Trustworthy Claims: Developments (such as *Bellingham*) on What Claims a Trustee May or May Not Bring

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TABLE OF CONTENTS

Getting Particular: The Various Standards of Plan Specificity for Preserving Post-Confirmation Claims

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I. Introduction

Retaining causes of action in a chapter 11 bankruptcy plan is essential for a trustee (or other designee of the debtor) to prosecute pre-confirmation claims post-confirmation. While 11 U.S.C. § 1123(b)(3)(B) provides a mechanism by which a trustee may retain the right to object to claims or bring causes of action following the confirmation of a plan, courts have varying standards regarding what specificity is required in the plan to adequately notice and preserve such claims. The consequences of failing to comply with a jurisdiction's standard of specificity can lead to the loss of the right to pursue such claims and causes of action post-confirmation.

II. Background

Section 1123 of Title 11 of the United States Code (the "Bankruptcy Code") governs the contents of a Chapter 11 plan of reorganization. As a general rule, a bankruptcy reorganization plan may include provisions reserving the debtor's right to object to claims or to bring causes of action following the entry of an order on confirmation. Specifically, section 1123(b)(3) provides that:

> (b) Subject to subsection (a) of this section, a plan may—
>
> . . .
>
> (3) provide for--
>
> (A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or
>
> **(B) the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest**;

11 U.S.C. § 1123(b)(3) (emphasis added). While section 1123(b)(3)(B) provides that the contents of a plan may provide for the retention by the debtor or other parties of any claim or interest, it does not specify the manner in which the retention of any such claims or interests should be drafted or disclosed.

With that in mind, section 1123(b)(3)(B) is treated as a notice provision. Harstad v. First Am. Bank, 39 F.3d 898, 903 (8th Cir. 1994). The history of that section indicates that the notice at issue in § 1123(b)(3) is not notice to potential defendants, it is notice to creditors generally that there are assets yet to be liquidated that are being preserved for prosecution by the reorganized debtor or its designee. In re Pen Holdings, Inc., 316 B.R. 495, 500-01 (Bankr. M.D. Tenn. 2004). "Creditors have the right to know of any potential causes of action that might enlarge the estate—and that could be used to increase payment to the creditors." Harstad, 39 F.3d at 903. Section 1123(b)(3) provides the proper procedure to give notice to creditors in order to retain those claims. Id.

III. Effect of Failure to Meet Specificity Standard

Several circuits have held that the failure to properly provide for the retention and enforcement of claims belonging to the debtor or the estate may bar post-confirmation prosecution of those claims due to the *res judicata* effect of confirmation of the plan of reorganization and the doctrine of equitable estoppel. See, e.g., P.A. Bergner & Co. v. Bank One, Milwaukee, N.A. (Matter of P.A. Bergner & Co.), 140 F.3d 1111, 1117–18 (7th Cir. 1998); McFarland v. Leyh (In re Texas Gen. Petroleum Corp.), 52 F.3d 1330, 1335 n. 4 (5th Cir. 1995); Harstad v. First American Bank (In re Harstad), 39 F.3d 898, 903 (8th Cir. 1994); In re Heritage Hotel P'ship I, 160 B.R. 374 (B.A.P. 9th Cir. 1993) aff'd, 59 F.3d 175 (9th Cir. 1995) ("a bankruptcy court's confirmation order is a binding, final order, accorded full *res judicata* effect and precludes the raising of issues which could or should have been raised during the pendency of the case . . . ."); In re Mako, 985 F.2d 1052, 1056 (10th Cir. 1993).

Sections 1123 and 1141 of the Bankruptcy Code also have been treated as eliminating the debtor's standing to bring, post-confirmation, any claims not properly reserved in the bankruptcy plan. See Dynasty Oil and Gas, LLC v. Citizens Bank (In re United Operating, LLC), 540 F.3d 351, 355 (5th Cir. 2008) ("A debtor may preserve its standing to bring [a post-confirmation action on a claim or interest belonging to the debtor or to the estate] but only if the plan of reorganization expressly provides for the claim's 'retention and enforcement by the debtor.'"); In re Bankvest Capital Corp., 375 F.3d 51, 58 (1st Cir. 2004) ("the confirmation of a plan of reorganization binds the debtor and any entity issuing securities or acquiring property under the plan to the provisions of the plan and, except as otherwise provided in the plan, precludes parties from raising claims or issues that could have or should have been raised before confirmation but were not"). Thus, when a Chapter 11 plan is confirmed by the bankruptcy court, the debtor loses its standing to pursue the estate's claims. In re United Operating, LLC, 540 F.3d at 355; In re MPF Holdings US LLC, 701 F.3d 449, 453 (5th Cir. 2012). This loss of standing is a logical consequence of the nature of a bankruptcy, which is designed primarily to "secure prompt, effective administration and settlement of all debtor's assets and liabilities within a limited time." In re United Operating, LLC, at 355 (citing In re Kroh Bros. Dev. Co., 100 B.R. 487, 495 (Bankr. W.D. Mo. 1989)).

Accordingly, after confirmation, the debtor (or its representative) will have standing to bring claims that the debtor reserved in the plan or reorganization, but will not have standing to bring claims that were not reserved in the plan. Id. Additionally, the *res judicata* effect of the confirmation of the plan and the doctrine of equitable estoppel also may bar post-confirmation prosecution of the debtor's (or its designee's) claims. However, section 1123(b)(3) provides an exception to those rules and mechanism by which the reorganized debtor (or its designee) may bring post-confirmation actions for pre-confirmation claims. As noted above, section 1123(b)(3) permits a bankruptcy plan to provide for the retention by debtor or its designee of a pre-confirmation claim or interest belonging to the debtor or the estate. 11 U.S.C. § 1123(b)(3). The exception provided by that section is consistent with the prompt and effective administration of the debtor's assets: "[w]ithout the ability to reserve the estate's claims for later enforcement, . . . the debtor may have to adjudicate every claim to finality prior to plan confirmation or risk losing that claim." In re Kmart Corp., 310 B.R. 107, 119 (Bankr. N.D. Ill. 2004). While the purpose of the 1123(b)(3) mechanism is clear, questions remain regarding the proper use of the mechanism. In particular, what specificity is required for a plan's provision for the post-confirmation retention of a claim or interest belonging to the debtor or the estate.

IV. Degree of Specificity for Retention of Claims

While courts agree that section 1123(b)(3) of the Bankruptcy Code allows a plan to reserve various claims for post-confirmation litigation, several standards have emerged regarding the level of specificity necessary for a plan to effectively and sufficiently preserve causes of action. Courts fall along a spectrum at one end of which a general reservation of claims is sufficient, and at the other end, a high degree of specificity is required. See In re Commercial Loan Corp., 363 B.R. 559, 567 (Bankr. N.D. Ill. 2007) (collecting cases and discussing court split). Because courts are not in agreement as to the degree of specificity of the language in a plan required to properly retain a claim, the issue continues to be an area of uncertainty and contention. The following points provide a general cross-section of the spectrum.

A. General Reservation is Sufficient

Some courts have held that general reservation language in a plan or disclosure statement is sufficient under Section 1123(b)(3) to retain claims for post-confirmation prosecution. For example, in In re Bleu Room Experience, Inc., the debtor's disclosure statement generally reserved the right to object to claims as follows: "Debtor has not completed its review of Proof of Claim, however, and therefore reserves the right to object to any Proofs of Claims filed pursuant to Article XV of the Plan." In re Bleu Room Experience, Inc., 304 B.R. 309, 312 (Bankr. E.D. Mich. 2004). In that case, after confirmation of the plan, the debtor filed an omnibus objection to claims, including an objection to the claim of creditor DCG. Declining to adopt DCG's argument, the In re Bleu Room Court held that that *res judicata* did not bar the debtor's right to object to DCG's post-confirmation claims. In so holding, the court stated that "[s]o long as the debtor's plan reserves the right to object to claims, creditors have sufficient notice that the amount of their claim may be in dispute." Id. at 315. In another case, the Bankruptcy Court for the District of Delaware held that section 1123 and *res judicata* did not bar a post-confirmation claim where the disclosure statement and plan contained a general reservation of "any and all claims." In re USN Commc'ns, Inc., 280 B.R. 573, 594 (Bankr. D. Del. 2002).

B. Broad Categorical Language is Sufficient

Moving further along the specificity scale, some courts, including several circuit courts, have held that broad, categorical language in the plan is enough to properly retain post-confirmation claims under section 1123(b)(3). See Roye Zur, *Preserving Estate Causes of Action for Post-Confirmation Litigation*, 32 CAL. BANKR. J. 427, n. 9 (2013) (collecting cases). In a First Circuit case, the court found that a plan provision that retained the right to assert "any Cause of Action" permitted post-confirmation pursuit of an avoidance action where "Cause of Action" was expressly defined in the plan to include avoidance actions. In re Bankvest Capital Corp., 375 F.3d 51, 59 (1st Cir. 2004); see also Alary Corp. v. Sims (In re Associated Vintage Grp.), Inc., 283 B.R. 549, 563 (B.A.P. 9th Cir. 2002) ("A plan, as here, may provide that particular causes of action, or categories of causes of action, are preserved and not affected by confirmation and may, likewise, prescribe terms for conducting post-confirmation litigation over specific matters or categories of matters."); In re Ampace Corp., 279 B.R. 145, 158 (Bankr. D. Del. 2002) (stating that "there is nothing in [Section 1123(b)(3)] to suggest that the plan must specifically identify each and every claim and/or interest belonging to the debtor that may be subject to retention and enforcement."); In re Ice Cream Liquidation, Inc., 319 B.R. 324, 337-38 (Bankr. D. Conn. 2005) (holding that while creditors must be told in the plan that avoidance actions will be pursued post-confirmation, individual prospective defendants did not have to be identified); JP Morgan Trust Co. Nat. Ass'n v. Mid-Am. Pipeline Co., 413 F. Supp. 2d 1244, 1280 (D. Kan. 2006) (holding that the general reservation of "Litigation Claims" in the plan together with the definition of that term elsewhere was sufficient to preserve claims against the defendants post-confirmation and avoid application of *res judicata*).

In Matter of P.A. Bergner & Co., the Seventh Circuit held that a claim itself need not be "specific and unequivocal" because "the statute itself contains no such requirement." Matter of P.A. Bergner & Co., 140 F.3d at 1117 (7th Cir. 1998). Rather, the plan of reorganization must "unequivocally retain claims of a given type, not on any rule that individual claims must be listed specifically." Id. In other words, the Bergner decision holds that a categorical reservation of claims in the plan is a sufficient retention of those claims for purposes of Section 1123(b)(3). Importantly, in Bergner, although there was some emphasis placed on the fact that the subject lawsuit was pending and being actively litigated prior to plan confirmation, the Seventh Circuit concluded that "[t]he language of [the] plan provided all the notice to which [the defendant] was entitled under the statute to preserve the ongoing proceeding between the parties." Id. (quoting pertinent language in the plan which provided that the debtors waived the right to prosecute any avoidance or recovery actions "other than any such actions that may be pending on such date").

Relying on Bergner, lower courts have held that "categorical reservation" can effectively prevent *res judicata* after confirmation of a plan of reorganization. See, e.g., In re Kmart Corp., 310 B.R. 107, 124 (Bankr. N.D. Ill. 2004) (noting that "a blanket or general provision . . . will not suffice to defeat the preclusive effect of the confirmation order. Bergner stands for the proposition that plan provisions identifying causes of action by type or category are not mere blanket reservations. Therefore, categorical reservation can effectively avoid the *res judicata* bar.").

C. Factual Bases of Claims and Names of Prospective Defendants Required

The Sixth Circuit has taken a stricter approach to the issue, requiring that the retention language of the plan identify the potential defendants and the factual basis for the cause of action. Browning v. Levy, 283 F.3d 761, 775 (6th Cir. 2002). In Browning, the Sixth Circuit found that "a general reservation of rights does not suffice to avoid *res judicata*." Id. at 774. Thus, the court held that the broad, "blanket reservation" did not reserve the plaintiff's malpractice claims, as it did not specifically mention those claims. Id. In so holding, the Court noted that the reservation in the plan at issue neither named the party against whom the claims were to be asserted nor stated the factual basis for the reserved claims. Id. at 775.

In In re Crowley, Milner & Co., the reservation of rights clause in the bankruptcy plan reserved to various creditors' committees the right to pursue the debtors' "claims or causes of action against any person . . . ." In re Crowley, Milner & Co., 299 B.R. 830, 847 (Bankr. E.D. Mich. 2003). After the bankruptcy plan was confirmed, the committees sued some of the debtors' officers, alleging that they breached their fiduciary duties. Id. at 848-49. The court found, however, that the committees' claims were barred by *res judicata* and that the debtors had not effectively reserved their claims. Id. at 851. Relying primarily on Browning, the Court noted that the debtors' plan did not specifically name any officer or director, nor did it describe any specific causes of action or a factual basis for any claims that might exist against any officer or director. Id. at 850; see also Groupwell Int'l (HK) Ltd. v. Gourmet Exp., LLC, No. 4:09-CV-00094-M, 2013 WL 309177, at *8 (W.D. Ky. Jan. 25, 2013) (finding that "the bankruptcy documents do not specifically name [the defendant] or state the factual basis for any claim against it."). The lack of any meaningful information in the bankruptcy documents "regarding the nature, factual basis, or value of any claims" reinforced the court's conclusion that the reservation was insufficient. Id. at 852; but see In re Pen Holdings, Inc., 316 B.R. 495, 504 (Bankr. M.D. Tenn. 2004) (stating that Browning did not "establish a general rule that naming each defendant or stating the factual basis for each cause of action are the only ways to preserve a cause of action at confirmation of a Chapter 11 plan.").

D. "Specific and Unequivocal" Language is Required

On the far end of the specificity spectrum is the Fifth Circuit's "specific and unequivocal" standard, first enumerated in the seminal case of In re United Operating, LLC. In that case, the Fifth Circuit held that "[f]or a debtor to preserve a claim [under Section 1123(b)(3)], 'the plan must expressly retain the right to pursue such actions.'" In re United Operating, LLC, 540 F.3d at 355 (5th Cir. 2008). According to the Fifth Circuit, the reservation in the plan must be "specific and unequivocal." Id. Thus, a blanket and generic reservation of all claims is not proper. See id. at 356 (finding that "[n]either the Plan's blanket reservation of 'any and all claims' arising under the Code, nor its specific reservation of other types of claims under various Code provisions" was sufficient to preserve the claims at issue).

Subsequently, the Fifth Circuit relaxed this view in the case of Spicer v. Laguna Madre Oil & Gas II, L.L.C. (In re Tex. Wyo. Drilling, Inc.), 647 F.3d 547 (5th Cir. 2011). In that case, a litigation trustee filed over thirty avoidance actions against the debtor's former shareholders, seeking to recover dividends paid to the shareholders while the debtor was insolvent. Id. at 549. The disclosure statement stated that the debtor reserved the right to pursue "any preference to the full extent allowed under the Bankruptcy Code" and expressly referenced Chapter 5 of the Code, which relates to avoidance actions. Id. The disclosure statement further provided that among the "various claims and causes of action the Debtor or the Reorganized Debtor may pursue on behalf of the Debtor's estate" are claims against "[v]arious pre-petition shareholders of the Debtor [for] fraudulent transfer and recovery of dividends paid to shareholders." Id. Neither the disclosure statement nor the reorganization plan identified any individual pre-petition shareholders that the debtor planned to sue or any specific transfers the debtor would seek to avoid. Id. at 549 & 551.

As a result, the defendant argued that the debtor's reservation of avoidance actions failed the "specific and unequivocal" test because it did not identify individual defendants. Id. at 551–52. The court rejected that argument, stating: "We observe that In re United Operating focused exclusively on the retention of claims. It never held that intended defendants must be named in the plan." Id. at 552. That said, the Fifth Circuit expressly declined to decide "whether a debtor whose plan fails to identify any prospective defendants has standing to pursue post-confirmation claims against subsequently-named defendants" because the disclosure statement at issue in Texas Wyoming "did identify the prospective defendants as '[v]arious pre-petition shareholders of the Debtor' who might be sued for 'fraudulent transfer and recovery of dividends paid to shareholders.'" Id.

Overturning a bankruptcy court's ruling that retention language was not sufficiently specific and unequivocal, the Fifth Circuit, in Compton v. Anderson (In re MPF Holdings US, LLC), 701 F.3d 449 (5th Cir. 2012), further clarified the requirements for post-confirmation standing. Specifically, the Fifth Circuit: (1) reiterated its position that the parties to be sued after confirmation need not be individually identified in the plan; (2) rejected the bankruptcy court's conclusion that retention language "must also state that following confirmation, these defendants will be sued—not that they may be sued or could be sued or might be sued"; and (3) in dicta, noted that the existence of an ambiguity in reservation language is not invalid per se under the "specific and unequivocal" standard and that parol evidence could be applied to resolve such ambiguity. Id. at 455-57.

The Fifth Circuit's holding in In re United Operating was recently reaffirmed in Wooley v. Haynes & Boone L.L.P. (In re SI Restructuring Inc.), 714 F.3d 860 (5th Cir. 2013), in which the court held that claims for breaches of fiduciary duties were not effectively preserved because "[n]either the Plan nor the disclosure statement reference[d] specific state law claims for fraud, breach of fiduciary duty, or any other particular cause of action. Instead, the Plan simply refer[red] to all causes of action . . . [and] such a blanket reservation is not sufficient . . . ." Id. at 864-65.

In another recent decision, the U.S. Bankruptcy Court of the Northern District of Texas held that the confirmed bankruptcy plan of a liquidated company was not required to specifically preserve the bankruptcy-created rights of the company against its former principal. Harvey L. Morton v. Robert Lewis Adkins, Sr. (In re Robert Lewis Adkins, Sr.), No. 12-10314-RLJ-7, 2015 WL 1952591 (Bankr. N.D. Tex. Mar. 27, 2015). In that case, the bankruptcy plan established a liquidating trust that, upon plan confirmation, received all the assets in the bankruptcy estate of the company, including all "Retained Causes of Action." Id. at *1. The plan defined "Retained Causes of Action" as "all estate causes of action belonging to the Debtor and estate based on federal or state law, and any claims, counterclaims, rights, defenses, setoffs, recoupments, and actions in law or equity arising under the Bankruptcy Code or applicable nonbankruptcy law." Id. The plan then illustrated a number of claims that were retained claims, including claims for breach of fiduciary duty and common law actions. Id.

In addition to the company, the former principal of the company filed an individual chapter 7 petition. Id. The trustee for the liquidating trust filed an adversary action against the former principal, in his personal chapter 7 case, seeking recovery for alleged breach of fiduciary duties and a determination that the debt arising from such claim is not dischargeable under § 523(a)(4) and (6) of the Bankruptcy Code. Id. As to the non-dischargeability counts, the principal argued that since those actions were not specifically reserved in the Plan, the Trustee lacked standing to bring such actions. Id. After discussing In re United Operating and its progeny, the court recognized that the plan did not specifically reserve a non-dischargeability action but found that such an action did not amount to a "claim," which is defined as a "right to payment" under 11 U.S.C. § 101(5)(A). Id. at *2. Because the non-dischargeabilty action was not seeking a "right to payment," the court held that it was not a "claim" and therefore was not within the parameters of section 1123(b)(3). Id. ("[H]ad the . . . Plan not reserved the breach of fiduciary duty claim, the Trustee's dischargeability counts would likely be jeopardized. The . . . Plan does, however, list breach of fiduciary duty claims among the claims retained and assigned to the . . . Trustee. Section 1123(b)(3) does not apply to the dischargeability issues.").

LITIGATION ISSUES RELATED TO COMMITTEE PURSUIT OF CAUSES OF ACTION

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Liquidating chapter 11 cases often result in turnover of claims and causes of action against various parties to a trust or other representative of the stakeholders of the estate. These claims and causes of action are then pursued for the benefit of the stakeholders, be they unsecured creditors, equity holders or both. These causes of action come with variable results with the potential for successful recovery driven largely by the question of how the causes of action came about and to which party the causes of action legitimately belong. This section of the materials will discuss at a topical level certain impediments to the successful prosecution of causes of action on behalf of estate stakeholders.

I. *In Pari Delicto* Defense

The *In Pari Delicto* defense, deriving from the phrase "*in pari delicto potior est conditio defendantis"* stands for the notion that, in a case where both defendant and plaintiff are of equal or mutual fault, the position of the defendant is superior. This defense arises under state law and is *"grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality"*[1]*.* Thus, in a case where a debtor and some other party, such as a professional firm, have acted in concert to conceal financial fraud, for example, the chapter 11 debtor's efforts to sue the professional firm for malpractice, breach of fiduciary duty or other claims may likely be frustrated by this defense, in that the debtor was of equal fault in the wrongdoing with the professional.

Of tantamount importance in evaluating claims and causes of action for wrongdoing by the debtor or debtor's management, then, is who the beneficiary of the claim is and who should be correctly bring the causes of action. For a defendant, to successfully invoke application of the *in pari delicto* defense requires showing that the debtor plaintiff (or a trustee or receiver who stands in the shoes of the debtor) was an "active, voluntary participant in the unlawful activity that is the subject of the suit."[2] In the Second Circuit, the *in pari delicto* defense is often referred to as the "Wagoner Rule", based upon the 2nd Circuit's 1991 finding that, as to a debtor in possession, if prior management was *in pari delicto* with a third party

[1] Mosier v. Callister, Nebeker & McCullough PC, 546 F.3d 1271, 1275 (10th Cir. 2008) (citation omitted)
[2] Pinter v. Dahl, 486 U.S. 622, 636 (1988)

in a fraud, then the trustee lacked standing to assert claims related to that fraud.[3] Therefore, a debtor or successor to the debtor, be it a purchaser of claims, assignee of claims or post-confirmation trust to which claims have been gifted, can be barred from pursuing claims against parties acting alongside a pre-petition debtor in the commission of fraud.

There are exceptions to the *in pari delicto* defense, however. The "Adverse Interest" exception provides that the doctrine is inapplicable in such instances where the complicit debtor's officer, employee or director was acting in their own self-interest and acting adversely to the debtor's own interests. Therefore, a company management knowing of or being involved in a fraud will not impute to the company itself if management was acting entirely for their own self-benefit and not the benefit of the corporation.[4] This exception, however, is limited in its reach. If the management's actions were of any benefit to the debtor, then the adverse interest exception fails.[5] A second exception is that of the "sole actor" – in cases where a single shareholder was in control of the debtor, rendering the actor and the corporation one and the same, the *in pari delicto* defense also fails.

The *in pari delicto* defense has been accepted in the 1st, 2nd, 3rd, 6th, 8th, 10th and 11th Circuits, which have all held that a bankruptcy trustee is barred from pursuing claims against third parties for participating in schemes with the pre-petition debtors' management, officers, employees or directors. There have been some exceptions to the impact of the defense on successors that stand in the shoes of the debtor. In Scholes v. Lehmann, the 7th Circuit held that *in pari delicto* should not apply to impute a debtor's misconduct to a U.S. SEC Receiver appointed for the benefit of creditors, and in this is a significant distinction. The Receiver is appointed for the benefit of creditors and is not simply a new incarnation of the debtor – thus, if one is standing in the shoes of creditors and is suing on behalf of creditors, then these are creditors causes of action and *in pari delicto* would not apply as a defense.

Another exclusion from the *in pari delicto* defense whose applicability may continue to mature arose in the Allegheny Health Education and Research Foundation (AHERF) cases [6], in which the Pennsylvania Supreme Court provided guidance to the U.S. 3rd Circuit Court of Appeals related to the availability and applicability to of the defense in the contact of auditor liability. In this case, PWC was AHERF's auditor as the hospital chain sought a purchaser. Upon removal of the CEO by AHERF's board of directors, PWC was terminated and, shortly thereafter, disavowed the reliability of the previous year's financial statements. AHERF later filed a chapter 11 bankruptcy case and, upon selling all of its assets, realized

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[3] Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114 (2nd Cir. 1991; Accord CBI Holding Company, Inc. v. Ernst & Young, 529 F. 3d 432 (2d Cir. 2008)

[4] *In re* Am. Int'l Group, Inc., 965 A.2d 763 (Del. Ch. 2009)

[5] Kirchner v. KPMG, LLP, 590 F.3d 186, 195 (2d. Cir. N.Y. 2009)

[6] Official Committee of Unsecured Creditors of Allegheny Health Education and Research Foundation v. Pricewaterhouse Coopers, LLP, 989 A.2d 313 (Pa. 2010)

consideration significantly less than was initially anticipated. Though a trustee was appointed in the case, it was the unsecured creditors who, though the official committee, brought suits against AHERF's directors and officers and, finally, against PWC as the debtor's pre-petition auditor. The suits alleged that the financial statements were knowingly, intentionally and materially misstated by a group of insiders, including high-level officers, and that PWC was guilty of breach of contract, professional negligence and aiding and abetting a breach of fiduciary duty under state law, alleging collusion between PWC and the AHERF officers.

Unsurprisingly, PWC sought to dismiss the claims using the *in pari delicto* doctrine as a defense. The District Court agreed and dismissed the suit against PWC. The Creditors' Committee appealed the decision and the 3rd Circuit certified to the Penna. Supreme Court the questions concerning the interaction between *in pari delicto* on the one hand and the imputation of an agents fraud against the principal on the other[7]. The Pa. Court, while holding that the *in pari delicto* defense is valud under Pa. law, held the doctrine was limited to non-collusive scenarios. The Court expanded the adverse interest exception to exclude "secretive, collusive conduct between corporate agents and third parties" that was "overwhelmingly adverse to the corporation", even in those cases where the collusion provided the corporation "a peppercorn of benefit."[8] [9] The state court held that the correct means by which to test the availability of the *in pari delicto* defense in cases involving "non-innocents" rests in determining whether or not the defendant acted and dealt with the principal in good faith.[10] The Court held that a defendant who has not dealth in good faith with the client is "effectively foreclosed from asserting an *in pari delicto* defense for scenarios involving secretive collusion between officers and auditors to misstate corporate finances to the corporation's ultimate detriment." [11] The 3rd Circuit later held that, with respect to the *in pari delicto* defense, the doctrine's "origins in equity mean that it is subject to appropriate and necessary limits and that the doctrine can not be "woodenly applied and vindicated in any and all instances", but that the doctrine can be trumped by another policy more important than the policy basis for *in pari delicto* itself.

Perhaps the greatest clarity from the 3rd Circuit's ruling in AHERF is that in the case of financial statement fraud, the doctoring of financial statements and the attendant results of that act does not rise to providing a benefit to the company because "a knowing, secretive, fraudulent misstatement of corporate financial information" is not "of benefit to a company." Conversely, once situation in which the defense continually provides benefits to bad actors is in the context of claims

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[7] Official Comm. Of Unsecured Creditors of Allegheny Health, Educ. & Research Found. V. PricewaterhouseCoopers, LLP (Allegheny II), No. 07-1397, 2008 WL 3895559, at *6 (3d. Cir. July 1, 2008)
[8] This would be a great name for the debut album of an okay band.
[9] 989 A.2d at 334-335.
[10] *Id.* at 339.
[11] *Id.* at 339.

against professionals or parties that aided ponzi schemes, when those claims are brought by the bankruptcy trustees of the bad-acting debtor.

The key in successful avoiding the *in pari delicto* defense is in understanding the relationships between the parties and who might be able to bring the claims before starting the litigation. In any instances where creditors might hold the rights to those claims, having the creditors, or a creditors trust, bring the causes of action should minimize the applicability of the *in pari delicto* defense. In cases where the debtors' books and records were doctored in concert by management and outside accountants or auditors, one should determine who benefitted from the act – if it was management and no the debtor, then the adverse interest exclusion may apply to moot the *in pari delicto* doctrine. If the professional colluded with management, directors, officers or employees, then the 3rd Circuit's holdings in AHERF may render inapt the *in pari delicto* defense. Conversely, if the only party standing to bring the claims is the debtor, a trustee of the debtor, a successor or purchaser of the debtor, then be prepared to lose the claims to the *in pari delicto* defense unless you can show applicability of the adverse interest or sole actor exclusions.

II. Insured versus Insured Exclusions

Similar to *in pari delicto* defenses, Insured v. Insured exclusions frustrate recoveries on causes of action by stakeholders. Unlike a defense from liability, however, the insured v. insured exclusions do not touch upon liability – in fact, they only arise when liability has been proven or accepted. Insured v. insured exclusions exempt insurers under D&O policies from paying on a claim against an insured when the claim was brought by another insured under the same policy – essentially ensuring that the insurer will not be in a position to pay a claim for the benefit of a director of a company against its fellow directors. These exclusions protect an insurer from collusion by a company to use a supposed claim as a means by which to access insurance proceeds for some improper benefit.

Like the reach of *in pari delicto* defenses, the reach of the Insured v. Insured exclusion generally extends to the debtor, any successor to the debtor such as a Trustee, receiver, purchaser or post-confirmation trust in which the debtor has assigned or transferred causes of action or claims. And like the *in pari delicto* defense, there are exclusions which, in the case of insurance policies, are referred to as "carve backs". Typical carve backs might remove from the exemption claims brought in bankruptcy proceedings, claims brought by an examiner, trustee, receiver, liquidator or rehabilitator of an insured organization or bankruptcy organization.

A recent landmark case in Insured v. Insured exemptions is that of Visitalk, which filed a chapter 11 petition and, while a debtor in possession, sued certain directors and officers for breach of fiduciary duty. The insurers disclaimed coverage on the basis of the Insured v. Insured exclusion. The Ninth Circuit Opinion, handed down on July 10, 2009, noted that "*risks such as collusion and moral hazard are much* *greater for claims by one insured against another insured … than for claims by strangers*." Because, in the Visitalk case, none of the exceptions to the policy's Insured v. Insured exclusion were present, the Court needed only determine if the case being brought was "brought or maintained on behalf of any Insured in any capacity."

The Court found that the case and the underlying claims had been "instigated and continued" by the debtor in its capacity as a chapter 11 debtor and a debtor in possession and, while the claims were brought by a "creditors' trustee", the trustee was bringing the claims only as an assignee of the debtor which, the court noted, can have no stronger claim than the debtor who assigned the claim in the first place. The Court held that the post-petition chapter 11 debtor was the same entity as the pre-petition debtor for purposes of the Insured v. Insured exclusion and that, while the suit might have been brought for the benefit of creditors, the suit was not brought by creditors and was not brought on behalf of creditors. In attempting to illustrate the problem presented, the Court opinioned that the Trustee "cannot jump into the insured's shoes to bring the lawsuit, out of their shoes to claim not to be suing as though it were the insureds, and then back into their shoes to get compensatory and punitive damages for the insurers' failure to cover their liabilities." [12]

Key here in determining how to avoid Insured v. Insured exclusions is a thorough reading and vetting of all D&O policies by insurance and litigation counsel before crafting a plan, settlement or other structure by which claims will be assigned or pursued. In cases where a claim is assigned by a debtor, expect that Insured v. Insured exclusions will apply unless the necessary carve back language is present in the policies. For cases where breach of fiduciary duty are alleged, consider if these can be brought as creditor claims by a creditors' trust for the benefit of stakeholders, which should limit or otherwise moot the impact of exclusions from payment by insurers. Finally, know what language governs policy limits. Many policies limit liability for fraud, for example – a quick way to lose coverage for the targets is to sue for fraud among a panoply of claims or causes of action. If a trustee is not excluded from the Insured v. Insured exclusion, consider having creditors who own the claims appoint an otherwise-titled party to hold and pursue the claims under, such as a liquidator. In cases involving insurance policies, the nomenclature used at each step in the process has a significant and seemingly overblown impact on the possible results.

III. Bankruptcy versus State Law Claims

Please see the included article, Ted Gavin, Delaware Opinion's Implications for Post-Confirmation Trust Litigation, XXXII ABI Journal 5, 18-19, 72-73, June 2013 for a discussion of recent decisions impacting choice of venue for creditor causes of action in post-confirmation chapter 11 cases.

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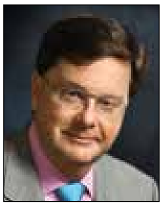
[12] Biltmore Assocs. LLC v. Twin City Fire Ins. Co., 572 F.3d 663 (9th Cir. 2009)

Legislative Update

By William A. Brandt, Jr. and Geoffrey L. Berman

ABI Commission Update: Report on Avoiding Powers



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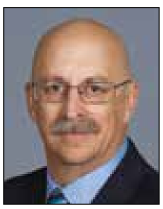

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As ABI members should now be well aware, the ABI Commission to Study the Reform of Chapter 11 ("the Commission") released its Final Report on Dec. 8, 2014. The 400-page report contained more than 240 individual recommendations covering a wide range of topics affecting all facets of the chapter 11 process.[1] This article focuses solely on issues of avoiding powers, which was one of the 13 topic areas that the Commission reviewed.[2]

The Commission heard from the trade creditor community often and received constant feedback from this sector of the insolvency arena throughout its two-plus years of deliberations. Direct meetings with trade creditor representatives included testimony at a field hearing held in conjunction with the 2012 National Association of Credit Managers (NACM) Credit Congress in Las Vegas. As a follow-up to that hearing, written submissions were solicited on topics affecting trade creditors and a further follow-up session was held at NACM's June 2014 Credit Congress. This constant interaction between representatives of trade creditors and the Commission led to a more complete understanding of the trade community's concerns regarding the prosecution of preference claims under § 547 and claims under § 503(b)(9). It was not lost on Commission members that a significant amount of feedback that congressional offices receive about the Bankruptcy Code pertains to the trade creditor body's perception that there is an inherent unfairness in the prosecution of preference actions.[3]

Preferences and Defenses

Specifically, as to actions to recover preferential transfers, the trade creditor community expressed significant concerns regarding the manner in which preference actions are prosecuted and the concomitant burdens placed on trade creditors that are forced to defend such actions. Recognizing these concerns, the Commission analyzed a number of potential reforms regarding preference issues.

The Commission's recommendations included keeping the burden of proof for the defense with respect to recovery actions under § 547, as is currently embodied in the Bankruptcy Code. Simply put, the Commission believed that creditors should continue to have the burden of proving that a transfer (usually a payment) received from a debtor within 90 days of the filing of the commencement of a bankruptcy is either covered by the ordinary course of business defense or the new value defense, or was a contemporaneous exchange for new value.[4] That being said, the Commission did find it appropriate that a trustee, or any other person charged with the authority on behalf of an estate to prosecute preference recovery actions, perform reasonable due diligence and make a good-faith effort to evaluate the merits of any preference claims before making a demand for preference recovery, much less filing suit against a creditor for such recovery. The Commission also expressed its sympathy with those trade creditors who brought up the example of demand letters being sent on behalf of the estate without measurable foundation, often simply after a review of the company's check register for the preceding 90 days. As a result, the Commission found it appropriate that § 547 claims be pled with particularity as to the facts supporting the claim, as is currently required by the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*.[5] A complaint needs to be specific as to the preference allegations involved and not be a mere generalized statement that a creditor received payments during the preference period.

In its report, the Commission also felt that it was appropriate to recommend raising the limits on the amounts of claims being filed under §§ 547(c)(9) and 1409(b) of title 28 of the U.S. Code.[6] These proposed new limits are $25,000 under § 547 and $50,000 under § 1409. Effectively, claims must now reasonably be estimated to be worth more than $25,000 in order to be filed; if under $50,000, such claims must be brought in the district where the creditor resides rather than in the district in which the bankruptcy proceeding is pending.

This recommendation by the Commission still requires a potentially responsible creditor to be prepared to defend a preference claim when a debtor files

1 The Final Report and archived video of past hearings are available on the Commission's website at commission.abi.org. An excerpt of the Final Report was featured in the January 2015 issue of the *ABI Journal*.

2 The members of the Avoiding Powers Committee were Prof. **Christopher W. Frost** (University of Kentucky College of Law; Lexington, Ky.), **Debra I. Grassgreen** (Pachulski Stang Ziehl & Jones LLP; San Francisco), Hon. **Stacey G. C. Jernigan** (U.S. Bankruptcy Court (N.D. Tex.); Dallas), **Bruce S. Nathan** (Lowenstein Sandler LLP; New York), **John D. Penn** (Perkins Coie LLP; Dallas), **Ronald R. Peterson** (Jenner & Block LLP; Chicago), Hon. **Steven W. Rhodes** (U.S. Bankruptcy Court (E.D. Mich.); Detroit), Prof. **G. Ray Warner** (St. John's University School of Law/Greenberg Traurig, LLP; Jamaica, N.Y.), **David B. Wheeler** (Moore & Van Allen, PLLC; Charleston, S.C.) and **R. Scott Williams** (Rumberger, Kirk & Caldwell, PA; Birmingham, Ala.).

3 Based on conversations that Mr. Brandt has had with many members of Congress.

4 The defenses are found at 11 U.S.C. § 547(c).

5 *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

6 This is the small claims venue provision.

for bankruptcy, even if the demand or suit is not alleged until near the end of the two-year statute of limitations in which such claims must be brought. However, the debtor/trustee must now have a reasonable basis to bring the claim and will be required to be specific in the bona fides of the claim if an adversary proceeding is to be filed. The Commission examined a number of other issues regarding preference actions and recoveries, but ultimately believed it best to leave the supervision of preference actions to the applicable court.[7]

Reclamation and *In Pari Delicto*

The Commission also gave a great deal of attention to claims of creditors under § 503(b)(9), as well as reclamation claims. The Commission believed that the protections in § 503(b)(9) were an important protection for unsecured creditors. Despite concerns that allowing these claims to remain as administrative expense reimbursement claims can cause a debtor significant issues in conjunction with plan confirmation, the Commission felt that it was important that these claims remain as currently authorized under the Bankruptcy Code. There was significant testimony and discussion about including "drop shipments" under the definition of "goods" under the statute, wherein a vendor sends its product to the debtor's customer(s) on direct delivery rather than to the debtor first. The Commission felt that it was appropriate to recommend that such deliveries as these "drop shipments" be included in the definition of "goods" and therefore made a part of those items potentially allowed under a § 503(b)(9) claim structure.

However, the Commission did not feel that it was appropriate to further expand the definition of an allowed § 503(b)(9) claim to include the concept of "services" rather than "goods." The Commission also felt that it was important that creditors be required to file a claim for recovery of such § 503(b)(9) claims as they may exist. Rather than assuming that these claims are valid per the debtor's records, the Final Report recommends that creditors be required to file a claim, by the applicable claims bar date as set by the court, to qualify for administrative expense claim treatment and be advised that such proofs of claim need to be specific as to the shipments included in the asserted claim, as well as a breakout of the amount of drop shipments vs. direct delivery.

Not surprisingly, the Commission also found, in conducting its research in the trade creditor arena, that creditors rarely pursued their state law reclamation rights and any rights that they might have under § 546(c) after a debtor has filed for bankruptcy. The general thinking on this appears to be that the § 503(b)(9) remedies have largely trumped reclamation claims remedies, such that the § 503(b)(9) claim structure now appears to be the primary mode of recovery for most creditors. Therefore, the Commission believed that when a creditor files a claim under § 503(b)(9), it should give up any state law reclamation right(s).[8] Further, the Commission felt that preserving the trade creditors' § 503(b)(9) rights should also replace any "critical vendor" designation or treatment by the debtor.

Also included in the Commission's deliberations were the implications of the *in pari delicto* defense. This defense to claims brought by a trustee "generally bars the pursuit of a cause of action by a plaintiff who allegedly acted in concert with the defendants or was otherwise involved in the wrongful conduct underlying the plaintiff's complaint."[9] The underlying premise in this interpretation is that a court should not "lend their good offices to mediating a dispute among wrongdoers."[10] The cause of action brought by a trustee is typically based on the pre-petition conduct of the debtor's principals and/or its professionals, and this cause of action belongs to the estate under § 41 as property of the debtor.

As most professionals may know, present law precludes recovery because of a debtor's wrongdoing (subject to various exceptions).[11] The Ninth Circuit Court of Appeals is the only circuit court yet to rule on the issue; every other circuit court to examine the proposition has found that the *in pari delicto* doctrine bars a trustee's claims when the doctrine would also bar the debtor from bringing these types of claims. This situation relates only to those claims that are property of the debtor's estate under § 541 and does not apply to a trustee's recovery rights under other Bankruptcy Code sections, such as §§ 544 and 547 or the bringing of fraudulent transfer claims under §§ 548 and 550.

The issues facing the Commission in dealing with the *in pari delicto* doctrine included the fact that the claims brought by the trustee, if successful, would often not benefit the wrongdoers, but rather the creditors who have lost money because of the bankruptcy being filed. The Commission was unable to reach a consensus on its recommendations as to the application of the *in pari delicto* defense except in cases where the cause of action is brought by any *trustee appointed in the case*. In those instances and under those circumstances, the Commission recommended that the *in pari delicto* defense not be applicable. However, a trustee was not defined to include a post-confirmation trustee, such as the trustee of a liquidation or litigation trust.[12]

Conclusion

The Commission listened carefully to the everyday issues that trade creditors deal with and then tried to balance the trade creditors' needs with other imperatives of the Bankruptcy Code. Like every other aspect of the Commission's deliberations, extensive time was spent looking at the needs of trade creditors and the potential recoveries by unsecured creditors in bankruptcy cases and working to ensure that its recommendations were balanced and represented an improvement over the current application of the existing provisions of the Bankruptcy Code. abi

7 For example, testimony that was submitted to the Commission included instances where creditors felt that the preference action process was being abused by the trustee, as well as the potential of shifting the burden of proof in these cases to the trustee. For more information on these issues, *see* the Commission's Final Report at p. 150.

8 For a more detailed look at the recommendations related to § 503(b)(9) and reclamation claims, *see* the Final Report, beginning at p. 169.

9 Final Report at p. 186.

10 *See Mosier v. Callister, Nebeker & McCullough PC*, 546 F3d. 1271, 1275 (10th Cir. 2008), and the Final Report at p. 186.

11 For more information on the *in pari delicto* defense, *see* Gregory W. Fox, "Limits of Expansive Protection of New York's *In Pari Delicto* Defense," XXXIII *ABI Journal* 9, 20-21, 76-77, September 2014; Allan B. Diamond and J. Maxwell Beatty, "*In Pari Delicto*: The Inequitable Application of an Equitable Doctrine," XXX *ABI Journal* 4, 36-37, 78-79, May 2011; Emily Stone and Emily Horowitz, "*In Pari Delicto*: 'At Equal Fault' Defense Explained," XXX *ABI Journal* 5, 54-55, 69, June 2011; Catherine E. Vance, "*In Pari Delicto*, Reconsidered," XXVIII *ABI Journal* 9, 40-41,78, November 2009. These articles are available on the *ABI Journal*'s website at journal.abi.org/content/journal-archive.

12 For more information on this area of the Commission's study, *see* the Final Report, beginning at p. 188.

Understanding the Evolution of the 546(e) Safe Harbor: What is Safe and Where Else Can I Go?

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I. Introduction

This article provides a brief history of the "safe harbor" under 11 U.S.C. § 546(e), the current split of authority regarding its interpretation and application, the recent findings and recommendations of the ABI Commission (defined herein) with respect to the provision, and the impact that the unsettled interpretation of the section has on venue selection and exclusive jurisdiction provisions in chapter 11 plans.

II. History of 546(e) Safe Harbor

Pursuant to Section 547(b) and 548 of Title 11 of the United States Code (the "Bankruptcy Code"), a trustee may pursue claims to avoid transfers made by the debtor that were preferential or fraudulent (via either actual fraud or constructive fraud). These avoidance claims are limited, however, by the safe harbor provision found in Section 546(e) of the Bankruptcy Code ("546(e)"). 546(e) 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 margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

11 U.S.C. § 546(e). Stated more simply, 546(e) protects "margin payments"[1] and "settlement payments"[2] from the avoiding powers unless such transfers are made with actual intent to hinder, delay or defraud creditors. Id.

[1] The term "margin payment" means, for purposes of the forward contract provisions of the Bankruptcy Code, payment or deposit of cash, a security or other property, that is commonly known in the forward contract trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, or variation payments. 11 U.S.C.A. § 101(38). "Margin payment" as used in the stockbroker

Section 546(e), along with other safe harbor provisions exempting certain qualified financial contracts from various provisions of the Bankruptcy Code, originally made its appearance as Section 746(c) of the 1978 version of the Bankruptcy Code to protect settlement and clearing systems for stock purchases and sales and to promote stability in the commodity markets. S. REP. NO. 95-989, at 8 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5794; see also In re OODC, LLC, 321 B.R. 128 (Bankr. D. Del. 2005). In 1982, Congress repealed Section 746(c) and replaced it with Section 546(e) in order to "clarify and, in some instances, broaden the commodities market protections and expressly extend similar protections to the securities market." H.R. REP. NO. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583. Congress continued to expand and enhance the protections given to those types of contracts in 1990, 1994, 2005, and 2006, all with the continued intention of protecting the nation's financial markets from the instability that could be caused by the reversal of settled securities transactions. COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS, 95 (2014). Specifically, Congress wanted to limit a trustee in bankruptcy from avoiding margin and settlement payments made by or to certain parties in the clearance and

liquidation provisions, means payment or deposit of cash, a security, or other property, that is commonly known to the securities trade as original margin, initial margin, maintenance margin, or variation margin, or as a mark-to-market payment, or that secures an obligation of a participant in a securities clearing agency. 11 U.S.C.A. § 741(5). In commodity-broker liquidation cases, "margin payment" means payment or deposit of cash, a security, or other property, that is commonly known to the commodities trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, and variation payments. 11 U.S.C.A. § 761(15).

[2] "Settlement payment" is defined by the general definitional provisions of the Bankruptcy Code as meaning, for purposes of the Code's forward contract provisions, a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade. 11 U.S.C.A. § 101(51A). "Settlement payment," as used in the stockbroker liquidation provisions, means a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade. 11 U.S.C.A. § 741(8). In commodity-broker liquidation cases, margin payments include settlement payments, daily settlement payments, and final settlement payments made as adjustments to settlement prices. 11 U.S.C.A. § 761(15).

settlement system[3] in order to prevent the insolvency of one commodity or security firm from spreading to other firms (and thereby potentially leading to the collapse of the entire commodities or securities market).[4] Id. While commentators disagree on whether that purpose continues to be met by the current iteration of Section 546(e), the courts are similarly divided on how expansively the safe harbor should be interpreted.

III. Interpreting 546(e) - Disagreement Among the Courts

The protected payments under Section 546(e) cover a broad range of transfers, and the term "settlement payment" specifically has been broadly defined by courts. 9B AM. JUR. 2D. Bankruptcy § 2052 (2015). A "settlement payment" is defined in section 741(8) of the Bankruptcy Code as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." 11 U.S.C. §741(8). Courts have interpreted the term to include many types of transfers, many of which are arguably not within the original legislative intent to protect the commodities and securities market. COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 96 (2014); see also Geltzer v. Mooney (In re MacMenamin's Grill Ltd.), 450 B.R. 414 (Bankr.

[3] The clearance and settlement system was described by the District Court for the Northern District of Illinois as follows:

> [T]ypically, when a customer wishes to buy a security, he or she places an order with his or her broker, who purchases the security from another broker, who is acting on behalf of a party who has placed an order to sell. Once the trade has been agreed upon, the process by which the security is delivered in exchange for the purchase price is known as "clearance and settlement". The clearing agency compares the trades its member brokers have made to arrive at an accounting of the day's transactions, which it then uses to establish each broker's money and securities settlement obligations. Finally, the trades are "settled" – funds and securities are delivered in satisfaction of the obligations.

In re Wieboldt Stores Inc. v. Schottenstein, 131 B.R. 655, 664 at n.9 (N.D. Ill. 1991).

[4] Each party in the clearance and settlement chain independently guarantees its obligation to the other parties in the chain. These guarantees prompted Congress to enact the safe harbor, as it was concerned that the bankruptcy of one party could, as a result of the guarantees, spread to other parties.

S.D.N.Y. 2011) (holding that, after examining the legislative history, the risks to the securities and commodities markets that Congress sought to address with the safe harbor of 546(e) were not implicated by the avoidance of transfers to debtor's three shareholders in a leveraged buyout of a privately held company), but see Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329 (2d Cir. 2011) (holding that the analysis of 546(e) should be limited to its plain language and that the definition of "settlement payment" is sufficiently broad to encompass any payment made to conclude a securities transaction where the payment is made by or through a financial intermediary, including the redemption payments at issue in the case). As a result of the continued expansion of 546(e), virtually all prepetition transfers made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency with respect to a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract are immune from attack as preferences or fraudulent conveyances ("Protected Payments").

A. LBOs of Privately Held Companies

One example of how the Courts are split in their interpretation of 546(e) is with respect to whether transfers made to shareholders resulting from a leveraged buyout ("LBO") of a privately held company are protected by the safe harbor defense of 546(e). Some courts, relying in large part on the legislative intent behind 546(e), have held that the safe harbor protection does not apply in LBOs involving privately held securities. See, e.g., Official Comm. Of Unsecured Creditors v. Lattman (In re Norstan Apparel Shops, Inc.), 367 B.R. 68, 77 (Bankr. E.D.N.Y. 2007) (holding that transfers made to shareholders of a debtor pursuant to an LBO transaction did not constitute "settlement payments" because the transaction did not involve the public securities markets); Kipperman v. Circle Trust F.B.O. (In re Grafton Partners, L.P.), 321 B.R.

527, 538-41 (B.A.P. 9th Cir. 2005) (relying on the legislative history to hold that payments made for membership interests in a limited liability company were not protected by section 546(e) because they did not occur on a public market, did not involve the process of clearing trades, and were made in furtherance of a Ponzi scheme); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 353 (N.D. Tex. 1996), Kapila v. Espirito Santo Bank (In re Bankest Capital Corp.), 374 B.R. 333, 346 (Bankr. S.D. Fla. 2007).

More recently, however, the Third, Sixth and Eighth Circuits, relying on a strict construction of the applicable statutory provisions, have held that payments made through conduits and to beneficial owners of privately held securities, in addition to publicly held securities, are Protected Payments. Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009) (holding that payments made by an outside investment group through a financial institution to shareholders of a privately held corporation in an LBO transaction were "settlement payments" protected by 546(e) under the plain reading of the statute); QSI Holdings, Inc. v. Alford (In re QSI Holdings, Inc.), 571 F.3d 545 (6th Cir. 2009) (holding that the plain meaning and legislative intent behind 546(e) serve to protect payments made from a disbursing agent bank to shareholders in an LBO transaction involving privately held securities, while noting that there may be some transactions that might fall outside of the safe harbor due to a "lack of indicia of transactions 'commonly used in the securities trade'"); Brandt v. B.A. Capital Co. (In re Plassein Int'l Corp.), 90 F.3d 252 (3d Cir. 2009), cert denied, 559 U.S. 1093 (2010) (holding that payments made to the shareholders of privately held companies as part of an LBO transaction were "settlement payments" protected by the safe harbor defense of section 546(e)).

B. State Law Actions

Courts are similarly split with respect to whether or not the safe harbor protection of 546(e) extends to actions under state law that are avoidable by the trustee under section 544(b) or by a litigation trust or individual creditors after confirmation of a chapter 11 plan. Some courts have held that 546(e) of the Bankruptcy Code is not applicable to claims brought on behalf of individual creditors under state law. See, e.g., Weisfelner v. Fund 1 (In re Lyondell Chem. Co.), 503 B.R. 348 (Bankr. S.D.N.Y. 2014); In re Tribune Co. Fraudulent Conveyance Litig., 499 B.R. 310 (S.D.N.Y. 2013) (holding that the section 546(e) safe harbor for securities transaction settlement payments applies only to protect such payments against fraudulent transfer avoidance actions brought by a bankruptcy trustee and does not preclude state law constructive fraudulent transfer claims asserted by individual creditors). Other courts, however, have extended the protection to preclude state law causes of action. See Whyte v. Barclays Bank PLC, 494 B.R. 196 (S.D.N.Y. 2014) (holding that where creditors' claims are assigned along with Chapter 5 federal avoidance claims to a litigation trust organized pursuant to a Chapter 11 plan, the "safe harbor" sections impliedly preempt state-law fraudulent conveyance actions seeking to avoid "swap transactions" as defined by the Bankruptcy Code).

IV. ABI Commission Report

On December 8, 2014, the ABI Commission[5] issued its Final Report and Recommendation (the "ABI Commission Report") proposing amendments to the Bankruptcy Code, including, in particular, changes to the safe harbor protection set forth in Section 546(e). After carefully reviewing the history behind 546(e) and the evolving, disparate decisions surrounding 546(e), especially with respect to transactions involving privately issued securities,

[5] "ABI Commission" refers to The Commission to Study the Reform of Chapter 11 that was established in 2012 by the American Bankruptcy Institute ("ABI").

the ABI Commission proposed that 546(e) should be amended "to remove protection from avoidance action for beneficial owners of privately issued securities in connection with prepetition transactions using some or all of the debtor's assets to facilitate the transaction (e.g., leveraged buyouts)." COMM'N TO STUDY THE REFORM OF CHAPTER 11, AM. BANKR. INST., FINAL REPORT AND RECOMMENDATIONS 95 (2014). The ABI Commission was concerned about the imbalance in LBOs involving privately issued securities getting safe harbor protection, when such protection does not serve to support the original purpose of the legislation (i.e., to insulate the securities transfer system from fraudulent conveyance and preference actions). Id. at 97. Of particular concern to the ABI Commission was the perverse result of protecting prepetition transfers in connection with an LBO that leaves the debtor with insufficient capital and that is attributable, at least in part, to bad faith on the part of the debtor's insiders. Id. The proposed revision to 546(e) would allow a trustee to bring fraudulent transfer claims against insiders of the debtor where such insiders were the beneficial recipients of settlement payments in private securities transactions. Id.

In making the above recommendation to amend 546(e), the ABI Commission was careful to ensure that the safe harbor continued to protect securities industries participants that act as conduits in prepetition transfers. Id. The ABI Commission noted in its report that "the beneficial owner of privately issued securities should be deemed the initial transferee for purposes of fraudulent transfer law, and that conduits should not be affected by any limited change to Section 546(e)." Id. at 98. Accordingly, the ABI Commission agreed that conduits should be expressly covered by 546(e) to avoid any uncertainty that might implicate the financial markets. Id. Moreover, the ABI Commission also considered whether 546(e) should be limited solely to securities industries participants that act as conduits and not beneficial owners of publicly issued securities, but ultimately determined that allowing avoidance claims against such beneficial owners of publicly issued securities could affect the securities transfer system. Id. As a result, the ABI Commission formulated and proposed the following recommendation, declining to limit the protection provided to beneficial owners of publicly issued securities with any good faith qualification:

> Section 546(e) should continue the existing protection from avoidance actions for (i) securities industries participants who act as conduits in both public and private securities transactions and (ii) public securities holders.

Id. at 95.

Finally, the ABI Commission carefully considered the issue of whether the protections of 546(e) should extend to state law actions that are avoidable by the trustee under section 544(b) of the Bankruptcy Code or by a litigation trust or individual creditors after confirmation of a chapter 11 plan. Id. at 98. The ABI Commission reviewed the conflicting case-law and discussed the practical consequences of allowing state law actions to proceed while precluding federal causes of action brought by the trustee on behalf of the estate. Id. While the ABI Commission ultimately determined that the safe harbor should not apply to actual intent fraudulent transfers whether such actions are brought under sections 544(b) or 548,[6] it was unable to reach a consensus on extending the safe harbor protection of 546(e) to actions outside a federal bankruptcy case. Id.

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[6] Specifically, the ABI Commission made the following recommendations:

- Section 546(e) and the parallel provisions of section 546 applicable to other qualified financial contracts should continue to exclude from the safe harbors transfers made with actual intent to hinder, delay, or defraud, and such transfers should remain voidable under section 548(a)(1)(A).
- The exclusion from the safe harbors for transfers made with actual intent to hinder, delay, or defraud should also apply to transfers made with similar intent that are voidable under applicable state fraudulent transfer or conveyance laws avoidable by the trustee under section 544(b).

V. Venue Issues

A final area of interest arising from the ever-evolving interpretation of 546(e) is with respect to venue shopping and, by extension, the use of "exclusive jurisdiction" provisions in chapter 11 plans. A recent opinion by Judge Carey out of the Bankruptcy Court for the District of Delaware provides an excellent example of how the disagreement amongst various jurisdictions with respect to what types of transfers are protected by the safe harbor of 546(e) affects where a trustee might seek to bring avoidance actions, thereby implicating the practical effect of jurisdiction clauses in chapter 11 plans. FTI Consulting, Inc. v. Malvern V. Burroughs and Thomas Hicks (In re Centaur, LLC), 2015 WL 76667 (Bankr. D. Del. 2015).

In the case, a litigation trustee (the "Trustee") brought a post-confirmation suit against two individuals in the United States Bankruptcy Court for the Southern District of Florida (the "Florida Court"), despite the fact that (i) the chapter 11 proceedings were administered before the Bankruptcy Court for the District of Delaware (the "Delaware Court") and (ii) the confirmed plan (the "Plan") provided specifically that the Delaware Court would have exclusive jurisdiction over the avoidance actions designated to be prosecuted by the litigation trust, including the adversary proceeding at issue. Id. at *1. The defendants moved to dismiss the adversary proceeding for improper venue or, alternatively, to transfer venue to the Delaware Court. The Florida Court entered an order transferring the adversary proceeding to the Delaware Court, and the Trustee responded by filing a motion to re-transfer the adversary proceeding back to the Florida Court. Id.

The Trustee argued that litigating the avoidance action before the Delaware Court would undeniably frustrate the purpose of the litigation trust "because the Third Circuit's interpretation of 11 U.S.C. §546(e) provides an obstacle to pursuit of the trustee's avoidance action against former shareholders." Id. at *1. In other words, because of the Third Circuit's decision in Brandt v. B.A. Capital Co., LP (In re Plassein Int'l Corp.) extending the scope of section 546(e) to cover transfers like the ones made to the defendants, the Trustee would likely be precluded from bringing the avoidance action against the former shareholders. As a result, the Trustee wished to keep the actions in the Florida Court where he, arguably, would have a better chance of prevailing since the safe harbor would not apply to preclude the adversary proceeding. The defendants argued that "frustration of purpose" is not a factor that should be evaluated when deciding whether to transfer a proceeding. Id. Moreover, the defendants argued that the exclusive jurisdiction provision of the Plan covered the adversary proceeding at issue and thus precluded the action from being retransferred to the Florida Court. Id. at *2. The Trustee argued that "notwithstanding the 'exclusive jurisdiction' provision of the Plan, concurrent jurisdiction resided in both [the Delaware] Court and in the Florida Court, or, in the alternative, he should be relieved of the Plan's exclusive jurisdiction provision by virtue of Rule 60(b) of the Federal Rules of Civil Procedure."[7] Id.

Judge Carey ultimately held that there were no circumstances, extraordinary or otherwise, that existed sufficient to upset the Florida Court's determination that the adversary proceeding

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[7] Rule 60(b) of the Federal Rules of Civil Procedure provides:

> (b) Grounds for Relief from a Final Judgment, Order, or Proceeding. On motion and just terms, the court may relieve a party or its legal representative from a final judgment, order, or proceeding for the following reasons:
>
> (1) mistake, inadvertence, surprise, or excusable neglect;
>
> (2) newly discovered evidence that, with reasonable diligence, could not have been discovered in time to move for a new trial under Rule 59(b);
>
> (3) fraud (whether previously called intrinsic or extrinsic), misrepresentation, or misconduct by an opposing party;
>
> (4) the judgment is void;
>
> (5) the judgment has been satisfied, released, or discharged; it is based on an earlier judgment that has been reversed or vacated; or applying it prospectively is no longer equitable; or
>
> (6) any other reason that justifies relief.

FED. R. CIV. PRO. 60(b).

should proceed before the Delaware Court. Id. In so holding, the Delaware Court did not have to decide whether or not the Trustee should be relieved from the Plan's exclusive jurisdiction provision. Id. Judge Carey did make the following observation, however:

> Although an 'exclusive jurisdiction' provision may be considered 'boiler plate,' the dispute before me illustrates the unintended mischief that an 'exclusive jurisdiction' clause in a confirmed plan—as contrasted with a non-exclusive retention of jurisdiction provision—can occasion and informs me that proposed plan provisions of this nature should be discouraged, if not precluded.

Id. at *3, n. 4. Clearly, without further revision and clarity to the safe harbor provisions of the Bankruptcy Code, the disagreement among the jurisdictions regarding the interpretation and scope of 546(e)'s safe harbor will continue to impact not only how but where a trustee may prosecute an avoidance action with respect to prepetition transfers.

Last in Line

Recovery of LBO Fraudulent Transfers: Can § 546(e) Be Circumvented?

Written by:
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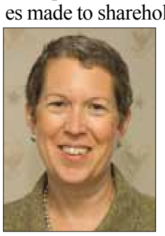
The economic optimism and greed of the last decade and the resulting leveraged buyouts (LBOs) placed a number of companies in dire financial situations. While management and shareholders reaped the benefits of LBOs, unsecured creditors were denied their share of the largess. Frequently, transfers to shareholders and management siphoned out so much cash that even if the company was not insolvent at the time of a stock redemption, it was left with insufficient capital to operate as a going-concern. As a result of certain LBOs, companies collapsed under the weight of their debt, leaving unsecured creditors to attempt to recover fraudulent conveyances made to shareholders and management.


Deborah L. Thorne

Among the most notable is that involving the failed LBO of the Tribune Co., the publisher of the *Chicago Tribune* and *Los Angeles Times* and former owner of the Chicago Cubs. The Tribune Co. was burdened with nearly $9 billion of new debt through a complicated LBO in 2007. Less than one year later, it filed for chapter 11 relief in an effort to reorganize the financial ruin in which it found itself due in large part to the LBO.[2] The out-of-the money creditors determined that the payments to the former shareholders receiving transfers at the time of the LBO should be recovered for the benefit of the unsecured creditors and filed an action seeking recovery of the transfers.[3] The unsecured creditors' committee also filed adversary proceedings, one seeking to recover transfers made to the redeeming former shareholders and a second proceeding to recover transfers made to certain lenders.[4]

In other cases, unsecured creditors recovered or are attempting to recover transfers made to "old" equity as fraudulent transfers at the time of the LBO.[5] Many of these attempts have been attacked, and some thwarted, by the assertion of § 546(e) claiming that the transfers were "settlement payments" that qualified for statutory "safe-harbor" treatment. Section 546(e) does not offer the broad protection claimed by former shareholders.

Recovery of Fraudulent Transfers under § 548

Under the Bankruptcy Code, the trustee or debtor in possession (DIP) may seek to recover fraudulent transfers under § 548(a), under which the trustee may avoid transfers that were made with intent to defraud or for which less than a reasonably equivalent value was received at a time when the debtor was insolvent or the transfer caused the debtor to become insolvent. Under § 546, the trustee or DIP is restricted by a two-year statute of limitations.

Recovery under UFTA

An additional remedy is available to trustees and DIPs under § 544 of the Code, which allows recovery under state law incorporating the Uniform Fraudulent Transfer Act (UFTA). UFTA § 5 states:

> (a) A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made...if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer...and the debtor was insolvent at the time or... became insolvent as a result of the transfer.

The UFTA has a decided advantage because it has a longer statute of limitation depending on the individual state statute. Thus, if the payments received in the LBO are for less than reasonably equivalent value and the debtor was insolvent on the date of the transfer or became insolvent as a result of the transfer, the transferred payment is subject to avoidance by the trustee. The determination of what is "reasonably equivalent value" is a factual issue, as is whether the debtor was insolvent or became insolvent. Before the court can even get to the factual determinations, however, many claims are eliminated as a result of the defense provided by § 546(e).

Section 546(e) as a Defense to Recovery of LBO Transfers

Section 546(e) provides a safe harbor for redeeming shareholders in an LBO:

> [T]he trustee may not avoid a transfer that...is a settlement payment, as defined in section 101 or 741...made by a...financial institution, financial participant or securities-clearing agency that is made before the commencement of the case, except under section 548(a)(1)(A).

Section 741(8) defines "settlement payment" as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment or any other similar payment commonly used in the securities trade."

Courts considering the question of whether payments made as a part of an LBO are included under § 546(e) have

1 The author thanks **Rebecca Workman** and **John T. Gregg** of Barnes & Thornburg LLP for their comments and constructive criticism for this article.

2 *In re Tribune Co., et al.*, Case No. 08-13141 (KJC), Jointly Administered (Bankr. D. Del.).

3 *Wilmington Trust Co. v. JPMorgan Chase Bank NA*, No. 10-50732 (Bankr. D. Del. March 4, 2010).

4 *Official Committee of Unsecured Creditors v. Fitzsimmons*, Adversary Nos. 10-54010, and Official Committee of Unsecured Creditors v. JPMorgan Chase Bank NA, 10-55969 (Bankr. D. Del.).

5 *Official Committee of Unsecured Creditors of Quebecor World (USA) Inc. v. American United Life Insurance Co. (In re Quebecor World (USA) Inc.)*, 435 B.R. 201 (Bankr. S.D.N.Y. 2011) (payments involved transfer of cash to complete securities transaction and were "settlement payments" that qualified for statutory "safe harbor" treatment); *QSI Holdings Inc., et al. v. Alford, et al. (In re QSI Holdings Inc.)*, 571 F.3d 545 (6th Cir. 2009) (shareholder payments qualified as "settlement payment" for purposes of § 546(e) barring trustee's avoidance). *See also Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011) (payments to former shareholders in closely held corporation received in connection with LBO were not "settlement payments" because such payments did not disrupt the securities' market so § 546(e) did not apply).

generally determined that §§ 546(e) and 741(8) include payments made to redeem public or private stock in the course of an LBO,[6] although some courts have held that this section is only meant to protect the public securities markets, and that the safe harbor is not available to recipients of transfers for the purchase of private company stock through an LBO.[7]

In general, § 546(e) is likely to present a defense to claims brought under §§ 544 and 548 that may be very hard to overcome and may preclude the recovery. The question is this: Is there any way to recover the transfers made to shareholders, and particularly insiders, through a failed LBO? It seems inherently unfair for major shareholders to be allowed to strip a company of significant value and leave unsecured creditors holding an empty bag of claims.

Can § 546(e) Be Circumvented?

Section 546(e) states that "the *trustee* may not avoid a transfer." What if there is another party with the authority to recover or avoid fraudulent transfers under the UFTA when an LBO fails?

UFTA claims are held by unsecured creditors outside of a bankruptcy case. The creditors continue to hold the claims, but *during the pendency of the bankruptcy proceeding*, only the trustee or DIP can assert them for the benefit of the estate. If the DIP or the bankruptcy trustee asserts UFTA claims in the bankruptcy proceedings, then they do so under the constraints imposed by the Bankruptcy Code, including § 546(e).

It can be argued that once a bankruptcy is concluded without prejudice to UFTA claims, individual creditors are free to bring their individual claims. Moreover, where a liquidating trust is established to pursue claims of the debtor that have been assigned to it, the plan and trust document can provide for assignment of creditors' UFTA claims to the trust to allow for the more efficient handling of these claims. Defendants raising § 546(e) as a defense to the claims of a liquidating trustee who holds creditor claims should not be allowed to do so because the Code does not regulate the behavior of the liquidating trustee, does not impinge upon the rights of creditors outside of bankruptcy and does not apply to claims brought outside of bankruptcy.

By the plain language of § 546(e), the statute applies only to actions brought under §§ 544, 545, 547, 548 and 553 of the Code. Post-bankruptcy actions brought by an individual creditor or a liquidating trustee under the UFTA are not brought under the Code but under state law. Such claims could have been brought pre-petition by the creditors independently and without the filing of a bankruptcy petition. Several cases have discussed the implications of a bankruptcy trustee not pursuing UFTA claims either through abandonment or because the action was not brought within the § 548 two-year statute of limitations. These cases articulate that after the bankruptcy is complete, if the UFTA claims are still alive and revert to their rightful owners, the creditors may bring actions under the UFTA.

In *Dixon v. Bennett*,[8] a chapter 7 trustee did not bring avoidance actions to recover fraudulent transfers under § 548 or the UFTA prior to the lapse of the two-year statute of limitations. After the chapter 7 debtor was discharged, an unsecured creditor filed an action to recover the UFTA claims in state court. The defendants moved for summary judgment, contending that the creditor's state law claim was barred because the trustee had the exclusive right to bring an action to set aside any alleged fraudulent transfers. The trial court entered summary judgment in the defendants' favor.

On appeal, the creditor claimed that the failure of the bankruptcy trustee to avoid fraudulent transfers within the two-year statute of limitations of the Bankruptcy Code did not preclude an unsecured creditor, whose statute of limitations under state law had not expired, from bringing the state cause of action against the transferee of the property fraudulently conveyed by the debtor. The appellate court vacated the judgment, stating the following:

> An unsecured creditor's cause of action is precluded once the bankruptcy petition is filed until after the trustee's right to bring suit expires. During that time, the bankruptcy provisions...[e]nsure that the fundamental bankruptcy policies are met. Appellees ask us to prohibit an unsecured creditor from using the remedies granted by the State to protect his or her rights. They would have us do this regardless of whether the fraudulent conveyance is discovered before or after the trustee's powers have expired. To do so would only serve to shield the recipients of fraudulent transfers at the expense of the unsecured creditor.[9]

A trustee under the Bankruptcy Code is not the same as the liquidating trustee or another who receives claims under the UFTA as a result of a confirmed plan. The Seventh Circuit recently considered the capacity of a liquidating trustee in *Grede v. Bank of New York Mellon*.[10] A trust was created by the confirmed chapter 11 plan for the purpose of holding most of Sentinel's assets while the business was being wound down, the investments cashed out and claims paid. Sentinel's claims against the Bank of New York, including those seeking to recover preferential and fraudulent-conveyance transfers, were transferred to the trust. Investor claims against the bank did not belong to Sentinel and were not part of the bankruptcy estate. Under the terms of the liquidation trust, investors were able to assign their claims to the liquidation trust for collection. The liquidating trustee then filed a diversity action in the district court to recover the investors' claims.

The bank objected to the cause of action, in part stating that the trustee lacked authority to bring the investors' claims. The district court dismissed the suit after concluding that the trustee lacked authority to act on behalf of the investors. It relied on *Caplin v. Marine Midland Grace Trust Co.*[11] and *Williams v. California 1st Bank*.[12] On appeal, the trustee argued that the *Caplin* approach made him the only one of the world's citizens who could not sue on assignments of rights. The trustee relied instead on *Semi-Tech Litigation LLC v. Bankers Trust Co.*[13]

In analyzing the disparate holdings of the Second and Ninth Circuits, the Seventh Circuit noted that the Bankruptcy Code specifies the duties of a bankruptcy trustee, but the terms of

6 *QSI Holdings Inc., et al. v. Alford, et al. (In re QSI Holdings Inc.)*, 571 F.3d 545 (6th Cir. 2009), *cert. denied*, __ U.S. ___, 130 S.Ct. 1141, 175 L.Ed.2d 972 (2010); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *Lowenschuss v. Resorts Int'l Inc. (In re Resorts Int'l Inc.)*, 181 F.3d 505, 514, 516 (3d Cir. 1999), *cert. denied* (holding that "settlement payment" means "the transfer of cash or securities made to complete a securities transaction" and that phrase "made by or to...a financial institution" includes wire transfer of payment from debtor's bank account to selling stockholder); *Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.)*, 952 F. 2d 1230 (10th Cir. 1991).

7 *Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011); *Munford v. Valuation Research Corp. (In re Munford Inc.)*, 98 F.3d 604, 610 (11th Cir. 1996), *cert. denied*, 522 U.S. 1068, 118 S.Ct. 738, 739, 139 L.Ed.2d 675 (1998).

8 72 Md. App. 620, 633, 531 A.2d 1318, 1324 (Md. Ct. Spec. App. 1987), *overruled on other grounds by BAA, PLC v. Acacia Mut. Life Ins. Co.*, 929 A.2d 1 (Md. July 27, 2007).

9 *Id.* at 635.

10 598 F.3d 899 (7th Cir. 2010).

11 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972) (bankruptcy trustee may not sue on behalf of investors who thought that third party's acts had injured them and debtor jointly).

12 859 F.2d 664 (9th Cir. 1988).

13 272 F.Supp.2d 319, 323-24 (S.D.N.Y. 2003), *affirmed and adopted*, 450 F.3d 121, 123 (2d Cir. 2006).

continued on page 78

Last in Line: Circumventing § 546(e) in Recovery of LBO Fraudulent Transfers

from page 29

the reorganization plan and trust agreement govern the duties of the liquidating trustee after bankruptcy. In this respect, the Sentinel Liquidation Trust was no different than a reorganized debtor and their rights are governed by the plan, trust document, articles of incorporation and rules of trust or corporate law, not the Code. Finally, even if there had been objections, they would properly have been made by the trust beneficiaries, not by the defendants to the Sentinel Liquidation Trust's complaint. There were no objections, and the plan was confirmed and became effective. The bank could not now make collateral attacks on the confirmed plan. Thus, the liquidating trustee had authority to bring third-party claims that were assigned as part of the reorganization plan.

Where a DIP or a bankruptcy trustee fails to or elects not to pursue UFTA claims in a bankruptcy proceeding, those claims revert to creditors. Similarly, where creditors assign their UFTA claims to a liquidation trust, § 546(e) is not a defense. The confirmed plan can provide for a liquidating trust to which certain claims of the debtor are assigned and to which creditors may assign their UFTA claims or individual creditors can pursue their own actions. In either event, when the trust or individual creditors bring those state law UFTA claims, the Code and § 546(e) no longer apply. Although the *Tribune* adversaries are currently stayed, plaintiffs may want to consider whether the complaints should be brought outside the bankruptcy court and under the UFTA to circumvent the certain arguments that will be raised claiming the safe harbor of § 546(e). ■

Testimony of Hon. Christopher S. Sontchi

United States Bankruptcy Judge for the District of Delaware

"Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives"

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

The Committee on the Judiciary

United States House of Representatives

Washington, D.C.

March 26, 2014

Chairman Bachus, Ranking Member Johnson and Members of the Committee:

Thank you for inviting me to testify today. My name is Christopher Sontchi and I am a sitting United States Bankruptcy Judge for the District of Delaware. I have presided over a number of cases involving the safe harbors for financial contracts, derivatives and repurchase agreements. Most notably, I presided over the *American Home Mortgage* case. At the time of its filing in 2007, American Home Mortgage was the 10th largest home mortgage originator in the country and was in the business of originating, securitizing, selling and servicing "Alt-A" home mortgage loans, a step above the now infamous subprime market. As part of its origination and securitization business the company was a party to numerous repurchase agreements involving billions of dollars. In addition, commencing in late 2007, I presided over the case of *Delta Financial Corporation*, which was a somewhat smaller version of American Home Mortgage, albeit in the riskier subprime market. I have presided over numerous other cases and issued numerous opinions involving repurchase agreements, tri-party setoffs and swaps. Finally, I have had the honor of serving as a member of the *Committee on Financial Contracts, Derivatives and Safe Harbors* of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.

Today, I would like to discuss two important issues related to the "safe harbors" for derivatives, repurchase agreements and other similar contracts. The first is narrow in scope and, I think, for the most part uncontroversial. I believe Congress should consider amending section 546(e) of the Bankruptcy Code to significantly narrow its scope. As set forth more fully below, Section 546(e) exempts from avoidance as preferences or fraudulent conveyances "settlement payments" and transfers made to a class of financial institutions. I believe Congress's intent was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

The second issue is broader and significantly more controversial. I believe Congress should consider scaling back the scope of the safe harbors for repurchase agreements. The original 1984 safe harbor for "repurchase agreements" or "repos" encompassed repos on U.S. government and Agency securities and other highly liquid assets. In 2005 and 2006, the definition of "repurchase agreement" and "securities contract," under which certain repos had been afforded safe harbor treatment, were expanded to include a broader range of potentially less liquid assets, including mortgage loans and interests in mortgage loans. The current safe harbors for repurchase agreements allow for "runs" on financial institutions by counterparties who are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually impossible to reorganize companies with significant repo exposure such as American Home Mortgage.

Section 546(e) of the Bankruptcy Code

As written and applied, the section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts and other transactions, even if the securities were privately issued. Absent the safe harbors, these payments – often made to the directors, officers and other company insiders that led the company into bankruptcy - would be potentially voidable as fraudulent or preferential transfers. The safe harbor of section 546(e) should protect the *securities transfer system*, if and when the financial institutions are acting as conduits for payment, regardless of whether the securities involved are public or private. This safe harbor for the securities industry is important because the initial transferee is not accorded a good faith defense under section 550, potentially exposing the securities industry to large and inappropriate liability for acting as mere intermediaries in securities transactions.

However, section 546(e) should not protect settlement payments or other transfers with respect to the beneficial owners of *privately* placed debt securities or of equity securities of a closely held entity. With regard to *publicly* traded securities, section 546(e) should only protect transfers to the beneficial owners of public securities holders that have acted in good faith.

Section 546(e) of the Bankruptcy Code provides as follows:

> 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 margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

"Settlement payment" is defined in section 741(8) in a circular fashion as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade." Because of this broad and circular language, courts have interpreted it to include many kinds of transactions regardless of whether it advances the legislative intent/policy behind enactment of the safe harbor, i.e., protection of the securities transfer system. These have included transfers to insiders owning private and public securities and LBO's that would otherwise have been fraudulent transfers.

Courts have applied section 546(e) literally and shielded from avoidance transfers involving little or no impact on the functioning of the public securities market. For example, in the case of *In re Quebecor World (USA), Inc.*, 719 F.3d. 94 (2d Cir. 2013), *aff'g*, 453 B.R. 201 (Bankr. S.D.N.Y. 2011), the Second Circuit affirmed the holding of the bankruptcy court that payments made to repurchase *privately-placed notes* were both "settlement payments" and transfers made in connection with a securities contract that were protected under the safe harbor.[1] I propose narrowing the scope of section 546(e) to make it clear that the safe harbor only protects the securities transfer system and settlement payments made in connection with publicly traded securities.

Section 546(e) has also been successfully invoked to protect leveraged buyouts or LBO's. In cases involving LBO transactions, the issue is whether a payment made to the shareholders of the target company in exchange for their securities is a settlement payment entitled to protection. There is a split in authority in cases interpreting the safe harbor in the LBO context. A minority of courts have held that the safe harbor only applies to LBO's involving publicly traded securities or involving the public system of intermediaries and guarantees typical of the securities industry[2] but a majority of courts have increasingly found that the safe harbor protects the beneficial recipient even if the transaction involved private securities and regardless of the involvement of a financial intermediary.[3] My proposal supports the minority position and calls for revising the statute to specifically exclude private transactions from the safe harbor.

Section 546(e) can also impact LBO's of public companies. If the LBO leaves the firm with an unreasonably small capital or if it renders the firm insolvent, then the payments to shareholders are potentially recoverable in a subsequent bankruptcy, for the benefit of the target firm's pre-transaction creditors, if the other elements of a

[1] *See also Enron Creditors Recovery Corp.*, 651 F.3d 329 (2d Cir. 2011); and *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996).

[2] *In re Munford, Inc.*, 98 F.3d 604 (11th Cir. 1996); *In re MacMenamin's Grill Ltd.*, 450 B.R. 414 (S.D.N.Y. 2012); and *In re Norstan Apparel Shops, Inc.*, 367 B.R. 68 (E.D.N.Y. 2007).

[3] *In re Plassein Int'l Corp.*, 590 F.3d 252 (3d Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545 (6th Cir. 2009); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981 (8th Cir. 2009); *In re Kaiser Steel Corporation*, 952 F.2d 1230 (10th Cir. 1991); and *AP Services LLP v. Silva*, 483 B.R. 63 (S.D.N.Y. 2012).

fraudulent transfer are in place. Section 546(e) as written, however, can immunize transfers made in connection with LBO's involving public companies, including those that render the target firm insolvent, even if the target's insiders acted in bad faith.[4] I propose that shareholders of public companies would not be automatically immunized, *per se*, by section 546(e). Rather they would only be protected if they have acted in good faith.

Again, I believe Congress's intent in implementing the safe harbor in section 546(e) was to insulate the securities transfer system. Securities industry transferees are generally not the beneficial owners of the subject transactions but, rather, are the conduits. Subjecting these conduits in the securities transfer system to avoidance actions could trigger a series of unintended and disastrous defaults in the interconnected securities markets. As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.

[4] *Compare Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488 (N.D.Ill. 1988) (With respect to fraudulent conveyance claim against insider shareholders of a public company, the court "collapsed" the LBO transaction so that insiders were considered to have received property of the debtor in the transaction but did not collapse the transaction with respect to non-insider shareholders and, therefore, dismissed the actions against the non-insiders); and *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71 (D. Del. 2002). (In a fraudulent conveyance action against insider shareholders resulting from an LBO of a public company, the court concluded that the distinction between insider and non-insider status was "not one that [held] legal significance under section 546(e)" and the insider shareholders were protected by the safe harbor).

I respectfully recommend that Section 546(e) of the Bankruptcy Code be amended (1) to affirm the current statutory protections in section 546(e) to security industries participants who act as conduits in both public and private securities transactions, (2) to remove the section 546(e) protection from avoidance actions for beneficial owners of privately-issued securities, and (3) to continue to safe harbor public securities holders from avoidance actions, if the public securities holder acted in good faith.

More specifically, without providing precise statutory language, section 546(e) should be amended as follows:

> (1) If the settlement payment or transfer is made to (or a securities contract is made with) a stockbroker, bank, clearing agency such as the DTC or a similar financial institution obligated to forward what has been paid or transferred, then, to the extent that the institution received such settlement payment or transfer for the benefit of a client or customer of the transferee and is obligated to forward that payment or transfer, then the institution shall receive the benefit of the existing section 546(e).
>
> (2) The first beneficial recipient of the transfer chain in question will be deemed to have received the relevant settlement payment or transfer directly from the debtor.
>
> (3) Parties receiving payments or transfers as beneficial owners of non-public securities shall not be protected by section 546(e).
>
> (4) Parties receiving payments or transfers as beneficial owners of public securities shall be protected by section 546(e) from constructive fraudulent transfer actions, as well as preferences under section 547, provided they acted in good faith without knowledge of the avoidability of the underlying transaction.

I have and continue to be faced with a flurry of motions to dismiss and for summary judgment filed by insiders of bankrupt companies seeking shelter from liability through the section 546(e) safe harbor. The "secret" is out and defense attorneys are seeking to take advantage of the safe harbor to the fullest extent possible. I believe these changes would align the statutory language and the courts' interpretation of the statute with Congress' original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith.

I respectfully urge Congress to act quickly to close this unintended loophole in the otherwise necessary safe harbor for the securities transfer system.

The Scope of the Safe Harbors for Repurchase Agreements

The second subject I would like to discuss is more controversial: what is the proper scope of the safe harbors governing mortgage repurchase agreements?

For the reasons discussed below, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A). The effect would be to remove "mortgages" and "interests in mortgages" from the safe harbors of sections 555 and 559 (and 561 under Chapter 15).

The genesis of my request is my experience in the *American Home Mortgage* bankruptcy case filed in 2007. It became quickly apparent to me during that case that mortgages simply do not fit into one of the primary purposes behind protecting repurchase agreements, i.e., preservation of liquidity of investments. In fact, mortgages and interests in mortgages are not liquid assets. This is due in large part to the fact that mortgages are sold by the originators to investors or securitization trusts in bundles containing as many as thousands of mortgages as well as the unique nature of mortgages. Every mortgage is secured by a unique piece of real property and involves a buyer that has a unique credit profile and payment history. In order to address the uncertainty arising from the individual nature of mortgages, sales often include lengthy look back periods where the buyer can return some mortgages in a portfolio to the seller if there is an early default or representations regarding the loans turn out to be inaccurate. In fact, it can take several months to complete the sale of a portfolio of mortgages.[5] These are not United States government securities. The reality is that the counterparties to repurchase agreements, i.e., the lenders, are not interested as much in preserving the liquidity of their investment in the mortgages originated by a debtor as they are in owning what would otherwise be property of the estate and the lender's collateral.

The current safe harbors for repurchase agreements allow for "runs" on financial institutions such as American Home Mortgage by counterparties/lenders which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio, and accelerate its liquidation. The end result is that it is virtually

[5] While the same argument may be applied to "mortgage related securities" and "interests in mortgage related securities" there can be no question that these agreements are much more liquid than the underlying mortgages themselves and, thus, I do not recommend their removal from the protections of the safe harbors.

impossible to reorganize companies with significant repo exposure such as American Home Mortgage.[6]

The business of originating mortgages requires access to a huge amount of capital. For example, when a new homeowner buys a house for $100,000 with 20% or $20,000 down and borrows the remainder of the purchase price through a mortgage, the mortgage company must deliver $80,000 in cash at the closing of the sale. As of the end of 2013, there were approximately $9.9 trillion in home mortgage loans outstanding, every penny of which came from a mortgage lender.[7] In most cases, the mortgage lender providing the cash at closing obtained that money from a counterparty to a repurchase agreement or through a secured loan.

Traditionally, a mortgage lender would borrow the money necessary to originate mortgage loans through a warehouse secured line of credit or loan. That warehouse loan would be for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come from the warehouse lender (either directly or through the mortgage lender). The amount of the balance under the warehouse loan would increase by the amount of the mortgage loan and the mortgage itself would automatically become the warehouse lender's collateral. However, the mortgage would remain property of the

[6] There is a persuasive argument to be made that the current scope of the repo safe harbors increases systematic risk for the financial system as a whole and exacerbated the financial crisis of 2007-09. Although I support that position, I am not addressing it in today's testimony. Rather, I am limiting my comments to the adverse effect that allowing the termination of repurchase agreements, notwithstanding the automatic stay, has on a company's ability to reorganize.

[7] BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MORTGAGE DEBT OUTSTANDING (March 6, 2014), http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

mortgage lender. When the mortgage lender later sold the mortgage loan to another financial institution or a securitization trust, the cash received from the sale would be used to pay down the warehouse secured loan (plus interest) and the mortgage loan would automatically be removed from the warehouse lender's collateral pool. In the event of a bankruptcy by the mortgage lender, the mortgage loans that had been originated but not yet sold would become property of the bankruptcy estate, the automatic stay would prevent the warehouse lender from taking control of the mortgage loans, and the warehouse lender would both have a secured claim against the estate collateralized by the mortgage loans and be entitled to adequate protection.

Starting in the late 1990's, master repurchase agreements began to replace warehouse secured loans. The prevalence of mortgage repos increased slowly until, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include mortgages.[8] Since 2005, the bulk of lending to mortgage originators has been through repurchase agreements. Mortgage repurchase agreements are virtually identical to warehouse secured loans except for the fact that, under a repo, the mortgage belongs to the repo counterparty/lender rather than to the mortgage lender. As discussed below, this difference is of huge import.

[8] Prior to 2005, mortgage repurchase agreements proceeded under the theory that they were protected by the safe harbors governing securities contracts. The number of repos under that theory were limited by the litigation risk that courts might not agree the safe harbors were applicable and the transaction was, in fact, a loan.

The procedure for originating mortgage loans under a master repurchase agreement and a warehouse secured loan are virtually identical. The mortgage lender and the repo counterparty/lender would enter into a master repurchase agreement for a large amount of money, say $100 million. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come either directly from the repo counterparty or the mortgage lender. Simultaneously with the mortgage loan closing (or very shortly thereafter), the mortgage lender would sell the mortgage loan to the counterparty with an agreement that the mortgage lender would repurchase the mortgage loan within a specified period of time (usually between thirty and ninety days) for the original purchase price plus a fee. The mortgage lender would use the time of the repurchase agreement to arrange to sell the mortgage to a "permanent" investor or a securitization trust. At the time of the closing of the ultimate sale or securitization of the mortgage loan (or immediately prior), the mortgage lender would repurchase the mortgage from the repo counterparty and flip it to the buyer. As mortgage loans were sold to the repo counter party the balance of loans subject to the master repurchase agreement would increase and as they were repurchased it would decrease. I hope it is readily apparent that warehouse secured loans and repurchase agreements are virtually identical except for the ownership of the mortgage loans themselves.

Under a repurchase agreement, the mortgage loan is property of the repo counterparty. In the event of a default or bankruptcy by the mortgage lender, the repo counterparty has the right to declare a default and require the mortgage lender to immediately repurchase the mortgages (in secured creditor parlance this would be the equivalent of calling the loan). In the event the mortgage lender could not immediately repurchase the loan, the repo counterparty would obtain permanent ownership over the mortgage loans and would be able to immediately sell them directly to permanent investors, securitization trusts or any other third party willing to buy the loans. Alternatively, the repo counterparty could maintain ownership over the mortgages. In any event, the mortgage loans would not be property of the estate and the automatic stay would not be applicable. The structure discussed above and the safe harbor from the rules governing warehouse secured loans such as the automatic stay have been codified by the repo safe harbors.[9]

The ability of a repo counterparty/lender to be able to immediately sell the mortgage loans to a third party and, thus, limit its exposure to the risks inherent in the mortgage itself, i.e., liquidity, is asserted as one of the primary bases for the repo safe harbors. The argument is that without the liquidity supplied by the safe harbors the cost of lending would increase and, in the event of a default, there could be a cascading series of defaults that might spread to the repo counter party/lender and parties to other agreements with the repo counterparty.

So far, so good. But, in my experience, the repo counterparty may not be interested in having the ability to preserve liquidity by selling the mortgages but, rather, is likely to hold the loans for later disposition, especially in a crisis such as in 2007-2009 where the value of the mortgage was artificially low. Indeed, as described

[9] See Exhibit A attached hereto for a brief recitation of the relevant safe harbor provisions.

above, mortgage loans are illiquid assets and, thus, the counterparty may have no choice but to hold the loans. The safe harbors allow the repo counterparty rather than the debtor to hold the mortgage and obtain the upside of any increase in value. In the event the transaction was treated as a loan, the debtor would be able to retain ownership and control over the mortgage loans, subject to providing adequate protection, and preserve the upside for the estate as a whole. As applied to mortgages, the safe harbors allow for the repo counter party/lender to grab what otherwise would be its collateral and prevent the mortgage lender/debtor from maximizing the value of those loans for the benefit of the bankruptcy estate.

This is contrary to the treatment of secured loans in bankruptcy and turns the Bankruptcy Code on its head. The economic reality is that a mortgage lender such as American Home Mortgage can be stripped of its assets in days or even hours, leaving no ongoing business and denying its creditors in general of the value of its assets, i.e., its mortgage loans.[10] While these safe harbors make sense in the context of assets that are actually liquid such as U.S. Treasuries, they do not in the context of an illiquid asset such as mortgages.

Let me close my discussion of mortgage repurchase agreements with a real world example. In the *American Home Mortgage* case, the debtor was a party to a master repurchase agreement with Calyon Bank. At the time of the bankruptcy filing in 2007,

[10] Generally speaking, a debtor would not be able to force a lender under a warehouse secured loan or a repurchase agreement to continue funding future mortgages. 11 U.S.C. §365(c)(2). But, at the very least, the debtor would still own its portfolio. In addition, forcing a debtor and a secured lender to deal with each other often results in continued lending.

the outstanding principal amount of the mortgage loans subject to the master repurchase agreement was approximately $1 billion. Immediately prior to the bankruptcy filing, Calyon declared a default under the master repurchase agreement and took ownership of the mortgage loans. If a repo counterparty such as Calyon takes ownership of the mortgages subject to the repurchase agreement and the value of those mortgages is less than the outstanding principal balance of the loans, the counterparty, *i.e.*, Calyon, can assert an unsecured claim for the deficit. They are, in effect, an undersecured creditor asserting a claim for unsecured portion of their loan.

I conducted a trial over two related issues: (1) at what time does the court value the mortgage loans for considering whether there is a deficit and, thus, a claim; and (2) how does the court calculate the value of the loans. I ultimately issued an opinion on those issues that was affirmed by the Third Circuit.[11] I raise the issue here, however, for a different reason. It became clear in trial that Calyon never had any intention of selling the mortgage loans in the foreseeable future. Rather, its strategy was to hold the mortgages until value rebounded and in the interim its credit exposure was minimized because the mortgage borrowers, i.e., the homeowners, were continuing to make principal and interest payments.

There is nothing morally wrong with Calyon's strategy to hold on to the loans. Indeed, it makes perfectly valid economic sense. The problem is that it should have been in the debtor's purview – not Calyon's - to make the decision whether to hold the

[11] *In re American Home Mortgage Holdings, Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd*, 637 F.3d 246 (3d Cir. 2011).

loans for the benefit of the bankruptcy estate and the debtor's creditors rather than just for Calyon. With virtually every other type of asset that serves as collateral for a secured loan control rests in the debtor. But secured creditors are not without protection. For example, they may be entitled to adequate protection. The law governing the rights of secured creditors and the balance of those rights with other considerations are well developed. The repo safe harbors remove what would otherwise be considered a secured loan from the bankruptcy estate, depriving the debtor with any control over what would otherwise be its property and the lender's collateral. The asserted reason for exempting mortgages from the rules governing virtually every other type of collateral is that those protections are necessary to preserve liquidity in the system and, more particularly, for the repo counterparty's exposure. But, that asserted basis for extraordinary treatment is fallacious because mortgage loans are not liquid, especially in times when there is likely to be a default under the loans such as in 2007-2009. There is no reason to exempt mortgage loans and interests in mortgage loans from the ordinary, well established rules governing secured lending.

I am cognizant that the application of the safe harbors to mortgages and interests in mortgages is a complicated and controversial subject and any amendment to the safe harbors should be carefully weighed. It is not my intention to address the entirety of the issues. Rather, I have attempted to pass on my conclusions as to one issue based on my experience as a bankruptcy judge overseeing several cases involving repurchase agreements governing mortgages, especially the *American Home Mortgage* case.

Based on my experience, I respectfully urge Congress to consider removing "mortgages" and "interests in mortgages" from the definition of repurchase agreements in section 101(47)(a)(i) as well as the definition of "securities contract" in section 741(7)(A).

In closing, thank you very much for inviting me to testify on these important issues. I do not envy this committee's task in addressing these complicated issues. Nonetheless, I believe there are important, discrete changes that can be quickly addressed such as amending section 546(e) to align the statutory language and the courts' interpretation of the statute with Congress's original intent – to insulate the securities transfer system from damaging and inappropriate litigation - while not protecting the beneficiaries of private transactions or shielding insiders of bankrupt public companies who have acted in bad faith. In addition, I think the committee should take a step back and reconsider the scope of the repo safe harbors, especially as they apply to mortgages. While there are a number of issues and arguments that should be considered in such an examination, I think one thing is clear – the assertion that the repo safe harbors are necessary to preserve liquidity does not apply to illiquid assets such as mortgages. They should be returned to whence they came and be subject to the normal, long-standing, well-developed law governing secured lending.

Thank you again.

Exhibit A

Since 1982, Congress has enacted a number of amendments to the Bankruptcy Code that work in concert to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions such as the automatic stay:

- Sections 555, 559 and 561, which protect the exercise of certain contractual rights to liquidate, terminate and accelerate repurchase agreements from stays, avoidance and other limitations;
- Sections 362(b)(7) and 362(o), which exempt from the automatic stay and all other Bankruptcy Code stays setoffs under repurchase agreements and the realization against collateral for repurchase agreements;
- Sections 546(f) and 548(d), which provide exemptions from preference and fraudulent transfer avoidance for settlement and margin payments; and
- Portions of sections 101 and 741, which define the key terms repurchase agreement, margin payment, settlement payment, repo participant and financial participant.

Section 559 and its exclusion of repurchase agreements from the automatic stay are of primary significance. Collier explains that "[m]ost repurchase agreements afford a non-defaulting party the right to 'close-out' or 'liquidate' the agreement upon the other party's default.[1] Furthermore, virtually all repurchase agreements contain *ipso facto* clauses which authorize repo participants to terminate "for cause" (or otherwise forfeit or modify rights) if the other party becomes bankrupt, insolvent, or fails to maintain contractually specified conditions.[2] "In almost all instances, commencement of a Bankruptcy Code case by a party ... will constitute a default triggering the availability of such rights."[3] Such clauses permit termination of the repurchase

[1] 5 Collier On Bankruptcy ¶¶ 559.04 (Alan N. Resnick and Henry J. Sommer eds. 15th ed. rev. 2007).

[2] *Id.* at ¶¶ 559.04 and 559.LH.

[3] *Id.*

agreement simply because of the other party's distressed financial condition. Section 559 protects rights triggered by a condition of the kind specified in section 365(e)(1), i.e., *ipso facto* clauses or bankruptcy defaults.[4] Thus, "section 559 allows protected parties to act upon *ipso facto* clauses."[5]

In addition, section 555 of the Bankruptcy Code provides the tool for the non-defaulting repo participant to exercise its contractual right to close-out, terminate or accelerate a "securities contract."[6] "Such a close-out or liquidation typically entails termination or cancellation of the contract, fixing of the damages suffered by the non-defaulting party based on market conditions at the time of the liquidation, and accelerating the required payment date of the net amount of the remaining obligations and damages."[7]

Finally, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Congress expanded the definition of "repurchase agreement" to include the transfer of "mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, [and] interests in mortgage related securities or mortgage loans."[8]

Section 101(47) of the Bankruptcy Code contains the definition of a repurchase agreement. A repurchase agreement is an agreement, including related terms, which (i)

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[4] *Id.*

[5] *Id.*

[6] As defined in 11 U.S.C. § 741.

[7] 5 Collier On Bankruptcy ¶ 555.04.

[8] 11 U.S.C. § 101(47).

provides for the transfer of one or more mortgage loans or interests in mortgage loans; (ii) against the transfer of funds by the transferee of such mortgage loans or interests in mortgage loans; (iii) with a simultaneous agreement by such transferee to transfer to the transferor thereof mortgage loans or interests mortgage loans; (iv) at a date certain not later than 1 year after such transfer or on demand; and (v) against the transfer of funds.[9] No other criteria are set forth in the statute for a contract to be considered a repurchase agreement under the Bankruptcy Code.

The definition of repurchase agreement is incorporated into section 559 of the Bankruptcy Code. As noted earlier, since 1982, Congress has enacted a number of amendments to the Bankruptcy Code to preserve the liquidity of the repo market by exempting repurchase agreements from significant provisions of the Bankruptcy Code. Section 559 and its companion statute, section 555, preserve market liquidity by providing a "safe harbor" for non-defaulting repo participants "to terminate, liquidate or accelerate . . . repurchase agreements with the bankrupt or insolvent party."[10] Indeed, the legislative history of the 2005 amendments specifically provides that:

> The reference to "repurchase and reverse repurchase transactions" is intended to eliminate any inquiry under section 555 and related provisions as to whether a repurchase or reverse repurchase transaction is a purchase and sale transaction or a secured financing. Repurchase and reverse repurchase transactions meeting certain criteria are already covered under the definition of "repurchase agreement" in the Bankruptcy Code.[11]

[9] *Id.*

[10] H.R. Rep. 109-31, pt. 1, at 133 (2005).

[11] *Id.* at 130.

Red Flags Part III: Director and Officer Liability

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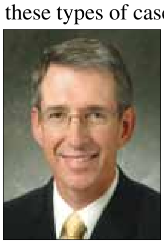
Feature

The concept of constructive knowledge—knew or should have known—has become a popular feature of plaintiff's claims and court opinions to impose liability in a variety of insolvency contexts. Plaintiffs or bankruptcy trustees allege that there were the obvious red flags and that had the investors or officers and directors seen them and acted, the economic conflagration would not have occurred. The authors have explored this topic in two previous articles this year, where Ponzi scheme trustees posit "red flags" as a central allegation triggering investors' duties to return funds to the estate.[1] Red flags are also key allegations in director's and officer's (D&O) liability suits. Because trustees and creditors frequently examine the debtor's managements' and directors' potential liability, this article explores red flags in that context and the potential link in the concepts between these types of cases.



Paul Sinclair

In *In re Bayou Group LLC*,[2] the district court recently held that the red flags may negate a good-faith defense under § 548(c), but only if they suggest insolvency or a fraudulent purpose in making the transfer. In reversing the opinion below, it held that red flags that merely suggested some infirmity in the investment fund or the integrity of management were not sufficient.

D&Os of corporations owe fiduciary duties of care, loyalty, good faith and candor to the corporation. In the context of D&O liability, plaintiffs cite red flags to demonstrate violations of the duty to monitor (falling within duty of care) rather than a loyalty issue. The seminal monitoring case is *In re Caremark International Inc. Derivative Litigation.*[3]

The duty of care for an oversight or monitoring case is breached when (1) the directors knew or should have known that violations of law were occurring, (2) the directors took no steps in a good-faith effort to prevent or remedy the situation and (3) such failure proximately resulted in economic loss.[4] If a plaintiff can plead particularized facts that directors knew or should have known of red flags, then they can get past a motion to dismiss.

The "oversight" theory of director liability is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."[5] Only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure that a reasonable information and reporting system exists —will establish the lack of good faith that is a necessary condition to liability.[6] "In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations"[7] and therefore, acted in "bad faith."[8]

Red Flags in Citigroup

In re Citigroup Inc. Shareholder Derivative Litigation[9] delved into red flags after plaintiffs brought action against the D&Os of Citigroup alleging that defendants breached their fiduciary duties (1) by failing to properly monitor and manage the risks that the company faced from problems in the subprime lending markets, even in the face of red

Michael Foster

flags, and (2) for failing to ensure that its disclosures were thorough and accurate, causing billions in losses. The red flags in *Citigroup* included (1) the steady decline of the housing market, (2) receipt of guidance issued by the Financial Accounting Standards Board (FASB) in December 2005 that certain loan products may increase exposure, (3) the drastic rise in foreclosure rates in 2006, (4) reporting by several large subprime lenders of substantial losses in 2006 and (5) billions of dollars in losses reported by Bear Stearns and Merrill.[10] The court rejected the directors' liability, stating that "[t]he warning signs [of red flags] alleged by plaintiffs are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions."[11]

The court stated that "[n]othing about plaintiffs' 'red flags' supports plaintiffs' conclusory allegation that 'defendants have not made a good faith attempt to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market.' Indeed, plaintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the defendant director knew of these inadequacies and consciously ignored them."[12] The court stated:

> [T]he mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, and without more, is not a basis for personal director liability. That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation

1 Paul Sinclair and Brendan McPherson, "Red Flags of Fraud: Background for Due Diligence," XXX *ABI Journal* 4, 34-35, 69-70, May 2011; Sinclair and McPherson, "Red Flags of Fraud Part II: A Due-Diligence Checklist," XXX *ABI Journal* 5, 20, 72-73, June 2011.
2 439 B.R. 284 (S.D.N.Y. 2010) (*Bayou V*).
3 698 A.2d 959 (Del. Ch. 1996) (Allen, Ch.).
4 *Id.* at 970-71.
5 *Id.* at 967.
6 *Id.* at 967, 970. *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (approving *Caremark* standard).
7 *Stone*, 911 A.2d at 370.
8 *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) ("[A] scienter-based standard applies to claims in the delicate monitoring context.").
9 964 A.2d 106 (Del. Ch. 2009) (Chandler, Ch.).
10 *Id.* at 127.
11 *Id.* at 128.
12 *Id.* at 128.

for this Court to disregard the presumptions of the business-judgment rule and conclude that the directors are liable because they did not properly evaluate the business risk. What plaintiffs are asking the Court to conclude from the presence of these "red flags" is that the directors failed to see the extent of Citigroup's business risk and therefore made a "wrong" business decision by allowing Citigroup to be exposed to the subprime mortgage market.[13]

Demand Futility

A critical prerequisite to a shareholder's or trustee's action is making a demand on the company is board and its subsequent refusal to pursue the issue, known as "demand futility."[14] Just as there is a distinction between a director's monitoring liability and liability for an active decision, there are differing standards for satisfying "demand futility." Red flags are again a key determinant here. In the case of "claims involving a contested transaction, *i.e.*, where it is alleged that the directors made a conscious business decision in breach of their fiduciary duties," courts must apply the *Aronson* test to determine whether demand was futile.[15] Under *Aronson*, trial courts determine whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts and if not, whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.[16] These two inquiries are disjunctive, meaning that if either prong is met, demand is excused.[17] However, "where the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board's oversight duties," the court uses the *Rales* test and considers whether the plaintiff has alleged "particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'"[18]

The seminal case where where demand on directors was deemed futile because of multiple, significant red flags is *In re Abbott Labs. Derivative Shareholders Litigation.*[19] In *Abbott*, the Food and Drug Administration (FDA) conducted 13 inspections of the company to determine whether it was in compliance with FDA regulations, sent four formal warning letters to the company (three directly to the chairman), implemented a "voluntary compliance plan" to remedy compliance problems, filed a complaint for an injunction, ordered the company to destroy noncompliant product inventory and met at least 10 times with company representatives, including the chairman of the board.[20] These events led to "the largest civil fine ever imposed by the FDA" and total losses of approximately $250 million.[21]

Abbott held that *Aronson*, not *Rales*, provided the applicable test for demand futility because plaintiffs alleged that the directors "knowingly," and in an "intentional breach and/or reckless disregard" of their fiduciary duties, "'chose' not to address the FDA problems in a timely manner."[22] By pleading that the directors were aware of the noncompliance, *Abbott* distinguished the plaintiffs' claim from the typical *Caremark* theory, which is predicated on the directors' ignorance of the illegality.[23] Applying *Aronson*, the court held that the plaintiffs established that demand was futile. The extensive paper trail concerning the violations supported a reasonable assumption that there was a "sustained and systematic failure of the board to exercise oversight," and the directors took no steps to prevent or remedy the situation.[24]

Delaware Analysis

The red flags cited by the plaintiff in *In re Intel Corp. Deriv. Litig.,*[25] in which the board was charged with failing to prevent the company from committing anticompetitive practices to monopolize the microprocessor market, included (1) a European Commission 2001 investigation, (2) the Japan Fair Trade Commission's 2004 investigation, (3) a South Korean Fair Trade Commission's 2005 inquiry and (4) *Business Week*'s 2008 report that the New York Attorney General sought information regarding whether Intel stifled competition.[26] The plaintiff alleged that it did not need to make a demand on the board because the board failed to respond to red flags and the directors faced a "substantial likelihood" of personal liability.[27]

Relying on the *Rales* test, the court held that the plaintiff failed to identify what the directors actually knew about the red flags and how they responded to them.[28] Similarly, no allegations were made as to how often and by whom the board was advised regarding the red flags and that any of the directors was a party to any of the proceedings or investigations that plaintiff alleged was a "red flag."[29] The court disagreed with the plaintiff's approach of cataloging the ongoing investigations into Intel's alleged wrongdoing, and then asserted that the thickness of the catalog demonstrated that Intel's conduct was so egregious that the directors must face at least a "substantial likelihood" of personal liability for having ignored the red flags.[30]

Southern District of New York

Cases in the Southern District of New York have ruled both ways on the sufficiency of the red flags. In *In re Veeco Instruments Inc. Sec. Litig.*,[31] the plaintiff alleged *specific facts* regarding the role of the audit committee, including its duties to respond to whistleblowers and oversee regulatory compliance. The complaint detailed the company's failed response to two whistleblower reports and an internal audit that concluded that the company violated the law at least nine times.[32] With regard to accounting controls, the company allowed its accounting staff to be reduced to only two people and in light of several resulting accounting improprieties, acknowledged in its 10-K a deficiency "in the internal control over financial reporting."[33] Despite meeting 27 times, the audit committee, which included five director-defendants, took no action to correct the problems.[34]

In *In re ITT Corp. Derivative Litigation*,[35] the court held that the complaint's allegations were not sufficiently particularized to establish demand futility. The case arose out of a criminal proceeding in which ITT paid more than $100 million in criminal fines, penalties and forfeitures.[36]

13 *Id.* at 130.
14 8 Del. C. § 141; Fed. R. Civ. P. 23.1(b); Del. Ch. Ct. Rule 23.1.
15 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008).
16 *Levine v. Smith*, 591 A.2d 194, 205 (Del. 1991) (overruled on other grounds).
17 *In re JPMorgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 820 (Del. Ch. 2005).
18 *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).
19 325 F.3d 795 (7th Cir. 2003).
20 *Id.* at 799-802.
21 *Id.* at 808-9.
22 *Id.* at 806.
23 *Id.*
24 *Id.*
25 621 F.Supp.2d 165 (D. Del. 2009).
26 *Id.* at 169.
27 *Id.* at 174.
28 *Id.* at 174.
29 *Id.*
30 *Id.* at 175.
31 434 F.Supp.2d 267 (S.D.N.Y. 2006).
32 *Id.* at 277-78.
33 *Id.* at 277.
34 *Id.*
35 653 F.Supp.2d 453 (S.D.N.Y. 2009).
36 *Id.*

continued on page 79

Red Flags Part III: Director and Officer Liability

from page 51

The plaintiffs alleged that the defendant directors failed to establish internal controls, but even the plaintiffs' own allegations showed that at least four board committees were responsible for maintaining and implementing internal controls.[37] The complaint also failed to allege with particularity that the committees failed to review and discuss information received from management, including information regarding the government investigations.[38] In fact, ITT even hired an export license manager to ensure compliance.[39] Indeed, "the fact that the controls put in place ultimately failed to prevent illegal conduct does not mean that 'the directors utterly failed to implement any reporting or information system or controls.'"[40]

The plaintiffs also alleged that the directors consciously failed to oversee their operations, ignoring numerous red flags of felonious company conduct.[41] The first red flag was that the directors should have been alerted to wrongdoing when ITT engaged an outside law firm to prepare and send to the State Department voluntary disclosures regarding ITT's failure to obtain temporary export licenses.[42] The court stated that these speculative and vague allegations were insufficient to establish that a majority of the defendants were aware of illegal conduct and consciously failed to act.[43]

The second red flag was the defendant's disregard of the initiation of the government's criminal investigation.[44] While the allegations specified what information the defendants received and when, it did nothing to show what response, if any, was taken by each individual director.

The final red flag was that the directors knew that the government possessed evidence of wrongdoing and decided to pursue criminal proceedings, but wrongdoing continued at ITT.[45] Sufficient facts were not alleged to show that a majority of the board had knowledge of the violations of the law and plaintiffs did not meet their burden of pleading that five of the director defendants faced a substantial likelihood of liability.[46]

In *In re Pfizer Inc. Shareholder Derivative Litigation*,[47] the court held that under *Rales,* there was a substantial likelihood that a majority of the board faced personal liability by excusing a pre-suit demand and overruled a motion to dismiss, finding that the complaint stated a claim for breach of fiduciary duty. Investors sought recovery from senior executives and current and former board members for misconduct that resulted in the imposition of $2.3 billion in fines and penalties arising from illegal "off-label" marketing of various regulated drugs. Over seven years, Pfizer had entered into three different settlements with the government for illegal practices before the latest fine and promised to take significant steps to monitor and prevent further violations.[48]

The complaint detailed at great length (1) a large number of reports (including reports to the board of settlements) made to a majority of the board from which it could be inferred that they all knew of Pfizer's continued misconduct and disregarded it, (2) a large number of FDA violation notices and warning letters, (3) several reports to Pfizer's compliance personnel and senior executives of continuing kickbacks and off-label marketing, and (4) allegations of the *qui tam* lawsuits.[49] The complaint specifically alleged conduct of such pervasiveness and magnitude, undertaken in the face of the board's own express formal undertakings to directly monitor and prevent such misconduct, that the inference of deliberate disregard by every member of the board was reasonable.[50]

Conclusion

Just as red flags in Ponzi cases must point to insolvency or fraud in the investment, red flags in D&O oversight cases must plead particularized factual allegations demonstrating such knowledge as amounts to bad faith by the director defendants. This is an extremely hard standard to meet at the pleading stage before discovery commences. Plaintiffs have to show with specificity how the oversight mechanism was consistently inadequate, and how such inadequacies constituted a systemic failure, and that directors knew of these inadequacies and consciously ignored them. Significantly, Delaware courts have emphasized that red flags "are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer."[51] ■

37 *Id.* at 461.
38 *Id.*
39 *Id.*
40 *Id.* (citing *Stone*, 911 A.2d at 370, 372-73).
41 *Id.* at 461.
42 *Id.* at 461-62.
43 *Id.*
44 *Id.*
45 *Id.* at 463.
46 *Id.*
47 722 F.Supp.2d 453 (S.D.N.Y. 2010).
48 *Id.* at 456.
49 *Id.* at 460.
50 *Id.* at 462.
51 *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008).