital structure within approximately 100 days after the case was filed.

BAWAG P.S.K. in the successful negotiation of a complex global settlement resolving litigations and investigations focused on allegations of fraud asserted by Refco and other parties. Dechert, on behalf of BAWAG P.S.K., obtained a favorable settlement with Refco and with numerous other parties on two continents. After entering into the settlement, the bank's management was able to sell it for a record price.

Who's Speaking Where?

Glenn Siegel is the co-chair of the 2008 New York City American Bankruptcy Institute Conference on May 12, 2008. He is also a participant in a panel discussion on "Rights Offerings" at that conference.

H. Jeffrey Schwartz will moderate a panel discussion on "Current Issues on Avoidance Actions" at the 2008 Northeast Bankruptcy Conference on July 11, 2008.

New Counsel Joins the Group

In February 2008, Brian E. Greer joined Dechert as counsel in the business restructuring and reorganization group. Mr. Greer has extensive experience representing corporations, financial institutions, hedge funds, equity holders, directors and officers, financial advisors, and other constituencies in connection with domestic and cross-border insolvency proceedings, out-of-court workouts, litigation, distressed M&A transactions, and executive compensation matters. Mr. Greer also has significant experience advising clients in connection with their rights under repurchase agreements, securities contracts, and swap agreements.

Some notable chapter 11 transactions Mr. Greer has been significantly involved in include Curative Health Services (debtor), Sunbeam (debtor), Carmike Cinemas (debtor), Orbital Imaging (creditors' committee), and Comdisco (prepetition lenders Citibank and Royal Bank of Scotland). In addition, Mr. Greer has advised clients with respect to the restructuring of SIVs and CDOs.

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Mr. Schwartz has more than 28 years of experience as a bankruptcy lawyer. He is a leading practitioner nationwide representing debtors and other parties-in-interest in bankruptcy cases and out-of-court workouts and representing acquirors of distressed businesses. Mr. Schwartz is recognized in, among many sources, the 2007 edition of *The Best Lawyers in America* and by *Chambers USA*.

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Mr. Weissman focuses his practice on mergers and acquisitions and private equity. He has extensive experience representing buyers and sellers in leveraged M&A deals and representing borrowers and other constituencies in workouts and recapitalization transactions. Mr. Weissman is recognized as a leading lawyer by *The Legal 500* (USA).

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Ms. Burroughs is a leading and widely-published expert on the ongoing sub-prime crisis. She has represented various parties across the U.S., Canadian, and European markets in securitization, commercial mortgage, mezzanine and subordinate loan origination and acquisition, loan servicing and special servicing, debt restructuring, workout, bankruptcy, and foreclosure matters.

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Mr. Gonne has advised on numerous restructuring matters for publicly listed and unlisted companies. Mr. Gonne has led the restructuring representations for most of the French and Benelux steel producers including Cockerill Sambre, Fafer, Usinor, Usines Gustave Boël, Forges de Clabecq, and Arbed Aceralia Usinor. Mr. Gonne also represented several large and international holders of bonds issued by SIC, the financial subsidiary of Sabena, during its bankruptcy.

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Mr. Levander represents parties in securities fraud and commercial litigation and criminal and government investigations. He has had enormous success litigating and settling criminal and civil cases arising in connection with fraud-driven bankruptcies such as Adelphia and Refco. Mr. Levander, who has tried to verdict more than 40 cases as well as numerous arbitrations, is recognized in, among many sources, the 2007 edition of *The Best Lawyers in America*.

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About Dechert LLP

With more than 1,000 lawyers in the United States, Europe and Asia, Dechert LLP is an international law firm focused on corporate and securities, business restructuring and reorganization, complex litigation and international arbitration, real estate finance, financial services and asset management, intellectual property, labor and employment, and tax law.

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