AMERICAN BANKRUPTCY INSTITUTE

2019 Winter Leadership Conference

Sponsor Liability, Including Liability Relating to Sponsors Purchasing Debt or Equity in Their Portfolios

Hosted by the Business Reorganization and Claims Trading Committees

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Lawyer Conflicts: Joint Representation of Sponsor and Distressed Portfolio Company Thereof

- Model Rule of Professional Conduct
- Professional Ethics Committees' Opinions
- Bankruptcy Code Requirements
- Bankruptcy Rules Requirement
- Privilege Issues
- Strategic Planning for Potential Lawyer Conflicts

Model Rule of Professional Conduct

- Rule 1.7: Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Professional Ethics Committees' Opinions

- A law firm may represent a client whose interests in a corporate transaction are adverse to those of a current client in a separate matter, and may represent multiple clients in a single matter, with disclosure and informed consent, so long as a disinterested lawyer would believe that the law firm can competently represent the interests of each.
  - Satisfaction of the "disinterested lawyer" test in this context will depend on an evaluation of the nature and circumstances of the simultaneous representations, including:
    - (1) the nature of the conflict;
    - (2) the likelihood that client confidences or secrets in one matter will be relevant to the other representation;
    - (3) the ability of the lawyer or law firm to ensure that confidential information of the clients will be preserved;
    - (4) the ability of the lawyer to explain, and the client's ability to understand, the reasonably foreseeable risks of the conflict; and
    - (5) the lawyer's relationship with the clients.

Source: New York City Bar Professional Ethics Committee Formal Opinion 2001-2: Conflicts in Corporate and Transactional Matters

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Bankruptcy Code Requirements

- Section 327(a) of the Bankruptcy Code:
  - Requires that bankruptcy professionals, including attorneys, who "represent or assist the trustee in carrying out the trustee's duties under [the Bankruptcy Code]" be "disinterested persons."
    - A disinterested person "does not have an interest adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason." 11 U.S.C. § 101(14).
- Section 327(e) of the Bankruptcy Code:
  - "The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."
    - Section 327(e) retention is less restrictive than section 327(a) retention because it requires only that the lawyer does not represent or hold an interest adverse to the special purpose for which the lawyer is employed.

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Bankruptcy Rules Requirement

- Federal Rule of Bankruptcy Procedure 2014:
  - Requires a professional retained in a bankruptcy case to disclose connections to parties in interest ("to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee").

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Privilege Issues

- Communications with portfolio company counsel may not be privileged if such communications pertain to legal advice to entities other than the company.
- In an insolvency scenario, the portfolio company may assert an entitlement to documents of the sponsor (or *vice versa*) on the theory that they were joint clients of counsel (whether in-house or external) on relevant matters. These risks can be managed by, among other things, carefully delineating the scope of any joint representations and by "seasonably [] separat[ing] counsel on matters in which subsidiaries are adverse to the parent." *In re Teleglobe Commc'ns Corp.*, 493 F.3d 345, 374 (3d Cir. 2007), *as amended* (Oct. 12, 2007).
- A future bankruptcy trustee may choose to waive the company's attorney-client privilege in the context of a bankruptcy proceeding.

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Strategic Planning for Potential Lawyer Conflicts

- A law firm considering whether to represent both a sponsor and its distressed portfolio company should:
  - consider the likelihood of potential intercompany claims;
  - evaluate whether a restructuring would involve an actual conflict;
  - evaluate likelihood restructuring will be implemented through a bankruptcy;
  - assess whether it can provide undivided loyalty to both clients;
  - make robust disclosures to both sponsors and portfolio companies, including any dual representations or investments;
  - establish safeguards and measures to preserve confidentiality and protect interests;
  - obtain clear, specific waivers for potential conflicts arising out of dual representations and personal investments;
  - consider whether and when new counsel should be retained and for which client(s); and
  - in the event of the portfolio company's bankruptcy filing and the law firm's disclosure obligations, ensure full and complete disclosure of all connections.
- A law firm must plan for potential conflicts and be able to provide undivided loyalty to both clients, including on matters potentially adverse to the sponsor resulting from the restructuring or potential bankruptcy of the distressed portfolio company.

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Sponsor/Portfolio Company Conflicts: Fiduciary Duties and Governance

- Duty of Care
- Duty of Loyalty
- Control Persons
- Related-Party Transactions
- Applicable Standard of Review
- Independent Directors and Special Committees
- Fairness and Solvency Opinions in Distressed Situations
- Strategic Planning for Related-Party Transactions

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Duty of Care

- In satisfying their duty of care, directors, managing members and managers should:
  - inform themselves of all material information reasonably available to them;
  - carefully consider that information and all reasonable alternatives with sufficient time; and
  - act with "requisite care" in discharging their duties.
- Directors, managing members, and managers may reasonably rely on information and advice from management and advisors, including counsel, financial advisors, and others.
  - Directors, managing members, and managers should not merely be passive recipients of advice. They should actively participate in discussions and decision making, critically evaluate any information received and consider various options and the risks and benefits of each.
  - Directors, managing members, and managers should have direct access to and receive advice from the company's financial, legal and other advisors and be provided with materials to facilitate their decision making.
  - Directors, managing members, and managers should review and understand presentations and key transaction terms.
- Process, advice, analyses, and opinions of financial advisors are important in fulfilling the duty of care.
- It is important to establish and follow a decision-making process and maintain good records to demonstrate compliance with the duty of care.

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Duty of Loyalty

- Directors, managing members and managers must act in good faith and in a manner they reasonably believe to be in the best interests of the company.
- To comply with the duty of loyalty, directors, managing members, and managers must be disinterested and independent in exercising their judgment, and subordinate other interests to those of the corporation.
- Duty of loyalty prohibits bad faith or self-dealing, such as participating in decision making on matters in which the director, managing members or manager has a material, disabling conflict of interest.
- Directors and officers, as well as managing members, and managers, must not act for a personal or non-corporate purpose, such as to preserve their positions or compensation.
- Directors, managing members, and managers should promptly disclose any conflicts (or potential conflicts).
- Bad faith may be found to exist if directors, managing members or managers exhibit a conscious disregard for their fiduciary duties or if directors, managing members or managers act with a purpose other than to advance the best interests of the company.

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Control Persons

- Directors and officers owe fiduciary duties—principally duties of loyalty and care—to the companies they serve in favor of the company's shareholders.
- Controlling shareholders have at least some of the same duties. *See, e.g., Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
- In the "zone of insolvency," directors can, but are not necessarily obligated to, consider how their decisions will affect solvency and recoveries for all constituents.
- In an insolvent company, these duties run to the company in favor of the creditors, who may obtain standing to pursue claims. *See generally N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

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Related-Party Transactions

- Under Delaware law, sponsors who are "controlling shareholders" owe fiduciary duties to the companies they control and their minority shareholders.
  - Who constitutes a "controlling shareholder"?
    - *De jure*: over 50% shareholder
    - *De facto*: significant block in addition to the exercise of sufficient influence over the board

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Applicable Standard of Review

- Transactions between a sponsor and controlled portfolio company generally means heightened "entire fairness" review as opposed to more lenient "business judgment" review.
  - **Business judgment rule** – Presumes that directors acted on an informed basis, in good faith, and in best interests of the company. Such actions will be upheld if attributable to rational business purpose.
  - **Entire fairness** – Burden is on sponsor to prove that both transaction price and procedure are fair to other shareholders.
    - Burden may be shifted back to plaintiff if procedural safeguards exist, such as (a) a special committee or (b) approval by a majority of the minority investors.
    - If *both* (a) and (b) are present and proper from the outset, then the business judgment rule still applies (*MFW Shareholders Litigation*).

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Independent Directors and Special Committees

- **Background**
  - Independent directors and special committees are often used to ensure proper corporate governance decision-making processes as companies approach insolvency. Although their use is not mandated by Delaware law, the DGCL expressly permits their formation. (*DGCL §141(c)(1)*). Generally, board resolutions will define the scope of authority delegated to the independent director(s) or special committee.
- **Independence**
  - There is no uniform standard for determination of independence, but the following formulae have been applied:
    - Independent directors must not be dominated or controlled by any party with an interest in the relevant transaction. *See In re Maxxam, Inc. / Federated Dev. Stockholder Litigation, 659 A.2d 760 (Del. Ch. 2003).*
    - Independent directors must not have any personal interest or relationship that renders the director incapable of acting in the best interest of the company. *See In re Oracle Corp Derivative Litigation. 824 A.2d 917 (Del. Ch. 2003).*
  - In addition to independence, independent directors and special committees must also be fully active and aware of developments at the portfolio company. *See In re Puda Coal, Inc. Stockholders Litigation, C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013).*
- **Benefits**
  - In transactions not involving the sponsor, increase likelihood that the business judgement rule applies.
  - In related-party transactions involving the sponsor, where entire fairness applies, may help to shift the burden back to the plaintiff to prove lack of fairness.

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Fairness and Solvency Opinions in Distressed Situations

- **Fairness Opinions in Pre-Bankruptcy Transactions**
  - Related-party transactions
  - Divestiture of enterprise, business units, assets or subsidiaries
  - Asset sale where buyer requests seller obtain opinion
- **Solvency Opinions in Pre-Bankruptcy Transactions**
  - Separation transaction – particularly when profitable operations are separated from distressed operations
  - Dividend distributions
  - Recapitalizations

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Strategic Planning for Related-Party Transactions

- A portfolio company's insolvency ultimately will be viewed by parties in interest with 20/20 hindsight, most likely raising questions about the sponsor's acquisition of the company, historical payments by the company made to or for the benefit of the sponsor, especially dividends financed through recapitalizations, or transactions designed to extend the life of a portfolio company experiencing operational and/or financial distress, including asset sales, spin-offs and creation of unrestricted subsidiaries. In light thereof, at the time of engaging in the related-party transaction, the sponsor should consider:
  - the scope of, and compliance with, fiduciary duties;
  - use of independent directors and special committees;
  - use of external professionals;
  - engaging in risk-benefit analyses of contemplated transactions from the perspective of the portfolio company;
  - well documenting the bases or rationale underlying decision-making; and
  - distinguishing between, and being able to defend, decisions made as a shareholder and decisions made as a director.

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Debt Purchases

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Moderator: Hon. Elizabeth S. Stong

Panelist: Jay D. Rao

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DISTRESSED DEBT GENERALLY

- "The practice of distressed debt investing is not new; however, the market for distressed debt has expanded significantly since its inception . . . These practices make it easy for traditional lenders and investors to exit, and hedge funds, private equity firms and other nontraditional lenders to enter, troubled situations."
  - -Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 Am. Bankr. Inst. L. Rev. 69, 75-76 (2008) (internal citations omitted).

- "New players in the distressed debt space have intensified turf wars, and conflicts among private equity firms, hedge funds, and other creditors appear to be on the rise. In addition, a debtor's management may not be aware of potential conflicts within the debtor's capital structure, and they consequently may align with the interests of one stakeholder group prematurely or be unprepared for, and become paralyzed by, the resulting conflict."
  - -Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians At the Gate?*, 89 Wash. U.L. Rev. 155, 166-67 (2011) (internal citations omitted).

Hon. Michelle M. Harner of the U.S. Bankruptcy Court for the District of Maryland (previously, Judge Harner served on the faculty of the University of Maryland Francis King Carey School of Law)

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DISTRESSED DEBT GENERALLY

- Recently, Judge Harner conducted an empirical study regarding distressed debt investing.
    - "I draw three key inferences from the data. First, the practices of activist distressed debt investors may lead to potential conflicts among creditors in the chapter 11 context. Second, activist distressed debt investors seek to exert control over the company, placing the company's board and management in a difficult position. ***Finally, the number of investors that actually seek to acquire a controlling ownership interest in the debtor--either through their distressed debt holdings or direct loans--is relatively small. These investors, however, possess the financial resources to influence the restructuring market."***
        - - Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors' Objectives*, 16 Am. Bankr. Inst. L. Rev. 69, 92 (2008) (emphasis added).

Hon. Michelle M. Harner of the U.S. Bankruptcy Court for the District of Maryland (previously, Judge Harner served on the faculty of the University of Maryland Francis King Carey School of Law)

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DISTRESSED DEBT GENERALLY

"Websites such as Creditex and Markit also provide trading and settlement information about certain bankruptcy claims and credit default swaps . . . These private information providers lubricate the secondary market in distressed debt in important ways. They provide some price data and, in some cases, trading and settlement platforms."

-Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. Rev. 1609, 1646 (2009) (internal citations omitted) .

"Technology has changed the dynamics of restructurings and reorganizations with access to greater information and, thus, greater transparency - a transparency that is used by many more sophisticated persons and institutions in dealing with economic distress."

-Harvey R. Miller, *Chapter 11 In Transition- From Boom to Bust and Into the Future*, 81 Am. Bankr. L.J. 375-76 (2007)

Prof. Jonathan C. Lipson (Temple University Beasley School of Law faculty)

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DISTRESSED DEBT GENERALLY

- Distressed debt investors are sophisticated players in the space.
  - Achieve ROI through increase in market value or eventual distributions (often labeled passive strategies).
  - Achieve ROI through complex strategies, including "loan to own" (often labeled as active strategies).

  - "Although the risks of investing in distressed companies are high and can be very difficult to analyze, requiring intimate knowledge of not only the debtor's business but also bankruptcy law, returns on investment can exceed 30 percent."
    - -Anne M. Huber & Thomas H. Young, *The Trading of Bank Debt In and Out of Chapter 11*, 15 J. Bankr. L. & Prac. 1 Art. 3 (2006) (internal citations omitted).

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SPONSOR GROUP REPRESENTATIONS

- Although not private equity sponsor-exclusive, it's clear practitioners have taken notice of distressed debt investing trends and the complexity of modern capital structures. Many top law firms have created new practice groups, altered existing groups to house relevant expertise with easy access to high caliber interdisciplinary support, and/or hired respected restructuring practitioners.

Examples:

- Simpson Thacher & Bartlett LLP: Private Capital and Special Situations Investment Group
- Cadwalader, Wickersham & Taft LLP: Special Situations Group and Debt and Claims Trading Group
- Latham & Watkins LLP: Restructuring and Special Situations Group

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COMPLEX CAP STRUCTURES

- Harvey R. Miller observed financings are ". . .often ***accomplished with very complex debt structures*** sometimes involving different tranches of debts, inclusive of first and second liens. It makes one think that when a company fails, we may very well find tranche warfare breaking out."
  - Harvey R. Miller, *Chapter 11 In Transition- From Boom to Bust and Into the Future*, 81 Am. Bankr. L.J. 375, 394 (2007) (emphasis added).

Harvey R. Miller was a well known restructuring practitioner and educator

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COMPLEX CAP STRUCTURES

- "The empirical research of Lynn LoPucki, for example, finds that the 'paradigm financial structure'- ***the three-level structure scholars often refer to of equity, unsecured and secured debt- is simply not the way that modern firms are structured***. Instead, modern firms have complex credit covenants that create secured and unsecured classes with many different seniority and structural levels. In LoPucki's research of large, public bankruptcies, 62% of firms had a capital structure in which there are more than one creditor class, often across multiple priority levels, that might qualify as the ideal residual owner with claims directly affected by marginal gains and losses in firm value."
  - Paul M. Goldschmid, *More Phoenix than Vulture: The Case for Distressed Debt Investor Presence in the Bankruptcy Reorganization Process*, 2005 Colum. Bus. L. Rev. 191, 199 (2005) (citing Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 Wash. U. L.Q. 1341 (2004)) (internal citations omitted) (emphasis added).

Prof. Lynn M. LoPucki
(University of California,
Los Angeles School of Law faculty)

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COMPLEX CAP STRUCTURES

- In the first theoretical paper to analyze the interaction between capital structure complexity and its effects in financial distress, Prof. Kenneth Ayotte highlights certain salient points for practitioners to keep in mind.
  - Prof. Ayotte's scholarship focuses on the economic analysis of the bankruptcy system.
    - His paper *Bankruptcy or Bailouts?* with Prof. David A. Skeel, analyzing the role of bankruptcy law in the financial crises, was chosen as a Top 10 article in corporate and securities law by the *Corporate Practice Commentator*.
    - In addition to his scholarship, Prof. Ayotte received the Dean's Award for Teaching Excellence from Columbia Business School.
  - Note: For more background information, please review the Harvard Law Bankruptcy Roundtable website (available at https://blogs.harvard.edu/bankruptcyroundtable/tag/kenneth-ayotte/).

Prof. Kenneth Ayotte (University of California, Berkeley School of Law faculty)

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COMPLEX CAP STRUCTURES

- "Existing theories in corporate finance have difficulty explaining the complexity of the capital structures we observe in large firms. Large public company capital structures are often characterized by corporate groups, ***with assets spread across numerous legal entities (horizontal fragmentation) and many layers of debt arranged according to seniority (vertical fragmentation)***."
- -Kenneth Ayotte, *Disagreement and Capital Structure Complexity* (working draft accessed on 9/26/19) (emphasis added).

Prof. Kenneth Ayotte (University of California, Berkeley School of Law faculty)

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COMPLEX CAP STRUCTURES

- "***My theory argues that complex capital structures can be a deliberate product of financial engineering by owners to take advantage of differences in beliefs among investors***. Bankruptcy law confers both priority and control rights based on the value of individual assets that make up a firm. These values are not always easily verifiable and often require costly, contested valuation hearings to establish. ***Firms in the model have incentive to fragment the capital structure by creating targeted claims to subsets of the firm's assets that some investors are more optimistic about***."
- -Kenneth Ayotte, *Disagreement and Capital Structure Complexity* (working draft accessed on 9/26/19) (emphasis added).

Prof. Kenneth Ayotte
(University of California,
Berkeley School of Law faculty)

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COMPLEX CAP STRUCTURES

- "***These strategies are often described as unlocking value in assets that are underappreciated by the firm's current investors. This strategy can minimize a firm's all-in cost of debt financing*** and thus maximize the value of equity. ***But when distress occurs, the disagreement about the firm's asset values leads to valuation disputes that are socially costly***."
- -Kenneth Ayotte, *Disagreement and Capital Structure Complexity* (working draft accessed on 9/26/19) (emphasis added).

Prof. Kenneth Ayotte
(University of California,
Berkeley School of Law faculty)

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SPONSOR DEBT PURCHASES

- There are potential economic advantages to a private equity sponsor group holding debt in its portfolio company group capital structure:
  - Diversification prevents financial overexposure to equity returns, particular tranche, or particular entity within portfolio company group by maintaining positions throughout capital structure horizontally and vertically.
  - Can target debt backed by assets the private equity firm is relatively optimistic about.
  - Equity primarily serves to provide high returns in upside scenario and debt holdings provide certain limited downside protection. New money debt, depending on circumstances, might boost equity value.
  - Various debt holdings provides potential for returns based on intercompany portfolio group transactions and, in theory, can be utilized to influence potential negotiations in downside scenario (*i.e.*, potential activist intent).

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SPONSOR DEBT PURCHASES

- As otherwise noted in this panel, there is a risk that certain issues will be raised regarding sponsor group transactions, including debt purchases and issuances, in a downside scenario.
- Examples of Issues:
  - Equitable Subordination of Debt
  - Recharacterization of Debt
  - Breach of Fiduciary Duty (Including Duty of Loyalty)
  - Fraudulent Transfers
  - Designation

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SPONSOR DEBT PURCHASES

- As a practical matter, the focus of experienced restructuring practitioners in the space has been on engaging in risk reduction techiques to limit the potential for various causes of action arising from sponsor group transactions (*e.g.*, use of independent directors, special committees, consulting advisors, documenting basis for decisions, obtaining solvency/fairness opinions).
- Leaving aside the substance of these techniques, they are intended to reduce potential for adverse economic outcome on an *ex post* basis and reduce potential for a party to raise issues on an *ex ante* basis.

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SPONSOR DEBT PURCHASES

- It's difficult, if not impossible, to quantify all the risks on an *ex ante* basis. Therefore, it's difficult for sponsors to engage in a meaningful economic risk-reward calculation while deciding whether to engage in transactions within a sponsor group that could raise issues in future (*e.g.*, debt purchases, new money lending, intercompany transfers).
- Examples of Issues:
  - Equitable Subordination of Debt
  - Recharacterization of Debt
  - Breach of Fiduciary Duty (Including Duty of Loyalty)
  - Fraudulent Transfers
  - Designation

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SPONSOR DEBT PURCHASES

- I believe a large cost of engaging in complex transactions within a sponsor group (including engaging in an affiliate debt purchase strategy) might be reputational and difficult to quantify, even on an *ex post* basis.
- Generally, many sponsors:
  - Don't desire to engage in a strategy that will likely result in litigation and/or negative publicity.
  - Don't desire to create unease in the market that might negatively impact other portfolio companies, ability for sponsor to acquire future portfolio companies, and ability to raise funds in capital markets or otherwise do deals.
  - Prioritize classic private equity business of investment and exit, as well as reputation for managerial excellence and industry-specific knowledge.
  - Note: Different sponsors have different risk appetites.

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PRACTITIONER INSIGHTS

- "***Markets have become more sensitive*** to transactions that were not contemplated at the time of the original financing or are perceived to strip assets from stakeholders who expected that all assets pledged would remain part of the collateral pool."
  - From ABI NYC Spring Conference PowerPoint presentation (emphasis added).
- "***Companies should not be surprised when markets react*** to actions taken, especially when the underlying business trends are challenged."
  - From ABI NYC Spring Conference PowerPoint presentation (emphasis added).

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ILLUSTRATIVE EXAMPLES

- "In years leading up to bankruptcy, **Caesars OpCo engages in billions of dollars of asset transfers at the direction of its Board and its controlling shareholder parent**. The Boards of OpCo and parent overlap substantially and are majority controlled by the same equityholders. At relevant times, OpCo has **no independent directors**. The transactions allegedly remove OpCo assets for less than fair value and place them under other of the parent's subsidiaries. The Examiner concludes that potential claims for breach of fiduciary duty and aiding and abetting exist. *See* Final Report of Examiner, Richard J. Davis, *In re Caesars Entm't Operating Co.*, Case No. 15-01145 (ABG) (Bankr. N.D. Ill. filed Mar. 15, 2016) (ECF No. 3401)."

- -From ABI NYC Spring Conference PowerPoint presentation (emphasis in original).

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ILLUSTRATIVE EXAMPLES

- Potential legal liability aside, there can be PR issues.
- Example:
  - Press Article from *Financial Times*'s blog, FTAlphaville:
    - "The Examiner's report on the death of Caesars appropriately landed late on the Ides of March and came in at a juicy 1,787 pages. It reviewed 8.8m pages of documents and contains interviews with nearly 100 people. ***For anyone who has followed the machinations at Caesars, the blow-by-blow accounts behind all the deals makes for an incredible read — the first 100 or so pages of executive summary has plenty of dirt. And even if you have not, just reading the lengths private equity firms will go to salvage bad investments is mind-blowing.***"
      - -Sujeet Indap, *Liquidity v. Solvency: Caesars Edition*, Apr. 11, 2016 (https://ftalphaville.ft.com/2016/04/11/2158973/liquidity-v-solvency-caesars-edition/) (emphasis added).

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ILLUSTRATIVE EXAMPLES

- Another Example of PR from *Financial Times*:
  - Bankruptcy of Cengage Learning eventually required mediation led by Judge Robert Drain, in part, because of complexities causes by sponsor group debt purchases.
  - "In an attempt to maintain control of Cengage Learning, the struggling textbooks business it bought in a deal worth $7.75bn at the peak of the buyout boom in 2007, Apax doubled down on its investment by buying debt alongside its equity . . . In addition to these sizeable losses, Apax has opened itself up to the charge of conflict of interest by purchasing the debt of a company it already controls . . . One bankruptcy lawyer who often represents creditors in such skirmishes said Apax could be open to claims of equitable subordination . . ."
    - Henny Sender, *Debt investment in Cengage backfires on Apax Partners*, July 4, 2013 (https://www.ft.com/content/ea599274-e496-11e2-875b-00144feabdc0)

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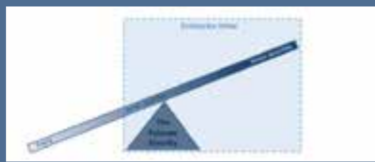
FULCRUM SECURITY

- Fulcrum security is a term of art used by restructuring professionals for the portion of the company's capital structure that will ultimately control the company in the event of a restructuring (sometimes called the equity level).
  - Parts of the capital structure senior to the fulcrum security are described as "in the money."
  - Parts of the capital structure junior to the fulcrum security are described as "out of the money."
  - Attractive to investors because fulcrum security is thought to provide highest yield attainable in a structure that could potentially go through a restructuring.
  - In the past, generally fulcrum viewed as unsecured debt- in modern era, professionals increasingly view fulcrum as secured debt.



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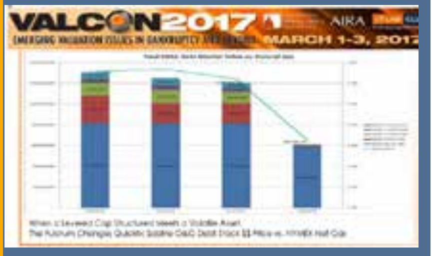
FULCRUM SECURITY

- Fulcrum security is a term of art used by restructuring professionals for the portion of the company's capital structure that will ultimately control the company in the event of a restructuring (sometimes called the equity level).
  - In simple and abstract terms, locating the fulcrum security requires:
    - Determining the enterprise value (likely weighted average based on an upside case, base case, and downside case)
    - Determining expected new capital structure
    - Applying a waterfall methodology to creditors to locate fulcrum
    - Note: Based on enterprise value, in theory, can determine whether fulcrum security is trading at premium or discount to internal calculations. If trading at discount, can explore possibility of selling fulcrum and obtaining ROI well in advance of restructuring.



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FULCRUM SECURITY

- Fulcrum security is a term of art used by restructuring professionals for the portion of the company's capital structure that will ultimately control the company in the event of a restructuring (sometimes called the equity level).
  - Identifying on an *ex ante* basis is, of course, difficult.
  - Long liquidity runway can make identification of fulcrum security more challenging.
  - A sponsor that attempts to purchase fulcrum security as portfolio company deteriorates, though arguably an economically rationale strategy, invites difficult to quantify litigation and reputation risk.

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OPEN QUESTIONS

- Given the complexity of modern capital structures, will chasing the fulcrum security become an antiquated concept (for any distressed debt purchaser, including sponsors)?
  - "In spite of the theoretical difficulties in identifying the single residual owners of bankrupt firms, the scholars who employ residual owner approaches believe that in reality, residual owners exist and can be easily identified in most cases. Parties may bluster about the uncertainty of firm value and other parties may be compelled to compromise with them in order to avoid an expensive, burdensome valuation process. But at bottom, those scholars assume that the parties all know who is in the money, who is out of it, and who--the residual owner--is in between . . . ***The study concludes that no identifiable, single residual owner class exists in most reorganizing large public companies. Even by the end of the case, the parties have not been able to identify such a class . . . The problem is not merely that single residual owners are difficult to identify. The problem is that they rarely exist.***"
  - Lynn M. LoPucki, *The Myth of the Residual Owner: An Empirical Study*, 82 Wash. U. L.Q. 1341, 1342-43 (2004) (internal citations omitted) (emphasis added).

Prof. Lynn M. LoPucki
(University of California,
Los Angeles School of Law faculty)

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OPEN QUESTIONS

- Is there an anti-private equity bias permeating segments of the restructuring community today, including the judiciary?

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OPEN QUESTIONS

- Can other stakeholders adequately protect themselves through restrictions in relevant documentation and “price in” sponsor flexibility and the perceived reputation of sponsor?
    - If so, should courts seek to avoid *ex post* second guessing and reduce *ex ante* uncertainty to sponsor groups (and limit potential hold-up value)?
    - Academic community seems to be trending away from this thinking.

Berkeley

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OPEN QUESTIONS

- Should the bankruptcy system seek to disincentivize sponsors on an *ex ante* basis from engaging in affiliate debt purchases, new money extensions, and intercompany transactions to preserve the integrity of the traditional creditor-debtor paradigm contemplated by the framework enacted in 1978?
    - As a practical matter, would trying to effectuate the foregoing as a policy matter raise a complicated zone of insolvency determination issue?
- Should the bankruptcy system permit and/or encourage sponsors to limit downside protection through synthetic instruments?

Berkeley

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THE FUTURE

- I expect next generation academics to follow the lead of Prof. Ayotte (and other scholars) in considering issues related to the role of private equity sponsor groups in our insolvency system.
- Examples:
  - Prof. Edward R. Morrison: current research focuses include studying patterns in intercreditor agreements and valuation disputes in corporate bankruptcies. In addition to his scholarship, Prof. Morrison received the 2018 Willis L.M. Reese Prize for Excellence in Teaching from Columbia Law School.
  - Prof. Adam J. Levitin: current research includes corporate bankruptcies and has served as an advisory committee reporter for the ABI Commission to Study the Reform of Chapter 11 and the Robert Zinman Scholar in Residence at the ABI.
  - Prof. Jared Ellias: current research focuses on the governance of large bankrupt firms and the role played by activist investors and the effect of bankruptcy filings on firms. He received the UC Hastings Foundation Faculty Award for Faculty Scholarship, the highest research award given by UC Hastings to faculty.

Prof. Jared Ellias, Founding Faculty Director of the Center for Business Law at University of California, Hastings College of Law

Berkeley

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ABOUT THE PANELIST

Jayant (Jay) D. Rao joined the Berkeley Law Visiting Scholars Program under the sponsorship of Prof. Kenneth Ayotte to study the intersection of equitable subordination and the modern bankruptcy claims market. Prior to moving to Berkeley, he served as an adjunct professor teaching a litigation drafting workshop under the supervision of Prof. Christine M. Tamer at the University of North Texas at Dallas College of Law and a lecturer teaching transactional drafting at Baylor Law School. The former institution, which was recently founded with a mission to widen access to legal education, is the only public law school in Dallas. Additionally, on a volunteer basis, Jay taught English as a second language through the Richardson Adult Literacy Center and social studies through the Aberg Center for Literacy's high school equivalency program.

He obtained legal training in New York as a corporate associate at Cravath, Swaine & Moore LLP and as a corporate associate within the restructuring practice at Simpson Thacher & Bartlett LLP. At the latter firm, Jay served as a Research Fellow for the American Bankruptcy Institute Commission to Study the Reform of Chapter 11, focusing on distribution issues. Additionally, he received training from Credit Suisse's corporate banking group, the president of buy-side institution CSG Investments, and in-house counsel at IHS Markit.

Jay received his B.B.A. in finance from The University of Texas at Austin, McCombs School of Business and, after completing his first year of coursework at The University of Texas at Austin School of Law, his J.D. from Columbia Law School, where he served as a research and teaching assistant to Prof. Robert E. Scott and a research assistant to Prof. Jeffrey N. Gordon.

Jay was born in Athens, Georgia and raised in Plano, Texas. His parents are immigrants to the United States of America from the Republic of India.

Berkeley

Debt Purchases

American Bankruptcy Institute
Winter Leadership Conference

Sponsor Liability, Including Liability Relating to Sponsors Purchasing Debt or Equity in Their Portfolios

Presented by: Business Reorganization and Claims Trading Committees

Moderator: Hon. Elizabeth S. Stong

Panelist: Jay D. Rao

Lawyer Conflicts: Joint Representation of Sponsor and Distressed Portfolio Company Thereof

- Model Rule of Professional Conduct
- Professional Ethics Committees' Opinions
- Bankruptcy Code Requirements
- Bankruptcy Rules Requirement
- Privilege Issues
- Strategic Planning for Potential Lawyer Conflicts

Model Rule of Professional Conduct

- Rule 1.7: Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

(1) the representation of one client will be directly adverse to another client; or

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Professional Ethics Committees' Opinions

- A law firm may represent a client whose interests in a corporate transaction are adverse to those of a current client in a separate matter, and may represent multiple clients in a single matter, with disclosure and informed consent, so long as a disinterested lawyer would believe that the law firm can competently represent the interests of each.
  - Satisfaction of the "disinterested lawyer" test in this context will depend on an evaluation of the nature and circumstances of the simultaneous representations, including:
    - (1) the nature of the conflict;
    - (2) the likelihood that client confidences or secrets in one matter will be relevant to the other representation;
    - (3) the ability of the lawyer or law firm to ensure that confidential information of the clients will be preserved;
    - (4) the ability of the lawyer to explain, and the client's ability to understand, the reasonably foreseeable risks of the conflict; and
    - (5) the lawyer's relationship with the clients.

Source: New York City Bar Professional Ethics Committee Formal Opinion 2001-2: Conflicts in Corporate and Transactional Matters

3

Bankruptcy Code Requirements

- <u>Section 327(a) of the Bankruptcy Code</u>:
  - Requires that bankruptcy professionals, including attorneys, who "represent or assist the trustee in carrying out the trustee's duties under [the Bankruptcy Code]" be "disinterested persons."
    - A disinterested person "does not have an interest adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason." 11 U.S.C. § 101(14).
- <u>Section 327(e) of the Bankruptcy Code</u>:
  - "The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."
    - Section 327(e) retention is less restrictive than section 327(a) retention because it requires only that the lawyer does not represent or hold an interest adverse to the special purpose for which the lawyer is employed.

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Bankruptcy Rules Requirement

- Federal Rule of Bankruptcy Procedure 2014:
  - Requires a professional retained in a bankruptcy case to disclose connections to parties in interest ("to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee").

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Privilege Issues

- Communications with portfolio company counsel may not be privileged if such communications pertain to legal advice to entities other than the company.
- In an insolvency scenario, the portfolio company may assert an entitlement to documents of the sponsor (or *vice versa*) on the theory that they were joint clients of counsel (whether in-house or external) on relevant matters. These risks can be managed by, among other things, carefully delineating the scope of any joint representations and by "seasonably [] separat[ing] counsel on matters in which subsidiaries are adverse to the parent." *In re Teleglobe Commc'ns Corp.*, 493 F.3d 345, 374 (3d Cir. 2007), *as amended* (Oct. 12, 2007).
- A future bankruptcy trustee may choose to waive the company's attorney-client privilege in the context of a bankruptcy proceeding.

6

Strategic Planning for Potential Lawyer Conflicts

- A law firm considering whether to represent both a sponsor and its distressed portfolio company should:
  - consider the likelihood of potential intercompany claims;
  - evaluate whether a restructuring would involve an actual conflict;
  - evaluate likelihood restructuring will be implemented through a bankruptcy;
  - assess whether it can provide undivided loyalty to both clients;
  - make robust disclosures to both sponsors and portfolio companies, including any dual representations or investments;
  - establish safeguards and measures to preserve confidentiality and protect interests;
  - obtain clear, specific waivers for potential conflicts arising out of dual representations and personal investments;
  - consider whether and when new counsel should be retained and for which client(s); and
  - in the event of the portfolio company's bankruptcy filing and the law firm's disclosure obligations, ensure full and complete disclosure of all connections.
- A law firm must plan for potential conflicts and be able to provide undivided loyalty to both clients, including on matters potentially adverse to the sponsor resulting from the restructuring or potential bankruptcy of the distressed portfolio company.

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Sponsor/Portfolio Company Conflicts: Fiduciary Duties and Governance

- Duty of Care
- Duty of Loyalty
- Control Persons
- Related-Party Transactions
- Applicable Standard of Review
- Independent Directors and Special Committees
- Fairness and Solvency Opinions in Distressed Situations
- Strategic Planning for Related-Party Transactions

8

Duty of Care

- In satisfying their duty of care, directors, managing members and managers should:
  - inform themselves of all material information reasonably available to them;
  - carefully consider that information and all reasonable alternatives with sufficient time; and
  - act with "requisite care" in discharging their duties.
- Directors, managing members, and managers may reasonably rely on information and advice from management and advisors, including counsel, financial advisors, and others.
  - Directors, managing members, and managers should not merely be passive recipients of advice. They should actively participate in discussions and decision making, critically evaluate any information received and consider various options and the risks and benefits of each.
  - Directors, managing members, and managers should have direct access to and receive advice from the company's financial, legal and other advisors and be provided with materials to facilitate their decision making.
  - Directors, managing members, and managers should review and understand presentations and key transaction terms.
- Process, advice, analyses, and opinions of financial advisors are important in fulfilling the duty of care.
- It is important to establish and follow a decision-making process and maintain good records to demonstrate compliance with the duty of care.

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Duty of Loyalty

- Directors, managing members and managers must act in good faith and in a manner they reasonably believe to be in the best interests of the company.
- To comply with the duty of loyalty, directors, managing members, and managers must be disinterested and independent in exercising their judgment, and subordinate other interests to those of the corporation.
- Duty of loyalty prohibits bad faith or self-dealing, such as participating in decision making on matters in which the director, managing members or manager has a material, disabling conflict of interest.
- Directors and officers, as well as managing members, and managers, must not act for a personal or non-corporate purpose, such as to preserve their positions or compensation.
- Directors, managing members, and managers should promptly disclose any conflicts (or potential conflicts).
- Bad faith may be found to exist if directors, managing members or managers exhibit a conscious disregard for their fiduciary duties or if directors, managing members or managers act with a purpose other than to advance the best interests of the company.

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Control Persons

- Directors and officers owe fiduciary duties—principally duties of loyalty and care—to the companies they serve in favor of the company's shareholders.
- Controlling shareholders have at least some of the same duties. *See, e.g., Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
- In the "zone of insolvency," directors can, but are not necessarily obligated to, consider how their decisions will affect solvency and recoveries for all constituents.
- In an insolvent company, these duties run to the company in favor of the creditors, who may obtain standing to pursue claims. *See generally N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

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Related-Party Transactions

- Under Delaware law, sponsors who are "controlling shareholders" owe fiduciary duties to the companies they control and their minority shareholders.
  - Who constitutes a "controlling shareholder"?
    - *De jure*: over 50% shareholder
    - *De facto*: significant block in addition to the exercise of sufficient influence over the board

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Applicable Standard of Review

- Transactions between a sponsor and controlled portfolio company generally means heightened "entire fairness" review as opposed to more lenient "business judgment" review.
  - **Business judgment rule** – Presumes that directors acted on an informed basis, in good faith, and in best interests of the company. Such actions will be upheld if attributable to rational business purpose.
  - **Entire fairness** – Burden is on sponsor to prove that both transaction price and procedure are fair to other shareholders.
    - Burden may be shifted back to plaintiff if procedural safeguards exist, such as (a) a special committee or (b) approval by a majority of the minority investors.
    - If *both* (a) and (b) are present and proper from the outset, then the business judgment rule still applies (*MFW Shareholders Litigation*).

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Independent Directors and Special Committees

- **Background**
  - Independent directors and special committees are often used to ensure proper corporate governance decision-making processes as companies approach insolvency. Although their use is not mandated by Delaware law, the DGCL expressly permits their formation. (*DGCL §141(c)(1)*). Generally, board resolutions will define the scope of authority delegated to the independent director(s) or special committee.
- **Independence**
  - There is no uniform standard for determination of independence, but the following formulae have been applied:
    - Independent directors must not be dominated or controlled by any party with an interest in the relevant transaction. *See In re Maxxam, Inc. / Federated Dev. Stockholder Litigation, 659 A.2d 760 (Del. Ch. 2003).*
    - Independent directors must not have any personal interest or relationship that renders the director incapable of acting in the best interest of the company. *See In re Oracle Corp Derivative Litigation. 824 A.2d 917 (Del. Ch. 2003).*
  - In addition to independence, independent directors and special committees must also be fully active and aware of developments at the portfolio company. *See In re Puda Coal, Inc. Stockholders Litigation, C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013).*
- **Benefits**
  - In transactions not involving the sponsor, increase likelihood that the business judgement rule applies.
  - In related-party transactions involving the sponsor, where entire fairness applies, may help to shift the burden back to the plaintiff to prove lack of fairness.

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Fairness and Solvency Opinions in Distressed Situations

- **Fairness Opinions in Pre-Bankruptcy Transactions**
  - Related-party transactions
  - Divestiture of enterprise, business units, assets or subsidiaries
  - Asset sale where buyer requests seller obtain opinion
- **Solvency Opinions in Pre-Bankruptcy Transactions**
  - Separation transaction – particularly when profitable operations are separated from distressed operations
  - Dividend distributions
  - Recapitalizations

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Strategic Planning for Related-Party Transactions

- A portfolio company's insolvency ultimately will be viewed by parties in interest with 20/20 hindsight, most likely raising questions about the sponsor's acquisition of the company, historical payments by the company made to or for the benefit of the sponsor, especially dividends financed through recapitalizations, or transactions designed to extend the life of a portfolio company experiencing operational and/or financial distress, including asset sales, spin-offs and creation of unrestricted subsidiaries. In light thereof, at the time of engaging in the related-party transaction, the sponsor should consider:
  - the scope of, and compliance with, fiduciary duties;
  - use of independent directors and special committees;
  - use of external professionals;
  - engaging in risk-benefit analyses of contemplated transactions from the perspective of the portfolio company;
  - well documenting the bases or rationale underlying decision-making; and
  - distinguishing between, and being able to defend, decisions made as a shareholder and decisions made as a director.

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American Bankruptcy Institute Winter Leadership Conference

December 5-7, 2019 Rancho Palos Verdes, CA

SPONSOR LIABILITY, INCLUDING LIABILITY RELATING TO SPONSORS PURCHASING DEBT OR EQUITY IN THEIR PORTFOLIOS

Structural Risks of Private Equity Sponsors and Proposed Legislation in Response to Recent Retail Liquidating Chapter 11 Cases

Presented by:

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Corbi Law

DISCLAIMER: The views and opinions expressed in this presentation are those of the author and do not necessarily reflect the views of the Law Offices of Richard J. Corbi PLLC and its clients.

Structural Risks of Private Equity Sponsors[1]

In re DSI Renal Holdings, LLC, 574 B.R. 446 (Bankr. D. Del. 2017) – breach of fiduciary duty

In *DSI Renal Holdings*, directors were on both sides of a transaction that allegedly sold the debtor's key operating asset to purchaser for less than fair value (in combination with other actions allegedly intended to leave creditors without recourse to assets and to artificially lower the valuation of the operating asset). Board of debtor has independent directors. Trustee brings claims for fraudulent transfer, breach of fiduciary duty, and more. Court denies motion to dismiss.

In re Nuisance Corp., 117 B.R. 80 (Bankr. D.N.J. – breach of fiduciary duty.

Plaintiff insiders brought an adversary proceeding against defendant trustee seeking to enforce a security interest in proceeds in the trustee's hands resulting from the sale of the debtor's assets. The trustee argued that the insiders' claim and security interest were obtained in violation of the fiduciary duty they owed to the debtor corporation as officers and directors. One insider was the debtor's president. The other two were his wife and sister, who collectively owned 66% of the debtor's stock. A bank obtained a judgment in state court against the debtor. The president purchased the judgment at a discount and took an assignment of the judgment and the insiders perfected a security interest in the debtors' assets. The sister, who was a real estate agent, then arranged the sale of the debtor's assets to another corporation, taking a commission on the sale. The debtor then filed bankruptcy.

The insiders claimed a security interest in the remaining proceeds of the sale, now in the hands of the trustee. The court held that the claim was not allowable under 11 U.S.C.S. § 502(b)(1). That section disallowed a creditor's claim to the extent that the debtor had a valid defense to the claim under applicable law. State law imposed a fiduciary duty upon officers, directors, and controlling shareholders in dealings with their corporation. The insiders had taken advantage of an opportunity to purchase the judgment at a discount and sought to use it to the detriment of the Debtor's minority shareholders and creditors.

In re LightSquared Inc., 513 B.R. 56 (Bankr. S.D.N.Y. 2014) – vote designation

In *LightSquared*, SP Special Opportunities LLC (SPSO), an entity that was wholly owned by the chairman and controlling shareholder of a competitor of the debtors, purchased all pre-petition secured debt. Under the debtors' plan, the SPSO claim was separately classified, whereby it would receive a note, while the non-SPSO pre-petition secured debt would be paid in cash equal to their secured claims. The court found that the separate classification of the SPSO claim was proper because it was a competitor with significant non-creditor interests. However, the court held that the SPSO class's vote could not be designated under 11 U.S.C. § 1126(e) as it was cast in "bad faith." The court acknowledged that votes cast by competitors should be viewed with scrutiny, but found that SPSO did not buy the "claims with the intent of voting against any plan that did not give it a strategic interest in the reorganized company." In its analysis, the court

[1] Copies of the cases discussed in this section are attached as Appendix A.

focused on the following factors in refusing to designate SPSO's claim: (1) SPSO purchased the debt below par and acquired all of the debt prior to the filing of the plan; and (2) there were valid reasons for SPSO's rejection of the plan outside of its position as a competitor, specifically, that the plan deprived SPSO of its first lien security interest and instead gave it an equity interest.

Proposed Legislation in Response to Recent Retail Liquidating Chapter 11 Cases[2]

Recent Retail Chapter 11 Liquidations and Worker Severance Claims Litigation

In re Toys "R" Us, Inc., et al., Case No. 17-34665 (KLP).

As a result of the Debtors' liquidation, litigation between the Debtors and a class of 30,000 laid off workers resulted in an allowed administrative expense claim of $10 million.

See ORDER (I) APPROVING THE SETTLEMENT AGREEMENT, (II) CERTIFYING A CLASS OF FORMER EMPLOYEES FOR SETTLEMENT PURPOSES ONLY, (III) APPOINTING CLASS COUNSELAND CLASS REPRESENTATIVE, (IV) APPROVING THE FORM AND MANNER OF NOTICE OF THE CLASS CERTIFICATION AND SETTLEMENT, (V) SETTING THE AGGREGATE RECOVERY OF THE CLASS UNDER THE GLOBAL SETTLEMENT AGREEMENT, AND (VI) GRANTING RELATED RELIEF. [Dkt No. 7110] (Bankr. E.D. Va. June 29, 2019).

Post Toys 'R' Us Legislation

State Law

New Jersey Amends its State WARN Act Statute

The New Jersey legislature amended its state WARN Act Statute entitled the "Millville Dallas Airmotive Plant Job Loss Notification Act", P.L.2007, c.212

As a result of former workers at Toys "R" Us Inc. and Sears Holdings Corp. receiving little or no severance after their stores closed, New Jersey lawmakers voted on Thursday to require companies to provide compensation to employees dismissed in mass layoffs, and extends the employee notice period for mass firings to 90 days from 60 and require warnings about impending bankruptcy filings.

Federal Law

The "Stop Wall Street Looting Act" of 2019 introduced by Sen. Elizabeth Warren as a result of the wave of retail chapter 11 liquidations. The Bill is targeted at private equity firms who invest in companies that eventually file chapter 11 or shut down. Key provisions of the proposed legislation:

- Private Equity firms will share responsibility for the liabilities of companies under their control including debt, legal judgments and pension-related obligations to better align the incentives of private equity firms and the companies they own.

[2] Copies of the pleadings, passed legislation and proposed legislation discussed in this section are attached as Appendix B.

- The Act proposes to ban dividends to investors for two years after a company is acquired and ends the extraction of wealth from acquired companies through excessive fees.

- Private equity managers will be required to disclose fees, returns, and political expenditures so that investors can monitor their investments.

- This Acts proposes to prevent private equity firms from walking away when a company fails and protects stakeholders by:

    - Prioritizing worker pay in the bankruptcy process, and improving rules so workers are more likely to receive severance, pensions, and other payments they earned.
    - Ending the immunity of private equity firms from legal liability when their portfolio companies break the law, including the WARN Act.
    - Clarifying that gift cards are consumer deposits, ensuring their priority in bankruptcy.

Appendix A

User Name: Richard Corbi

Date and Time: Monday, September 30, 2019 3:08:00 PM EDT

Job Number: 98759441

Document (1)

1. *In re Guiliano v. Schnabel (In re DSI Renal Holdings, LLC), 574 B.R. 446*

   Client/Matter: -None-

   Search Terms: 574 br 446

   Search Type: Natural Language

   Narrowed by:

Content Type	Narrowed by
Cases	-None-

Caution
As of: September 30, 2019 7:08 PM Z

In re Guiliano v. Schnabel (In re DSI Renal Holdings, LLC)

United States Bankruptcy Court for the District of Delaware

July 20, 2017, Decided

CHAPTER 7, Case No. 11-11722 (KJC) (Jointly Administered), Adv. Proc. No. 14-50356 (KJC), (Adv. D.I. 14, 15, 16, 17)

Reporter
574 B.R. 446 *; 2017 Bankr. LEXIS 2023 **

In re: DSI RENAL HOLDINGS, LLC, et al., Debtors.ALFRED T. GIULIANO, as Chapter 7 Trustee, Plaintiff, v. MICHAEL SCHNABEL, et al., Defendants.

Core Terms

DSI, Renal, restructuring, Holdings, motion to dismiss, alleges, transfers, email, entity, breach of fiduciary duty, bankruptcy case, fraudulent transfer, transactions, courts, fiduciary duty, consolidation, fiduciary, Counts, shareholders, holding company, collapsible, aiding and abetting, stock, fraudulent, deferred, insiders, subsidiaries, Defendants', factual allegations, asserts

Case Summary

Overview

HOLDINGS: [1]-Where Chapter 7 Trustee alleged that defendants orchestrated a restructuring of entities through a complex series of transfers and transactions that stripped debtor's assets, count alleging violation of *11 U.S.C.S. § 548(a)(1)(A)* was not subject to dismissal because Trustee properly alleged that the transfers constituted avoidable intentional fraudulent transfers and allegations satisfied *Fed. R. Civ. P. 9(b)* standards; [2]-Consideration deferred for motion to dismiss count that raised similar issues about *11 U.S.C.S. § 546(e)* as those raised in a case pending before the Supreme Court; [3]-Claims alleging breach of fiduciary duty were sufficiently stated; [4]-Dismissal of corporate waste claim was premature because complaint adequately alleged that debtor's transfer of certain interests served no rational business purpose and debtor did not receive adequate consideration.

Outcome

Motions to dismiss denied in part, granted in part, and deferred in part.

LexisNexis® Headnotes

Bankruptcy Law > Procedural Matters > Jurisdiction > Noncore Proceedings

Bankruptcy Law > Procedural Matters

HN1[] **Jurisdiction, Noncore Proceedings**

A Bankruptcy Court may enter an order on a motion to dismiss even if the matter is non-core or it has no authority to enter a final order on the merits.

Bankruptcy Law > Procedural Matters > Adversary Proceedings > Defenses & Objections

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN2[] **Adversary Proceedings, Defenses & Objections**

Fed. R. Civ. P. 12(b)(6), made applicable by *Fed. R. Bankr. P. 7012(b)(6)*, governs a motion to dismiss for failing to state a claim upon which relief can be granted. The purpose of a motion to dismiss is to test the sufficiency of a complaint, not to resolve disputed facts or decide the merits of the case. When reviewing a motion to dismiss, the court will construe the complaint in the light most favorable to the plaintiff. The court will therefore accept all factual allegations in the complaint as true and give the pleader the benefit of all reasonable inferences that can be fairly drawn therefrom. The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims.

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN3[] Motions to Dismiss, Failure to State Claim

To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its face. Although a complaint challenged by a *Fed. R. Civ. P. 12(b)(6)* motion to dismiss need not contain detailed factual allegations, a plaintiff's obligation to provide the grounds of his entitlement to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do. Factual allegations must be enough to raise a right to relief above the speculative level.

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

HN4[] Motions to Dismiss, Failure to State Claim

The United States Court of Appeals for the Third Circuit has outlined a three-step process to determine the sufficiency of a complaint under Twombly and Iqbal: First, the court must take note of the elements a plaintiff must plead to state a claim. Second, the court should identify allegations that, because they are no more than conclusions, are not entitled to the assumption of truth. Finally, where there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement for relief. The relevant record under consideration consists of the complaint and any document integral or explicitly relied on in the complaint. When considering a motion to dismiss, it is axiomatic that the complaint may not be amended by the briefs in opposition to a motion to dismiss. The movant carries the burden of demonstrating that dismissal is appropriate.

Bankruptcy Law > Estate Property > Avoidance > Fraudulent Transfers

HN5[] Avoidance, Fraudulent Transfers

11 U.S.C.S. 548(a)(1)(A) aims to make available to creditors those assets of the debtor that are rightfully a part of the bankruptcy estate, even if they have been transferred away.

Bankruptcy Law > Procedural Matters > Adversary Proceedings

Civil Procedure > ... > Pleadings > Heightened Pleading Requirements > Fraud Claims

HN6[] Procedural Matters, Adversary Proceedings

The purpose of *Fed. R. Civ. P. 9(b)* is to place the defendants on notice of the precise misconduct with which they are charged. However, Rule 9(b) is interpreted liberally in the bankruptcy context, particularly when the plaintiff is a third party, such as a trustee, because a third party generally has less information on which to base its allegations.

Bankruptcy Law > ... > Avoidance > Fraudulent Transfers > Intent

HN7[] Fraudulent Transfers, Intent

Because actual intent to defraud is often difficult to prove, courts may rely on circumstantial evidence or "badges of fraud" to infer actual fraudulent intent. Those "badges of fraud" include: (1) a close relationship among the parties to the transaction; (2) a secret and hasty transfer not in the usual course of business; (3) inadequacy of consideration; (4) the transferor's knowledge of the creditor's claim and the transferor's inability to pay it; (5) the use of dummies or fictitious parties; and (6) retention of control of property by the transferor after the conveyance. While "consideration" is an issue when analyzing constructive fraud, a claim for actual fraud under *11 U.S.C.S. § 548(a)(1)(A)* need not contain allegations about the value of consideration received by the debtor in the transaction.

Bankruptcy Law > Estate Property > Avoidance > Fraudulent Transfers

HN8[] **Avoidance, Fraudulent Transfers**

The Bankruptcy Code defines "transfer" as each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property. *11 U.S.C.S. § 101(54)(D).*

Bankruptcy Law > Estate Property > Avoidance > Fraudulent Transfers

HN9[] **Avoidance, Fraudulent Transfers**

When assessing a defendant's fraudulent transfer liability, the United States Court of Appeals for the Third Circuit has recognized that multi-step transactions may be collapsed and treated as one integrated transaction. Deciding whether to collapse transactions is a fact-intensive exercise, and courts have been reluctant to solve collapsible transaction issues at the motion to dismiss stage. To determine whether a series of transactions should be collapsed and viewed as a single integrated transaction, courts focus on the substance rather than on the form of the transactions and consider the overall intent and impact of the transactions.

Bankruptcy Law > Estate Property > Avoidance > Fraudulent Transfers

HN10[] **Avoidance, Fraudulent Transfers**

When viewing collapsing transactions as part of an analysis of a defendant's fraudulent transfer liability, courts consider: (1) whether all the parties involved had knowledge of the multiple transactions; (2) whether each transaction would have occurred on its own; and (3) whether each transaction was conditioned or dependent upon the other transactions. While the transactions that are sought to be collapsed may be structurally independent and distinct from one another, courts focus their analysis not on the structure of the transaction but the knowledge and intent of the parties involved in the transaction. Courts will consider the collapse of a series of transactions upon a showing that the transactions were part of an overall scheme to defraud the estate and its creditors by depleting assets through a restructuring.

Bankruptcy Law > Estate Property > Avoidance > Fraudulent Transfers

HN11[] **Avoidance, Fraudulent Transfers**

The creation of an intermediary corporation does not insulate defendants from liability for fraudulent transfers. The United States Court of Appeals for the Third Circuit has held that a fraudulent transfer can occur when employees, customer base, and physical assets are subsumed by another entity. The circumstances surrounding the debtor's demise and the new entity's ascendance matter more than the classification of each transfer. If one acts with knowledge that creditors will be hindered or delayed by a transfer but then intentionally enters the transaction in disregard of this fact, he acts with actual intent to hinder and delay them.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

HN12[] **Management Duties & Liabilities, Fiduciary Duties**

A corporation's directors and officers are fiduciaries of the company. Among the duties owed by a fiduciary are the duties of loyalty, good faith, and care.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Loyalty

HN13[] **Fiduciary Duties, Duty of Loyalty**

The duty of loyalty obligates corporate fiduciaries to commit themselves to the business of the corporation with the attitude of promoting the corporation's interests, not their own. A director is considered to be "interested" if he stands on both sides of the transaction or if he looks to derive a personal financial benefit from the transaction. The fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest, but may also include a failure to act in good faith. A director cannot act loyally towards the the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Duty of Care

HN14[] **Fiduciary Duties, Duty of Care**

The duty of care has been described as the duty to act on an informed basis. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information. When analyzing a claim for breach of the duty of care, Delaware courts apply a standard of gross negligence, which has been defined as reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > Fiduciary Duties

Torts > Intentional Torts > Breach of Fiduciary Duty > Elements

HN15[] **Management Duties & Liabilities, Fiduciary Duties**

The fiduciary duties of officers are the same as those of directors. To state a claim against an officer for breach of fiduciary duty, the complaint must allege facts demonstrating that the officer: (1) took part in the challenged conduct; and (2) failed to demonstrate the due care attendant to his particular office in doing so.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Civil Procedure > ... > Responses > Defenses, Demurrers & Objections > Affirmative Defenses

Civil Procedure > ... > Defenses, Demurrers & Objections > Motions to Dismiss > Failure to State Claim

HN16[] **Fiduciary Duties, Business Judgment Rule**

An exculpatory clause is an affirmative defense and cannot form the basis of a Fed. R. Civ. P. 12(b)(6) dismissal. The application of the business judgment rule is an affirmative defense, the determination of which is not proper at the motion to dismiss stage. However, a complaint may be dismissed under Rule 12(b)(6) where an unanswered affirmative defense appears on its face and, in that instance, to survive a motion to dismiss, a plaintiff must plead around the business judgment rule. A plaintiff can rebut the presumptive protection afforded by the business judgment rule by showing that the board of directors, in reaching its challenged decision, violated any one of its triad of fiduciary duties: due care, loyalty, or good faith.

Civil Procedure > ... > Pleadings > Complaints > Requirements for Complaint

Torts > Intentional Torts > Breach of Fiduciary Duty

HN17[] **Complaints, Requirements for Complaint**

Federal Courts sitting in Delaware generally do not apply the Fed. R. Civ. P. 9(b) pleading requirements to state law claims for breach of fiduciary duty. Therefore, a plaintiff is only required to meet the pleading requirements of Fed. R. Civ. P. 8(a) for such claims.

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Controlling Shareholders > Fiduciary Duties

HN18[] **Controlling Shareholders, Fiduciary Duties**

A shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation. A shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct. For a "control group" to be treated the same as a single controlling stockholder, it must be connected in some legally significant way - - e.g., by contract, common ownership, agreement or other arrangement - - to work together toward a shared goal. Whether a control group exists is a fact-intensive inquiry; some courts have been hesitant to make this determination in pre-trial motions.

Torts > Intentional Torts > Breach of Fiduciary Duty

Torts > ... > Multiple Defendants > Concerted Action > Civil Aiding & Abetting

HN19[] Intentional Torts, Breach of Fiduciary Duty

Under Delaware law, the four elements of an aiding and abetting a breach of fiduciary duty claim are (1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, (3) knowing participation in that breach by the defendants, and (4) damages proximately caused by the breach.

Torts > Intentional Torts > Breach of Fiduciary Duty

Torts > ... > Multiple Defendants > Concerted Action > Civil Aiding & Abetting

HN20[] Intentional Torts, Breach of Fiduciary Duty

Fiduciaries cannot aid and abet their own breaches of fiduciary duty. However, although the elements of a claim for aiding and abetting a breach of fiduciary duty count are couched in terms of the primary violator being a fiduciary and the aider and abettor a non-fiduciary, there is no case law that precludes such a claim against a fiduciary. While a corporate director owes the corporation fiduciary duties, in some instances those duties may be limited (by corporate charter or statute). Thus, the Court may find that a director had no fiduciary duty but aided and abetted a party that did.

Torts > Intentional Torts > Breach of Fiduciary Duty

Torts > ... > Multiple Defendants > Concerted Action > Civil Aiding & Abetting

HN21[] Intentional Torts, Breach of Fiduciary Duty

"Knowing participation" is a critical element of a claim for aiding and abetting in a breach of fiduciary duty.

Business & Corporate Law > ... > Management Duties & Liabilities > Fiduciary Duties > Business Judgment Rule

Business & Corporate Law > ... > Shareholder Duties & Liabilities > Controlling Shareholders > Causes of Action

HN22[] Fiduciary Duties, Business Judgment Rule

Under Delaware law, directors waste corporate assets when they approve a decision that cannot be attributed to any rational business purpose. A claim for corporate waste is a residual protection for stockholders that polices the outer boundaries of the broad field of discretion afforded directors by the business judgment rule. To state a claim for corporate waste, the complaint must allege that the directors authorized an exchange that was so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration. In evaluating a waste claim, courts look to the exchange itself rather than process. The exchange must be irrational. Waste is a standard rarely satisfied in Delaware courts.

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles

Bankruptcy Law > ... > Bankruptcy > Estate Property > Contents of Estate

HN23[] Duties & Functions, Capacities & Roles

11 U.S.C.S. § 541(a) provides that a bankruptcy estate consists of all legal and equitable interests of the debtor in property as of the commencement of the case. This includes causes of action existing at the time the bankruptcy action commences. In addition, 11 U.S.C.S. § 323(a) provides that the trustee is the sole representative of the estate and 11 U.S.C.S. § 323(b) provides that the trustee has the capacity to sue and be sued. Taken together, § 323(a) and (b) grant the trustee the exclusive standing to assert causes of action that have become property of the estate by operation of § 541. But property of the bankruptcy estate does not include claims for damages caused to individual creditors or stockholders of the debtor.

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles

Business & Corporate Law > ... > Shareholder Actions > Actions Against Corporations > Derivative Actions

HN24[] Duties & Functions, Capacities & Roles

Trustees have standing to bring derivative claims (based on an injury to the corporation) as opposed to direct claims (based on an injury to the individual shareholder or creditor). Under Delaware law, a court decides whether a claim is direct or derivative by considering who suffered the alleged harm - - the corporation or the suing stockholder or creditor individually - - and who would receive the benefit of the recovery or other remedy?

Bankruptcy Law > ... > Commencement of Case > Joint Cases > Consolidation

HN25[] **Joint Cases, Consolidation**

Substantive consolidation, a construct of federal common law, emanates from equity. It treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claim against the consolidated survivor. Consolidation restructures (and thus revalues) rights of creditors and for certain creditors this may result in significantly less recovery.

Bankruptcy Law > ... > Commencement of Case > Joint Cases > Consolidation

HN26[] **Joint Cases, Consolidation**

Substantive consolidation is only appropriate by consent or if the party moving to substantively consolidate entities can prove that (i) prepetition the 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. Corporate disregard as a fault may lead to corporate disregard as a remedy. Substantive consolidation has a profound effect on the assets of the consolidated entities and an order may have a preclusive effect on the merits of other litigation. Substantive consolidation may harm some creditors, so all creditors should have an opportunity to appear and be heard in a substantive consolidation action.

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For Siemens Financial Services, Inc., Interested Party (1:11bk11722): James G. McMillian, III, Pepper Hamilton LLP, Wilmington DE.

For Alfred Thomas Giuliano, Trustee (1:11bk11722): Steven M. Coren, Benjamin M. Mather, Lead Attorneys, Kaufman, Coren & Ress, P.C., Philadelphia PA; David Dormont, Lead Attorney, Montgomery McCracken

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For Centre Bregal Partners II, L.P., Centre Bregal Partners, L.P., Centre Capital Investors IV, L.P., Centre Capital Non-Qualified Investors IV, L.P., Centre Capital Non-Qualified Investors V, L.P., Centre Partners Coinvestment V, L.P., Centre Partners IV L.P., Centre Partners IV LLC, Centre Partners Management LLC, Centre Partners V L.P., Centre Partners V LLC, Leif Murphy, Bruce Pollack, Michael Schnabel, The Northwestern Mutual Life Insurance Company, Jay Yalowitz, Defendants (1:14ap50356): Andrew R. Remming, Eric D. Schwartz, Morris, Nichols, Arsht & Tunnell LLP, Wilmington DE.

For Centre Capital Investors V, L.P., Defendant (1:14ap50356): Andrew R. Remming, Morris, Nichols, Arsht & Tunnell LLP, Wilmington DE.

For Centre Defendants, D&O Defendants, Nml, Interested Parties (1:14ap50356): Andrew R. Remming, Morris, Nichols, Arsht & Tunnell LLP, Wilmington DE.

For Centre Partners Coinvestment IV, L.P., Defendant (1:14ap50356): Edward D. Kutchin, Berluti McLaughlin & Kutchin LLP, **[**4]** Boston MA; Andrew R. Remming, Eric D. Schwartz, Morris, Nichols, Arsht & Tunnell LLP, Wilmington DE.

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For The Northwestern Mutual Life Insurance Company For its Group Annuity Separate Account, Defendant (1:14ap50356): Michael W. Ott, Schiff Hardin LLP, Chicago IL; Andrew R. Remming, Eric D. Schwartz, Morris, Nichols, Arsht & Tunnell LLP, Wilmington DE.

Judges: KEVIN J. CAREY, UNITED STATES BANKRUPTCY JUDGE.

Opinion by: KEVIN J. CAREY

Opinion

[*453] BY: KEVIN J. CAREY, UNITED STATES BANKRUPTCY JUDGE

BACKGROUND

On June 3, 2011 (the "Petition Date"), Debtors DSI Renal Holdings LLC ("DSI Renal Holdings"), DSI Hospitals, Inc. ("DSI Hospitals"), and DSI Facility Development, LLC ("DSI Facility"), filed voluntary petitions for relief under Chapter 7 of the United States Bankruptcy Code[1] in the United States Bankruptcy Court for the District of Delaware.[2] On May 20, 2013, Alfred T. Giuliano, as Chapter 7 Trustee for the jointly administered Chapter 7 estates of the Debtors **[**5]** (the "Trustee"), filed an adversary complaint (the "Complaint") in the United States District Court for the Eastern District of Pennsylvania (the "Pennsylvania District Court") against Apollo Investment Corporation ("Apollo"), Ares Capital Corporation ("Ares"), the Centre Defendants,[3] the Director and Officer Defendants (the "D&O Defendants"),[4] and The Northwestern Mutual Life Insurance Company, for itself **[*454]** and for its Group Annuity Separate Account (in either capacity, the "NML

[1] ***11 U.S.C. § 101 et seq.***

[2] The bankruptcy cases of DSI Renal Holdings, DSI Hospitals and DSI Facility are jointly administered under the caption *In re DSI Renal Holdings LLC, et al., Ch. 7 Case No. 11-11722, 2011 Bankr. LEXIS 5800 (KJC) (Bankr. D. Del.)* (the "Delaware Bankruptcy Case"). *See* Order dated July 27, 2011. D.I. 25. DSI Renal Holdings, DSI Hospitals and DSI Facility are referred to collectively herein as the "Debtors."

[3] The Centre Defendants are, collectively, Centre Partners Management LLC, Centre Bregal Partners, L.P., Centre Bregal Partners II, L.P., Centre Capital Investors IV, L.P., Centre Capital Investors V, L.P., Centre Capital Non-Qualified Investors IV, L.P., Centre Capital Non-Qualified Investors V, L.P., Centre Partners Coinvestment IV, L.P., Centre Partners Coinvestment V, L.P., Centre Partners IV L.P., Centre Partners IV, LLC, Centre Partners V, L.P., and Centre Partners V, LLC.

[4] The D&O Defendants are: Michael Schnabel, Leif Murphy, Bruce Pollack, Robert Bergmann, and Jay Yalowitz. All claims against director Ken Kencel were dismissed without prejudice on November 1, 2013, pursuant to *Fed. R. Civ. P. 41(a)(1)(A)(i)*, made applicable hereto by *Fed. R. Bankr. P. 7041*. Adv. D.I. 42.

Defendants")[5] seeking, among other things, to recover in excess of $425 million in alleged fraudulent transfers.[6] On August 5, 2013, the Defendants filed motions to dismiss the Complaint for failure to state a claim and, with regard to Count 8, lack of subject matter jurisdiction (the "Motions to Dismiss"),[7] and motions to dismiss for improper venue or, in the alternative, to transfer the action to the United States District Court for the District of Delaware (the "Delaware District Court") for referral to this Court (the "Improper Venue Motions").

On March 17, 2014, the Pennsylvania District Court entered an order transferring the case to the Delaware District Court.[8] The **[**6]** Delaware District Court referred the case to this Court,[9] commencing this adversary proceeding (Adv. Proc. No. 14-50356). Subsequently, I heard oral argument on the Motions to Dismiss. For the reasons set forth herein, the Motions to Dismiss will be denied in part, granted in part, and deferred in part.

The following chart presents the counts from the Complaint, and states whether the Motions to Dismiss are denied, granted or deferred as to each Count, for reasons discussed in this Opinion.

Go to table1

[*455] JURISDICTION

The Court has jurisdiction over this matter pursuant to 28 U.S.C. § 1334 and § 157(a). Counts 1 through 4 are core proceedings pursuant to 28 U.S.C. §157(b)(1) and (b)(2)(H). The remaining counts are non-core. The Trustee demands a jury trial for all claims, and does not consent to the entry of final judgment or adjudication by this Court. Compl. ¶ 4.

HN1[] The Bankruptcy Court may enter an order on a motion to dismiss even if the matter is non-core or it has no authority to enter a final order on the merits.[11] To the extent parties do not agree that this Court may enter a final order for non-core related proceedings, or if any court determines that a final order or judgment in this matter by this Court is not consistent with Article III of the United States Constitution, then this Opinion and Order are submitted as proposed findings of fact and conclusions of law in accordance with the District Court's Amended Standing Order of Reference dated February 29, 2012.[12]

FACTUAL ALLEGATIONS

This case is somewhat unusual in that, before filing his Complaint, the Trustee had the benefit of extensive discovery through (a) numerous documents in the Trustee's possession, **[**8]** including company board minutes, internal and external company emails, insider emails and internal notes and emails of the Debtors' prior counsel; and (b) sworn deposition testimony taken in connection with the Trustee's investigation and examinations under Fed. R. Bankr. P. 2004, including those of (i) the Debtors' former outside counsel, (ii) Defendant Murphy, (iii) Defendant Yalowitz, and (iv) Defendant Schnabel. Compl. ¶ 89. A summary of the factual allegations in the Complaint follows.

The Debtors (DSI Renal Holdings, DSI Hospitals, and DSI Facility), are the empty shells of a healthcare

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[5] Ares, Apollo, the Centre Defendants, the D&O Defendants, and the NML Defendants are referred to collectively herein as the "Defendants." All claims against CDSI I Holding Company, Inc. (CDSI I), and CDSI II Holding Company, Inc. (CDSI II), were dismissed without prejudice on August 2, 2013, pursuant to Fed. R. Civ. P. 41(a)(1)(A)(i), made applicable hereto pursuant to Fed. R. Bankr. P. 7041. Adv. D.I. 11.

[6] The Complaint was docketed in the United States District Court for the Eastern District of Pennsylvania, C.A. No. 13-CV02776-CMR.

[7] Items on the docket for this Adversary Proceeding No. 14-50356 are referred to as "Adv. D.I. __." The Motions to Dismiss are Adv. D.I.s 14, 15, 16 and 17.

[8] Adv. D.I. 24.

[9] Adv. D.I. 29.

[11] *See* Burtch v. Owlstone, Inc. (In re Advance Nanotech, Inc.), Bky. No. 11-10776 (MFW), Adv. No. 13-51215, 2014 Bankr. LEXIS 1362, 2014 WL 1320145, at *2 (Bankr. D. Del. Apr. 2, 2014) (citing O'Toole v. McTaggart (In re Trinsum Grp., Inc.), 467 B.R. 734, 739 (Bankr. S.D.N.Y. 2012)) ("After *Stern v. Marshall*, the ability of bankruptcy judges to enter interlocutory orders in proceedings . . . has been reaffirmed . . . .");*see also* Boyd v. King Par, LLC, Case No. 1:11—CV—1106, 2011 U.S. Dist. LEXIS 130070, 2011 WL 5509873, at *2 (W.D. Mich. Nov. 10, 2011) ("[U]ncertainty regarding the bankruptcy court's ability to enter a final judgment . . . does not deprive the bankruptcy court of the power to entertain all pretrial proceedings, including summary judgment motions.").

[12] *See, e.g.,* Zazzali v. 1031 Exchange Grp. (In re DBSI, Inc.), 467 B.R. 767, 775-76 (Bankr. D. Del. 2012).

conglomerate that once comprised more than twenty-five companies. Compl. ¶ 35. On the Petition Date, DSI Renal Holdings and DSI Facility were Delaware limited liability companies, and DSI Hospitals was a Delaware corporation. Compl. ¶ 7. Prior to the Petition Date, the Debtors' ultimate parent, DSI Holding Company, Inc. ("DSI Holding"), a Delaware corporation, was merged into DSI Renal Holdings during a restructuring in 2010, with DSI Renal Holdings as the surviving company. Compl. ¶¶ 7, 83-85.

The crux of the Trustee's Complaint is that the Defendants orchestrated a restructuring of the DSI entities through a complex **[**9]** series of agreements, transfers and transactions that, ultimately, stripped DSI Renal Holdings (formerly DSI Holding) of its valuable assets by diluting its 100% ownership of the operating subsidiaries **[*456]** to less than one-thousandth of a percent of an interest (*i.e.*, 1 share of a total of 138,154.275 shares) in the post-restructuring entity. Compl. ¶¶ 71-85. The Trustee alleges that, as a result of the restructuring, the Debtors were left as insolvent shells, with liabilities in excess of $40 million and assets as little as $300,000. Compl. ¶ 86a. When the Renal Business (defined *infra.*) was sold in February 2011 for more than $700 million to DaVita, Inc. (the "DaVita Merger Transaction") (Compl. ¶¶ 1, 100), the Debtors remained insolvent, while the Defendants shared sale proceeds of more than $425 million. Compl. ¶ 86b.

<u>The Pre-Petition Companies</u>

DSI Holding, the prepetition parent company, through its 100% ownership of DSI Renal Holdings, DSI Renal, Inc. ("DSI Renal") and its operating subsidiaries, was the fifth-largest provider of outpatient dialysis clinics in the United States, owning and operating 106 clinics and providing services to twenty-six acute care facilities (the "Renal **[**10]** Business"). Compl. ¶¶ 36, 74(b). As of October 31, 2009, the Debtors' clinics treated approximately 7,800 patients in twenty-three states and generated annual revenues of approximately $350 million. *Id.*

The Trustee alleges that the Debtors and their subsidiaries operated as a single entity, with millions of dollars routinely transferred among the companies without regard to which company generated the cash or which company incurred the expense being paid. Compl. ¶ 44.

For the year ending December 31, 2008, the Debtors - - who had filed consolidated tax returns - - suffered a write-down of more than $100 million in the value of accounts receivable. Compl. ¶ 37. Around October 2008, Defendant Lief Murphy was hired to serve as CEO and implement a turnaround plan. Compl. ¶ 38.

Debtor DSI Hospitals (a subsidiary of DSI Holding) owned a specialty breast cancer treatment hospital in Bensalem, Pennsylvania—Bucks County Oncoplastic Institute, LLC (the "Bucks County Hospital" or "Bucks County"). Compl. ¶ 39. Because the Bucks County Hospital was never profitable and incurred tens of millions of dollars of losses, Defendant Murphy recommended closure of the Bucks County Hospital. Compl. ¶¶ 40-41. **[**11]**

After unsuccessful negotiations with secured creditor MPT of Bucks County, L.P. ("MPT"), DSI Hospitals closed the Bucks County Hospital. Compl. ¶¶ 45-46. According to an email authored by DSI Holding's former CEO, DSI Holding guaranteed between $7-9 million of claims owing to creditors of the Bucks County Hospital (MPT and Siemens). Compl. ¶ 90(c).

<u>The Tennessee Bankruptcy Case</u>

The Trustee alleges that, to avoid DSI Holdings' liability for the debts of the Bucks County Hospital, the Debtors' management/directors caused the Bucks County Hospital to commence a Chapter 7 bankruptcy case in Tennessee on March 30, 2009 (the "Tennessee Bankruptcy Case").[13] Compl. ¶ 47. The Bucks County Hospital's schedules showed deb t s in excess of $36 million owed to more than 200 creditors. Compl. ¶ 48.

In numerous internal documents, directors and officers of DSI Holding conceded the company's potential liability to numerous creditors of the Bucks County Hospital and were concerned that the creditors would take action against the Debtors on the theory that DSI Holdings and Bucks County "were the same entity." **[*457]** Yet, in most instances, DSI Holdings' status as "co-debtor" **[**12]** for the Bucks County Hospital was omitted from the schedules, and the Tennessee Bankruptcy Case closed without that status ever having been revealed. Compl. ¶¶ 49-53, 90(c). The Trustee alleges that company insiders did not disclose DSI Holding's codebtor status to diminish the likelihood that the Bucks County Hospital's creditors would commence

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[13] The Tennessee Bankruptcy Case was captioned *In re Bucks County Oncoplastic Institute, LLC*, Ch. 7, Case No. 09-03570-MH3-7 (Bankr. M.D. Tenn.).

litigation or take other action, such as filing an involuntary bankruptcy proceeding, against DSI Holding, which would have "torpedoed" the Defendants' scheme to strip out the Renal Business. Compl. ¶¶ 51, 90(f).

To substantiate these allegations, the Trustee quotes two emails about dragging out actions that could have potentially brought to light the connection between the Debtors and the Bucks County Hospital. Compl. ¶¶ 52-53. A September 25, 2009 email from Defendant Yalotitz (the company's former general counsel) to Defendant Murphy (the company's former CEO) states:

> FYI. The Trustee [in the Tennessee Bankruptcy Case] has filed suit against DSI Holding Company seeking recovery of $90,000 in management fees that we received . . . In light of what may likely occur with DSI Holding Company I am going to slow walk this and try to drag it out **[**13]** as long as possible.

Compl. ¶ 52. And a November 23, 2009 email from the Bucks County Hospital's bankruptcy counsel to Defendant Yalowitz states:

> [The Tennessee Bankruptcy Court] asked that we notify all Bucks County creditors of our joint representation [of DSI Holding and Bucks County] and give them an opportunity to object. I'm thinking maybe we should wait a few weeks before sending that notice in order to see what happens at the DSI level, because I don't want such a notice to give any more creditors the idea that they can/should sue DSI for Bucks County debt on the theory that they are the same entity.

Compl. ¶ 53. The trustee in the Tennessee Bankruptcy Case (the "Tennessee Trustee") eventually distributed about $215,000[14] to about forty creditors on account of scheduled claims initially exceeding $36 million. Compl. ¶ 54.

On or about January 11, 2013 (as a result of the Trustee's allegations in the Complaint filed in this adversary proceeding), the United States Trustee for the Middle District of Tennessee filed a motion to reopen the Tennessee Bankruptcy Case. Compl. ¶ 55. On February 6, 2013, the Tennessee Bankruptcy Court granted the **[**14]** motion and reopened the Tennessee Bankruptcy Case. Compl. ¶ 56.[15]

[*458] <u>The Stabilization of the Renal Business</u>

Promptly after he was hired in October 2008, Defendant Murphy identified and implemented revenue enhancement opportunities (in the form of increased insurance reimbursement from third-party payers), and expense reduction opportunities, effecting a dramatic improvement of the Debtors' business and finances. Compl. ¶¶ 38, 57. By June 2009, the Debtors' turnaround plan was well on its way to success, with the company having experienced two consecutive quarters of improved financial operation and better than projected revenues and earnings. Compl. ¶ 58. Both management and the D&O Defendants expected that operational and financial performance would continue to improve through the end of 2009 and beyond, with 2009 earnings then projected between $56 - 61 million. Compl. ¶59.

<u>The Trustee Alleges the Insider Defendants Conducted a Half-hearted Sale Process as Cover for Their Unlawful Scheme to Strip Out Substantially all of the Assets of DSI Renal Holdings LLC for the Benefit of the Defendants</u>

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[14] The final figure distributed to claimants was $214,535.37 according to the Tennessee Trustee's Final Account and Distribution Report 1, *In re Bucks County Oncoplastic Institute, LLC*, No. 09-03570-MH3-7 (M.D. Tenn. June 6, 2012), ECF No. 181.

[15] Since the Complaint was filed on May 20, 2013, several proofs of claim ("POC") related to the Bucks County Hospital debt have been filed in the reopened Tennessee Bankruptcy Case and the Delaware Bankruptcy Case. On May 31, 2013, MPT filed a POC in the Delaware Bankruptcy Case for $10.4 million with a detailed attachment in support. (Claims Register, *In re DSI Renal Holdings LLC, et al.*, No. 11-11722 (KJC) (Bankr. D. Del.), Claim No. 15-1). On July 10, 2013, MPT amended a POC filed in the original Tennessee Bankruptcy Case (based on an alleged breach of contract related to a lease and promissory notes), by amending the claim amount from "Unknown" to $75.5 million. (Claims Register, *In re Bucks County*, No. 09-03570-MH3-7 (M.D. Tenn.), Claim Nos. 53-1 & 53-2). On August 22, 2013, the Tennessee Trustee filed a $108 million POC in the Delaware Bankruptcy Case, including MPT's $75.5 million claim. (Claims Register, *In re DSI Renal Holdings LLC*, et al., No. 11-11722 (KJC) (Bankr. D. Del. Aug. 22, 2013), Claim No. 16-1). On October 11, 2013, the Tennessee Trustee amended the POC to $151,822,439, itemized as $103 million in total claims filed in the Tennessee Bankruptcy Case, minus the $235,614 distributed, plus $45.5 million in interest at 10% from April 2, 2009-August 31, 2013, $3.5 million Trustee commission, and $40,000 for various fees and expenses. (*Id.*, Claim No. 16-2. On July 8, 2014, Siemens amended a previously stated claim to the final amount of $3,122,039. (*Id.*, Claim No. 10-2).

The Trustee **[**15]** alleges that, as part of a ruse to appease its lenders and establish a suppressed "restructure valuation" to the detriment of certain shareholders and "all of the Debtors' non-insider creditors," the Debtors engaged Goldman Sachs to solicit outside interest in acquiring the companies.[16] Compl. ¶ 60. Goldman Sachs did not use updated earnings projections as part of the attempted sale process, resulting in low-ball offers that did not represent the companies' fair value. Compl. ¶¶ 64, 66. The Complaint references internal documents showing, *inter alia*, Defendant Murphy's elation at receiving a "pathetic" offer from DaVita, Inc. (the post-restructuring purchaser) (Compl. ¶ 63), and, around the same time, the NML Defendants' awareness that a "strong turnaround is underway," (Compl. ¶ 65). The Trustee asserts that the documents support the theory that the sale process was a prematurely terminated sham meant to justify the restructuring based upon an artificially depressed valuation. Compl. ¶¶ 62-70. This gave the Defendants the opportunity to pilfer the Debtors' ownership in the Renal Business, the only remaining asset in the entire corporate structure and effectively its "crown jewel," before **[**16]** its true worth was known to outsiders. Compl. ¶¶ 65-67, 69-70.

<u>The Trustee Alleges that Insider Defendants Caused the Fraudulent Transfer of DSI Renal through the DSI Restructuring and Subsequent Sale to DaVita - - all to the Substantial Detriment of "the Debtors' Non-insider Creditors"</u>

On September 14, 2009, at a joint meeting of the board of directors of DSI Holding and DSI Renal, the Director Defendants voted to terminate the Goldman Sachs sale process, to provide no additional information to bidders (rebuffing an expressed willingness by eventual purchaser DaVita to increase its offer), and, instead, **[*459]** to pursue a restructuring of the company.[17] Compl. ¶¶ 68, 71. On January 6, 2010, the Director Defendants approved a global restructuring of the Debtors and their affiliates, including the operating subsidiary DSI Renal (the "DSI Restructuring"), which closed on January 11, 2010. Compl. ¶¶ 72-73.

[16] The Trustee has not asserted any claims against Goldman Sachs in the Complaint.

[17] The Trustee also alleges that the Centre Defendants, and NML Defendants pushed to end the sale process prematurely to begin the DSI Restructuring. Compl. ¶¶ 65, 69.

The Trustee alleges that the DSI Restructuring plan was developed by the Centre Defendants who, at that time, owned 46% of the stock of DSI Holding and controlled a majority of the boards of the Debtors and their subsidiaries. Compl. ¶¶ 74, 90(d).

The alleged scheme involved: (a) the formation of **[**17]** two new holding companies - - *i.e.*, former defendants CDSI I and CDSI II - - approximately 90% of whose stock was issued to the Debtor's largest shareholders (*i.e.*, 49.1% to the Centre Defendants, 19.8% to the NML Defendants, 14.3% to Ares, and 6.7% to Apollo), while 10% of the stock was issued to the Debtor's other shareholders; and, (b) the transfers by DSI Holding of: (i) the Debtor's 100% ownership interest in DSI Renal; (ii) $250 million of net operating loss carryforwards; (iii) the Debtor's management contracts and upper-management team; and (iv) fixed assets (*e.g.*, desks, computers, furniture, etc.) and certain receivables. Compl. ¶¶ 74, 83-85. In return for these transfers, DSI Renal Holdings/DSI Holding received one share out of 138,154,275 total shares of stock in CDSI I, an "insignificant amount of cash, and relief from certain liabilities to insiders." Compl. ¶¶ 74(b), 80. As part of the seven step DSI Restructuring process (detailed in paragraph 84 of the Complaint), DSI Holding was merged with and into the surviving company - - Debtor DSI Renal Holdings. Compl. ¶ 84.

In January 2010, the Defendants placed a restructuring value on the company of $477.7 million. Compl. **[**18]** ¶ 75. To enable insiders to purchase the Renal Business at an artificially low price, the Trustee alleges that the restructuring value was not based upon fair market value, but upon the debt associated with the continued operation of the Renal Business and restructuring costs. Compl. ¶ 75-77.

To support his allegations of the suppressed restructuring value, the Trustee also asserts the following:

- A September 30, 2009, pre-restructuring internal valuation by the Centre Defendants valued the restructured company at approximately $562 million; this valuation was itself $30 million higher than a valuation three months earlier and an amount sufficient to pay the Debtors' creditors in full. Compl. ¶ 78.
- When DSI Holding's former CEO (replaced by Defendant Murphy) and one of its consulting surgeons threatened to derail the restructuring by expressing the view that the company was worth $632 million, the D&O Defendants caused the

former CEO and surgeon to receive consideration worth approximately $2 million in exchange for "cooperating" with the restructuring. Compl. ¶ 79.

• An excerpt of an email sent by an officer of the NML Defendants dated July 27, 2010, within six months of the restructuring, **[**19]** describes an offer of $650 million for the company as "clearly too low." Compl. ¶ 98. The email also states that Centre (referred to as one entity) "is thinking around 900mm . . . ." *Id.*

[*460] • On February 4, 2011, the business was sold to DaVita for $700 million, of which Defendants received $425 million. Compl. ¶¶ 86(b), 100.[18]

Internal Documents and Sworn Testimony

The Trustee provided support for his allegations through many documents and via sworn testimony obtained in discovery. Among the documents:

• A September 2, 2009 email from a senior attorney on Debtors' restructuring team which notes that, "we understand that DSI Holding has guaranteed obligations of Bucks County [Hospital] . . . for a total of approx. $8M . . . . To get around these guarantee obligations [of the Bucks County Hospital], Centre and a subset of existing DSI investors are contemplating putting funds into a new entity . . . ." Compl. ¶ 90(a).

• A September 9, 2009 email in which Defendant Murphy states that one of the primary goals of the restructuring is to "[p]rotect the new capital from guarantor claims against Holdings." Compl. ¶ 90(b).

• A September 20, 2009 memo from Defendant Murphy stating, "Prior to October 2008, all **[**20]** of the Buck's [County Hospital] Pos were issued under Holdings name, making it possible for a number of the Buck's creditors to attempt to look to Holdings for satisfaction of the invoice amounts." Compl. ¶ 90(c).

• A September 29, 2009 email in which the Debtors' lead restructuring counsel states: "Centre wants to liquidate just the holding company [DSI Renal Holdings/DSI Holding] and do their new equity investment at a level below that, wiping out the claims of the creditors at holdings [the Debtor] and thru the investment wiping out the equity interest of holdings [the Debtor] in [DSI Renal]." Compl. ¶ 90(d).

• An October 2, 2009 email between Debtors' restructuring counsels states concerns about the risks arising if a bankruptcy were commenced before the restructuring was complete: "To be clear, any equity that resides at DSI Renal and below would become an asset in any Holdings' bankruptcy. Putting on my chapter 7 trustee cap, I would probably (i) order a valuation of the full enterprise, (ii) consider an auction to sell the equity interests, and (iii) investigate any and all claims/causes of action against Holdings' [directors and officers] like bad faith filing, breach of fiduciary **[**21]** duty . . . ." Compl. ¶ 90(f).

• An October 16, 2009 email exchange between Debtor's former outside auditor, KPMG, and its former treasurer states in part:

> Former Auditor: One sticking point: early in our discussions, someone mentioned that there was some debt at the DSI Holding level (I want to say guarantees of some loans) and a goal was to avoid using new equity to pay off that debt. Has there been any further discussions about how that may be accomplished?
>
> Former Treasurer: Right now it appears that we will be forming a new acquisition sub . . . to buy DSI Renal, Inc. We will then shut down the holding **[*461]** company since there are no assets there and only such guarantees.

Compl. ¶ 90(h).

• A June 25, 2010 email exchange between Debtor's former general counsel [it is unclear from the complaint whether this is Defendant Yalowitz] and former CEO states a concern that creditor MPT might challenge the restructuring over their guaranty.

> Former general counsel: I assume what he means is that they [creditor MPT] might challenge the restructuring.
> Former CEO: Yep. Over their guaranty. Seems like a lot to establish for a small amount of money [$4 million].
>
> Former general counsel: Well of course that's **[**22]** the whole reason we did it—spent millions of dollars to restructure just to avoid the guaranty.

Compl. ¶ 90(r).

[18] The Trustee notes that he asserts no claims against DaVita and does not seek to avoid DaVita's purchase of the Debtors' operating subsidiaries (including DSI Renal). Compl. ¶ 86(b) n.4.

• A December 2, 2009 email from Debtor's lead restructuring counsel states: "Think a fairness opinion would help here? I assumed you would never get [Goldman Sachs] to say the deal was 'fair' to the stockholder of dsi renal [Debtor DSI Renal Holdings] as they are effectively getting wiped out—pretty tough opinion to give." Compl. ¶ 90(j).

• Minutes of the December 23, 2009 Joint Meeting of the Board of Directors report Director Defendant and CEO Murphy informing the board of the risk that "creditors (such as MPT, Siemens, Bucks County vendors that had been issued DSIHC purchase orders) could seek to challenge the transaction on the basis of a preference, fraudulent conveyance, breach of fiduciary duty or other theory . . . ." Compl. ¶ 90(n).

• Deposition testimony from Defendant Schnabel that: o "the renal business is where the operations were, where the value was"

○ "There was no reason to invest in the old holding company anymore. We wanted to invest in the renal business only, not in any of the other operations."

○ "The only operating business at the time was the renal business **[**23]** . . . ."

○ Q: Well, was there some reason you didn't want to put money in the holding company? Was there a reason you can think of?

A: Again, we wanted to invest in and save the renal business and we only wanted the ongoing—we only wanted the assets and liabilities associated with the ongoing operations of the renal business.

○ Q: Okay. So, the intent was to isolate the, what you considered to be the assets and liabilities with running Renal, and they would stay with the restructured company and everything else would be left behind; is that correct?

A: Correct

Q: And everybody, to your knowledge, all the people involved knew that motivation; is that correct? [objections omitted]

A: To my knowledge, yes.

○ "There was no desire on the part of the new investors or the creditors who were transferring to equity to take on any liabilities that were not associated with the ongoing operations of the Renal business."

Compl. ¶ 91(a).

[*462] • The sworn testimony of Defendant Murphy:

Q: And then the final goal was to protect the new capital from the guarantor claims against Holdings, correct?

A: That's correct.

Q: And the claims . . . included 7 to 9 million in guarantees to MPT and/or Siemens?

A: That's right.

[24]** Compl. ¶ 91(b).

• The sworn testimony of one of the Debtor's [unnamed] outside counsel:

○ Q: Well, the goal, was it not, was to put money in that would not be subject to the claims of the unsecured creditors at that level, correct?

A: I'm not sure what the goal was, but looking at this email, my recollection is that there was a concern that if we were to put money in at DSI Holding, then the existing trade creditors would have access to it.

Q: And there was an effort to avoid that from happening, correct?

A: I think there were several considerations in structuring the transaction the way we did. That may have been one among several.

Q: [I]t's not a question of may have been, you knew that was one of the considerations, correct?

A: From what I can remember right now, probably.

Q: Is that a yes?

A: That's as far as I can remember right now, yeah.

○ Q: What do you recall about the liabilities that were not intended to be paid as part of the restructuring or by the restructured company? Which liabilities were being left behind?

A: The liabilities to the unsecured creditors.

Compl. ¶ 91(c)(2)-(3).

With specific regard to Defendant Yalowitz on Counts 5 and 7:

• A September 25, 2009 email states: "FYI. The **[**25]** Trustee [in the Tennessee Bankruptcy Case] has filed suit against DSI Holding seeking recovery of $90,000 in management fees that we received. . . . In light of what may likely occur with DSI Holding Company I am going to slow walk this and try to drag it out as long as possible." Compl. ¶ 52.

• An October 1, 2009 email between Debtors' restructuring counsels states: "[lead restructuring counsel] wants us to call the GC of DSI today [Defendant Yalowitz] to cover contracts, assets and in particular which liabilities exist at DSI Holding that they are looking to get rid of." Compl. ¶ 90(e).

• A January 10, 2010 email expresses concern about providing information concerning the restructuring to the attorney representing the trustee in the Tennessee Bankruptcy Case because, "I don't want to open up a can of worms in terms of him thinking that DSI Holding did not get adequate value through this process . . . ." Compl. ¶ 90(o).

• An April 1, 2010 email from the Bucks County Hospital's bankruptcy counsel states: "On our call today I understood you to say that the procurement system was set up such that every P[urchase]O[rder] was designated 'Bill to Holdco' (regardless of whether it was a Renal or Hospital **[**26]** purchase.)" Compl. ¶ 43 n.2.

[*463] • An April 15, 2010 email to Bucks County's bankruptcy counsel addresses the issue of "offering a settlement now after [a creditor] raised the corporate veil theory" and states that, "The original plan was to kill DSI Holding but that plan has been put off." Compl. ¶ 90(q).

• An August 26, 2010 email to Debtor's outside counsel expresses concern about creditors of the Debtor seeking to recover from DSI Renal on a veil piercing theory and wanting to preserve the ability to upstream money from the Renal Business to the Debtor to hide that the money was coming from DSI Renal: "We have some situations where Bucks County vendors are seeking recovery from DSI Holding and DSI Renal []. I wouldn't want to be precluded from paying them from DSI Holding so as to keep DSI Renal out of it." Compl. ¶ 90(s).

• An August 26, 2010, email to Debtor's outside counsel states, "at some point it is possible that we will have DSI Renal fund monies up to DSI Holding to fund the litigation [against the Debtor] (alternatively we may just have DSI Renal directly pay some expenses)." Compl. ¶ 90(t).

• "Defendants Murphy and Yalowitz received millions of dollars of bonuses for their roles **[**27]** in facilitating and implementing the DSI Restructuring and DaVita Merger Transaction . . . ." Compl. ¶ 134.

• Defendant Yalowitz received 135 shares in CDSI I, then received $1,846,500.04 in the DaVita Merger Transaction. Compl. ¶ 87.

DISCUSSION

Standard for Evaluating a Motion to Dismiss

HN2[ ] *Federal Rule of Civil Procedure 12(b)(6)*, made applicable here by *Fed. R. Bankr. P. 7012(b)(6)*, governs a motion to dismiss for failing to state a claim upon which relief can be granted. "The purpose of a motion to dismiss is to test the sufficiency of a complaint, not to resolve disputed facts or decide the merits of the case."[19] When reviewing a motion to dismiss, the court will construe the complaint "in the light most favorable to the plaintiff."[20] The court will "therefore accept all factual allegations in the complaint as true and give the pleader the benefit of all reasonable inferences that can be fairly drawn therefrom."[21] "The issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims."[22]

HN3[ ] "To survive a motion to dismiss, a complaint must contain sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.'"[23] Although **[**28]** **[*464]** a complaint challenged by a *Rule 12(b)(6)* motion to dismiss need not contain

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[19] *Paul v. Intel Corp. (In re Intel Corp. Microprocessor Antitrust Litig.), 496 F. Supp. 2d 404, 407 (D. Del. 2007)* (citing *Kost v. Kozakiewicz, 1 F.3d 176, 183 (3d Cir. 1993))*.

[20] *Burtch v. Milberg Factors, Inc., 662 F.3d 212, 220 (3d Cir. 2011)* (quoting *In re Ins. Brokerage Antitrust Litig., 618 F.3d 300, 314 (3d Cir. 2010))*.

[21] *Kost, 1 F.3d at 183*.

[22] *Scheuer v. Rhodes, 416 U.S. 232, 236, 94 S. Ct. 1683, 40 L. Ed. 2d 90 (1974)*, *abrogated on other grounds by* *Harlow v. Fitzgerald, 457 U.S. 800, 102 S. Ct. 2727, 73 L. Ed. 2d 396 (1982)*; *see also* *Rosener v. Majestic Mgmt. Inc. (In re OODC, LLC), 321 B.R. 128, 134 (Bankr. D. Del. 2005)* ("Granting a motion to dismiss is a 'disfavored practice.'").

[23] *Ashcroft v. Iqbal, 556 U.S. 662, 678, 129 S. Ct. 1937, 173 L. Ed. 2d 868 (2009)* (quoting *Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007))*.

detailed factual allegations, "a plaintiff's obligation to provide the 'grounds' of his 'entitle[ment] to relief' requires more than labels and conclusions, and a formulaic recitation of the elements of a cause of action will not do. Factual allegations must be enough to raise a right to relief above the speculative level."[24]

HN4[] The Court of Appeals for the Third Circuit has outlined a three-step process to determine the sufficiency of a complaint under *Twombly* and *Iqbal*:

> First, the court must "tak[e] note of the elements a plaintiff must plead to state a claim." Second, the court should identify allegations that, "because they are no more than conclusions, are not entitled to the assumption of truth." Finally, "where there are well-pleaded factual allegations, a court should assume their veracity and then determine whether they plausibly give rise to an entitlement for relief."[25]

The relevant record under consideration consists of the complaint and any "document integral or explicitly relied on in the complaint."[26] When considering a motion to dismiss, "it is axiomatic that the complaint may not be amended by the briefs in opposition to a **[**29]** motion to dismiss."[27] The movant carries the burden of demonstrating that dismissal is appropriate.[28]

A. Count 1: Actual Fraudulent Transfers Pursuant to 11 U.S.C. § 548(a)(1)(A)

Count 1 seeks to avoid transfers made with actual intent to hinder, delay and defraud creditors pursuant to 11 U.S.C. § 548(a)(1)(A), which provides that the trustee may avoid any transfer:

> of an interest of the debtor in property, or any obligation . . . incurred by the debtor, that was made or incurred within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily . . . made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any [creditor].[29]

HN5[] "This provision aims to make available to creditors those assets of the debtor that are rightfully a part of the bankruptcy estate, even if they have been transferred away."[30]

The Defendants argue that the Plaintiff alleges intentional fraud without identifying the requisite details about each transfer and, therefore, Count 1 fails to **[*465]** meet the pleading requirements of Rule 9(b).[31] HN6[] The purpose of Rule 9(b) is to "place the defendants on notice of the **[**30]** precise misconduct with which they are charged."[32] However, Rule 9(b) is interpreted liberally in the bankruptcy context, particularly when the plaintiff is a third party, such as a trustee, because a third party generally has less information on which to base its allegations.[33]

HN7[] Because actual intent to defraud is often

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[24] Twombly, 550 U.S. at 555 (citations omitted).

[25] Burtch, 662 F.3d at 221 (quoting Santiago v. Warminster Twp., 629 F.3d 121, 130 (3d Cir. 2010)); *see also* Great Western Mining & Mineral Co. v. Fox Rothschild LLP, 615 F.3d 159, 177 (3d Cir. 2010).

[26] U.S. Express Lines, Ltd. v. Higgins, 281 F.3d 383, 388 (3d Cir. 2002) (citing In re Burlington Coat Factory Sec. Litig., 114 F.3d 1410, 1426 (3d Cir. 1997)).

[27] Commonwealth of Pa., ex rel. Zimmerman v. PepsiCo, Inc., 836 F.2d 173, 181 (3d Cir. 1988) (quoting Car Carriers v. Ford Motor Co., 745 F.2d 1101, 1107 (7th Cir. 1984), *cert. denied*, ***470 U.S. 1054, 105 S. Ct. 1758, 84 L. Ed. 2d 821 (1984))***.

[28] Intel Corp., 496 F.Supp.2d at 408. Constructive fraudulent transfer claims are evaluated at the Rule 12(b)(6) stage under Rule 8(a). Mervyn's LLC v. Lubert-Adler Group IV, LLC (In re Mervyn's Holdings, LLC), 426 B.R. 488, 495 n.5 (Bankr. D. Del. 2010).

[29] 11 U.S.C. § 548(a)(1)(A).

[30] *See* Pension Transfer Corp. v. Beneficiaries under the Third Amendment to Fruehauf Trailer Corp. Retirement Plan No. 003 (In re Fruehauf Trailer Corp.), 444 F.3d 203, 210 (3d Cir. 2006).

[31] Fed. R. Civ. P. 9(b), made applicable here by Fed. R. Bankr. P. 7009, provides that "[i]n alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake. Malice, intent, knowledge, and other conditions of a person's mind may be alleged generally."

[32] Rosener v. Majestic Mgmt. Inc. (In re OODC, LLC), 321 B.R. 128, 140 (Bankr. D. Del. 2005) (quoting Seville Indus. Mach. Corp. v. Southmost Mach. Corp., 742 F.2d 786, 791 (3d Cir. 1984) *abrogated in part on other grounds by* Bell Atl. Corp. v. Twombly, 550 U.S. 544, 127 S. Ct. 1955, 167 L. Ed. 2d 929 (2007)).

[33] OODC, 321 B.R. at 140; Pardo v. Gonzaba (In re APF Co.), 308 B.R. 183, 188 (Bankr. D. Del. 2004).

difficult to prove, courts may rely on circumstantial evidence or "badges of fraud" to infer actual fraudulent intent.[34] Those "badges of fraud" include: (1) a close relationship among the parties to the transaction; (2) a secret and hasty transfer not in the usual course of business; (3) inadequacy of consideration; (4) the transferor's knowledge of the creditor's claim and the transferor's inability to pay it; (5) the use of dummies or fictitious parties; and (6) retention of control of property by the transferor after the conveyance.[35] While "consideration" is an issue when analyzing constructive fraud, a claim for actual fraud under § 548(a)(1)(A) need not contain allegations about the value of consideration received by the debtor in the transaction.[36]

Here, through reference to numerous internal documents belonging to **[**31]** DSI or CDSI, the Trustee alleges with great specificity the fraudulent scheme, the parties' intent, and the transfers undertaken with the express goal of shielding Renal Business assets from creditors. Compl. ¶ 90(a)-(t). The documents and testimony referenced in the Complaint often reflect the explicit intent to hinder or delay creditors. Compl. ¶¶ 90-91. The Complaint alleges that the parties involved intended to defraud outside creditors by using the Goldman Sachs sale process to set a low value to justify the transfer and sale of DSI Renal, which, in turn, favored inside creditors. Compl. ¶¶ 60-70. Several documents referred to in the Complaint evince secrecy, haste, and concealment. *See, e.g.*, Compl. ¶¶ 52, 53, 90(m), (r). The Trustee includes charts in the Complaint listing the transfers of stock and funds that he seeks to avoid with the requisite particularity to **[*466]** place the Defendants on notice of the specific misconduct charged. Compl. ¶ 87.

The Trustee aims to reverse two specific sets of transfers: (1) transfers to the Defendants of stock in CDSI I which, while made in reverse order before CDSI I had any assets, effectively transferred the Renal Business through DSI Holding's **[**32]** transfer of its 100% ownership of DSI Renal to CDSI I during the DSI Rstructuring; and (2) the payments made to the Defendants as a result of the $700 million sale to DaVita. *Id.* The Trustee also alleges that an earlier maneuver in the same overall scheme - - the Bucks County Hospital's chapter 7 bankruptcy filing in Tennessee - - defrauded creditors by filing intentionally materially false schedules in that case to escape liability for guarantees made to the hospital's creditors. Compl. ¶¶ 42-56. In addition to the guarantees, the Trustee argues, under an alter ego theory, that DSI Holding was responsible for the claims of all of the hospital's creditors, because the parent routinely ignored corporate boundaries and issued purchase orders to vendors, paid bills, controlled hospital personnel, and commingled funds (along with those of other affiliates). Compl. ¶ 43.

The Defendants argue that the fraudulent transfer claim fails because transfers of CDSI I stock do not constitute transfers of property belonging to the Debtors.[37] The Bankruptcy Code broadly defines estate property as encompassing "all legal or equitable interests of the debtor in property."[38] Estate property includes contingent **[**33]** interests and future interests, whether or not transferable by the debtor.[39] HN8[] The Bankruptcy Code defines "transfer" as: "each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or an interest in property."[40]

HN9[] When assessing a defendant's fraudulent transfer liability, the Third Circuit has recognized that multi-step transactions may be collapsed and treated as one integrated transaction.[41] Deciding whether to

[34] OODC, 321 B.R. at 140; *see also* Autobacs Strauss v. Autobacs Seven Co. (In re Autobacs Strauss, Inc.), 473 B.R. 525, 565 (Bankr. D. Del. 2012).

[35] OODC, 321 B.R. at 140 (quoting MFS/Sun Life Trust - High Yield Series v. Van Dusen Airport Services Co., 910 F. Supp. 913, 935 (S.D.N.Y. 1995).

[36] *See, e.g.*, In re Metro Shippers, Inc., 78 B.R. 747, 752 (Bankr. E.D. Pa. 1987) ("where a conveyance is made with the requisite actual intent, the factor of fair consideration is immaterial" (quoting 4 Collier on Bankruptcy ¶ 548.02 at 548-51 (15th ed. 1985)); Brandt v. Leasing One Corp. (In re Equip. Acquisition Res., Inc.), 481 B.R. 433, 440 (Bankr. N.D. Ill. 2012) ("unlike transfers that are only constructively fraudulent, the equivalence of value given in exchange for the actual intent fraudulent transfer is immaterial to the question whether the transfer is actually fraudulent.").

[37] Defs. Joint Mem. 11.

[38] 11 U.S.C. § 541(a)(1).

[39] *See* In re Fruehauf Trailer Corp., 444 F.3d at 211.

[40] ***11 U.S.C. § 101(54)(D).***

[41] *See* Official Comm. of Unsecured Creditors v. The CIT Group/Business Credit, Inc. (In re Jevic Holding Corp.), Case No. 08-11006 (BLS), Adv. No. 08-51903, 2011 Bankr. LEXIS

collapse transactions is a fact-intensive exercise, and courts have been reluctant to solve collapsible transaction issues at the motion to dismiss stage.[42] "To determine whether a series of transactions should be 'collapsed' and viewed as a single integrated transaction, courts focus on the substance rather than on the form of the transactions and consider the overall intent and impact of the transactions."[43]

HN10[] In collapsing transactions, courts consider: (1) whether all the parties involved had knowledge of the multiple transactions; (2) whether each transaction would have occurred on its own; and **[**34]** (3) whether each transaction was conditioned or dependent upon the other transactions.[44] "While the transactions that are **[*467]** sought to be collapsed may be structurally independent and distinct from one another, courts focus their analysis 'not on the structure of the transaction but the knowledge and intent of the parties involved in the transaction.'"[45] Courts will consider the collapse of a series of transactions upon a showing that the transactions were part of an overall scheme to defraud the estate and its creditors by depleting assets through a restructuring.[46]

HN11[] The creation of an intermediary corporation does not insulate the defendants from liability for fraudulent transfers.[47] Additionally, the Third Circuit has held that a fraudulent transfer can occur when employees, customer base, and physical assets are subsumed by another entity.[48] The circumstances surrounding the debtor's demise and the new entity's ascendance matter more than the classification of each transfer.[49] "[I]f one acts with knowledge that creditors will be hindered or delayed by a transfer but then intentionally enters the transaction in disregard of this fact, he acts with actual intent to hinder and delay them."[50]

The Trustee provided numerous examples, for present purposes accepted as true, that sufficiently allege the parties' fraudulent intent to strip the Debtors of their assets through the creation of an intermediary, CDSI I. Compl. ¶¶ 90-91. Defendant Schnabel's alleged strategy to sever the link between the Debtors' liabilities and the corporate structure's only remaining assets (the Renal Business) to escape liability on the guarantor claims and the Bucks County Hospital's vendor claims, depicts a fraudulent scheme. Compl. ¶ 91(a)-(b).

Although the NML Defendants, Ares, and Apollo are not mentioned by name in the Complaint as knowing that the DSI Restructuring was being carried out with the aim to hinder, delay, or defraud creditors, the Complaint's allegations support inferences that all of the new investors and existing creditors transferring to equity *were aware* of the scheme, and *knowingly participated* in actions which hindered, delayed, or defrauded creditors. During sworn testimony, Defendant Schnabel: (1) acknowledged that the motivation for the DSI Restructuring was to isolate the Renal Business **[**36]** assets and leave behind the DSI Holding/DSI Renal Holdings guaranty liabilities, (2) stated that, to his knowledge, everybody (*i.e.*, all the parties involved) knew the motivation; and (3) stated that "there was no desire on the part of the new investors or the creditors who were transferring to equity to take on any liabilities that were not associated with the ongoing operations of the Renal Business." Compl. ¶ 91(a)(2)-(3). Testimony of outside counsel to DSI Renal Holdings/DSI Holding acknowledged that he was the author of a September 2, 2009 email stating that, "To get around these guarantee obligations, Centre and a subset of existing DSI investors are contemplating putting funds into a new entity . . . ." **[*468]** Compl. ¶¶ 90(a), 91(c)(1). The same

3553, 2011 WL 4345204, at *4 (Bankr. D. Del. Sept. 15, 2011) (citing, *inter alia*, U.S. v. Tabor Court Realty Corp., 803 F.2d 1288, 1301-03 (3d Cir. 1986)).

[42] *See* Official Comm. Of Unsecured Creditors v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co. of Del.), 274 B.R. 71, 91 (D. Del. 2002).

[43] Jevic Holding Corp., 2011 Bankr. LEXIS 3553, 2011 WL 4345204, at *5.

[44] Mervyn's v. Lubert-Adler Group IV, LLC (In re Mervyn's Holdings, LLC), 426 B.R. 488, 497 (Bankr. D. Del. 2010).

[45] Jevic Holding Corp., 2011 Bankr. LEXIS 3553, 2011 WL 4345204, at *5 (quoting Hechinger Inv. Co, 274 B.R. at 91).

[46] *See id.*

[47] See Indus. [**35] Enters. of Am., Inc. v. Tabor Acad. (In re Pitt Penn Holding Co., Inc.), Case No. 09-11475 (BLS), Adv. No. 11-51879, 2011 Bankr. LEXIS 3554, 2011 WL 4352373, at *5 (Bankr. D. Del. Sept. 16, 2011).

[48] *See* Dobin v. Taiwan Mach. Trade Ctr. Corp. (In re Victor Int'l, Inc.), 97 F. App'x 365, 368-69 (3d Cir. 2004).

[49] *See id.*

[50] *See* ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278, 387 (S.D. Tex. 2008) (applying Delaware law).

unnamed counsel then recalled that "there was a concern that if we were to put money in at DSI Holding Company, then the existing trade creditors would have access to it." Compl. ¶ 91(c)(2).

If the multiple transactions at issue are viewed as a single integrated transaction, the facts as pled are sufficient to support an inference that the Defendants moved DSI Renal Holdings/DSI Holding's assets through an intermediary with actual intent to **[**37]** hinder, delay, or defraud non-insider creditors. The Complaint adequately pleads a fraudulent scheme, the parties' intent and involvement, the expressed goal of shielding DSI Renal assets from creditors, and is supported by reference to numerous internal documents belonging to the DSI entities, deposition testimony and exhibits detailing the relevant transfers. Accordingly, Count 1 satisfies the *Rule 9(b)* standard. Therefore, the Trustee has properly alleged that the Transfers constitute avoidable intentional fraudulent transfers pursuant to *11 U.S.C. § 548(a)(1)(A)*. The Motions to Dismiss Count 1 will be denied.

B. Counts 2 and 3: Fraudulent Transfers Pursuant to *11 U.S.C. § 548(a)(1)(B)* and *6 Del. C. §§ 1304* & *1305* Pursuant to *11 U.S.C. § 544*

Counts 2 and 3 of the Complaint seek to avoid constructive fraudulent transfers pursuant to Bankruptcy Code *11 U.S.C. § 548(a)(1)(B)*, and fraudulent transfers pursuant to *11 U.S.C. § 544* and applicable non-bankruptcy law. The Defendants argue that the Transfers are not avoidable under Counts 2 and 3 due to the safe harbor provision of Bankruptcy Code *11 U.S.C. § 546(e)*, which provides:

> *Notwithstanding sections 544, 545,* 547, *548(a)(1)(B)*, and *548(b)* of this title, the trustee may not avoid a transfer that is . . . a settlement payment, as defined in *section 101* or *741* of this title, made by or to (or for the **[**38]** benefit of) a . . . financial institution . . . or that is a transfer made by or to (or for the benefit of) a . . . financial institution . . ., in connection with a securities contract, as defined in *section 741(7)*, . . . that is made before the commencement of the case, *except under section 548(a)(1)(A) of this title.*[51]

The Defendants argue that the transfers at issue relating to the DSI Restructuring fall under the protection of *§ 546(e)* because the alleged transfers were (i) settlement payments to or for the benefit of financial institutions or financial participants; or (ii) transfers made by or to a financial institution or participant in connection with a securities contract. The Trustee argues that *§ 546(e)* does not apply to the DSI Restructuring because it was one-sided, and the assets were transferred for virtually no consideration. In such situations some courts have refused to apply *§ 546(e)*.[52]

On May 1, 2017, the United States Supreme Court granted *certiorari* to review the decision of the United States Court of Appeals for the Seventh Circuit in *FTI Consulting, Inc. v. Merit Management Group, LP ("Merit Management*"),[53] which may resolve a split among circuit courts (including the Third Circuit) regarding the **[*469]** issue of whether **[**39]** the safe harbor of *§ 546(e)* "protects transfers that are simply conducted *through* financial institutions (or the other entities named in *section 546(e)*), where the entity is neither the debtor nor the transferee but only the conduit."[54]

The Defendants rely on the Third Circuit case law rejecting the argument that *§ 546(e)* requires the financial institution to acquire a beneficial interest in the shares.[55] "So long as a financial institution is involved, the payment is an unavoidable 'settlement payment.'"[56] The requirement is satisfied by a wire transfer from a bank.[57] Federal regulations "require that a wire transfer *must* be performed by a bank; thus, a wire transfer must be made through a financial institution."[58]

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[51] *11 U.S.C. § 546(e)* (emphasis added).

[52] *See, e.g., Michaelson v. Farmer (In re Appleseed's Intermediate Holdings, LLC), 470 B.R. 289, 302 (D. Del. 2012)*; *Mervyn's Holdings, 426 B.R. at 500*.

[53] *Merit Mgmt. Grp. v. FTI Consulting, Inc., 830 F.3d 690 (7th Cir. 2016)* cert. granted ***137 S.Ct. 2092, 197 L.Ed.2d 894 (U.S. May 1, 2017)*** (No. 16-784).

[54] *Merit Mgmt., 830 F.3d at 691*.

[55] *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts, Int'l, Inc.), 181 F.3d 505, 516 (3d Cir. 1999)*.

[56] *Hechinger Inv. Co., 274 B.R. at 87*.

[57] *See Resorts Int'l, 181 F.3d at 515*.

[58] *Mervyn's Holdings, 426 B.R. at 499-500* (citing *Loranger Mfg. Corp. v. PNC Bank (In re Loranger Mfg. Corp.), 324 B.R. 575, 585 (Bankr. W.D. Pa. 2005)* (taking judicial notice of

Because the Motion to Dismiss requires consideration of similar issues about § 546(e) as those raised in *Merit Management*, I will defer consideration of the Defendants' request to dismiss Counts 2 and 3 pending a decision by the United States Supreme Court in *Merit Management*.

C. Count 4: Recovery of Transfers under 11 U.S.C. § 550

Count 4 seeks recovery of fraudulent transfers under 11 U.S.C. § 550. Section 550 provides, in pertinent part:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544 . . . [or] **[**40]** 548, . . . of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—
>
> (1) the initial transferee of such transfer or the entity for whose benefits such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.
>
> (b) The trustee may not recover under section (a)(2) of this section from—
>
> (1) a transferee that takes for value, . . . in good faith, and without knowledge of the voidability of the transfer avoided; or
>
> (2) any immediate or mediate good faith transferee of such transferee.[59]

The § 550 claim thus depends on the viability of a successful fraudulent transfer claim under § 548. Because the Motions to Dismiss will be denied for Count 1, but deferred for Counts 2 and 3, the Motions to Dismiss Count 4 will be denied as they apply to Count 1, and will be deferred as they apply to Counts 2 and 3.

D. Count 5 — Breach of Fiduciary Duties

In Count 5, the Trustee asserts breach of fiduciary duty claims against the D&O Defendants and the Centre Defendants. *HN12*[] A corporation's directors and officers are fiduciaries of the company.[60] **[*470]** Among the duties owed by a fiduciary are the duties of **[**41]** loyalty, good faith, and care.[61]

(1) Fiduciary Duties

HN13[] The duty of loyalty obligates corporate fiduciaries to commit themselves to the business of the corporation with the attitude of promoting the corporation's interests, not their own.[62] A director is considered to be "interested" if he stands on both sides of the transaction or if he looks to derive a personal financial benefit from the transaction.[63] "The fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest," but may also include a failure to act in good faith.[64] "A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation's best interest."[65]

HN14[] "The duty of care has been described as the duty to act on an informed basis."[66] "Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information."[67] When analyzing a claim for breach of the duty of care, Delaware courts apply a standard of gross negligence, which has been defined as "reckless indifference to or a deliberate **[**42]** disregard of the whole body of stockholders or actions which are without the bounds of reason."[68]

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federal regulation requiring that a wire transfer must be accomplished by a bank)).

[59] *11 U.S.C. § 550*.

[60] *See* *Gantler v. Stephens, 965 A.2d 695, 708-09 (Del. 2009)*.

[61] *See* Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001).

[62] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) *modified* 636 A.2d 956 (Del. 1994).

[63] *See* ASARCO, 396 B.R. at 405 (applying Delaware law).

[64] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[65] *Id.* (quoting Guttman v. Huang, 823 A.2d 492, 506 n. 34 (Del. Ch. 2003)).

[66] Burtch v. Huston (In re USDigital, Inc.), 443 B.R. 22, 41 (Bankr. D. Del. 2011) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[67] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) *overruled, in part, on other grounds by* Gantler v. Stephens, 965 A.2d 695, 714 n. 54 (Del. 2009).

[68] Benihana of Tokyo, Inc. v. Benihana, Inc. 891 A.2d 150, 192

HN15[] The fiduciary duties of officers are the same as those of directors.[69] To state a claim against an officer for breach of fiduciary duty, the complaint must allege facts demonstrating that the officer: (1) took part in the challenged conduct; and (2) failed to demonstrate the due care attendant to his particular office in doing so.[70]

(2) Fiduciary Duties and Collapsing Transactions

As a threshold matter, acts constituting breaches of fiduciary duty may be examined in isolation, or under the same collapsible transaction analysis employed in review of Count 1. Deciding whether to collapse transactions is a fact-intensive exercise, and courts have been reluctant to solve collapsible transaction issues at the motion to dismiss stage.[71] In one *Hechinger* **[*471]** decision (one of many opinions issued during extensive proceedings), the court denied a motion to dismiss all breach of fiduciary duty counts, stating:

> At this stage of the case, the court is reluctant to conclude that because the defendants structured the **[**43]** set of transactions in a certain manner, they are immune from a claim of breach of fiduciary duty, especially where the Committee alleges that the harms it complains of were foreseeable results of the acts of the defendants. Therefore, the court concludes that for any of the following reasons, the Hechinger Defendants' motion to dismiss the fiduciary duty claims against them must be rejected: (i) it is alleged that the approval of the Builders Square Merger was an independent harm that constituted a breach of fiduciary duty; (ii) the court cannot at this point say that the Builders Square acquisition and Hechinger LBO are not collapsible into one integrated transaction; (iii) even if the transactions are found on a more complete record to not be collapsible, the Committee has nonetheless stated a cause of action for breach of fiduciary duty based on the foreseeability of the alleged harm. Accordingly, the court will deny the Hechinger Defendants' motion to dismiss.[72]

A similar set of difficulties could be said to apply to issues surrounding the series of events described in the Trustee's Complaint. For the same reasons, I will deny the motion to dismiss Count 5 in light of outstanding **[**44]** issues involving the Tennessee Bankruptcy Case and the DSI Restructuring, along with allegations about the foreseeability of the alleged harm.

(3) Exculpation and Business Judgment Rule Defenses

The D&O Defendants also raise exculpation and business judgment rule defenses to the Count 5 claims. *HN16*[] An exculpatory clause is an affirmative defense and cannot form the basis of a *Rule 12(b)(6)* dismissal.[73] *The Brown Schools* decision also holds that "the application of the business judgment rule is an affirmative defense, the determination of which is not proper at the motion to dismiss stage."[74] However, "[a] complaint may be dismissed under *Rule 12(b)(6)* where an unanswered affirmative defense appears on its face" and, in that instance, to survive a motion to dismiss, a plaintiff must "plead around the business judgment rule."[75] A plaintiff can rebut the presumptive protection afforded by the business judgment rule by showing that "the board of directors, in reaching its challenged decision, violated any one of its triad of fiduciary duties: due care, loyalty, or good faith."[76]

A plaintiff must meet the pleading requirements of *Fed. R. Civ. P. 8(a)* in stating state law claims for breach of fiduciary duties.[77] Here, the Trustee alleges **[*472]**

(Del. Ch. 2005).

[69] *Gantler, 965 A.2d 695 at 708-09*.

[70] *See* *Burtch v. Owlstone, Inc. (In re Advance Nanotech, Inc.), Case No. 11—10776, Adv. No. 13- 51215, 2014 WL 1320145, at *6 (Bankr. D. Del. Apr. 2, 2014)* (citing *Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.), 388 B.R. 548 (Bankr. D. Del. 2008))*.

[71] *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co. of Del.), 274 B.R. 71, 91 (D. Del. 2002)*.

[72] *Id.*

[73] *See* *Miller v. McCown De Leeuw & Co. (In re The Brown Sch.), 368 B.R. 394, 401 (Bankr. D. Del. 2007)*.

[74] *Id.*

[75] *Joseph v. Frank (In re Troll Commc'n, LLC), 385 B.R. 110, 118 & n.14 (Bankr. D. Del. 2008)* (citing *Stanziale v. Nachtomi (In re Tower Air, Inc.), 416 F.3d. 229, 238 (3d Cir. 2005))*.

[76] *Troll Commc'n, 385 B.R. at 118* (citing *Emerald Partners v. Berlin, 787 A.2d 85, 91 (Del. 2001))*.

[77] *Fed. R. Civ. P. 8(a)*, made applicable pursuant to *Fed. R. Bankr. P. 7008*, provides that a pleading must contain "a short and plain statement of the claim showing that the pleader is

that **[**45]** the D&O Defendants and the Centre Defendants breached their fiduciary duties to the Debtors and creditors by engaging in self-interested and wrongful conduct, including (a) orchestrating and implementing the DSI Restructuring, which included fraudulent transfers, (b) using a sham sale process to justify a low valuation to support the DSI Restructuring, (c) filing intentionally materially false schedules in the Tennessee Bankruptcy Case and misleading the court and Tennessee Trustee in that bankruptcy case, and (d) misusing the Tennessee Bankruptcy Case as part of a scheme to facilitate the DSI Restructuring. Compl. ¶ 132. Viewing these allegations in the light most favorable to the Trustee, the Defendants' wrongful conduct was intentional, reckless, or grossly negligent. Compl. ¶ 133.

The allegations also support inferences that the Defendants' breached the duty of loyalty by, *inter alia*, engaging in a self-interested decision-making process, or by acting with gross negligence, when the Defendants failed to seek the highest value reasonably available for the company during the first Goldman Sachs sales process, specifically, by basing the company's value on depressed past performance **[**46]** rather than more positive projections. The allegations further support inferences that the Defendants breached their duties of loyalty and good faith by, *inter alia*, stripping DSI Holding/DSI Renal Holdings of its only asset, leaving it an empty shell, and profiting individually from their actions. The Trustee includes specific allegations of self-interest with regard to stock and cash bonuses received by Defendants Murphy and Yalowitz in connection with the series of transactions. Compl. ¶¶ 87, 134. Reviewing these allegations with reasonable inferences in favor of the Trustee, the Trustee has alleged sufficient facts to "plead around" the business judgment rule and the exculpation clauses and state plausible breach of fiduciary duty claims.

Director Defendants Schnabel and Pollack are alleged to be insiders of the Centre Defendants. Compl. ¶¶ 10-11. The Debtors' boards are alleged to have had no "independent" directors. Compl. ¶ 16. The presence of the Centre Defendants on both sides of the transaction, combined with the charge that the Centre Defendants were exercising control over the affairs of DSI Holding/DSI Renal Holdings' board and, more specifically, the restructuring process, **[**47]** alleges sufficiently breach of the fiduciary duties of loyalty and good faith. The Trustee has not alleged specific amounts of stock received by Schnabel and Pollack - - nor does he need to at this stage of the proceedings given the surrounding plausibly pled scheme.

With regard to Defendant Yalowitz, former secretary and general counsel to DSI Renal Holdings/DSI Holding, secretary to DSI Hospitals, and secretary of DSI Renal, the Complaint contains factual allegations and reference to internal documents that sufficiently support his direct participation in the challenged conduct, failure to demonstrate the due care attendant to his particular office in doing so, and receipt of a personal benefit from his involvement. Compl. ¶¶ 15, 52, 87, 90(e), (o), (q), (s), (t), 134.

(4) The Centre Defendants

HN18[] "[A] shareholder owes a fiduciary duty only if it owns a majority interest **[*473]** in or *exercises control* over the business affairs of the corporation."[78]

> [A] shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling **[**48]** stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct.[79]

The Trustee asserts that the Centre Defendants also owed fiduciary duties to Debtors because they formed a "control group" which exercised control over the business affairs of the companies. For a "control group" to be treated the same as a single controlling stockholder, it must be "connected in some legally significant way - - *e.g.*, by contract, common ownership, agreement or other arrangement - - to work together

entitled to relief . . . ." S*ee also* Miller v. Greenwich Capital Fin. Prods., Inc. (In re Am. Bus. Fin. Serv., Inc.), 362 B.R. 135, 145 (Bankr. D. Del. 2007) (HN17[] "Federal Courts sitting in Delaware generally do not apply the Rule 9(b) pleading requirements to state law claims for breach of fiduciary duty. . . . Therefore, the Trustee is only required to meet the pleading requirements of Rule 8(a).") (citing In re Fruehauf Trailer Corp., 250 B.R. 168, 197-98 (D. Del. 2000)).

[78] Kahn v. Lynch Commc'n Sys., 638 A.2d 1110, 1113 (Del. 1994) (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987) (affirming the decision that a 43.3% minority shareholder owed the fiduciary duties of a controlling shareholder when it effectively controlled a corporation's management and board of directors)).

[79] Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 70 (Del. 1989) (citations omitted).

toward a shared goal."[80] Whether a control group exists is a fact-intensive inquiry; some courts have been hesitant to make this determination in pre-trial motions.[81]

The Complaint alleges that the Centre Defendants controlled four out of five seats on the board of directors for DSI Holding and the Debtors. Compl. ¶ 30. Although controlling a majority of board seats may indicate board domination, this Complaint's conclusory statement is insufficient by itself, especially when only two of the five directors listed in the Complaint (Schnabel and Pollack) are alleged to be insiders of the Centre Defendants. Compl. ¶¶ 10-14. The Defendants further argue that **[**49]** the thirteen separate Centre Defendants are each an autonomous entity, and the Trustee has identified no overt agreement among those entities to defraud the creditors of DSI.[82]

However, when considering a motion to dismiss, courts will "construe the complaint in the light most favorable to the plaintiff, and determine whether, under any reasonable reading of the complaint, the plaintiff may be entitled to relief."[83] Here, the sources referenced in the Complaint allege sufficiently that the Centre Defendants worked together as one entity and exercised control over the Debtors, specifically as to driving the DSI Restructuring.

The Complaint alleges that the Centre Defendants directed the termination of the Goldman Sachs sale process. Compl. ¶ 66. The Trustee also alleges that the Centre Defendants developed the restructuring plan. Compl. ¶ 74. After the allegedly fraudulent restructuring, the Centre Defendants owned 49.1% of the stock of CDSI I. Compl. ¶ 87(1). The Centre Partners **[*474]** received a combined $161,981,086 from the DaVita Merger Transaction. Compl. ¶ 87(2). A September 9, 2009 email from Defendant Murphy indicates that the primary goal of the DSI Restructuring was to satisfy the Centre **[**50]** Defendants' objectives. Compl. ¶ 90(b). A September 30, 2009 email from DSI Renal Holdings/DSI Holding's lead restructuring counsel indicates that the restructuring was structured to effectuate the intent of the Centre Defendants. Compl. ¶ 90(d).[84] The Centre Defendants' insider board members saw several of the emails and other documents detailing a plan that would hinder, delay, or defraud creditors holding guarantees from the Debtor. Although the Centre Defendants did not hold a majority ownership of stock, the Complaint adequately alleges that the Centre Defendants acted as one concerted entity and exercised dominant control of the corporation, making the Centre Defendants insiders and subjecting them to the same fiduciary duties owed by the D&O Defendants.

The Motions to Dismiss Count 5 will be denied.

E. Count 6 — Aiding and Abetting a Breach of Fiduciary Duty

HN19[] Under Delaware law, the four elements of an aiding and abetting a breach of fiduciary duty claim are "(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, (3) knowing participation in that breach by the defendants, and (4) damages proximately caused by the breach."[85]

HN20[] Fiduciaries cannot aid and abet **[**51]** their own breaches of fiduciary duty.[86] However:

[80] Dubroff v. Wren Holdings, 2009 Del. Ch. LEXIS 89, 2009 WL 1478697, at *3 (Del. Ch. May 22, 2009).

[81] Frank v. Elgamal, 2014 Del. Ch. LEXIS 37, 2014 WL 957550, at *18 (Del. Ch. Mar. 10, 2014) (citing In re Nine Systems Corp. S'holders Litig., 2013 Del. Ch. LEXIS 59, 2013 WL 771897, *6 (Del. Ch. Feb. 28, 2013)).

[82] Mem. of Law of Defendants Centre Partners, Murphy, Yalowitz, Pollack and Schnabel in Supp. of their Mot. to Dismiss Claims VI, VII & VII 10-11, Adv. D.I. 17.

[83] Stanziale v. Versa Capital Mgmt., LLC (In re Simplexity, LLC), Adv. No. 16-50212, 2017 Bankr. LEXIS 37, 2017 WL 65069, *3 (Bankr. D. Del. Jan. 5, 2017) (citing Phillips v. County of Allegheny, 515 F.3d 224, 233 (3d Cir. 2008)).

[84] The September 30, 2009 email states: "Centre wants to liquidate just the holding company [DSI Renal Holdings/DSI Holding] and do their new equity investment at a level below that, wiping out the claims of the creditors at holdings and thru the investment wiping out the equity interest of holdings in renal [DSI Renal]." Compl. ¶ 90(d).

[85] In re Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 836 (Del. Ch. 2011) (quoting Malpiede v. Townson, 780 A.2d 1075, 1096 (Del. 2001) (internal punctuation omitted)).

[86] *See* Cargill, Inc. v. JWH Special Circumstance LLC, 959 A.2d 1096, 1125 (Del. Ch. 2008) (stating that a claim for "aiding and abetting a breach of fiduciary duty requires proof of four elements: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, *who is not a fiduciary*, knowingly participated in a breach; and (4) damages to the plaintiff resulted from the concerted action of the fiduciary and the *nonfiduciary*." (emphasis added)).

> Although the elements of a claim for aiding and abetting a breach of fiduciary duty count are couched in terms of the primary violator being a fiduciary and the aider and abettor a non-fiduciary, there is no case law that precludes such a claim against a fiduciary. While a corporate director owes the corporation fiduciary duties, in some instances those duties may be limited (by corporate charter or statute). Thus, the Court may find that a director had no fiduciary duty but aided and abetted a party that did.[87]

The Trustee alleges that, even in the absence of an owed fiduciary duty, "each such Defendant is nevertheless liable for having aided and abetted the breach of fiduciary duties by one or more of the other Defendants possessing such duties at the relevant times." Compl. ¶ 137.

At this stage in the proceedings, determination of the precise outer boundaries of each D&O Defendant's or Centre Defendant's fiduciary duties is premature. For example, the directors may prove to be **[*475]** shielded by their exculpatory clauses, but liable for assisting officer Defendant Yalowitz; Centre Partners may be determined **[**52]** to have no fiduciary duties, but could be held liable for aiding and abetting a breach of fiduciary duty by any D&O Defendant. According all reasonable inferences in favor of the Trustee, the Complaint adequately pleads the elements of aiding and abetting a breach of fiduciary duty as to all D&O Defendants and Centre Defendants.

HN21[] "Knowing participation" is a critical element of a claim for aiding and abetting in a breach of fiduciary duty.[88] The NML Defendants, Ares, and Apollo argue that the Complaint fails to state a claim against them for aiding and abetting fiduciary duties, particularly because the Complaint does not allege a "knowing participation" in the allegedly wrongful conduct. They argue that the Trustee offers only one conclusory assertion in the Complaint that "Apollo, Ares, and the [NML] Defendants held DSI related debt. They approved the DSI Restructuring with knowledge of its fraudulent intent, and received fraudulent transfers in connection with that debt." Compl. ¶ 82. This, by itself, is not enough to pass the pleading requirements of *Rule 8(a)*.

However, the Trustee asserts that testimony gained through discovery and referenced in the Complaint supports reasonable inferences **[**53]** that the NML Defendants, Ares, and Apollo knew that the underlying motivation of the DSI Restructuring was to isolate the Renal Business and leave behind DSI Renal Holdings/DSI Holding's liabilities; in short, their knowledge that the fiduciaries were acting with reckless indifference to or deliberate disregard of the Debtors' creditors and shareholders, through the following:

(i) testimony of Defendant Schnabel that "everybody, . . . all the people involved knew that motivation" and, further, that "there was no desire on the part of the new investors or the creditors who were converting to equity to take on any liabilities that were not associated with the ongoing operations of the Renal business." Compl. ¶ 91(a)(2)-(3);

(ii) testimony of outside counsel to DSI Renal Holdings/DSI Holding acknowledging that he was the author of a September 2, 2009 email stating that, "To get around these guarantee obligations, Centre and a subset of existing DSI investors are contemplating putting funds into a new entity . . . ." Compl. ¶¶ 90(a), 91(c)(1);

(iii) testimony of the same outside counsel then recalled that "there was a concern that if we were to put money in at DSI Holding, then the existing **[**54]** trade creditors would have access to it." Compl. ¶ 91(c)(2).

Although the NML Defendants, Ares, and Apollo are not mentioned by name, the Complaint supports that all of the new investors and creditors transferring to equity were aware of the scheme and knowingly participated in it. According all reasonable inferences to the Trustee at this stage of the proceeding, the Complaint states a claim for aiding and abetting a breach of fiduciary duty as to all the Defendants.

The Motions to Dismiss Count 6 will be denied for all Defendants.

F. Count 7 — Corporate Waste

A corporate waste claim is asserted against the D&O Defendants and the Centre Defendants. Preliminarily, the Centre Defendants and Defendant Yalowitz **[*476]** move to dismiss themselves from the corporate waste claim, arguing that only *directors* may be liable for corporate waste and the Complaint does not allege that the Centre Defendants or Defendant Yalowitz are

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[87] *The Brown Sch., 368 B.R. at 402-03*.

[88] *Del Monte Foods, 25 A.3d at 836*.

directors.[89] In support, the Defendants cite the Supreme Court of Delaware's opinion in *Walt Disney Co. Derivative Litig.*, which provides that "[a] claim of waste will arise only in the rare, 'unconscionable case where *directors* irrationally squander or give away corporate assets.'" **[**55]** [90] The Defendants, however, added their own emphasis to the term "directors" in the quoted language. The *Walt Disney* case does not discuss whether corporate waste claims may be brought against officers or controlling shareholders because the plaintiff in *Walt Disney* only asserted claims against directors who served at the time of the events in question.[91] On the other hand, the Trustee has not cited to (nor did I uncover) any cases in which the Delaware courts have determined that officers or controlling shareholders could be liable for corporate waste.[92] In the absence of precedent from the Delaware courts, I will dismiss Count 7 against the Centre Defendants and Defendant Yalowitz.

The remaining D&O Defendants argue that the Complaint fails to allege facts showing a complete failure of consideration, not merely insufficient consideration, in the DSI Restructuring transaction, as is required to support a corporate waste claim.[93] ***HN22***[] "Under Delaware law, directors waste corporate assets when they approve a decision that cannot be attributed to 'any rational business purpose.'"[94] A claim for corporate waste is "a residual protection for stockholders that polices the **[**56]** outer boundaries of the broad field of discretion afforded directors by the business judgment rule."[95] To state a claim for corporate waste, the Complaint must allege that the directors "authorized an exchange that was so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has **[*477]** received adequate consideration."[96] "In evaluating a waste claim, courts look to the exchange *itself* [rather than process]. The exchange must be *irrational*."[97] "Waste is a standard rarely satisfied in Delaware courts."[98]

However, the Trustee in this case, accorded all inferences, adequately alleges that the Debtor's transfer of its interest in DSI Renal (viewed as one continuous collapsed transaction) served no rational business purpose, and that no business person of ordinary sound judgment could conclude that DSI Renal Holdings/DSI Holding received adequate consideration in exchange for the transfers. The Trustee alleges that DSI Renal Holdings/DSI Holding was left an empty shell; its highly profitable Renal Business stripped away, in exchange for less than one-thousandth of a percent of an interest in the holding company now owning the business **[**57]** it formerly owned in full. Compl. ¶¶ 71- 85. The Complaint cites to internal documents showing that, at the time the transaction was undertaken, insiders knew that the Renal Business was returning to profitability and

[89] Reply Mem. of Law of Defs. Centre Partners, Murphy, Yalowitz, Pollack and Schnabel in Further Supp. Of their Mot. To Dismiss Claims V, VI & VII (Adv. D.I. 20), 10.

[90] *In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006)* (quoting *Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000)*) (emphasis added).

[91] *Walt Disney Co., 906 A.2d at 35*.

[92] *See, generally, Sample v. Morgan, 914 A.2d 647, 650 (Del. 2007)* (corporate waste claim brought against directors of the company); *Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000)* (corporate waste claim brought against members of the new board of directors); *Calma on behalf of Citrix Sys., Inc. v. Templeton, 114 A.3d 563, 570 (Del. Ch. 2015)* (corporate waste claim asserted against nine members of Citrix's board of directors).

[93] Reply Mem. of Law (Adv. D.I. 20) at 10 (citing *In re 3Com Corp. S'holders Litig., 1999 Del. Ch. LEXIS 215, 1999 WL 1009210,*4 (Del. Ch. Oct. 25, 1999)*).

[94] *Calma on behalf of Citrix Sys., Inc. v. Templeton, 114 A.3d 563, 590 (Del. Ch. 2015)* (citation omitted).

[95] *Sample v. Morgan, 914 A.2d 647, 669 (Del. Ch. 2007)*. The business judgment rule has been described in Delaware case law as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Therefore, the judgment of a properly functioning board will not be second-guessed and absent an abuse of discretion, that judgment will be respected by the courts. Because a board is presumed to have acted properly, the burden is on the party challenging the decision to establish facts rebutting the presumption." *Orman v. Cullman, 794 A.2d 5, 19-20 (Del. Ch. 2001)* (citations and internal punctuation omitted).

[96] *Citrix Sys., 114 A.3d at 590* (citing *Glazer v. Zapata Corp., 658 A.2d 176, 183 (Del. Ch. 1993)*).

[97] *Official Comm. of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins, 2004 Del. Ch. LEXIS 122, 2004 WL 1949290, *17 (Del. Ch. Aug. 24, 2004)* (emphasis in original).

[98] *Id.*

that Defendants did not want trade creditors or non-insider shareholders to benefit from those conditions. Compl. ¶¶ 75, 78-79, 91(a), 98. A January 10, 2010, email from Defendant Yalowitz expresses concern about providing information concerning the restructuring to the attorney representing the trustee in the Tennessee Bankruptcy Case because, "I don't want to open up a can of worms in terms of him thinking that DSI Holding did not get adequate value through this process . . . ." Compl. ¶ 90(o). Most troubling is a December 2, 2009 email from the Debtors' lead restructuring counsel (obtained by the Trustee during discovery) stating: "Think a fairness opinion would help here? I assumed you would never get [Goldman Sachs] to say the deal was 'fair' to the stockholder of dsi renal [the Debtor] as they are effectively getting wiped out—pretty tough opinion to give." Compl. ¶ 90(j).

As the Delaware Court of Chancery said in *Telxon Corp. v. Bogomolny*, "the terms and circumstances **[**58]** . . . appear at this point sufficiently unusual to require the court to allow the claim to survive beyond the pleading stage."[99] When a company's own restructuring counsel cannot imagine obtaining a fairness opinion, a reasonable inference can be drawn that no businessperson of ordinary sound judgment could believe that adequate consideration was received. Dismissal of the Trustee's corporate waste claim is premature at this juncture.

The Motions to Dismiss Count 7 will be granted as to the Centre Defendants and Defendant Yalowitz, but denied as to the remaining D&O Defendants.

G. Count 8 — Declaratory Judgment

In Count 8 of the Complaint, the Trustee seeks:

> declaratory relief, including a declaratory judgment to the effect that: (a) CDSI I and CDSI II were the vehicles used by the Defendants to facilitate the fraudulent transfer of the Debtors' interest in DSI Renal; (b) Defendants CDSI I and CDSI II are the alter egos and successors **[*478]** of Debtor DSI Renal Holdings/DSI Holding; (c) Defendants CSDI I and CDSI II are liable for: (1) all of the debts of Debtors DSI Renal Holdings/DSI Holding, DSI Hospitals, and DSI Facility; and (2) all of the debts of non-debtor the Bucks County Hospital; and, **[**59]** (d) Debtor DSI Renal Holdings/DSI Holding is liable for all of the debts of debtors DSI Hospitals and DSI Facility and non-debtor the Bucks County Hospital. Compl. ¶ 144.

The Trustee voluntarily dismissed defendants CDSI I and CDSI II without prejudice on August 2, 2013, pursuant to *Fed. R. Civ. P. 41(a)(1)(A)(i)*, and, as a result, the Trustee clarified at oral argument that he was no longer seeking to hold those entities liable for the debts of the Debtors or the Bucks County Hospital.[100]

The Defendants (correctly, I think) recast the remainder of Count 8 as claims by the Trustee for piercing the corporate veil/alter ego or substantive consolidation. The Defendants seek dismissal of those claims pursuant to *Fed. R. Civ. P. 12(b)(1)* and *(6)*, made applicable by *Fed. R. Bankr. P. 7012*. First, the Defendants claim that the Trustee lacks standing to seek a declaratory judgment that DSI Renal Holdings/DSI Holding is liable for all the debts of Debtors DSI Hospitals and DSI Facility and non-debtor Bucks County Hospital; hence, this Court is without subject matter jurisdiction to entertain such a claim. Second, the Defendants contend that, even if the Trustee has standing, the Complaint's factual allegations do not support the veil piercing/alter ego and substantive consolidation **[**60]** claims underlying Count 8.

1. Standing- Veil Piercing/Alter Ego claim

The Defendants challenge the Trustee's standing to seek a declaratory judgment that DSI Renal Holdings/DSI Holding is liable for the claims of the non-debtor Bucks County Hospital. The Defendants argue that the Trustee does not have standing to assert claims that would render the Debtors and their bankruptcy estates *more* insolvent by taking on the liability of the Bucks County Hospital.

In response, the Trustee argues that the claims in Count 8 are a necessary part of performing his duties. He notes that *Bankruptcy Code § 704* provides that a

[99] *792 A.2d 964, 976 (Del. Ch. 2001)*.

[100] Adv. D.I. 11. Tr. at 25 (Adv. D.I. 53). At oral argument the Defendants noted that, as part of the stipulation to dismiss CDSI I and CDSI II, the Defendants agreed not to argue that those entities were necessary parties to the litigation. Tr. at 15 (Adv. D.I. 53). While the Trustee may still argue that the Defendants used CDSI I and CDSI II as vehicles to facilitate the fraudulent transfer of the Debtor's interest in DSI Renal, any arguments about the Trustee's "reverse veil piercing" claim will not be addressed, as the claims against CDSI I and CSDI II are no longer being pursued.

trustee shall "investigate the financial affairs of the debtor" and to "collect and reduce to money the property of the estate." Trustees have "a duty to maximize the value of the estate . . . and in so doing is bound to be vigilant and attentive in advancing [the estate's] interests."[101]

The Trustee also relies upon the Third Circuit decision recognizing that "a trustee has a fiduciary relationship with *all* creditors of the estate."[102] The Trustee asserts that, as a result of discovery pursuant to *Fed. R. Bankr. P. 2004*, he uncovered a potentially fraudulent scheme (Compl. **[*479]** ¶¶ 1-2, 55-56), and it is the Trustee's duty to recover **[**61]** the value of the Delaware estate's fraudulently transferred property on behalf of *all* creditors of the Delaware estate. The Trustee claims that if, in performing his duties, he finds that the Tennessee creditors were misled by intentionally materially false schedules filed in the Tennessee Bankruptcy Case under Defendants' direction and control (Compl. ¶¶ 47-50), the Trustee should not ignore those creditors, but should include those creditors in the Delaware Bankruptcy Case.

Although *Bankruptcy Code § 501(c)*[103] allows a trustee to file claims on behalf of creditors, the Defendants assert that any claim now filed by the Trustee on behalf of creditors, such as the Bucks County Hospital creditors, would be untimely under *Fed. R. Bankr. P. 3004*, which grants a trustee only thirty additional days to file a claim on behalf of a creditor that fails to file his or her claim within the ninety-day period allotted in *Fed. R. Bankr. P. 3002*. The Trustee points out that neither the Tennessee Trustee nor the Bucks County Hospital creditors knew that DSI Renal Holdings/DSI Holding were co-guarantors. At this stage in the proceeding, I cannot determine whether facts may develop that would allow tardy filing of claims.[104] However, a discussion of the Trustee's duties or **[**62]** ability to file a proof of claim on behalf of creditors does not address the underlying issue of whether the Trustee has standing to pursue a declaratory judgment on the liability of DSI Renal Holdings/DSI Holding to the creditors of Bucks County Hospital.

HN23[ ] *Bankruptcy Code § 541(a)* provides that a bankruptcy estate consists of "all legal and equitable interests of the debtor in property as of the commencement of the case."[105] "This includes 'causes of action existing at the time the bankruptcy action commences.'"[106] "In addition, *11 U.S.C. § 323(a)* provides that the trustee is the sole representative of [the] estate and *11 U.S.C. §323(b)* of the Code provides that the trustee has the capacity to sue and be sued. . . . Taken together, *§ 323(a)* and *(b)* grant the trustee the exclusive standing to assert causes of action that have become property of the estate by operation of *§ 541*."[107]

"But property of the bankruptcy estate does not include claims for damages caused to individual creditors or stockholders of the debtor."[108] In *Think3*, the court held that the Trustee did not have standing to assert claims on behalf of pre-merger stockholders who were allegedly harmed by the director defendants' **[*480]** purported misleading statements and omission of material facts in connection **[**63]** with a 2010 merger.[109] The *Think3* Court also determined, however, that the Trustee could bring claims for damages suffered by the debtor corporation based on the same factual allegations.[110] "The legal fiction of corporate

[101] *Myers v. Martin (In re Martin), 91 F.3d 389, 394 (3d Cir. 1996)* (citing ***In re Baird, 112 F. 960, 960 (E.D. Pa. 1902))***.

[102] *Martin, 91 F.3d at 394* (emphasis in original) (citing *Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 354-55, 105 S. Ct. 1986, 1993, 85 L.Ed.2d 372 (1985))*.

[103] *11 U.S.C. § 501(c)* provides that "[i]f a creditor does not timely file a proof of such creditor's claim, the debtor or the trustee may file a proof of such claim."

[104] *See, e.g.*, *11 U.S.C. §§ 502(b)(9)* and *726(a)*.

[105] *11 U.S.C. § 541(a)(1)*.

[106] *Miller v. Elway Co., LLP (In re Elrod Holdings Corp.), 392 B.R. 110, 114 (Bankr. D. Del. 2008)* (quoting *Anderson v. Acme Markets, Inc., 287 B.R. 624, 628 (E.D. Pa. 2002))*.

[107] *Id.* (citations and internal punctuation omitted).

[108] *Think3 Litig. Trust v. Zuccarello (In re Think3, Inc.), 529 B.R. 147, 187 (Bankr. W.D. Tex. 2015)* (citing *Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 433, 92 S. Ct. 1678, 32 L.Ed.2d 195 (1972)* (bankruptcy trustee has no standing to sue for damages on behalf of debenture creditors of debtor under Bankruptcy Act); *Schertz-Cibolo-Universal City v. Wright (In re Educators Group Health Trust, 25 F.3d 1281, 1284-85 (5th Cir. 1994)* (under *Caplin*, if direct injury is caused to the debtor, trustee has standing to bring suit; if direct injury is caused to creditors that is not derivative of harm to the debtor, trustee does not have standing to bring suit.)).

[109] *Id. at 186*.

[110] *Id. at 187*. The *Think3* Court decided that *§ 541(a)(1)* gives

existence corresponds with the view that an injury to the corporate body is legally distinct from an injury to another person. . . . [A] corporation can suffer an injury unto itself, and any claim it asserts to recover for that injury is independent and separate from the claims of shareholders, creditors, and others."[111] This is often phrased as the difference between direct and derivative claims: HN24[] trustees have standing to bring derivative claims (based on an injury to the corporation) as opposed to direct claims (based on an injury to the individual shareholder or creditor). Under Delaware law, a court decides whether a claim is direct or derivative by considering "who suffered the alleged harm - - the corporation or the suing stockholder [or creditor] individually - - and who would receive the benefit of the recovery or other remedy?"[112]

The claim underlying Count 8 seeks a declaratory judgment that DSI **[**64]** Renal Holdings/DSI Holding is liable for the debts of the Bucks County Hospital; in short, alleging a corporate veil piercing claim on behalf of the creditors of a pre-merger subsidiary. This claim is not a derivative claim alleging damages suffered by the Debtor corporations, but a claim seeking a remedy for damages to a particular subset of creditors. The Trustee does not have standing to assert this claim.[113]

2. Does the Complaint, in essence, call for Substantive Consolidation?

Count 8 also asserts that DSI Renal Holdings/DSI Holding should be liable for the claims of creditors of the related Debtors. The Defendants argue that the relief requested effectively would substantively consolidate the Debtors.

In *Owens Corning*, the Third Circuit described substantive consolidation as follows:

> HN25[] Substantive consolidation, a construct of federal common law, emanates from equity. It "treats separate legal entities as if they were merged into a single survivor left with all the cumulative assets and liabilities (save for inter-entity liabilities, which are erased). The result is that claims of creditors against separate debtors morph to claim against the consolidated survivor." . . . Consolidation **[**65]** restructures (and thus revalues) rights of creditors and for certain creditors **[*481]** this may result in significantly less recovery.[114]

HN26[] Substantive consolidation is only appropriate by consent or if the party moving to substantively consolidate entities can prove that "(i) prepetition [the 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."[115] Corporate disregard as a fault may lead to corporate disregard as a remedy.[116]

"Substantive consolidation has a profound effect on the assets of the consolidated entities" and an order may have a preclusive effect on the merits of other litigation.[117] Substantive consolidation may harm some creditors, so all creditors should have an opportunity to appear and be heard in a substantive consolidation action. Count 8 does not seek relief from the Defendants, but seeks a declaratory judgment that will impact all creditors. Considering the factual allegations

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a trustee "standing to bring a cause of action for damages suffered by a debtor corporation against corporate officers and directors for alleged misconduct and breach of fiduciary duties." *Id.*

[111] Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 348 (3d Cir. 2001).

[112] Stanziale v. Versa Capital Mgmt., LLC (In re Simplexity), LLC, 2017 Bankr. LEXIS 1506, 2017 WL 2385404, *6 (Bankr. D. Del. June 1, 2017) (quoting Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1038-39 (Del. 2004)). *See also* Williams v. McGreevey (In re Touch Am. Holdings, Inc.), 401 B.R. 107, 122 n. 26 (Bankr. D. Del. 2009).

[113] *See also* Burtch v. Opus, LLC (In re Opus East, LLC), 480 B.R. 561, 575 (Bankr. D. Del. 2012) (holding that the Trustee did not have standing to assert a direct claim alleging that the debtor's wholly-owned subsidiary suffered an injury based on tortious interference with, or conversion of, the subsidiary's property and, further, that the Trustee failed to plead a derivative claim on behalf of the wholly-owned subsidiary).

[114] In re Owens Corning, 419 F.3d 195, 205 (3d Cir. 2010) (*quoting* Genesis Health Ventures, Inc. v. Stapleton (In re Genesis Health Ventures, Inc.), 402 F.3d 416, 423 (3d Cir. 2005)).

[115] Owens Corning, 419 F.3d at 211 (footnotes omitted).

[116] Id. at 205 (citing Mary Elisabeth Kors, *Altered Egos: Deciphering Substantive Consolidation*, 59 U. Pitt. L. Rev. 381, 383 (1998)).

[117] *Id.a*t 204.

and the stage of the litigation, **[**66]** this adversary proceeding does not appear to be an appropriate setting for consideration of a substantive consolidation claim, which, in any event, has not been expressly pled as such.

For the reasons set forth above, Count 8 will be dismissed.

H. Count 9 — Equitable Subordination

The Trustee voluntarily withdrew this claim for equitable subordination under *11 U.S.C. § 510(c)*, without prejudice, during oral argument.[118]

CONCLUSION

For the reasons set forth above, I conclude as follows:

(i) the Motions to Dismiss Counts 1, 5, and 6 will be denied;

(ii) consideration of the Motions to Dismiss Counts 2 and 3 will be deferred;

(iii) the Motions to Dismiss Count 4 will be denied, in part, to the extent recovery is sought under Count 1, and deferred, in part, to the extent recovery is sought on Counts 2 and 3; (iv) the Motions to Dismiss Count 7 will be granted, in part, as to the Centre Defendants and Defendant Yalowitz, and denied, in part, as to the remaining D&O Defendants; and

(v) the Motions to Dismiss Count 8 will be granted.

Count 9 was withdrawn by the Trustee voluntarily and without prejudice.

An appropriate order will follow.

BY THE COURT:

/s/ Kevin J. Carey

KEVIN J. CAREY

UNITED STATES BANKRUPTCY COURT

Dated: **[**67]** July 20, 2017

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[118] Adv. D.I. 53, at 7-8.

ORDER

AND NOW, this 20th day July, 2017, upon consideration of the Motions to Dismiss the Complaint (D.I. 14, 15, 16 and 17), after oral argument, and for the reasons set forth in the accompanying Opinion,[1] it is hereby **ORDERED** that:

(i) The Motions to Dismiss Counts 1, 5 and 6 are **DENIED**;

(ii) Consideration of the Motions to Dismiss Counts 2 and 3 is **DEFERRED** pending a decision by the United States Supreme Court in *Merit Management*;[2]

(iii) The Motions to Dismiss Count 4 are **DENIED** to the extent recovery is sought under Count 1, and consideration of the Motions to Dismiss Count 4 is **DEFERRED** pending a decision by the United States Supreme Court in *Merit Management* to the extent recovery is sought under Counts 2 and 3;

(iv) The Motions to Dismiss Count 7 are **GRANTED**, in part, and **DENIED**, in part, as follows:

- The Motions to Dismiss Count 7 are **GRANTED** as to the Centre Defendants and Defendant Yalowitz;
- The Motions to Dismiss Count 7 are **DENIED** as to the remaining D&O Defendants;

(v) The Motions to Dismiss Count 8 are **GRANTED**; and

(vi) Count 9 was withdrawn voluntarily and without prejudice by the Trustee.

It is further **ORDERED** that a status hearing will be held on **[**68] August 30, 2017 at 2:30 p.m**. in Bankruptcy Courtroom No. 5, 824 N. Market St., Fifth Floor, Wilmington, Delaware, to consider further scheduling and the remaining pretrial needs of the parties.

BY THE COURT:

/s/ Kevin J. Carey

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[1] Capitalized terms not defined herein shall have the definitions set forth in the accompanying Opinion.

[2] *Merit Mgmt. Grp. v. FTI Consulting, Inc., 830 F.3d 690 (7th Cir. 2016)* cert. granted ***137 S.Ct. 2092, 197 L.Ed.2d 894 (U.S. May 1, 2017)*** (No. 16-784).

KEVIN J. CAREY

UNITED STATES BANKRUPTCY JUDGE

Table1 (Return to related document text)

Count Number	Claim	Motion to Dismiss denied or granted	Defendants
1	Avoidance of Transfers Pursuant to 11 U.S.C. § 548(a)(1)(A).	Denied	All Defendants
2	Avoidance of Transfers Pursuant to 11 U.S.C. § 548(a)(1)(B).	Deferred	All Defendants
3	Avoidance of Transfers Pursuant to 6 Del. C. §§ 1304 & 1305, and 11 U.S.C. § 544.	Deferred	All Defendants
4	Recovery of Transfers under 11 U.S.C. § 550	Denied in part; Deferred in part	All Defendants
5	Breach of Fiduciary Duty	Denied	D&O Defendants and Centre Defendants
6	Aiding and Abetting Breach of Fiduciary Duty	Denied	All Defendants
7	Corporate Waste	Granted in part, Denied in part	D&O Defendants and Centre Defendants
8	Declaratory Judgment	Granted	
9	Equitable Subordination under 11 U.S.C. [**7] § 510(c)	Withdrawn[10]	All Defendants

Table1 (Return to related document text)

End of Document

[10] The Trustee withdrew Count 9 without prejudice during oral argument. Adv. D.I. 53, at 7-8.

User Name: Richard Corbi

Date and Time: Monday, September 30, 2019 3:23:00 PM EDT

Job Number: 98761759

Document (1)

1. *In re Nuisance Corp., 17 B.R. 80*

Client/Matter: -None-

Headnote:HN18 - In re Guiliano v. Schnabel (In re DSI Renal Holdings, LLC), 574 B.R. 446

[HN18 - A shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation. A shareholder who owns less than 50% of a corporation's outstanding stocks does not, without more, become a controlling shareholder of that corporation, with a concomitant fiduciary status. For a dominating relationship to exist in the absence of controlling stock ownership, a plaintiff must allege domination by a minority shareholder through actual control of corporation conduct. For a "control group" to be treated the same as a single controlling stockholder, it must be connected in some legally significant way - - e.g., by contract, common ownership, agreement or other arrangement - - to work together toward a shared goal. Whether a control group exists is a fact-intensive inquiry; some courts have been hesitant to make this determination in pre-trial motions.]

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In re Nuisance Corp.

United States Bankruptcy Court for the District of New Jersey

November 23, 1981

No. 80-0672

Reporter
17 B.R. 80 *; 1981 Bankr. LEXIS 2529 **

In the Matter of NUISANCE CORP., a New Jersey Corporation, formerly doing business as M. Cattafi & Son, Inc., Debtor; Lillian R. CATTAFI, Michael Cattafi, Jr. and Carolyn C. Cattafi, Plaintiffs, v. Thomas J. O'NEILL, Trustee in Bankruptcy, Defendant

Core Terms

security interest, ***fiduciary***, shareholders, plaintiffs', corporate assets, proceeds

Case Summary

Procedural Posture
Plaintiff insiders brought an adversary proceeding against defendant trustee within the debtor's bankruptcy seeking to enforce a security interest in proceeds in the trustee's hands resulting from the sale of the debtor's assets. The trustee contended that the insiders' claim and security interest were obtained in violation of the ***fiduciary duty*** they owed to the debtor corporation as officers and directors.

Overview

One insider was the debtor's president. The other two were his wife and sister. ***Together*** they owned 66 percent of the debtor's ***stock***. A bank obtained a judgment in state court against the debtor. The president purchased the judgment at a discount and took an assignment of the judgment. The insiders then properly perfected a security interest in the debtors' assets. The sister, who was a real estate agent, then arranged the sale of the debtor's assets to another corporation, taking a commission on the sale. The debtor then filed bankruptcy. The insiders claimed a security interest in the remaining proceeds of the sale, now in the hands of the trustee. The court held that the claim was not allowable under *11 U.S.C.S. § 502(b)(1)*. That section disallowed a creditor's claim to the extent that the debtor had a valid defense to the claim under applicable law. State law imposed a ***fiduciary duty*** upon officers, directors, and controlling shareholders in dealings with their corporation. The insiders had taken advantage of an opportunity to purchase the judgment at a discount and sought to use it to the detriment of the debtor's other shareholders and creditors.

Outcome
The court, in an adversary proceeding within the debtor's bankruptcy seeking to enforce a security interest in proceeds in the trustee's hands, disallowed the insiders' entire claim and invalidated their purported security interest in the funds.

LexisNexis® Headnotes

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > Claim Determinations

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > General Overview

HN1[] **Secured Claims & Liens, Claim Determinations**

Bankruptcy Code § 506 defines the qualifications of a secured claim as follows: An allowed claim of a creditor secured by a lien on property in which the estate has an interest, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property. *11 U.S.C.S. § 506(a)*.

Bankruptcy Law > ... > Bankruptcy > Claims > Allowance of Claims

Bankruptcy Law > Claims > General Overview

Bankruptcy Law > ... > Bankruptcy > Claims > Objections to Claims

HN2[] Claims, Allowance of Claims

The allowance of claims is governed by 11 U.S.C.S. § 502, which provides in pertinent part that a claim or interest, proof of which is filed under § 501, is deemed allowed, unless a party in interest objects. The language of § 502(a) is clear and unambiguous. A claim against the estate will be allowed unless objection is taken. There can be no question that a trustee qualifies as a "party in interest" and, therefore, permitted to object.

Bankruptcy Law > ... > Bankruptcy > Case Administration > Notice

Business & Corporate Compliance > ... > Contracts Law > Standards of Performance > Creditors & Debtors

Bankruptcy Law > ... > Bankruptcy > Claims > Allowance of Claims

Bankruptcy Law > ... > Bankruptcy > Claims > Objections to Claims

HN3[] Case Administration, Notice

11 U.S.C.S. § 502(b) provides that except as provided in subsections (f), (g), (h), and (i) of this section, if an exception to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that such claim is enforceable against the debtor, and unenforceable against property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured. The theme of § 502 is that, upon objection to a claim, the court, after notice and hearing, shall determine the proper amount of the claim. If, however, the claim falls within one of the paragraphs of § 502(b), it is simply not allowable.

Bankruptcy Law > ... > Bankruptcy > Claims > Allowance of Claims

HN4[] Claims, Allowance of Claims

Under 11 U.S.C.S. § 502(b)(1), to the extent that applicable law, including state law, provides the debtor a defense to the claim of a creditor, absent bankruptcy, such defense is available to the trustee in objecting to the claim.

Business & Corporate Law > ... > ***Shareholder*** Duties & Liabilities > Controlling Shareholders > ***Fiduciary*** Duties

Governments > Fiduciaries

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

HN5[] Controlling Shareholders, Fiduciary Duties

That officers and directors and controlling shareholders owe a ***fiduciary duty*** to their corporation and its ***minority*** shareholders, is well established under New Jersey law.

Bankruptcy Law > ... > Bankruptcy > Claims > Allowance of Claims

Governments > Fiduciaries

Bankruptcy Law > ... > Examiners, Officers & Trustees > Duties & Functions > Capacities & Roles

Bankruptcy Law > ... > Bankruptcy > Debtor Benefits & Duties > Debtor Duties

Business & Corporate Law > ... > Directors & Officers > Management Duties & Liabilities > General Overview

HN6[] Claims, Allowance of Claims

The bankruptcy court in passing on allowance of claims sits as a court of equity. Hence the rules governing the ***fiduciary*** responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction, the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or ***stockholder***. He who is in such a ***fiduciary*** position cannot serve himself first and his cestuis second. He cannot manipulate the ***affairs*** of a corporation to its detriment and in disregard of the standards of common decency and honesty. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the ***fiduciary*** to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

Counsel: **[**1]** Thomas J. O'Neill, Esq., Trustee.

Cossman, Levenstein & Goodkin, by: Peter J. Cossman, Esq. and William C. Petrics, Esq., attorneys for Lillian R. Cattafi, Lillian Cattafi and Michael Cattafi, Jr. in bankruptcy proceedings.

Kenihan & Cohen, by: Lawrence Cohen, Esq., attorneys for Lillian R. Cattafi, Lillian Cattafi and Michael Cattafi, Jr. in State court proceedings.

Judges: D. Joseph De Vito, Bankruptcy Judge.

Opinion by: DE VITO

Opinion

[*81] DE VITO, JUDGE.

Plaintiffs seek to enforce an alleged security interest in proceeds resulting from the sale of the debtor's assets. The relevant undisputed facts may be summarized as follows:

1. Plaintiffs, Michael Cattafi, Jr., his wife Carolyn C. Cattafi, and Lillian R. Cattafi, Michael Jr.'s sister, collectively owned approximately 66 per cent of the corporation's common ***stock***. Michael Jr. was the president and a director of the bankrupt corporation. It appears that Lillian R. also served as an officer and/or director of the corporation. Michael Cattafi, Sr., owner of the remaining shares of the corporation, is an unsecured creditor of the corporation.

2. On July 5, 1977 the First National Bank and Trust Company of Kearny **[**2]** (hereinafter, the bank) filed a state court action on a note against the predecessor corporation, M. Cattafi & Son, Inc., joining as defendants Michael Cattafi, Sr., Lillian Cattafi, his wife, and Michael Cattafi, Jr. and Carolyn C. Cattafi, his wife, individually as guarantors.

3. On September 26, 1977 the bank obtained a default judgment solely against the corporation in the sum of $ 58,505.82 plus costs of $ 125.25.

4. On March 1, 1978, Michael Jr., as president of the debtor, entered into a listing agreement granting Lillian R. Cattafi, his sister and a licensed real estate broker, an exclusive right to sell the corporate assets.

5. On March 22, 1978, upon payment of the sum of $ 52,772.69 to the bank, Michael Jr. obtained an assignment of the judgment and the bank's security interest in the corporate assets. The plaintiffs in the case at bar did not levy on those assets, but took a security interest therein in the amount of the judgment ($ 58,631.07), ***together*** with interest at the rate of 8 per cent per annum. Michael Jr., as president, signed the security agreement for the corporation and joined with the remaining plaintiffs as the secured parties, **[**3]** followed by the filing of the appropriate financing statement.

6. On June 15, 1978, the corporation agreed to sell its assets to Q. Petroleum, Inc. Michael Jr. arranged for the sale. Plaintiffs contend that Michael Jr. effected the sale while acting as sales agent in Lillian R.'s real estate agency, independent of his position as ***shareholder***, officer and director of the corporation. Both Michael Jr. and the real estate agency asserted a claim to a real estate commission of 10 per cent of the gross sales price, as provided for in the sales contract.

7. On July 31, 1978, the sale was consummated, with Q. Petroleum, Inc. paying a consideration of $ 67,121.63 to the corporation. The proceeds were allocated as follows:

Go to table1

It appears that, in addition to the principal amount of the judgment, $ 58,505.82, there was due costs of $ 125.25 ***together*** with interest of $ 3,962.37, totaling $ 62,593.44. As noted above, of that amount, $ 50,511.98 was paid in partial **[**4]** satisfaction, with the balance remaining in the sum of $ 12,081.46. To consummate the aforementioned sale, plaintiffs released their security interest in the corporate assets, obtaining in lieu thereof a new security agreement providing for a security interest in the proceeds from the sale of these assets to the extent of $ 12,081.46, ***together*** with interest at 8 per cent.

8. The debtor Nuisance Corporation, formerly known as M. Cattafi & Son, Inc., filed a voluntary petition in bankruptcy on April 14, 1980.

DISCUSSION

Plaintiffs seek validation of their alleged secured claim against funds currently held by the trustee; the trustee objects. ***HN1***[] *Bankruptcy Code § 506* defines the qualifications of a secured claim as follows:

> (a) An allowed claim of a creditor secured by a lien on property in which the **[*82]** estate has an interest, ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, ... (*§ 506[a]*)

It appears that the plaintiffs satisfied the formal requirements for perfection of their security interest pursuant to Article 9 of the Uniform Commercial Code. However, for the plaintiffs **[**5]** to prevail, their claim must first be an "allowed claim". *In re Hotel Associates, Inc., 3 Bankr. 340, 6 B.C.D. 145 (Bankr.E.D.Pa. 1980)*.

HN2[] The allowance of claims is governed by *§ 502 of the Bankruptcy Code*, which provides in pertinent part:

> (a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . . objects.

The language of *§ 502[a]* is clear and unambiguous. A claim against the estate will be allowed unless objection is taken. See 2 *Collier on Bankruptcy* para. 502.01 (15th ed. 1979).

There can be no question that a trustee qualifies as a "party in interest" and, therefore, permitted to object. See 2 Collier on Bankruptcy, para. 502.01 (15th ed. 1979). *Section 502 of the Bankruptcy Code* continues as follows:

> ***HN3***[] (b) Except as provided in subsections [f][g][h] and [i] of this section, if such exception to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that--
>
> > (1) such claim is enforceable against the **[**6]** debtor, and unenforceable against property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured . . . .

The theme of *§ 502* is that, upon objection to a claim, the court, after notice and hearing, shall determine the proper amount of the claim. If, however, the claim falls within one of the paragraphs of *§ 502[b]*, it is simply not allowable. It should be noted that the exceptions provided in subsections [f][g][h] and [i] are not relevant in the present case. See 2 *Collier on Bankruptcy* para. 502.2 (15th ed. 1979).

However, the applicability of *§ 502[b][1]* is clear. ***HN4***[] To the extent that applicable law, including state law, provides the debtor a defense to the claim of a creditor, absent bankruptcy, such defense is available to the trustee in objecting to the claim. See 2 *Collier on Bankruptcy,* para. 502.02 (15th ed. 1979).

The crux of the trustee's case is that Michael Jr. and Lillian R. Cattafi, as officers, directors and ***majority*** shareholders of the corporation, owed a ***fiduciary duty*** to the corporation and its ***minority*** shareholders; that, in seeking personal gain, they ignored **[**7]** this duty. Michael Jr. purchased the bank's judgment (which, ***together*** with interest, amounted to $ 62,593.44) for $ 52,772.69 and then sought to collect the entire amount from the corporation, a profit of $ 9,820.75. In addition, Michael Jr. and Lillian R. claimed a commission for themselves on the sale of the corporate assets, further reducing the corporation's proceeds by $ 9,407.90.

The fact ***HN5***[] that officers and directors and controlling shareholders owe a ***fiduciary duty*** to their corporation and its ***minority*** shareholders, is well established under New Jersey law; see *Eliasberg v. Standard Oil Co., 92 A 2d 862, 23 N.J. Super. 431 (N.J. Ch. 1952)* aff'd, *97 A 2d 437, 12 N.J. 467*; with respect to ***majority*** shareholders, see *Holub v. Jacobwitz, 123 N.J. Eq. 308, 197 A. 423 (N.J. Ch. 1937)*, aff'd *123 N.J. Eq. 162, 197 A. 425* (E & A 1938). Also see *The New Jersey Corporation -- A* ***Fiduciary*** *Relationship,* 23 Rutgers L.R. 671 (1969).

In the circumstances here, plaintiffs clearly breeched their ***fiduciary duty***. The opportunity to liquidate the judgment at less than its full value was available to the corporation, as well as to others. Only Michael Jr.'s apparent desire for personal **[**8]** profit prompted him to pursue his particular course of action. The imposition of the sales commission is further evidence of an **[*83]** attempt by plaintiffs to reap personal profits at the expense of the corporation, its ***minority*** shareholders and, conceivably, its creditors. It should be noted that, at the time of plaintiffs' action, the corporation was in financial difficulty and unable to honor its promissory note. Further, it was but days after the bank obtained its judgment that Michael Jr. began to arrange for the sale of the corporation's operating assets. The deprivation of the note discount availability, ***together*** with the additional expenses represented by the sales commission, could only exacerbate the corporation's financial problems. Upon these facts, the Court can only conclude that plaintiffs were totally indifferent to the well-being of the corporation, motivated solely by their desire to maximize their personal gain. In light of plaintiffs' breech of the ***fiduciary duty***, to allow their claim would result in gross inequity. This is so notwithstanding the formal procedure of perfection of their alleged security interest.

As noted in *Pepper v. Litton, 308 [**9] U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1938)*, in considering the predecessor to *§ 502[j] of the Bankruptcy Code*, Justice Douglas stated:

> As we have said, ***HN6***[] the bankruptcy court in passing on allowance of claims sits as a court of equity. Hence these rules governing the ***fiduciary*** responsibilities of directors and stockholders come into play on allowance of their claims in bankruptcy. In the exercise of its equitable jurisdiction, the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or ***stockholder***. He who is in such a ***fiduciary*** position cannot serve himself first and his cestuis second. He cannot manipulate the ***affairs*** of this corporation to their detriment and in disregard of the standards of common decency and honesty . . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical **[**10]** requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the ***fiduciary*** to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation . . . .

As noted earlier, the plaintiffs abused their ***fiduciary*** positions in an attempt to gain personal profits. Realization of these profits would have worked to the detriment of the corporation, its ***minority*** stockholders and its creditors. If the plaintiffs had attempted to enforce their claims against the corporation, the latter could, under New Jersey law, successfully plead a defense. The equities of the situation are such that this Court is compelled to disallow the plaintiffs' claim. Accordingly, plaintiffs' entire claim of $ 12,081.46 is disallowed. Any purported security interest in the $ 9,875.53 currently in the possession of the trustee is invalidated.

In his supplementary brief, the trustee contends that, not only should the plaintiffs' claim against the estate not be allowed, but that the estate has a claim against the plaintiffs **[**11]** for additional monies, contending that plaintiffs' share of the proceeds realized on the sale of the corporate assets should be limited to the amount that Michael Jr. paid to purchase the judgment, and that the sales commission should be refunded to the estate. These issues were not raised in the pleadings, and that particular request for relief is denied at this time without prejudice, leaving to the trustee an opportunity to file a complaint before the Court for the desired relief.

Submit an Order providing for the dismissal of the complaint.

Dated: November 23, 1981, Newark, New Jersey

D. JOSEPH DE VITO, Bankruptcy Judge

Table1 (*Return to related document text*)

$ 50,511.98	partial satisfaction of the assigned judgment and security interest
9,407.90	partial satisfaction of the real estate commission
7,191.75	legal fees
$ 67,111.63	

Table1 (*Return to related document text*)

End of Document

User Name: Richard Corbi

Date and Time: Friday, October 4, 2019 1:06:00 PM EDT

Job Number: 99188903

Document (1)

1. *In re LightSquared Inc., 513 B.R. 56*

   Client/Matter: -None-

   Search Terms: 513 br 56

   Search Type: Natural Language

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Content Type	**Narrowed by**
Cases	-None-

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In re LightSquared Inc.

United States Bankruptcy Court for the Southern District of New York

July 11, 2014, Decided

Chapter 11, Case No. 12-12080 (SCC) Jointly Administered

Reporter

513 B.R. 56 *; 2014 Bankr. LEXIS 2984 **; 59 Bankr. Ct. Dec. 231; 2014 WL 3535130

In re: LIGHTSQUARED INC., et al., Debtors.

Core Terms

spectrum, valuation, Confirmation, Designation, billion, parties, bid, Prepetition, competitor, technical issue, valuation report, Downlink, License, adversary proceedings, Modification, Uplink, auction, votes, cases, separate classification, indubitable, Lenders, confirmation hearing, subordination, reflects, holders, equity interest, acquisition, termination, collateral

Case Summary

Overview

HOLDINGS: [1]-The separate classification of the Prepetition LP Facility LLC Claim was necessary and appropriate and LLC must be viewed as a competitor of the debtors with significant "non-creditor" interests, or, in the alternative, LLC was an affiliate of a competitor controlled by LLC's ultimate owner; [2]-There was an ample basis to find that, notwithstanding LLC's alleged ulterior motives, its non-creditor/competitor interests, and its demonstrably inequitable conduct in acquiring at least a substantial portion of its claim, it cast its vote to block a plan that provided it with abysmal treatment that no similarly-situated creditor would have accepted; [3]-Contrary to the requirement of 11 U.S.C.S. § 1129(b)(1), the Plan discriminated unfairly against Class 7B.

Outcome

Confirmation denied.

LexisNexis® Headnotes

Bankruptcy Law > Claims > Types of Claims > Claim Classification

Constitutional Law > ... > Fundamental Rights > Procedural Due Process > Scope of Protection

HN1[] **Types of Claims, Claim Classification**

11 U.S.C.S. § 1122(a) provides that a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class. 11 U.S.C.S. § 1122(a). Although § 1122(a) specifies that a claim or an interest may only be included in a particular class if it is "substantially similar" to the other claims or interests in such class, it does not require that all similar claims be placed in a single class, nor does it address when similar claims may be placed in different classes. Stated differently, the Bankruptcy Code does not prohibit placing similar claims in separate classes. Courts that have considered the issue, including the Court of Appeals for the Second Circuit, have concluded that the separate classification of otherwise substantially similar claims and interests is appropriate so long as the plan proponent can articulate a "reasonable" (or "rational") justification for separate classification. Whether there is any "good business reason" to support a plan proponent's separate classification is a question of fact. However, the separate classification of substantially similar claims must not offend one's sensibility of due process and fair play.

Bankruptcy Law > Claims > Types of Claims > Claim Classification

HN2[] **Types of Claims, Claim Classification**

One reasonable justification for separate claim

Richard Corbi

classification is where a claimant is a competitor of the debtor. Importantly, it is not merely the creditor's status as a competitor that is dispositive so much as the "non-creditor" interests that the creditor-competitor may pursue.

Bankruptcy Law > Claims > Types of Claims > Claim Classification

HN3[] Types of Claims, Claim Classification

When considering claim classification issues, the focus should be on the legal nature of the underlying claim rather than on the motives and agenda of the claim holder. A claim reflects more than a dollar amount on a proof of claim; it reflects a bundle of rights and remedies that are wielded by the holder of the claim. Accordingly, both the nature of the claim and the identity of the claimant may be relevant in the context of separate classification.

Bankruptcy Law > Claims > Types of Claims > Claim Classification

HN4[] Types of Claims, Claim Classification

Separate claim classification cannot be used to mistreat a creditor, out of personal animosity or otherwise.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Good Faith Requirement

HN5[] Prerequisites, Good Faith Requirement

11 U.S.C.S. § 1126(e) provides that a bankruptcy court may designate the vote of any entity whose acceptance or rejection of a plan was not in good faith. 11 U.S.C.S. § 1126(e). The Bankruptcy Code provides no guidance about what constitutes a bad faith vote to accept or reject a plan. Rather, § 1126(e)'s "good faith" test effectively delegates to the courts the task of deciding when a party steps over the boundary. Bankruptcy courts should employ § 1126(e) designation sparingly, as the exception, not the rule. Merely purchasing claims in bankruptcy for the purpose of securing the approval or rejection of a plan does not of itself amount to "bad faith." Nor will selfishness alone defeat a creditor's good faith; the Code assumes that parties will act in their own self interest and allows them to do so. Section 1126(e) comes into play when voters venture beyond mere self-interested promotion of their claims. The section was intended to apply to those who were attempting to obtain some benefit to which they were not entitled. A bankruptcy court may, therefore, designate the vote of a party who votes in the hope that someone would pay them more than the ratable equivalent of their proportionate part of the bankrupt assets, or one who votes with an ulterior motive, that is, with an interest other than an interest as a creditor.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Good Faith Requirement

HN6[] Prerequisites, Good Faith Requirement

Votes cast by parties who purchase claims in a competitor's bankruptcy case are viewed by courts as being particularly worthy of scrutiny.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Good Faith Requirement

HN7[] Prerequisites, Good Faith Requirement

While casting a vote on a plan to gain more than one deserves is evidence of bad faith, it takes more than evidence of simply a selfish or aggressive attempt to maximize recovery to demonstrate bad faith.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Good Faith Requirement

HN8[] Prerequisites, Good Faith Requirement

Vote designation should not be ordered where a creditor can articulate a valid business reason for rejecting a plan even if such rejection may also be consistent with such creditor's non-creditor interests.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Good Faith Requirement

HN9[] **Prerequisites, Good Faith Requirement**

In the context of 11 U.S.C.S. § 1126(e), designation may be ordered with respect to any entity whose acceptance or rejection of such plan was not in good faith. It is vote-specific and plan-specific. It focuses on the voting conduct of the creditor holding the claim.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Fairness Requirement

HN10[] **Prerequisites, Fairness Requirement**

Pursuant to 11 U.S.C.S. § 1129(b)(1), a court may confirm a plan over a dissenting impaired class of claims so long as the plan is "fair and equitable" and does not "discriminate unfairly" with respect to the dissenting class. 11 U.S.C.S. § 1129(b)(1).

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Fairness Requirement

HN11[] **Prerequisites, Fairness Requirement**

A plan is fair and equitable with respect to a class of secured claims if it satisfies one of the three alternatives set forth in 11 U.S.C.S. § 1129(b)(2)(A). The plan must provide (i) that the holders of such claims (a) retain their liens on the same collateral, to the extent of the allowed amount of such claims and (b) receive deferred cash payments of a value equal, as of the effective date of the plan, to the value of the secured creditors' interests in the estates' interests in such collateral; (ii) for the sale of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens to comply with clause (i) or (iii) of § 1129(b)(2)(A); or (iii) for the realization by such holders of the indubitable equivalent of such claims. 11 U.S.C.S. § 1129(b)(2)(A).

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Fairness Requirement

HN12[] **Prerequisites, Fairness Requirement**

11 U.S.C.S. § 1129(b)(2)(A)(iii) requires the realization by the creditor of the "indubitable equivalent" of its claims. 11 U.S.C.S. § 1129(b)(2)(A)(iii). Although "indubitable equivalent" is not defined in the Bankruptcy Code, courts generally will find the requirement satisfied where a plan both protects the creditor's principal and provides for the present value of the creditor's claim. Courts focus on the value of the collateral relative to the secured claim, and the proposed interest rate of the facility providing the indubitable equivalent. Courts have held that the "indubitable equivalent" standard requires that there be no doubt that replacement recoveries are equal to existing security interests.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Fairness Requirement

HN13[] **Prerequisites, Fairness Requirement**

While some courts have held that a subordinated lien can constitute the indubitable equivalent of a secured creditor's claim under 11 U.S.C.S. § 1129(b)(2)(A)(iii), such cases are few and far between.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Fairness Requirement

HN14[] **Prerequisites, Fairness Requirement**

The purpose of the 11 U.S.C.S. § 1129(b)(1) requirement is to ensure that a dissenting class will receive relative value equal to the value given to all other similarly situated classes.

Bankruptcy Law > ... > Plan Confirmation > Prerequisites > Fairness Requirement

HN15[] **Prerequisites, Fairness Requirement**

To determine whether a plan discriminates unfairly, courts consider whether (i) there is a reasonable basis for discriminating, (ii) the debtor cannot consummate the plan without the discrimination, (iii) the discrimination is proposed in good faith, and (iv) the degree of discrimination is in direct proportion to its rationale.

Bankruptcy Law > ... > Bankruptcy > Claims > Allowance of Claims

HN16[] Claims, Allowance of Claims

The Bankruptcy Code does not contemplate or permit equitable disallowance of a creditor's claim.

Counsel: **[**1]** For Debtors and Debtors in Possession: Matthew S. Barr, Esq., Alan J. Stone, Esq., Michael L. Hirschfeld, Esq., Karen Gartenberg., Esq., MILBANK, TWEED, HADLEY & MCCLOY LLP, New York, NY; Andrew M. Leblanc, Esq., International Square Building, Washington, DC.

For SP Special Opportunities, LLC: Rachel C. Strickland, Esq., James C. Dugan, Esq., Tariq Mundiya, Esq., Matthew Freimuth, Esq., WILLKIE FARR & GALLAGHER LLP, New York, NY.

For Special Committee of Boards of Directors of LightSquared Inc. and LightSquared GP Inc.: Paul M. Basta, Esq., Joshua A. Sussberg, Esq., KIRKLAND & ELLIS LLP, New York, NY.

For Harbinger Capital Partners LLC, HGW US Holding Company LP, Blue Line DZM Corp., and Harbinger Capital Partners SP, Inc.: David M. Friedman, Esq., Adam Shiff, Esq., KASOWITZ, BENSON, TORRES & FRIEDMAN LLP, New York, NY.

For Ad Hoc Secured Group of LightSquared LP Lenders: Thomas E Lauria, Esq., Glenn M. Kurtz, Esq., Andrew C. Ambruoso, Esq., Julia M. Winters, Esq., WHITE & CASE LLP, New York, NY.

For U.S. Bank National Association and MAST Capital Management, LLC: Philip C. Dublin, Esq., AKIN, GUMP, STRAUSS, HAUER & FELD LLP, New York, NY.

For Centaurus Capital and Melody Business Finance: **[**2]** Jeffrey S. Sabin, Esq., BINGHAM MCCUTCHEN LLP, New York, NY.

For JPMorgan: Sandeep Qusba, Esq., SIMPSON THACHER & BARTLETT LLP, New York, NY.

Judges: Shelley C. Chapman, UNITED STATES BANKRUPTCY JUDGE.

Opinion by: Shelley C. Chapman

Opinion

[*60] DECISION DENYING CONFIRMATION OF DEBTORS' THIRD AMENDED JOINT PLAN PURSUANT TO CHAPTER 11 OF BANKRUPTCY CODE

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[*61]

SHELLEY C. CHAPMAN

UNITED STATES BANKRUPTCY JUDGE

Before the Court is the *Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code* [Docket No. 1308] (as amended, supplemented, or modified in accordance with the terms thereof, the "Third Amended Plan" or the "Plan"). The Plan enjoys the support of every significant party in interest in these cases, save one: SPSO, a special purpose entity owned and controlled by Mr. Charles Ergen. SPSO opposes confirmation of the Plan. SPSO holds approximately $844 million face amount of the outstanding LightSquared LP prepetition secured debt. The facts and circumstances surrounding SPSO's acquisition of its claim (the "SPSO Claim"), and the conduct of Mr. Ergen and certain of his affiliated entities in these cases, are the subject of a separate **[**4]** adversary proceeding pending in this Court and are also at issue in connection with consideration of confirmation of the Plan. Among other things, the Debtors seek to disallow or subordinate the SPSO Claim in its entirety, and have also moved, pursuant to *section 1126(e) of the Bankruptcy Code*, to designate SPSO's vote. Pointing to SPSO's connection to Mr. Ergen and DISH, the Debtors, Harbinger, and the Ad Hoc Group of LightSquared LP Lenders have constructed a Plan that **[*62]** purports to follow the blueprint laid out by the decisions in DBSD,[1] to address conduct by Mr. Ergen that they maintain is even more egregious than the conduct at issue in DBSD. The Plan Proponents separately classify the SPSO Claim; seek to designate SPSO's vote and disregard the class (7B) in which the SPSO Claim is the sole classified claim; and seek to confirm the Plan without satisfying the requirements of *section 1129(b)* of

[1] *In re DBSD North America, Inc., 421 B.R. 133 (Bankr. S.D.N.Y. 2009)*; *In re DBSD North America, Inc., 634 F.3d 79 (2d Cir. 2011)* (together, "DBSD").

the Code, among others. In the alternative, the Plan Proponents assert that the treatment of the SPSO Claim, which is markedly different from the treatment the Plan affords to the other holders of LightSquared LP prepetition secured debt, provides SPSO with the indubitable equivalent of its claim and satisfies all requirements for confirmation, **[**5]** including those embodied in *section 1129(b)*. It is no understatement to say that the parties have waged a lengthy and increasingly nasty litigation war against each other over the past year and the confirmation hearing was a particularly vivid display of the parties' animosity towards each other. The parties continued to file motions and cross-motions for weeks after the evidentiary record on confirmation was to be closed and for weeks after the evidentiary record in the Adversary Proceeding[2] was to be closed. This Decision[3] will address confirmation of the Plan and all pending motions related to the confirmation hearing.

I. BACKGROUND[4]

LightSquared LP, LightSquared Inc., LightSquared Investors Holdings Inc., TMI Communications Delaware Limited Partnership, LightSquared GP Inc., ATC Technologies, LLC, LightSquared Corp., LightSquared Inc. of Virginia, LightSquared Subsidiary LLC, SkyTerra Holdings (Canada) Inc., and SkyTerra (Canada) Inc., as debtors and debtors in possession (collectively, with certain of their affiliated debtors and debtors in possession, "LightSquared" or the "Debtors") provide wholesale mobile satellite communications and broadband services throughout North America. Through its ownership of several satellites and licenses to use mobile satellite service spectrum issued by the Federal Communications Commission (the "FCC"), LightSquared delivers voice and data services to mobile devices used by the military, first responders and other safety professionals, and individuals throughout North America. (See Declaration of Marc R. Montagner [Docket No. 3] ¶¶ 18-31.)

On May 14, 2012 (the "Petition Date"), LightSquared filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code (the "Chapter 11 Cases"). Pursuant **[**7]** to *Bankruptcy Rule 1015* and the *Order Directing Joint Administration of Related Chapter 11 Cases* [Docket No. 33], the Court directed the joint administration of the Chapter 11 Cases for procedural purposes only. LightSquared continues to operate its businesses and manage its properties **[*63]** as debtor in possession pursuant to *sections 1107(a)* and *1108 of the Bankruptcy Code*. No official committee has been appointed in the Chapter 11 Cases. No trustee or examiner has been appointed in the Chapter 11 Cases.

On August 6, 2013, Harbinger Capital Partners LLC, HGW US Holding Company LP, Blue Line DZM Corp., and Harbinger Capital Partners SP, Inc. (collectively, "Harbinger") commenced the Adversary Proceeding against Charles Ergen, DISH Network Corporation ("DISH"), EchoStar Corporation ("EchoStar"), L-Band Acquisition, LLC ("LBAC"), SP Special Opportunities LLC ("SPSO"), Special Opportunities Holdings LLC, Sound Point Capital Management LP, and Stephen Ketchum, alleging inequitable conduct, fraud, aiding and abetting fraud, tortious interference with prospective economic advantage, tortious interference with contractual relationship, unfair competition, and civil conspiracy; and seeking equitable disallowance of claims, compensatory and punitive damages, **[**8]** costs and fees, interest, and other appropriate relief. After the Court granted motions to dismiss Harbinger's complaint,[5] LightSquared filed a Complaint-in-Intervention against SPSO, DISH, EchoStar, and Mr. Ergen,[6] and Harbinger filed a second amended complaint. A trial in the Adversary Proceeding was held between January 9 and 17, 2014, with closing arguments held on March 17, 2014. This Court issued a bench decision on May 8, 2014, which was superseded by its Post-Trial Findings of Fact and Conclusions of Law, dated June 10, 2014 (the "Adversary Proceeding

[2] Harbinger Capital Partners LLC v. Ergen (In re LightSquared Inc.), Adv. Pro. 13-1390-scc (Bankr. S.D.N.Y.) (the "Adversary Proceeding").

[3] This Decision supersedes this Court's Bench Decision read into the record on May 8, 2014.

[4] The findings of fact and conclusions of law herein shall constitute the Court's findings of fact and conclusions of law pursuant to *Bankruptcy Rule 7052*, made applicable to this proceeding pursuant to *Bankruptcy Rule 9014*. To the extent any finding of fact later shall be determined to be a conclusion of law, it shall be so deemed, and to the extent any conclusion of **[**6]** law later shall be determined to be a finding of fact, it shall be so deemed.

[5] See Memorandum Decision Granting Motions to Dismiss Complaint [*Adv. Docket No. 68], 504 B.R. 321 (Bankr. S.D.N.Y. 2013)*.

[6] SPSO, DISH, EchoStar, Mr. Ergen, and LBAC will be referred to collectively herein as the "Ergen Parties."

Decision").[7]

On August 29, 2013, LightSquared filed the *General Disclosure Statement* [Docket No. 815] and, on October 7, 2013, filed the *First Amended General Disclosure Statement* [Docket No. 918] (the "General Disclosure Statement"). On October 10, 2013, the Court entered an order approving, **[**9]** among other things, the General Disclosure Statement and certain solicitation, notice, balloting, and confirmation procedures in the Chapter 11 Cases.[8] On December 31, 2013, LightSquared filed the *Debtors' Revised Second Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code* [Docket No. 1166] (the "Second Amended Plan").

On February 14, 2014, LightSquared filed the Plan[9] and the corresponding *Specific Disclosure Statement for Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code* [Docket No. 1308] (as amended, supplemented, or modified, the "Specific Disclosure Statement"). On February 24, 2014, the Court entered the *Order Approving (A) LightSquared's Third Amended Specific Disclosure Statement and (B) Shortened Time To Object to Confirmation of LightSquared's Third Amended Plan and Streamlined Resolicitation Thereof* [Docket No. 1343] (the "Revised Disclosure Statement Order"), approving, among other things, (a) the Specific Disclosure Statement, (b) **[*64]** the streamlined solicitation of votes on the Plan, and (c) certain amended dates and deadlines with respect thereto. The Revised Disclosure Statement Order established, among other things, (i) March **[**10]** 3, 2014 at 4:00 p.m. (prevailing Pacific time) as the Plan voting deadline and (ii) March 11, 2014 at 12:00 p.m. (prevailing Eastern time) as the Plan objection deadline, which was subsequently extended for SPSO until March 15, 2014 at 12:00 p.m. (prevailing Eastern Time). SPSO's Objection to Approval of the Specific Disclosure Statement [Docket No. 1325] was overruled.

A. The Third Amended Plan

Article III of the Third Amended Plan provides for separate classification of claims and equity interests into the following sixteen distinct classes:[10]

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(See Plan, Art. III.)

Each class of Claims and Equity Interests under the Plan contains only Claims or Equity Interests that are substantially similar to the other Claims or Equity Interests within that class. Pursuant to the Plan, holders of Prepetition LP Facility Claims[11] are divided into two classes, Class 7A and Class 7B. While holders of Prepetition LP Facility Non-SPSO Claims in Class 7A will receive Plan consideration in the form of cash payment equal to the amount of their allowed claims,[12] SPSO, the sole claimant in Class 7B (Prepetition LP Facility SPSO Claims) will receive Plan consideration in the form of the SPSO Note.[13] Pursuant to the Plan, the **[*65]** SPSO Note, which shall have a seven-year maturity and bear interest at LIBOR plus twelve percent, payable in kind, will be secured or unsecured as determined by this Court, provided, however, that if this Court determines that the SPSO Note **[**12]** shall be secured, the liens securing such note will be silent, third priority liens junior to the liens securing the two exit facilities created in connection with the Plan. Because SPSO is not being paid in cash, the Plan requires

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7 Post-Trial Findings of Fact and Conclusions of Law, [Adv. Docket No. 165], 511 B.R. 253, 2014 Bankr. LEXIS 2528 (Bankr. S.D.N.Y. June 10, 2014). Additional background on the Chapter 11 Cases and Adversary Proceeding can be found in the Adversary Proceeding Decision.

8 Docket No. 936.

9 The Plan was subsequently modified several times. See Docket Nos. 1336, 1422, and 1482.

10 In accordance with section 1123(a)(1) of the Bankruptcy Code, Administrative Claims, DIP Inc. Facility Claims, DIP LP Claims, New DIP Claims, U.S. Trustee Fees, and Priority Tax Claims are not classified in the Plan.

11 "Prepetition LP Facility Claims" refers to claims held by the Prepetition LP Agent or the Prepetition LP Lenders arising under, or related to, the $1,500,000,000 term loan credit facility provided in connection with the Prepetition LP Credit Agreement, dated as of October 1, 2010, by and among LightSquared LP and certain of its affiliates and the Prepetition LP Lenders thereunder. "LP Debt" refers to the secured debt of LightSquared LP issued pursuant to the Prepetition LP Credit Agreement.

12 Pursuant to the Plan, such claimants may also elect to receive Plan consideration in the form of New DIP Tranche B Claims (for Converted Prepetition LP Facility Non-SPSO Claims).

13 The Plan provides that Class 7B will receive the "SPSO Option A Treatment" or the "SPSO Option B Treatment," depending on whether SPSO votes to accept the Plan. Given that **[**13]** SPSO has voted to reject the Plan, it would receive the SPSO Option B Treatment, discussed herein.

almost $1 billion less in financing than the Second Amended Plan. (Plan § IV.A.; Mar. 6, 2014 Dep. Tr. (Montagner) 197:9-21.)

The Plan contemplates, among other things: (a) first lien exit financing, including a facility of not less than $1.0 billion; (b) the issuance of new debt and equity instruments; (c) the payment of all allowed claims and equity interests with cash and other consideration, as applicable; (d) the assumption of certain liabilities; (e) the provision of a $1.65 billion new debtor in possession facility by the Plan Support Parties (as defined below) shortly following confirmation of the Plan but prior to the Effective Date (the "New DIP Facility") (approximately (i) $930 million of which will be converted into second lien exit financing, (ii) $300 million of which will be converted into the Reorganized LightSquared Inc. Loan, and (iii) approximately $115 million of which will be converted into new equity,[14] in each case, subject to adjustments as set forth in the Plan), which New DIP Facility will be used to fund operations pending consummation of the Plan and to make distributions to certain creditors; and (f) the preservation of LightSquared's litigation claims.[15]

The Plan has the affirmative support of (a) Fortress Investment Group, on behalf of its affiliates' funds and/or managed accounts ("Fortress"), (b) Melody Capital Advisors, LLC and/or Melody NewCo, LLC, each of behalf of itself and its funds ("Melody"), (c) Harbinger, (d) JP Morgan Chase & Co. or its designated affiliates ("JPMorgan," and, collectively with Fortress, Melody, and Harbinger, the "Plan Support Parties"), (e) U.S. Bank National **[*66]** Association ("U.S. Bank") **[**16]** and MAST Capital Management, LLC ("MAST"), and (f) the Ad Hoc Secured Group of Prepetition LightSquared LP Lenders (the "Ad Hoc Secured Group").

The tabulation reports filed in connection with the Plan reflect the following voting results:

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(See *Certification of Gil Hopenstand with Respect to Tabulation of Votes on Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code*, sworn to March 7, 2014 [Docket No. 1380], Exs. A-B.) SPSO, the sole member of Class 7B (Prepetition LP Facility SPSO Claims), voted to reject the Plan. (See id.)

Under the Plan, Holders of Claims or Equity Interests in Classes 1 (Inc. Other Priority Claims), 2 (LP Other Priority Claims), 3 (Inc. **[**17]** Other Secured Claims), 4 (LP Other Secured Claims), 5 (Prepetition Inc. Non-Subordinated Facility Claims), 13 (Intercompany Claims), and 14 (Intercompany Interests) are Unimpaired and, pursuant to section 1126(f) of the Bankruptcy Code, are deemed to have voted to accept the Plan. (See Plan, Art. III.)

B. Motions Filed in Connection with Confirmation

In addition to confirmation of the Plan, there are numerous confirmation-related motions pending before the Court, and the various objections and responses thereto. They are:

- LightSquared's *Motion for Entry of Order Designating Vote of SP Special Opportunities, LLC* [Docket No. 1371] (the "Vote Designation Motion"). The Vote Designation Motion seeks to designate

[14] Pursuant to the Plan, this $115 **[**14]** million will be converted into equity junior to the proposed SPSO Note. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 55:1-12.)

[15] The Specific Disclosure Statement contained form agreements and/or related documents with respect to various Plan Supplement documents, including the First Lien Exit Credit Agreement, Reorganized LightSquared Inc. Loan, and New LightSquared Entities Corporate Governance Documents [Docket No. 1308]. This filing also contained copies of the SPSO Note Documents, the Schedule of Assumed Agreements, and the Schedule of Retained Causes of Action. On February 17, 2014, LightSquared filed a *Notice of Filing of Plan Supplement Documents for Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code* [Docket No. 1312], attaching copies of the Second Lien Exit Credit Agreement and NewCo Interest Holders Agreement.

On March 18, 2014, LightSquared filed a *Notice of Filing of (A) Modified Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code and (B) Accompanying Confirmation Order* [Docket No. 1422]. On March 21, 2014, LightSquared filed a *Notice of Filing Relating to Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code* [Docket **[**15]** No. 1433], attaching (a) Highly Confident Letters from J.P. Morgan Securities LLC and Credit Suisse Securities (USA), LLC Relating to First Lien Exit Credit Agreement, (b) the Pro Forma Ownership Summary for NewCo, and (c) a list of officers for the New LightSquared Entities (indicating that the identities of the directors of the New LightSquared Entities would be disclosed in a further supplement to the Plan). On March 31, 2014, LightSquared filed a *Notice of Filing Relating to Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code* [Docket No. 1456], attaching the Initial List of Directors for the New LightSquared Entities, subject to further supplement prior to the close of the Confirmation Hearing.

the vote of SPSO pursuant to section 1126(e) of the Bankruptcy Code.

• LightSquared's *Confirmation-Related Motion for Order (A) Approving Postpetition Financing, (B) Authorizing Use of Cash Collateral, If Any, (C) Granting Liens and Providing Superpriority Administrative Expense Status, (D) Granting Adequate Protection, and (E) Modifying Automatic Stay* [Docket No. 1311] (the "New DIP Motion"), seeking an order (a) approving postpetition financing for the period between post-confirmation and the Effective Date, (b) authorizing the use of cash collateral, if **[**18]** any, (c) granting liens and providing superpriority administrative expense status, (d) granting adequate protection, and (e) modifying the automatic stay.

• LightSquared's *Supplement to Motion for Entry of Order Authorizing LightSquared To Modify and Extend Existing Key Employee Incentive Plan* [Docket No. 1390] ("the KEIP Supplement"). The KEIP Supplement seeks an order authorizing LightSquared to modify its existing Key Employee **[*67]** Incentive Plan.[16]

• LightSquared's *Motion to Strike Certain Portions of Expert Testimony of Douglas Hyslop and J. Soren Reynerston* [Docket No. 1458] (the "Motion to Strike Hyslop and Reynertson")

• SPSO's *Motion to Strike Certain of the Testimony of Robert McDowell and Mark Hootnick* [Docket No. 1460] (the "Motion to Strike McDowell and Hootnick")

• SPSO's *Motion to Admit SPSO Confirmation Exhibit 2* [Docket No. 1505] (the "Exhibit 2 Motion")[17]

C. Pleadings Filed in Connection with the Plan and Confirmation-Related Motions

SPSO filed objections to the Plan, the Vote Designation Motion, the New DIP Motion, the KEIP Supplement, and the Motion to Strike Hyslop and Reynertson.

On March 18, 2014, LightSquared filed its *(A) Memorandum of Law in Support of Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code and (B) Omnibus Response to Objections to (i) Confirmation of Plan, (ii) Motion to Designate Vote of SP Special Opportunities, LLC, and (iii) Motion Seeking Approval of New DIP Facility* [Docket No. 1413], accompanied by the Declaration of Matthew S. Barr and the Declaration of Douglas Smith. Statements and/or pleadings in support of the Plan were filed by (a) Fortress, (b) Melody, (c) Harbinger, (d) JPMorgan, (e) U.S. Bank and MAST, (f) the Ad Hoc Secured Group, and (g) the Special Committee.[18]

D. The Confirmation Hearing

On March 19, 2014, the Court commenced a hearing on the Plan, the Vote Designation Motion, and the New DIP Motion; the evidentiary hearing was conducted over the course of eight days (the "Confirmation Hearing"). The Court heard live testimony from the following witnesses and rebuttal witnesses called by the Debtors, the Ad Hoc Secured Group, and SPSO: (i) Mr. Christopher Rogers, a member of the Special Committee; (ii) Mr. Robert McDowell, offered by the Debtors as an expert on FCC-related matters; (iii) Mr. Douglas Smith, the Debtors' Chief Executive Officer; (iv) Mr. Mark Hootnick, a Managing Director of Moelis & Company ("Moelis"), the Debtors' financial advisor; (v) Mr. John Jacob Rasweiler V, a principal of Sublime Wireless, offered by the Debtors as an expert with respect to the "technical issue;"[19] (vi) Mr. Charles **[*68]** Ergen, who is, among

[16] This Decision does not address the KEIP Supplement, which remains *sub judice*.

[17] Exhibit 2 (SPX002), produced by a non-party, has not been properly authenticated, contains multiple layers of hearsay, and does not fall under any exception to the prohibition on hearsay. Morever, the Exhibit 2 Motion, dated April 30, 2014, was filed **[**19]** well after the close of the evidentiary record on confirmation, rendering it procedurally improper. For these reasons, the Exhibit 2 Motion is denied and Exhibit 2 is excluded from the record.

[18] In September 2013, the Court ordered the appointment of the Special Committee of the Boards of Directors of **[**20]** LightSquared Inc. and LightSquared GP Inc. (the "Special Committee") to direct many of LightSquared's significant actions with respect to these Chapter 11 Cases. (See Docket No. 866; PX0755; PX0789.)

[19] In late 2013, SPSO, DISH, and LBAC raised what has been referred to as a "technical issue" with LightSquared's spectrum which would allegedly be an impediment to the use of certain LightSquared uplink spectrum. The Debtors submitted both documentary evidence and the live testimony of Mr. Rasweiler **[**22]** at trial in support of their position that that the "technical issue" poses no impediment to the use of

other things, the ultimate owner of SPSO, the controlling shareholder of DISH, and the Chairman of DISH's Board of Directors; **[**21]** (vii) Mr. Philip Falcone, the controlling member of Harbinger Capital Partners, one of the Plan Support Parties and the principal shareholder of LightSquared; (viii) Mr. Douglas Hyslop of Wireless Strategy LLC and SmartSky Networks LLC, offered by SPSO as an expert with respect to the "technical issue;" (ix) Mr. Omar Jaffrey, a principal of Melody, a private investment firm which is one of the Plan Support Parties; (x) Mr. J. Soren Reynertson, a Managing Director of GLC Advisors & Co. ("GLC"), offered by SPSO as an expert on valuation issues; and (xi) Mr. Steven Zelin, a Managing Director of The Blackstone Group ("Blackstone"), the financial advisor to the Ad Hoc Secured Group. The testimony of Mr. Marc Montagner, the Debtors' Chief Financial Officer, was presented via videotape and deposition transcript designations. Several volumes of documentary exhibits have also been admitted into evidence.

Detailed proposed findings of fact and lengthy post-trial memoranda were also submitted by the parties, which submissions were in addition to the pre-trial memoranda filed by the parties prior to the commencement of the Confirmation Hearing. The Court heard closing arguments concerning the Plan, the Vote Designation Motion, and the New DIP Motion on May 5 and 6, 2014.

E. LightSquared's Pending License Modification Application

The Plan valuation is premised on LightSquared's ownership and/or use of four spectrum blocks within the L-Band: (a) a 10 MHz downlink at 1526 to 1536 MHz ("Lower Downlink"); (b) a 10 MHz uplink at 1627.5 to 1637.5 MHz ("Uplink 1" or "Lower Uplink"); (c) a 10 MHz uplink at 1646.7 to 1656.7 **[**23]** MHz ("Uplink 2" or "Upper Uplink"); and (d) a spectrum block located at 1670 to 1680 MHz (the "New Downlink"), which is comprised of 5 MHz currently used by the National Oceanic and Atmospheric Administration ("NOAA") and 5 MHz currently leased by LightSquared.

On September 28, 2012, LightSquared filed with the FCC a series of applications seeking to modify various of its licenses (collectively, the "License Modification Application") to, among other things:

• authorize LightSquared to use the 1675-1680 MHz spectrum band (the "NOAA Spectrum") on a shared basis with certain government users, including NOAA;

• permit LightSquared to conduct terrestrial operations "pairing" the 1670-1680 MHz New Downlink with two 10 MHz L-Band uplink channels in which LightSquared currently is authorized to operate (Uplink 1 and Uplink 2); and

• permanently relinquish LightSquared's right to use its upper 10 MHz of L-Band downlink spectrum (a 10 MHz band at 1545.2 to 1555.2 MHz) for terrestrial purposes (that portion of the spectrum closest to the band designated for GPS devices).

In conjunction with submitting the License Modification Application, LightSquared also asked that the FCC open a proceeding via **[**24]** a petition for rulemaking, filed on November 2, 2012, to make an administrative change amending the U.S. Table of Frequency Allocations to add a **[*69]** primary allocation permitting non-federal terrestrial mobile use of the NOAA Spectrum. Thus, LightSquared has been pursuing a solution through the License Modification Application that would provide it with 30 MHz of spectrum — an amount, LightSquared states, that is sufficient to implement its business plan.[20] SPSO argues that one of the many reasons that the Plan is not feasible is that the NOAA Spectrum, which is needed for LightSquared to have a full 10 MHz of New Downlink, may be auctioned off by the FCC rather than assigned to LightSquared. LightSquared has conceded that it cannot predict with certainty whether the NOAA Spectrum will be assigned to LightSquared or put up for auction but maintains that this uncertainty does not preclude a finding of feasibility.

LightSquared has also requested that the FCC open an additional proceeding via a petition for rulemaking to examine the conditions and operational parameters under which its Lower Downlink could be used sometime in the future **[**25]** for terrestrial service. LightSquared asserts that it will have authorization to use the Lower Downlink within the next three to seven years. (See Conf. Hr'g Tr. Mar. 20, 2014 (Smith) 131:22-25 (three to five years); Mr. McDowell testified that "the

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LightSquared's spectrum and does not impact the value of LightSquared's assets. All pleadings and proceedings relating to the "technical issue" are confidential and have been filed under seal. Accordingly, the Court's findings with respect to the "technical issue" are reflected in Appendix A, which has been separately filed under seal and which is attached hereto in redacted form.

[20] See General Disclosure Statement [Docket No. 918] at 39-40.

lower 10 will be granted within approximately seven years." (See Conf. Hr'g Tr. Mar. 19, 2014 (McDowell) 73:17-19.) None of SPSO's witnesses testified regarding the timing or likelihood of FCC approval for the Lower Downlink.[21]

While effectiveness of the Plan is not conditioned on FCC approval of LightSquared's pending License Modification Application, LightSquared's Plan valuation relies on opinions offered at the Confirmation Hearing that the FCC will approve the pending License Modification Application and the later use of its Lower Downlink within the timeframes upon which the valuation is based.

II. CONFIRMATION TESTIMONY

A. Mr. Robert McDowell

Mr. Robert McDowell, a former FCC **[**26]** Commissioner, was retained by the Special Committee in November 2013 to advise it with respect to FCC issues and was presented as an expert witness at the Confirmation Hearing. (See Conf. Hr'g Tr. Mar. 19, 2014 (McDowell) at 73:22-24.) Mr. McDowell left the FCC in May 2013, having served as one of five FCC Commissioners for a period of almost seven years. (See Conf. Hr'g Tr. Mar. 19, 2014 (McDowell) at 70:22-25; PX1078.)[22]

During the Confirmation Hearing, Mr. McDowell offered his opinion that he agreed with LightSquared's forecast that it would receive FCC approval of the License Modification Application by December 31, 2015, including the premise that a portion of the New Downlink spectrum would be made available from the NOAA Spectrum. (See Conf. Hr'g Tr. Mar. 19, 2014 (McDowell) at Tr.75:1-7, 15-25.) In addition, Mr. McDowell testified that he believed it was very likely that the FCC would approve LightSquared's use of its 10 **[*70]** MHz of Lower Downlink (1526MHz to 1536MHz) for terrestrial use within the seven years contemplated **[**27]** by the Plan. (Id. at 75:8-9.)

Mr. McDowell did not pick these dates; rather, he was simply given the dates reflected in the Plan. Although he testified that he had participated in and had knowledge of matters relating to LightSquared during his tenure at the FCC, he acknowledged that he is precluded by government rules and regulations from having any contact with the FCC during the two years subsequent to his departure from the agency. Accordingly, since that two year period has yet to expire, Mr. McDowell has had no contact whatsoever with FCC personnel regarding matters pending before it relating to LightSquared. (Id. at 87:1-2.) Nonetheless, he offered his opinions "based on his thirty years of experience" that the FCC will grant the License Modification Application before the end of 2015; will not require an auction of the NOAA Spectrum; and will approve use of the Lower Downlink spectrum by the end of seven years.

Although Mr. McDowell admitted that the FCC could commence a rule-making proceeding with respect to the NOAA Spectrum which could take years and acknowledged that the FCC had filed a statement in these cases indicating that it could give no "assurances about what its decision **[**28]** would be or the timing of the decision,"[23] he nonetheless offered his opinions on the critical timing issues on which the Plan is premised. He testified that he examined, and ultimately discounted, a number of factors that could theoretically present issues for LightSquared's regulatory approval process, including (i) potential GPS interference issues raised by members of the GPS community during a meeting with the FCC in December 2013 (see id. at 80:10-81:2); (ii) potential handset interference issues raised by SPSO with respect to the use of

[21] SPSO's valuation expert, Mr. Reynertson, testified that "[t]he lower downlink block is still subject to controversy, and as highlighted by Mr. Smith's presentation, and so ultimately, we felt that there was a range of outcomes here." (Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 158:1-3.)

[22] As an FCC Commissioner, Mr. McDowell's duties included consideration of, and decisions regarding, spectrum issues involving satellite, media, and wireless companies. (See PX1078 at 2.)

[23] See *Statement Regarding the FCC Exit Condition in Debtors' Revised Second Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code*, dated January 17, 2014 [Docket **[**29]** No. 1235] (the "FCC Statement"). Mr. McDowell concluded that the FCC Statement did not change his opinion for two key reasons. First, he opined that the FCC Statement in this case is a "fairly routine filing for the Commission to preserve all of its legal options and [the statement] doesn't reach any conclusions." (Conf. Hr'g Tr. Mar. 19, 2014 (McDowell) at 81:22-82:4.) Second, Mr. McDowell noted that the FCC Statement "speaks to the second amended plan . . . which had a contingency of resolution at the FCC or grants by the end of this calendar year, 2014. And the third amended plan does not have such a contingency." (Id. at 82:5-10.)

LightSquared's uplink spectrum, which have not been raised by any party in a formal objection (see id. at 82:11-83:4); and (iii) the possibility that the FCC could auction the NOAA Spectrum instead of agreeing to swap it for LightSquared's 10 MHz of downlink spectrum closest to the GPS band. With respect to NOAA, he pointed out that the FCC has granted license modification applications in the past that involved spectrum swaps without holding an auction. (See id. at 83:5-84:7.)

Mr. McDowell concluded that, whether or not the FCC decides to hold an auction for the NOAA Spectrum, LightSquared's "license modification will be granted by the end of calendar year 2015." (Id. at 84:8-14.) Important to his conclusion in this regard were the following facts: (a) there is "more than ample time to resolve these issues" given that LightSquared's License Modification Application has already been pending for a year and a half and there are almost two years until the end of 2015; (b) precedent transactions, including the Sprint 800 MHz rebanding **[**30]** and the H-block auction that resulted in DISH as the **[*71]** winning bidder, illustrate that the FCC can issue orders resolving very complex issues within a relatively short timeframe; and (c) resolution of the bankruptcy is imminent, which will cause the FCC to "act with alacrity." (Id. at 84:15-85:25.) The only other support that Mr. McDowell offered for his opinions was the fact that no so-called "petitions to deny" or formal objections had been filed with respect to the License Modification Application.[24] Mr. McDowell pointed to no evidence indicating that the FCC will proceed along the timeline suggested, offered no evidence that he had any knowledge of how or when the National Telecommunications and Information Administration or any coordinate agency intends to act with respect to LightSquared's application, and could not credibly estimate or state when any required rulemaking proceeding may be commenced or how long it would take. His opinion is simply an educated guess and cannot be afforded significant weight.

B. Mr. Christopher Rogers

Mr. Christopher Rogers serves as a member of the three-member Special Committee of the boards of directors of LightSquared Inc. and LightSquared GP Inc., which was constituted in the fall of 2013. Against the backdrop of allegations by SPSO that the plan process was driven not by the Special Committee but by Harbinger and those parties that Mr. Falcone wished to "protect," including Harbinger, Fortress, and JPMorgan (see SPX78), Mr. Rogers testified to his personal involvement in the plan formulation and negotiation process and that of the Special Committee. (Conf. Hr'g Tr. Mar. 19, 2014 (Rogers) 12:10-67:2.) He estimated that he had spent around 500 hours working on the Plan and related issues,[25] although he did not provide much, if any, detail into how he or other members of the Special Committee had been involved in negotiating the economics of the Plan. For the most part, his testimony was credible but superficial, and consistent with the proposition that he and the other members of the Special Committee were involved in some discussions regarding the plan process from the time of their appointment through the present. **[**32]** However, in the face of a great deal of evidence that the economic terms of the Plan have been largely dictated by Harbinger, and in particular by Mr. Falcone, Mr. Rogers shed little light on how the economic terms of the Plan emerged and evolved, or on the involvement of the Special Committee in those negotiations. Because the Special Committee has asserted a broad common interest privilege with respect to communications among it, the Plan Support Parties, and the Ad Hoc Secured Group, there are no documents that were produced in discovery or are in evidence that reflect any communications on this point during the relevant timeframe.

C. Mr. Douglas Smith

Mr. Douglas Smith, the Debtors' Chief Executive Officer, testified at length about a variety of topics relating to the conduct of these cases, including the plan process and the involvement of LightSquared's management in plan negotiations. (Conf. Hr'g Tr. Mar. 20, 2014 (Smith).) He also testified about **[**33]** a host of issues relating to **[*72]** the FCC process and certain technical issues relating to LightSquared's spectrum assets. Mr. Smith has been involved in the implementation of

[24] At the Confirmation Hearing, Mr. McDowell noted that the window for lodging such formal objections to the License Modification Application had closed over a year ago. (Conf. Hr'g **[**31]** Tr. Mar. 19, 2014 (McDowell) at 78:1-11; 78:25-80:9.)

[25] Mr. Rogers testified that he personally spent more than five hundred hours on the work of the Special Committee, including meetings with stakeholders, regulators, and prospective purchasers. (See Conf. Hr'g Tr. Mar. 19, 2014 (Rogers) at 19:18-20:20.)

LightSquared's strategy for the long-term deployment of its spectrum assets since LightSquared filed such a plan with the FCC in September 2012. (See Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 32:19-35:7.)

During his testimony, Mr. Smith explained the basis of his belief that approval of the License Modification Application by December 31, 2015 and the seven-year Lower Downlink approval process timeline were achievable. (Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 32:15-18; 131:22-25.) In support of his opinion, Mr. Smith highlighted four specific points: (i) the completion of two comment cycles with respect to use of the two upper 10MHz of uplink spectrum (id. at 33:10-12); (ii) the fact that "great progress" has been made with NOAA (id. at 40:5-7); (iii) the observation that the latest U.S. budget reflects NOAA-related costs that are not inconsistent with LightSquared's projections and objectives (id. at 46:6-25); and (iv) the fact that a petition for rulemaking with respect to the lower 10MHz of downlink has already been **[**34]** filed with the FCC and could be complete in three to five years (id. at 129:13-18; 131:22-25). In addition to testifying about the FCC approval process, Mr. Smith gave substantial testimony regarding the "technical issue" raised by LBAC with respect to LightSquared's spectrum and the basis of LightSquared's belief that the issue does not exist or can easily be managed at minimal cost. Mr. Smith, though soft-spoken, is powerfully earnest and credible as a witness, and it is clear that he has been working tirelessly in pursuit of LightSquared's business and strategic goals.

D. Mr. Marc Montagner

Mr. Marc Montagner, the Debtors' Chief Financial Officer, gave deposition testimony regarding numerous issues, and certain portions of his videotaped deposition were designated by the parties, placed into the record, and viewed by the Court on videotape. (Mar. 6, 2014 Dep Tr. (Montagner).) Mr. Montagner testified, among other things, about (i) his participation in the plan process — which he described as "mostly being on the receiving end" (id. at 8:16-18); (ii) his preparation of financial forecasts for use in connection with the Plan (id. at 9:5-10:2); (iii) his views with respect to FCC matters; **[**35]** and (iv) his knowledge of the "technical issue." Mr. Montagner was forthright in his testimony, as he has been in the past in connection with other contested hearings in these cases.

E. Mr. Steven Zelin

The Ad Hoc Secured Group called its financial advisor, Mr. Steven Zelin, of Blackstone, to testify. (Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) 6:13-118:13.) Mr. Zelin detailed the various plan alternatives he had explored with the Ad Hoc Secured Group in 2013 and earlier, and he described his participation in the negotiations leading to the execution of the Plan Support Agreement in connection with the DISH/LBAC Bid.[26] He described in some detail his reaction to what he viewed as **[*73]** "strange" conduct and comments by DISH, SPSO, and their counsel in connection with the "technical issue" and in connection with the pursuit of the DISH/LBAC Bid in the time period leading up to and subsequent to the scheduled December 11, 2013 LightSquared auction.[27] He also shared his theories about why LBAC terminated its bid. Mr. Zelin's testimony was credible, but it added little of substance to the issues at the heart of this proceeding.

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[26] As described more fully in the Adversary Proceeding Decision, on May 15, 2013, **[**36]** Mr. Ergen, through his wholly-owned entity LBAC, submitted an unsolicited bid for LightSquared LP's spectrum assets for $2 billion. On July 22, 2013, DISH purchased LBAC for a dollar, and, the next day, DISH announced its intention to bid through LBAC for LightSquared LP's spectrum assets for $2.22 billion (the "DISH/LBAC Bid"). On that date, DISH also executed a Plan Support Agreement with the Ad Hoc Secured Group, pursuant to which LBAC would act as the stalking horse bidder for the Ad Hoc Secured Group's plan. A joint chapter 11 plan of reorganization proposed by the Ad Hoc Secured Group (of which SPSO was a member at that time) was filed on July 23, 2013. See *First Amended Joint Chapter 11 Plan for LightSquared LP, et al., Proposed by the Ad Hoc Secured Group of LightSquared LP Lenders* [Docket No. 970].

[27] Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) at 21:13-23:1 ("My reaction was that a bidder in a process demanding that information that they uncover that they think are issues that other bidders should know is quite strange. I've never experienced that before.") The Debtors and the Special Committee canceled the December 11, 2013 Court-scheduled auction for LightSquared's assets (or any **[**37]** grouping or subset thereof), and they did not deem any bid the "Successful Bid." See Specific Disclosure Statement at 3. On January 7, 2014, LBAC, through its counsel, sent the Ad Hoc Secured Group written notice of LBAC's termination of the Plan Support Agreement and subsequently informed the Ad Hoc Secured Group of the termination of the DISH/LBAC Bid. See id. at 4. On January 13, 2014, the Ad Hoc Secured Group filed the *Statement of the Ad Hoc Secured Group of LightSquared LP Lenders and Notice of Intent To Proceed with Confirmation of*

F. Mr. Charles Ergen

Mr. Charles Ergen was called as a witness by the Ad Hoc Secured Group and testified for a full day, taking the witness stand at ten in the morning, and stepping down at approximately 7:45 in the evening. (Conf. Hr'g Tr. Mar. 26, 2014 (Ergen).) He was questioned extensively on a number of topics, having already given substantial testimony during the trial in the Adversary **[**39]** Proceeding relating to SPSO's acquisition of its holdings in the LP Debt.[28] His testimony focused on, among other things: (i) the valuation analysis he prepared and presented to the DISH Board in July 2013 with respect to the LightSquared spectrum assets, which estimated that, in DISH's hands, the total value of LightSquared's assets would be between **[*74]** $5.17 billion and $8.99 billion (including value that would be realized by DISH based on enhanced ability to utilize its existing spectrum);[29] (ii) his knowledge of the fairness opinion and valuation of LightSquared prepared by Perella Weinberg Partners ("PWP")[30] for the DISH Board (the "PWP Valuation"); (iii) his knowledge of the so-called "technical issue" and how he believes it affects the value of the LightSquared spectrum; (iv) his participation, on behalf of DISH, in the LightSquared auction process in December 2013, including the readiness of DISH to increase its bid and DISH's ultimate decision to terminate the DISH/LBAC Bid; and (v) whether or not he views SPSO and/or DISH as competitors of LightSquared. Mr. Ergen's testimony leaves little doubt that he has a tremendous amount of knowledge and expertise with respect to the

the First Amended Joint Chapter 11 Plan for LightSquared LP, ATC Technologies, LLC, LightSquared Corp., LightSquared Inc. of Virginia, LightSquared Subsidiary LLC, LightSquared Finance Co., LightSquared Network LLC, LightSquared Bermuda Ltd., SkyTerra Holdings (Canada) Inc., and SkyTerra (Canada) Inc., Proposed by the Ad Hoc Secured Group of LightSquared LP Lenders [Docket No. 1220], in which the Ad Hoc Secured Group challenged LBAC's termination of the DISH/LBAC Bid (the "Ad Hoc Secured Group Motion to Enforce"). LBAC then sought a declaratory judgment "declaring that both the PSA and LBAC Bid were terminated in their entirety on or before January 10, 2014." **[**38]** See *Objection of L-Band Acquisition, LLC to the January 13, 2014 Statement of the Ad Hoc Secured Group of LightSquared LP Lenders and Notice of Intent To Proceed with Confirmation of the First Amended Joint Chapter 11 Plan and Motion for Declaratory Relief*, dated January 16, 2014 [Docket No. 1232] at 18; *Reply in Further Support of Objection of L-Band Acquisition, LLC to the January 13, 2014 Statement of the Ad Hoc Secured Group of LightSquared LP Lenders and Notice of Intent To Proceed with Confirmation of the First Amended Joint Chapter 11 Plan and Motion for Declaratory Relief*, dated January 21, 2014 [Docket No. 1246]. On January 22, 2014, this Court issued a ruling that the Plan Support Agreement and the DISH/LBAC Bid were lawfully terminated by LBAC. See Jan. 22, 2014 Hr'g Tr. [Docket No. 1278].

[28] See fn 11, *supra*. Between April 13, 2012 and April 26, 2013, SPSO contracted to purchase over $1 billion in face amount of LP Debt, of which it actually closed trades for $844,323,097.83, which is the current face amount of the SPSO Claim, excluding interest.

[29] Mr. Ergen's presentation **[**41]** (the "Ergen Valuation"), was entitled "Strategic Investment Opportunity — L-Band Acquisition, LLC." (PX1047.) It was delivered to the DISH Board of Directors by Mr. Ergen at a special meeting on July 8, 2013. Under a line item entitled "Implied Net Primary Asset Value," the Ergen Valuation listed a range of values of between $3.341 billion and $5.213 billion, with a mid-point of $4.277 billion, referring to Mr. Ergen's estimate of the value of 20 MHz of LightSquared's spectrum assets and its satellites, excluding its 10MHz of Lower Downlink. Under the heading "Implied Supplemental Asset Value," the Ergen Valuation listed a range of values of between $1.833 billion and $3.783 billion, with a mid-point of $2.308 billion, for what it identifies as the total of (i) 5.0 MHz of "Reclaimed Unuseable [*sic*] AWS-4," (ii) 5.0 MHz of "Reclaimed Impaired AWS-4," and (iii) "L-Band Downlink Spectrum." The Implied Supplemental Asset Value was Mr. Ergen's estimate of (a) the increase in value of DISH's existing spectrum that would flow from DISH's acquisition of LightSquared's spectrum, which would permit unusable and impaired uplink AWS-4 spectrum owned by DISH to be converted to downlink and (b) **[**42]** his range of values for 20 MHz of LightSquared's downlink spectrum. In other words, the supplemental value of LightSquared's assets to DISH was estimated by Mr. Ergen to be between $1.833 billion and $3.783 billion. Combined with the Implied Net Primary Asset Value of $3.341 billion to $5.213 billion, the total value of LightSquared's assets in DISH's hands was estimated by Mr. Ergen to be between $5.174 billion and $8.996 billion, with a midpoint of $7.085 billion.

[30] PWP served as financial advisor to the Special Committee of the DISH Board of Directors that was created on May 8, 2013 to evaluate and make recommendations to the DISH Board regarding a possible bid by DISH for LightSquared's assets and to review any potential conflicts of interest arising from Mr. Ergen's purchases of LightSquared debt.

wireless **[**40]** telecommunications industry, displaying great command of detail with respect to spectrum issues and spectrum deployment strategy. And yet his testimony became remarkably less precise and straightforward when queried about his involvement in the events leading to the termination of the DISH/LBAC Bid, and his answers with respect to potential competition between DISH and LightSquared were facile and disingenuous. Moreover, his testimony with respect to actions taken by DISH with respect to the "technical issue" supports the conclusion that once it was allegedly "identified" by DISH, there was no meaningful effort made to identify a solution that would preserve the billions of dollars in value that DISH would realize via consummation of the DISH/LBAC Bid. This defies common sense. Mr. Ergen's testimony on this point was not credible. His testimony with respect to his dealings with Inmarsat was also not credible.

G. Mr. Omar Jaffrey

SPSO next called Mr. Omar Jaffrey, a principal of Melody, to testify. (Conf. Hr'g Tr. Mar. 28, 2014 (Jaffrey) 27:8-99:25.) Mr. Jaffrey testified that he contacted **[*75]** Mr. Falcone in the summer of 2013 to find a way for his firm to invest in LightSquared. (Id. at 28:20-25.) Melody was first retained by Harbinger to provide a $550 million commitment for a debtor-in-possession **[**43]** financing for a plan of reorganization proposed by Harbinger. (Id. at 29:4-15.) Pursuant to that commitment, Melody was entitled to the payment of an eight percent per annum commitment fee for as long as the commitment remained outstanding, as well as a $4 million upfront fee and a double-digit break-up fee in the event that LightSquared was sold — all payable by Harbinger. (Id. at 52:18-25; 55:17-56:24.) It was Mr. Jaffrey's belief that Melody's commitment to Harbinger was still outstanding as of the date of his testimony on March 28, 2014. (Id. at 91:25-92:6.)

In December 2013, Melody took on a second commitment — a $550 million commitment to the Debtors' Second Amended Plan that included debtor-in-possession financing of $285 million. (Id. at 30:21-31:4.) Correspondence between Mr. Jaffrey and others was introduced into evidence reflecting Melody's view that, as of the time Melody entered into this commitment, "there was a ninety percent chance" that Mr. Ergen would purchase LightSquared out of the bankruptcy such that the Melody financing would never be needed. (Id. at 40:10-41:16; SPX365 (December 22, 2013 Melody investment memo).)

In January 2014, the Second Amended Plan was abandoned **[**44]** [31] and discussions began surrounding what would become the Third Amended Plan which would, in Mr. Jaffrey's words, "allow the company to exit quicker from bankruptcy and drop an FCC conditionality." (Conf. Hr'g Tr. Mar. 28, 2014 (Jaffrey) at 49:8-11.) Extensive testimony was elicited from Mr. Jaffrey regarding the evolution of the economic terms of what eventually became the Plan; email correspondence from the January 2014 timeframe indicates that, even as the trial in the Adversary Proceeding was unfolding, there was close coordination among Mr. Jaffrey, Mr. Falcone, and Drew McKnight of Fortress regarding the economics of the Plan, how to structure it to satisfy the concerns of Fortress, how to include JPMorgan, and how to deal with the SPSO Claim. (Id. at 48:12-52:6: 57:6-69:13.) The entire premise of the Melody proposal was the subordination of the SPSO Claim, a notion that was obviously consistent with Mr. Falcone's mindset. (Id. at 49:22-50:18; SPX072; SPX337.) As Mr. Jaffrey put it in an email, the goal was a "win-win" — for everyone but SPSO. (SPX341; Conf. Hr'g Tr. Mar. 28, 2014 (Jaffrey) at 65:21-69:22; 71:4-72:4.) While Mr. Jaffrey, not surprisingly, declined to share the details of his so-called LightSquared **[**45]** investment thesis, it is clear that he and Melody have opportunistically entered the picture not to "help" but to earn a sizable return through fees, interest on Melody's highly secure proposed second lien exit investment, and equity upside tied to LightSquared's success.

H. Mr. Philip Falcone

Mr. Philip Falcone was the final witness called to testify at the Confirmation Hearing. (Conf. Hr'g Tr. Mar. 31, 2014 (Falcone).) The scope of Mr. Falcone's testimony did not include matters as to which he had previously testified during the Adversary Proceeding. Called by SPSO, Mr. **[*76]** Falcone testified about his intimate involvement in the formulation of the Plan, detailing his discussions with Mr. Jaffrey of Melody, Mr. McKnight of Fortress, and others. Email correspondence was introduced reflecting Mr. Falcone's desire to subordinate

[31] Because the Second Amended Plan was conditioned on FCC approval of the License Modification Application, and there was uncertainty about the timing of such approval, the parties determined to develop a different plan that was not conditioned on FCC approval. (See Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 17:16-18:15; Conf. Hr'g Tr. Mar. 28, 2014 (Jaffrey) at 41:17-42:7.)

Mr. Ergen's **[**46]** claim and to protect the interests of Harbinger, Fortress, and JPMorgan. He detailed his views about the FCC approval process and his continuing belief that approval is forthcoming. He indicated his view that the "technical issue" was fabricated by DISH and is merely "fluff" that the FCC will see "for what it is and will ultimately grant LightSquared the license." (Id. at 130:18; 143:19; 127:21-23.) Mr. Falcone also answered a number of questions about what consideration Harbinger would receive under the Plan and what Harbinger's options were to increase its proposed stake in the reorganized company. Mr. Falcone confirmed that Harbinger could put in an additional $150 million dollars to increase its post-confirmation stake in the reorganized company to thirty-six percent, and that at least part of that sum would be "part of the second lien" and therefore would be ahead of the SPSO Note. (Id. at 102:18-103:25.)[32] Mr. Falcone stated that he believed he did not get everything he had asked for and that Harbinger is entitled to in connection with the Plan, citing the fact that neither he nor anyone from Harbinger has a seat on the board of directors of the reorganized company and that he **[**47]** is giving up his causes of action against the GPS industry. (Id. at 105:13-107:5.)[33] It is fair to say that there was much correspondence introduced into evidence that, at best, reflects mean-spirited banter by Mr. Falcone about various aspects of these cases and, at worst, reflects genuinely malevolent views towards various individuals. His many attempts to spin his words otherwise were unconvincing. It is clear that Mr. Falcone more or less dictated the principal economic terms and structure of the Plan.

III. THE MOELIS VALUATION ANALYSIS

The Debtors called Mr. Mark Hootnick of Moelis to testify in support of the valuation that undergirds the Plan and that provides the basis and support for SPSO's treatment under the Plan. (Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick).)

In preparing Moelis' valuation, Mr. Hootnick conducted extensive research and analysis over the almost two years in which he has been involved as LightSquared's financial advisor and also relied on his experience with other valuation exercises of similar assets. (Id. at 129:13-18 (attesting that Moelis has "experience valuing spectrum other than in the LightSquared matter. . . We have a telecom practice that is run by my partner Stan Holtz who's been very involved in the entire LightSquared engagement. I've worked **[*77]** on a number of spectrum deals myself").) He also had "[e]xtensive discussions" with management on a "wide variety of topics," throughout these Chapter 11 Cases, including "regulatory issues" **[**49]** and LightSquared's "business plan" and "liquidity forecast." (Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 7:7-14.) Moelis' research, discussions with management, and discussions with Mr. McDowell concerning various assumptions on the likelihood of approval and timing of such approval of LightSquared's FCC regulatory applications culminated with Moelis' valuation report submitted to the Court (PX1001) (the "Moelis Valuation Report"), which report contains a thorough analysis of the value of LightSquared's assets. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 10:4-11.)

Mr. Hootnick relied on Mr. McDowell's opinions regarding the timing and outcome of the license modification process; he also relied on the opinions of Mr. Smith with respect to certain regulatory matters. For the purposes of preparing the Moelis Valuation Report, Mr. Hootnick assumed that the FCC would grant LightSquared a license for 30MHz of spectrum, including the 5 MHz of NOAA Spectrum, for terrestrial use, on or before the end of 2015; he further assumed that the Lower Downlink would be approved for terrestrial use within seven years.[34] He did not take into

[32] Mr. Falcone also added that, under the Plan, Harbinger could pay "a couple of hundred" million for a call option which would enable Harbinger to increase its stake in the reorganized company from thirty-six percent to forty-five percent. (Conf. Hr'g Tr. Mar. 31, 2014 (Falcone) 103:4-13.) He testified that the preferred and common stock that Harbinger would receive under the Plan would rank junior to the SPSO Note. (Id. at 102:8-12.)

[33] The Special Committee asserts that it adopted terms that were not beneficial to the Plan Support Parties, and actually contrary to "conditions precedent" initially proposed by the Plan Support Parties. For instance, the Special Committee rejected Harbinger's **[**48]** request for board representation in the New LightSquared Entities (see Conf. Hr'g Tr. Mar. 19, 2014 (Rogers) at 107:1-5), and Harbinger contributed to the estate its litigation claims against Mr. Ergen, the GPS industry, and the FCC. (Id. at 105:2-106:7.)

[34] Mr. Hootnick testified that both assumptions as to FCC approval are "outside dates," explaining that LightSquared, Mr. McDowell, and Moelis have utilized the "conservative view," while some expect the License Modification Application to be granted sooner. (Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 12:14-22; 22:14-23:13.)

account the alleged "technical issue" that has been raised by SPSO. He acknowledged that **[**50]** the FCC Statement means that the FCC is "making no promises" on timing, and he has had no personal contact with any FCC personnel on any issues related to LightSquared.[35] Mr. Hootnick's valuation rises or falls with Mr. McDowell's opinions on the timing of FCC approvals.

In preparing the Moelis Valuation Report, Moelis adopted an industry-accepted valuation method in its valuation of LightSquared, specifically the use of a market multiple comparable based on the price per MHz/POP, which reflects the market price as a function of the size of the spectrum and the number of people it covers. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 16:13-17:6 (describing the MHz/POP terminology and usage); Moelis Valuation Report at 10 (detailing, based on spectrum characteristics, LightSquared's attractive, low-frequency spectrum with strong propagation and in-building penetration).) Moelis reviewed "comparable spectrum" transactions and, by taking into account the unique considerations relevant to each spectrum block, derived the appropriate $/MHz/POP range multiples to apply to LightSquared's spectrum assets.[36] **[*78]** The processes, conclusions, and comparables reflected in the Moelis Valuation Report are similar to those reflected in the Ergen Valuation and PWP Valuation, each described herein.[37]

Based on the assumption that the License Modification Application would be granted by the forecasted dates, Moelis derived a "market comp range of sixty to ninety cents" per MHz/POP. (Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 22:14-24:3.) Using that determined range, Moelis derived a value for LightSquared's spectrum assets. To account for the fact that the License Modification Application may not be achieved until the end of 2015, Moelis discounted the derived value back to October of 2014 (the estimated date of LightSquared's emergence from chapter 11) to determine its present value. (See id. at 22:14-24:3.) Using this generally accepted method, Moelis concluded a value of LightSquared's Uplinks, together with the New Downlink, of approximately $4.8 billion to $7.2 billion, with a midpoint of $6 billion. (See id. at 22:14-23:13; **[**53]** Moelis Valuation Report at 11.)

With respect to the Lower Downlink spectrum, Moelis adopted a similar approach using the information from Mr. Smith and the expert opinion of Mr. McDowell that the Lower Downlink (located at 1526 to 1536 MHz) would be available within seven years of LightSquared's emergence from bankruptcy. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 10:15-13:6.) Mr. Hootnick discounted that value back to present value from the outside date of October 2021, resulting in a multiple of $.26-$.39/MHz/POP, or a value of $811 million to approximately $1.22 billion, with a midpoint of $1.03 billion. (See id. at 24:4-12; Moelis Valuation Report at 11.)

Upon measuring the value of each component of LightSquared's spectrum and satellite portfolio, Moelis provided a conclusion regarding the total enterprise value of such assets. (See Moelis Valuation Report at 11.) Mr. Hootnick opined that LightSquared's total enterprise value is approximately $6.2 billion to $9.1 billion, with a midpoint of $7.7 billion. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 25:4-27:7 (explaining sum of valuations of LightSquared's "U.S. spectrum value, the Canadian L-band spectrum, and the value of the satellite **[**54]** system"); Moelis Valuation Report at 11 (same).) After netting out certain payment obligations, LightSquared's total value approximated $4.47 billion to $7.4 billion, with a midpoint of $5.96 billion. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 27:8-29:1.)

The Moelis Valuation Report is consistent with aspects of the valuations performed by the Ergen Parties. In July 2013, both Mr. Ergen and PWP performed valuations of LightSquared's spectrum to aid the DISH Board in its consideration of whether to pursue an acquisition of

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[35] To perform its valuation of LightSquared's Lower Uplink and Upper Uplink (together, the "Uplinks") and the New Downlink, Moelis relied on discussions with Mr. Smith and Jeffrey Carlisle, LightSquared's Executive Vice President for Regulatory Affairs and Public Policy, and the opinion of Mr. McDowell, that, by the end of 2015, the FCC would have granted the License Modification Application, which includes the use of the Uplinks and the swap with the NOAA Spectrum to make a ten-by-twenty block of spectrum. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 10:15-13:6, 24:21-25:3.) Messrs. Smith and Carlisle **[**51]** were the "two main parties interacting with the FCC." (Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 11:23-12:7.)

[36] Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 22:19-22 ("We came up with a market comp **[**52]** range of sixty cents to ninety cents a megahertz POP for use in our valuation. We then made some additional -- or adjustments based on the assumptions we talked about earlier."); see also id. at 29:2-14; Moelis Valuation Report at 12 (setting forth selected broadband wireless spectrum precedents).

[37] See PX1047, PX1048; Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 32:5-37:16.

LightSquared's spectrum. (PX1047; PX1048.) Both Mr. Ergen and PWP valued LightSquared spectrum on an "as is" basis, without assuming favorable FCC modifications. (See id.)

Moelis, Mr. Ergen, and PWP incorporated the same basic spectrum valuation methodologies, assumptions, and views in their respective valuations of LightSquared. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 32:13-34:1 (agreeing with Mr. Ergen's observations in the Ergen Valuation that L-Band is low band spectrum and is uniquely positioned due to its **[*79]** excellent propagation characteristics); 34:2-16 (noting that Ergen Valuation contains "a similar valuation exercise to what we've just walked through that Moelis **[**55]** did. . . . [They are] . . . very consistent as far as the market valuation of the L-band spectrum"); 36:22-37:4 (noting that PWP Valuation is "very similar").) Mr. Ergen's valuation applies a higher range of $/MHz/POP than that used by Moelis in its valuation (see id. at 34:2-16 ("[T]heir valuation range is actually a little bit higher than the Moelis range. We were sixty to ninety cents a megahertz POP. They're sixty-five to ninety-five cents[.]")), and includes only a portion of LightSquared's assets (see id. at 34:2-16 ("The other big differential, they only include 20 megahertz of our spectrum in their primary asset value."), 34:21-24.) As for the PWP Valuation, the $/MHz/POP range applied to LightSquared's Uplinks — "fifty to nine[t]y cents" — is similar to Moelis's $.60-$.90 range. (See id. at 36:22-37:4.) The Ergen Valuation and the PWP Valuation reflect a similar, but ultimately higher, value of LightSquared's satellite system. (See id. at 35:19-36:2 (as to Ergen Valuation: "They did a similar valuation and exercise but notably came up with a higher estimate of the satellite system than the Moelis valuation"); 37:5-16 (as to PWP Valuation: "they conclude to a range that's almost identical **[**56]** to the Moelis valuation or the higher end of their range of the satellites and the satellite spectrum").)

The Ergen Valuation reflects that LightSquared LP's spectrum assets carried an implied net primary value of up to $5.213 billion, with a midpoint of $4.277 billion. (See Ergen Valuation at 5.) The PWP Valuation reflects a $2.3 to $5.4 billion standalone valuation of LightSquared LP. (See PWP Valuation at 6.)

LightSquared, its FCC expert, and Moelis all assume that LightSquared's Upper Downlink will be relinquished in a future spectrum swap arrangement and, accordingly, the Moelis Valuation Report does not attribute any value to the Upper Downlink. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 16:2-6; 35:12-18.) Mr. Ergen valued the Upper and Lower Downlinks together, at between $312 million to $1.56 billion, with a midpoint of $936 million. (See Ergen Valuation at 5.)

IV. THE GLC VALUATION ANALYSIS

SPSO offered the expert valuation testimony of Mr. J. Soren Reynertson of GLC. (Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) 121:4-250:11.) Mr. Reynertson was paid $1.25 million dollars by SPSO for his work[38] and was given three weeks to form his opinions.[39] The Debtors raised a Daubert challenge to Mr. Reynertson's qualifications under *Federal Rule of Evidence 702*,[40] which was overruled by the **[**57]** Court, in **[*80]** part because there had been no notice of such challenge prior to the witness taking the stand, and in part based on the Court's conclusion that a Daubert exclusion was inappropriate on the merits. (Id. at 140:11-143:13.) The Debtors have renewed their objection to a portion of Mr. Reynertson's testimony in their Motion to Strike Hyslop and Reynertson.

Mr. Reynertson testified that he relied "100 percent" on the opinions of Mr. Hyslop with respect to the amount of spectrum that will be available to and usable by LightSquared, including with respect to Uplink 1 and Uplink 2. (See Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 208:8-11; 246:15-247:7.) Despite this admission, Mr. Reynertson purported to value LightSquared's assets based on GLC's assessment of the risk associated with obtaining FCC approval for use of the spectrum, notwithstanding the fact that Mr.

[38] See Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) 73:3-15.

[39] On March 4, 2014, when Mr. Reynertson submitted GLC's valuation report (PX1002 and SPX158, the "GLC Valuation Report"), he had had only three weeks of experience with spectrum and satellite valuation generally — those being the three weeks beginning with his retention by SPSO and concluding with delivery of the GLC Valuation Report. (See Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 199:20-200:6.)

[40] Conf. Hr'g Tr. Mar. 27, 2014 at 135:10-15 (Mr. Cohen: "They would like this witness to offer valuation testimony when he just told you he didn't do a valuation on the assets of the company, which are the spectrum and the satellites. We don't think . . . it meets the standards under [*Federal Rule of Evidence] 702*."); 137:1-140:21 (Mr. Cohen: "And with respect to those issues, I think he . . . acquired them for purposes of this case in **[**58]** the last five weeks. I don't think that makes him an expert.").

Reynertson was not offered as an FCC expert. (See id. at 152:9-19 (explaining, for GLC Valuation Report, "[w]hat we did was evaluate each of the individual blocks of spectrum that LightSquared either owns, leases or has an option to auction on, and evaluated the risk associated with the interference issues, which are widely known, and determined with conversations with Hyslop and the research what the ultimate available footprint might look like"); 164:19-24 (purporting to identify range of risks in spectrum blocks); 235:2-10.)[41]

Mr. Reynertson's analysis utilized Mr. Hootnick's valuation methodology but changed many of the inputs, including (a) reducing the amount of available spectrum by 10 MHz by applying two 5 MHz guard bands as a result of purported interference concerns and (b) discounting the price per MHz/POP from the price used by Mr. Hootnick by assuming that LightSquared's License Modification Application would not be approved. (GLC Valuation Report at 12.)

With respect to the reduction by 10 MHz of LightSquared's spectrum for a guard band, the GLC Valuation Report concludes that "[a]fter resolution of the technical issues facing LightSquared spectrum, the Company will have 15-30 MHz of useable spectrum." (GLC Valuation Report at 12; Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 159:21-160:6.) This reduction of LightSquared's spectrum footprint was based, in part, on the alleged need to designate 50 percent of LightSquared's Uplinks as unusable guard bands due to certain alleged interference issues.

Mr. Reynertson testified that he based his conclusions on the opinions of Mr. Hyslop. **[*81]** (See Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 246:15-247:7.) **[**61]** However, with respect to the use of guard bands, Mr. Reynertson could not have relied on Mr. Hyslop's opinion when he wrote the GLC Valuation Report (which was completed on March 4, 2014) or when he testified at his deposition (on March 5, 2014) because Mr. Hyslop did not think about a guard band as a potential solution until some days or weeks after his own deposition on March 8, 2014. (See Motion to Strike Hyslop and Reynerston ¶¶ 14-19, 32-34.) In addition, Mr. Reynertson conceded that if the "guard band" assumption that underlies his report is mistaken or unsupported, that will moot the portion of the GLC Valuation Report based thereon. (See Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 221:9-14 (conceding reliance on Hyslop to subtract 5 MHz for guard band, and, if that number is wrong, it would affect opinion).)

Many aspects of Mr. Reynertson's testimony are noteworthy: (i) he had never previously valued satellites or spectrum (see Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 126:14-23); (ii) he applied certain faulty and arbitrary assumptions in his valuation methodology (see fn 41, *supra*); and (iii) he was not provided with the valuation analyses that had been prepared by Mr. Ergen and by PWP during the summer **[**62]** of 2013, and, when presented with such analyses at the Confirmation Hearing, he admitted that seeing these would have helped him and may have changed what he did in connection with forming his opinions.[42]

The GLC Valuation Report was rife with inconsistencies and flaws; it was on the whole an unimpressive piece of work and will not be afforded significant weight. In addition, a portion of Mr. Reynertson's testimony relied on the expert opinion of Mr. Hyslop. As the Court finds that portions of Mr. Hyslop's expert opinion shall be

[41] Mr. Reynertson, using his own judgment, made reductions to the value of LightSquared's spectrum based on the "risk" **[**59]** associated with achieving regulatory approval. (See Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 164:19-24 (noting that page 12 of GLC Valuation Report reflects "the sum of the proposed 2021 numbers the debtors hope to achieve, and then a reduction for the risks that we saw, the range of risks that we saw in each of the blocks").) Mr. Reynertson, however, could not assess those risks himself and did not have anyone upon whom he could rely to do so. He also drew his own conclusions as to which interference issues are insurmountable or, alternatively, would cause reductions in the value of the spectrum. (See id. at 164:19-24.) For example, he deducted from the value of LightSquared's spectrum the costs of relocating NOAA from its current spectrum block as a result of the granting of the License Modification Application. (See Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) 38:2-42:14 (discussing inaccuracies in the GLC Valuation Report).) In addition, Mr. Reynertson improperly discounted twice for the same purported "defect" in the uplink spectrum: the "guard bands" he created in the Uplinks are intended to "cure" the purported interference issues, yet he valued the remaining 5 MHz of spectrum in each uplink band **[**60]** as if the interference "problem" had not been resolved, and FCC approval had not been obtained.

[42] The first time Mr. Reynertson saw the PWP Valuation and the Ergen Valuation was at his deposition on March 5, 2014, the day after he completed the GLC Valuation Report. (Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) 144:24-146:1.) Mr. Reynertson acknowledged that reviewing these reports would have been "informative" and would "have helped [him] understand how other sophisticated investors have looked at this spectrum." (Id. at 249:24-250:5.)

stricken from the record, as discussed *infra*, the portion of the GLC Valuation Report that relies on the stricken Hyslop testimony shall be afforded little weight.

V. CONFIRMATION TESTIMONY REGARDING THE "TECHNICAL ISSUE"[43]

A. Mr. Douglas Hyslop

SPSO called Mr. Douglas Hyslop of Wireless Strategy LLC and SmartSky Networks LLC, engineering consulting firms which provide engineering services for wireless operators. (Conf. Hr'g Tr. Mar. 25, 2014 (Hyslop) [under seal].) SPSO retained Mr. Hyslop to provide expert testimony on the "technical issue." Mr. Hyslop was retained on February 28, 2014 and formed his opinions by March 3, 2014; his deposition was conducted on March 8, 2014. The Debtors have moved to strike a portion of Mr. Hyslop's testimony on the basis that it reflects, in his own words, a new opinion regarding "guard bands" that first occurred to him after he gave his deposition testimony and thus was first revealed to the Debtors at the Confirmation Hearing. (See Motion to Strike Hyslop and Reynertson at ¶¶ 2-3, 20-31.) The parties dispute whether or not this opinion should be considered "new" and **[*82]** whether or not gamesmanship is implicated in the Debtors' approach to eliciting the opinion. For the reasons set forth in the Debtors' Motion to Strike Hyslop and Reynertson, the motion shall be granted as to Mr. Hyslop, and the requested portions of Mr. Hyslop's **[**64]** testimony shall be stricken from the record. The remainder of Mr. Hyslop's testimony, as to which the Court makes detailed findings under seal, does not lend credible support to SPSO's position with respect to the existence and magnitude of the "technical issue." (See Appendix A (filed under seal).)

B. Mr. John Jacob Rasweiler V

Mr. John Jacob Rasweiler V testified as the Debtors' rebuttal expert with respect to the "technical issue." (Conf. Hr'g Tr. Mar. 28, 2014 (Rasweiler) [under seal].) Mr. Rasweiler is employed by Sublime Wireless, a professional engineering and services firm that provides communications services for operators and equipment providers such as Sprint, Samsung, and AT&T. He has substantial experience in radio frequency engineering and network design. In response to SPSO's contentions with respect to the "technical issue," Mr. Rasweiler provided credible and compelling testimony that the "technical issue" is unlikely to exist at all and that, even if it did exist, technology is available today that can eliminate the problem, rendering it a non-issue. In addition, Mr. Rasweiler identified new technology which, while not currently in commercial production, reflects further **[**65]** advances in certain devices that could be deployed to address the "technical issue." Mr. Rasweiler's testimony substantially undercut the credibility of Mr. Hyslop's conclusions with respect to many critical aspects of the "technical issue" alleged by SPSO. (See Appendix A (filed under seal).)

DISCUSSION

I. THE PLAN CANNOT BE CONFIRMED

A. Separate Classification of Prepetition LP Facility SPSO Claim Complies With Section 1122

Under the Plan, the Prepetition LP Facility SPSO Claim is placed in a separate class (Class 7B) from the Prepetition LP Facility Non-SPSO Claims (Class 7A). The proffered justification for such separate classification of claims which, on their face, are identical is not equitable subordination but rather that the holder of the SPSO Claim is a competitor of the Debtors that has various non-creditor interests and that there is thus a valid business reason for separately classifying the SPSO Claim. SPSO vehemently opposes separate classification of its claim. For the reasons set forth herein, the Court finds that such separate classification is permitted by the Bankruptcy Code and applicable case law.

HN1[] *Section 1122(a) of the Bankruptcy Code* provides that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or **[**66]** interests of such class." See *11 U.S.C. § 1122(a)*. Although *section 1122(a)* specifies that a claim or an interest may only be included in a particular class if it is "substantially similar" to the other claims or interests in such class, it does not *require* that all similar claims be placed in a single class, nor does it address when similar claims may be placed in different classes. Stated differently, the Bankruptcy Code does not prohibit

[43] See fn **[**63]** 19, *supra*; Appendix A (filed under seal).

placing similar claims in separate classes.

Courts that have considered the issue, including the Court of Appeals for the Second Circuit as well as numerous courts in this District, have concluded that **[*83]** the separate classification of otherwise substantially similar claims and interests is appropriate so long as the plan proponent can articulate a "reasonable" (or "rational") justification for separate classification. See, e.g., *Aetna Cas. and Sur. Co. v. Clerk, U.S. Bankr. Ct., New York, N.Y. (In re Chateaugay Corp.), 89 F.3d 942, 949 (2d Cir. 1996)*; *In re Lafayette Hotel Partnership, 227 B.R. 445*, aff'd, *198 F.3d 234 (2d Cir. 1999)*; *In re Adelphia Commc'ns Corp., 368 B.R. 140, 246-247 (Bankr. S.D.N.Y. 2007)*. Whether there is any "good business reason" to support a plan proponent's separate classification is a question of fact. *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture), 995 F.2d 1274, 1279 n. 7 (5th Cir. 1991)*, cert. denied, *506 U.S. 821, 113 S. Ct. 72, 121 L. Ed. 2d 37 (1992)*. However, the "separate classification of substantially similar . . . claims . . . [must not] offend one's sensibility of due process and fair play." *In re One Times Square Assocs. Ltd. P'ship, 159 B.R. 695, 703 (Bankr. S.D.N.Y. 1993)*.

HN2[] One such reasonable justification for separate classification **[**67]** is where a claimant is a competitor of the debtor. See, e.g. *In re Premiere Networks Servs., Inc., 333 B.R. 130, 133-34 (Bankr. N.D. Tex. 2005)* ("a non-creditor interest in the reorganized debtor meets the 'good business reason' standard and justifies separate classification of the creditor's claim"); *In re Graphic Commc'ns, Inc., 200 B.R. 143 (Bankr. E.D. Mich. 1996)* (holding that a rational business reason existed for classifying competitor separately from general trade creditors); *In re Texas Star Refreshments, LLC, 494 B.R. 684, 696 (Bankr. N.D. Tex. 2013)* (separately classifying trade creditors from competitor creditor). Importantly, it is not merely the creditor's status as a competitor that is dispositive so much as the "non-creditor" interests that the creditor-competitor may pursue. In Premiere Networks, for example, the separately classified creditor's "non-creditor interest" was "a different stake in the future viability of the reorganized company." *333 B.R. at 134*.[44]

The parties also cite to *In re 500 Fifth Ave. Assocs., 148 B.R. 1010 (Bankr. S.D.N.Y. 1993)*, but disagree on its applicability here. In 500 Fifth Ave. Assocs., the debtor isolated the unsecured deficiency claim of a secured creditor in a separate plan class from other recourse unsecured claims, arguing that such treatment was justified due to the legal distinction between non-recourse deficiency claims and other unsecured claims. *Id. at 1019*. The court found that separate classification was not justified because the deficiency claim of the secured lender was an allowed, unsecured claim that was no different in a bankruptcy case from the obligation owed to a recourse creditor, and it also found that the separate classification of the deficiency claim was based on the debtor's clear desire to gerrymander an impaired accepting class to ensure confirmation of its plan. Id. The court, perhaps presaging Judge Gerber's views in *Adelphia, 368 B.R. 140*, observed that the fact that a creditor's secured claim may drive the manner in which it votes its unsecured deficiency claim (which may be contrary to **[*84]** its best interests as an unsecured creditor) is not a valid reason for separately classifying a secured **[**69]** creditor's deficiency claim. Id.

SPSO, relying on 500 Fifth Ave. Assocs., argues that a secured creditor's "motives and agenda" cannot justify separate classification of a creditor's claims and that the Court should focus, instead, on the legal nature of the underlying claim. The Debtors and the Ad Hoc Secured Group argue that 500 Fifth Ave. Assocs. merely addresses the separate classification of a secured creditor's garden variety unsecured deficiency claim, and it does not address the propriety of separately classifying the claim of a competitor creditor "whose sole interest was to acquire the company by one means or another."[45] The Court agrees.

While SPSO urges that the Court should decline to delve into an analysis of ulterior motives, and poses myriad hypotheticals to demonstrate instances in which

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[44] In addition to a creditor being a competitor, other justifications for separate classification cited to the Court by the Debtors include (i) ulterior motives demonstrated by the creditor's conduct during a debtor's case and (ii) necessity. *LightSquared's Post-Trial Memorandum of Law in Further Support of (I) Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code, (II) Motion To Designate Vote of SP Special Opportunities, **[**68]** LLC, and (III) Motion Seeking Approval of New DIP Facility* [Docket No. 1486] at 78, 82-86.

[45] *LightSquared's (A) Memorandum of Law in Support of Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code and (B) Omnibus Response to Objections to (i) Confirmation of Plan, (ii) Motion To Designate Vote of SP Special Opportunities, LLC, and (iii) Motion Seeking Approval of New DIP Facility* [Docket No. 1413] at 19 n.24.

evaluation of a classification **[**70]** scheme based on claim holder considerations would be a "complicated and arbitrary line-drawing exercise,"[46] there is no need to go down that path here. SPSO's different stake in the future of LightSquared is manifest and does not require a searching inquiry into ulterior motives. Although, as a general matter, *500 Fifth Ave. Assocs*. does indeed hold that, ***HN3***[] when considering classification issues, the focus should be on the legal nature of the underlying claim rather than on the motives and agenda of the claim holder,[47] here it is necessary to recognize that a claim reflects more than a dollar amount on a proof of claim; it reflects a bunddle of rights and remedies that are wielded by the holder of the claim. Accordingly, both the nature of the claim and the identity of the claimant may be relevant in the context of separate classification.

While SPSO (as opposed to DISH or Mr. Ergen) is the holder of the SPSO Claim, the Court finds that, under the circumstances here, SPSO, **[**71]** which is wholly-owned by Mr. Ergen, the Chairman of the Board of Directors and controlling shareholder of DISH, must be considered to have interests which are aligned with those of DISH, which is a competitor of the Debtors.[48] Notwithstanding Mr. Ergen's reluctance to admit as much, the record makes it clear that (a) both DISH and the Debtors own spectrum assets; (b) DISH has been and remains active in the market to acquire more spectrum assets and/or to engage in transactions with third parties that own spectrum assets;[49] (c) **[*85]** Mr. Ergen himself purports to having an interest in owning spectrum "personally" (if his testimony in the Adversary Proceeding is to be credited); and (d) both DISH and the Debtors have announced their intention to develop and operate telephonic networks that would utilize spectrum assets and that would compete with each other for customers and business.[50] The Debtors and the Ergen Parties (one of which is SPSO) are competitors for spectrum assets under any reasonable meaning of the word.[51]

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[46] *Objection of SPSO to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1408] at 7 n.5.

[47] See *500 Fifth Ave. Assocs., 148 B.R. at 1019-20* (citing 5 L. King, COLLIER ON BANKRUPTCY pp. 1122.03[1]-[b](15th ed.1992)).

[48] This Court has previously found that "one could reasonably expect a competitor to vote differently than a non-competitor lender on material matters concerning LightSquared, and, more **[**72]** significantly, a competitor given access to material non-public information about LightSquared may use it to LightSquared's detriment, given that a competitor may possess a desire to see LightSquared fail." Adversary Proceeding Decision at 128.

[49] Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) at 17:13-18:7 (explaining how DISH and LightSquared were competitors prior to the commencement of the Chapter 11 Cases: "It's clear what DISH's business plan was having experienced it and read about it in other matters where [Ergen] was looking to build a network, LightSquared was looking to get its spectrum issues behind it and build a network, or had been building a network until the spectrum issues popped up. They'd be competing for handset designs, customer designs. In fact, LightSquared had a deal with Sprint to be the backbone of their infrastructure before the filing. In the months before, DISH was making — Ergen was making a competing hostile offer to buy Sprint. So they might have been competing for kind of parties that could support the infrastructure as well"); Conf. Hr'g Tr. Mar. 27, 2014 (Reynertson) at 209:10-13) (acknowledging that DISH will be a direct competitor of LightSquared following LightSquared's emergence from bankruptcy, "I think DISH intends to **[**73]** — presumably intends to become a competitor. Certainly the marketplace thinks that they intend to become a competitor"); Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 328:15-329:15 (admitting that (a) both DISH and LightSquared had previously sought (in LightSquared's case) to partner with or (in DISH's case) acquire Sprint as part of their respective spectrum-deployment strategies, and (b) DISH and LightSquared, each owners of valuable spectrum assets, will compete in the marketplace for lucrative partnership arrangements).

[50] DISH was seeking, among other things, to acquire spectrum in competition with LightSquared, to develop handsets in competition with LightSquared, and to take control of Sprint, with which LightSquared had hoped to join in building its network. (See Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) at 15:18-18:7; Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 26:21-29:10 (explaining circumstances of LightSquared's relationship with Sprint and the difficulties that SPSO could have caused if it had been a lender at the time LightSquared first negotiated and entered into its agreement with Sprint and could cause in the future for negotiation of similar contractual arrangements).

[51] In fact, as early as the spring of 2013, Mr. Zelin **[**74]** suggested placing SPSO in a separate plan class because, despite not knowing with certainty the identity of SPSO, the parties suspected it was a competitor. (Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) 17:13-18:7 (explaining basis for Ad Hoc Secured Group separately classifying SPSO's claims in restructuring proposal in May 2013 to LightSquared: "I think in our judgment and the judgment of our clients, Ergen, whether he was SPSO, whether he was LBAC, the initials didn't make a difference to me, Ergen was Ergen. He was a competitor, somebody who would have competing interests").)

Given Mr. Ergen's interests as the sole beneficial owner of SPSO and as the Chairman of the Board of Directors and controlling shareholder of DISH, it is not hard to conjure a set of facts and circumstances in which he personally would benefit more from LightSquared's failure than its success; stated differently, his fiduciary duties as the Chairman of the DISH Board may at some point require him to take action that is contrary to the best interests of LightSquared and contrary to his interests as a creditor (through SPSO) of LightSquared LP. As Mr. Ergen himself made clear in pursuing his so-called personal bid for **[**75]** LightSquared's spectrum through LBAC, preserving optionality for DISH is a hallmark of his ongoing strategy for DISH in these cases, and more generally. See Adversary Proceeding Decision at FOF ¶ 178. Optionality for DISH should not come at the expense of the interests of LightSquared's creditors who do not share Mr. Ergen's economic interest in and lifelong commitment to DISH.

Since becoming a holder of LP Debt, SPSO and Mr. Ergen have acted to further **[*86]** the interests of DISH and EchoStar with respect to LightSquared and its spectrum assets, which interests are different from the interests of LightSquared's other creditors. At all relevant times, SPSO has acted in a manner which is consistent with DISH's strategic motivations, instead of as an ordinary creditor, and also has taken steps that had the potential to destroy LightSquared's value and interrupt its business plans and operations, including the following:

▪ SPSO deliberately delayed the closing of trades of LP Debt, which created uncertainty as to ownership and impeded LightSquared's negotiation of a consensual plan of reorganization. (Adversary Proceeding Decision at 155, 166-67.)

▪ Mr. Ergen told the DISH Board that SPSO's blocking position was available to facilitate **[**76]** an acquisition of LightSquared's spectrum by DISH. (Adversary Proceeding Decision FOF ¶¶ 131-32.)

▪ When DISH did not act quickly enough, Mr. Ergen himself undertook to do so, by submitting a "personal" bid for LightSquared's most significant assets. Mr. Ergen later sold LBAC (and thus the option to purchase LightSquared's assets through such bid) to DISH for $1. (Adversary Proceeding Decision FOF ¶¶ 136-37, 161-62.)

▪ SPSO and the Ergen Parties negotiated and bound the Ad Hoc Secured Group to a plan that would effectuate the DISH/LBAC Bid and prevent the Ad Hoc Secured Group from negotiating any other plan with LightSquared and its other stakeholders. (Adversary Proceeding Decision FOF ¶¶ 273-74.) In January 2014, they withdrew the DISH/LBAC Bid. (See fns 26-27, *supra*.)[52]

▪ Although the Ad Hoc Secured Group filed its Motion to Enforce, seeking to compel specific performance of the DISH/LBAC Bid and advance its creditor interests (which would have paid SPSO almost in full), SPSO declined to support that effort and, instead, allowed its lawyers to act for DISH and LBAC in opposing and defeating such motion. (See *Objection of L-Band Acquisition, LLC to the January 13, 2014 Statement of the* **[**77]** *Ad Hoc Secured Group of LightSquared LP Lenders and Notice of Intent To Proceed with Confirmation of the First Amended Joint Chapter 11 Plan and Motion for Declaratory Relief*, dated January 16, 2014 [Docket No. 1232]; *Reply in Further Support of Objection of L-Band Acquisition, LLC to the January 13, 2014 Statement of the Ad Hoc Secured Group of LightSquared LP Lenders and Notice of Intent To Proceed with Confirmation of the First Amended Joint Chapter 11 Plan and Motion for Declaratory Relief*, dated January 21, 2014 [Docket No. 1246]; Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 131:12-138:4.)[53]

[*87] ▪ SPSO and the Ergen Parties spoke to FCC personnel about DISH's plans for LightSquared's spectrum should DISH ultimately acquire it. (Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 22:5-12.)

▪ In the first quarter of 2014, Mr. Ergen met with executives of Inmarsat on two separate occasions. At these meetings, Mr. Ergen discussed LightSquared even though LightSquared is currently negotiating a modification of its cooperation agreement with Inmarsat and such modification is a condition of the Plan. (Conf. Hr'g

[52] During the day of the auction scheduled for December 11, 2013, LBAC's and SPSO's counsel told Mr. Zelin that she hoped that someone else showed up or it would be bad for his clients. (Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) at 37:25-39:3.) Later that same day, after **[**79]** the auction was cancelled by the Special Committee, counsel told the Ad Hoc Secured Group that LBAC was not prepared to close on the terms that they had negotiated. (Id. at 39:4-21.)

[53] Mr. Ergen testified that he did not even talk to SPSO's counsel about the specific performance on behalf of SPSO because he alone viewed the claim as frivolous. (See Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 133:24-142:3.)

Tr. Mar. 26, 2014 (Ergen) at 188:4-190:19; 207:24-209:5.)

▪ SPSO and the Ergen Parties raised a "technical issue" with respect to LightSquared **[**78]** and insisted that notification of the purported "technical issue" be given to all parties evaluating a potential bid in the auction for LightSquared's spectrum scheduled to occur in December 2013. (See Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) at 37:25-39:21; 40:1-43:20; 57:6-18.) DISH's engineers have been told by different vendors, including Huawei and Avago, that the "technical issue" was not an impediment to use of LightSquared's Uplinks. One email from Huawei acknowledged Mr. Ergen's intent to use the "technical issue" as a device to "lower" the acquisition price for LightSquared's spectrum. (PX1026.)

▪ SPSO has argued that the NOAA Spectrum should and would be auctioned, an argument which is not consistent with the interests of an ordinary, non-competitor creditor. (See *Objection of SPSO to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1408] at 37-38; Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 23:8-17.)

While SPSO maintains that is not a competitor of the Debtors because, although it is affiliated with DISH and EchoStar, those companies are in the pay television business while the Debtors own spectrum "but have no ability or authority to use it for commercial purposes,"[54] this position is demonstrably unsupportable and is contrary to Mr. Ergen's sworn testimony.[55] Mr. Ergen clearly has big ambitions for DISH — indeed, DISH is expanding, or at least has the desire to expand, into the terrestrial wireless business. Mr. Ergen has specifically testified that DISH would like to compete with telecommunication companies such as AT&T and Verizon. (Jan. 13, 2014 Hr'g Tr. (Ergen) at 26:18-20; 96:18-98:22; 100:25-101:4.)[56] Doing so requires obtaining spectrum, which Mr. Ergen describes as a limited commodity. (Id. at **[**80]** 47:3-48:10; 96:5-14.) DISH's takeover of DBSD and TerreStar and its failed attempts at transactions with, among others, Clearwire Corp., Sprint Corp., and **[*88]** Inmarsat plc.[57] demonstrate that DISH is an active market participant in the race for spectrum and a player on the every-changing chessboard of spectrum usage. Indeed, DISH's participation in the recently concluded H-block auction has been raised many times in these cases in a variety of contexts.

The fact that the Ergen Parties are competitors of LightSquared is bolstered by the fact that DISH was listed as a "Disqualified Company" under the Prepetition LP Credit Agreement and, as a result, was prohibited from purchasing LP Debt. (Adversary Proceeding Decision FOF ¶¶ 22, 25, 26.) Mr. Ergen's testimony, as well as the testimony of SPSO's valuation expert, Mr. Reynertson, supports the conclusion that DISH and LightSquared are currently competitors, and would continue to be competitors upon LightSquared's emergence from chapter 11. (See, e.g., Mar. 26, 2014 Conf. Hr'g Tr. (Ergen) at 279:18-282:2; 328:15-330:2; Mar. 27, 2014 Conf. Hr'g Tr. (Reynertson) at 209:11-13.) Even if the status of DISH and EchoStar as competitors of LightSquared were not imputable to Mr. Ergen and SPSO (which it is), SPSO is clearly an affiliate of such entities and, by virtue of such affiliation and the common control exercised by Mr. Ergen with respect to these entities, SPSO is properly viewed **[**82]** as a competitor of the Debtors.[58] SPSO's attempts to

[54] See *Objection of SPSO to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1408] ¶ 13, n.4.

[55] Mr. Ergen attempted to disclaim that DISH and LightSquared were competitors. Mr. Ergen testified that (a) LightSquared did not have a network today that could compete with a DISH network of the future and (b) LightSquared did not have the financial wherewithal to bid on other available spectrum and thus did not compete with DISH. (See Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 279:2-282:12.) Mr. Ergen later admitted that both DISH and LightSquared today would compete in the marketplace as sellers of spectrum or as potential partners for other network owners. (See id. at 328:15-330:2.)

[56] Mr. Ergen's January 13, 2014 **[**81]** testimony was given in the Adversary Proceeding trial.

[57] DISH Form 10-K at F-18 (Feb. 21, 2014); Jan. 13, 2014 Hr'g Tr. (Ergen) 95:6-96:4; 101:5-103:5; 105:11-108:10; Mar. 26, 2014 Conf. Hr'g Tr. (Ergen) 328:15-329:15.

[58] See Conf. Hr'g Tr. Mar. 20, 2014 (Smith) at 21:13-25 ("The primary reason [for separately classifying SPSO's claims] is that SPSO is a competitor of LightSquared. . . . [A]s a competitor, and we absolutely view them as a competitor here in that their interests are not those typically of a financial investor, meaning that their actions and behaviors are driven by different motivations."); 28:7-29:10 ("Part of the classification certainly has to do with the competitor status, as I said. And I'd like to illustrate a point. So there are certain rights that our first and second lien holders have. It's [sic] right

distance itself from the overwhelming evidence of its competitor status and interests must be rejected. That being said, SPSO is quite correct in its argument that **HN4**[] separate classification cannot be used to mistreat a creditor, out of personal animosity or otherwise.[59] The unfair discrimination against SPSO reflected in the Plan will be dealt with separately herein.

For all of these reasons, the separate classification of the Prepetition LP Facility SPSO Claim is thus necessary and appropriate. SPSO must be viewed as a competitor **[*89]** of the Debtors with significant "non-creditor" interests, or, in the alternative, SPSO is an affiliate of a competitor controlled by SPSO's ultimate owner, Mr. Ergen. Under the facts and circumstances of this case, the separate classification of SPSO's claim comports with *section 1122* of the Code. It is worth noting that, while the separate classification of the SPSO Claim and the Prepetition LP Facility Non-SPSO Claims is permissible under *section 1122*, that does not mean that it is required; indeed, it is possible to envision a plan of reorganization which classifies *all* Prepetition LP Facility Claims in the same class, subject to being able to navigate successfully the requirements of *section 1123(a)(4)*. Of course, that portion of the SPSO Claim which is equitably subordinated could not be included in such a class absent the consent of all affected parties.

B. SPSO's Vote to Reject the Plan Shall Not Be Designated

HN5[] *Section 1126(e) of the Bankruptcy Code* provides that a bankruptcy court may **[**85]** designate the vote of "any entity whose acceptance or rejection of [a] plan was not in good faith." *11 U.S.C. § 1126(e)*. The seminal decision in this Circuit addressing vote designation is the Second Circuit's 2011 decision in *In re DBSD N. Am., Inc., 634 F.3d 79 (2d Cir. 2011)*, in which the court made the following observations:

> The Code provides no guidance about what constitutes a bad faith vote to accept or reject a plan. Rather, *§ 1126(e)*'s "good faith" test effectively delegates to the courts the task of deciding when a party steps over the boundary. . . . Bankruptcy courts should employ *§ 1126(e)* designation sparingly, as "the exception, not the rule. . . . Merely purchasing claims in bankruptcy "for the purpose of securing the approval or rejection of a plan does not of itself amount to 'bad faith.'" Nor will selfishness alone defeat a creditor's good faith; the Code assumes that parties will act in their own self interest and allows them to do so. . . . *Section 1126(e)* comes into play when voters venture beyond mere self-interested promotion of their claims. "[T]he section was intended to apply to those who were not attempting to protect their own proper interests, but who were, instead, attempting to obtain some benefit to which they were not entitled." A bankruptcy court may, therefore, **[**86]** designate the vote of a party who votes "in the hope that someone would pay them more than the ratable equivalent of their proportionate part of the bankrupt assets," or one who votes with an "ulterior motive," that is, with "an interest other than an interest as a creditor."

Id. at 101-102 (all citations omitted). Moreover, **HN6**[] votes cast by parties who purchase claims in a competitor's bankruptcy case are viewed by courts as being particularly worthy of scrutiny. *Id. at 105, n. 12* (citations omitted); see also *In re Allegheny Int'l, Inc., 118 B.R. 282, 296 (Bankr. W.D. Pa. 1990).*

As described in greater detail in the Vote Designation Motion and the Ad Hoc Secured Group's joinder to that motion [Docket No. 1384] (the "Vote Designation Joinder"), the Debtors maintain that (i) Mr. Ergen's

to information, it's [sic] approval rights. So, for example, under the current LP debt documents, back when we were building our network in 2011, we signed an agreement with **[**83]** Sprint. That was an agreement that needed lender approval. So we had to make them aware of exactly what we were doing before we had signed a document. We had to seek their approval so we got certain waivers so that we could actually enter into that agreement. That's a situation and an example that I would not want a competitor to know what we were doing before we did it. In that case specifically, I understand through press reports and other statements that DISH was also trying to seek a similar agreement with Sprint in and around the same time for a network sharing agreement. And that's something where we can't be effective as a company if that type of information is given to a competitor and they can see the terms of the agreement, they can see exactly what we're doing, and they still have time to go in and try and take it from us. So part of this is governance as well, which is we need to control the information, and part of the position and the treatment that SPSO receives does limit what we have to share with them and it's really focused on the competitive nature of what we're doing.").

[59] *Post Confirmation Trial Brief of SP Special Opportunities, LLC and Objection to Confirmation **[**84]** of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1517] at 42-43.

attempt to secure control of the LP Debtors' assets by purchasing a blocking position in the LP Debt is precisely the behavior the Second Circuit attempted to deter and punish in DBSD and (ii) the behavior of SPSO in these cases is even worse than the behavior of DISH in DBSD. (See Vote Designation Motion at ¶¶ 69-85; Vote Designation Joinder at ¶¶ 10, 14, 16-17.) They allege the following in support of their conclusion:

[*90] • SPSO and the Ergen Parties have followed the DBSD and TerreStar "playbooks" to gain **[**87]** control of a company in distress by buying claims and manipulating the chapter 11 process for their non-creditor interests, but, in this case, they did so with stealth.

• SPSO's purchase of the LP Debt at close to par to acquire a blocking position was part of Mr. Ergen's scheme and not simply, as he testified, to obtain higher returns or to ensure he had "bankruptcy protections" against cramdown.

• Mr. Ergen's overall interest in these cases (as an owner of LP Debt through SPSO and as the majority equity owner of DISH) gives him incentives to help DISH achieve as low a purchase price for the Debtors' assets as possible, in direct contravention of his interests as a creditor.

• Rather than acting in its interests as a creditor, SPSO opposed a near full recovery in cash under the Ad Hoc Secured Group's plan by authorizing its counsel to object to the Ad Hoc Secured Group Motion to Enforce and to seek a declaratory judgment that the DISH/LBAC Bid was terminated.[60]

And, once again, the Debtors **[**88]** and the Ad Hoc Secured Group urge that the bad acts of all Ergen Parties other than SPSO should be imputed to SPSO for purposes of vote designation. (See *Corrected Post-Trial Confirmation Brief of the Ad Hoc Secured Group of LightSquared LP Lenders* [Docket No. 1494] at 70 (pointing out that "[i]f this were not the case, it would be easy to eviscerate the protections intended by section 1126(e) by simply forming multiple entities and having one buy claims while the others engaged in disruptive inequitable conduct—exactly as the Ergen Parties did here").) While there is certainly truth to such an observation, those are not the facts before the Court with respect to vote designation. Moreover, whether or not the alleged bad acts of all the Ergen Parties (including LBAC) can be imputed or attributed to SPSO, the Court finds that SPSO's vote to reject the Plan cannot be designated.

What the Debtors and the Ad Hoc Secured Group ignore is the fact that, as will be discussed in detail below, the Third Amended Plan is unconfirmable for a variety of reasons, not the least of which is the unpalatable treatment it affords the SPSO Claim. Where a creditor votes to reject a plan for an admixture of reasons, some of **[**89]** which can be characterized as being consistent with the interests of a creditor acting to protect its legitimate creditor interests, its vote cannot be designated. SPSO has voted against a plan that not only deprives it of its first lien security interest but provides it with plan consideration that is virtually indistinguishable from equity interests. It is not at all surprising that SPSO declined to accept such treatment; the other members of the Ad Hoc Secured Group would most certainly have done likewise. Indeed, Mr. Falcone could not even interest Mr. McKnight in taking that treatment on account of the LP Preferred Equity Interests held by Fortress.[61]

[*91] While the Debtors urge that DBSD compels designation of SPSO's vote to reject the Plan, to do so would materially extend the reach of DBSD in ways that section 1126(e) does not contemplate. The centerpiece of the Second Circuit's decision in DBSD was its observation **[**90]** that a competitor of DBSD (DISH) "bought claims with the intent of voting against any plan that did not give it a strategic interest in the reorganized company," and it bought those claims above par and after a plan had been proposed by DBSD. *DBSD, 634 F.3d at 104*. So too in Allegheny, in which creditor Japonica purchased its claims after balloting on a plan had already begun. *In re Allegheny Int'l, Inc., 118 B.R. at 286*. As Judge Gerber noted in DBSD, DISH intended "to use [its] status as a creditor to provide advantages over proposing a plan as an outsider or making a traditional bid for the company or its assets." *DBSD, 421 B.R. at 139-40*. However, both Judge Gerber and the Second Circuit were particularly focused on the timing of DISH's debt purchases which were made after the plan in *DBSD* had been filed. Here, SPSO made no

[60] See Vote Designation Motion at ¶¶ 69-85; Vote Designation Joinder at ¶¶ 10, 14, 16-17; *Corrected Post-Trial Confirmation Brief of the Ad Hoc Secured Group of LightSquared LP Lenders* [Docket No. 1494] at 70.

[61] Mr. Falcone offered to move Fortress' and the other LP preferred holders' claims ahead of the SPSO Claim. (SPX069 ("Then move it ahead of charlie."); SPX071 ("What if we move the LP pref ahead of Charlie?"); SPX070 ("We are working on elevating the pref ahead of Charlie. Will that help?").)

purchases of debt above par and acquired a significant portion (approximately $287 million) of its claim before the Chapter 11 Cases were commenced, when the LP Debt was trading at or below approximately 60 cents on the dollar; moreover, SPSO acquired all of its LP Debt below par and prior to the filing of any plan.[62] SPSO is thus arguably, at least in part, a "pre-existing creditor,"[63] albeit one who has allegedly voted with strategic intentions — **[**91]** the type of creditor that the Second Circuit did not expressly include in the ambit of its prohibition on voting in connection with strategic claims acquisitions. DBSD, 634 F.3d at 106. The Court declines to extend the holding of DBSD to cover votes cast with respect to claims which were acquired before a plan had been proposed by any party and where, as discussed below, there are valid, economically self-interested creditor reasons for the holder of such claims to reject a proposed plan.

While courts in this District and elsewhere have held that HN7[] casting a vote on a plan to gain more than one deserves is evidence of bad faith, it takes more than evidence of simply a selfish or aggressive attempt to maximize recovery to demonstrate bad faith. See, e.g., Adelphia, 359 B.R. 54, 63-64 (Bankr. S.D.N.Y. 2006) (declining to designate votes of creditor who held claims against two different Adelphia debtors and who cast votes with respect to one set of claims with ulterior purpose of increasing its recovery on the claims it held against another debtor). Judge Gonzalez had occasion to analyze **[**92]** the issue of alleged "mixed-motive" voting post-DBSD in the case of In re GSC, Inc., 453 B.R. 132 (S.D.N.Y. 2011). In GSC, there were allegations that a creditor, Black Diamond, had voted against a plan in order to pursue a sale transaction that would have given it more than its ratable share of the debtors' assets. In analyzing whether there was evidence to this effect, Judge Gonzalez observed that, even if there were such evidence, the objectors would have needed to establish Black Diamond's intent to pursue this alternative at the time of voting and that, even if the objectors could have succeeded in making such a showing, the objectors would "have had to further prove that Black Diamond's *sole* or *primary* goal in rejecting the [p]lan was to benefit at the expense of other **[*92]** creditors." Id. at 161 (emphasis in original). Stated differently, HN8[] vote designation should not be ordered where a creditor can articulate a valid business reason for rejecting a plan even if such rejection may also be consistent with such creditor's non-creditor interests. See also In re Figter Ltd., 118 F.3d 635 (9th Cir. 1997) (denying vote designation where creditor acted to preserve what he reasonably perceived as his fair share of the debtor's estate); In re Landing Assocs., Ltd., 157 B.R. 791, 807-08 (Bankr. W.D.Tex. 1993) (noting that creditors act with a variety of motives and evaluating **[**93]** an admixture of creditor-related and non-creditor-related motives); In re Dune Deck Owners Corp., 175 B.R. 839, 845 (S.D.N.Y. 1995) (stating that court must decide whether the creditor opposes the plan because of how it affects his claim, or instead, because the creditor really seeks to obtain some collateral advantage in another capacity and has voted without regard to the treatment of its claim). Here, there is an ample basis to find that, notwithstanding SPSO's alleged ulterior motives, its non-creditor/competitor interests, and its demonstrably inequitable conduct in acquiring at least a substantial portion of its claim, it cast its vote to block a plan that provided it with abysmal treatment that no similarly-situated creditor would have accepted.

The Debtors would have the Court conflate the provisions of section 1126(e) and section 510(c) and hold that a finding of inequitable conduct sufficient to support equitable subordination of a creditor's claim necessarily translates into the basis for designating the bad actor's vote. Moreover, the Debtors would seek to transform vote designation into a substantive treatment provision. The Court declines to read section 1126(e) so broadly; in the plain words of the statute, HN9[] designation may be ordered with respect to "any entity whose acceptance **[**94]** or rejection of such plan was not in good faith." It is vote-specific and plan-specific. It focuses on the voting conduct of the creditor holding the claim. Simply put, had SPSO voted to reject a plan that proposed to pay it in full in cash or a plan proposing that SPSO receive some other treatment that was accepted by the non-SPSO holders of LP Debt, SPSO's good faith in rejecting such a plan would be open to serious question. Indeed, as SPSO itself ironically points out in drawing a distinction between this case and DBSD, "[i]t is one thing to designate a creditor that votes against a [p]lan that manifestly compensates the designated stakeholder's economic expectations *in full*" but quite another thing to designate SPSO's vote on this Plan.[64]

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[62] See Adversary Proceeding Decision FOF ¶¶ 63, 89.

[63] It is unclear exactly what the Second Circuit intended by the words "pre-existing" — i.e., pre-petition or pre-plan proposal.

[64] *Post Confirmation Trial Brief of SP Special Opportunities, LLC and Objection to Confirmation of Debtors' Third Amended*

Here, while it is not subject to credible dispute that SPSO has non-creditor interests, its vote to reject this demonstrably unconfirmable plan cannot be designated, especially when to do so would arguably render the protections of *section 1129(b)* inapplicable.

C. Because [95] SPSO's Vote Cannot be Designated, the Cramdown Requirements of *Section 1129(b)* Are Applicable to Class 7B**

HN10[] Pursuant to *section 1129(b)(1) of the Bankruptcy Code*, the Court may confirm a plan over a dissenting impaired class of claims so long as the plan is "fair and equitable" and does not "discriminate unfairly" with respect to the dissenting class. *11 U.S.C. § 1129(b)(1)*. See, e.g., *Kane v. Johns-Manville Corp. (In re Johns-Manville Corp.), 843 F.2d 636, 650 [*93] (2d Cir. 1988)*; *In re Chemtura Corp., 439 B.R. 561, 592, n. 131 (Bankr. S.D.N.Y. 2010)*. The Plan satisfies neither requirement with respect to Class 7B.

1. The Plan Is Not Fair and Equitable With Respect to Class 7B

HN11[] A plan is fair and equitable with respect to a class of secured claims if it satisfies one of the three alternatives set forth in *section 1129(b)(2)(A)*. The plan must provide (i) that the holders of such claims (a) retain their liens on the same collateral, to the extent of the allowed amount of such claims and (b) receive deferred cash payments of a value equal, as of the effective date of the plan, to the value of the secured creditors' interests in the estates' interests in such collateral; (ii) for the sale of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens to comply with clause (i) or (iii) of *section 1129(b)(2)(A)* (a provision which the parties agree is not **[**96]** applicable here); or (iii) for the realization by such holders of the indubitable equivalent of such claims. *11 U.S.C. § 1129(b)(2)(A)*.

The Plan is not fair and equitable with respect to Class 7B. Although the parties here disagree as to whether the Plan must comply with *section 1129(b)(2)(A)(i)* or *section 1129(b)(2)(A)(iii)* with respect to SPSO, see *RadLAX Gateway Hotel, LLC v. Amalgamated Bank, U.S. , 132 S. Ct. 2065, 2072, 182 L. Ed. 2d 967 (2012)*, the Plan fails to satisfy either subsection. On its face, the Plan does not comply with *subsection (A)(i)* inasmuch as it replaces SPSO's first lien with a third lien. Since the SPSO Claim will not be subordinated in its entirety, the analysis of this species of "fair and equitable" treatment ends there.

Nor does the Plan fare better under ***HN12***[] *section 1129(b)(2)(A)(iii)*, which requires the realization by the creditor of the "indubitable equivalent" of its claims. *11 U.S.C. § 1129(b)(2)(A)(iii)*. In DBSD, the bankruptcy court held that, although "indubitable equivalent" is not defined in the Bankruptcy Code, "courts generally will find the requirement satisfied where a plan both protects the creditor's principal and provides for the present value of the creditor's claim." *DBSD, 419 B.R. at 207* (citing *In re Sparks, 171 B.R. 860, 866 (Bankr. N.D. Ill. 1994)*). The court continued, stating that "courts focus on the value of the collateral relative to the secured claim, and the proposed interest rate of the facility providing the indubitable equivalent." Id. Courts have **[**97]** held that the "indubitable equivalent" standard requires that there be no doubt that replacement recoveries are equal to existing security interests. See *In re Philadelphia Newspapers, LLC, 599 F.3d 298, 310 (3d Cir. 2010)* ("Thus the 'indubitable equivalent' under *subsection (iii)* is the unquestionable value of a lender's secured interest in the collateral."); see also *In re Salem Suede, Inc., 219 B.R. 922, 935 (Bankr. D. Mass. 1998)* (requiring that "there [be] no reasonable doubt that [the subject creditor] will receive the full value of what it bargained for") (internal citation omitted).

Here, the Plan proposes to give SPSO the SPSO Note, which (i) accrues PIK interest at the rate of LIBOR plus twelve percent, (ii) has a seven year maturity, and (iii) is secured by a third-priority lien on all of the assets of the New LightSquared Entities. SPSO argues that the SPSO Note does not represent the indubitable equivalent of its claim because, among other things, (a) the value of such note will be highly speculative as of the Effective Date of the Plan; (b) such note does not provide for postpetition interest accrued through **[*94]** the Effective Date; (c) such note contains economic terms that are inferior to those SPSO enjoys pursuant to the Prepetition LP Facility, as the SPSO Note provides for the payment of interest in kind, rather than **[**98]** in cash, and its seven-year maturity is longer than the four-year maturity under the Prepetition LP Facility; and (d) such note will be subject to more rigorous transfer restrictions and be less liquid than SPSO's Prepetition LP Facility Claim, while at the same time containing

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Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code [Docket No. 1517] at ¶ 185.

reduced covenant protections for SPSO.[65]

The Debtors submit that the SPSO Note will provide SPSO with the indubitable equivalent of its claim by providing SPSO with payment in full. To determine whether the SPSO Note provides for the indubitable equivalent of the SPSO Claim, the Debtors suggest that the Court must (i) compare the value of the collateral securing the SPSO Note to the value of the SPSO Claim to ensure SPSO's principal is protected and (ii) analyze the interest rate and maturity of the SPSO Note to ensure SPSO is receiving the present value of its claim; if an equity cushion can be shown, the Debtors argue, indubitable equivalence is established. (See Conf. Hr'g Tr. May 6, 2014 at 70:1-81:4.) Pointing **[**99]** to the Moelis Valuation Report, a collateral valuation with a midpoint of $7.7 billion, the Debtors argue that the full principal value of the SPSO Claim would be more than sufficiently protected by a third-lien note on the existing collateral securing the Prepetition LP Facility. (See id.)

Nevertheless, to "erase any shadow of doubt (to the extent any such doubt existed), that SPSO was not receiving fair and equitable treatment,"[66] the Debtors emphasize that the Plan enhances SPSO's collateral package by providing SPSO with a third lien on existing collateral as well as a lien on certain *new* collateral,[67] including substantially all of the assets of NewCo and its direct and indirect subsidiaries.[68] The SPSO Note, according to the Debtors, is thus secured by a new collateral package that is more "expansive" than that provided under the Prepetition LP Facility;[69] and the Ad Hoc Secured Group argues that this so-called "additional collateral," which includes the assets of LightSquared Inc., increases SPSO's collateral package by at least hundreds of millions of dollars, given the value of the Inc. Debtors. (See *Corrected Post-Trial Confirmation Brief of the Ad Hoc Secured Group of LightSquared* ***[**100] [*95]*** *LP Lenders* [Docket No. 1494] at 75-76; see also Mar. 26, 2014 Conf. Hr'g Tr. (Ergen) 43:2-13 (testifying that, in the new proposal sent by SPSO on December 31, 2013, SPSO was willing to pay $348 million dollars for the Inc. Debtors' assets); Mar. 24, 2014 Conf. Hr'g Tr. (Hootnick) 60:9-16 ("Moelis has never been asked nor have we done a separate valuation for the Inc. assets. We . . . believe it to be worth at least a few hundred million dollars. I know that other parties in this room believe they could be worth as much as a billion dollars. We don't have a full presentation nor have we gone to an internal committee to give you a decided-on view, but I think it's safe to say that it's worth a few hundred million dollars.")).[70]

SPSO disagrees entirely. In addition to disputing the Debtors' valuation **[**102]** and projections, SPSO argues that the third lien it will receive under the SPSO Note cannot satisfy indubitable equivalence where SPSO currently purports to enjoy a first lien. (*Objection of SPSO to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1408] at ¶¶ 82-87).

HN13[] While some courts have held that a subordinated lien can constitute the indubitable equivalent of a secured creditor's claim under *section 1129(b)(2)(A)(iii)*, such cases are few and far between. See, e.g., *Woods v. Pine Mountain, Ltd. (In re Pine*

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[65] *Post Confirmation Trial Brief of SP Special Opportunities, LLC and Objection to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1517] at ¶ 158.

[66] *LightSquared's (A) Memorandum of Law in Support of Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code and (B) Omnibus Response to Objections to (i) Confirmation of Plan, (ii) Motion To Designate Vote of SP Special Opportunities, LLC, and (iii) Motion Seeking Approval of New DIP Facility* [Docket No. 1413] at ¶ 175.

[67] Because the SPSO Claim will not be subordinated in its entirety, it must be considered a secured claim for purposes **[**101]** of the cramdown analysis.

[68] See *Notice of Filing of Clean and Blackline Versions of (A) Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code, (B) Debtors' Third Amended Specific Disclosure Statement and (C) Revised Form of Final DIP Order* [Docket No. 1336] at Exhibit B (Projections); Mar. 24, 2014 Conf. Hr'g Tr. (Hootnick) 25:4-27:7; 52:19-24; 54:12-20; 62:2-6; 66:7-11; 112:11-113:2; see also Mar. 20, 2014 Conf. Hr'g Tr. (Smith) 45:10-47:6; 48:4-50:23; Mar. 6, 2014 Dep. Tr. (Montagner) 10:17-14:5; 38:4-39:18; 67:25-68:5.

[69] See Plan at I.A.303 ("the liens securing the SPSO Note shall be silent, third priority liens limited to the assets of NewCo and each of its subsidiaries . . .").

[70] At closing argument, counsel for the Special Committee also highlighted for the Court the increased value of the Debtors' assets under the Plan due to the fact that the Plan integrates the estates of LightSquared LP and LightSquared Inc. and thus creates increased value through (i) synergies between the two estates and (ii) the preservation of a valuable net operating loss. (May 5, 2014 Conf. Hr'g Tr. at 28:24-30:7.)

Mountain, Ltd.), 80 B.R. 171, 174-75 (9th Cir. B.A.P. 1987) (finding indubitable equivalent where secured creditor received new promissory notes junior only to a construction loan); Affiliated Nat'l Bank-Englewood v. TMA Assocs., Ltd., 160 B.R. 172, 176 (D. Col. 1993) (holding that secured creditor received indubitable equivalent despite payment in full to partially junior and partially senior creditor). No cases from courts in this District have been cited to the Court in support of this contention. Moreover, in each case cited by the Ad Hoc Secured Group in support of its indubitable equivalence argument, the court found that the secured creditor in question was demonstrably oversecured and that the creditor's equity cushion protected it from any diminution of its security interest. In In re Pine Mountain, for example, the 9th **[**103]** Circuit B.A.P. based its determination that the secured creditor received the indubitable equivalent of its claim on the fact that the creditor's claim "would still be fully secured" even after obtaining a senior construction loan. 80 B.R. at 174-75. Similarly, in Affiliated Nat'l Bank-Englewood, the court based its holding on the bankruptcy court's determination that property securing the creditor's $1 million claim was worth between $1.8 million and $2.0 million. 160 B.R. at 174-75.

The Debtors readily concede that, although the Plan is not conditioned on FCC approval, the Debtors' valuation of the SPSO Note and SPSO's proposed recovery thereunder indeed rely on opinions offered at the Confirmation Hearing that the FCC will approve LightSquared's pending License Modification Application and the later use of its lower downlink spectrum.[71] **[*96]** Thus, the value of the collateral securing the SPSO Note depends — almost entirely — on whether or not such approvals occur. Accordingly, it appears that the parties are in agreement that the valuation of LightSquared and its assets, including its spectrum assets, is ultimately dispositive of the question of indubitable equivalence.

There is enormous disagreement on valuation, however. Not surprisingly, the Debtors and the Plan Support Parties, on the one hand (with the vocal support of the Ad Hoc Secured Group), and SPSO, on the other hand, have drastically different views on valuation. Mr. Ergen himself prepared a valuation of the Debtors' spectrum assets, as did PWP when it issued a fairness opinion for the DISH Special Committee in connection with the now-terminated DISH/LBAC Bid. Of course, the assumptions underlying each of these valuations are radically different from one another, with respect to variables such as the appropriate price per MHz/POP metric, the impact of FCC approval on the License Modification Application, the proposed use of each block of spectrum, and the question of whether or not there is a "technical issue" with respect to portions of the spectrum.

The Court makes the following findings with respect to valuation.

a. The Moelis Valuation

As **[**105]** the Debtors readily concede, the value of LightSquared's assets is central to the determination of the feasibility of the Plan and the appropriateness of the treatment of the SPSO Claim. Under the direction of Mr. Hootnick, Moelis prepared a valuation analysis of LightSquared's assets that reflects a range of value from $6.2 billion at the low end to $9.1 billion at the high end. The methodology employed by Moelis is industry-accepted and indeed does not differ in any material respect from the methodology used by SPSO's valuation expert, or from the methodology used in the valuations performed by PWP for the DISH Special Committee or by Mr. Ergen himself. The methodology employs market comparables based on the price per MHz/POP, which reflects, among other things, the market price as a function of the size of the band of spectrum and the number of people it covers. Spectrum characteristics are also taken into account, including, for example, the propagation characteristics of the spectrum. (See Moelis Valuation Report at 10; Mar. 24, 2014 Conf. Tr. (Hootnick) at 16:13-20:5.) Moelis relied on the opinions of Mr. Smith, Mr. McDowell, and Mr. Jeffrey Carlisle, LightSquared's EVP for Regulatory **[**106]** Affairs, that the FCC will grant LightSquared's License Modification Application by the end of 2015 and will approve the use of the Lower Downlink in seven years. Mr. Hootnick's qualifications as an expert are stellar; Moelis' experience in valuing complex assets in the telecommunications space is broad and deep; and the methodology employed in the Moelis Valuation Report is clearly consistent with industry standards. But because the Moelis Valuation rests almost entirely on unsupportable assumptions about the timing of FCC approvals, the Court is unable

[71] *LightSquared's Post-Trial Memorandum of Law in Further **[**104]** Support of (I) Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code, (II) Motion To Designate Vote of SP Special Opportunities, LLC, and (III) Motion Seeking Approval of New DIP Facility* [Docket No. 1486] at 23.

to afford it weight sufficient to support the valuation premise of the Plan.[72]

b. The GLC Valuation

The GLC Valuation Report offered by SPSO suffered from many infirmities and inconsistencies. On the one hand, Mr. Reynertson purported to have relied on **[*97]** the opinions of Mr. Hyslop for his determination of how **[**107]** much of LightSquared's spectrum should be included in his valuation analysis and how much might be sidelined due to the "technical issue." He appears to have relied in part on a Hyslop opinion that was first revealed at the Confirmation Hearing; this undermines the integrity of Mr. Reynertson's opinion and, more generally, raises questions about his credibility. Moreover, notwithstanding his reliance on others for regulatory and technical assumptions, he appears to have used his own judgment to risk-adjust his valuation analysis. Simply put, his methodology is all over the place. Paid $1.25 million dollars for his work, Mr. Reynertson delivered a superficial analysis that was not even informed by a review of the valuations prepared by Mr. Ergen and PWP. The Court affords it little weight.

c. The Ergen Valuation

In connection with the consideration of Mr. Ergen's LBAC bid by the DISH Board and the DISH Special Committee, Mr. Ergen prepared the Ergen Valuation, a six-page presentation, dated July 3, 2013, entitled "*Strategic Investment Opportunity — L-Band Acquisition, LLC*." (PX1047.) The Ergen Valuation reflects Mr. Ergen's analysis of the aggregate value of LightSquared's assets to DISH, **[**108]** comprised of (a) the value of 20 MHz of the LightSquared spectrum and satellites themselves and (b) the incremental value that would be realized by DISH due to the substantial additional value that LightSquared's spectrum would bring to DISH's existing AWS-4 spectrum. The range of value for the former, per Mr. Ergen, is $3.3 billion to $5.2 billion; the range of value for the latter (i.e., inclusive of DISH supplemental asset value) is $5.1 billion to $8.9 billion. The Ergen Valuation includes a higher range of $/MHz /POP than the Moelis Valuation ($0.65 to $0.95 versus $0.60 to $0.90). SPSO has attempted to retreat from the numbers reflected in the Ergen Valuation on the grounds that it does not reflect the negative effect of the "technical issue." As the Court repeatedly observed during the Confirmation Hearing, however, no attempt was ever made by DISH to solve (let alone quantify) the "technical issue" which allegedly stood in the way of the realization by DISH of billions of dollars of supplemental asset value. It is indeed a curious thing. The Ergen Valuation, while offering strong support for the proposition that LightSquared's assets have tremendous value in the hands of DISH, **[**109]** does not provide sufficient support for the valuation on which the Plan and the treatment of the SPSO Claim are premised.

d. The PWP Valuation

In addition to the Ergen Valuation, a valuation prepared by PWP was considered by the DISH Special Committee. (PX1048.) PWP was retained by the DISH Special Committee to issue a fairness opinion with respect to the potential $2.2 billion DISH/LBAC Bid in July 2013. In connection with its assignment, PWP performed an extensive valuation analysis of LightSquared's assets and concluded that "the cumulative value . . . is estimated to be $4.4 billion to $13.3 billion." (PWP Valuation at 39.) This valuation range includes the stand-alone value of LightSquared's spectrum and an estimate of the magnitude of the ways in which the LightSquared spectrum would enhance the value of DISH's existing and planned businesses.

e. Additional Valuation Issues

In order to demonstrate the existence of an equity cushion, the Debtors point not only to the Moelis Valuation Report but also to (i) the Ergen Valuation, which yields an approximately 23 percent "equity cushion" (not including value attributable **[*98]** to the Lower Downlink) and (ii) the PWP Valuation, which yields an approximately 15 **[**110]** percent equity cushion, both of which are higher than the 10 percent equity cushion which has been found to be sufficient by courts in this District. (See Conf. Hr'g Tr. May 6, 2014 at 76:13-80:3.) SPSO, not surprisingly, argues that these various equity cushion calculations should be given little credence because of the "technical issue" that was allegedly discovered after preparation of the Ergen and

[72] The Moelis Valuation Report was not the first valuation performed by Moelis with respect to LightSquared. Moelis has performed valuations of the Debtors' assets on several previous occasions, including in connection with proposed DIP financing; none of these reflects a valuation as high as that reflected in the Moelis Valuation Report.

PWP Valuations and, as such, these valuations are no longer indicative of current value. The Debtors contend that the Ergen and PWP Valuations, which are consistent with the Moelis Valuation, are illustrative and persuasive evidence of the value of LightSquared's assets and that the purported "technical issue" is a red herring manufactured by SPSO that likely does not materially alter such valuations. The Court is inclined to agree, but, other than as reflected in Appendix A hereto (filed under seal), this issue was not explored or fully developed during the evidentiary hearing.[73]

Based on all of the valuation **[**111]** evidence in the record, it is clear that LightSquared is indeed the owner of valuable spectrum assets — unbuilt "beachfront property"[74] that has yet to be put to its highest and best use. But as long as the regulatory hurdles that exist remain unresolved, it is impossible to conclude, by a preponderance of the evidence, that the Debtors' valuation and projections are sufficiently reliable to support — indubitably — the valuation on which SPSO's treatment under the Plan is premised. As the Court has found, the Moelis Valuation Report is premised on unsupportable assumptions about the timing of FCC approvals, and no party has the ability to predict when and if such approvals will be obtained. Moreover, the fact that certain of the Plan Support Parties appear to be investing what the Debtors characterize as "hundreds of millions" of dollars junior to the SPSO Note does not persuade the Court otherwise. As graphically demonstrated in SPSO's Post-Confirmation Trial Brief, the Plan is in large part a sophisticated shell game that moves debt and cash up and down the capital structure in ways that are less than obvious but nonetheless real.[75] A substantial amount of the purportedly junior investment **[**112]** by Melody is being offset by substantial fees paid to Melody by Harbinger in connection with the defunct Harbinger Plan. Moreover, certain of the Plan Support Parties who are holders of Existing LP Preferred Equity Interests, including Fortress, would receive some $223 million in cash and additional Preferred PIK Interests under the Plan. As the January 2014 correspondence among the Plan Support Parties makes very clear, the Plan was constructed to bootstrap these preferred interests into the second lien position ahead of Mr. Ergen. When Mr. McKnight balked at being third to Mr. Ergen's second, Mr. Falcone simply moved him up "ahead of Charlie." (See SPX069.) Breathtakingly simple — but entirely unsupportable.

Because the Debtors' asset valuation does not support the valuation on which **[*99]** the Plan and the treatment of the SPSO Claim are premised, the Court **[**113]** cannot conclude that, under the Plan, SPSO will realize the indubitable equivalent of its existing Prepetition LP Facility Claim such that the Plan is fair and equitable with respect to Class 7B.[76] Even if the Court were to find that the valuation that undergirds the Plan is sufficient to protect SPSO's principal, however, the Court determines that the SPSO Note would still not constitute the indubitable equivalent of the SPSO Claim because of other features of the SPSO Note, including the alteration of the type of interest received under the SPSO Note as compared to the Prepetition LP Facility (PIK versus cash), the longer maturity of the SPSO Note as compared to the Prepetition LP Facility (seven years versus four years), and the fact that the note, instead of providing SPSO with a first lien, provides for far riskier third lien treatment subordinated behind at least $2.2 billion of senior debt.

2. The Plan Unfairly Discriminates Against Class 7B

Contrary to the requirement of *section 1129(b)(1)* of the Code, the Plan discriminates unfairly against Class 7B. While the "currency" with which the Prepetition LP Facility SPSO Claim is paid (i.e., the SPSO Note) does not have to be exactly the same as that provided to the Prepetition LP Facility Non-SPSO Claims, there must nonetheless be a determination that the treatment afforded SPSO does not discriminate unfairly against SPSO. ***HN14***[] The purpose of the requirement is to ensure that a dissenting class will receive relative value equal to the value given to all other similarly situated classes. *In re Johns-Manville Corp., 68 B.R. 618, 636 (Bankr. S.D.N.Y. 1987)*; see also *In re Sea Trail Corp.,*

[73] As a consequence of the Court's overall ruling on valuation, there is no need to quantify the effect, if any, on the value of LightSquared's spectrum assets due to the "technical issue."

[74] Jan. 16, 2014 Hr'g Tr. (Falcone) 15:17-16:1. Mr. Falcone's January 16, 2014 testimony was given in the Adversary Proceeding trial.

[75] *Post Confirmation Trial Brief of SP Special Opportunities, LLC and Objection to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1517], Attachment B.

[76] The Court does not reach the second prong of the indubitable equivalent analysis — appropriateness of the interest rate of the note — and makes no findings with respect to the appropriateness of the proposed rate of interest of the SPSO Note, which is LIBOR (with a floor of 1.00%) plus 12.00%. **[**114]** (Plan at § I.A.300).

No. 11-07370-8, 2012 Bankr. LEXIS 4985, 2012 WL 5247175, at *9 (Bankr. E.D.N.C. Oct. 23, 2012) (holding that a chapter 11 plan providing one class of unsecured creditors with proceeds of asset sales and avoidance actions and another class of unsecured creditors with title to a sewer facility and assignment of a sewer service agreement was not unfairly discriminatory); In re Hawaiian Telcom Commc'ns, Inc., 430 B.R. 564, 605 (Bankr. D. Haw. 2009) (plan that awards cash to general unsecured creditors and warrants to unsecured senior noteholders does not unfairly discriminate; section 1129(b) of the Bankruptcy Code does not preclude a plan's disparate treatment of classes of same-priority claims, it prohibits only unfair discrimination); In re Greate Bay Hotel & Casino, Inc., 251 B.R. 213, 222-23, 231-32 (Bankr. D. N.J. 2000) (chapter **[**115]** 11 plan providing undersecured noteholders with new notes and new common stock on account of their deficiency claims but other unsecured creditors with cash was not unfairly discriminatory because the debtors' value was determined to be sufficient to ensure payment).

HN15[] To determine whether a plan discriminates unfairly, courts consider whether (i) there is a reasonable basis for discriminating, (ii) the debtor cannot consummate the plan without the discrimination, (iii) the discrimination is proposed in good faith, and (iv) the degree of discrimination is in direct proportion to its rationale. In re WorldCom, Inc., 2003 Bankr. LEXIS 1401, *174-175 (Bankr. S.D.N.Y. Oct. 31, 2003) (citations omitted). The Debtors argue **[*100]** that each of these elements has been satisfied, because (a) SPSO impermissibly acquired LP Debt intending to facilitate the acquisition of LightSquared's assets by DISH, a competitor, thus providing a rational basis for the treatment, (b) the treatment of the SPSO Claim is necessary because the Plan represents the "best and only path for LightSquared to emerge," (c) the Plan has been proposed in good faith, and (d) there is nothing "unfair" about the fact that the Plan satisfies the SPSO Claim in full.[77] SPSO vehemently disputes such assertions, arguing that **[**116]** the disparate treatment of SPSO is not supported by any reasonable basis, and, far from providing payment in full, the SPSO Note "is at best, a highly distressed debt instrument and, at worst, is entirely worthless."[78]

At a minimum, the treatment proposed in the Plan clearly does not pass muster under prongs (i) and (iv) of the WorldCom test, and likely falls short on the "good faith" prong as well. Simply put, it is difficult to imagine discrimination that could be much more unfair than that contemplated by the Plan: close to full cash payment on confirmation (not the Effective Date) for Class 7A versus an equity-like deeply subordinated seven year third-lien PIK interest note for Class 7B — treatment that, even **[**117]** if possibly yielding payment of the value of the SPSO Claim seven years down the road, for all intents and purposes puts SPSO at the mercy of the rest of the proposed post-confirmation capital structure, including the equityholders below it. (See, e.g., Conf. Hr'g Tr. Mar. 31, 2014 (Falcone) at 103:9-25 (testifying regarding $150 million call option of Harbinger that would be part of the second lien and above SPSO); Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 68:7-25 (describing LightSquared's future ability pursuant to the Plan to raise another $500 million which would come in ahead of the second lien debt and the SPSO Note).)

While some discrimination in this case may be necessary to address the non-creditor/competitor interests of SPSO, see Section I.A., *supra*, the Plan's treatment of Class 7B is not designed to achieve that goal. The legitimate business reasons for separately classifying the SPSO Claim hardly entitle the Debtors to discriminate against SPSO in ways that far exceed those necessary to address the legitimate concerns attendant to SPSO's competitor status and connections to DISH, e.g., through appropriate covenants and other non-economic protective measures. Moreover, the fact that, as Mr. Smith testified, SPSO is **[**118]** getting a "promissory note" because "there's not enough cash for everybody to receive cash" does not provide a legitimate basis for the Plan's discriminatory treatment of Class 7B. (Conf. Hr'g Tr., Mar 20, 2014 (Smith) at 26:18-27:14.) Nor is it a justification for such discrimination to point to the fact that, as some have observed, the Ad Hoc Secured Group "requires" early payment in full in cash. (See, e.g., Conf. Hr'g Tr. Mar. 24, 2014 (Hootnick) at 45:4-7 ("And [the plan] satisfies the requirement of certain constituents, particularly the non-SPSO lenders who have been promised an early pay-out by the LBAC approach [and] who have required

[77] *LightSquared's Reply in Support of Its Post-Trial Memorandum of Law in Further Support of (I) Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of Bankruptcy Code, (II) Motion To Designate Vote of SP Special Opportunities, LLC, and (III) Motion Seeking Approval of New DIP Facility* [Docket No. 1525] at Ex. A, p. 21.

[78] *Objection of SPSO to Confirmation of Debtors' Third Amended Joint Plan Pursuant to Chapter 11 of the Bankruptcy Code* [Docket No. 1408] at ¶ 72.

throughout that they be paid off **[*101]** quickly"); Conf. Hr'g Tr. Mar. 27, 2014 (Zelin) at 69:15 ("I think our clients want to be paid in full in cash").) There are many creative ways to attempt to address the limited availability of cash,[79] but unfair discrimination is not one of them. Thus, separate and apart from its failure to satisfy the fair and equitable requirement of *section 1129(b)(2)(B)*, the Plan fails to pass muster on unfair discrimination grounds as well and, thus, cannot be confirmed.

D. The Claim of SPSO Shall Be Subordinated to the Extent of Harm Caused to Innocent Creditors

As set forth in detail in the Adversary Proceeding Decision, the Court has concluded that SPSO has engaged in inequitable conduct in connection with its acquisition of its now nearly $1 billion LP Debt claim. Although the Confirmation Hearing did not encompass a re-trial of those issues that were presented and have now been adjudicated in connection with Adversary Proceeding, there are additional allegations of inequitable conduct that were raised in connection with confirmation. In essence, the Ad Hoc Secured Group maintains that they were the victims of an elaborate "bait and switch" strategy perpetrated by Mr. Ergen **[**120]** through SPSO, LBAC, and DISH. The strategy was allegedly hatched in a presentation prepared by Mr. Ergen's counsel in late April 2013 and presented by Mr. Ergen to the DISH Board in May 2013, which stated, among other things, that Mr. Ergen wanted to "see [the] results of [the] marketing process and, if [the] process is unsuccessful, revert with [a] different bid later." (See Adv. Pro. Ex. PX0867; Adversary Proceeding Decision FOF ¶¶ 131-32.) There, says the Ad Hoc Secured Group, it is made crystal clear that the Ergen-led strategy was to make a bid, wait and see if anyone else is interested in the LightSquared assets at that price, and if not, pull the bid and come back later with a lower bid. "Had they only known," say the members of the Ad Hoc Secured Group, they would never have gone down that path. But now, pointing again and again to the DBSD and Terrestar "playbooks" as evidence of Mr. Ergen's *modus operandi* for acquiring distressed assets, the Ad Hoc Secured Group complains that it was deceived into signing up for a deal that Mr. Ergen never intended to close.[80] The fly now regrets having accepted the invitation of the spider to enter its parlour.

Not surprisingly, there is no documentary evidence reflecting the alleged "bait and switch" strategy. Mr. Ergen's May 2, 2013 DISH Board presentation,[81] on which the Ad Hoc Secured Group principally relies, cannot be fairly read as the Ad Hoc Secured Group suggests it should be read. The DISH Board minutes in the December 2013 timeframe contain carefully constructed high level summaries of the status of the DISH/LBAC Bid and, not surprisingly, contain no hint of any such strategy. Consistent with the allegations of the Ad **[*102]** Hoc Secured Group that the so-called "technical issue" was fabricated as a pretext for LBAC's termination of its bid, there are, however, DISH internal documents that suggest that the so-called "technical issue" was not being approached as something to be resolved in order to keep the proposed transaction on track, but rather was being viewed as something DISH was hoping would turn out to be real.[82] In addition to the unsettling content and tenor of some of the documents, Mr. Ergen's testimony on this issue was quite evasive.

Moreover, the words and behavior of Mr. Ergen in connection with the December 11 auction are not exactly what one would expect to hear and see from a stalking horse bidder who had snagged assets that were worth, in DISH's hands, billions of dollars of net

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[79] See, e.g., In re Central European Distribution Corporation, et al., Case No. 13-10738 (CSS) (Bankr. D. Del. March **[**119]** 13, 2013), Findings of Fact and Conclusions of Law (I) Approving (A) The Disclosure Statement, (B) The Prepetition Solicitation Procedures, and (C) Forms of Ballots, and (II) Confirming the Second Amended and Restated Joint Prepackaged Chapter 11 Pan of Reorganization of Central European Distribution Corporation, et al., dated March 13, 2013 [Docket No. 166] (confirming plan employing a reverse Dutch auction procedure in which noteholders could elect to bid for cash treatment).

[80] See *Corrected Post-Trial Confirmation **[**121]** Brief of the Ad Hoc Secured Group of LightSquared LP Lenders* [Docket No. 1494] at 2-3, 32-33, 36-38.

[81] Adv. Pro. Ex. PX0867.

[82] Evidence was presented at **[**122]** the Confirmation Hearing that DISH's engineers have been told by different vendors, including Huawei and Avago, that the "technical issue" is not an impediment to use of LightSquared's Uplinks. One email from Huawei acknowledged Mr. Ergen's intent to use the "technical issue" as a device to "lower" the acquisition price for LightSquared's spectrum. (PX1026) (Huawei employee stating that "technically, we are optimistic to make L-band . . . work for DISH but understand it might involve more than technical for Charlie to make decision now, and wise to leave the door open and drive the price down in the future.").

incremental value. Why would Mr. Ergen fly to New York to attend the auction with a sizeable team of DISH personnel and the DISH Board on standby[83] but on that very day have his counsel tell Mr. Zelin that she hoped another bidder would appear or it would be bad for the Ad Hoc Secured Group?[84] Why in December did the DISH Board waive **[**123]** its 48-hour meeting notice requirement[85] until January 9, 2014 — the very day on which the DISH/LBAC Bid termination became effective? There are no good answers to these and many other questions about the conduct of LBAC and SPSO.

Nonetheless, the fact **[**124]** remains that the LBAC transaction was tied to the achievement of certain milestones set forth in the PSA.[86] And LBAC, as this Court has ruled, was free to terminate the PSA and then terminate its bid — for any reason — once any of those milestones was missed.[87] The milestones were aggressive from the outset, and were soon missed. Moreover, the Bid Procedures Order only required LBAC to remain in place as a back-up **[*103]** bidder until mid-February 2014 only if another party had outbid it at the auction.[88] That did not occur.

Whether LBAC terminated its bid because it "believed" there was a technical issue (even though the record does **[**125]** not support a finding that there was or is such an issue), or because it wanted to make a lower conditional bid, or because Mr. Ergen decided to direct DISH and its capital elsewhere, or because of negative implications for DISH in connection with the Nevada shareholder litigation, remains unclear. What is in undisputable, however, is that the actions of Mr. Ergen in this regard defy logical explanation. Mr. Ergen was particularly evasive when asked at the Confirmation Hearing about his reasons for coming to the December 11 auction fully prepared to proceed, and then terminating his bid shortly thereafter.[89] Notwithstanding, the record of the Confirmation Hearing does not provide compelling additional support for the equitable subordination of the SPSO Claim, even assuming that the conduct of LBAC and DISH in terminating the DISH/LBAC Bid were attributable to SPSO.

II. ADDITIONAL OBJECTIONS TO THE PLAN

SPSO has raised numerous additional objections to confirmation of the Plan including: the failure to satisfy the "best interests of creditors" test under *section 1129(a)(7)* of the Code; the failure of the Plan to contain projections that extend beyond the **[**126]** first quarter of 2016; the impermissibility of the Plan's proposed Non-Debtor Releases; the effect of the Plan on SPSO's inter-creditor rights under the Prepetition LP Credit Agreement; certain infirmities with the proposed New DIP Facility, including its alleged lack of adequate protection; the alleged artificial impairment of certain accepting classes; the Debtors' failure to demonstrate that the Plan is feasible; and the Debtors' alleged lack of good faith in soliciting acceptances of the Plan under *section 1125(e)*. While there may be merit to several of these additional objections, the Court need not address

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[83] Mr. Ergen flew to New York to attend the auction with a team of DISH personnel, including Stanton Dodge (DISH General Counsel), Tom Cullen (DISH Executive Vice President, Corporate Development), George Brokaw (DISH Independent Director), Carl Vogel (DISH Director), and at least two members of DISH's technical team. (See Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 81:16-83:7; 230:18-231:13.) Mr. Ergen also had a quorum of DISH's Board ready to be on standby during the auction. ((Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 82:18-83:7.)

[84] See fn 52, *supra*.

[85] Before the auction, Mr. Ergen consulted with the DISH Board with respect to the auction and put the DISH board on notice to act immediately. The Board granted a waiver of the typical forty-eight hour requirement for board meetings until January 9, 2014, which was the day that the trial in the Adversary Proceeding was scheduled to begin. (Conf. Hr'g Tr. Mar. 26, 2014 (Ergen) at 256:25-257:6; 286:7-287:5; SPX028.)

[86] Section 6.1(f)(1) of the Plan Support Agreement permitted LBAC to terminate on three business days' written notice in the event that one or more of the milestones set forth on Exhibit C to the Plan Support Agreement were not satisfied. See Plan Support Agreement [Docket No. 765] at Ex. A, §6.1(f)(1).

[87] See Jan. 22, 2014 Hr'g Tr. [Docket No. 1278].

[88] Id. at 109:23-110:9; *Order (A) Establishing Bid Procedures, (B) Scheduling Date and Time for Auction, (C) Approving Assumption and Assignment Procedures, (D) Approving Form of Notice and (E) Granting Related Relief*, dated October 1, 2013 [Docket No. 892].

[89] Mar. 26, 2014 Conf. Hr'g Tr. (Ergen) at 93:25-102:6.

them now in light of the other bases on which the Court has denied confirmation of the Plan.

One final observation is in order. This Court has previously ruled, in this case, that *HN16*[] the Bankruptcy Code does not contemplate or permit equitable disallowance of a creditor's claim.[90] Against the backdrop of allegations — and findings — that SPSO and Mr. Ergen indeed orchestrated an end-run around the restrictions on the Prepetition LP Credit Agreement, it is remarkable that the Debtors and those parties who support the Plan have constructed a plan of reorganization that is a gerrymandered end-run **[**127]** around their inability to disallow the SPSO Claim. The latest such attempt is the invocation of "unjust enrichment" by the Ad Hoc Secured Group. (See *Corrected Post-Trial Confirmation Brief of the Ad Hoc Group of Secured Lenders* [Docket 1494] at 23.) And the trial record leaves no doubt that subordinating the SPSO Claim — with or without a finding of equitable subordination — was the *sine qua non* of the Harbinger-driven plan process. This was a plan that was orchestrated by Mr. Falcone **[*104]** and those he sought to "protect;" it provides the Ad Hoc Secured Group with the quick cash payout it had hoped to obtain from LBAC's purchase of the LP assets; and it assumes a result in the Adversary Proceeding that is not to be. As these cases approach their two-year anniversary in this Court, the time is long overdue for the parties to adjust their expectations, tone down their animosity, and work constructively to maximize the value of LightSquared's valuable spectrum assets.

CONCLUSION

For all of the foregoing reasons, (i) confirmation of the Third Amended Joint Plan is denied; (ii) SPSO's Motion to Strike McDowell and Hootnick is denied; (iii) the Debtors' Motion to Strike Hyslop and Reynertson is granted as to Mr. Hyslop and denied **[**128]** as to Mr. Reynertson; (iv) the Vote Designation Motion is denied; (v) the New DIP Motion and its request for related relief, including the request to approve the Plan Support Party Break-up Fee, is denied, as moot; (vi) the Exhibit 2 Motion is denied; and (vii) the request for equitable subordination of the SPSO Claim is granted for the reasons set forth in the Adversary Proceeding Decision, with the extent of such subordination to be determined in further proceedings to be held in this Court. Counsel to the Debtors shall be provided with an unredacted copy of Appendix A and shall distribute it to those parties entitled to receive it pursuant to applicable confidentiality agreements and sealing orders.

IT IS SO ORDERED.

Dated: July 11, 2014

New York, New York

/s/ Shelley C. Chapman

UNITED STATES BANKRUPTCY JUDGE

APPENDIX A

FILED UNDER SEAL

[90] See Memorandum Decision Granting Motions to Dismiss Complaint [Adv. Docket No. 68], *504 B.R. 321, 339 (Bankr. S.D.N.Y. 2013)*.

Table1 (Return to related document text)

I. BACKGROUND

A. The Third Amended Plan

B. Motions Filed in Connection with Confirmation

C. Pleadings Filed in Connection with the Plan

and Confirmation-Related Motions

D. The Confirmation Hearing

E. LightSquared's Pending License Modification

II. CONFIRMATION TESTIMONY

A. Mr. Robert McDowell

B. Mr. Christopher Rogers

C. Mr. Douglas Smith

D. Mr. Marc Montagner

E. Mr. Steven Zelin

F. Mr. Charles Ergen

G. Mr. Omar Jaffrey

H. Mr. Philip Falcone

III. THE MOELIS VALUATION ANALYSIS

IV. THE GLC VALUATION ANALYSIS

V. CONFIRMATION TESTIMONY REGARDING THE "TECHNICAL ISSUE"

A. Mr. Douglas Hyslop

B. Mr. John Jacob Rasweiler V

DISCUSSION

I. THE PLAN CANNOT BE CONFIRMED

A. Separate Classification of Prepetition LP Facility SPSO Claim

Complies With Section 1122

B. SPSO's Vote to Reject the Plan Shall Not Be Designated

C. Because SPSO's Vote Cannot Be Designated, the Cramdown Requirements

of Section **[**3]** 1129(b) Are Applicable to Class 7B

1. The Plan Is Not Fair and Equitable With Respect to Class 7B

a. The Moelis Valuation

b. The GLC Valuation

c. The Ergen Valuation

d. The PWP Valuation

e. Additional Valuation Issues

2. The Plan Unfairly Discriminates Against Class 7B

D. The Claim of SPSO Shall be Subordinated to the Extent of Harm

Caused to Innocent Creditors

II. ADDITIONAL OBJECTIONS TO THE PLAN

CONCLUSION

Table1 (Return to related document text)

Table2 (Return to related document text)

Class 1:	Inc. Other Priority Claims
Class 2:	LP Other Priority Claims
Class 3:	Inc. Other Secured Claims
Class 4:	LP Other Secured Claims
Class 5:	Prepetition Inc. Facility Non-Subordinated Claims
Class 6:	Prepetition Inc. Facility Subordinated Claims
Class 7A:	Prepetition LP Facility Non-SPSO Claims
Class 7B:	Prepetition LP Facility SPSO Claims
Class 8:	Inc. General Unsecured Claims
Class 9:	LP General Unsecured **[**11]** Claims
Class 10:	Existing LP Preferred Units Equity Interests
Class 11A:	Existing Inc. Series A Preferred Stock Equity Interests
Class 11B:	Existing Inc. Series B Preferred Stock Equity Interests
Class 12:	Existing Inc. Common Stock Equity Interests
Class 13:	Intercompany Claims
Class 14:	Intercompany Interests

Table2 (*Return to related document text*)

Table3 (*Return to related document text*)

Class	**Amount Accepted**	**Number Accepted**
6 (Prepetition Inc. Facility Subordinated Claims)	**100%**	**100%**
7A (Prepetition LP Facility Non-SPSO Claims)	100%	100%
7B (Prepetition LP Facility SPSO Claims)	0%	0%
8 (Inc. General Unsecured Claims)	100%	100%
9 (LP General Unsecured Claims)	100%	100%
10 (Existing LP Preferred Units Equity Interests)	100%	100%
11A (Existing Inc. Series A Preferred Stock Equity Interests)	100%	100%
11B (Existing Inc. Series B Preferred Stock Equity Interests)	100%	100%
12 (Existing Inc. Common Stock Equity Interests)	100%	100%

Table3 (*Return to related document text*)

End of Document

Appendix B

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Counsel for Ms. Ann Marie Reinhart on behalf of herself and those similarly situated

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION**

In re:	)	Chapter 11
TOYS "R" US, INC., *et al.*,[1]	)	Case No. 17-34665 (KLP)
Debtors.	)	(Jointly Administered)

ORDER (I) APPROVING THE SETTLEMENT AGREEMENT, (II) CERTIFYING A CLASS OF FORMER EMPLOYEES FOR SETTLEMENT PURPOSES ONLY, (III) APPOINTING CLASS COUNSEL AND CLASS REPRESENTATIVE, (IV) APPROVING THE FORM AND MANNER OF NOTICE OF THE CLASS CERTIFICATION AND SETTLEMENT, (V) SETTING THE AGGREGATE RECOVERY OF THE CLASS UNDER THE GLOBAL SETTLEMENT AGREEMENT, AND (VI) GRANTING RELATED RELIEF

Upon the joint motion (the "Motion")[2] of Wayne Services Legacy Inc., ("Wayne"), as wind-down entity for Toys "R" Us-Delaware, Inc. ("Toys-Delaware"), and Ms. Ann Marie Reinhart (the "Class Representative"), on behalf of herself and on behalf of a putative class of similarly-situated former employees of Toys-Delaware (together with the Class Representative,

[1] The above-captioned debtors in these chapter 11 cases (collectively, the "Debtors"), along with the last four digits of each Debtor's federal tax identification number, are set forth in the *Order (I) Directing Joint Administration of Chapter 11 Cases and (II) Granting Related Relief* [Docket No. 78]. The location of the Debtors' service address is One Geoffrey Way, Wayne, New Jersey 07470.

[2] Capitalized terms used but not otherwise defined herein have the meanings ascribed to them in the Motion or the Settlement Agreement, as applicable.

the "Class Members" or "Class," and collectively Wayne, the "Parties") for entry of an order (this "Order"): (a) approving the settlement agreement attached to this Order as **Exhibit 1** (the "Settlement Agreement"); (b) certifying the Class as a class within the meaning of Civil Rule 23 for settlement purposes only; (c) appointing the Class Representative as class representative and Outten & Golden LLP as class counsel ("Class Counsel"); (d) approving the form and manner of notice of the class certification and settlement; (e) setting the aggregate recovery of the Class under that certain *Settlement Agreement* dated July 17, 2018 (the "Global Settlement Agreement"); and (f) granting related relief; all as more fully set forth in the Motion; and this Court having jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334 and the *Standing Order of Reference from the United States District Court for the Eastern District of Virginia*, dated July 10, 1984; and this Court having found that it may enter a final order consistent with Article III of the United States Constitution; and this Court having found that venue of this proceeding and the Motion in this district is proper pursuant to 28 U.S.C. §§ 1408 and 1409; and this Court having found that the relief requested in the Motion is in the best interests of the Debtors' estates, their creditors, the Class, and other parties in interest; and this Court having found that the Parties' notice of the Motion and opportunity for a hearing on the Motion were appropriate under the circumstances and that no other notice need be provided; and this Court having reviewed the Motion and having heard the statements in support of the relief requested therein at a hearing before this Court (the "Hearing"); and this Court having determined that the legal and factual bases set forth in the Motion and at the Hearing establish just cause for the relief granted herein; and upon all of the proceedings had before this Court; and after due deliberation and sufficient cause appearing therefor, the Court hereby makes and issues the following findings of fact, conclusions of law, and orders:

I. FINDINGS OF FACT AND CONCLUSIONS OF LAW

NOW, THEREFORE, THIS COURT HEREBY FINDS AND CONCLUDES THAT:[3]

A. The legal and factual bases set forth in the Motion establish just and sufficient cause to grant the relief requested therein.

B. Notice of the Motion was served by first class mail on the parties listed on the proof of service filed with this Court and was also published in *USA Today* (national edition) and electronically at https://cases.primeclerk.com/toysrus. The publication of such notice as described in the Motion conformed to the requirements of Bankruptcy Rules 2002(l) and 9008, was reasonably calculated to provide notice to Class Members, and afforded Class Members the opportunity to exercise any rights affected by the Motion and the relief granted by this Order.

C. Notice of the Motion is sufficient notice of the Settlement Agreement and no other notice is required.

D. Parties-in-interest were afforded a full opportunity to participate in the Hearing on the Motion.

E. For purposes of the Settlement Agreement, Class Counsel has extensive experience handling class action employee termination litigation, and the proposed fee award to Class Counsel is reasonable.

F. The Class Representative does not have interests antagonistic to those of the Class, and the requested Service Award is reasonable.

G. For purposes of the Settlement Agreement: (i) the Class, consisting of approximately 30,000 former employees of Toys-Delaware, is so numerous that joinder of all

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[3] Findings of fact shall be construed as conclusions of law, and conclusions of law shall be construed as findings of fact, as appropriate, pursuant to Bankruptcy Rule 7052.

Class Members is impracticable; (ii) there are questions of law or fact common to the Class; (iii) the law firm of Outten & Golden, LLP has fairly and adequately protected the interests of the Class; (iv) questions of law or fact common to the Class Members predominate over any questions affecting only the individual Class Members; and (v) the class settlement mechanism is superior to other available methods of resolving the alleged Severance Claims. Therefore, the Class should be certified for settlement purposes only, pursuant to Civil Rules 23(a) and (b)(1) and Bankruptcy Rule 7023, consisting of all persons who (i) were employed Toys Delaware, (ii) were terminated after February 16, 2018, and (iii) are not "insiders" as that term is used under the Bankruptcy Code.

H. Based on the range of possible outcomes and the cost, delay, and uncertainty associated with further litigation, the Settlement Agreement is reasonable and cost-effective, and approval of the Settlement Agreement is warranted.

I. The Settlement Agreement should be approved.

J. Other good and sufficient cause exists for granting the relief requested in the Motion.

II. ORDER

BASED ON THE FOREGOING FINDINGS OF FACT, IT IS THEREFORE ORDERED, ADJUDGED, AND DECREED THAT:

1. The Motion is granted as set forth herein.

2. The Settlement Agreement attached hereto as **Exhibit 1** is approved pursuant to sections 363 and 105(a) of the Bankruptcy Code and in accordance with Bankruptcy Rule 9019.

3. The Parties are hereby authorized to enter into, perform under, execute, and deliver the Settlement Agreement and the Parties are authorized and directed to take any and all actions as may be necessary or desirable to effectuate and implement the Settlement Agreement.

4. The Class is hereby certified for settlement purposes only, pursuant to Civil Rules 23(a) and (b)(1) and Bankruptcy Rule 7023, with respect to their Severance Claims against the Toys-Delaware and all other claims released pursuant to the Settlement Agreement.

5. Ms. Ann Marie Reinhart is hereby appointed as Class Representative and the law firm of Outten & Golden, LLP is hereby appointed as Class Counsel.

6. All Parties, including Wayne, will reasonably cooperate to facilitate a distribution to Class Members on account of the Allowed Administrative Claim in accordance with the Settlement Agreement.

7. The Court shall have and shall retain jurisdiction over the Settlement Agreement, this Order, and any non-released Severance Claims.

8. Notice of the Motion as provided therein shall be deemed good and sufficient notice of such Motion and of the Settlement Agreement and the requirements of Bankruptcy Rules 2002, 6004(a), 7023, and 9008 and Civil Rule 23(e)(1) are satisfied by such notice.

9. Notwithstanding Bankruptcy Rule 6004(h), the terms and conditions of this Order are immediately effective and enforceable upon its entry.

10. The Parties are authorized to take all actions necessary to effectuate the relief granted in this Order in accordance with the Motion and Settlement Agreement.

11. This Court retains exclusive jurisdiction with respect to all matters arising from or related to the implementation, interpretation, and enforcement of this Order.

Dated: Jun 27 2019

Richmond, Virginia

/s/ Keith L. Phillips

UNITED STATES BANKRUPTCY JUDGE

Entered on Docket: Jun 27 2019

WE ASK FOR THIS:

/s/ Henry P. (Toby) Long, III
J.R. Smith (VSB No. 41913)
Henry P. (Toby) Long, III (VSB No. 75134)
HUNTON ANDREWS KURTH LLP
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, VA 23219
Tel: (804) 788-8200
Fax: (804) 788-8218

Counsel to Wayne Services Legacy, Inc.

**CERTIFICATION OF ENDORSEMENT
UNDER LOCAL BANKRUPTCY RULE 9022-1(C)**

I hereby certify that the foregoing proposed order has been endorsed by or served upon all necessary parties.

/s/ Henry P. (Toby) Long, III

<u>Exhibit 1</u>

Settlement Agreement

SETTLEMENT AGREEMENT

This Settlement Agreement, dated as of June 12, 2019 (this "Settlement Agreement" or "Settlement"), is entered into by and among Wayne Services Legacy Inc. ("Wayne"), on behalf of Toys "R" Us-Delaware, Inc. ("Toys-Delaware"; together with Wayne, "Delaware"), on the one hand, and Ms. Reinhart (the "Class Representative"), on behalf of herself and on behalf of similarly situated class members specifically identified in Section 2.2 below (together with the Class Representative, the "Class Members" or "Class"), on the other hand. Delaware and the Class Members are collectively referred to herein as the "Parties," or, as to each, a "Party."

RECITALS

WHEREAS, on September 18, 2017, Toys-Delaware, along with 24 other affiliated entities (collectively, the "Debtors") filed voluntary petitions for relief commencing cases (the "Chapter 11 Cases") under chapter 11 of title 11 of the United States Code, 11 U.S.C. §§ 101–1532 (the "Bankruptcy Code"), in the United States Bankruptcy Court for the Eastern District of Virginia (the "Court");

WHEREAS, historically, Toys-Delaware maintained a severance plan for terminated employees (the "Severance Plan");

WHEREAS, on February 16, 2018, Toys-Delaware alleged their Health and Welfare Plan Committee terminated the Severance Plan (the "Severance Termination Date");

WHEREAS, Ms. Reinhart has alleged the Class has potential claims against Toys-Delaware arising under the Severance Plan (the "Severance Claims");

WHEREAS, the law firm Outten & Golden LLP ("Class Counsel") represents Ms. Reinhart;

WHEREAS, on November 21, 2018, the Court entered the *Order Confirming the Fourth Amended Chapter 11 Plans of the Toys Delaware Debtors and Geoffrey Debtors* in the Chapter 11 Cases, confirming the *Fourth Amended Chapter 11 Plans of Toys Delaware Debtors and Geoffrey Debtors* (the "Plan");

WHEREAS, the Plan became effective on January 20, 2019;

WHEREAS, pursuant to the Plan, Wayne is charged with winding down Toys-Delaware, including collecting and administering assets and resolving claims of and against Toys-Delaware;

WHEREAS, Delaware denies the merits of the Severance Claims and further denies that, absent this Settlement Agreement, the Class Representatives could certify a class under Rule 23 of the Federal Rules of Civil Procedure or proceed with a class claim in the Chapter 11 Cases;

WHEREAS, the Parties entered into and have extended a *Stipulation and Agreed Order Further Extending the Bar Date with Respect to Certain Claims and Related Relief* setting forth certain terms to facilitate a resolution of the Severance Claims (Case 17-34665-KLP, Doc. 6950); and

WHEREAS, the Parties wish to fully and finally resolve any and all disputes, controversies, or causes of action between Delaware and Class, that the Parties and/or their respective affiliates and/or subsidiaries have related to the Chapter 11 Cases and the Severance Claims, in each case pursuant to the terms and conditions set forth in this Settlement Agreement.

<u>AGREEMENT</u>

NOW, THEREFORE, in consideration of the above recitals and the promises and mutual covenants and agreements contained herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, and subject to approval of the Court, the Parties agree as follows:

Section 1. Interpretation.

1.1 Interpretation. For the purposes of this Settlement Agreement:

(a) in the appropriate context, each term, whether stated in the singular or the plural, shall include both the singular and the plural, and pronouns stated in the masculine, feminine, or neuter gender shall include the masculine, feminine, and the neuter gender;

(b) capitalized terms defined only in the plural or singular form shall nonetheless have their defined meanings when used in the opposite form;

(c) unless otherwise specified, any reference herein to a contract, lease, instrument, release, indenture, or other agreement or document being in a particular form or on particular terms and conditions means that such document shall be substantially in such form or substantially on such terms and conditions;

(d) unless otherwise specified, any reference herein to an existing document, schedule, or exhibit shall mean such document, schedule, or exhibit, as it may have been or may be amended, restated, supplemented, or otherwise modified from time to time; provided that any capitalized terms herein which are defined with reference to another agreement, are defined with reference to such other agreement as of the date of this Settlement Agreement, without giving effect to any termination of such other agreement or amendments to such capitalized terms in any such other agreement following the date hereof;

(e) unless otherwise specified, all references herein to “Sections” are references to Sections of this Settlement Agreement;

(f) the words “herein,” “hereof,” and “hereto” refer to this Settlement Agreement in its entirety rather than to any particular portion of this Settlement Agreement;

(g) captions and headings to Sections are inserted for convenience of reference only and are not intended to be a part of or to affect the interpretation or construction of this Settlement Agreement;

(h) references to "shareholders," "directors," and/or "officers" shall also include "members" and/or "managers," as applicable, as such terms are defined under the applicable laws and in proper context;

(i) the use of "include" or "including" is without limitation, whether stated or not; and

(j) terms with initial capitalization not otherwise defined herein shall have the meaning ascribed to them in the Global Settlement Agreement (defined below).

Section 2. Settlement Terms.

2.1 Settlement Filings.

Upon execution of this Settlement Agreement by all Parties, Delaware shall promptly file a motion in the Chapter 11 Cases under Rules 9019 and 7023 of the Federal Rules of Bankruptcy Procedure for approval of the Settlement (the "Settlement Motion"). The Settlement Motion shall request a hearing at which time the Parties shall seek entry of an order (the "Settlement Order") from the Court, which shall be reasonably acceptable to the Parties, approving the Settlement, including the award of Class Counsel's Fees (defined below), and approving the form and manner of notice to the Class Members of class certification and the Settlement. For the avoidance of doubt, all provisions of this Settlement Agreement shall not become effective unless and until the Settlement Order is final and non-appealable.

2.2 Class Certification.

Upon execution of this Settlement Agreement by all Parties, as part of the Settlement Motion pursuant to Rules 9019 and 7023 of the Federal Rules of Bankruptcy Procedure, the Parties shall seek certification of the Class in connection with the Severance Claims comprised of all persons who (i) were employed by Toys-Delaware, (ii) are not "insiders" as that term is defined in section 101(31) of the Bankruptcy Code, and (iii) were terminated after the Severance Termination Date.

2.3 The Allowed Administrative Claim

Effective upon the Settlement Order becoming final and non-appealable, in full and final settlement of any and all Severance Claims, the Class shall be deemed to have an allowed administrative expense claim against Toys-Delaware in the total amount of $10,000,000 (the "Allowed Administrative Claim").

2.4 The Distributable Amount.

(a) *Satisfaction of the Allowed Administrative Claim.* Notwithstanding anything to the contrary in the Global Settlement Agreement, in full and final satisfaction of the Allowed Administrative Claim, the Class Members shall be entitled to an aggregate distribution on account of the Allowed Administrative Claim in the amount of $2,000,000 (the "Distributable Amount").

(b) *Employment Taxes.* The Distributable Amount shall be inclusive of any and all payments by, and obligations of, Delaware under this Settlement Agreement, other than the employer federal, state or local taxes owed or withheld ("Employment Taxes") on the net pre-tax Settlement distributions to the Class Members. Delaware promptly will pay the Employment Taxes to applicable taxing or other authorities upon any distribution to the Class on account of the Distributable Amount.

(c) *Distribution of the Distributable Amount.* The Distributable Amount shall be distributed by Delaware as set forth in the Global Settlement Agreement, subject to Section 2.8 hereof. For the avoidance of doubt, the Class Counsel's Fees (as defined below) shall be payable solely out of the Distributable Amount and Delaware shall not have any responsibility or obligation with respect to the Allowed Administrative Claim beyond payment of the Employment Taxes and distributions on account of the Settlement Agreement in accordance with the Global Settlement Agreement, including the administration thereof.

2.5 Class Notices

After filing the Settlement Motion, Delaware shall timely: (a) serve the Settlement Motion on any Class Members that have properly filed administrative claims relating to the Severance Claims; and (b) publish a notice of the Settlement Motion in *USA Today* (national edition) and electronically at https://cases.primeclerk.com/toysrus. To the extent the Court orders additional notice of the Settlement, Delaware shall be responsible for the execution of such notice and any related costs.

2.6 Service Award

Delaware will pay the Class Representative the additional amount of $2,000, as a one-time Service Award, to be paid from the Distributable Amount at the time of its distribution to the Class. Delaware shall pay the Service Award without withholding or Employment Taxes and report it to the IRS on a 1099 Form; *provided, however*, Delaware shall not be responsible for any taxes penalties, or interest imposed with respect to the payment of the Service Award to the Class Representative.

2.7 Class Counsel's Fees

Class Counsel is entitled to attorneys' fees ("Class Counsel's Fees") in the amount of thirty-three and one-third percent (33⅓%) of the Distributable Amount (not including the Service Award). Class Counsel's Fees will be distributed to Class Counsel (according to instructions to be supplied by Class Counsel) contemporaneously with the distribution of the Distributable Amount payments to Class Members and shall be payment in full for Class Counsel's work and expenses in connection with this matter. Reduction of the Distributable Amount by the Service Award and Class Counsel's Fees shall result in the Net Distributable Amount.

2.8 The Allocation of the Net Distributable Amount and Disbursements

(a) *Allocation of the Net Distributable Amount*. The Net Distributable Amount shall be allocated to each Class Member (each, an "Individual Claim") as follows: (i) Class Members that worked less than 40 hours per week and were considered part-time employees at the time of their termination shall receive a gross payment of approximately $34 each from the Distributable Amount, and (ii) Class Members that worked 40 hours or more per week and were considered full-time employees at the time of their termination shall receive a gross payment of approximately $60 each from the Distributable Amount. The part-time and full-time amounts may be adjusted such that each Class Member in the respective groups receives an equal amount from the fully disbursed Net Distributable Amount. The employee's share of employee taxes shall be deducted from the gross payment.

(b) *Disbursements on Account of Distributable Amount*. As soon as practicable following the Settlement Order becoming final and non-appealable, Delaware shall be responsible for the preparation and mailing of the individual settlement checks to Class Members for the Individual Claims. The Initial Distribution mailing shall include the following brief statement explaining to the Class Member the purpose of the check as agreed by the Parties:

> "Payment of Severance Claim, pursuant to Settlement Order entered in the Chapter 11 Cases of Toys "R" Us-Delaware, Inc. and its affiliates. Check must be deposited or cashed or negotiated within 75 days of the date of this check."

Checks mailed in respect of the First Reissuance Date and the Second Reissuance Date shall include the following brief statement explaining to the Class Member the purpose of the check as agreed by the Parties:

> "Payment of Severance Claim, pursuant to Settlement Order entered in the Chapter 11 Cases of Toys "R" Us-Delaware, Inc. and its affiliates. Check must be deposited or cashed or negotiated within 45 days of the date of this check."

(c) *Class Counsel Notice*. Following distribution of the settlement checks to Class Members for the Individual Claims (the "Initial Distribution"), Delaware shall provide Class Counsel an update every two weeks with the names of those Class Members whose settlement checks have been (i) returned as undeliverable, or (ii) remain uncashed or unnegotiated; *provided, however,* Delaware shall only have to provide such updates for a period of sixty-five (65) days following the Initial Distribution. Delaware shall only perform two (2) mailings of any settlement checks that need to be reissued for any reason. The first reissuance mailing shall occur forty-five (45) days after the Initial Distribution (the "First Reissuance Date") and only include distributions to Class Members for which written notice of an updated address or stop payment was provided to Delaware by Class Counsel at least ten (10) days prior to such mailing. The second reissuance mailing shall occur seventy-five (75) days after the Initial Distribution (the "Second Reissuance Date"; together with the First Reissuance Date, the "Reissuance Date") and only include distributions to Class Members for which written notice of an updated address or stop payment was provided to Delaware by Class Counsel at least ten (10) days prior to such mailing. Upon Class Counsel's written notice of a Class Member's updated correct address for any returned settlement checks, Delaware shall mail the returned settlement check to the Class Member at such corrected address as part of the first or second reissuance mailing provided that written notice of an updated correct address is provided to Delaware by Class Counsel at least ten (10) days prior to such mailing. Class Counsel shall provide any updated correct address in Excel or another format reasonably requested by Delaware. Upon Class Counsel's written notice of a Class Member's need for a "stop payment" on their settlement check and reissuance, Delaware shall stop payment on the settlement check and reissue it as part of the first or second reissuance mailing provided that written notice of a stop payment is provided to Delaware by Class Counsel at least ten (10) days prior to such mailing and any costs to stop payment and reissue the settlement check shall be paid from the Individual Claim at the time. All reissued settlement checks and any unsent returned settlement checks for which Class Counsel has furnished a new address up until the sixty-fifth (65^{th}) day after the Initial Distribution, shall be distributed on the Second Reissuance Date. Delaware shall only be responsible for reissuing a settlement check once per each Class Member. Any distributions which are not deposited, endorsed or negotiated within seventy-five (75) days of the Initial Distribution, or forty-five (45) days of the Reissuance Date, as applicable, and are not the subject of any notice from Class Counsel described in this Section, shall be deemed residual funds (the "Residual Fund") on the one-hundred twenty first (121) day following the Initial Distribution. All Residual Funds shall revert to Delaware and be distributed in accordance with Article VI.F.4 of the Plan.

(d) *Withholding Taxes*.

1. Delaware shall report the pre-tax amount each Class Member would receive on account of their Individual Claims on account of this Settlement and the Global Settlement Agreement (the "Pre-Tax Amounts") as wages to the United States Internal Revenue Service and to other appropriate taxing authorities ("Taxing Authority" or "Taxing Authorities") on a Form W-2 issued to the Class Member with his or her taxpayer identification number. The Pre-Tax Amounts shall be subject to deductions for applicable taxes and withholdings as required by federal, state, and local law. Any employee payroll tax withholdings required by federal, state or local law shall be withheld from the distributions to the Class Members receiving payments for Individual Claims under this Settlement Agreement and the Class Members shall be issued a Form W-2 reflecting such payment. These amounts shall include the employee portion of all applicable federal, state and local taxes, including, without limitation, Federal Insurance Contribution Act ("FICA") taxes, as well as any other taxes and unemployment compensation contributions which are required to be withheld from the Class Members distributions based on the treatment of those distributions as wages. Delaware shall determine in its sole discretion,

based on applicable law, the amount of any employee taxes that will become due and owing and shall be withheld. All such employee taxes shall be withheld and deducted from the Individual Claims and paid to the appropriate Taxing Authorities. Delaware shall be responsible for the reporting of same, as well as the provision of Forms W-2 and other required tax reporting forms. For the purpose of calculating applicable taxes, the Parties agree that the Individual Claim shall constitute wages reportable on IRS Form W-2. Delaware shall also be responsible for paying the employer portion of FICA taxes and required federal and state unemployment taxes from funds other than the Distributable Amount.

2. In the event that it is subsequently determined by any Taxing Authority that any Class Member owes any additional taxes with respect to any money distributed under this Agreement, it is agreed that the determination of any tax liability is between the Class Member(s) and the Taxing Authority, and that neither Delaware nor the Debtors will be responsible for the payment of such taxes, including any interest and penalties, and any such additional taxes are the responsibility of the Class Member.

2.9 Joinder to Global Settlement Agreement.

The Class Representative agrees that the Allowed Administrative Claim constitutes an Administrative Claim (as defined under the Global Settlement Agreement), and the Class as Administrative Claim Holders (as defined under the Global Settlement Agreement) shall be bound to, and deemed not to opt out of, the Global Settlement Agreement, and the Class, including the Class Representative and each of the Class Members, shall be subject to all provisions thereof, which are incorporated herein by reference, including releases of the Debtors and their successors and assigns under the Global Settlement Agreement; *provided*, *however*, the only rights that any of the Class Members may have with respect to the Severance Claims is the right to share in the Distributable Amount pursuant to section 2.8 hereof.

2.10 Disallowance of Proofs of Claim.

Any and all proofs of claim filed on account of Severance Claims shall be disallowed and expunged from the Debtors' claims register on the Effective Date. Nothing in this Settlement Agreement shall waive or limit defenses available to the Debtors and their successors and assigns against a proof of claim that has been or may be filed against the Debtors in the Chapter 11 Cases. Any additional claims or causes of action filed or asserted by any of the Class Members with respect to liabilities related to the Several Claims shall be null, void and of no effect.

Section 3. Miscellaneous Provisions

3.1 Settlement Agreement Effective Date.

This Settlement Agreement shall become effective and binding on the Parties at 12:01 a.m., prevailing Eastern Time, on the date (the "Settlement Effective Date") on which all of the Parties have executed and delivered to the other Parties hereof counterpart signature pages of this

Settlement Agreement; *provided*, *however*, that no provisions of this Settlement Agreement shall be effective as to Delaware until the Settlement Order becomes final and non-appealable.

3.2 Representations and Warranties.

Each Party represents and warrants that upon Court approval of this Settlement, it will have the legal right and authority to enter into this Settlement and the transactions and releases contemplated hereby.

3.3 Termination.

This Settlement Agreement and the obligations of the Parties may be terminated by mutual written agreement of the Parties.

3.4 Effect of Termination.

Upon termination of this Settlement Agreement in accordance with Section 3.3 hereof, all obligations of the Parties under this Settlement Agreement shall terminate and shall be of no further force and effect; *provided*, *however*, that any claim for prior breach of this Settlement Agreement shall survive termination and all rights and remedies with respect to such claim shall be neither waived nor prejudiced in any way by termination of this Settlement Agreement.

3.5 Cooperation and Support.

The Parties shall cooperate with each other in good faith and shall coordinate their activities (to the extent possible and subject to the terms of this Settlement Agreement) in respect of: (a) the filing the Settlement Motion, obtaining Court approval of this Settlement Agreement, the entry of the Settlement Order, and the implementation of the terms set forth in this Settlement Agreement; and (b) the consummation of the transactions contemplated by this Settlement Agreement.

3.6 No Litigation.

Except as may be necessary to enforce the terms of this Settlement, each of Delaware, the Class Representative, Class Counsel, and any other person who accepts payment hereunder agree that she or he shall not commence or proceed with any action, claim, suit, proceeding or litigation on the Severance Claims, or take any action inconsistent with the terms of the Settlement.

3.7 Governing Law; Jurisdiction.

(a) This Settlement Agreement shall be construed and enforced in accordance with, and the rights of the Parties shall be governed by, the laws of the State of New York, without giving effect to the conflict of laws principles thereof. Each Party hereto agrees that it shall bring any action or proceeding in respect of any claim arising out of or related to this Settlement Agreement in the Court, and solely in connection with claims arising under this Settlement Agreement: (i) irrevocably submits to the exclusive jurisdiction and the constitutional authority of the Court; (ii) waives any objection to laying venue in any such action or proceeding in the Court; and (iii) waives any objection that the Court is an inconvenient forum, does not have jurisdiction over any Party hereto, or lacks the constitutional authority to enter final orders in connection with such action or proceeding; *provided*, *however*, that this Settlement Agreement and the releases set forth herein may be submitted in any court, arbitration, and/or other legal proceeding to enforce the terms of such releases.

(b) Each Party hereby waives, to the fullest extent permitted by applicable law, any right it may have to a trial by jury in any legal proceeding arising out of, or relating to, this Settlement Agreement or the transactions contemplated hereby (whether based on contract, tort, or any other theory). Each Party (i) certifies that no representative, agent, or attorney of any other Party has represented, expressly or otherwise, that such other Party would not, in the event of litigation, seek to enforce the foregoing waiver, and (ii) acknowledges that it and the other Parties have been induced to enter into this Settlement Agreement by, among other things, the mutual waivers and certifications in this Section 3.7.

3.8 No Admission of Liability.

Each Party enters into this Settlement Agreement without admitting any liability or conceding any allegations not already expressly admitted. This Settlement Agreement and its provisions shall not be offered or received in evidence in any action or proceeding as an admission or concession of liability or wrongdoing of any nature on the part of any Party except that it may be offered and received in evidence solely to enforce this Settlement Agreement.

3.9 Notices.

All notices hereunder shall be deemed given if in writing and delivered, if sent by electronic mail, courier, or registered or certified mail (return receipt requested) to the following addresses (or at such other addresses as shall be specified by like notice):

(a) if to Delaware, to:

Wayne Services Legacy Inc.
5 Wood Hollow Road
Parsippany, NJ 07054
Attention: Bradley E. Scher, President
Scott J. Friedman
E-mail address: bscher@oceanridgecapital.com
sjfwsli@gmail.com

with copies (which shall not constitute notice) to:

Hunton Andrews Kurth LLP
Riverfront Plaza, East Tower
951 East Byrd Street
Richmond, Virginia 23219
Attention: J.R. Smith, Esq.
E-mail address: jrsmith@hunton.com

(b) if to the Class, to:

Outten & Golden LLP
685 Third Avenue
New York, New York 10017
Attention: Jack A. Raisner, Esq.
E-mail address: jar@outtengolden.com

or such other address as may have been furnished by a Party to each of the other Parties by notice given in accordance with the requirements set forth above. Any notice given by delivery, mail, or courier shall be effective when received.

3.10 Entire Agreement.

This Settlement Agreement, including any exhibits, annexes, and/or schedules hereto and the exhibits, annexes, and/or schedules thereto, constitutes the entire agreement between the Parties concerning the subject matter of this Settlement Agreement and supersedes all prior negotiations, agreements, and understandings, whether written or oral, between and among the Parties concerning the subject matter of this Settlement Agreement. Each of the Parties hereto acknowledges that it is executing this Settlement Agreement without reliance on any representations, warranties, or commitments other than those representations, warranties, and commitments expressly set forth in this Settlement Agreement.

3.11 Modification or Amendment.

This Settlement Agreement may be modified or amended only by written agreement executed by Delaware and Class Representative. The Parties may extend or modify any dates in this Settlement Agreement via e-mail confirmation.

3.12 Further Assurances.

From and after the Settlement Effective Date, each of the Parties agrees to use their respective reasonable best efforts to execute or cause to be executed and deliver or cause to be delivered all such agreements, instruments and documents and take or cause to be taken all such further actions as may reasonably be necessary from time to time to carry out the intent and purpose of this Settlement Agreement, and to consummate the transactions contemplated hereby and thereby.

3.13 Successors and Assigns.

Except as otherwise provided in this Settlement Agreement, this Settlement Agreement is intended to bind and inure to the benefit of each of the Parties and each of their respective successors, assigns, heirs, executors, administrators, and representatives.

3.14 Interpretation.

This Settlement Agreement is the product of negotiations among the Parties, and the enforcement or interpretation of this Settlement Agreement is to be interpreted in a neutral manner and in accordance with section 102 of the Bankruptcy Code; and any presumption with regard to interpretation for or against any Party by reason of that Party (or its counsel) having drafted or caused to be drafted this Settlement Agreement or any portion of this Settlement Agreement, shall not be effective in regard to the interpretation of this Settlement Agreement.

3.15 Settlement Discussions.

This Settlement Agreement and the transactions contemplated herein are part of a settlement among the Parties. Nothing herein shall be deemed an admission of any kind. To the extent provided by Federal Rule of Evidence 408, any applicable mediation privileges, and any applicable state rules of evidence, this Settlement Agreement and all negotiations relating thereto shall not be admissible into evidence in any proceeding other than a proceeding to enforce the terms of this Settlement Agreement.

3.16 Specific Performance.

It is understood and agreed by the Parties that money damages would be an insufficient remedy for any breach of this Settlement Agreement by any Party, that such breach would represent irreparable harm, and that each non-breaching Party shall be entitled to specific performance and injunctive relief (without the posting of any bond and without proof of actual damages), but no other form of equitable relief, as the sole remedy for any such breach, including an order of the Court or other court of competent jurisdiction requiring any Party to comply promptly with any of its obligations hereunder; *provided*, *however*, that each Party agrees to waive any requirement for the securing or posting of a bond in connection with such remedy.

3.17 Execution of Agreement.

This Settlement Agreement may be executed in counterparts, and by the different Parties hereto on separate counterparts, each of which when executed and delivered shall constitute an original. Delivery of an executed counterpart by facsimile or electronic mail shall be equally as effective as delivery of an original executed counterpart.

3.18 Non-Severability of Agreement.

This Settlement Agreement is to be construed as a whole, and all provisions of it are to be read and construed together. Notwithstanding anything in this Settlement Agreement or the Settlement Order to the contrary, and in light of the integrated nature of the settlements and compromises embodied in this Settlement Agreement and the Settlement Order, in the event that: (a) a court of competent jurisdiction enters a final order ruling that any of the provisions of this Settlement Agreement or the Settlement Order are void, invalid, illegal, or unenforceable in any material respect; or (b) any of the provisions of this Settlement Agreement or the Settlement Order are reversed, vacated, overturned, voided, or unwound in any material respect, then in each case, the entirety of this Settlement Agreement (other than this Section 3.18) shall be void ab initio and of no force and effect and, during any subsequent proceeding, the Parties shall not assert claim preclusion, issue preclusion, estoppel or any similar defense in respect of rights and claims of the

Parties that were the subject of this Settlement Agreement prior to this Settlement Agreement being of no force or effect.

[Signature Pages follow]

IN WITNESS WHEREOF, the parties hereto have executed this Settlement Agreement on the date first written above.

Wayne Services Legacy Inc., on behalf of itself and Toys "R" Us-Delaware, Inc.	Counsel for Anne-Marie Reinhart and the Putative **Class Members**
By: Bradley E. Scher	By: Jack A. Raisner
Title: President	Title: Partner, Outten & Golden LLP, Putative Class Counsel

IN WITNESS WHEREOF, the parties hereto have executed this Settlement Agreement on the date first written above.

Wayne Services Legacy Inc., on behalf of itself and Toys "R" Us-Delaware, Inc.	**Class Members**
By: Bradley E. Scher	By:
Title: President	Title:

User Name: Richard Corbi

Date and Time: Tuesday, October 1, 2019 10:55:00 AM EDT

Job Number: 98832135

Document (1)

1. *2018 Bill Text NJ A.B. 5145*

   Client/Matter: -None-

2018 Bill Text NJ A.B. 5145

Introduced, March 5, 2019

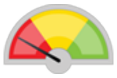
Reporter
2018 Bill Text NJ A.B. 5145

Notice

Added: Text highlighted in green
Deleted: ~~Red text with a strikethrough~~

THE STATE OF NEW JERSEY BILL TEXT > NEW JERSEY 218TH LEGISLATURE - SECOND REGULAR SESSION > ASSEMBLY BILL 5145

Progress



Low chance to pass next stage | Legislative Outlook in detail

Synopsis

An Act concerning certain plant closings, transfers, mass layoffs, and changes in control and amending and supplementing P.L.2007, c.212.

Digest

STATEMENT

This bill amends the "Millville Dallas Airmotive Plant Job Loss Notification Act", P.L.2007, c.212, to increase, from 60 days to 90 days, the minimum number of days that covered employers must give to employees of a covered plant closing, transfer, or mass layoff, and makes the act's requirement to provide severance pay apply whether or not the employer provides the required notice. The bill provides that the severance is regarded as compensation due to an employee for back pay, and earned in full upon the termination of the employment relationship.

The bill revises the act's definitions of "establishment" and "mass layoff" to include a greater number of employers across the State. The bill provides that the act applies to any reduction in workforce which is not the result of a transfer or termination of operations and which results in the termination of employment at an establishment during any 30-day period for 50 or more of the full or part-time employees at or reporting to the establishment. Previously, the act applied to lay-offs only of 500 or more full-time employees or to 50 or more full-time employees representing at least one-third of employees in a worksite.

Richard Corbi

The bill provides that if an employer provides an employee with less than 90 days of notification before termination of employment, the employer must provide that employee with an additional four weeks of pay.

The bill expands the definition of employers that are subject to the act to include a person or entity that makes a decision responsible for the employment action that gives rise to a mass layoff subject to notification.

The bill provides that no waiver of the right to severance provided pursuant to the bill may be effective without approval by the commissioner or a court of competent jurisdiction.

The bill provides additional employment protections for employees of an employer that employs 50 or more employees if the employer undergoes a "change in control," that is, a change in ownership or filing of bankruptcy in which control of the employees' workplace changes hands to a successor employer.

The bill requires the successor employer to retain, without reduction of pay, all employees, other than managerial, supervisory, confidential, temporary, and certain part-time employees, for a transition period of not less than 180 days following the date of the change of control, unless the commissioner approves a reduction in the workforce.

The bill requires, no later than 15 days before the date of the change of control, the predecessor employer to post public notice of the change of control at the work sites of all affected employees, and provide specified information about employees to the successor employer, who is required to retain that list and other records regarding offers of employment, termination, or written evaluations of the employees.

The bill permits, for two years after the transition period, the successor employer to reduce the total number of employees only if approved by the commissioner, who may not authorize a reduction except upon a showing by a preponderance of the evidence that the employer has conducted a study of the nature and scope of the work performed by the employees proposed to be eliminated, and that the study shows that the reduction is necessary for the continued solvency of the business.

Text

Be It Enacted by the Senate and General Assembly of the State of New Jersey:

1.

Section 1 of P.L.2007, c.212 *(C.34:21-1) is amended* to read as follows:

1.

As used in ~~this act~~ P.L.2007, C.212 (C.34:21-1 ET SEQ.) :

"Commissioner" means the Commissioner of Labor and Workforce Development.

"Department" means the Department of Labor and Workforce Development.

"Employer" means an individual or private business entity which employs the workforce at an establishment.

"Establishment" means a ~~single~~ place of employment which has been operated by an employer for a period longer than three years, but shall not include a temporary construction site. "Establishment" may be a single location or a group of ~~contiguous~~ locations, including ~~groups of~~ ANY facilities ~~which form an office or industrial park or separate facilities just across the street from each other~~ LOCATED IN THIS STATE .

"Facility" means a building.

~~"Full-time employee" means an employee who is not a part-time employee.~~

"Mass layoff" means a reduction in force which is not the result of a transfer or termination of operations and which results in the termination of employment at an establishment during any 30-day period ~~for 500 or more full-time employees or~~ for 50 or more of the ~~full-time~~ employees ~~representing one third or more of the full-time employees~~ at OR REPORTING TO the establishment.

"Operating unit" means an organizationally distinct product, operation, or specific work function within or across facilities at a single establishment.

~~"Part-time employee" means an employee who is employed for an average of fewer than 20 hours per week or who has been employed for fewer than six of the 12 months preceding the date on which notice is required pursuant to this act.~~

"Response team" means the plant closing response team established pursuant to section 5 of ~~this act~~ P.L.2007, C.212 (C.34:21-5) .

"Termination of employment" means the layoff of an employee without a commitment to reinstate the employee to his previous employment within six months of the layoff, except that "termination of employment" shall not mean a voluntary departure or retirement or a discharge or suspension for misconduct of the employee connected with the employment or any layoff of a seasonal employee or refer to any situation in which an employer offers to an employee, at a location inside the State and not more than 50 miles from the previous place of employment, the same employment or a position with equivalent status, benefits, pay and other terms and conditions of employment, and, except that a layoff of more than six months which, at its outset, was announced to be a layoff of six months or less, shall not be treated as a termination of employment under ~~this act~~ P.L.2007, C.212 (C.34:21-1 ET SEQ.) if the extension beyond six months is caused by business circumstances not reasonably foreseeable at the time of the initial layoff, and notice is given at the time it becomes reasonably foreseeable that the extension beyond six months will be required.

"Termination of operations" means the permanent or temporary shutdown of a single establishment, or of one or more facilities or operating units within a single establishment, except that "termination of operations" shall not include a termination of operations made necessary because of a fire, flood, natural disaster, national emergency, act of war, civil disorder or industrial sabotage, decertification from participation in the Medicare and Medicaid programs as provided under Titles XVIII and XIX of the federal "Social Security Act," Pub.L. 74-271 (42 U.S.C. s.1395 et seq.) or license revocation pursuant to P.L.1971, c.136 (C.26:2H-1 et al.).

"Transfer of operations" means the permanent or temporary transfer of a single establishment, or one or more facilities or operating units within a single establishment, to another location, inside or outside of this State.

(cf: P.L.2007, c.212, s.1)

2.

Section 2 of P.L.2007, c.212 *(C.34:21-2) is amended* to read as follows:

2.

If an establishment is subject to a transfer of operations or a termination of operations which results, during any continuous period of not more than 30 days, in the termination of employment of 50 or more ~~full-time~~ employees, or if an employer conducts a mass layoff, the employer who operates the establishment or conducts the mass layoff shall:

a.

Provide, in the case of an employer who employs 100 or more ~~full-time~~ employees, not less than ~~60~~ 90 days, or the period of time required pursuant to the federal "Worker Adjustment and Retraining Notification Act," 29 U.S.C. s.2101 et seq., or any amendments thereto, whichever is longer, before the first termination of employment occurs in connection with the termination or transfer of operations, or mass layoff, notification of the termination or transfer of operations or mass layoff to the Commissioner of Labor and Workforce Development, the chief elected official of the municipality where the establishment is located, each employee whose employment is to be terminated and any collective bargaining units of employees at the establishment;

b.

Provide to each employee whose employment is terminated ~~and to whom the employer provides less than the number of days of notification required pursuant to subsection a. of this section,~~

severance pay equal to one week of pay for each full year of employment. IF THE EMPLOYER PROVIDES ANY EMPLOYEE WITH LESS THAN THE NUMBER OF DAYS OF NOTIFICATION REQUIRED PURSUANT TO SUBSECTION A. OF THIS SECTION, THE EMPLOYER SHALL PROVIDE THAT EMPLOYEE WITH AN ADDITIONAL FOUR WEEKS OF PAY. The rate of severance pay provided by the employer pursuant to this subsection b. shall be the average regular rate of compensation received during the employee's last three years of employment with the employer or the final regular rate of compensation paid to the employee, whichever rate is higher. SEVERANCE UNDER THIS SUBSECTION SHALL BE REGARDED AS COMPENSATION DUE TO AN EMPLOYEE FOR BACK PAY AND LOSSES ASSOCIATED WITH THE TERMINATION OF THE EMPLOYMENT RELATIONSHIP, AND EARNED IN FULL UPON THE TERMINATION OF THE EMPLOYMENT RELATIONSHIP, NOTWITHSTANDING THE CALCULATION OF THE AMOUNT OF THE PAYMENT WITH REFERENCE TO THE EMPLOYEE'S LENGTH OF SERVICE. The severance pay provided by the employer pursuant to this subsection b. shall be in addition to any severance pay provided by the employer pursuant to a collective bargaining agreement or for any other reason, except that any back pay provided by the employer to the employee pursuant to section 5 of the "Worker Adjustment and Retraining Notification Act," Pub.L.100-379 (29 U.S.C. s.2104), because of a violation of section 3 of that act *(29 U.S.C. s. 2102)* shall be credited toward meeting the severance pay requirements of this subsection b.; and

c.

Provide the response team with the amount of on-site work-time access to the employees of the establishment that the response team determines is necessary for the response team to carry out its responsibilities pursuant to section 5 of P.L.2007, c.212 (C.34:21-5).

In determining whether a termination or transfer of operations or a mass layoff is subject to the notification requirements of this section, any terminations of employment for two or more groups at a single establishment occurring within any 90-day period, when each group has less than the number of terminations which would trigger the notification requirements of this section but the aggregate for all of the groups exceeds that number, shall be regarded as subject to the notification requirements unless the employer demonstrates that the cause of the terminations for each group is separate and distinct from the causes of the terminations for the other group or groups.

D.

FOR PURPOSES OF THIS SECTION, "EMPLOYER" INCLUDES ANY INDIVIDUAL, PARTNERSHIP, ASSOCIATION, CORPORATION, OR ANY PERSON OR GROUP OF PERSONS ACTING DIRECTLY OR INDIRECTLY IN THE INTEREST OF AN EMPLOYER IN RELATION TO AN EMPLOYEE, AND INCLUDES ANY PERSON WHO, DIRECTLY OR INDIRECTLY, OWNS AND OPERATES THE NOMINAL EMPLOYER, OR OWNS A CORPORATE SUBSIDIARY THAT, DIRECTLY OR INDIRECTLY, OWNS AND OPERATES THE NOMINAL EMPLOYER OR MAKES THE DECISION RESPONSIBLE FOR THE EMPLOYMENT ACTION THAT GIVES RISE TO A MASS LAYOFF SUBJECT TO NOTIFICATION.

E.

NO WAIVER OF THE RIGHT TO SEVERANCE PROVIDED PURSUANT TO THIS SECTION SHALL BE EFFECTIVE WITHOUT APPROVAL OF THE WAIVER BY THE COMMISSIONER OR A COURT OF COMPETENT JURISDICTION.

(cf: P.L.2007, c.212, s.2)

3.

(New section) a. As used in this section:

"Business" means any individual, partnership, association, corporation, or any person or group of persons that employ 50 or more employees.

"Change of control" means any material change in ownership of an employer or any filing seeking bankruptcy protection.

"Covered employee" means an individual who has been employed by an employer for at least 90 days immediately before a change of control affecting that individual's principal place of employment. A change of control affects a covered employee's principal place of employment if the change of control results in the predecessor employer transferring control of the place of employment to the successor employer.

"Covered employee" does not include any of the following:

(1)

A managerial, supervisory, or confidential employee;

(2)

A temporary employee; or

(3)

A part-time employee who has worked less than 20 hours per week for the predecessor employer for at least 90 days immediately before the change of control.

"Predecessor employer" means the person who controls a business before the change of control.

"Principal place of employment" of an employee means the office or other facility where the employee is principally assigned to work by the predecessor employer.

"Successor employer" means the person who controls a business after the change of control.

"Total compensation" means the combined value of the covered employee's wages and benefits immediately before the change of control. Total compensation may be paid entirely as wages or in any combination of wages and fringe benefits, to be determined by the successor employer. Total compensation includes, but is not limited to, the covered employee's hourly wage rate or the per diem value of the covered employee's monthly salary, and the employer payments toward the covered employee's health and welfare and pension benefits.

"Transition period" means a period of 180 days immediately following the effective date of a change of control.

b.

(1)

Except as otherwise provided in this section, a successor employer shall retain all covered employees for at least the transition period following a change of control, unless the commissioner approves a reduction in the workforce pursuant to subsection h. of this section. During the transition period, the successor employer shall not reduce the total compensation of a covered employee.

(2)

During the transition period, a successor employer shall not terminate a covered employee without cause.

(3)

A successor employer and a labor organization representing covered employees may, in a collective bargaining agreement, provide that the agreement supersedes the requirements of this section.

c.

No later than 15 days before the effective date of a change of control, the predecessor employer shall post public notice of the change of control at each principal place of employment of any covered employee. The notice shall include the name of the predecessor employer and its contact information, the name of the successor employer and its contact information, and the effective date of the change of control. The notice shall be posted in a conspicuous place in a manner that is readily viewed by covered employees. No later than 15 days before the effective date of a change of control, the predecessor employer shall also cause the notice to be sent to any labor organization that represents covered employees.

d.

This section shall not be construed to limit the right of covered employees to bring legal action for wrongful termination.

e.

The rights and remedies provided pursuant to this section are in addition to, and are not intended to supplant, any existing rights or remedies.

f.

No later than 15 days before the effective date of a change of control, a predecessor employer shall provide to the successor employer the name, address, date of hire, total compensation, and classification of each covered employee.

g.

A successor employer shall retain the following written or electronic records for at least three years:

(1)

The list provided to the successor employer pursuant to subsection e. of this section;

(2)

Any offer of employment made to a covered employee;

(3)

Any termination of a covered employee during a transition period, including the reasons for the termination; and

(4)

Any written evaluation of a covered employee.

h.

For two years after the transition period, a successor employer may reduce the total number of employees who would have qualified as covered employees during the 90-day period immediately before a change of control only if approved by the commissioner. The commissioner shall not authorize a successor employer to reduce the number of those employees except on a showing by a preponderance of the evidence that the employer has conducted a study of the nature and scope of the work performed by those employees proposed to be eliminated and the study shows that the elimination of the employees is necessary for the continued solvency of the business.

i.

A successor employer may terminate an employee with cause consistent with any applicable collective bargaining agreement during the period specified in subsection h. of this section.

4.

This act shall take effect immediately.

History

ASSEMBLY, NO. 5145

STATE OF NEW JERSEY

218TH LEGISLATURE

INTRODUCED MARCH 5, 2019

SPONSORED BY:

ASSEMBLYWOMAN ANNETTE QUIJANO

DISTRICT 20 (UNION)

SYNOPSIS

INCREASES PRENOTIFICATION TIME AND REQUIRES SEVERANCE PAY IN CERTAIN PLANT CLOSINGS, TRANSFERS, AND MASS LAYOFFS; REQUIRES BUSINESSES THAT HAVE CHANGE OF CONTROL TO NOTIFY AND RETAIN EMPLOYEES FOR CERTAIN PERIOD.

CURRENT VERSION OF TEXT

AS INTRODUCED.

Sponsor(s)

Quijano

Classification

Subject: LAYOFFS (96%); FULL TIME EMPLOYMENT (96%); EMPLOYEE TERMINATION (95%); CLOSINGS (93%); PART TIME EMPLOYMENT (93%); LABOR FORCE (82%); MISCONDUCT (78%); PLANT CLOSINGS (63%); LEGISLATION (63%); WAGES & SALARIES (63%); DISMISSALS (63%); SOCIAL SECURITY ACTS (63%); SEVERANCE PAY (63%); EMPLOYMENT (63%); LEGISLATORS (63%); APPROVALS (62%); NATURAL DISASTERS (62%); EVIDENCE (50%)

Load-Date: March 7, 2019

THE STATE OF NEW JERSEY BILL TEXT
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End of Document

116TH CONGRESS
1ST SESSION

S. ____

To require the Securities and Exchange Commission to issue rules requiring private funds to publicly disclose certain information, and for other purposes.

IN THE SENATE OF THE UNITED STATES

Ms. WARREN (for herself, Ms. BALDWIN, Mrs. GILLIBRAND, and Mr. BROWN) introduced the following bill; which was read twice and referred to the Committee on ____________________

A BILL

To require the Securities and Exchange Commission to issue rules requiring private funds to publicly disclose certain information, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "Stop Wall Street Looting Act".

(b) TABLE OF CONTENTS.—The table of contents for this Act is as follows:

Sec. 1. Short title; table of contents.
Sec. 2. Findings.
Sec. 3. Definitions.

TITLE I—CORPORATE RESPONSIBILITY

Sec. 101. Joint and several liability for controlling private funds.
Sec. 102. Joint and several liability for holders of economic interests in controlling private funds.
Sec. 103. Indemnification void as against public policy.

TITLE II—ANTI-LOOTING

Sec. 201. Limitations on post-acquisition dividends, distributions, redemptions, and buybacks.
Sec. 202. Prevention of fraudulent transfers.
Sec. 203. Surtax on certain amounts received by investment firms from controlled target firms.
Sec. 204. Limitation on deduction for business interest of certain businesses owned by private funds.

TITLE III—PROTECTING WORKERS WHEN COMPANIES GO BANKRUPT

Sec. 301. Increased priority for wages.
Sec. 302. Priority for severance pay and contributions to employee benefit plans.
Sec. 303. Priority for violations of Federal and State laws.
Sec. 304. Limitation on executive compensation enhancements.
Sec. 305. Prohibition against special compensation payments.
Sec. 306. Executive compensation upon exit from bankruptcy.
Sec. 307. Collateral surcharge for employee obligations.
Sec. 308. Voidability of preferential compensation transfers.
Sec. 309. Protection for employees in a sale of assets.
Sec. 310. Protection of gift card purchasers.
Sec. 311. Commercial real estate.

TITLE IV—CLOSING THE CARRIED INTEREST LOOPHOLE

Sec. 401. Amendment of 1986 Code.
Sec. 402. Partnership interests transferred in connection with performance of services.
Sec. 403. Special rules for partners providing investment management services to partnerships.

TITLE V—INVESTOR PROTECTION AND MARKET TRANSPARENCY

Sec. 501. Disclosure of fees and returns.
Sec. 502. Fiduciary obligations.
Sec. 503. Disclosures relating to the marketing of private equity funds.

TITLE VI—RESTRICTIONS ON SECURITIZING RISKY CORPORATE DEBT

Sec. 601. Risk retention requirements for securitization of corporate debt.

TITLE VII—MISCELLANEOUS

Sec. 701. Anti-evasion.
Sec. 702. Severability.

SEC. 2. FINDINGS.

Congress finds the following:

(1) During the 20-year period preceding the date of enactment of this Act, activity by private equity funds has exploded.

(2) Millions of people in communities across the United States rely on companies that are owned by private equity funds, including almost 5,800,000 individuals who work for companies owned by those funds. For millions of additional individuals, a private investment fund acts as a landlord, a lender, or an owner of a local grocery store, newspaper, or hospital. Many pension funds are also investors in private investment funds.

(3) Private investment funds have taken controlling stakes in companies in a wide variety of industries, including the financial services, real estate, media, and healthcare industries, but some of the largest impacts from private investment funds have been in the retail sector. In the 2 years preceding the date of enactment of this Act, cases have been commenced under title 11, United States Code, with respect to dozens of retailers in the United States, including Sears, Toys "R" Us, Shopko, Payless ShoeSource, Charlotte Russe, Bon-Ton, Nine West, David's Bridal, Claire's, and Southeastern Grocers,

which was the parent company for BI-LO and Winn-Dixie.

(4) Private investment funds have also targeted entities that serve low-income or vulnerable populations, including affordable housing developments, for-profit colleges, payday lenders, medical providers, and nursing homes.

(5) While private investment funds often purport to take over struggling companies and make those companies viable, the opposite is often true. Leveraged buyouts impose enormous debt loads on otherwise viable companies and then strip those companies of assets, hobbling the operations of those companies and preventing them from making necessary investments for future growth. If an investment goes well, the fund reaps most of the rewards, but if the investment does not go well, workers and customers of the company, and the community relying on the company, suffer.

(6) Regardless of the performance of a private investment fund, the managers of the fund often make profits through fees, dividends, and other financial engineering. Private funds should have a stake in the outcome of their investments, enjoying

returns if those investments are successful but absorbing losses if those investments fail.

(7) When a case is commenced under title 11, United States Code, with respect to a portfolio company, workers not only lose jobs, but also lose wages and benefits that are owed, severance pay that has been promised, and pensions that have been earned. Workers should not be sent to the back of the line behind other creditors if, through no fault of those workers, an investment fails.

(8) The performance of private investment funds is cloaked in secrecy. Those funds have full control over the information that the funds disclose to investors, which allows the funds to manufacture their own performance metrics and makes it difficult for an investor to compare the returns to other investment options. Funds also increasingly require investors to waive the fiduciary obligations applicable to the funds. Investors should have the information and bargaining power to take control over their own investments.

(9) An increasing amount of risky debt is being introduced into the market and the quality of that debt is deteriorating, raising concerns with regulators and lawmakers about systemic risk. The insti-

tutions that make and securitize risky loans collect large fees and then pass on risk to unwitting investors. The financial system should not bear all of the risk while lenders and securitizers reap the rewards.

(10) The Federal Government should—

(A) protect workers, companies, consumers, and investors in the United States; and

(B) put an end to the practice of looting of economically viable companies for the enrichment of private investment fund managers.

SEC. 3. DEFINITIONS.

In this Act:

(1) AFFILIATE.—The term ''affiliate'' means—

(A) a person that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of another entity, other than a person that holds such securities—

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(B) a corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by another entity (referred to in this subparagraph as a ''covered entity''), or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the covered entity, other than an entity that holds such securities—

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) a person whose business is operated under a lease or operating agreement by another entity, or person substantially all of whose property is operated under an operating agreement with that other entity; or

(D) an entity that operates the business or substantially all of the property of another entity under a lease or operating agreement.

(2) CAPITAL DISTRIBUTION.—The term "capital distribution" means—

(A) a cash or share dividend;

(B) a share repurchase;

(C) a share redemption;

(D) a share buyback;

(E) a payment of interest or fee on a share of stock; and

(F) any other transaction similar to a transaction described in subparagraphs (A) through (E).

(3) CHANGE IN CONTROL.—The term "change in control" means a change of economic interest with respect to—

(A) the power to vote more than 50 per centum of any class of voting securities of a corporation that engages in interstate commerce; or

(B) any lesser per centum of any class of voting securities of a corporation that engages in interstate commerce that is sufficient to make the acquirer of such an interest a person that has the ability to direct the actions of that corporation.

(4) CHANGE IN CONTROL TRANSACTION.—The term ''change in control transaction'' means a transaction that effects a change in control.

(5) COMMISSION.—The term ''Commission'' means the Securities and Exchange Commission.

(6) CONTROL PERSON.—The term ''control person''—

(A) means—

(i) a person—

(I) that directly or indirectly owns, controls, or holds with power to vote, including through coordination with other persons, 20 percent or more of the outstanding voting interests of a target firm; or

(II) that operates the business or substantially all of the property of a target firm under a lease or operating agreement;

(ii) a corporation, other than a target firm, that has 20 percent or more of its outstanding voting interests directly or indirectly owned, controlled, or held with power to vote by a person that directly or indirectly owns, controls, or holds with power to vote, including through coordination with other persons, 20 percent or more of the outstanding voting interests of a target firm; and

(iii) a person that otherwise has the ability to direct the actions of a target firm; and

(B) does not include a person that—

(i) holds the voting interests of a corporation solely—

(I) in a fiduciary or agency capacity without sole discretionary power to vote the securities; or

(II) to secure a debt, if the person has not exercised the power to vote; or

(ii)(I) is a limited partner with respect to a person described in subparagraph (A) that is a partnership; and

(II) does not participate in the direction of the management or policy of a corporation.

(7) CORPORATION.—The term ''corporation'' means—

(A) a joint-stock company;

(B) a company or partnership association organized under a law that makes only the capital subscribed or callable up to a specified amount responsible for the debts of the association, including a limited partnership and a limited liability company;

(C) a trust; and

(D) an association having a power or privilege that a private corporation, but not an individual or a partnership, possesses.

(8) HOLDER OF AN ECONOMIC INTEREST.—The term ''holder of an economic interest''—

(A) means a person that directly or indirectly has an economic interest in a corporation or a right to participate in the governance of a corporation, without regard to the form or source of that interest or right; and

(B) if the economic interest described in subparagraph (A) is a security, does not include—

(i) an individual who is engaged in business as an underwriter of securities and who acquires that security through the good faith participation of the individual in a firm commitment underwriting registered under the Securities Act of 1933 (15 U.S.C. 77b) until the date that is 40 days after the date on which that acquisition occurs; or

(ii) a member of a national securities exchange solely because that member is the record holder of that security and, under the rules of that exchange—

(I) may direct the vote of that security, without instruction, on—

(aa) other than contested matters; or

(bb) matters that may substantially affect the rights or privileges of the holders of the security to be voted; and

(II) is otherwise precluded from voting without instruction; and

(C) does not include—

(i) a person that holds an economic interest solely to secure a debt if that person does not exercise any voting other governance rights with respect to the interest; or

(ii) a person that is not an insider with respect to a control person.

(9) INSIDER.—The term ‘‘insider’’ means any—

(A) director of a corporation;

(B) officer of a corporation;

(C) managing agent of a corporation;

(D) control person with respect to a corporation;

(E) affiliate of a corporation;

(F) consultant or contractor retained by a corporation;

(G) affiliate, relative, or agent of a person described in any of subparagraphs (A) through (E); and

(H) affiliate, relative, or agent of a person described in subparagraph (G).

(10) INVESTMENT ADVISER.—The term ‘‘investment adviser’’ has the meaning given the term in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)).

(11) ISSUER.—The term ‘‘issuer’’ has the meaning given the term in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)).

(12) NATIONAL SECURITIES EXCHANGE.—The term ‘‘national securities exchange’’ means an ex-

change that is registered as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f).

(13) PRIVATE FUND.—Except as otherwise expressly provided, the term "private fund"—

(A) means a company or partnership that—

(i) would be considered an investment company under section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3) but for the application of paragraph (1) or (7) of subsection (c) of such section 3;

(ii) directly or through an affiliate, acts as a control person; and

(iii) is not a venture capital fund, as defined in section 275.203(l)–1 of title 17, Code of Federal Regulations, as in effect on the date of enactment of this Act; and

(B) does not include an institution selected under section 107 of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. 4706).

(14) RELATIVE.—The term "relative" has the meaning given the term in section 101 of title 11, United States Code.

(15) TARGET FIRM.—The term ''target firm'' means a corporation that is acquired in a change in control transaction.

TITLE I—CORPORATE RESPONSIBILITY

SEC. 101. JOINT AND SEVERAL LIABILITY FOR CONTROLLING PRIVATE FUNDS.

(a) IN GENERAL.—Notwithstanding any other provision of law, or the terms of any contract or agreement, a private fund shall be jointly and severally liable for all liabilities of each target firm with respect to the private fund, and any affiliate of such a target firm, including—

(1) any debt incurred by the target firm or an affiliate of the target firm, including as part of the acquisition of the target firm by the private fund;

(2) any Federal or State civil monetary penalty, or obligation under a settlement or consent order with a Federal or State governmental agency or instrumentality, including a consumer restitution obligation, for which the target firm, or an affiliate of the target firm, is liable;

(3) any liability resulting from a violation of section 3 of the Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102) by the target firm or an affiliate of the target firm;

(4) any withdrawal liability determined under part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1381 et seq.) that is incurred by the target firm or an affiliate of the target firm; and

(5) any claim for unfunded benefit liabilities owed to the Pension Benefit Guaranty Corporation under subtitle D of title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1361 et seq.) with respect to the termination of a pension plan sponsored by the target firm or an affiliate of the target firm.

(b) RULE OF CONSTRUCTION.—Nothing in this section may be construed to diminish existing, as of the date of this Act, controlled group liability under the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.).

SEC. 102. JOINT AND SEVERAL LIABILITY FOR HOLDERS OF ECONOMIC INTERESTS IN CONTROLLING PRIVATE FUNDS.

(a) IN GENERAL.—Notwithstanding any other provision of law, or the terms of any contract or agreement, a holder of an economic interest in a private fund shall be jointly and severally liable for all liabilities of each target firm with respect to the private fund, and any affiliate of such a target firm, including—

(1) any debt incurred by the target firm or an affiliate of the target firm, including as part of the acquisition of the target firm by the private fund;

(2) any Federal or State civil monetary penalty, or obligation under a settlement or consent order with a Federal or State governmental agency or instrumentality, including a consumer restitution obligation, for which the target firm, or an affiliate of the target firm, is liable;

(3) any liability resulting from a violation of section 3 of the Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102) by the target firm or an affiliate of the target firm;

(4) any withdrawal liability determined under part 1 of subtitle E of title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1381 et seq.) that is incurred by the target firm or an affiliate of the target firm; and

(5) any claim for unfunded benefit liabilities owed to the Pension Benefit Guaranty Corporation under subtitle D of title IV of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1361 et seq.) with respect to the termination of a pension

plan sponsored by the target firm or an affiliate of the target firm.

(b) RULE OF CONSTRUCTION.—Nothing in this section may be construed to diminish existing, as of the date of this Act, controlled group liability under the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.).

SEC. 103. INDEMNIFICATION VOID AS AGAINST PUBLIC POLICY.

It shall be void as against public policy for a target firm, or an affiliate of a target firm, to indemnify a private fund that is a control person with respect to the target firm, or any affiliate of the target firm, with respect to the liabilities of the fund or the affiliate, as applicable, under sections 101 and 102.

TITLE II—ANTI-LOOTING

SEC. 201. LIMITATIONS ON POST-ACQUISITION DIVIDENDS, DISTRIBUTIONS, REDEMPTIONS, AND BUYBACKS.

(a) IN GENERAL.—No target firm may, during the 2-year period beginning on the closing date of a change in control transaction that results in control of the target firm by a private fund—

(1) make a capital distribution or similarly reduce the equity capital of the target firm; or

(2) incur an obligation that commits the target firm to making a capital distribution or a similar reduction of the equity capital of the target firm after the end of that 2-year period.

(b) VOID.—Any transfer made or obligation incurred by a target firm or an affiliate with respect to a target firm in violation of subsection (a) shall be void.

(c) JOINT AND SEVERAL LIABILITY FOR AIDERS AND ABETTORS.—Any control person that is a private fund, any holder of an economic interest in a control person that is a private fund, or any affiliate of a target firm that aids, abets, facilitates, supports, or instructs any violation of subsection (a) shall be jointly and severally liable under this subsection for any transfer made or obligation incurred, including for reasonable attorney's fees and costs awarded to a plaintiff under subsection (d)(2).

(d) CAUSE OF ACTION.—

(1) IN GENERAL.—Any employee or creditor, or representative of an employee or creditor, of a target firm that is a debtor under title 11, United States Code, or of an affiliate of a target firm that is such a debtor, may bring an action in an appropriate district court of the United States against the direct or indirect transferee or obligee or beneficiary of the transfer or obligation to void the transfer or obliga-

tion and recover any transferred property for the target firm.

(2) AWARD.—In a successful action to recover a transfer, the court shall also award the plaintiff reasonable attorney's fees and costs.

SEC. 202. PREVENTION OF FRAUDULENT TRANSFERS.

(a) LIMITATION ON SAFE HARBORS.—Section 546(e) of title 11, United States Code, is amended by inserting after ''548(b) of this title,'' the following: ''and except in the case of a transfer made in connection with a change in control transaction, as defined in section 3 of the Stop Wall Street Looting Act, or during the protected period, as defined in section 548(f) of this title,''.

(b) PRESUMPTION OF INSOLVENCY IN TRANSFERS UNDERTAKEN IN CONNECTION WITH CHANGE IN CONTROL TRANSACTIONS.—Section 548 of title 11, United States Code, is amended by adding at the end the following:

''(f)(1) In this subsection—

''(A) the terms 'change in control transaction', 'control person', and 'target firm' have the meanings given those terms in section 3 of the Stop Wall Street Looting Act; and

''(B) the term 'protected period' means the shorter of—

"(i) the 8-year period beginning on the date on which a change in control transaction closed; or

"(ii) the period beginning on the date on which a change in control transaction closed and ending on the earliest subsequent date on which a public offering of a controlling share of the common equity securities of the target firm occurs.

"(2) For purposes of this section, the debtor is presumed to have made a transfer or incurred an obligation described in subparagraphs (A) and (B) of subsection (a)(1) if—

"(A) the transfer is made to or obligation is incurred by a target firm or an affiliate in connection with a change in control transaction; or

"(B) the transfer is made to a target firm or an affiliate by, or obligation is incurred by a target firm or an affiliate from, a control person, an affiliate, or an insider during a protected period.

"(3) For the purposes of this section, a court shall, in analyzing related transactions, link together as a single transaction any interrelated yet formally distinct steps in an integrated transaction (commonly known as the 'step transaction doctrine').".

(c) STATUTE OF LIMITATIONS.—Section 3306(b) of title 28, United States Code, is amended—

(1) in paragraph (2), by striking ''or'' at the end;

(2) in paragraph (3), by striking the period at the end and inserting ''; or''; and

(3) by adding at the end the following:

''(4) within 8 years after the transfer was made or the obligation was incurred, if the transfer was made or the obligation was incurred—

''(A) in connection with a change in control transaction, as defined in section 3 of the Stop Wall Street Looting Act; or

''(B) during a protected period, as defined in section 548(f) of title 11.''.

SEC. 203. SURTAX ON CERTAIN AMOUNTS RECEIVED BY INVESTMENT FIRMS FROM CONTROLLED TARGET FIRMS.

(a) IMPOSITION OF TAX.—Subchapter A of chapter 1 of the Internal Revenue Code of 1986 is amended by adding at the end the following new part:

''PART VIII—SURTAX ON CERTAIN AMOUNTS RECEIVED BY INVESTMENT FIRMS

''Sec. 59B. Surtax on certain amounts received by investment firms from controlled target firms.

"SEC. 59B. SURTAX ON CERTAIN AMOUNTS RECEIVED BY INVESTMENT FIRMS FROM CONTROLLED TARGET FIRMS.

"(a) IMPOSITION OF TAX.—

"(1) IN GENERAL.—If 1 or more applicable payments are included in the gross income of a taxpayer for any taxable year, then there is hereby imposed on the taxpayer for the taxable year a tax equal to the applicable percentage of the aggregate amount of such payments. Such tax shall be in addition to any other tax imposed by this subtitle.

"(2) APPLICABLE PERCENTAGE.—For purposes of this subsection, the term 'applicable percentage' means 100 percent, minus the highest rate of tax under section 1 or 11 (whichever is applicable) for the taxable year.

"(b) APPLICABLE PAYMENT.—For purposes of this section—

"(1) IN GENERAL.—The term 'applicable payment' means any amount paid or incurred by an applicable entity (or any person related within the meaning of section 267(b) or 707(b) to such entity) to any other person which, at the time such amount is paid or incurred, is an applicable controlling entity. An amount shall be treated as an applicable payment without regard to whether it is paid or incurred to the taxpayer including it in gross income and to which subsection (a) applies.

"(2) EXCEPTIONS.—Such term shall not include any of the following:

"(A) INTEREST.—Any amount paid or incurred which is treated as interest for purposes of this chapter.

"(B) DISTRIBUTIONS OF PROPERTY WITH RESPECT TO STOCK.—Any distribution of property (as defined in section 317(a)) to which section 301(a) applies.

"(c) DEFINITIONS RELATING TO ENTITIES.—For purposes of this section—

"(1) APPLICABLE ENTITY.—The term 'applicable entity' means any person—

"(A) which is engaged in the active conduct of a trade or business, and

"(B) with respect to which any other person conducts activities in connection with an applicable trade or business.

"(2) APPLICABLE CONTROLLING ENTITY.—The term 'applicable controlling entity' means, with respect to any applicable entity, any person—

"(A) which is engaged in an applicable trade or business some or all of the activities of which are conducted in connection with the applicable entity, and

"(B) which controls (or is related within the meaning of section 267(b) or 707(b) to a person which controls) the applicable entity.

"(3) APPLICABLE TRADE OR BUSINESS.—The term 'applicable trade or business' means any activity conducted on a regular, continuous, and substantial basis which, regardless of whether the activity is conducted in one or more entities, consists, in whole or in part, of—

"(A) raising or returning capital, and

"(B) either—

"(i) investing in or disposing of specified assets (or identifying specified assets for such investing or disposition), or

"(ii) developing specified assets.

"(4) SPECIFIED ASSET.—The term 'specified asset' means—

"(A) securities (as defined in section 475(c)(2) but without regard to the phrase 'widely held or publicly traded' in subparagraph (B) thereof and without regard to the last sentence thereof), and

"(B) real estate held for rental or investment.

"(d) RULES AND DEFINITIONS RELATING TO OWNERSHIP ATTRIBUTION AND CONTROL.—For purposes of this section—

"(1) CONSTRUCTIVE OWNERSHIP RULES USED IN DETERMINING RELATED PARTY.—In determining whether persons are related within the meaning of section 267(b) or 707(b), the constructive ownership rules of section 318 shall apply in lieu of the constructive ownership rules which would otherwise apply, except that in applying such rules the term 'stock' shall include capital, profits, or other beneficial interests in persons other than corporations .

"(2) CONTROL.—

"(A) CORPORATIONS.—In the case of a corporation, the term 'control' has the meaning given such term by section 304(c) (without regard to paragraph (3)(B) thereof).

"(B) OTHER ENTITIES.—In the case of a person other than a corporation, such term means the ownership, directly or indirectly, of at least 50 percent of the capital, profits, or other beneficial interests in the person.

"(e) REGULATIONS.—The Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of this section, including regulations—

"(1) providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including through the use of unrelated persons, or conduit transactions, and

"(2) modifying the constructive ownership rules under section 318 to the extent necessary to apply such rules to capital, profits, or other beneficial interests as well as stock.".

(b) DISALLOWANCE OF CREDITS AGAINST TAX.—Subparagraph (B) of section 26(b)(2) of the Internal Revenue Code of 1986 is amended by inserting "or section 59B (relating to surtax on certain amounts received by investment firms from controlled target firms)" after "anti-abuse tax)".

(c) CONFORMING AMENDMENTS.—

(1) The table of parts for subchapter A of chapter 1 of the Internal Revenue Code of 1986 is amended by adding after the item relating to part VI the following new item:

"Part VIII. Surtax on certain amounts received by investment firms".

(2) Section 871(b)(1) of such Code is amended by inserting "and shall be taxable as provided in section 59B on applicable payments included in gross income which are effectively connected with the conduct of a trade or business within the United States" after "United States".

(3) Section 882(a)(1) of such Code is amended by inserting "and shall be taxable as provided in section 59B on applicable payments included in gross income which are effectively connected with the conduct of a trade or business within the United States" after "United States".

(4) Subparagraph (A) of section 6425(c)(1) of such Code is amended by striking "plus" at the end of clause (i), by striking "over" at the end of clause (ii) and inserting "plus" and by adding at the end the following new clause:

"(iii) the tax imposed by section 59B, over".

(5) Paragraph (1) of section 6654(f) of such Code is amended by striking "tax" each place it appears and inserting "taxes".

(6) Subparagraph (A) of section 6655(g)(1) of such Code is amended by striking "plus" at the end of clause (ii), by redesignating clause (iii) as clause

(iv), and by inserting after clause (ii) the following new clause:

"(iii) the tax imposed by section 59B, plus".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to applicable payments (as defined in section 59B(b) of the Internal Revenue Code of 1986, as added by this section) paid or accrued on or after the date of enactment of this Act.

SEC. 204. LIMITATION ON DEDUCTION FOR BUSINESS INTEREST OF CERTAIN BUSINESSES OWNED BY PRIVATE FUNDS.

(a) IN GENERAL.—Section 163(j) of the Internal Revenue Code of 1986 is amended by redesignating paragraph (10) as paragraph (11) and by inserting after paragraph (9) the following new paragraph:

"(10) MODIFICATION OF LIMITATION FOR CERTAIN BUSINESSES OWNED BY PRIVATE FIRMS.—

"(A) IN GENERAL.—In the case of a taxpayer which is an applicable entity controlled by an applicable controlling entity (or any person related within the meaning of section 267(b) or 707(b) to such entity) at any time during the taxable year—

"(i) if the ratio of debt to equity of the taxpayer as of the close of the taxable year (or on any other day during the taxable year as the Secretary may prescribe in regulations) exceeds 1, then paragraph (1) shall be applied by substituting '______ percent' for '30 percent', and

"(ii) in the case of the election under paragraph (7)(B) to treat any trade or business of the taxpayer as an electing real property trade or business—

"(I) the taxpayer may not make any such election during such taxable year, and

"(II) any such election of the taxpayer in effect as of the close of the taxable year preceding such taxable year with respect to a trade or business shall be revoked, effective for such taxable year and all succeeding taxable years.

"(B) RATIO OF DEBT TO EQUITY.—For purposes of this paragraph, the term 'ratio of debt to equity' means, with respect to any taxpayer, the ratio which the total indebtedness of the taxpayer bears to the sum of the taxpayer's money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence—

"(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,

"(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272 (determined without regard to subsection (a)(7) or (b)(4) thereof), and

"(iii) there shall be such other adjustments as the Secretary may by regulations prescribe.

"(C) COORDINATION WITH DEPRECIATION RULES.—If the alternative depreciation system under section 168(g) applies to property by reason of an election under paragraph (7)(B) which is revoked under subparagraph (A)(ii)(II), then the depreciation deduction under section 167(a) with respect to such property for the taxable year of revocation and all succeeding taxable years shall be determined under section 168 in the same manner as if such revocation were a change in use of the property under section 168(i)(5) and the regulations thereunder.

"(D) DEFINITIONS AND RULES.—For purposes of this paragraph—

"(i) any term used in this paragraph which is also used in section 59B shall have the same meaning as when used in such section, and

"(ii) the constructive ownership rules of section 318 shall apply in the same manner as such rules apply for purposes of section 59B.".

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—The amendments made by this section shall apply to taxable years beginning on or after the date of enactment of this Act.

(2) REVOCATION OF ELECTIONS.—Subparagraphs (A)(ii)(II) and (C) of section 163(j)(10) of the Internal Revenue Code of 1986, as added by this section, shall apply to taxable years beginning on or

after the date of enactment of this Act, with respect to elections under section 163(j)(7)(B) of such Code made before, on, or after such date.

TITLE III—PROTECTING WORKERS WHEN COMPANIES GO BANKRUPT

SEC. 301. INCREASED PRIORITY FOR WAGES.

Section 507(a) of title 11, United States Code, is amended—

(1) in paragraph (4)—

(A) by redesignating subparagraphs (A) and (B) as clauses (i) and (ii), respectively;

(B) in the matter preceding clause (i), as so redesignated, by inserting ''(A)'' before ''Fourth'';

(C) in subparagraph (A), as so designated, in the matter preceding clause (i), as so redesignated—

(i) by striking ''$10,000'' and inserting ''$20,000'';

(ii) by striking ''within 180 days''; and

(iii) by striking ''or the date of the cessation of the debtor's business, whichever occurs first''; and

(D) by adding at the end the following:

“(B) Severance pay described in subparagraph (A)(i) shall be deemed earned in full upon the layoff or termination of employment of the individual to whom the severance pay is owed.”; and

(2) in paragraph (5)—

(A) in subparagraph (A)—

(i) by striking “within 180 days”; and

(ii) by striking “or the date of the cessation of the debtor’s business, whichever occurs first”; and

(B) by striking subparagraph (B) and inserting the following:

“(B) for each such plan, to the extent of the number of employees covered by each such plan multiplied by $20,000.”.

SEC. 302. PRIORITY FOR SEVERANCE PAY AND CONTRIBUTIONS TO EMPLOYEE BENEFIT PLANS.

Section 503(b) of title 11, United States Code, is amended—

(1) in paragraph (8)(B), by striking “and” at the end;

(2) in paragraph (9), by striking the period and inserting a semicolon; and

(3) by adding at the end the following:

"(10) severance pay owed to employees of the debtor (other than to an insider of the debtor or a senior executive officer of the debtor), under a plan, program, or policy generally applicable to employees of the debtor (but not under an individual contract of employment), or owed pursuant to a collective bargaining agreement, for layoff or termination on or after the date of the filing of the petition, which pay shall be deemed earned in full upon such layoff or termination of employment; and

"(11) any contribution due on or after the date of the filing of the petition under an employee benefit plan.".

SEC. 303. PRIORITY FOR VIOLATIONS OF FEDERAL AND STATE LAWS.

(a) ALLOWANCE OF ADMINISTRATIVE EXPENSES IN BANKRUPTCY CASES.—Section 503(b)(1)(A)(ii) of title 11, United States Code, is amended by inserting after "(ii)" the following: "any back pay, civil penalty, or damages for a violation of any Federal or State labor and employment law, including the Worker Adjustment and Retraining Notification Act (29 U.S.C. 2101 et seq.) and any comparable State law, and".

(b) ADMINISTRATION AND ENFORCEMENT OF WORKER ADJUSTMENT AND RETRAINING NOTIFICATION RE-

QUIREMENTS.—Section 5(a)(1) of the Worker Adjustment and Retraining Notification Act (29 U.S.C. 2104(a)(1)) is amended, in the matter following subparagraph (B)—

(1) by inserting "which for purposes of this sentence shall consist of the days, in the notification period, that are or that follow the date of the prohibited closing or layoff under this Act," after "period of the violation,"; and

(2) by inserting "calendar" after "60".

SEC. 304. LIMITATION ON EXECUTIVE COMPENSATION ENHANCEMENTS.

Section 503(c) of title 11, United States Code, is amended—

(1) in the matter preceding paragraph (1), by inserting "and subject to section 363(b)(3)," after "Notwithstanding subsection (b),";

(2) in paragraph (1), in the matter preceding subparagraph (A)—

(A) by inserting ", a senior executive officer of the debtor, or any of the 20 next most highly compensated employees of the debtor, department or division managers of the debtor, or consultants providing services to the debtor (regardless of whether the executive officer, employee, manager, or consultant is an insider)'' after ''insider of the debtor'';

(B) by inserting ''or for the payment of performance or incentive compensation, a bonus of any kind, or any other financial return designed to replace or enhance incentive, stock, or other compensation in effect before the date of the commencement of the case,'' after ''remain with the debtor's business,''; and

(C) by inserting ''clear and convincing'' before ''evidence in the record'';

(3) in paragraph (2), in the matter preceding subparagraph (A), by inserting '', a senior executive officer of the debtor, or any of the 20 next most highly compensated employees of the debtor, department or division managers of the debtor, or consultants providing services to the debtor (regardless of whether the executive officer, employee, manager, or consultant is an insider)'' after ''an insider of the debtor''; and

(4) by striking paragraph (3) and inserting the following:

''(3) any other transfer or obligation to or for the benefit of an insider of the debtor, a senior executive officer of the debtor, or any of the 20 next most highly compensated employees of the debtor, department or division managers of the debtor, or consultants providing services to the debtor (regardless of whether the executive officer, employee, manager, or consultant is an insider), absent a finding by the court, based upon clear and convincing evidence in the record, and without deference to a request by the debtor for such payment, that—

"(A) because of the essential and particularized nature of the services provided by the insider, executive officer, employee, manager, or consultant, the transfer or obligation is essential to—

"(i) the survival of the business of the debtor; or

"(ii) in a case in which some or all of the assets of the debtor are liquidated, the orderly liquidation of the assets;

"(B) in the case of a transfer or obligation under an incentive program, the transfer or obligation is part of a workforce incentive program generally applicable to the nonmanagement workforce of the debtor; and

"(C) the cost of the transfer or obligation—

"(i) is reasonable;

"(ii) is not excessive in the context of the financial circumstances of the debtor; and

"(iii) is not disproportionate in light of any economic loss incurred by the non-management workforce of the debtor during the case.".

SEC. 305. PROHIBITION AGAINST SPECIAL COMPENSATION PAYMENTS.

Section 363 of title 11, United States Code, is amended—

(1) in subsection (b), by adding at the end the following:

"(3) No plan, program, or other transfer or obligation to or for the benefit of an insider of the debtor, a senior executive officer of the debtor, or any of the 20 next most highly compensated employees of the debtor, department or division managers of the debtor, or consultants providing services to the debtor (regardless of whether the executive officer, employee, manager, or consultant is an insider) shall be approved if the debtor has, on or after the date that is 1 year before the date of the filing of the petition—

"(A) discontinued any plan, program, policy or practice of paying severance pay to the nonmanagement workforce of the debtor; or

"(B) modified any plan, program, policy, or practice described in subparagraph (A) in order to reduce benefits under the plan, program, policy or practice."; and

(2) in subsection (c)(1), by inserting before the period at the end the following: ", except that, for any transaction that constitutes a transfer or obligation subject to section 503(c), the trustee shall be required to obtain the prior approval of the court after notice and an opportunity for a hearing".

SEC. 306. EXECUTIVE COMPENSATION UPON EXIT FROM BANKRUPTCY.

Section 1129(a) of title 11, United States Code, is amended—

(1) in paragraph (4), by adding at the end the following: "Except for compensation subject to review under paragraph (5), any payment or other distribution under the plan to or for the benefit of an insider of the debtor, a senior executive officer of the debtor, or any of the 20 next most highly compensated employees of the debtor, department or division managers of the debtor, or consultants pro-

viding services to the debtor (regardless of whether the executive officer, employee, manager, or consultant is an insider), shall not be approved by the court except as part of a program of payments or distributions generally applicable to employees of the debtor, and only to the extent that the court determines that the payment or other distribution is not excessive or disproportionate in comparison to payments or other distributions to the nonmanagement workforce of the debtor.''; and

(2) in paragraph (5)—

(A) in subparagraph (A)(ii), by striking ''and'' at the end;

(B) in subparagraph (B), by striking the period at the end and inserting ''; and''; and

(C) by adding at the end the following:

''(C) the compensation disclosed pursuant to subparagraph (B) has been approved by, or is subject to the approval of, the court as—

''(i) reasonable in comparison to compensation paid to individuals holding comparable positions at comparable companies in the same industry; and "(ii) not disproportionate in light of any economic concession made by the nonmanagement workforce of the debtor during the case.".

SEC. 307. COLLATERAL SURCHARGE FOR EMPLOYEE OBLIGATIONS.

Section 506(c) of title 11, United States Code, is amended—

(1) by inserting "(1)" before "The trustee"; and

(2) by adding at the end the following:

"(2) If 1 or more employees of the debtor have not received wages, accrued vacation, severance, or any other compensation owed under a plan, program, policy, or practice of the debtor, or pursuant to the terms of a collective bargaining agreement, for services rendered on or after the date of the commencement of the case, or the debtor has not made a contribution due under an employee benefit plan on or after the date of the commencement of the case, such unpaid obligations shall be—

"(A) deemed—

"(i) reasonable, necessary costs and expenses of preserving, or disposing of, property securing an allowed secured claim; and

"(ii) benefitting the holder of the allowed secured claim; and

"(B) recovered by the trustee for payment to the employees or the employee benefit plan, as applicable, even if the trustee, or a predecessor or successor in interest, has otherwise waived the provisions of this subsection under an agreement with the holder of the allowed secured claim or a successor or predecessor in interest of the holder of the allowed secured claim.".

SEC. 308. VOIDABILITY OF PREFERENTIAL COMPENSATION TRANSFERS.

Section 547 of title 11, United States Code, is amended by adding at the end the following:

"(j)(1) The trustee may avoid a transfer to or for the benefit of an insider of the debtor, a senior executive officer of the debtor, or any of the 20 next most highly compensated employees of the debtor, department or division managers of the debtor, or consultants providing services to the debtor (regardless of whether the executive officer, employee, manager, or consultant is an insider), that—

"(A) is made or incurred under a retention, bonus, or incentive plan devised before the date of the filing of the petition; and

"(B) does not meet the requirements under section 363(b)(3) or 503(c).

"(2) Subsection (c) shall not constitute a defense against the recovery of a transfer under paragraph (1) of this subsection.

"(3)(A) The trustee, or a committee appointed under section 1102, may commence an action to recover a transfer under paragraph (1) of this subsection.

"(B) If neither the trustee nor a committee commences an action to recover a transfer under subparagraph (A) before the date of the commencement of a hearing on the confirmation of a plan, any party in interest may apply to the court for authority to recover the transfer for the benefit of the estate, in which case the costs of recovery shall be borne by the estate.".

SEC. 309. PROTECTION FOR EMPLOYEES IN A SALE OF ASSETS.

(a) REQUIREMENT RELATING TO PRESERVING JOBS AND MAINTAINING TERMS AND CONDITIONS RELATING TO EMPLOYMENT.—Section 363 of title 11, United States Code, is amended by adding at the end the following:

"(q)(1) In approving a sale or lease of property of the estate under this section, or under a plan under chapter 11, the court shall give substantial weight to the extent to which a prospective purchaser or lessee, respectively, of the property will—

"(A) preserve the jobs of the workforce of the debtor; and

"(B) maintain the terms and conditions of employment of the workforce of the debtor.

"(2) If there are 2 or more offers to purchase or lease property of the estate under this section, or under a plan under chapter 11, that qualify under the procedures for the sale or lease, respectively, approved by the court, the court shall approve the offer that best—

"(A) preserves the jobs of the workforce of the debtor; and

"(B) maintains the terms and conditions of employment of the workforce of the debtor.

"(r)(1) Any party seeking to purchase or lease property of the estate under this section, or under a plan under chapter 11, shall represent to the court the effect of such a transaction with respect to—

"(A) the preservation of the jobs of the workforce of the debtor; and

"(B) the maintenance of the terms and conditions of employment of the workforce of the debtor.

"(2) The court shall expressly include in an order approving a purchase or lease of property of the estate under this section, or under a plan under chapter 11, any representation made by a purchaser or lessee of the property under paragraph (1).

"(3) With respect to a purchase or lease of property of the estate under this section, or under a plan under chapter 11—

"(A) the court shall have jurisdiction over the purchaser or lessee of the property in order to enforce the terms of the order approving the purchase or lease;

"(B) the purchaser or lessee shall promptly disclose to the court any material noncompliance with the terms of the order described in subparagraph (A) and explain the basis for such noncompliance; and

"(C) with respect to material noncompliance described in subparagraph (B), the court may impose any appropriate remedy, including injunctive relief, to address the noncompliance.".

(b) PLANS UNDER CHAPTER 11.—

(1) CONTENTS OF PLAN.—Section 1123(b)(4) of title 11, United States Code, is amended by inserting ", which sale shall be subject to the requirements under subsections (q) and (r) of section 363 of this title," after "property of the estate".

(2) CONFIRMATION OF PLAN.—Section 1129(a) of title 11, United States Code, is amended by adding at the end the following:

"(17) If the plan provides for the sale of all or substantially all of the property of the estate, the sale meets the requirements under subsections (q) and (r) of section 363 of this title.".

SEC. 310. PROTECTION OF GIFT CARD PURCHASERS.

(a) DEFINITION OF GIFT CARD.—Section 101(a) of title 11, United States Code, is amended by inserting after paragraph (26) the following:

"(26A) The term 'gift card' means a paper or electronic promise, plastic card, or other payment code or device that is—

"(A) redeemable at—

"(i) a single merchant; or

"(ii) an affiliated group of merchants that share the same name, mark, or logo;

"(B) issued in a specified amount, regardless of whether that amount may be increased in value or reloaded at the request of the holder;

"(C) purchased on a prepaid basis in exchange for payment; and

"(D) honored by the single merchant or affiliated group of merchants described in subparagraph (A) upon presentation for goods or services.".

(b) CONSUMER DEPOSIT.—Section 507(a) of title 11, United States Code, is amended by striking paragraph (7) and inserting the following:

"(7) Seventh, allowed unsecured claims of individuals, to the extent of $1,800 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with—

"(A) the purchase, lease, or rental of property;

"(B) the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided; or

"(C) the purchase of a gift card with respect to which funds exist that have not been redeemed.".

SEC. 311. COMMERCIAL REAL ESTATE.

Section 365(d) of title 11, United States Code, is amended—

(1) by striking paragraph (4); and

(2) by redesignating paragraph (5) as paragraph (4).

TITLE IV—CLOSING THE CARRIED INTEREST LOOPHOLE

SEC. 401. AMENDMENT OF 1986 CODE.

Except as otherwise expressly provided, whenever in this title an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

SEC. 402. PARTNERSHIP INTERESTS TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) MODIFICATION TO ELECTION TO INCLUDE PARTNERSHIP INTEREST IN GROSS INCOME IN YEAR OF TRANSFER.—Subsection (c) of section 83 is amended by redesignating paragraph (4) as paragraph (5) and by inserting after paragraph (3) the following new paragraph:

"(4) PARTNERSHIP INTERESTS.—Except as provided by the Secretary—

"(A) IN GENERAL.—In the case of any transfer of an interest in a partnership in connection with the provision of services to (or for the benefit of) such partnership—

"(i) the fair market value of such interest shall be treated for purposes of this section as being equal to the amount of the distribution which the partner would receive if the partnership sold (at the time of the transfer) all of its assets at fair market value and distributed the proceeds of such sale (reduced by the liabilities of the partnership) to its partners in liquidation of the partnership, and

"(ii) the person receiving such interest shall be treated as having made the election under subsection (b)(1) unless such person makes an election under this paragraph to have such subsection not apply.

"(B) ELECTION.—The election under subparagraph (A)(ii) shall be made under rules similar to the rules of subsection (b)(2).".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to interests in partnerships transferred after the date of enactment of this Act.

SEC. 403. SPECIAL RULES FOR PARTNERS PROVIDING INVESTMENT MANAGEMENT SERVICES TO PARTNERSHIPS.

(a) IN GENERAL.—Part I of subchapter K of chapter 1 is amended by adding at the end the following new section:

"SEC. 710. SPECIAL RULES FOR PARTNERS PROVIDING INVESTMENT MANAGEMENT SERVICES TO PARTNERSHIPS.

''(a) TREATMENT OF DISTRIBUTIVE SHARE OF PARTNERSHIP ITEMS.—For purposes of this title, in the case of an investment services partnership interest—

''(1) IN GENERAL.—Notwithstanding section 702(b)—

''(A) an amount equal to the net capital gain with respect to such interest for any partnership taxable year shall be treated as ordinary income, and

''(B) subject to the limitation of paragraph (2), an amount equal to the net capital loss with respect to such interest for any partnership taxable year shall be treated as an ordinary loss.

''(2) RECHARACTERIZATION OF LOSSES LIMITED TO RECHARACTERIZED GAINS.—The amount treated as ordinary loss under paragraph (1)(B) for any taxable year shall not exceed the excess (if any) of—

"(A) the aggregate amount treated as ordinary income under paragraph (1)(A) with respect to the investment services partnership interest for all preceding partnership taxable years to which this section applies, over

"(B) the aggregate amount treated as ordinary loss under paragraph (1)(B) with respect to such interest for all preceding partnership taxable years to which this section applies.

"(3) ALLOCATION TO ITEMS OF GAIN AND LOSS.—

"(A) NET CAPITAL GAIN.—The amount treated as ordinary income under paragraph (1)(A) shall be allocated ratably among the items of long-term capital gain taken into account in determining such net capital gain.

"(B) NET CAPITAL LOSS.—The amount treated as ordinary loss under paragraph (1)(B) shall be allocated ratably among the items of long-term capital loss and short-term capital loss taken into account in determining such net capital loss.

"(4) TERMS RELATING TO CAPITAL GAINS AND LOSSES.—For purposes of this section—

"(A) IN GENERAL.—Net capital gain, long-term capital gain, and long-term capital loss, with respect to any investment services partnership interest for any taxable year, shall be determined under section 1222, except that such section shall be applied—

"(i) without regard to the recharacterization of any item as ordinary income or ordinary loss under this section,

"(ii) by only taking into account items of gain and loss taken into account by the holder of such interest under section 702 (other than subsection (a)(9) thereof) with respect to such interest for such taxable year, and

"(iii) by treating property which is taken into account in determining gains and losses to which section 1231 applies as capital assets held for more than 1 year.

"(B) NET CAPITAL LOSS.—The term 'net capital loss' means the excess of the losses from sales or exchanges of capital assets over the gains from such sales or exchanges. Rules similar to the rules of clauses (i) through (iii) of subparagraph (A) shall apply for purposes of the preceding sentence.

"(5) SPECIAL RULE FOR DIVIDENDS.—Any dividend allocated with respect to any investment services partnership interest shall not be treated as qualified dividend income for purposes of section 1(h).

"(6) SPECIAL RULE FOR QUALIFIED SMALL BUSINESS STOCK.—Section 1202 shall not apply to any gain from the sale or exchange of qualified small business stock (as defined in section 1202(c)) allocated with respect to any investment services partnership interest.

"(b) DISPOSITIONS OF PARTNERSHIP INTERESTS.—

"(1) GAIN.—

"(A) IN GENERAL.—Any gain on the disposition of an investment services partnership interest shall be—

"(i) treated as ordinary income, and

"(ii) recognized notwithstanding any other provision of this subtitle.

"(B) GIFT AND TRANSFERS AT DEATH.—In the case of a disposition of an investment services partnership interest by gift or by reason of death of the taxpayer—

"(i) subparagraph (A) shall not apply,

"(ii) such interest shall be treated as an investment services partnership interest in the hands of the person acquiring such interest, and

"(iii) any amount that would have been treated as ordinary income under this subsection had the decedent sold such interest immediately before death shall be treated as an item of income in respect of a decedent under section 691.

"(2) LOSS.—Any loss on the disposition of an investment services partnership interest shall be treated as an ordinary loss to the extent of the excess (if any) of—

"(A) the aggregate amount treated as ordinary income under subsection (a) with respect to such interest for all partnership taxable years to which this section applies, over

"(B) the aggregate amount treated as ordinary loss under subsection (a) with respect to such interest for all partnership taxable years to which this section applies.

"(3) ELECTION WITH RESPECT TO CERTAIN EXCHANGES.—Paragraph (1)(A)(ii) shall not apply to the contribution of an investment services partnership interest to a partnership in exchange for an interest in such partnership if—

"(A) the taxpayer makes an irrevocable election to treat the partnership interest received in the exchange as an investment services partnership interest, and

"(B) the taxpayer agrees to comply with such reporting and recordkeeping requirements as the Secretary may prescribe.

"(4) DISTRIBUTIONS OF PARTNERSHIP PROPERTY.—

"(A) IN GENERAL.—In the case of any distribution of property by a partnership with respect to any investment services partnership interest held by a partner, the partner receiving such property shall recognize gain equal to the excess (if any) of—

"(i) the fair market value of such property at the time of such distribution, over

"(ii) the adjusted basis of such property in the hands of such partner (determined without regard to subparagraph (C)).

"(B) TREATMENT OF GAIN AS ORDINARY INCOME.—Any gain recognized by such partner under subparagraph (A) shall be treated as ordinary income to the same extent and in the same manner as the increase in such partner's distributive share of the taxable income of the partnership would be treated under subsection (a) if, immediately prior to the distribution, the partnership had sold the distributed property at fair market value and all of the gain from such disposition were allocated to such partner. For purposes of applying subsection (a)(2), any gain treated as ordinary income under this subparagraph shall be treated as an amount treated as ordinary income under subsection (a)(1)(A).

"(C) ADJUSTMENT OF BASIS.—In the case a distribution to which subparagraph (A) applies, the basis of the distributed property in the hands of the distributee partner shall be the fair market value of such property.

"(D) SPECIAL RULES WITH RESPECT TO MERGERS AND DIVISIONS.—In the case of a taxpayer which satisfies requirements similar to the requirements of subparagraphs (A) and (B) of paragraph (3), this paragraph and paragraph (1)(A)(ii) shall not apply to the distribution of a partnership interest if such distribution is in connection with a contribution (or deemed contribution) of any property of the partnership to which section 721 applies pursuant to a transaction described in section 708(b)(2).

"(c) INVESTMENT SERVICES PARTNERSHIP INTEREST.—For purposes of this section—

"(1) IN GENERAL.—The term 'investment services partnership interest' means any interest in an investment partnership acquired or held by any person in connection with the conduct of a trade or business described in paragraph (2) by such person (or any person related to such person). An interest in an investment partnership held by any person—

"(A) shall not be treated as an investment services partnership interest for any period before the first date on which it is so held in connection with such a trade or business,

"(B) shall not cease to be an investment services partnership interest merely because such person holds such interest other than in connection with such a trade or business, and

"(C) shall be treated as an investment services partnership interest if acquired from a related person in whose hands such interest was an investment services partnership interest.

"(2) BUSINESSES TO WHICH THIS SECTION APPLIES.—A trade or business is described in this paragraph if such trade or business primarily involves the performance of any of the following services with respect to assets held (directly or indirectly) by one or more investment partnerships referred to in paragraph (1):

"(A) Advising as to the advisability of investing in, purchasing, or selling any specified asset.

"(B) Managing, acquiring, or disposing of any specified asset.

"(C) Arranging financing with respect to acquiring specified assets.

"(D) Any activity in support of any service described in subparagraphs (A) through (C).

"(3) INVESTMENT PARTNERSHIP.—

"(A) IN GENERAL.—The term 'investment partnership' means any partnership if, at the end of any two consecutive calendar quarters ending after the date of enactment of this section—

"(i) substantially all of the assets of the partnership are specified assets (determined without regard to any section 197 intangible within the meaning of section 197(d)), and

"(ii) less than 75 percent of the capital of the partnership is attributable to qualified capital interests which constitute property held in connection with a trade or business of the owner of such interest.

"(B) LOOK-THROUGH OF CERTAIN WHOLLY OWNED ENTITIES FOR PURPOSES OF DETERMINING ASSETS OF THE PARTNERSHIP.—

"(i) IN GENERAL.—For purposes of determining the assets of a partnership under subparagraph (A)(i)—

"(I) any interest in a specified entity shall not be treated as an asset of such partnership, and

"(II) such partnership shall be treated as holding its proportionate share of each of the assets of such specified entity.

"(ii) SPECIFIED ENTITY.—For purposes of clause (i), the term 'specified entity' means, with respect to any partnership (hereafter referred to as the upper-tier partnership), any person which engages in the same trade or business as the upper-tier partnership and is—

"(I) a partnership all of the capital and profits interests of which are held directly or indirectly by the upper-tier partnership, or

"(II) a foreign corporation which does not engage in a trade or business in the United States and all of the stock of which is held directly or indirectly by the upper-tier partnership.

"(C) SPECIAL RULES FOR DETERMINING IF PROPERTY HELD IN CONNECTION WITH TRADE OR BUSINESS.—

"(i) IN GENERAL.—Except as otherwise provided by the Secretary, solely for purposes of determining whether any interest in a partnership constitutes property held in connection with a trade or business under subparagraph (A)(ii)—

“(I) a trade or business of any person closely related to the owner of such interest shall be treated as a trade or business of such owner,

“(II) such interest shall be treated as held by a person in connection with a trade or business during any taxable year if such interest was so held by such person during any 3 taxable years preceding such taxable year, and

“(III) paragraph (5)(B) shall not apply.

“(ii) CLOSELY RELATED PERSONS.—For purposes of clause (i)(I), a person shall be treated as closely related to another person if, taking into account the rules of section 267(c), the relationship between such persons is described in—

“(I) paragraph (1) or (9) of section 267(b), or

“(II) section 267(b)(4), but solely in the case of a trust with respect to which each current beneficiary is the grantor or a person whose relationship to the grantor is described in paragraph (1) or (9) of section 267(b).

"(D) ANTIABUSE RULES.—The Secretary may issue regulations or other guidance which prevent the avoidance of the purposes of subparagraph (A), including regulations or other guidance which treat convertible and contingent debt (and other debt having the attributes of equity) as a capital interest in the partnership.

"(E) CONTROLLED GROUPS OF ENTITIES.—

"(i) IN GENERAL.—In the case of a controlled group of entities, if an interest in the partnership received in exchange for a contribution to the capital of the partnership by any member of such controlled group would (in the hands of such member) constitute property held in connection with a trade or business, then any interest in such partnership held by any member of such group shall be treated for purposes of subparagraph (A) as constituting (in the hands of such member) property held in connection with a trade or business.

"(ii) CONTROLLED GROUP OF ENTITIES.—For purposes of clause (i), the term 'controlled group of entities' means a controlled group of corporations as defined in section 1563(a)(1), applied without regard to subsections (a)(4) and (b)(2) of section 1563. A partnership or any other entity (other than a corporation) shall be treated as a member of a controlled group of entities if such entity is controlled (within the meaning of section 954(d)(3)) by members of such group (including any entity treated as a member of such group by reason of this sentence).

"(F) SPECIAL RULE FOR CORPORATIONS.—For purposes of this paragraph, in the case of a corporation, the determination of whether property is held in connection with a trade or business shall be determined as if the taxpayer were an individual.

"(4) SPECIFIED ASSET.—The term 'specified asset' means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), real estate held for rental or investment, interests in partnerships, commodities (as defined in section 475(e)(2)), cash or cash equivalents, or options or derivative contracts with respect to any of the foregoing.

"(5) RELATED PERSONS.—

"(A) IN GENERAL.—A person shall be treated as related to another person if the relationship between such persons is described in section 267(b) or 707(b).

"(B) ATTRIBUTION OF PARTNER SERVICES.—Any service described in paragraph (2) which is provided by a partner of a partnership shall be treated as also provided by such partnership.

"(d) EXCEPTION FOR CERTAIN CAPITAL INTERESTS.—

"(1) IN GENERAL.—In the case of any portion of an investment services partnership interest which is a qualified capital interest, all items of gain and loss (and any dividends) which are allocated to such qualified capital interest shall not be taken into account under subsection (a) if—

"(A) allocations of items are made by the partnership to such qualified capital interest in the same manner as such allocations are made to other qualified capital interests held by partners who do not provide any services described in subsection (c)(2) and who are not related to the partner holding the qualified capital interest, and

"(B) the allocations made to such other interests are significant compared to the allocations made to such qualified capital interest.

"(2) AUTHORITY TO PROVIDE EXCEPTIONS TO ALLOCATION REQUIREMENTS.—To the extent provided by the Secretary in regulations or other guidance—

"(A) ALLOCATIONS TO PORTION OF QUALIFIED CAPITAL INTEREST.—Paragraph (1) may be applied separately with respect to a portion of a qualified capital interest.

"(B) NO OR INSIGNIFICANT ALLOCATIONS TO NONSERVICE PROVIDERS.—In any case in which the requirements of paragraph (1)(B) are not satisfied, items of gain and loss (and any dividends) shall not be taken into account under subsection (a) to the extent that such items are properly allocable under such regulations or other guidance to qualified capital interests.

"(C) ALLOCATIONS TO SERVICE PROVIDERS' QUALIFIED CAPITAL INTERESTS WHICH

ARE LESS THAN OTHER ALLOCATIONS.—Allocations shall not be treated as failing to meet the requirement of paragraph (1)(A) merely because the allocations to the qualified capital interest represent a lower return than the allocations made to the other qualified capital interests referred to in such paragraph.

"(3) SPECIAL RULE FOR CHANGES IN SERVICES AND CAPITAL CONTRIBUTIONS.—In the case of an interest in a partnership which was not an investment services partnership interest and which, by reason of a change in the services with respect to assets held (directly or indirectly) by the partnership or by reason of a change in the capital contributions to such partnership, becomes an investment services partnership interest, the qualified capital interest of the holder of such partnership interest immediately after such change shall not, for purposes of this subsection, be less than the fair market value of such interest (determined immediately before such change).

"(4) SPECIAL RULE FOR TIERED PARTNERSHIPS.—Except as otherwise provided by the Secretary, in the case of tiered partnerships, all items which are allocated in a manner which meets the requirements of paragraph (1) to qualified capital interests in a lower-tier partnership shall retain such character to the extent allocated on the basis of qualified capital interests in any upper-tier partnership.

"(5) EXCEPTION FOR NO-SELF-CHARGED CARRY AND MANAGEMENT FEE PROVISIONS.—Except as otherwise provided by the Secretary, an interest shall not fail to be treated as satisfying the requirement of paragraph (1)(A) merely because the allocations made by the partnership to such interest do not reflect the cost of services described in subsection (c)(2) which are provided (directly or indirectly) to the partnership by the holder of such interest (or a related person).

"(6) SPECIAL RULE FOR DISPOSITIONS.—In the case of any investment services partnership interest any portion of which is a qualified capital interest, subsection (b) shall not apply to so much of any gain or loss as bears the same proportion to the entire amount of such gain or loss as—

"(A) the distributive share of gain or loss that would have been allocated to the qualified capital interest (consistent with the requirements of paragraph (1)) if the partnership had sold all of its assets at fair market value immediately before the disposition, bears to

"(B) the distributive share of gain or loss that would have been so allocated to the investment services partnership interest of which such qualified capital interest is a part.

"(7) QUALIFIED CAPITAL INTEREST.—For purposes of this section—

"(A) IN GENERAL.—The term 'qualified capital interest' means so much of a partner's interest in the capital of the partnership as is attributable to—

"(i) the fair market value of any money or other property contributed to the partnership in exchange for such interest (determined without regard to section 752(a)),

"(ii) any amounts which have been included in gross income under section 83 with respect to the transfer of such interest, and

"(iii) the excess (if any) of—

"(I) any items of income and gain taken into account under section 702 with respect to such interest, over

"(II) any items of deduction and loss so taken into account.

"(B) ADJUSTMENT TO QUALIFIED CAPITAL INTEREST.—

"(i) DISTRIBUTIONS AND LOSSES.— The qualified capital interest shall be reduced by distributions from the partnership with respect to such interest and by the excess (if any) of the amount described in subparagraph (A)(iii)(II) over the amount described in subparagraph (A)(iii)(I).

"(ii) SPECIAL RULE FOR CONTRIBUTIONS OF PROPERTY.—In the case of any contribution of property described in subparagraph (A)(i) with respect to which the fair market value of such property is not equal to the adjusted basis of such property immediately before such contribution, proper adjustments shall be made to the qualified capital interest to take into account such difference consistent with such regulations or other guidance as the Secretary may provide.

"(C) Technical terminations, etc., disregarded.—No increase or decrease in the qualified capital interest of any partner shall result from a termination, merger, consolidation, or division described in section 708, or any similar transaction.

"(8) Treatment of certain loans.—

"(A) Proceeds of partnership loans not treated as qualified capital interest of service providing partners.—For purposes of this subsection, an investment services partnership interest shall not be treated as a qualified capital interest to the extent that such interest is acquired in connection with the proceeds of any loan or other advance made or guaranteed, directly or indirectly, by any other partner or the partnership (or any person related to any such other partner or the partnership). The preceding sentence shall not apply to the extent the loan or other advance is repaid before the date of enactment of this section unless such repayment is made with the proceeds of a loan or other advance described in the preceding sentence.

"(B) REDUCTION IN ALLOCATIONS TO QUALIFIED CAPITAL INTERESTS FOR LOANS FROM NONSERVICE-PROVIDING PARTNERS TO THE PARTNERSHIP.—For purposes of this subsection, any loan or other advance to the partnership made or guaranteed, directly or indirectly, by a partner not providing services described in subsection (c)(2) to the partnership (or any person related to such partner) shall be taken into account in determining the qualified capital interests of the partners in the partnership.

"(9) SPECIAL RULE FOR QUALIFIED FAMILY PARTNERSHIPS.—

"(A) IN GENERAL.—In the case of any specified family partnership interest, paragraph (1)(A) shall be applied without regard to the phrase 'and who are not related to the partner holding the qualified capital interest'.

"(B) SPECIFIED FAMILY PARTNERSHIP INTEREST.—For purposes of this paragraph, the term 'specified family partnership interest' means any investment services partnership interest if—

"(i) such interest is an interest in a qualified family partnership,

"(ii) such interest is held by a natural person or by a trust with respect to which each beneficiary is a grantor or a person whose relationship to the grantor is described in section 267(b)(1), and

"(iii) all other interests in such qualified family partnership with respect to which significant allocations are made (within the meaning of paragraph (1)(B) and in comparison to the allocations made to the interest described in clause (ii)) are held by persons who—

"(I) are related to the natural person or trust referred to in clause (ii), or

"(II) provide services described in subsection (c)(2).

"(C) QUALIFIED FAMILY PARTNERSHIP.—For purposes of this paragraph, the term 'qualified family partnership' means any partnership if—

"(i) all of the capital and profits interests of such partnership are held by—

"(I) specified family members,

"(II) any person closely related (within the meaning of subsection (c)(3)(C)(ii)) to a specified family member, or

"(III) any other person (not described in subclause (I) or (II)) if such interest is an investment services partnership interest with respect to such person, and

"(ii) such partnership does not hold itself out to the public as an investment advisor.

"(D) SPECIFIED FAMILY MEMBERS.—For purposes of subparagraph (C), individuals shall be treated as specified family members if such individuals would be treated as one person under the rules of section 1361(c)(1) if the applicable date (within the meaning of subparagraph (B)(iii) thereof) were the latest of—

"(i) the date of the establishment of the partnership,

"(ii) the earliest date that the common ancestor holds a capital or profits interest in the partnership, or "(iii) the date of enactment of this section.

"(e) OTHER INCOME AND GAIN IN CONNECTION WITH INVESTMENT MANAGEMENT SERVICES.—

"(1) IN GENERAL.—If—

"(A) a person performs (directly or indirectly) investment management services for any investment entity,

"(B) such person holds (directly or indirectly) a disqualified interest with respect to such entity, and

"(C) the value of such interest (or payments thereunder) is substantially related to the amount of income or gain (whether or not realized) from the assets with respect to which the investment management services are performed,

any income or gain with respect to such interest shall be treated as ordinary income. Rules similar to the rules of subsections (a)(5) and (d) shall apply for purposes of this subsection.

"(2) DEFINITIONS.—For purposes of this subsection—

"(A) DISQUALIFIED INTEREST.—

"(i) IN GENERAL.—The term 'disqualified interest' means, with respect to any investment entity—

"(I) any interest in such entity other than indebtedness,

"(II) convertible or contingent debt of such entity,

"(III) any option or other right to acquire property described in subclause (I) or (II), and

"(IV) any derivative instrument entered into (directly or indirectly) with such entity or any investor in such entity.

"(ii) EXCEPTIONS.—Such term shall not include—

"(I) a partnership interest,

"(II) except as provided by the Secretary, any interest in a taxable corporation, and

"(III) except as provided by the Secretary, stock in an S corporation.

"(B) TAXABLE CORPORATION.—The term 'taxable corporation' means—

"(i) a domestic C corporation, or

"(ii) a foreign corporation substantially all of the income of which is—

"(I) effectively connected with the conduct of a trade or business in the United States, or

"(II) subject to a comprehensive foreign income tax (as defined in section 457A(d)(2)).

"(C) INVESTMENT MANAGEMENT SERVICES.—The term 'investment management services' means a substantial quantity of any of the services described in subsection (c)(2).

"(D) INVESTMENT ENTITY.—The term 'investment entity' means any entity which, if it were a partnership, would be an investment partnership.

"(f) EXCEPTION FOR DOMESTIC C CORPORATIONS.—Except as otherwise provided by the Secretary, in the case of a domestic C corporation—

"(1) subsections (a) and (b) shall not apply to any item allocated to such corporation with respect to any investment services partnership interest (or to any gain or loss with respect to the disposition of such an interest), and

"(2) subsection (e) shall not apply.

"(g) REGULATIONS.—The Secretary shall prescribe such regulations or other guidance as is necessary or appropriate to carry out the purposes of this section, including regulations or other guidance to—

"(1) require such reporting and recordkeeping by any person in such manner and at such time as the Secretary may prescribe for purposes of enabling the partnership to meet the requirements of section 6031 with respect to any item described in section 702(a)(9),

"(2) provide modifications to the application of this section (including treating related persons as not related to one another) to the extent such modification is consistent with the purposes of this section,

"(3) prevent the avoidance of the purposes of this section (including through the use of qualified family partnerships), and

"(4) coordinate this section with the other provisions of this title.

"(h) CROSS REFERENCE.—For 40 percent penalty on certain underpayments due to the avoidance of this section, see section 6662.".

(b) APPLICATION OF SECTION 751 TO INDIRECT DISPOSITIONS OF INVESTMENT SERVICES PARTNERSHIP INTERESTS.—

(1) IN GENERAL.—Subsection (a) of section 751 is amended by striking "or" at the end of paragraph (1), by inserting "or" at the end of paragraph (2), and by inserting after paragraph (2) the following new paragraph:

"(3) investment services partnership interests held by the partnership,".

(2) CERTAIN DISTRIBUTIONS TREATED AS SALES OR EXCHANGES.—Subparagraph (A) of section 751(b)(1) is amended by striking "or" at the end of clause (i), by inserting "or" at the end of clause (ii), and by inserting after clause (ii) the following new clause:

"(iii) investment services partnership interests held by the partnership,".

(3) APPLICATION OF SPECIAL RULES IN THE CASE OF TIERED PARTNERSHIPS.—Subsection (f) of section 751 is amended—

(A) by striking "or" at the end of paragraph (1), by inserting "or" at the end of paragraph (2), and by inserting after paragraph (2) the following new paragraph:

"(3) an investment services partnership interest held by the partnership,", and

(B) by striking "partner." and inserting "partner (other than a partnership in which it holds an investment services partnership interest).".

(4) INVESTMENT SERVICES PARTNERSHIP INTERESTS; QUALIFIED CAPITAL INTERESTS.—Section 751 is amended by adding at the end the following new subsection:

"(g) INVESTMENT SERVICES PARTNERSHIP INTERESTS.—For purposes of this section—

"(1) IN GENERAL.—The term 'investment services partnership interest' has the meaning given such term by section 710(c).

"(2) ADJUSTMENTS FOR QUALIFIED CAPITAL INTERESTS.—The amount to which subsection (a) applies by reason of paragraph (3) thereof shall not include so much of such amount as is attributable to any portion of the investment services partnership interest which is a qualified capital interest (determined under rules similar to the rules of section 710(d)).

"(3) EXCEPTION FOR PUBLICLY TRADED PARTNERSHIPS.—Except as otherwise provided by the

Secretary, in the case of an exchange of an interest in a publicly traded partnership (as defined in section 7704) to which subsection (a) applies—

"(A) this section shall be applied without regard to subsections (a)(3), (b)(1)(A)(iii), and (f)(3), and

"(B) such partnership shall be treated as owning its proportionate share of the property of any other partnership in which it is a partner.

"(4) RECOGNITION OF GAINS.—Any gain with respect to which subsection (a) applies by reason of paragraph (3) thereof shall be recognized notwithstanding any other provision of this title.

"(5) COORDINATION WITH INVENTORY ITEMS.—An investment services partnership interest held by the partnership shall not be treated as an inventory item of the partnership.

"(6) PREVENTION OF DOUBLE COUNTING.—Under regulations or other guidance prescribed by the Secretary, subsection (a)(3) shall not apply with respect to any amount to which section 710 applies.

"(7) VALUATION METHODS.—The Secretary shall prescribe regulations or other guidance which provide the acceptable methods for valuing investment services partnership interests for purposes of this section.''.

(c) TREATMENT FOR PURPOSES OF SECTION 7704.—Subsection (d) of section 7704 is amended by adding at the end the following new paragraph:

``(6) INCOME FROM CERTAIN CARRIED INTERESTS NOT QUALIFIED.—

``(A) IN GENERAL.—Specified carried interest income shall not be treated as qualifying income.

``(B) SPECIFIED CARRIED INTEREST INCOME.—For purposes of this paragraph—

``(i) IN GENERAL.—The term 'specified carried interest income' means—

``(I) any item of income or gain allocated to an investment services partnership interest (as defined in section 710(c)) held by the partnership,

``(II) any gain on the disposition of an investment services partnership interest (as so defined) or a partnership interest to which (in the hands of the partnership) section 751 applies, and

"(III) any income or gain taken into account by the partnership under subsection (b)(4) or (e) of section 710.

"(ii) EXCEPTION FOR QUALIFIED CAPITAL INTERESTS.—A rule similar to the rule of section 710(d) shall apply for purposes of clause (i).

"(C) COORDINATION WITH OTHER PROVISIONS.—Subparagraph (A) shall not apply to any item described in paragraph (1)(E) (or so much of paragraph (1)(F) as relates to paragraph (1)(E)).

"(D) SPECIAL RULES FOR CERTAIN PARTNERSHIPS.—

"(i) CERTAIN PARTNERSHIPS OWNED BY REAL ESTATE INVESTMENT TRUSTS.—Subparagraph (A) shall not apply in the case of a partnership which meets each of the following requirements:

"(I) Such partnership is treated as publicly traded under this section solely by reason of interests in such partnership being convertible into interests in a real estate investment trust which is publicly traded.

"(II) Fifty percent or more of the capital and profits interests of such partnership are owned, directly or indirectly, at all times during the taxable year by such real estate investment trust (determined with the application of section 267(c)).

"(III) Such partnership meets the requirements of paragraphs (2), (3), and (4) of section 856(c).

"(ii) CERTAIN PARTNERSHIPS OWNING OTHER PUBLICLY TRADED PARTNERSHIPS.—Subparagraph (A) shall not apply in the case of a partnership which meets each of the following requirements:

"(I) Substantially all of the assets of such partnership consist of interests in one or more publicly traded partnerships (determined without regard to subsection (b)(2)).

"(II) Substantially all of the income of such partnership is ordinary income or section 1231 gain (as defined in section 1231(a)(3)).

"(E) TRANSITIONAL RULE.—Subparagraph (A) shall not apply to any taxable year of the partnership beginning before the date which is 10 years after the date of enactment of this paragraph.".

(d) IMPOSITION OF PENALTY ON UNDERPAYMENTS.—

(1) IN GENERAL.—Subsection (b) of section 6662 is amended by inserting after paragraph (8) the following new paragraph:

"(9) The application of section 710(e) or the regulations or other guidance prescribed under section 710(g) to prevent the avoidance of the purposes of section 710.".

(2) AMOUNT OF PENALTY.—

(A) IN GENERAL.—Section 6662 is amended by adding at the end the following new subsection:

"(l) INCREASE IN PENALTY IN CASE OF PROPERTY TRANSFERRED FOR INVESTMENT MANAGEMENT SERVICES.—In the case of any portion of an underpayment to which this section applies by reason of subsection (b)(9), subsection (a) shall be applied with respect to such portion by substituting '40 percent' for '20 percent'.''.

(B) CONFORMING AMENDMENT.—Subparagraph (B) of section 6662A(e)(2) is amended by striking ''or (i)'' and inserting '', (i), or (l)''.

(3) SPECIAL RULES FOR APPLICATION OF REASONABLE CAUSE EXCEPTION.—Subsection (c) of section 6664 is amended—

(A) by redesignating paragraphs (3) and (4) as paragraphs (4) and (5), respectively;

(B) by striking ''paragraph (3)'' in paragraph (5)(A), as so redesignated, and inserting ''paragraph (4)''; and

(C) by inserting after paragraph (2) the following new paragraph:

''(3) SPECIAL RULE FOR UNDERPAYMENTS ATTRIBUTABLE TO INVESTMENT MANAGEMENT SERVICES.—

''(A) IN GENERAL.—Paragraph (1) shall not apply to any portion of an underpayment to which section 6662 applies by reason of subsection (b)(9) unless—

''(i) the relevant facts affecting the tax treatment of the item are adequately disclosed, "(ii) there is or was substantial authority for such treatment, and

"(iii) the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

"(B) RULES RELATING TO REASONABLE BELIEF.—Rules similar to the rules of subsection (d)(4) shall apply for purposes of subparagraph (A)(iii).".

(e) INCOME AND LOSS FROM INVESTMENT SERVICES PARTNERSHIP INTERESTS TAKEN INTO ACCOUNT IN DETERMINING NET EARNINGS FROM SELF-EMPLOYMENT.—

(1) INTERNAL REVENUE CODE.—

(A) IN GENERAL.—Section 1402(a) is amended by striking "and" at the end of paragraph (16), by striking the period at the end of paragraph (17) and inserting "; and", and by inserting after paragraph (17) the following new paragraph:

"(18) notwithstanding the preceding provisions of this subsection, in the case of any individual engaged in the trade or business of providing services described in section 710(c)(2) with respect to any entity, investment services partnership income or loss (as defined in subsection (m)) of such individual with respect to such entity shall be taken into account in determining the net earnings from self-employment of such individual.''.

(B) INVESTMENT SERVICES PARTNERSHIP INCOME OR LOSS.—Section 1402 is amended by adding at the end the following new subsection:

''(m) INVESTMENT SERVICES PARTNERSHIP INCOME OR LOSS.—For purposes of subsection (a)—

''(1) IN GENERAL.—The term 'investment services partnership income or loss' means, with respect to any investment services partnership interest (as defined in section 710(c)) or disqualified interest (as defined in section 710(e)), the net of—

''(A) the amounts treated as ordinary income or ordinary loss under subsections (b) and (e) of section 710 with respect to such interest,

''(B) all items of income, gain, loss, and deduction allocated to such interest, and

''(C) the amounts treated as realized from the sale or exchange of property other than a capital asset under section 751 with respect to such interest.

''(2) EXCEPTION FOR QUALIFIED CAPITAL INTERESTS.—A rule similar to the rule of section

710(d) shall apply for purposes of applying paragraph (1)(B).''.

(2) SOCIAL SECURITY ACT.—Section 211(a) of the Social Security Act is amended by striking ''and'' at the end of paragraph (15), by striking the period at the end of paragraph (16) and inserting ''; and'', and by inserting after paragraph (16) the following new paragraph:

''(17) Notwithstanding the preceding provisions of this subsection, in the case of any individual engaged in the trade or business of providing services described in section 710(c)(2) of the Internal Revenue Code of 1986 with respect to any entity, investment services partnership income or loss (as defined in section 1402(m) of such Code) shall be taken into account in determining the net earnings from self-employment of such individual.''.

(f) SEPARATE ACCOUNTING BY PARTNER.—Section 702(a) is amended by striking ''and'' at the end of paragraph (7), by striking the period at the end of paragraph (8) and inserting '', and'', and by inserting after paragraph (8) the following:

''(9) any amount treated as ordinary income or loss under subsection (a), (b), or (e) of section 710.''.

(g) CONFORMING AMENDMENTS.—

(1) Subsection (d) of section 731 is amended by inserting "section 710(b)(4) (relating to distributions of partnership property)," after "to the extent otherwise provided by".

(2) Section 741 is amended by inserting "or section 710 (relating to special rules for partners providing investment management services to partnerships)" before the period at the end.

(3) The table of sections for part I of subchapter K of chapter 1 is amended by adding at the end the following new item:

"Sec. 710. Special rules for partners providing investment management services to partnerships.".

(4)(A) Part IV of subchapter O of chapter 1 is amended by striking section 1061.

(B) The table of sections for part IV of subchapter O of chapter 1 is amended by striking the item relating to section 1061.

(h) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as otherwise provided in this subsection, the amendments made by this section shall apply to taxable years ending after the date of enactment of this Act.

(2) PARTNERSHIP TAXABLE YEARS WHICH INCLUDE EFFECTIVE DATE.—In applying section

710(a) of the Internal Revenue Code of 1986 (as added by this section) in the case of any partnership taxable year which includes the date of enactment of this Act, the amount of the net capital gain referred to in such section shall be treated as being the lesser of the net capital gain for the entire partnership taxable year or the net capital gain determined by only taking into account items attributable to the portion of the partnership taxable year which is after such date.

(3) DISPOSITIONS OF PARTNERSHIP INTERESTS.—

(A) IN GENERAL.—Section 710(b) of such Code (as added by this section) shall apply to dispositions and distributions after the date of enactment of this Act.

(B) INDIRECT DISPOSITIONS.—The amendments made by subsection (b) shall apply to transactions after the date of enactment of this Act.

(4) OTHER INCOME AND GAIN IN CONNECTION WITH INVESTMENT MANAGEMENT SERVICES.—Section 710(e) of such Code (as added by this section) shall take effect on the date of enactment of this Act.

TITLE V—INVESTOR PROTECTION AND MARKET TRANSPARENCY

SEC. 501. DISCLOSURE OF FEES AND RETURNS.

The Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.) is amended by adding at the end the following:

"SEC. 66. DISCLOSURE OF FEES AND RETURNS.

"(a) DEFINITIONS.—In this section, the terms 'private fund' and 'target firm' have the meanings given the terms in section 3 of the Stop Wall Street Looting Act.

"(b) RULES.—Not later than 1 year after the date of enactment of this section, the Commission shall issue final rules that require a private fund to, using generally accepted accounting principles, annually report the following information with respect to that private fund:

"(1) The name, address, and vintage year of the fund.

"(2) The name of each general partner of the fund.

"(3) The name of each limited partner of the fund.

"(4) A list of each entity with respect to which the fund owns a percentage.

"(5) In dollars, the total amount of regulatory assets under management by the fund.

"(6) In dollars, the total amount of net assets under management by the fund.

"(7) The percentage of fund equity contributed by the general partners of the fund and the percentage of fund equity contributed by the limited partners of the fund.

"(8) Information on the debt held by the fund, including—

"(A) the dollar amount of total debt;

"(B) the percentage of debt for which the creditor is a financial institution in the United States;

"(C) the percentage of debt for which the creditor is a financial institution outside of the United States;

"(D) the percentage of debt for which the creditor is an entity that is located in the United States and is not a financial institution; and

"(E) the percentage of debt for which the creditor is an entity that is located outside of the United States and is not a financial institution.

"(9) The gross performance of the fund during the year covered by the report.

"(10) For the year covered by the report, the difference obtained by subtracting the financial gains of the fund by the fees that the general partners of the fund charged to the limited partners of the fund (commonly referred to as the 'performance net of fees').

"(11) For the year covered by the report, an annual financial statement, which shall include income statements, a balance sheet, and cash flow statements.

"(12) The average debt-to-equity ratio of each target firm with respect to the fund and the debt-to-equity ratio of each such target firm.

"(13) The total gross asset value of each target firm with respect to the fund and the gross asset value of each such target firm.

"(14) The total amount of debt held by each target firm with respect to the fund and the total amount of debt held by each such target firm.

"(15) The total amount of debt held by each target firm with respect to the fund that, as of the date on which the report is submitted, are categorized as liabilities, long-term liabilities, and payment in kind or zero coupon debt.

"(16) The total number of target firms with respect to the fund that experienced default during the period covered by the report, including the name of any such target firm.

"(17) The total number of the target firms with respect to the fund with respect to which a case was commenced under title 11, United States Code, during the period covered by the report, including the name of any such target firm.

"(18) The percentage of the equity of the fund that is owned by—

"(A) citizens of the United States;

"(B) individuals who are not citizens of the United States;

"(C) brokers or dealers;

"(D) insurance companies;

"(E) investment companies that are registered with the Commission under this Act;

"(F) private funds and other investment companies not required to be registered with the Commission;

"(G) nonprofit organizations;

"(H) pension plans maintained by State or local governments (or an agency or instrumentality of either);

"(I) pension plans maintained by nongovernmental employers;

"(J) State or municipal government entities;

"(K) banking or thrift institutions;

"(L) sovereign wealth funds; and

"(M) other investors.

"(19) The total dollar amount of aggregate fees and expenses collected by the fund, the manager of the fund, or related parties from target firms with respect to the fund, which shall—

"(A) be categorized by the type of fee; and

"(B) include a description of the purpose of the fees.

"(20) The total dollar amount of aggregate fees and expenses collected by the fund, the manager of the fund, or related parties from the limited partners of the fund, which shall—

"(A) be categorized by the type of fee; and

"(B) include a description of the purpose of the fees.

"(21) The total carried interest claimed by the fund, the manager of the fund, or related parties and the total dollar amount of carried interest distributed to the limited partners of the fund.

"(22) A description of, during the year covered by the report, any material changes in risk factors at the fund level, including—

"(A) concentration risk;

"(B) foreign exchange risk; and

"(C) extra-financial risk, including environmental, social, and corporate governance risk.

"(23) Any other information that the Commission determines is necessary and appropriate for the protection of investors.

"(c) PERIODIC REVIEW.—The Commission shall, with respect to the rules issued under subsection (b)—

"(1) review the rules once every 5 years; and

"(2) revise the rules as necessary to ensure that the disclosures required under the rules reflect contemporary (as of the date on which the rules are revised) trends and characteristics with respect to private investment markets.

"(d) PUBLIC AVAILABILITY.—Notwithstanding any provision of section 204 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–4), the information disclosed under the rules issued under subsection (b) shall be made available to the public.''.

SEC. 502. FIDUCIARY OBLIGATIONS.

(a) FIDUCIARY DUTIES UNDER ERISA.—Section 401(b)(1) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1101(b)(1)) is amended—

(1) by inserting ''or a private fund (as defined in section 3 of the Stop Wall Street Looting Act)'' before '', the assets''; and

(2) by inserting ''or such private fund, as applicable'' before the period at the end.

(b) PROHIBITION AGAINST WAIVING FIDUCIARY DUTIES.—Section 211(h) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–11(h)) is amended—

(1) in paragraph (1), by striking ''and'' at the end;

(2) in paragraph (2), by striking the period at the end and inserting ''; and''; and

(3) by adding at the end the following:

''(3) promulgate rules that prohibit an investment adviser from requiring any person to which the investment adviser provides investment advice, including a pension plan (as defined in section 3 of the Employee Retirement Income Security Act of 1974

(29 U.S.C. 1002)) that is subject to title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1001 et seq.), to, as a condition of the investment adviser providing that advice, sign a contract or other agreement in which that person waives a fiduciary duty owed by that person to another person.''.

(c) APPLICABILITY OF BENEFITS.—The general partner of a private fund may not provide any term or benefit to any limited partner of the fund unless the general partner provides that term or benefit to all limited partners of the fund.

SEC. 503. DISCLOSURES RELATING TO THE MARKETING OF PRIVATE EQUITY FUNDS.

Any investment adviser to a private fund shall disclose to potential investors with respect to the other private funds, as defined in section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)), managed by that investment adviser (referred to in this section as ''managed firms'') the following information:

(1) A list of all managed firms with respect to the investment adviser, including those managed firms that, as of the date on which the disclosure is made—

(A) have active investments; and

(B) have liquidated the assets of the firms.

(2) For each managed firm listed under paragraph (1), the following information:

(A) As applicable, the total term of the listed firm beginning with the commencement of the commitment period with respect to the firm and ending on the date on which the firm is dissolved, including, with respect to a listed firm that, as of the date on which the disclosure is made, is actively investing—

(i) the term specified by any limited partnership agreement; and

(ii) the nature of any provisions that would allow for the extension of that term.

(B) The performance of the listed firm's net of fees, as measured by the public market equivalent or a similar measure.

(C) A list of target firms with respect to which the listed firm was a control person and the period of that control.

(D) The number of employees at each target firm identified under subparagraph (C), as of the date on which the listed firm became a control person with respect to the target firm, and the date on which the listed firm ceased to be a control person with respect to the target firm.

(E) A list of target firms with respect to the listed firm with respect to which a case has been commenced under title 11, United States Code.

(F) For each target firm with respect to the listed firm, and with respect to which the listed firm is a control person—

(i) a list of actions taken by any State or local regulatory agency; and

(ii) any legal or regulatory penalties paid, or settlements entered into, by the general partners of the target firm or the target firm itself.

(3) The percentage breakdown of the means employed by the investment adviser to divest ownership or control of target firms, including—

(A) the sale of target firms to other private funds;

(B) the sale of target firms to private entities;

(C) the sale of target firms to issuers, the securities of which are traded on a national securities exchange;

(D) the commencement of cases under title 11, United States Code, with respect to target firms; and

(E) initial public offerings with respect to target firms.

TITLE VI—RESTRICTIONS ON SECURITIZING RISKY CORPORATE DEBT

SEC. 601. RISK RETENTION REQUIREMENTS FOR SECURITIZATION OF CORPORATE DEBT.

Section 15G of the Securities Exchange Act of 1934 (15 U.S.C. 78o–11) is amended—

(1) in subsection (a)(3)—

(A) in subparagraph (A), by striking ‘‘or’’ at the end;

(B) in subparagraph (B), by striking ‘‘and’’ at the end and inserting ‘‘or’’; and

(C) by adding at the end the following:

‘‘(C) a manager of a collateralized debt obligation; and’’;

(2) by redesignating subsection (i) as subsection (j); and

(3) by inserting after subsection (h) the following:

"(i) RULES OF CONSTRUCTION.—With respect to a securitizer described in subsection (a)(3)(C)—

"(1) any provision of this section that requires that securitizer to retain a portion of the credit risk for an asset that such securitizer does not hold, or has never held, shall be construed as requiring that securitizer to obtain that portion of the credit risk for that asset; and

"(2) any reference in this section to an asset transferred by the securitizer shall be construed to include any transfer caused by the securitizer.".

TITLE VII—MISCELLANEOUS

SEC. 701. ANTI-EVASION.

It shall be unlawful to conduct any activity, including by entering into an agreement or contract, engaging in a transaction, or structuring an entity, to willfully evade or attempt to evade any provision of this Act.

SEC. 702. SEVERABILITY.

If any provision of this Act or the application of such a provision to any person or circumstance is held to be invalid or unconstitutional, the remainder of this Act and the application of the provisions of this Act to any person or circumstance shall remain and shall not be affected by that holding.