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Evan D. Flaschen and Kurt A. Mayr

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## HEADNOTE

# ARMs and PDPs

STEVEN A. MEYEROWITZ

**T**he first two articles in this issue explore different “alphabetical soups” of note to the bankruptcy world.

First, in “A Farewell to ARMs: Lessons from the Subprime Origination Meltdown,” Jonathan W. Jordan, an attorney in the Financial Restructuring Group in King & Spalding’s Atlanta office, explores adjustable rate mortgages following the subprime mess. As Mr. Jordan explains, the contraction of the American housing market in late 2006 sent off a chain reaction in U.S. and global capital markets that put a succession of housing, investment and retail industries in economic distress. The first casualties to enter the Chapter 11 process were the mortgage originators, and their experience with the bankruptcy courts may provide insight that will prove useful to successive industries that go through the restructuring and bankruptcy process during the next three years.

### ABCs of PDPs

Since early 2004, the number and size of civil aircraft pre-delivery payment (“PDP”) financings have increased dramatically. Airlines view them as a way to enhance liquidity during the aircraft production cycle. Bankers view them as a way to get short-term exposure to aviation assets and deepen relationships. Manufacturers view them as a way to facilitate sales. With significant recent appreciation in aircraft values, improved customer credit and, in many cases, committed delivery financing in place, these transactions have made increasing commercial sense.

In the last 18 months, however, manufacturers have been taking new

approaches to limit their risk in light of this proliferation. In the next article, "The ABCs of PDPs: Advance Rates, Bankruptcy Risks and Collateral Management," Mark N. Lessard, a senior associate at Pillsbury Winthrop Shaw Pittman LLP, examines various legal aspects of negotiating, documenting and closing a PDP facility in this new setting. Mr. Lessard begins with some brief background then summarizes the principal issues arising from the complex, tri-partite negotiations between the borrower, the lender and the manufacturer.

The first section, entitled "Advance Rates," looks at the core issues that a lender should focus on in attempting to contain its exposure. The second section, entitled "Bankruptcy Risks," addresses the dynamics between the manufacturer and lender in a default scenario. The last section, entitled "Collateral Management," focuses on issues of import to the borrower in the management of its aircraft order during the life of the facility.

And More....

We have more here, of course, including articles on Chapter 15, Canadian insolvency law reform, and a lawsuit challenging the termination of insured credit default swaps.

Enjoy the issue!

Steven A. Meyerowitz  
Editor  
May 2008

# A Farewell to ARMs: Lessons from the Subprime Origination Meltdown

JONATHAN W. JORDAN

*The contraction of the American housing market in late 2006 set off a chain reaction in U.S. and global capital markets that put a succession of housing, investment and retail industries in economic distress. The first casualties to enter the Chapter 11 process were the mortgage originators, and their experience with the bankruptcy courts may provide insight that will prove useful to successive industries that go through the restructuring and bankruptcy process during the next three years.*

**C**reditors will be sorting out the financial and legal fallout from the current mortgage market contraction for years to come. But even before the smoke clears, the wave of mortgage origination bankruptcies that began in the Fall of 2006 and continued into 2008 has left its legal and economic footprint on the Chapter 11 process. By looking backwards, at the causes and immediate effects of the mortgage origination bankruptcies, the contours of future bankruptcies of financial services providers may become clearer.

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## PRELUDE TO A MELTDOWN

The base of the residential mortgage backed securities (“RMBS”) pyramid was the humble subprime mortgage, underwritten through an originator, with or without the help of a mortgage broker. Subprime loans, which command higher than prime interest rates because they are extended to high risk borrowers, accounted for 8.6 percent of all residential mortgages in 2001, a share that ballooned to 20 percent by 2006.<sup>1</sup> Given the overall size of the U.S. mortgage market, the resulting numbers were huge; by mid-2007, the outstanding principal balance of subprime loans totaled approximately \$1.6 trillion.<sup>2</sup>

Of particular interest to many subprime borrowers was the adjustable rate mortgage (“ARM”), a product that took advantage of low interest rates facilitated by the Federal Reserve Board in the early 2000’s and offered low initial interest rates for a certain period of time, say, two or three years. After the introductory period, the loan would reset to a market rate of interest, often prime plus two to eight percentage points.<sup>3</sup> Because the initial payments under these mortgages were low, many buyers purchased homes they could not otherwise afford because they either did not understand the impact of the reset feature, or because they believed that housing values would continue to climb, allowing them to refinance their way into a conventional fixed rate mortgage before the introductory period expired. By 2006, ARM loans accounted for 91 percent of all subprime mortgages.<sup>4</sup>

Another distinguishing feature of the subprime boom was the high incidence of 100 percent loan-to-value mortgages, in which have buyers could obtain a loan with no money down. In cases of refinanced mortgages, professional appraisers allegedly were pressured by lenders to inflate property values to support larger loan balances, and some lenders offered higher interest lines of credit that were nominally unsecured.<sup>5</sup> Some borrowers therefore were able to “cash out” home equity they did not have to fund consumer purchases or pay off large credit card balances.

One distinct feature of the 2002-2007 subprime boom was the high incidence of “low document/no document” loans, in which little or no evidence of income or assets was required for loan approval. In 2006, one

half of all subprime loans were of this minimal documentation type, up from 28 percent just five years earlier.<sup>6</sup> In making these loans without the usual due diligence, the ultimate investors — hedge funds, commercial banks, investment banks, insurance companies, pension funds, and others — bet on the same gamble the borrowers did: that housing prices would continue to rise, ensuring that those with money at risk could look to a relatively safe collateral package.

The intermediate level of the subprime pyramid was the mortgage originator/seller. Large originators such as Aegis and New Century underwrote billions of dollars of loans on a beautifully simple model: they did not lend their own money. They immediately sold their loans (either directly or packaged as RMBS) to a network of securitization arrangers — principally investment banks or specialized financing arms of commercial banks, and sometimes to financing arms of the originator, as in the cases of Countrywide and American Business Financial Services. Approximately 80 percent of all subprime loans originated in 2005 and 2006 were securitized, up from 50 percent in 2001,<sup>7</sup> and mortgage loans sold to securitizers were subject to repurchase agreements providing for their mandatory repurchase if the loans remained delinquent for a set period of time. Many origination companies also had loan servicing departments, which would service the loans for purchasers through contractual arrangement. Originators obtained working capital through warehouse lenders who held liens on mortgages that were awaiting securitization or were in the process of closing (sometimes referred to as “pipeline loans”).

The securitization sale formed the apex of the pyramid and provided the capital that drove the market’s explosive growth. Securitizations could be structured in a wide variety of ways, but the general structure was as follows: an arranger, such as a division of Bear Stearns, would then fund a bankruptcy-remote trust or other special purpose vehicle (“SPV”) whose only role was to hold the loans and issue securities backed by these mortgages, called collateralized debt obligations (“CDOs”).<sup>8</sup> The SPV would divide the CDOs into tranches to accommodate varying risk tolerances. Senior tranches would be paid first and were therefore the safest tranche; they were awarded the highest ratings and carried the lowest interest rates. To ensure that senior tranches obtained investment grade

ratings from Standard & Poor's, Moody's or one of the other recognized ratings agencies, these tranches were generally insured by AAA-rated credit insurers. Mezzanine (BBB-rated) and equity (junk grade) tranches carried successively higher risk and interest rates.

After the RMBS were segregated into tranches, the SPV would sell investment grade CDOs on the open market, while mezzanine and equity tranches would be sold to risk friendly hedge funds, parked with cash flush institutions such as foreign banks, or become repackaged into synthetic CDOs through the creative use of credit default swaps or further slicing and leveraging.

Thus, a discreet set of mortgages would be parceled out to potentially thousands of individuals and institutions with varying rights and remedies and a complex set of interlocking documents that governed the relationships. In this way, the creditworthiness of the subprime borrower — traditionally the market's least creditworthy prospect — supported a pervasive, trillion dollar sector of the credit market.

## OILY RAGS, PAPER, AND MATCHES

The securitization wave of 2001-2007 represented a departure from previous real estate booms in several respects. First, the ready supply of securitization products altered the traditional relationship between homeowner and immediate lender because the focus shifted from long term investment to short term monetization. New home buyers began purchasing more expensive homes than they could afford on a two or three year refinance timetable, and existing homeowners began looking at their homes as cash machines that could be tapped to pay short term debts. Mortgage lenders, whose income derived from origination fees rather than loan interest, lacked an incentive to safeguard the integrity of the loan process because they did not intend to hold the loan or ensure that it would remain current beyond the time frame set out in the repurchase agreement's representations and warranties. Critically, neither of the two parties best able to police the transaction—the borrower and the mortgage originator—put any money at risk, and both had an economic incentive to close a deal. As a result of this systemic moral hazard, underwriting stan-

dards for many loans deteriorated, and a foundation was laid for unrealistic expectations further down securitization stream.<sup>9</sup>

A second factor that made the 2001–2007 subprime securitization process different was the huge size of the market and the rapid rate at which it ballooned during that six year period. From 2001 to 2005, annual subprime loan originations leaped from roughly \$190 billion to \$625 billion; 2006 originations declined only slightly, to \$600 billion.<sup>10</sup> The result of this mortgage boom was a fourth quarter 2004–2007 home ownership rate that exceeded the 1981–1999 historical average of 64.5 percent, peaking at 69.2 percent in 2004 and tapering off at 67.8 percent for the first quarter of 2008.<sup>11</sup> The subprime CDO boom thus drove home ownership to artificially high levels.

A final distinguishing factor was the lack of transparency up and down the securitization chain. As the origination bankruptcies were to show, many parties to complex CDO transactions did not know precisely which mortgages they owned, much less have the documentation necessary to support claims of legal or beneficial title. Moreover, the process of blending, slicing and repackaging a blizzard of subprime paper — much of which was carried off balance sheet in SPVs and in synthetic CDOs — robbed the system of the sort of transparency that allows market players to estimate their exposure when the market takes a sudden fall. As one Lehman Brothers economist put it, high dollar products spawned by the subprime boom included “parts of the capital markets that most of us had never heard of.”<sup>12</sup>

The sole backstop to this financial tinderbox was an article of faith supported by a trend dating back to 1995: that housing prices would continue to rise at healthy if not steep levels. Since 1981, housing prices almost invariably rose on an annual basis, and from 1997 to 2006, home prices rose 85 percent, an appreciation level not reached since the housing boom immediately following World War II.<sup>13</sup> As long as home prices went up, cornered borrowers could refinance their way out of high interest rates when their ARMs adjusted, originators would not have to weather repurchase demands, and CDOs would remain solidly collateralized because the houses that backed them were worth the face amount of the securities. Everyone was happy.

## THE FIRST DOMINOS

Of course, the housing market could not sustain such exponential (and artificial) growth. Beginning in the second quarter of 2006 most major U.S. markets began to flatten and decline.<sup>14</sup> Consumers whose incomes could only support mortgages at the low introductory rates found themselves unable to afford large increases in their monthly payments when their ARMs reset. By the end of 2007, one in five ARMs was seriously delinquent, meaning either 90 days past due or in the foreclosure process,<sup>15</sup> and subprime borrowers began defaulting on mortgage loans at an estimated rate of 18 to 20 percent.<sup>16</sup> The Mortgage Bankers Association recently concluded that delinquency rates have reached a peak not witnessed since 1985.<sup>17</sup>

As a result, foreclosures in January 2008 were up 60 percent over the same period for 2007, and one tracking organization estimated that the percentage of U.S. households in some state of the foreclosure process rose from .58 percent in 2006 to one percent in early 2007.<sup>18</sup> In many cases borrowers, having no equity in their homes, simply walked away from their mortgages, leaving entire subdivisions of vacant houses and burdening a housing market that already had 79,000 more vacant homes for sale in 2007 than in 2006.<sup>19</sup>

The last quarter of 2007 witnessed a national median house price drop of 5.8 percent, the steepest drop since the National Association of Realtors began keeping records in 1979 — until the first quarter of 2008, which racked up another 7.7 percent.<sup>20</sup> The first institutions to feel the pinch were the mortgage loan originators, which were besieged with repurchase demands from loan purchasing clients, cease and desist orders from state authorities, tighter warehouse lending criteria and less money for their mortgages and RMBS. While a few of these institutions, such as Countrywide Financial Corporation, were able to win a reprieve through massive equity infusions, most had no choice but to shut their doors or, in the case of companies with substantial assets, to file for bankruptcy protection.<sup>21</sup> December 2006 therefore commenced a year long roster of mortgage originator bankruptcies that reads like a “Who’s Who” of mid-sized and large mortgage industry players:

<i>Debtor</i>	<i>Date Filed</i>	<i>Venue</i>	<i>Case No./Chapter</i>
Ownit Mortgage Solutions, Inc.	12/28/2006	C.D. Cal.	06-12579 (11)
Mortgage Lenders Network USA, Inc.	02/05/2007	D. Del.	07-10146 (11)
ResMAE Mortgage Corporation	02/12/2007	D. Del.	07-10177 (11)
LoriMac Inc.	02/13/2007	N.D. Cal.	07-30165 (7)
People's Choice Home Loan, Inc.	03/20/2007	C.D. Cal.	07-10765 (11)
New Century TRS Holdings, Inc.	04/02/2007	D. Del.	07-10416 (11)
SouthStar Mortgage Funding, LLC	04/11/2007	N.D. Ga.	07-65842 (7)
Oak Street Mortgage LLC	06/08/2007	S.D. Ind.	07-05279 (11)
Alliance Mortgage Investments, Inc.	07/13/2007	D. Del.	07-10941 (7)
American Home Mortgage Holdings, Inc.	08/06/2007	D. Del.	07-11047 (11)
HomeBanc Mortgage Corp.	08/09/2007	D. Del.	07-11079 (11)
Aegis Mortgage Corp.	08/13/2007	D. Del.	07-11119 (11)
First Magnus Financial Corp.	08/21/2007	D. Ariz.	07-01578 (11)
Quality Home Loans	08/21/2007	C.D. Cal.	07-13006 (11)
Fieldstone Mortgage Co.	11/23/2007	D. Md.	07-21814 (11)
Delta Financial Corp.	12/17/2007	D. Del.	07-11880 (11)
First NLC Financial Services, LLC	01/18/2008	S.D. Fla.	08-10632 (11)
NovaStar Home Mortgage, Inc.	01/23/2008	W.D. Mo.	08-40245 (7)

## MORTGAGE ORIGINATOR ISSUES

The mortgage originator cases of 2006-2008 yielded a wide variety of nonstandard bankruptcy disputes between the originators, warehouse lenders, loan purchasers, SPV trustees, credit insurers and buyers, in addition to more conventional bankruptcy disputes over items such as utilities motions, lease rejections and key employee retention plans. While a detailed review of the most contentious issues in each case would fill a large tome, a sampling of the issues raised in these cases gives a fair idea of the twists and turns this generation of Chapter 11 cases took.

### Stay Relief

Warehouse lenders moved quickly to request stay relief on their collateral, which naturally impacted each debtor's ability to generate cash from operations. For example, in the case of *American Home Mortgage Holdings* — a debtor whose loans were predominantly prime and Alt-A loans rather than subprime — its lender, Bank of America, moved for stay relief to foreclose on some \$584 million in mortgage loans, arguing that cause for stay relief existed under Bankruptcy Code Section 362(d)(1) because the market value for the loans was declining rapidly in the contracting housing market.<sup>22</sup> Similarly, in *HomeBanc Mortgage Corp.*, lender JPMorgan Chase moved on the first day of the case for adequate protection for its \$69 million prepetition loan secured by the debtor's servicing rights, intangibles and deposit accounts.<sup>23</sup> In many cases, commingling of funds and dispersed documentation complicated the adequate protection analysis.

Another type of stay relief litigation arose in cases where the originator holds a junior mortgage under a foreclosing senior mortgagee. In these cases, the delay imposed upon the senior, non-debtor mortgagee by the automatic stay can impose costs on the debtor (a) by delaying foreclosure in a declining housing market, and (b) by forcing the senior mortgagee to incur fees and expenses in obtaining stay relief, which costs may be added to the indebtedness secured by the senior lien. To avoid the costs of stay relief rebounding against the debtor, some debtors moved proactively to modify the stay in those instances.<sup>24</sup>

A third variation of stay relief litigation turns on whether the stay applies at all. In *American Home Mortgage*, a counterparty to a “servicing retained” master repurchase agreement moved for a declaratory judgment that the agreement was not subject to the automatic stay by virtue of Bankruptcy Code Sections 362(b)(7) and 559, which exempt repurchase agreements from stay and executory contract termination prohibitions in Bankruptcy Code Sections 362(a) and 365(e). (Section 546(f) also exempts repurchase agreement counterparties from certain avoiding powers of a bankruptcy trustee.) American Home Mortgage contended that the repurchase agreement was actually a disguised financing agreement that fell outside the definition of repurchase agreement set forth in Bankruptcy Code Section 101(47). In the alternative, the debtor argued that, at a minimum, the servicing provisions did not constitute a repurchase agreement, and were severable from the rest of the agreement. The court ultimately found that the agreement was both a repurchase agreement under Section 101(47), and a securities contract under Section 741(7) (which provides similar safe harbor provisions for mortgage purchases and other types of derivative transactions), but it also held that the servicing provisions of the agreement were severable and remained property of the estate. The repurchase agreement counterparty was therefore entitled to enforce any setoff and liquidation rights available due to the debtor’s bankruptcy filing — a trigger normally prohibited in executory contracts by Bankruptcy Code Section 365(e)(1). Because the order in this case did not adjudicate the dispute over the servicing rights, it was not a final order, and the repurchase agreement party could not immediately appeal the bankruptcy court’s order residual holding that the servicing rights remained property of the debtor’s estate.<sup>25</sup>

### Section 363 Asset Sales

Consistent with broader trends in large Chapter 11 cases, the goal of most of mortgage lender cases was the liquidation of non-securitized or “whole” loans, interests in securitization trusts, servicing agreement rights, and other loan platform assets. Accordingly, Section 363 sales played a large role in these cases. Of the 14 Chapter 11 cases noted here, all but two of them resulted in sales of substantially all business assets

within 10 months of the petition date. In cases where the assets have not yet been approved for sale, the debtors are marketing them. In many cases, the debtor moved for the sale or consummation of prepetition sales on or near the first day of the case, or had sold most of their assets immediately prior to filing.

## Litigation

Litigation against warehouse lenders, parties to repurchase agreements, insurers, directors/officers and professionals has also become a standard feature of subprime originator bankruptcy cases.

### *Claims Against Mortgage Purchasers*

In the *Ownit Mortgage Solutions* case, for instance, the debtor investigated or brought claims against JPMorgan Chase (for turnover of account funds, conversion, wrongful participation in the collapse of the debtor's restructuring efforts, and improper use of confidential information), Merrill Lynch (for conversion and/or turnover of purchased loans, recharacterization of true sales as disguised financing transactions, avoidance of allegedly unperfected security interests, equitable subordination, turnover of funds paid by the debtor's prepetition servicing agent, participation in the collapsed restructuring efforts, and preferential transfers), and the debtors' loan servicer, Litton Loan Servicing (for wrongful payment to Merrill Lynch). In addition, JPMorgan Chase sued the debtor and certain Merrill Lynch affiliates alleging senior rights in certain operating accounts of the debtor.<sup>26</sup>

### *Fiduciary Duty Claims*

Reflecting the wave of nonbankruptcy lawsuits directed at officers, directors, arrangers and other parties to securitization transactions, bankruptcy trustees and liquidation agents have begun looking at possible claims against securitization players. In a hefty 581 page report, the examiner appointed in the *New Century TRS Holdings* case found that the debtor's estate holds colorable claims against New Century's auditor, as well as former directors and officers of the debtor for departing from proper account-

ing practices, such as in the valuation of loss reserves, which aided and abetted material misstatements of New Century's financial status. The *New Century* examiner's report may provide a blueprint for other liquidating agents and bankruptcy trustees to follow in future cases.<sup>27</sup>

### *Claims by Mortgage Purchasers*

In some cases, parties to master repurchasing agreements have sued debtors to obtain access to records of purchased mortgage loans, control over the loans as required by their repurchasing agreements, and accounting of custodial funds collected by the debtors prior to their repurchase. In the *New Century* case, the largest Chapter 11 case filed in 2007, repurchase agreement counterparty UBS Real Estate Securities and other purchasers commenced adversary proceedings to obtain accountings of custodial funds collected by New Century for purchased loans.<sup>28</sup> In the second largest case of 2007, *American Home Mortgage*, Credit Suisse First Boston Mortgage Capital, Bear Stearns Mortgage Capital Corporation, and Morgan Stanley Mortgage Capital Holdings similarly filed adversary proceedings to obtain control over certain purchased loans, recover loan files and terminate the debtor's servicing rights.<sup>29</sup>

### *Investor Claims*

Where bonds are sold directly from the mortgage company to investors, a bankruptcy trustee may have standing to pursue claims on behalf of the investors. This situation arose from the Chapter 7 case of American Business Financial Services, Inc., a subprime lender that securitized its loans through Bear Stearns, JPMorgan Chase, Morgan Stanley, and Credit Suisse Group. The cause of ABFS's collapse in 2005 was different from the current wave of subprime originator cases — ABFS had, among other things, miscalculated prepayment rates — but the investment bank group faced similar exposure under fraudulent conveyance and other theories. The trustee's lawsuit against the investment banks, filed in 2006, has since been removed from Pennsylvania state court to federal court, and as it plays out, it may provide some guidance as to the path other bankruptcy trustees may follow in those cases where investors are direct creditors of the originator.<sup>30</sup>

### *Insurance Litigation*

Because bond insurers are a critical part of the subprime securitization structure, debtors and insurers have engaged in litigation when the insurer desires to cancel insurance policies or otherwise refuses to accede to debtor demands. In the American Home Mortgage case, for example, Federal Guaranty Insurance Company, a well known credit insurer for complex financial products, sued the debtor to require the turnover of servicing rights to FGIC's designated servicing successor.<sup>31</sup> In an analogous adversary proceeding in the same case (although one not involving insurance per se), one of the debtors' SPVs sued Bank of America to enforce a credit default swap that backstopped certain losses on the sale of mortgage loans.<sup>32</sup>

Since director and officer ("D&O") claims have predictably risen with the collapse of the subprime securitization market, D&O liability insurers have become minor though important players in Chapter 11 cases. In the *Delta Financial* case, the debtor filed an adversary proceeding to force its D&O liability carriers to fund the defense of the debtors' officers and directors who were defendants in suits related to their work for the defunct originator.<sup>33</sup>

### *People's Choice: A Case Study*

Fairly typical in this population is the case of People's Choice Home Loans, Inc., an Irvine, California-based mortgage company that owned bankruptcy remote SPVs to facilitate the securitization of its mortgage loans.<sup>34</sup> People's Choice and its affiliates originated, funded, sold and serviced loans through wholesale and retail channels. Financing for its lending operations was provided through warehouse facilities with Bear Stearns, Credit Suisse First Boston, Deutsche Bank, Lehman Brothers, Wachovia, Washington Mutual, Wells Fargo, and other well known financial institutions. On the petition date, these lenders asserted claims totaling \$84 million and held some \$26.5 million on deposit in margin call accounts. People's Choice also sold loans not for purposes of securitization (called "whole loan" sales) with repurchase obligations to third parties such as Citigroup Global Markets, DB Structured Products, Credit-

Based Asset Servicing, UBS, Nomura, Merrill Lynch, and other institutions, while retaining servicing rights on these loans to itself. The debtor's exposure under repurchase obligations for whole loan sales was around \$79 million. Finally, the debtor securitized about \$3 billion in RMBS in 2004, and another \$4 billion in RMBS in 2005.<sup>35</sup>

As the housing market began to slide in late 2006, the debtors began receiving margin calls from warehouse lenders, repurchase demands from loan purchasers, and reduced pricing offers from secondary buyers of RMBS. Unable to finance their way out of this convergence of threats, People's Choice and its affiliates filed their Chapter 11 petitions on March 20, 2007.<sup>36</sup>

### *Cash Collateral Use*

In addition to fairly standard Chapter 11 disputes, People's Choice confronted a variety of issues specific to its mortgage business. First, several different warehouse loan participants claimed an interest in the debtors' commingled cash, which thwarted easy tracing of funds claims by particular parties. This created problems for the provision of adequate protection to the lenders for the debtor's use of cash collateral under Bankruptcy Code Section 363, a mess that had to be resolved through consensual adequate protection carve-outs.<sup>37</sup>

### *Section 363 Sales*

The debtor's Chapter 11 strategy was to execute Section 363 sales of its major assets, including:

- residual interests in securitization trusts (sold to PC Asset Acquisition for \$21 million);
- servicing interests (sold to Equity One, Inc. for \$24 million);
- loan servicing and origination platforms (sold to UBS for \$2.5 million); and
- certain loans that it had been required to repurchase (referred to as "scratch and dent loans"), which sold in small parcels for a total of \$1.7 million.

The servicing agreement sale to Equity One proved the most contentious, as the counterparty to the servicing agreement, EMC Mortgage Corporation, objected to the sale, and the debtors and creditors committee had to enter into settlement and transition services agreements with EMC to pave the way for the sale.<sup>38</sup> These sales were consummated prior to the confirmation of a Chapter 11 plan and drove the estimated 10 to 14 percent return for most general unsecured creditors.<sup>39</sup>

### *Tax Issues*

People's Choice also had to address maintenance of its subsidiary's status as a real estate investment trust ("REIT") under Sections 856 through 860 of the Internal Revenue Code, to avoid significant tax consequences for tax year 2007, and to ensure that the four mortgage securitization trusts it set up for 2007 would continue to be treated as separate legal entities. These tax considerations affected both the debtor's corporate tax liability and the IRS's proof of claim.<sup>40</sup>

### *D&O Litigation*

In its disclosure statement, the debtor has raised claims against certain former directors, officers and shareholders on a variety of theories, including:

- excessive compensation;
- fraudulent conveyance;
- illegal dividends;
- approving improper intercompany transfers;
- approving unsafe lending practices for subprime borrowers;
- approving stock repurchases, and;
- generally causing the company to fail.<sup>41</sup>

These claims have not yet been filed, and absent settlement, litigation involving the debtors (or their successor), the directors and officers, and the D&O insurance policy carrier will likely last well into 2009.

### *Lender Litigation*

As one of the debtor's principle prepetition lenders, Washington Mutual Bank claimed a security interest in certain prepetition tax refund proceeds; when a dispute over this interest could not be worked out, the debtor filed an adversary proceeding alleging preferential transfers, breach of contract, conversion, and objection to Washington Mutual's claims. The complaint, which has not yet been resolved, also attempts to avoid Washington Mutual's security interest in the refund proceeds. Absent settlement, litigation will continue well into 2008.<sup>42</sup>

The debtor also investigated avoidance claims against one of its warehouse lenders, Residential Funding Company, LLC, which claimed an interest in certain commingled funds in the debtors' bank accounts, as well as a security interest in the proceeds of certain scratch and dent loans. Ultimately the two parties settled RFC's claims for approximately 72 cents on the dollar.<sup>43</sup>

### *Substantive Consolidation*

Because of the interconnected nature of the debtors' securitization businesses, the debtors and their financial advisors conducted an extensive review of various intercompany transactions to determine whether substantive consolidation was appropriate under the Second Circuit's *Augie/Restivo* test, as adopted by the Ninth Circuit<sup>44</sup> While the assets and liabilities of the debtors were not hopelessly entangled, there were enough factors favoring substantive consolidation — the creation of subsidiaries for tax rather than business reasons, below market sales to subsidiaries, consolidated liquidity management, and commonality of management, for instance—that protracted litigation was a real threat. Ultimately, the debtors and the creditors committee ultimately agreed not to press for substantive consolidation, subject to a number of allocation and administrative conditions set forth in the debtor's proposed plan.<sup>45</sup>

## LESSONS FOR THE FUTURE, ECONOMIC AND LEGAL

The impact of the subprime contraction is likely to continue well into 2009 as 2005- and 2006-vintage ARMs reset themselves to higher inter-

est rates over the next 12 months. Federal Reserve Chairman Ben Bernanke cited estimates of 1.5 million ARM resets in 2008,<sup>46</sup> and one study estimated that ARM resets in 2008 will raise mortgage payments by an average of 32 percent.<sup>47</sup> This will undoubtedly spawn a new wave of defaults and foreclosures; a Congressional Joint Economic Committee report predicted that by the end of 2009 home foreclosures will reach the two million mark.<sup>48</sup>

As market players slowly become aware of the magnitude of 2007's biggest "black swan," loss estimates continue to be revised. In July 2007 Chairman Bernanke estimated \$100 billion of subprime-related write-downs. That total grew to \$120 billion in write-downs by major banks as of February 2008, and lurking out there are another \$123 billion in additional write-downs that UBS analysts warn may be necessary before all losses are accounted for.<sup>49</sup> The OECD revised its "all in" total for the subprime crisis at \$350-420 billion, disputing an IMF worldwide estimate of \$1 trillion.<sup>50</sup>

The effects of the subprime debacle will not be limited to the residential mortgage industry; the home building and building materials industries have been directly hurt by the housing glut (resulting in several large home builder filings in 2007 and 2008).<sup>51</sup> The relative collapse of the subprime capital market has also spilled into other credit sub-industries, affecting bond insurance, credit default swaps, auction rate securities, synthetic CDOs, and other complex financial products, and the contraction in the availability of commercial paper has limited the ability of businesses outside the housing industry, such as specialty retail chains and airline companies, to refinance their way out of cash flow problems. A few investment funds, such as First NLC Financial Services and Bear Stearns High-Grade Structured Credit Strategies, have filed for bankruptcy protection, and as many besieged hedge funds close their doors, others are likely to consider their options in Chapter 11.

While the full impact of the subprime contraction is still murky, there are some legal and economic conclusions that can be drawn from the recent bankruptcy experiences of mortgage originators.

## The Post-BAPCPA Trend is Reversing, Temporarily

Business bankruptcy filings have been on a steep and steady decline since the implementation of the 2005 amendments to the Bankruptcy Code, which limited exclusivity, key employee retention plans, and debtor leverage in areas such as reclamation rights and preference claims.<sup>52</sup> As the subprime meltdown reaches into the lower tiers of corporate credit, however, both consumer and business bankruptcy filings are beginning to buck this trend, at least for 2008. Consumer filings were up 40 percent from 2006 to 2007,<sup>53</sup> and public company filings during the last two years rose from 66 in 2006 to 78 in 2007, on total Chapter 11 filings of 5,010 for 2006 and 6,236 in 2007.<sup>54</sup> Anecdotal evidence indicates that 2008 business filings will substantially exceed those of 2007 in both quantity and claim amounts, and one source estimates that Chapter 11 filings increased 16 percent during the first quarter of 2008.<sup>55</sup>

## The Claims are Huge, but the Cases are Not

In terms of assets, mortgage lenders filed the five biggest public company bankruptcy cases of 2007.<sup>56</sup> But in these cases asset size does not correlate with case duration or complexity. Most of the mortgage bankruptcies of 2007 resulted in Section 363 sales of most business assets or converted to Chapter 7 within four to ten months of filing. This result is explained by the fact that (1) most mortgage lenders had few business assets other than servicing agreements, which were sold off to distressed investors or strategic buyers, (2) the major repurchase agreements will fall within the safe harbor protections of Bankruptcy Code Sections 362(b)(7), 546(f) and 559, reducing bankruptcy entanglements for those counterparties, and (3) because none of the creditors — hedge funds and investment banks, for the most part — had any real interest in preserving a debtor's going concern value. It is not unrealistic to believe that future Chapter 11s in other financial services sectors will follow the blueprint of "carve up and sell off." Those rare companies that survive Chapter 11 will likely be ones that have prearranged or prepackaged plans set on a fast judicial track.

## The Biggest Legacy of These Bankruptcy Cases May Be Litigation

While in many Chapter 11 cases litigation revolves around basic avoidance actions and low probability “kitchen sink” complaints filed by committees against prepetition lenders, subprime-related lawsuits against directors and officers, underwriters, insurers, lenders and audit professionals are likely to comprise a large part of creditor recovery. This litigation, whether commenced inside or outside bankruptcy court, is likely to trail the effective end of the bankruptcy cases for many years.

## DIP and Exit Financing Will Become More Expensive

As the economic effects of the subprime contraction ripple through capital markets, financing for distressed entities will become more expensive. In a seller's market, DIP lenders can be expected to demand shorter termination periods, more due diligence, wider rate spreads and higher fees. Although a strict comparison of initial proposed DIP facilities is not easily accomplished, a comparison of the 10 largest Chapter 11 cases for 2007 and 2008 generally indicates that rate spreads in DIP loans are widening, meaning that financing — inside or outside the mortgage industry — is becoming more expensive.<sup>57</sup> Exit lenders, for their part, will be more reluctant to wait until after closing to syndicate loan commitments and will likely impose (and enforce) more restrictive covenants than in previous deals.<sup>58</sup>

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<sup>3</sup> Christopher L. Cagan, “Mortgage Payment Reset: The Issue and the Impact,” March 19, 2007, at 28, accessed April 2, 2008 at [404](http://www.facore-</a></p></div><div data-bbox=)

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<sup>5</sup> “NY Attorney General Files Appraiser Fraud Suit Against First American,” *Mortgage News Daily*, November 2, 2007, accessed April 10, 2008 at [http://www.mortgagenewsdaily.com/1122007\\_Appraiser\\_Fraud\\_Suit.asp](http://www.mortgagenewsdaily.com/1122007_Appraiser_Fraud_Suit.asp).

<sup>6</sup> Jennifer E. Bethel, Allen Ferrell and Gang Hu, “Law and Economic Issues in Subprime Litigation,” Discussion Paper dated March 2008, accessed April 2, 2008 at [http://www.law.harvard.edu/programs/olin\\_center/papers/pdf/Ferrell\\_et\\_al\\_612.pdf](http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf); Subprime Report, at 10.

<sup>7</sup> Subprime Report, at 18.

<sup>8</sup> Bethel, et al., at 6-7. Because the structure of the various financial products often makes for loose terminology, for the limited purpose of this article “straight pass-through” residential mortgage-backed obligations as “RMBS” and mortgage pools that have been packaged then segregated into various priority tranches as “CDOs.”

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<sup>10</sup> Adam B. Ashcraft and Til Schuermann, “Understanding the Securitization of Subprime Mortgage Credit,” Federal Reserve Bank of New York Staff Reports, March 2008, at 8, accessed April 2, 2008 at [http://www.newyork-fed.org/research/staff\\_reports/sr318.pdf](http://www.newyork-fed.org/research/staff_reports/sr318.pdf); Subprime Report, at 10.

<sup>11</sup> Robert R. Callis and Linda C. Cavanaugh, “Census Bureau Reports on Residential Vacancies and Homeownership,” *U.S. Census Bureau News*, release dated January 29, 2008, p.4; U.S. Census Bureau, “Census Bureau Reports on Residential Vacancies and Homeownership,” April 28, 2008, p. 4, accessed May 16, 2008, at [www.census.gov/hhes/www/housing/hvs/qtr108/q108press.pdf](http://www.census.gov/hhes/www/housing/hvs/qtr108/q108press.pdf).

<sup>12</sup> David Leonhardt, “Can’t Grasp the Credit Crisis? Join the Club,” *New York Times*, March 19, 2008, accessed April 2, 2008 at <http://www.nytimes.com/2008/03/19/business/19leonhardt.html> (quoting Ethan Harris of Lehman Brothers).

<sup>13</sup> Subprime Report, at 2.

<sup>14</sup> National Association of Realtors, “Median Sales Price of Existing Single-Family Homes for Metropolitan Areas, 2005-2007,” accessed April 2, 2008 at

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<sup>25</sup> Order on Phase 1 Trial, *Calyon New York Branch v. American Home Mortgage Corp.* Adv. Pro. 07-51704, in *In re American Home Mortgage, Inc.*, Case No. 07-11047, docket no. 77, at 1.

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<sup>36</sup> *Id.* at 27-28.

<sup>37</sup> *Id.* at 29-30.

<sup>38</sup> *Id.* at 30-32.

<sup>39</sup> *Id.* at 20-21.

<sup>40</sup> *Id.* at 36-38.

<sup>41</sup> *Id.* at 45-47, Exhibit C.

<sup>42</sup> *Id.* at 52-53.

<sup>43</sup> Notice of Motion and Motion for Order Approving Debtors' Settlement with Residential Funding Company, LLC and Homecomings Financial, LLC, in *In re People's Choice Home Loan, Inc.*, Case No. 07-10765 (Bankr. C.D. Cal.), docket no. 886 (approved by order dated March 24, 2008).

<sup>44</sup> *In re Bonham*, 229 F.3d 750, 766 (9th Cir. 2000).

<sup>45</sup> PCDS, at 53-63.

<sup>46</sup> Bernanke, *supra*.

<sup>47</sup> Cagan, at 30.

<sup>48</sup> Subprime Report, at 4, 6.

<sup>49</sup> Jenny Anderson, "Wall St. Banks Confront a String of Write-Downs," *New York Times*, February 19, 2008, accessed April 2, 2008 at [http://www.nytimes.com/2008/02/19/business/19banks.html?\\_r=2&ref=business&oref=slogin&oref=slogin](http://www.nytimes.com/2008/02/19/business/19banks.html?_r=2&ref=business&oref=slogin&oref=slogin)

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<sup>55</sup> Tiffany Kary and Caroline Salas, “Bankruptcies Rise for ‘Firms that Should Have Failed (Update 1),” *Bloomberg News Service*, accessed April 15, 2008 at <http://www.bloomberg.com/apps/news?pid=20601109&sid=ar84gQGhY7Ic&refer=news> (citing Jupiter eSources LLC).

<sup>56</sup> *Id.* (New Century, American Home Mortgage, Homebanc, Delta and NetBank).

<sup>57</sup> LIBOR spreads for large 2008 cases have tended to run in the “LIBOR plus 4-7 percent” range, while DIPs for large 2007 cases tended to offer LIBOR plus 2-3 percent.

<sup>58</sup> An example of a “worst-case” scenario for debtors may be found in the adversary proceeding *Solutia, Inc. v. Citigroup Global Markets, Inc., et al.*, Adv. Pro. No. 08-01057, in *In re Solutia, Inc.*, Case No. 03-17949 (Bankr. S.D.N.Y.), a \$3.2 billion dollar lawsuit brought by a debtor after its prospective exit lender refused to close, citing problems syndicating the loan. In another case, Appaloosa Management, a \$2.55 billion exit lender, announced that it was pulling out of a \$6.1 billion exit financing package for ailing automotive components manufacturer Delphi Corporation. *In re Delphi Corporation*, Case No. 05-44481 (Bankr. S.D.N.Y.); “Appaloosa hedge fund terminates \$2.55 billion investment agreement with Delphi International,” *International Herald Tribune*, April 4, 2008, accessed on April 15, 2008 at <http://www.ihf.com/articles/2008/04/04/business/delphi.php>.

# The ABCs of PDPs: Advance Rates, Bankruptcy Risks and Collateral Management

MARK N. LESSARD

*This article examines various legal aspects of negotiating, documenting, and closing an aircraft pre-delivery payment facility, addresses the dynamics between the manufacturer and lender in a default scenario and focuses on issues of import to the borrower in the management of its aircraft order during the life of the facility.*

Since early 2004, the number and size of civil aircraft pre-delivery payment (“PDP”) financings have increased dramatically. Airlines view them as a way to enhance liquidity during the aircraft production cycle. Bankers view them as a way to get short-term exposure to aviation assets and deepen relationships. Manufacturers view them as a way to facilitate sales. With significant appreciation in aircraft values and improvements in customer credit during this period, these transactions made increasing commercial sense.

In the last 18 months, however, manufacturers have been taking new approaches to limit their risk in light of this proliferation. This article examines various legal aspects of negotiating, documenting and closing a

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PDP facility in this new setting. It begins with some brief background then summarizes the principal issues arising from the complex, tri-partite negotiations between the borrower, the lender and the manufacturer.

The first section, entitled “Advance Rates,” looks at the core issues that a lender should focus on in attempting to contain its exposure. The second section, entitled “Bankruptcy Risks,” addresses the dynamics between the manufacturer and lender in a default scenario. The last section, entitled “Collateral Management,” focuses on issues of import to the borrower in the management of its aircraft order during the life of the facility.

## BACKGROUND

A PDP financing involves the establishment of a credit facility in favor of an aircraft purchaser to finance a portion of the significant progress payments due on an aircraft order. These progress payments can run into the hundreds of millions of dollars for large orders and are especially significant for Airbus and Boeing aircraft. Often, the facility involves an initial draw to reimburse the borrower for a portion of the PDPs it has previously deposited with the manufacturer. Further PDPs are then partially funded by the lender directly to the manufacturer on each PDP due date, with the aircraft purchaser making up any shortfall. The loans for an aircraft typically mature on the delivery date for that aircraft.

The lender is secured by a first priority lien on portions of the aircraft purchase agreement and has the right to step in and purchase the relevant aircraft if the borrower defaults. In cases where there is a separate engine purchase agreement, it must be assigned as well. PDP loans relating to several aircraft are cross-collateralized so that the lender need only purchase as much equipment as is necessary to cover the debt secured by that facility. For legal purposes, this is a collateral assignment of contract rights to purchase the aircraft, as opposed to a security interest in the aircraft itself. This is because the borrower does not own the aircraft, or even its constituent parts — the manufacturer does. One can also imagine the difficulties involved in attempting to identify, trace and encumber the various aircraft parts during the production cycle and the unacceptable restraints on the manufacturer’s operations that would entail.

As a result, perfection of the lien in the United States is achieved by filing a UCC-1 financing statement in the appropriate jurisdiction; no FAA or Cape Town filings are required since these special notice systems relate to aircraft or aircraft objects only. It is not easy in any jurisdiction to determine with certainty how enforcement will take place, but it is always important for a lender to seek advice from local counsel in the borrower's jurisdiction. Parties who set up a special purpose borrower in a friendly enforcement jurisdiction to hold the purchase agreement rights should be wary of consolidation issues and taxable gains on the transfer of the purchase agreement.

The borrower, the lender and the manufacturer enter into a consent and agreement, pursuant to which the assigned purchase agreement terms and the rights of the parties are defined. Confidentiality, control over delivery slots and aircraft pricing are the key drivers for the manufacturer, which typically requires the right to buy-out the lender in a default scenario and imposes certain limitations on transfer of the asset. Negotiating this key document with manufacturers can be trying if the customer and lender have limited leverage against the manufacturer. But market standards are emerging.

### "A" STANDS FOR "ADVANCE RATES"

In a PDP facility, the lender's exposure is determined not only by the rate of its advances against the PDPs, but by the purchase price the lender ultimately would need to pay for possession of the aircraft (i.e., the loan-to-cost ratio). The exact purchase price for the customer is highly confidential and will usually not be disclosed to the lender. Instead, manufacturers typically offer a discount to the list price that makes it economically sensible for the lender to participate. But even with an agreed discount, lenders should bear in mind a number of factors that can influence the loan-to-cost ratio, including the following:

- *Escalation*: Have the escalation factors been locked down? If so, are they assignable? If not, what are the variables? Does the agreed discount apply before or after escalation? Does escalation apply during an excusable delay in delivery of the aircraft?

- *Equity and Set-Off*: How much equity does the borrower have in the form of paid-in PDPs? Has the manufacturer agreed not to set-off any unrelated borrower obligations against the paid-in equity? Has the borrower agreed that all PDP reimbursements will go directly to the lender? Upon delivery of one aircraft, is the borrower equity released or re-allocated to other aircraft?
- *Purchase Option*: What time period does the manufacturer have to exercise its right to buy-out the lender? When does that period commence? What amounts, if any, are excluded from the buy-out price? Are there any caps on interest?
- *Cherry-Picking*: Can the lender assume the right to purchase less than all of the relevant aircraft? Can the manufacturer exercise its buy-out right with respect to less than all of the aircraft?
- *Standstill Period*: How much notice must the manufacturer give to the lender before terminating the purchase agreement as it relates to the aircraft? Is the manufacturer required to enter into a substitute purchase agreement?
- *Aircraft Options and Configuration*: What is the maximum amount by which the lender's purchase price can be increased without its consent? Can the borrower exceed that limit and fund the difference to the manufacturer or to the lender as a prepayment of the loan? Does the same standard apply for FAA-mandated or other regulatory changes?
- *Warranties and Product Support*: Is the standard warranty and support package available to the lender and their potential transferees? Are the engine warranties available through the airframe manufacturer or does the lender need an assignment from the engine manufacturer? Is the manufacturer offering performance guaranties or remarketing assistance?

Just as each lender has its own pre-occupations, each deal has its own characteristics and it sometimes takes a while for the parties to achieve the right commercial balance. Escalation caps and performance guaranties, if they exist in the first instance, are contract features that are usually treated — like the purchase price itself — as highly confidential.

As a result, these should be negotiated up front along with the purchase price discount. The manufacturer waiver of its right to set-off any PDPs against unrelated customer obligations is both standard and essential for the protection of the lender, as is the cap on modifications resulting in a purchase price increase. The exact wording and mechanics surrounding the purchase option, cherry-picking and standstill period are heavily negotiated in a typical PDP financing.

### "B" STANDS FOR "BANKRUPTCY RISKS"

The most likely enforcement scenario for a PDP lender involves an airline bankruptcy, and there has been no shortage of those since the early 1990s. Yet a recent search of the Westlaw and Lexis-Nexis databases revealed no reported U.S. cases dealing with an adversarial enforcement by a PDP lender. This can partially be explained by the fact that PDP financings were out of fashion with U.S. airlines for a large part of the 1990s, but also by the fact that manufacturers typically prefer to restructure their purchase arrangements on a consensual basis (the manufacturer's option to take out the lender can be helpful in this regard). In addition, assumption by a lender of the purchase contract carries significant risks, including foreclosure risk and remarketing risk, and requires large outlays for the purchase price balance and reconfiguration. But it is certainly possible the day will come when a bankruptcy court faces the competing claims of the parties to a PDP financing.

### Automatic Stay and Adequate Protection

In order to understand the risks to the parties in a U.S. bankruptcy scenario, one should go back to the basics. The purchase contract, which has been partially assigned as security, forms part of the debtor's estate in a Chapter 11 case. This includes any rights of the airline to obtain reimbursement of PDPs under the purchase contract, which rights have also been pledged. Upon filing by an airline of a petition under Chapter 11, the lender will be stayed from foreclosing on, or stepping into, the purchase agreement. In addition, the manufacturer will be stayed from terminating the purchase agreement itself. Section 1110 of the Bankruptcy

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Code, which mandates the expiration of the automatic stay for aircraft after 60 days, does not apply to general intangibles such as the purchase agreement rights.

The PDP lender will be treated like any other secured creditor in bankruptcy. To the extent that the airline has equity in the purchase contract (*i.e.*, the combined value of the aircraft and the paid-in PDPs exceeds the debt), or that the aircraft at issue will form core assets of the restructured entity, a lender will likely encounter difficulty lifting the stay on remedies unless there is a risk of harm to the value of the collateral. U.S. bankruptcy law allows a secured creditor to ask the court for adequate protection against diminution in value or other harm in the value of the property during the bankruptcy case. If the debtor fails to provide court-ordered adequate protection, the court can terminate the automatic stay, thereby permitting the secured creditor to repossess the collateral.

The principal scenario where the collateral could face diminution in value is where the manufacturer is suffering or will imminently suffer damages from the non-performance of the airline under the purchase agreement (*e.g.*, significant overdue PDPs, failure to take delivery). This is because the lender, as assignee of purchase agreement, must make the manufacturer whole to take the aircraft; thus the lender's purchase price increases with each claim for damages by the manufacturer under the purchase agreement. In this situation, the manufacturer may petition to lift the stay and terminate the purchase agreement so that it can proceed to mitigate its losses. The lender may also petition to lift the stay on remedies so that it can foreclose and prevent the accretion of damages. If manufacturer damages truly are imminent (as in the case of an aircraft on the tarmac), it is possible that a judge would require the airline either to assume or reject the purchase agreement. It should be noted that bankruptcy courts, as courts of equity, could allow a debtor to perform on an aircraft-by-aircraft basis as they come up for delivery, even though the purchase contract and PDP facility covers several aircraft. If the airline assumes the purchase agreement as it relates to an aircraft, cures any defaults and continues to perform, then the risk of immediate harm to the manufacturer would abate and the automatic stay would remain in place. If the airline's assumption of the purchase agreement was not accompa-

nied by an assumption of the related PDP loans, a lender would still need to petition the court for the stay to be lifted or for the repayment of the related PDP loans at delivery.

### Rejection of the Purchase Contract and Enforcement Dynamics

When an airline rejects the purchase contract as it relates to an aircraft, either the manufacturer will move to terminate or the lender will move to exercise remedies. In the first case, the lender will have the agreed upon standstill period to determine whether to assume the contract as it relates to the affected aircraft. In both cases, the lender's exercise of remedies will trigger the manufacturer's buy-out option.

If the manufacturer exercises the buy-out option, it will be free to remarket the aircraft to a third party and claim damages, including incidental costs and any shortfall between the contract price and the price achieved in the market (subject to any legal duties to mitigate such damages). The PDPs held on account of such aircraft can be applied by the manufacturer against any such damages. It appears unlikely that a manufacturer would be entitled to retain PDPs in excess of its actual damages, either as liquidated damages or otherwise, although that would need to be determined on a case-by-case basis. The lender would release its lien upon receipt of the buy-out amount and retain an unsecured claim against the borrower for any shortfall between the amount received and the outstanding secured obligations relating to such aircraft.

If the manufacturer does not exercise the buy-out option, then the lender will become bound to purchase the aircraft (to the extent it has so elected). Assuming the airline's right to receive PDP refunds is properly pledged to the lender and that the manufacturer has agreed not to set-off such PDPs against unrelated obligations, the lender should get credit for all PDPs previously paid to the manufacturer on account of such aircraft. However, until foreclosure occurs and the interest of the airline in the purchase contract is extinguished, the airline can theoretically make a claim for the return of its paid-in PDPs. Initially, the lender and the manufacturer would have competing claims to those funds, but the manufacturer's claim would become moot if the lender agrees to perform under the purchase agreement. Clearly, the lender will seek to enforce its lien on those

reimbursement rights and will argue with vigor that the rejection of the purchase agreement constituted abandonment of its right to claim reimbursement of the PDP equity. After all, the lender is still bound to conduct commercially reasonable foreclosure proceedings and to account to the airline as regards the proceeds of the collateral. However, this is untested ground and there are no guarantees that the bankruptcy court will rule in favor of the lender, especially if the court finds the lender to be over-secured (though it may seem abhorrent for a lender to be over-secured when it faces enforcement expenditures that dwarf the size of the loans). Manufacturers are increasingly seeking to make sure they do not get caught holding the bag if, after giving the lender credit for PDPs, the bankruptcy court requires the manufacturer to disgorge them to the airline.

This so-called “claw-back” risk has become a sticky issue for many lenders, who do not view bankruptcy litigation as part of their collateral package. One should hope that lenders and manufacturers will realize that their interests are aligned in ensuring that all PDPs be applied to the purchase price and agree in the documentation to take all reasonable steps to make it so.

### Foreclosure and Remarketing

The Uniform Commercial Code prohibits a borrower from agreeing to a strict foreclosure prior to the occurrence of a default. Therefore, an “assumption” by the lender of the purchase contract after an event of default pursuant to pre-negotiated agreements would technically remain subject to the airline’s equity of redemption until such time as a foreclosure is properly conducted. This generally entails a commercially reasonable sale of the collateral. Given the nature of the collateral (a contractual right to purchase an aircraft), commercial reasonableness could require a targeted remarketing effort as opposed to a public sale, though in both cases the lender would be entitled to bid in its debt. Alternatively, the lender may seek a consensual foreclosure.

If no foreclosure is completed on the purchase agreement, the lender may still as mortgagee-in-possession take delivery of the aircraft by putting up the purchase price. At that point the collateral will include the

aircraft and the secured obligations will increase with the lender's expenditures. However, the airline's equity of redemption would remain intact. Foreclosure would be effective upon completion of the sale of the aircraft, at which point the proceeds would flow through the waterfall in the credit agreement and go to reimburse the lender for all enforcement expenses (including remarketing commissions) and all principal, default interest and other fees and amounts due under the document. The remainder, if any, would go the borrower.

If a foreclosure on the purchase agreement has properly been conducted, the proceeds of the foreclosure sale would similarly flow through the waterfall. However, the purchaser (which could be the lender so long as the sale was commercially reasonable) would take the purchase agreement rights free and clear of the borrower's interest. The owner of the purchase agreement would then be free to sell on the purchase agreement (subject to transfer limitations) or to take delivery of the aircraft by putting up the purchase price. In each case, any upside or downside would be for the account of the purchaser.

## "C" STANDS FOR "COLLATERAL MANAGEMENT"

The tenure of PDP facilities rarely exceeds two or three years, though the average has been increasing in tandem with manufacturer backlogs. From the time PDPs are advanced until the delivery date of the aircraft, the airline and the manufacturer must work closely together to manage the manufacturing process and prepare for the incorporation of the aircraft into the airline's fleet. In addition, the airline must arrange or finalize long-term financing for the aircraft. All of this requires significant flexibility for the airline in the management of its purchase agreement.

## Amendments and Options

The crucial element for the manufacturer is that it have "one master" at all times. If there has been no event of default, the guiding principle is that the lender should not interfere with operational aspects. It is quite common for an airline to make changes to the aircraft being delivered under the purchase agreement prior to delivery. Whether it is by amend-

ment, waiver or election, the airline and manufacturer must finalize the aircraft configuration and options, address regulatory changes and performance standards and coordinate the installation of buyer-furnished equipment. Airlines need the flexibility to adapt the aircraft and lenders usually are willing to accept some fluctuation so long as the lender's purchase price is not increased by more than an agreed cap. If for any reason that cap is exceeded as a result of a change, the airline can usually proceed and pay the manufacturer up front or prepay the loans by the amount of the excess (the latter choice makes more economic sense if the amounts are not yet due to the manufacturer). The lender's consent is nevertheless required for major changes that have an impact on the nature or value of the collateral, such as a change in aircraft type, cancellation of a delivery slot or amending the PDP due dates or scheduled aircraft delivery dates.

### Buyer-Furnished Equipment

Assigning security in the buyer-furnished equipment ("BFE") purchase agreements can be time consuming and, in some cases, futile. It is generally not practical to get an assignment of all BFE contracts where they require the consent of the BFE manufacturer. In addition, BFE is tailored for the airline that is financing PDPs; the cabin configuration is likely to be altered in the event of a repossession and disposition to a third party. For example, the in-flight entertainment equipment may be incompatible and the seating configuration sub-optimal. On the other hand, a passenger aircraft without seats or galleys is of limited use. Where the BFE involved is core to the operation of the aircraft in revenue service, a lender may wish to obtain a security assignment of those two or three core purchase agreements so that it has the option and benefit of the airline's price. Airlines should take care when negotiating BFE contracts to obtain the right to assign them as security without the BFE manufacturer's consent.

### Take-Out Financing and Delivery

An airline entering into a PDP facility should make sure that its ability to secure long-term financing is not hampered by the lien on the purchase agreement. Entry into a conditional sale or other financing commitment during the term of the PDP facility should be a permitted encum-

brance, so long as the consummation of such long-term financing transaction remains subject to payment of the amounts under the PDP facility that relate to the relevant aircraft.

Since the timing of the delivery is never etched in stone, the airline should have the option of rolling over the loans from the scheduled delivery date until the actual delivery date. Conversely, if the delivery takes place early the airline may need to pay breakage, unless it has arranged for a shortened interest period. Either way, the manufacturer will be keen to make sure that when the aircraft comes up for delivery, the lender releases its lien on the purchase agreement as it relates to that aircraft whether or not it has received all payments owed under the facility. This can sometimes result in discomfort for lenders who are not accustomed to agreeing to release any liens until they are paid in full. But manufacturers typically will not deliver an aircraft if the PDP lien remains in place because it cannot take the risk of having any remaining obligations toward the lender after the aircraft is delivered to the borrower. Ultimately, it is the airline's responsibility to make sure the lien on the purchase agreement is released prior to delivery. Some airlines have found it practical to repay the PDP loans out of available corporate funds a day or two before the aircraft delivery in order to avoid last minute complications.

## CONCLUSION

The principal factors involved in negotiating a PDP credit facility are: containing a lender's exposure, understanding bankruptcy risks and allowing the airline to manage its assets. As deal volumes have increased, parties have focused increased attention on getting the balance right. Airbus and Boeing have recently adjusted their approach to these financings and market standards appear to be emerging. But for so long as the model is untested in bankruptcy, each PDP facility will remain the product of a unique negotiation.

## Offshore Hedge Funds and Chapter 15: Can You Ever Really Go Home Again?

WILLIAM M. O'CONNOR, MATTHEW W. CHENEY, AND NOAH S. BLOOMBERG

*In consideration of the possibility of seeking relief in (or being forced into) foreign insolvency proceedings, troubled offshore funds would do well to begin preparing for the fact-intensive nature of seeking recognition of such foreign proceedings under Chapter 15.*

**A**s the well-publicized problems in the credit markets continue to unfold, hedge funds and other distressed debt investors are poised as major participants in the gathering storm of business insolvencies. Many hedge funds are well-positioned as creditors. They will bring new dynamics to bankruptcy proceedings as they act to protect their unique interests and strategies.<sup>1</sup> Others, however, will find themselves

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unable to satisfy margin calls flowing from a lack of liquidity and the devaluation of their asset portfolios.<sup>2</sup>

Some of those struggling hedge funds already have sought relief under foreign insolvency laws, and their liquidators have filed Chapter 15 petitions for relief in U.S. Bankruptcy Courts. As the full measure of the credit crisis is taken, other hedge funds also may seek bankruptcy relief in the United States. Chapter 15 of the Bankruptcy Code presents new challenges for foreign business entities, particularly for the multitude of hedge funds registered in the Cayman Islands. As discussed below, cross-border insolvency matters for hedge funds require careful planning if the desired insolvency and bankruptcy relief is to be obtained.

## CAYMAN ISLANDS IS A HEDGE FUND HAVEN

More than 10,000 hedge funds are organized and registered in the Cayman Islands.<sup>3</sup> Funds are registered in the Cayman Islands for a variety of reasons, including:

- No regulatory restriction on investment policies or strategies, commercial terms (including performance and other fee arrangements) or the choice of service providers;
- Tax neutral environment with no direct corporation, capital gains, income, profits or withholding taxes applicable to funds;
- Speed of formation together with an efficient and simple registration system with the Cayman Islands Monetary Authority (“CIMA”);
- No requirement to appoint local directors or service providers (except for an approved auditor); and
- A regulatory regime that focuses on full and transparent disclosure in the offering document of all information necessary to enable a prospective investor to make an informed decision as to whether or not to invest in the fund and on an annual audit of the financial statements by an independent auditor to approved by CIMA.<sup>4</sup>

Although the Cayman Islands present many attractive qualities, in

today's economic climate, hedge funds would be well advised to understand the basic mechanics of Chapter 15. Advance planning may help to minimize potential problems in obtaining bankruptcy relief in the U.S. The recent decisions discussed below, which apply new Chapter 15 to offshore funds, underscore that obtaining relief in the U.S. is no longer a simple matter.

## BACKDROP TO THE NEW CHAPTER 15

In an effort to keep pace with the continued globalization of the world economy, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") created an entirely new chapter under title 11 of the United States Code (hereinafter, the "Bankruptcy Code") to address cross-border insolvencies. Chapter 15 of the Bankruptcy Code, entitled "Ancillary and Other Cross-Border Cases," adopts nearly all of the 1997 Model Law on Cross-Border Insolvency (the "Model Law") promulgated by the United Nations Commission on International Trade Law ("UNCITRAL").<sup>5</sup>

The Model Law was a direct response to inconsistent treatment of cross-border insolvencies around the world and sought to provide a uniform framework for their resolution.<sup>6</sup> In fact, this goal was so important to the drafters of the Model Law that it served as the basis for the Preamble to the Model Law, which provides:

The purpose of this Law is to provide effective mechanisms for dealing with cases of cross-border insolvency so as to promote the objectives of:

- (a) Cooperation between the courts and other competent authorities of this State and foreign States involved in cases of cross-border insolvency;
- (b) Greater legal certainty for trade and investment;
- (c) Fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested persons, including the debtor;

- (d) Protection and maximization of the value of the debtor's assets;  
and
- (e) Facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.<sup>7</sup>

By adopting most of the Model Law, Congress implemented significant changes to the administration of cross-border insolvency matters in the U.S. The move toward international cohesion regarding cross-border insolvencies is evidenced by the first subsection of Chapter 15, wherein Congress restated (almost verbatim) the Preamble to the Model Law in setting forth Chapter 15's purposes.<sup>8</sup>

## CHAPTER 15 REPLACED SECTION 304

Prior to BAPCPA, foreign liquidators, representatives, trustees, and similar parties seeking a unified process for the resolution of disputes and distribution of assets of foreign entities sought relief in the United States by filing a petition under Section 304 of the Bankruptcy Code. Upon the filing of a Section 304 petition, a U.S. bankruptcy case ancillary to a foreign proceeding was commenced. In an ancillary case, certain relief could be granted under Section 304. When determining whether to grant such relief, bankruptcy courts considered a list of factors set out in Section 304(c). The required analysis under Section 304 was subjective, and largely dependent on the application of the doctrine of comity to the unique circumstances of each case.<sup>9</sup>

Under Chapter 15, a petition for recognition of a foreign proceeding must be filed in accordance with Section 1515.<sup>10</sup> Chapter 15 contains a process for "recognition" of a foreign insolvency proceeding, under which the court's discretion is limited severely.<sup>11</sup> As a result, under the objective test for recognition, granting of recognition is not automatic.

Pursuant to Section 1517, a foreign proceeding shall only be recognized if it is a "foreign main proceeding" or "foreign nonmain proceeding." A foreign proceeding shall be recognized as a foreign main proceeding under Chapter 15 "if it is pending in the country where the debtor has the center of its main interests ["COMI"]."<sup>12</sup> A foreign proceeding

shall be recognized as a foreign nonmain proceeding under Chapter 15 “if the debtor has an establishment within the meaning of Section 1502 in the foreign country where the proceeding is pending.”<sup>13</sup>

Section 1502(2) further defines “establishment” as “any place of operations where the debtor carries out a nontransitory economic activity.” The determination of whether a foreign debtor has its COMI or, in the alternative, an establishment in the foreign country in which the foreign proceeding is pending is at the heart of Chapter 15. That determination directly impacts the scope of available relief.<sup>14</sup>

Although the term “COMI” is not defined in the Model Law or the Bankruptcy Code, Section 1516(c) of the Bankruptcy Code provides that “[i]n the absence of evidence to the contrary, the debtor’s registered office, . . . , is presumed to be the center of the debtor’s main interests.”<sup>15</sup> Moreover, UNCITRAL advises that the COMI “should correspond to ‘the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties.’”<sup>16</sup> As the discussion of particular cases below indicates, however, the determination of a debtor’s COMI and the interrelationship between the recognition provisions of Section 1517 and the presumption contained in Section 1516(c) are not nearly as simple as one would hope.<sup>17</sup>

## THE APPLICATION OF CHAPTER 15 TO CAYMAN ISLAND HEDGE FUNDS

As the problems in the credit markets began, a few hedge funds were unable to satisfy margin calls. These funds sought relief under foreign insolvency laws, followed by Chapter 15 petitions for relief in U.S. Bankruptcy Courts. A discussion of three such cases involving funds registered in the Cayman Islands follows. These cases demonstrate the challenges of obtaining “recognition” under Chapter 15 and the importance of proper pre-bankruptcy planning.

### *In re Amerindo Internet Growth Fund Ltd.*<sup>18</sup>

Amerindo Internet Growth Fund Ltd. (“Amerindo”) is a Cayman Islands hedge fund managed by Amerindo Investment Advisors, Inc.,

based in San Francisco, California. In December 2006, Amerindo was placed into foreign insolvency proceedings in the Cayman Islands due, in part, to an investigation by the U.S. Securities and Exchange Commission ("SEC") into allegations of fraud, commingling and misappropriation of funds, and other improprieties.

On February 9, 2007, the foreign liquidators for Amerindo filed a Chapter 15 petition seeking recognition of the Cayman Islands insolvency proceeding as a foreign main proceeding. In *In re Amerindo Internet Growth Fund Ltd.*, the foreign liquidators argued that Amerindo's COMI was in the Cayman Islands and, thus, the court must recognize the foreign insolvency proceeding as a foreign main proceeding under Section 1517(b)(1).

In support of this position, the foreign liquidators alleged numerous facts in the Chapter 15 petition indicating that the hedge fund's COMI was in fact located in the Cayman Islands. For example, the liquidators alleged that the administrator of the hedge fund, responsible for the day-to-day operations of the hedge fund, was at all times a Cayman Islands company.<sup>19</sup> Similarly, they alleged that the books and records of the hedge fund were maintained and stored in the Cayman Islands and subject to audits by a Cayman Islands company. According to the Amerindo Verified Petition, the only evidence that the hedge fund's COMI may not be in the Cayman Islands was the fact that the assets of the hedge fund, approximately \$14 million, were held by the Bear Stearns Securities Corporation in New York.<sup>20</sup>

In ruling on the foreign liquidators' petition under Chapter 15, the bankruptcy court did not undertake a lengthy analysis. Rather, the court succinctly laid out its findings and conclusions.<sup>21</sup> The court held that the foreign proceeding constituted a foreign main proceeding under 11 U.S.C. § 1517(b)(1).<sup>22</sup>

***In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, and *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*<sup>23</sup>**

On July 31, 2007, the liquidators for two Cayman Islands hedge funds managed by Bear Stearns filed Chapter 15 petitions in New York.<sup>24</sup> The

two Bear Stearns' funds suffered significant investment losses in 2007, due in large part to the current sub-prime mortgage crisis.<sup>25</sup> As a result of the devaluation of the asset portfolio arising from those losses, the respective boards of directors voted to wind up the funds pursuant to the Companies Law of the Cayman Islands.

The opinions by Judge Burton R. Lifland in these cases present an excellent analysis of the new framework under Chapter 15, in part because Judge Lifland, an expert on cross-border insolvencies, is a principal author of both the Model Law and Chapter 15.<sup>26</sup>

The petitioning liquidators sought recognition of the Cayman Islands insolvency proceedings for Bear Stearns Funds as foreign main proceedings. In stark contrast to the Amerindo Verified Petition, the Chapter 15 petitions in Bear Stearns Funds did not on their face support an argument that the funds' COMI was located in the Cayman Islands. Rather, the petitions stated facts that supported a determination that the funds' COMI was in the United States.

Specifically, the Bear Stearns Verified Petitions reflected that the administrator of the funds, who oversaw all day-to-day operations, was a Massachusetts corporation and that the assets of the funds were located in New York.<sup>27</sup> In addition, while the Bear Stearns Enhanced Fund Verified Petition stated that the books and records of that fund were located in the Cayman Islands,<sup>28</sup> the Bear Stearns Master Fund Verified Petition stated that the books and records of that fund were kept in Delaware.<sup>29</sup> The court ultimately determined that the books and records of both funds were stored and maintained in Delaware.<sup>30</sup> Aside from the funds' registration in the Cayman Islands, the foreign representatives presented no evidence to support a finding that the funds' COMI was in the Cayman Islands.

Although no party in interest objected to the Chapter 15 petitions, the bankruptcy court refused to rubber stamp the petitions with a determination of recognition, stating "[t]his court must make an independent determination as to whether the foreign proceeding meets the definitional requirements of Sections 1502 and 1517 of the Bankruptcy Code."<sup>31</sup>

The court first analyzed the relationship between the cases before it and the presumption in Section 1516(c) that, "[i]n the absence of evidence to the contrary, the debtor's registered office, . . . is presumed to be the cen-

ter of the debtor's main interests." The court found that "evidence to the contrary" was supplied by the foreign representatives in the verified petitions.<sup>32</sup> Specifically, the court found that the verified petitions stated that the funds were administered in the United States by a Massachusetts corporation, the funds' books and records were located in Delaware, and the funds' assets were located in New York. As a result, the court denied recognition as a foreign main proceeding.

Next, the court considered whether the funds maintained an "establishment" in the Cayman Islands and, if so, whether the foreign proceedings constituted foreign nonmain proceedings. In its analysis, the court focused on the funds' registration in the Cayman Islands under the Companies Law (2004 revision) of the Cayman Islands § 193.<sup>33</sup> Judge Lifland found that, because Section 193 of the Companies Law (2004 Revision) of the Cayman Islands prohibited exempted companies from "engaging in business in the Cayman Islands except in furtherance of their business otherwise carried on outside of the Cayman Islands," it would be especially difficult for an exempted company, such as the funds at issue in Bear Stearns Funds, to carry out a nontransitory economic activity there sufficient to warrant the finding of an "establishment."<sup>34</sup> The court thus concluded that the petitioning liquidators had failed to demonstrate that the funds had an "establishment" in the Cayman Islands. As a result, recognition of the foreign proceedings as either foreign main or foreign nonmain proceedings was denied.<sup>35</sup>

The petitioning liquidators appealed Judge Lifland's decision to the U.S. District Court.<sup>36</sup> They argued that the bankruptcy court erred in applying Chapter 15 in a rigid manner rather than the more pragmatic approach utilized by the court in *SPhinX*.<sup>37</sup> Specifically, the appellants argued:

- Chapter 15 provides a flexible framework for recognition, as opposed to the more rigid analysis employed by the court;
- the court erroneously interpreted the COMI presumption contained in Section 1516(c);
- the court incorrectly interpreted Section 193 of the Companies Law (2004 revision) of the Cayman Islands in finding that, as exempted companies, the funds did not have an "establishment" in the Cayman

Islands; and

- the court’s interpretation of Chapter 15 should be rejected as it “read[s] into Chapter 15 more onerous hurdles to recognition than former Section 304.”<sup>38</sup>

In response to the appellants’ brief, three of the principal authors of Chapter 15 sought and were granted leave of court to file a Brief of Amici Curiae (the “Opposition Brief”).<sup>39</sup> The Opposition Brief details the correctness of Judge Lifland’s application of Chapter 15, including a discussion of the mechanics and legislative history of Chapter 15 and the flaws in the arguments put forth by the petitioning liquidators on appeal.<sup>40</sup> For example, the amici argue that the objective approach employed by Judge Lifland in reaching his decision to deny recognition to the funds was consistent with both the Model Law and Chapter 15.<sup>41</sup>

The amici further argued that the foreign representatives could not possibly demonstrate an “establishment” in the Cayman Islands as all of the funds’ assets and operations were located in the United States.<sup>42</sup> According to the Bear Stearns Verified Petitions, the only connection between the funds and the Cayman Islands was their registration as exempt companies.

The appellants subsequently filed a reply in which they largely restated the arguments made in their opening brief. In an attempt to rebut the powerful effect of the amici’s statement of their intent as the drafters of Chapter 15, the appellants argued that the amici’s arguments lacked a basis in both law and fact. On May 27, 2008, the district court affirmed the bankruptcy court’s denial of recognition.<sup>43</sup>

#### *In re Basis Yield Alpha Fund (Master)*<sup>44</sup>

On August 29, 2007, the foreign liquidators for a Cayman Island hedge fund managed by Basis Capital, based in Sydney, Australia, filed a Chapter 15 petition for recognition of Cayman Islands insolvency proceedings as foreign main proceedings. In *In re Basis Yield Alpha Fund (Master)* (“*Basis Yield*”), the foreign liquidators further tested the presumption contained in Section 1516(c).

In response to the Chapter 15 petition, the court directed the petition-

ers to produce evidence of the fund's COMI and/or evidence as to whether the fund had an "establishment" in the Cayman Islands.<sup>45</sup> After the evidentiary hearing on recognition had been set, the foreign liquidators moved for summary judgment. They argued that because the fund was registered in the Cayman Islands and "because no evidence has been presented even suggesting that the [fund]'s COMI is in a jurisdiction other than the Cayman Islands, recognition of the [foreign proceeding] as a foreign main proceeding is proper as a matter of law."<sup>46</sup> The foreign liquidators also argued that Section 1516(c) should allow them, in the absence of any objections to the assertion that the fund's COMI is in the Cayman Islands, to avoid the unnecessary expenditure of additional estate resources to produce evidence as to the actual COMI of the funds.<sup>47</sup> The foreign liquidators further argued that such an evidentiary determination would be a waste of judicial resources.<sup>48</sup>

The foreign liquidators cited numerous cases, some of which have been discussed here, in which a foreign proceeding was granted recognition.<sup>49</sup> None of the cases relied upon by the foreign liquidators, however, involved a motion for summary judgment on the issue of recognition. Instead, in all of the cited cases, the court made a factual determination as to the location of the COMI based on the evidence, or lack thereof.

The bankruptcy court denied the Basis Yield Motion, agreeing with Judge Lifland's decision in *Bear Stearns*.<sup>50</sup> The court in *Basis Yield* ruled that "a court engaging in a recognition determination under Section 1517 is not bound by parties' failure to object; may, if it is so advised, consider any and all relevant facts (including facts not yet presented); and that the circumstances here make further factual inquiry necessary and appropriate."<sup>51</sup> In particular, the court found that no facts had been presented concerning the fund's COMI by any party.<sup>52</sup>

In considering the Basis Yield Motion, the court determined that the fund's registration under Section 193 of the Companies Law of the Cayman Islands was sufficient to merit its declining "to use a Section 1516 presumption as a substitute for actual evidence."<sup>53</sup> In reaching this determination, the court asked rhetorically, "[i]f the operation of the...exempted company will be conducted mainly outside the Islands, consistent with the representation required to be made under [the

Companies Law of the Cayman Islands], is it clear, as a matter of law, in the absence of additional facts, that the exempted company's [COMI] nevertheless is in the Islands?"<sup>54</sup>

The court acknowledged that a situation could arise in which an exempted company could make a sufficient COMI showing. However, the court refused to find as such in the context of a motion for summary judgment. Ultimately, the court concluded that the Section 1516 presumption "does not tie the hands of a court to examine the facts more closely in any instances where the court regards the issues to be sufficiently material to warrant further inquiry."<sup>55</sup>

As further support for the court's determination that it was free to require further evidence, the court found that under Section 1517 and Federal Rule of Evidence 614, the court has the right to inquire into facts so that it may satisfy itself that the requirements of Section 1517 are fulfilled.<sup>56</sup> Specifically, the court said that "[t]he court's power to ascertain the facts cannot be sidestepped by failures to object. Nor can it be sidestepped by elections not to plead or introduce inconvenient facts."<sup>57</sup>

The court also determined that it was not bound by the failure of any party to object. Relying on Judge Lifland's decision in *Bear Stearns* and in part on the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, the court found that the presumption of Section 1516(c) need not be called into question by a party, but may be called into question by the court.<sup>58</sup> The court also observed that the policy underlying Section 1517 permits a court to make its own determination as to the COMI.<sup>59</sup>

The court's decision in *Basis Yield* is a strong indication that, even in the absence of objections to recognition, the presumption under Section 1516(c) is not the final word. In denying summary judgment, Judge Gerber found that "the petition was strikingly silent as to the nature or extent of any business activity Basis Yield conducts (or in the relevant times conducted) in the Cayman Islands. Likewise, it was silent, *inter alia*, as to whether Basis Yield staffed any employees or managers in the Cayman Islands; whether any of its assets were in the Cayman Islands; and the location from which Basis Yield's funds were in fact managed."<sup>60</sup>

In denying the Basis Yield Motion, the court directed the petitioners

to produce evidence regarding the issues specified in the Order Re Upcoming Hearing on Motion for Recognition at a future hearing to be scheduled by the court. Rather than present their argument at an evidentiary hearing, however, the petitioners filed a motion seeking voluntary dismissal of the case.<sup>61</sup> The motion was granted on April 30, and the case was closed May 6, 2008.

## RECOGNITION OF FOREIGN PROCEEDINGS REQUIRES ADVANCE PLANNING

The foregoing cases reflect some of the challenges that offshore hedge funds face when seeking relief under new Chapter 15. Unlike the flexible, discretionary standards under which courts could grant relief under old Section 304 for reasons of comity, recognition of a foreign proceeding under Chapter 15 requires the petitioners to satisfy an objective test.

A foreign proceeding may be recognized under Chapter 15 as either main or nonmain. In light of the *Bear Stearns* and *Basis Yield* decisions, Chapter 15 petitions should not rely solely on the presumption of Section 1516(c) to demonstrate a debtor's COMI. In fact, for funds registered in the Cayman Islands as exempt companies under Section 193 of the Companies Law, that fact alone appears to rebut Section 1516(c)'s presumption. Thus, representatives of offshore hedge funds seeking Chapter 15 recognition should articulate a factual basis for recognition rather than relying on a fund's registration in the Cayman Islands and the presumption in Section 1516(c).

Given that exempt companies are prohibited from engaging in business in the Cayman Islands, it may be difficult to produce facts demonstrating a COMI in Cayman Islands for recognition of a foreign main proceeding. Thus, it would be prudent for troubled offshore funds to engage in pre-insolvency planning to better position themselves to obtain Chapter 15 relief.

Based on the *Bear Stearns* and *Basis Yield* opinions, it is crucial to consider the locations where a fund can demonstrate that it has an "establishment" for purposes of recognition as a foreign nonmain proceeding. Depending on the exigencies of the circumstances, offshore funds may be

able to consider other planning alternatives. In any event, a stressed offshore fund should consider the following factors, among others, before the fund becomes distressed: the locations of offices; the extent and scope of business operations in such offices; and the location(s) of assets, books and records, officers, directors, employees, fund administrators/managers, and advisors.

## CONCLUSION

As the scope and depth of the current credit crisis comes to light, hedge funds will be participants in the resulting insolvency issues. Many hedge funds are positioned to realize significant value as they help shake out the unprecedented leverage placed on distressed assets. Others, however, may find themselves unable to satisfy margin calls or survive the loss of investor confidence. In consideration of the possibility of seeking relief in (or being forced into) foreign insolvency proceedings, troubled offshore funds would do well to begin preparing for the fact-intensive nature of seeking recognition of such foreign proceedings under Chapter 15. Such funds should consult with insolvency counsel to map out a strategy, which should include considering options for whether and where to file foreign insolvency proceedings and whether and where to file Chapter 15 or Chapter 11 proceedings in the United States.

## NOTES

<sup>1</sup> Mark S. Lichtenstein and Matthew W. Cheney, *Riding the Fulcrum Seesaw: How Hedge Funds Will Change the Dynamics of Future Bankruptcies*, ALM's THE BANKRUPTCY STRATEGIST, Vol. 24, No. 12 (Oct. 2007).

<sup>2</sup> Ritchie Capital Management LLC found itself fighting an involuntary Chapter 11 petition filed by investors, who forced one of Ritchie Capital's hedge funds into bankruptcy in an attempt to recover their investments. See *In re Ritchie Multi-Strategy Global LLC*, No. 07-24236 (SPS) (Bankr. N.D. Ill. 2007), [www.ilnb.uscourts.gov](http://www.ilnb.uscourts.gov). The bankruptcy court eventually dismissed the involuntary bankruptcy petition at a hearing on April 11, 2008.

<sup>3</sup> *Cayman Islands Welcomes 10,000th Fund Registration*, <http://www.off->

shore2offshore.com/news/Cayman+Islands+Welcomes+10,000th+Fund+Registration.

<sup>4</sup> Alan de Saram, *Cayman Islands: Hedge Funds – a Cayman Islands Success Story*, Dec. 2, 2005, [www.mondaq.com/article.asp?articleid=36416](http://www.mondaq.com/article.asp?articleid=36416).

<sup>5</sup> The UNCITRAL Model Law can be found at U.N. G.A., 52d Sess., Supp. No. 17 (A/52/17). The Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency (the “Guide”) can be found at U.N. Gen. Ass., UNCITRAL 30th Sess. U.N. Doc. A/CN.9/442 (1997).

<sup>6</sup> Jennifer D. Morton, Note, *Recognition of Cross-Border Insolvency Proceedings: An Evaluation of Solvent Schemes of Arrangement and Part VII Transfers Under U.S. Chapter 15*, 29 FORDHAM INT’L L.J. 1312, 1336 (2006).

<sup>7</sup> UNCITRAL Model Law on Cross-Border Insolvency, U.N. G.A., 52d Sess., Supp. No. 17 (A/52/17).

<sup>8</sup> See 11 U.S.C. § 1501(a).

<sup>9</sup> See also S. Rep. 95-989, 1978 U.S.C.C.A.N. 5787, 5821 (“These guidelines are designed to give the court the maximum flexibility in handling ancillary cases. Principles of international comity and the respect for the judgments and laws of other nations suggest that the court be permitted to make the appropriate orders under all of the circumstances of each case, rather than being provided with inflexible rules.”).

<sup>10</sup> See 11 U.S.C. § 1504.

<sup>11</sup> “Recognition” is defined in 11 U.S.C. § 1502(7) as “the entry of an order granting recognition of a foreign main proceeding or foreign nonmain proceeding under this chapter.” Recognition of foreign proceedings and other matters under Chapter 15 are core proceedings under 28 U.S.C. § 157(b)(2)(P), and thus properly heard by the bankruptcy court. In determining where to commence a case under Chapter 15, the foreign representative must be mindful of the changes to the venue statute, 28 U.S.C. § 1410, which requires a foreign representative to file the petition in the district court:

for the district (1) in which the debtor has its principal place of business or principal assets in the United States; (2) if the debtor does not have a place of business or assets in the United States, in which there is pending against the debtor an action or proceeding in a Federal or State court; or (3) in a case other than those specified in paragraph (1) or (2), in which venue will be consistent with the interests of justice and the convenience of the parties, having regard to the relief sought by the foreign representative.

See also Hon. Sid Brooks & Robert Lantz, *Transnational Insolvency 101: A Guide to Cross-Border Bankruptcy Proceedings*, 16 J. Bankr. L. & Prac. 5, Art. I, p.4 (October 2007).

<sup>12</sup> 11 U.S.C. § 1517(b)(1), see also 11 U.S.C. § 1502(4).

<sup>13</sup> 11 U.S.C. § 1517(b)(2), see also 11 U.S.C. § 1502(5).

<sup>14</sup> See, e.g., Lynn P. Harrison 3rd & Jerrold L. Bregman, *Chapter 15 of the U.S. Bankruptcy Code: A Hands-on Guide to the New World Order of Ancillary and Cross-border Cases*, 14 J. Bankr. L. & Prac. 5, Art. I, p.4 (October 2005).

<sup>15</sup> 11 U.S.C. § 1516(c).

<sup>16</sup> UNCITRAL Legislative Guide on Insolvency Law, 41 ¶ 13 (United Nations 2005), quoting European Council (EC) Regulation No. 1346/2000 (Recital 13) of May 29, 2000; see also *The Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency*, U.N. Gen. Ass., UNCITRAL 30th Sess. U.N. Doc. A/CN 9/442 (1997).

<sup>17</sup> It is also important to note that the drafters of Chapter 15 included a public policy exception in Section 1506, whereby the court may refuse “to take an action governed by [Chapter 15] if the action would be manifestly contrary to the public policy of the United States.” The drafters of Chapter 15 intended this provision to be interpreted narrowly, restricting the application of the exception to the most fundamental policies of the United States. H.R. REP. No. 109-31, pt. 1, FN. 116 (2005), citing *The Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency*, U.N. Gen. Ass., UNCITRAL 30th Sess. U.N. Doc. A/CN 9/442 (1997) at 25; see also Morton, *supra* note 6, at 1344.

<sup>18</sup> *In re Amerindo Internet Growth Fund Ltd.*, Case No. 07-10327 (RDD) (Bankr. S.D.N.Y. 2007).

<sup>19</sup> Verified Petition for Recognition of Foreign Main Proceeding Pursuant to Sections 1515 and 1517 of the Bankruptcy Code and Related Relief at 4, *In re Amerindo Internet Growth Fund Ltd.*, Case No. 07-10327 (Bankr. S.D.N.Y. 2007), ECF 2, www.nysb.uscourts.gov. (“Amerindo Verified Petition”).

<sup>20</sup> The stated objective of the Chapter 15 petition was to obtain a court order compelling the Bear Stearns Securities Corporation in New York to release the funds to the foreign representatives, who had refused to do so absent such an order.

<sup>21</sup> The judge in *In re Amerindo Internet Growth Fund, Ltd.*, Judge Robert D. Drain, was also the judge in *In re SPhinX, Ltd., et al.*, Case No. 06-11760

(RDD) (Jointly Administered) (“*SPhinX*”). *SPhinX* was one of the first Cayman Island hedge fund cases before the bankruptcy court for the Southern District of New York, and Judge Drain’s decision to recognize the foreign proceeding without determining whether it constituted a foreign main or foreign nonmain proceeding was criticized. *See, e.g.*, Daniel M. Glosband, *SPhinX Chapter 15 Opinion Misses the Mark*, 25 Am. Bankr. Inst. J. 44 (Dec./Jan. 2007). Mr. Glosband is one of the drafters of Chapter 15.

<sup>22</sup> Order Granting Recognition of Foreign Main Proceeding Pursuant to Sections 1515 and 1517 of the Bankruptcy Code and Related Relief at 3, *In re Amerindo Internet Growth Fund Ltd.*, Case No. 07-10327 (Bankr. S.D.N.Y. 2007), ECF 7, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov).

<sup>23</sup> *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Case No. 07-12383 (BRL) (Bankr. S.D.N.Y. 2007) and *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Case No. 07-12384 (BRL) (Bankr. S.D.N.Y. 2007).

<sup>24</sup> *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.* Chapter 15, Case No. 07-12383 (BRL) (Bankr. S.D.N.Y. 2007) (“Bear Stearns Master Fund”) and *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Chapter 15, Case No. 07-12384 (BRL) (Bankr. S.D.N.Y. 2007) (“Bear Stearns Enhanced Fund,” and together with Bear Stearns Master Fund, “Bear Stearns Funds”).

<sup>25</sup> Verified Petition for Recognition of Foreign Main Proceeding Pursuant to Section 1515 and 1517 of the Bankruptcy Code and Related Relief, ¶ 4, *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Case No. 07-12383, ECF 2, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) (“Bear Stearns Master Fund Verified Petition”); Verified Petition for Recognition of Foreign Main Proceeding Pursuant to Section 1515 and 1517 of the Bankruptcy Code and Related Relief, ¶ 4, *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Case No. 07-12384, ECF 2, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) (“Bear Stearns Enhanced Fund Verified Petition,” and together with Bear Stearns Master Fund Verified Petition, the “Bear Stearns Verified Petitions”).

<sup>26</sup> Amended Decision and Order Denying Recognition of Foreign Proceeding, *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Case No. 07-12383, ECF 26, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) and *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Case No. 07-12384, ECF 25,

www.nysb.uscourts.gov (“Bear Stearns Amended Decision”).

<sup>27</sup> Master Fund Verified Petition, ¶ 9; Enhanced Fund Verified Petition, ¶ 6.

<sup>28</sup> Enhanced Fund Verified Petition, ¶ 3.

<sup>29</sup> Master Fund Verified Petition, ¶ 3.

<sup>30</sup> Bear Stearns Amended Decision, at 3 (stating “[t]he books and records of the [f]unds are maintained and stored in Delaware.”).

<sup>31</sup> Bear Stearns Amended Decision, at 5.

<sup>32</sup> *Id.* at 10, 12.

<sup>33</sup> Companies Law (2004 Revision) of the Cayman Islands § 193 states that “[a]n exempted company shall not trade in the Islands with any person, firm or corporation except in furtherance of the business of the exempted company carried on outside the islands: [p]rovided that nothing in this section shall be construed so as to prevent the exempted company effecting and concluding contracts in the Islands and exercising in the Islands all of its powers necessary for the carrying on of its business outside the Islands.”

<sup>34</sup> Bear Stearns Amended Decision, at 15.

<sup>35</sup> *Id.* at 18-19.

<sup>36</sup> *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Civil Case No. 07-8730 (RWS) (S.D.N.Y. 2007); *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Civil Case No. 07-8746 (RWS) (S.D.N.Y. 2007).

<sup>37</sup> Appellants’ Opening Brief at 3-4, *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Civil Case No. 07-8730 (RWS) (S.D.N.Y. 2007); *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.*, Civil Case No. 07-8746 (RWS) (S.D.N.Y. 2007). There is some irony in this argument given the significant criticism by commentators of the *SPhinX* decision. See, e.g., Glosband, *supra* note 21.

<sup>38</sup> *Id.* at 15-39.

<sup>39</sup> The three authors are Daniel M. Glosband, *see supra* note 21, Professor Jay L. Westbrook of the University of Texas School of Law, and Professor Kenneth N. Klee of the UCLA School of Law. As mentioned earlier, another author of both the Model Law and Chapter 15 was Judge Lifland, whose decision was the subject of the appeal.

<sup>40</sup> Brief of Amici Curiae, *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Civil Case No. 07-8730 (RWS) (S.D.N.Y. 2007); *In re Bear Stearns High-Grade Structured Credit Strategies Enhanced*

*Leverage Master Fund, Ltd.*, Civil Case No. 07-8746 (RWS) (S.D.N.Y. 2007).

<sup>41</sup> *Id.* at 25.

<sup>42</sup> *Id.* at 27-28.

<sup>43</sup> Opinion, *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, Civil Case No. 07-8730 (RWS) (S.D.N.Y. 2008).

<sup>44</sup> *In re Basis Yield Alpha Fund (Master)*, Case No. 07-12762 (REG) (Bankr. S.D.N.Y. 2007).

<sup>45</sup> Order Re Upcoming Hearing on Motion for Recognition, *In re Basis yield Alpha Fund (Master)*, Case No. 07-12762, ECF 16, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) (Bankr. S.D.N.Y. 2007). For the list of specific issues that the court directed the foreign liquidators to address, please see the Order Re Upcoming Hearing on Motion for Recognition.

<sup>46</sup> Memorandum of Law in Support of Foreign Representatives' Motion for Summary Judgment Regarding Recognition of this Chapter 15 Case as a Foreign Main Proceeding at 7, *In re Basis Yield Alpha Fund (Master)*, Case No. 07-12762, ECF 27, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) (Bankr. S.D.N.Y. 2007) ("Basis Yield Motion").

<sup>47</sup> *Id.* at 10.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.* citing *SPhinX*, *supra* note 21 (recognizing proceeding as a foreign non-main proceeding); *In re Bancredit Cayman Ltd. (In Liquidation)*, Case No. 06-11026 (SMB) (Bankr. S.D.N.Y. 2006) (recognizing proceeding as foreign main proceeding); *Amerindo*, Case No. 07-10327 (RDD) (Bankr. S.D.N.Y. 2007) (recognizing proceeding as foreign main proceeding).

<sup>50</sup> Decision and Order on Motion for Summary Judgment Seeking Recognition as Foreign Main Proceeding, *In re Basis Yield Alpha Fund (Master)*, Case No. 07-12762, ECF 37, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) (Bankr. S.D.N.Y. 2007) ("Basis Yield Order").

<sup>51</sup> *Id.* at 2.

<sup>52</sup> *Id.* at 14.

<sup>53</sup> *Id.* at 15.

<sup>54</sup> *Id.* at 16 (internal quotations omitted).

<sup>55</sup> *Id.* at 22.

<sup>56</sup> *Id.* at 18.

<sup>57</sup> *Id.*

<sup>58</sup> Basis Yield Order at 20.

<sup>59</sup> *Id.* at 21.

<sup>60</sup> *Id.*

<sup>61</sup> Motion for Entry of an Order Dismissing the Foreign Debtors' Chapter 15 Proceeding, *In re Basis Yield Alpha Fund (Master)*, Case No. 07-12762, ECF 40, [www.nysb.uscourts.gov](http://www.nysb.uscourts.gov) (Bankr. S.D.N.Y. 2007).

# Canadian Insolvency Law Reform

STEVEN J. WEISZ AND JACKIE MOHER

*This article provides an overview of amendments to the Canadian Insolvency expected to come into force this year.*

On June 3, 2005, Bill C-55 was introduced in the House of Commons. Bill C-55, entitled “An Act to Establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangement Act and to make consequential amendments to other Acts,”<sup>1</sup> proposed sweeping changes to Canada’s principal insolvency statutes. It was passed into law on November 25, 2005 and became Chapter 47 of the Statutes of Canada 2005 (the “2005 Amendments”). However, the legislation has yet to be proclaimed into force, as the Standing Senate Committee on Banking, Trade and Commerce (the “Senate Committee”) identified numerous technical flaws in the legislation and declared that further study was needed in a number of areas to ensure the effectiveness of Canada’s insolvency legislation. It was understood that prior to coming into force, the legislation would be subject to further review to resolve the identified technical issues. Accordingly, Parliament passed Bill C-12, the effect of which was to amend the earlier version of the amendments passed in 2005 (the “2007 Revisions”).<sup>2</sup> The 2005 statute, as amended, (the “Legislative

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Amendments”) is expected to come into force in 2008; however, a coming into force date has not yet been tabled.

As mentioned, the amendments propose to amend Canada’s principal insolvency statutes, namely the Bankruptcy and Insolvency Act<sup>3</sup> (the “BIA”) and the Companies’ Creditors and Arrangement Act (“CCAA”).<sup>4</sup>

The BIA is the principal statute for the liquidation of an insolvent debtor’s estate (both corporate and consumer) by the appointment of a trustee in bankruptcy over the debtor’s assets. The BIA also provides for the appointment of an interim receiver (discussed below). Further, the BIA contains proposal provisions which allow a debtor to seek a compromise of its debts with its creditors (a “BIA Proposal”). The BIA Proposal provisions are typically used for smaller, less complicated matters.

The CCAA is Canada’s principal statute for the reorganization of companies of significant size and complexity and only applies to debtors (including affiliates) that have liabilities in excess of C\$5 million. It is currently only 22 sections in length. In order to be applied effectively, vast judicial discretion and reliance on common law precedent (that is, prior consideration of matters before the court) is required. Initial orders, granting relief to debtors under the CCAA will, among other things: impose a sweeping stay of proceedings against the debtor and its assets; appoint a monitor as an officer of the court to be the eyes and ears of the court in the restructuring; and authorize the debtor to file a plan of arrangement or compromise with its creditors (a “CCAA Plan”). In many ways, it is analogous to Chapter 11 of the United States Bankruptcy Code (the “U.S. Code”).

The Legislative Amendments will create the Wage Earner Protection Program Act (the “WEPPA”),<sup>5</sup> which will create the legislative framework for the Wage Earner Protection Program (the “WEPP”), which will be discussed later.

This article provides a broad overview of the Legislative Amendments as they relate to the WEPPA, the BIA and the CCAA. Specifically, the article will address changes relating to:

- Cross-Border Insolvencies;
- Employee Protections;

- Successor Employer Liability;
- DIP Financing;
- Eligible Financial Contracts;
- Disclaimer of Contracts;
- Assignment of Agreements;
- National Receivers;
- Equity Claims;
- Income Trusts;
- Transfers at Undervalue;
- Stay of Actions by Regulatory Authorities;
- Monitors, Receivers and Trustees;
- Office of the Superintendent of Bankruptcy;
- *Ipso Facto* Clauses and Security Agreements;
- Aircraft Objects;
- Sale by Trustees;
- Removal of Directors;
- Asset Sales;
- Critical Suppliers;
- Professional Costs;
- 30 Day Goods; and
- Court-Ordered Charges.

## CROSS-BORDER INSOLVENCIES

The United Nations Commission on International Trade Law or “UNCITRAL” was established by the U.N. in 1966 to promote harmonization of the law of international trade. UNCITRAL established the UNCITRAL Model Law on Cross-Border Insolvencies (the “Model Law”) in an effort to provide a co-operative territorial approach to insol-

veny by encouraging and facilitating inter-state co-operation. The Model Law does not propose to unify or change the substantive insolvency laws of the enacting state, but seeks rather to change the procedural law of the enacting state. The Model Law provides that foreign creditors may be treated comparably to domestic general and secured creditors in local insolvency proceedings and addresses the problem of concurrent and multiple proceedings. It offers solutions that help in several significant ways, including: foreign assistance for an insolvency proceeding taking place in the enacting state; foreign representative's access to courts of the enacting State; recognition of foreign proceedings; cross-border co-operation; and co-ordination of concurrent proceedings.<sup>6</sup> The Legislative Amendments will adopt the principles of the Model Law.<sup>7</sup>

The Legislative Amendments provide that a foreign representative may apply to the court for recognition of a foreign proceeding. The court shall specify in the order whether the foreign proceeding is a foreign "main" proceeding or a foreign "non-main" proceeding.<sup>8</sup> A foreign proceeding will be a "main" proceeding if it is taking place in the jurisdiction that is the centre of the debtor's main interest.

On the making of an order recognizing a foreign proceeding as a "main proceeding," and provided that there are no insolvency proceedings commenced in Canada in respect of the debtor, there will be an automatic stay of proceedings and the debtor may not, outside the ordinary course, dispose of its property.<sup>9</sup>

If the court orders recognition of foreign proceeding as "non-main," the stay of proceedings is not automatic, but the court may, in its discretion, impose a stay of proceedings if the court is satisfied that such an order is necessary for the protection of the debtor's property or in the interests of creditors.<sup>10</sup>

If the court believes that further relief is necessary to protect the debtor's property and the interests of creditors, the court may make an order:

- (1) permitting the examination of witnesses and the taking of evidence or the delivery of information concerning the debtor's property, affairs, debts liabilities and obligations;

- (2) entrusting the administration or realization of all or part of the debtor's property in Canada to the foreign representative in a proceeding under the BIA;<sup>11</sup>
- (3) authorizing the foreign representative to monitor the debtor company's business and financial affairs in Canada for the purposes of reorganization in a proceeding under the CCAA.<sup>12</sup>

After such a recognition order is granted, the foreign representative must keep the court informed of any substantial changes or developments in the foreign proceedings.<sup>13</sup>

Legislation based on the UNCITRAL Model Law on Cross-Border Insolvency has been adopted in the British Virgin Islands, overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005), Colombia (2006), Eritrea, Great Britain (2006), Japan (2000), Mexico (2000), Montenegro (2002), New Zealand (2006), Poland (2003), Romania (2003), Serbia (2004), South Africa (2000), and the United States of America (2005).<sup>14</sup>

As such, the adoption of the Model Law will bring Canada in line with the foregoing countries with respect to procedures for dealing with cross-border insolvencies.

## EMPLOYEE PROTECTIONS

### Employee Wages

As noted above, the Legislative Amendments will create the legislative framework for the WEPP, which will provide for the payment of outstanding wages (up to C\$3,000) to employees whose employment is terminated as a result of a bankruptcy or receivership.<sup>15</sup> The term "wages" includes salary, commissions and vacation pay, but will not include a right to payment on account of severance or termination pay.<sup>16</sup> The onus is placed on the trustee or receiver to determine the amount of wages owing and to inform the employees of the existence of the program.<sup>17</sup> Following any payments from the WEPP, the Minister will have a subrogated priority claim for a maximum of C\$2,000 against the current assets of the debtor.<sup>18</sup> The 2007 Revisions clarified that "current assets" will include

“cash, cash equivalent, inventory or accounts receivable or the proceeds from any dealing with those assets.”<sup>19</sup>

While the WEPP is limited to those employees who are terminated as a result of bankruptcy or receivership, an employee who is terminated in respect of a BIA Proposal or a CCAA Plan, is to be paid immediately after court approval/sanction of such proposal or plan.<sup>20</sup>

The 2007 Revisions created an express requirement that the debtor must satisfy the court that outstanding wages will be paid before the court may approve an asset sale in a restructuring proceeding.<sup>21</sup>

## Unpaid Pension Contributions

In respect of receiverships and bankruptcies, pre-filing pension contributions will be secured against of the assets of the debtor;<sup>22</sup> however, it is not intended that an unfunded liability or special payments will have a priority claim. For example, an employer can be in compliance with its required contributions under the relevant statutes but, as a result of poor investment return and low interest rates, there may be a net deficiency in the plan, creating an unfunded liability.

While the priority for unpaid pension contributions does not apply to BIA proposals or CCAA plans, any BIA proposal or CCAA Plan that does not provide for payment of unpaid pension contributions, may not be approved by the court until the parties to the pension plan have entered into an agreement approved by the relevant pension regulator.<sup>23</sup>

## Collective Agreements

Collective agreements will remain in force during BIA proposals and CCAA proceedings.<sup>24</sup> This amendment addresses a controversial issue that was dealt with in the Air Canada restructuring wherein Air Canada took the position that if it were unable to renegotiate the terms of its collective agreements with the respective unions, Air Canada would seek the court’s authorization to repudiate the agreements. While this may be permitted by Chapter 11 of the U.S. Code, the unions asserted that in Canada, a collective agreement could not be terminated unilaterally by a debtor company. The issue was resolved when the presiding judge, Mr. Justice Farley, ordered mandatory mediation between management and labour

which resulted in consensual revisions to the collective agreements.

The proposed amendments, in effect, codify Justice Farley's approach by providing that unions can be forced to bargain, but the collective agreement itself cannot be revised or terminated unilaterally. The Legislative Amendments provide that upon application by the company, the court may make an order authorizing the company to serve a notice to bargain on the union.<sup>25</sup> If the court-ordered bargaining fails, the court may not authorize the disclaimer, termination or revision of the collective agreement.<sup>26</sup> It is now express that if the collective agreement is amended by agreement, the union has a claim as an unsecured creditor for the value of concessions granted.<sup>27</sup>

## SUCCESSOR EMPLOYER LIABILITY

While many of the changes found in the Legislative Amendments are an effort to codify the common law, in the case of successor employer liability, the opposite is true. Prior to the receivership proceedings of Ontario-based TCT Logistics, orders appointing a receiver frequently included provisions stating that the receiver would not be subject to any successor employer liabilities for which the debtor may be responsible at the time of the receiver's appointment. However, the Supreme Court of Canada in the *TCT Logistics* case held that the court supervising the receivership did not have jurisdiction to make such a declaration and that such jurisdiction resided with the Ontario Labour Relations Board.<sup>28</sup> This decision had a chilling effect on the use of receivers in Ontario for debtors with a unionized workforce.

The Legislative Amendments effectively reverses this decision and provides protection to a court-appointed officer from successor employer liability. A receiver, trustee in bankruptcy or monitor of an insolvent business will not be personally liable for a liability, including as a successor employer, in respect of employees or former employees of the debtor, a predecessor of the debtor, or in respect of a pension plan for such employees, that exists before its appointment or that is calculated by reference to a period before the appointment.<sup>29</sup> However, this protection applies only to a trustee, receiver or monitor, which means that a purchaser of an insol-

vent business will still need to review these potential liabilities as part of its due diligence.<sup>30</sup>

## DIP FINANCING

The provisions of the Legislative Amendments that relate to Debtor in Possession Financing (otherwise known as “DIP Financing”) largely codify existing practices, but remove the legal uncertainty regarding the scope of the court’s authority to authorize such interim financing. The legislation now expressly authorizes DIP financing during the restructuring (whether it be by way of BIA proposal or CCAA plan).<sup>31</sup>

In deciding whether to make the DIP order, the court must consider certain factors including, among other things: the period during which the company is expected to be subject to proceedings under the BIA or CCAA, as the case may be; how the company is managed during the proceedings; whether the company’s management has the confidence of its major creditors; whether the loan will enhance the prospects of a viable plan; the nature and value of the company’s property; whether any creditor will be materially prejudiced; and the Monitor’s report, if any.<sup>32</sup> The court can also order a charge against the debtor’s assets to secure the DIP loan.<sup>33</sup> Initially, the 2005 Amendments required advance notice to secured creditors who could be affected by the charge only if such interim financing took place after the first 30 days of the case. However, the 2007 Revisions provide that advance notice to such secured creditors will be required in all cases, notwithstanding the timing of the interim financing.

Additionally, the 2007 Revisions provide that the priority charge for DIP financing can only secure new loans made after the commencement of the proceedings.<sup>34</sup>

## ELIGIBLE FINANCIAL CONTRACTS

As will be mentioned below, certain contracts may not be terminated post-filing; however, the Legislative Amendments make it clear that an Eligible Financial Contract (an “EFC”) is excluded from the relevant provisions and, therefore, may be terminated post-filing.<sup>35</sup>

The definition of an EFC has been updated and made more flexible,

as the definition will be set out in regulations to the BIA and CCAA. Regulations are implemented by the federal cabinet, with the result that they can be modified from time to time without the need for amendment to the legislation itself.<sup>36</sup> The stay of proceedings in a BIA proposal or CCAA case will not apply to EFCs.<sup>37</sup>

## DISCLAIMER OF CONTRACTS

The 2007 Revisions significantly amended the provisions dealing with the debtor's right to disclaim a contract in CCAA proceedings or in a BIA proposal. Prior to disclaiming a contract, the debtor must obtain the approval of the monitor or the proposal trustee, or approval of the court.<sup>38</sup> If requested by the counterparty, the debtor must provide an explanation of the business reasons for wanting to disclaim the contract.<sup>39</sup> If the disclaimer is disputed, the court may approve the disclaimer, but is directed to consider a number of factors, including whether the disclaimer will enhance the prospects of a viable proposal or arrangement being made, and whether the disclaimer is likely to cause significant financial hardship to the counterparty.<sup>40</sup> The debtor does not have the right to disclaim certain types of contracts: an eligible financial contract; a collective agreement; a financing agreement where the debtor is the borrower; or a lease of real property or of an immovable if the debtor is the lessor.<sup>41</sup>

Whenever an agreement relates to intellectual property, the disclaimer may not affect the counterparty's right to use the intellectual property, or the right to enforce an exclusive right to use the intellectual property, as long as the counterparty is in compliance with the agreement and performs its obligations thereunder.<sup>42</sup>

## ASSIGNMENT OF AGREEMENTS

Agreements may be assigned by a trustee or a reorganizing debtor, under the court's supervision without consent of the counterparty<sup>43</sup> (with certain exceptions, such as collective agreements, an eligible financial contract or where the agreement is "not assignable by its nature").<sup>44</sup> The court is to consider, among other things, the assignee's ability to perform its obligations under the contract and whether the assignment is "appro-

priate.”<sup>45</sup> If the agreement is assigned by reason of a sale of all or substantially all of its assets, the court will also consider whether the trustee approved the assignment.<sup>46</sup>

The 2007 Amendments removed the prohibition of a buyer of a claim against the debtor from voting the claim in the CCAA proceeding unless the whole claim is acquired, as it would have impeded the active market in distressed debt, where creditors often sell part of their claim. Additionally, the debtor will not be permitted to ask the court to order an assignment of an agreement entered into after CCAA proceedings are commenced.<sup>47</sup> The requirement that the debtor cure all defaults under the agreement prior to the assignment will be limited to a requirement to cure all monetary defaults and related cross-defaults on or before a date fixed by the court.<sup>48</sup>

## NATIONAL RECEIVERS

The Legislative Amendments will restrict the powers and length of the term of an interim receiver appointed under the BIA; however, the amendments will also provide that, on application by a secured creditor, a receiver may be appointed under the BIA, with national powers for an unspecified period of time.<sup>49</sup>

The interim receiver, as initially conceived when the provisions allowing for its appointment were enacted in 1992, was to provide a watch dog function to preserve and protect assets for a limited period of time. However, practitioners found the interim receiver to be a useful realization tool because its powers derive from the federal BIA, thus giving the interim receiver national scope. Receivers appointed under the provincial rules of court had their jurisdiction limited to the province of their appointment.

In Ontario, in particular, “interim” became a misnomer since interim receivers were appointed for an undefined period of time and often granted the same comprehensive rights as receivers appointed under provincial rules of court. In addition, arguments were made that statutory obligations of receivers did not apply and certain rights of stakeholders were limited in an interim receivership.

In recent years, a practice has been developed across Canada for a

dual appointment under both provincial legislation and the provisions of the BIA, which provide for the appointment of an interim receiver. The interim receiver provides national scope; however, the appointment of the provincial receiver ensures statutory obligations are triggered.

The issue was that a “receiver” under Section 243 of the BIA specifically excluded an interim receiver appointed by a bankruptcy court. The BIA imposed obligations on receivers within the meaning of Section 243 only. The definition of “receiver” is to be broadened so that a receiver or interim receiver appointed by any court would be subject to any right that arises on the appointment of a receiver (i.e., 30-day good rights for unpaid suppliers). Statutory obligations, including reporting requirements, would also be triggered.

The 2007 Revisions expanded the amendments relating to the creation of a national receiver to elaborate on the powers the court can give to such a receiver, including taking possession of the debtor’s assets, exercising control over its business, and taking any other action the court considers advisable.<sup>50</sup> Another change will provide that the court may not appoint a receiver at the request of a secured creditor unless the debtor has received a 10-day notice of the secured creditor’s intention to enforce its security (just as a secured creditor would be required to do in respect of a private enforcement of security).<sup>51</sup>

## EQUITY CLAIMS

The Legislative Amendments stipulate that certain equity claims are to be subordinated to creditor claims in a restructuring, and that these claims will not have voting rights. The 2007 Amendments expand the description of “equity claims” found in the BIA to include a claim for a dividend or similar payment, a return of capital, a redemption or retraction obligation, a monetary loss resulting from the ownership, purchase or sale of an equity interest, or for contribution or indemnity in respect of any such claim.<sup>52</sup> The 2007 Amendments also clarify that a CCAA Plan or BIA Proposal can become effective without requiring a vote of the holders of equity claims.<sup>53</sup>

## INCOME TRUSTS

An income trust will be permitted to commence insolvency proceedings under the BIA or under the CCAA if it is listed on a prescribed stock exchange at the time the proceedings begin, or if its units are owned by a trust that is listed on a prescribed stock exchange<sup>54</sup> on that date. The 2007 Revisions ensure that filings of both levels of the “trust on trust” structure commonly used by many income trusts are permitted.

## TRANSFERS AT UNDERVALUE

Under the BIA, in its existing form, a trustee could attack a pre-bankruptcy transaction as a settlement. Settlements include various types of transfers to the extent such transfers were gratuitous or made for nominal consideration. The retention of the settled property by the recipient in some form is necessary for an attack by the trustee to be successful. The settlement provisions in the BIA are to be replaced by the concept of Transfer at Under Value (“TUV”).

A TUV means a transaction in which the consideration received by a person is conspicuously less than the fair market value of the property or services sold or disposed of by the other person in the transaction.<sup>55</sup> A judgment may be rendered in favour of the trustee for the difference between the fair market value and the actual consideration for the TUV. However, for arm’s length TUVs, this remedy is only available if (i) such a TUV occurred within the period that is one year before the date of the initial bankruptcy, (ii) the debtor was insolvent at the time of the TUV (or was rendered insolvent by it), and (iii) the debtor intended to defraud, defeat or delay a creditor.<sup>56</sup> If the TUV is between non arm’s-length parties, the trustee may obtain a judgment without having to satisfy the requirements that the debtor be insolvent or have intended to defeat the interest of creditors if such transfer occurred within the period that is one year before the date of the initial bankruptcy. In such cases, the trustee must simply establish that the transfer was for less than fair market value within the one year period.<sup>57</sup> The trustee must, however, satisfy the solvency and intention tests for non arm’s-length transactions between one year and five years prior to bankruptcy. The provisions do not apply to

transactions greater than five years.<sup>58</sup>

The 2007 Revisions provide that these remedies will be available in CCAA proceedings, as well as in bankruptcy proceedings under the BIA, and may be assigned to creditors.<sup>59</sup>

## STAY OF ACTIONS BY REGULATORY AUTHORITIES

The Legislative Amendments address another issue raised in the Air Canada proceedings: whether regulators can be stayed by a court order issued under the CCAA. Mr. Justice Farley's holding that regulators could be stayed in the Air Canada proceedings caused significant concern for federal regulators in Ottawa who argued that their mandate to, among other things, ensure public health and safety and preserve and protect human rights, should not be curtailed by a stay of proceedings. The proposed legislation sides with this view and provides that regulators cannot be stayed by CCAA orders unless the regulator is acting as a creditor.<sup>60</sup> It should be noted, however, that for certain regulators their sole remedy may be to issue a fine against the debtor and since their ability to collect this fine would be stayed, the effective powers of the regulatory body may be rendered inert in a BIA or CCAA restructuring.

## MONITORS, RECEIVERS AND TRUSTEES

The Legislative Amendments provide that the company's auditor may not be its monitor under the CCAA (the CCAA, as currently enacted, expressly provides that a monitor may be the auditor).<sup>61</sup> Moreover, the Legislative Amendments will allow for public filings of creditor lists (not previously available) and a searchable national register of CCAA cases. It requires the monitor to compile a list showing the names and addresses of the creditors in a prescribed manner, file reports as to the financial affairs of the company within certain prescribed time frames, provide appropriate notices and filings to the Office of the Superintendent of Bankruptcy, make all filings with the court publicly available, and advise creditors how they may access such information.<sup>62</sup>

Receivers (if appointed) and monitors, respectively, will have to be licensed trustees in bankruptcy.<sup>63</sup> Currently, only interim receivers are

required to be trustees. It should also be noted, however, that a secured creditor can be deemed to be a receiver if it takes possession of the debtor's assets. Thus, the requirement that a receiver be a trustee, will only apply to the extent that the receiver is appointed, either privately pursuant to the terms of a security agreement or by the court.

## OFFICE OF THE SUPERINTENDENT OF BANKRUPTCY

Currently, the Office of the Superintendent of Bankruptcy ("OSB") is not charged with oversight of CCAA cases. The OSB has general oversight of matters brought under the BIA only (i.e., bankruptcies and proposals). Thus there is no government administrator or regulatory body that supervises CCAA matters. Somewhat ironically, some of the largest insolvency proceedings required no formal filings of any kind with the government or any participation by the OSB. As already noted, monitors will have to make various filings with the OSB. The Legislative Amendments will grant the OSB investigative powers, subpoena powers and, following an administrative hearing, the right to suspend a monitor that is failing to comply with its obligations.<sup>64</sup>

## *IPSO FACTO* CLAUSES AND SECURITY AGREEMENTS

The Legislative Amendments propose to revise the provisions of the BIA dealing with *ipso facto* clauses<sup>65</sup> and create a similar provision in the CCAA,<sup>66</sup> to the effect that no person may terminate or amend an agreement with an insolvent person "for the mere fact" that it has sought protection under the relevant Act or is insolvent. In response to a concern raised in an unreported case dealing with a consumer proposal, the amended provision expressly includes security agreements, in the definition of "agreements."

## AIRCRAFT OBJECTS

There remain certain exceptions to the statutory rule set out above. For example, the relevant subsections will continue to provide that nothing in the BIA or CCAA prevents a person from requiring immediate pay-

ment for goods, services and the use of leased or licensed property following the filing. However, the Legislative Amendments provide that lessors of aircraft objects (airframes, aircraft engines and helicopters) may repossess the aircraft objects subject to the lease following 60 days after the commencement of a restructuring proceeding, unless the debtor has remedied the financial defaults and performs its other obligations under the agreement (including maintenance obligations).<sup>67</sup> This is analogous to a similar provision in the U.S. Code.

Reference should also be made to recent legislation relating to secured creditors of aircraft objects which has received Royal Assent (the final stage before a bill becomes law) but is not yet in force. The intention is that the International Interests in Mobile Equipment (Aircraft Equipment) Act<sup>68</sup> (the "IIMEA") not come into force until the amendments to the BIA and CCAA come into force. These changes will facilitate international asset-based financing (i.e., financing using the value of the equipment as security for payment and thus providing aircraft operators with access to new sources of low-cost financing, thereby reducing costs).<sup>69</sup> For information on the IIMEA and a definition of "aircraft objects," visit [www.canlii.org/ca/sta/i\\_19.6/whole.html](http://www.canlii.org/ca/sta/i_19.6/whole.html).

## SALE BY TRUSTEES

Section 30(1) of the BIA, as currently enacted, provides that a trustee can sell assets of a debtor (and perform other prescribed powers) with the approval of inspectors. Inspectors are representatives of creditors, elected at a meeting of creditors called, in part, for that purpose. Technically, if there were no inspectors appointed, a trustee was only able to sell assets with approval of the court. The Legislative Amendments provide that, where no inspectors are appointed, a trustee may sell assets and perform the other powers provided for in Section 30(1) without the requirement for court approval.<sup>70</sup> However, court approval will be required for sales to parties related to the bankrupt, or sales of all or substantially all assets of the bankrupt.<sup>71</sup>

## REMOVAL OF DIRECTORS

The Legislative Amendments provide that directors can be removed by the court under both BIA proposals<sup>72</sup> and CCAA proceedings<sup>73</sup> if they are impairing the proposal or plan or acting inappropriately. In the Stelco restructuring, the presiding judge ordered the removal of two directors, notwithstanding the fact that they had not engaged in inappropriate conduct.

Mr. Justice Farley held that, in effect, finding a reasonable apprehension of bias was sufficient to remove a sitting director. The Ontario Court of Appeal overturned this decision.<sup>74</sup> The court held that a judge cannot, under his/her discretionary authority under the CCAA or using his/her inherent jurisdiction, remove a sitting director without any legal basis (i.e., simply because the judge disagrees with the director's appointment). The Legislative Amendments are generally consistent with the Court of Appeal decision as there is a requirement that the director engage in inappropriate conduct prior to his or her removal by the court.

## ASSET SALES

The Legislative Amendments provide that a sale of all or substantially all of the assets of a company is expressly permitted in a BIA proposal<sup>75</sup> and CCAA proceedings,<sup>76</sup> subject to court approval. In deciding whether to authorize the sale, the court must consider: whether the process leading to the sale was reasonable in the circumstances; the extent to which the creditors were consulted in connection with the proposed sale; the effects of the proposed sale on creditors and other interested parties; and whether the consideration received for the assets is reasonable and fair.

## CRITICAL SUPPLIERS

Pursuant to the Legislative Amendments, critical suppliers may be forced to supply goods or services to a debtor company in a CCAA proceeding,<sup>77</sup> but not in a receivership or bankruptcy. The debtor company may, on notice to the secured creditors, make an application to the court for a declaration that a party is a critical supplier and, if the court is satis-

fied, it can compel the supplier to continue the provision of goods or services and may make an order requiring the person to supply on terms and conditions that are consistent with supplier arrangements or as the court otherwise considers appropriate. The court may also provide a charge in favour of the critical supplier for an amount equal to the value of goods and services supplied under the terms of the order. The priority of this charge is not specifically addressed in the Legislative Amendments and there is no definition of critical suppliers.

## PROFESSIONAL COSTS

Pursuant to the Legislative Amendments, the court may also allow a charge for professional costs, which includes the costs of the monitor, its legal counsel and financial advisers, the debtor's legal counsel and financial advisers and the legal and financial advisers of an interested party if the court is satisfied that incurring those costs is necessary for the interested party to participate in the proceeding.<sup>78</sup>

## 30 DAY GOODS

Recommendations have been made that the provision allowing unpaid suppliers, in the event of a bankruptcy or receivership, to recover goods sent 30 days before the issuance of a demand for the return of such goods, be deleted entirely. Rather, the only proposed amendment provides that goods delivered 30 days before the date of bankruptcy or the appointment of a receiver could be recovered if a written demand is provided 15 days after the date which the purchaser became bankrupt or subject to a receivership,<sup>79</sup> rather than the current regime which permits repossession of goods delivered 30 days before the issuance of the demand following a bankruptcy or receivership of the customer.

## COURT-ORDERED CHARGES

As noted above, the Legislative Amendments provide for a number of court-ordered charges over the debtor's property, including charges for DIP lenders, directors, critical suppliers and professionals. However,

there is no attempt to rank these charges or provide any guidance to courts as to what criteria should be utilized in so doing. Unless further clarification is given prior to enactment as law, one may anticipate a significant amount of litigation in an effort to bring greater certainty to this area and to protect the interests of the various stakeholders who would be the beneficiaries of such charges.

## CONCLUSION

The passage of the 2007 Revisions means that the Legislative Amendments are one step closer to taking effect. While the 2007 Revisions may not have addressed each and every concern touched upon by various commentators, many of the technical flaws identified by the Senate Committee have been dealt with. While the Legislative Amendments are not meant to completely overhaul the BIA or the CCAA, the changes are a significant contribution to an ongoing reform process of Canada's insolvency laws.

## NOTES

<sup>1</sup> S.C. 2005, c.47.

<sup>2</sup> S.C. 2007, c.36.

<sup>3</sup> R.S.C. 1985 c. B-3.

<sup>4</sup> R.S.C. 1985 c. C-36.

<sup>5</sup> R.S.C. 2005, C. 47, s.1 (not yet in force).

<sup>6</sup> UNCITRAL: [www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html).

<sup>7</sup> BIA, s. 267-284 (not in force) and CCAA, s.44-61 (not in force).

<sup>8</sup> BIA, s. 269 (not yet in force) and CCAA, s.46 (not yet in force).

<sup>9</sup> BIA, s. 271 (not yet in force) and CCAA, s. 48 (not yet in force).

<sup>10</sup> BIA, s. 272(1)(a) (not yet in force) and CCAA, s. 49(1) (not yet in force).

<sup>11</sup> BIA, s. 272(1) (not yet in force).

<sup>12</sup> CCAA, s. 49(1)(c) (not yet in force).

<sup>13</sup> BIA, s. 276 (not yet in force) and CCAA, s. 53 (not yet in force).

<sup>14</sup> UNCITRAL: [www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html).

- <sup>15</sup> WEPPA, s.7 (not yet in force).
- <sup>16</sup> WEPPA, s. 2(1) (not yet in force).
- <sup>17</sup> WEPPA, s. 21 (not yet in force).
- <sup>18</sup> WEPPA, s. 36(1) (not yet in force) and BIA, s. 81.4 and s. 81.3 (not yet in force).
- <sup>19</sup> BIA, s.2 “current assets” (not yet in force).
- <sup>20</sup> CCAA, s.6(5) (not yet in force) and BIA s.60(1.3)(a) (not in force).
- <sup>21</sup> CCAA, s. 36(7) (not yet in force) and BIA, s. 65.13(8) (not yet in force).
- <sup>22</sup> BIA, s.81.5 (not yet in force).
- <sup>23</sup> CCAA, s.6(6) and (7) (not yet in force) and BIA, s.60(1.5) and (1.6) (not yet in force).
- <sup>24</sup> BIA, s.65.12(6) (not yet in force) and CCAA, s.33(1).
- <sup>25</sup> BIA, s.65.12(1) and s.65.12(2) (not yet in force) and CCAA, s.33(2) and s.33(3) (not yet in force).
- <sup>26</sup> BIA, s.65.12(6) (not yet in force) and CCAA, s.33(8) (not yet in force).
- <sup>27</sup> BIA, s.65.12(4) (not yet in force) and CCAA, s.33(5) (not yet in force).
- <sup>28</sup> *GMAC Commercial Credit Corp. Canada v. TCT Logistics Inc.* [2006] 2 S.C.R. 123.
- <sup>29</sup> BIA, s.14.06(1.2) (not yet in force) and CCAA, s. 11.8 (not yet in force).
- <sup>30</sup> BIA, s.14.06(1.4) (not yet in force) and CCAA, s. 11.8(2.1) (not yet in force).
- <sup>31</sup> BIA, s.50.6 (not yet in force) and CCAA, s.11.2 (not yet in force).
- <sup>32</sup> BIA, s.50.6(5) (not yet in force) and CCAA, s.11.2(4) (not yet in force).
- <sup>33</sup> BIA, s.50.6(1) (not yet in force) and CCAA, s.11.2(1) (not yet in force).
- <sup>34</sup> BIA, s.50.6(1) (not yet in force) and CCAA, s.11.2(1) (not yet in force).
- <sup>35</sup> BIA, s. 84.2 (not yet in force) and CCAA, 11.05(1) (not yet in force).
- <sup>36</sup> BIA, s. 65.1 (not yet in force).
- <sup>37</sup> *Budget Implementation Act, 2007* (S.C. 2007, c. 29) Part 9.
- <sup>38</sup> BIA, s.65.11(1) and s. 65.11(4) (not yet in force) and CCAA, s.32(1) and s.32(3) (not yet in force).
- <sup>39</sup> BIA, s.65.11(9) (not yet in force) and CCAA, s.32(8) (not yet in force).
- <sup>40</sup> BIA, s.65.11(5) (not yet in force) and CCAA, s.32(4) (not yet in force).
- <sup>41</sup> BIA, s.65.11(10) (not yet in force) and CCAA, s.32(9) (not yet in force).
- <sup>42</sup> BIA, s.65.11(7) (not yet in force) and CCAA, s.32(6) (not yet in force).
- <sup>43</sup> BIA, s.84.1(1) (not yet in force) and CCAA, s.11.3(1) CCAA (not yet in force).
- <sup>44</sup> BIA, s.84.1(3) (not yet in force) and CCAA, s.11.3(2) (not yet in force).

- <sup>45</sup> BIA, s.84.1(4) (not yet in force) and CCAA, s.11.3(3) (not yet in force).
- <sup>46</sup> BIA, s.66(1.1) (not yet in force).
- <sup>47</sup> CCAA, s.11.3(2)(a) (not yet in force).
- <sup>48</sup> BIA, s.84.1(5) (not yet in force) and CCAA, s.11.3(4) (not yet in force).
- <sup>49</sup> BIA, s.243(not yet in force).
- <sup>50</sup> BIA, s.243(1) (not yet in force).
- <sup>51</sup> BIA, s.243(1.1) (not yet in force).
- <sup>52</sup> BIA, s.2 (not yet in force).
- <sup>53</sup> BIA, s.54.1 and s. 54(2)(d) (not yet in force) and CCAA, s.22.1 (not yet in force).
- <sup>54</sup> BIA, s.2 “person” and “income trust” (not yet in force) and CCAA, s.2(1) “company” and “income trust” (not yet in force).
- <sup>55</sup> BIA, s.2 (not yet in force).
- <sup>56</sup> BIA, s.96(1)(a)(not yet in force).
- <sup>57</sup> BIA, s.96(1)(b)(i) (not yet in force).
- <sup>58</sup> BIA, s.96(1)(b)(ii) (not yet in force).
- <sup>59</sup> CCAA, s. 36.1 (not yet in force).
- <sup>60</sup> CCAA s.11.1 (not yet in force).
- <sup>61</sup> CCAA, s.11.7(2)(a)(iii) (not yet in force).
- <sup>62</sup> CCAA, s. 23 (not yet in force).
- <sup>63</sup> BIA, s.243(4) (not yet in force) and CCAA, s.11.7(1) (not yet in force).
- <sup>64</sup> CCAA, s.26-31 (not yet in force).
- <sup>65</sup> BIA, s. 65.1.
- <sup>66</sup> CCAA, s. 34 (not yet in force).
- <sup>67</sup> BIA, s.65.1(4) (not yet in force) and CCAA, s.11.07 (not yet in force).
- <sup>68</sup> S.C. 2005 c.3.
- <sup>69</sup> Transport Canada: [www.tc.gc.ca/pol/en/report/anre\\_2005/9A\\_e.htm](http://www.tc.gc.ca/pol/en/report/anre_2005/9A_e.htm).
- <sup>70</sup> BIA, s.30(3) (not yet in force).
- <sup>71</sup> BIA, s.30(4) (not yet in force).
- <sup>72</sup> BIA, s. 64(1) (not yet in force).
- <sup>73</sup> CCAA, s. 11.5(1) (not yet in force).
- <sup>74</sup> *Stelco Inc. (Re)* (2005), 75 O.R. (3d) (C.A.).
- <sup>75</sup> BIA, s.65.13 BIA (not yet in force).
- <sup>76</sup> CCAA, s.36 (not yet in force).
- <sup>77</sup> CCAA, 11.4 (not yet in force).
- <sup>78</sup> BIA, s.64.2 BIA; (not yet in force) and CCAA, s.11.52 (not yet in force).
- <sup>79</sup> BIA, s.81.1 (not yet in force).

# Bear Stearns May Well Be Found to Have Acted in Good Faith in the Manhattan Investment Fund Case

ANGELA J. SOMERS

*A federal district court requires further factual findings on the issue of whether Bear Stearns acted in good faith with respect to monies deposited in a brokerage account by Manhattan Investment Fund before its Chapter 11 filing.*

In *Gredd v. Bear, Stearns Securities Corp. (In re Manhattan Investment Fund, Ltd.)*,<sup>1</sup> decided by the United States Bankruptcy Court for the Southern District of New York on a motion for summary judgment, the bankruptcy court found that monies deposited in a Bear Stearns brokerage account by Manhattan Investment Fund (the “Fund”) and used as margin payments to cover short selling positions were transfers made with actual intent to hinder, delay or defraud creditors that could be recovered by the Chapter 11 trustee as fraudulent transfers. The trustee’s argument has been called a “creative fraud” case, and many wondered whether the bankruptcy court had used hindsight to question the actions of Bear Stearns. Whether Bear Stearns acted in good faith has yet to be determined; however, a recent decision by the District Court for the Southern District of New York, at the very least, opens the door to a further fact finding mission.

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In *Gredd*, the bankruptcy court based its decision that the transfers could be recovered, in part, on a finding that the Fund was a Ponzi scheme. The bankruptcy court concluded that, if a company or a fund transfers money as part of a Ponzi scheme, as a matter of law, it is presumed to be made with actual intent to hinder, delay or defraud creditors. On appeal, in *Bear, Stearns Securities Corp. v. Gredd (In re Manhattan Investment Fund Ltd.)*,<sup>2</sup> Bear Stearns challenged this finding, arguing (i) that the payments subject to avoidance were not removed from the reach of creditors when they were placed in the Bear Stearns margin account, (ii) that, as a legal matter, there is no Ponzi scheme presumption and (iii) that, in any event, the returns offered by the Fund were not significant enough to constitute such a scheme.

## DISTRICT COURT RULING

The district court found that “once a transfer occurred [from the Fund’s account to the Bear Stearns’ margin account], those contributions were no longer accessible to the Fund”<sup>3</sup> or its creditors. The district court also rejected Bear Stearns’ argument that *In re Sharp International Corp.*<sup>4</sup> eliminated the Ponzi scheme presumption and held that it continues to apply. The district court found that the *Sharp* case, at most, emphasized that the scheme at issue must relate to the allegedly fraudulent transfers. The court also dismissed Bear Stearns’ argument that, because the Fund did not offer artificially high returns to investors, it was not a Ponzi scheme. The court reasoned that it was enough that new investments were solicited in order to pay redemption requests of old investors, and that Berger, the key player, was reporting that the Fund was doing exceedingly well. Because the transfers were also in furtherance of the Ponzi scheme (they were used to open new trading positions and to support existing open positions), they were deemed to be made with actual intent to hinder, delay or defraud creditors.

The district court next reviewed the bankruptcy court’s determination that Bear Stearns was an initial transferee under Section 550(a) of the Bankruptcy Code. A fraudulent transfer can be recovered from a transferee if the transferee is an initial transferee as opposed to a financial

intermediary or mere conduit. The court found that Bear Stearns was not a conduit because the funds were not received by it in order for Bear Stearns to pass them on to another party. The district court further found that Bear Stearns had sufficient dominion and control over the monies at issue. Despite the fact that Bear Stearns did not have unfettered control over the transferred funds, so long as there were open short positions, Bear Stearns was able to use the funds to cover these positions. The court explained that creditors receiving loan repayment have frequently been found to be initial transferees. Because Bear Stearns had enough control over the funds such that it could use the money for its own purposes (to protect itself against possible liability from the Fund's risky trading), it was an initial transferee.

## INQUIRY NOTICE

The district court then reviewed the bankruptcy court's decision that Bear Stearns had not accepted the transfers in good faith. Pursuant to Section 548(c) of the Bankruptcy Code, even if a transfer otherwise meets the requirements of a fraudulent transfer, if it is received in good faith, the transfer cannot be recovered. The bankruptcy court had broken the determination of this issue down into two parts: (i) whether Bear Stearns was on inquiry notice of the fraud, and (ii) whether it was diligent in its investigation of the fraud. The district court found that Bear Stearns was put on inquiry notice the day after one of its employees heard information at a cocktail party that indicated the Fund was reporting positive performance numbers. At that point in time, Bear Stearns did not know how many prime brokers the Fund used, but it did know that Bear Stearns was one of its prime brokers and that the Fund had been losing money in its account.

The district court, however, also concluded that Bear Stearns took numerous appropriate actions once it was informed that something was amiss. It made numerous inquiries, and even followed up by contacting the Fund's auditor, Deloitte & Touche, to urge caution in its upcoming audit. Bear Stearns further drafted questions for an investor to pose to Berger in order to clarify the Fund's position. When the responses to

those questions were vague, Bear Stearns contacted other prime brokers, obtained the Fund's financial statements and informed the SEC of the issues it had with the Fund. The district court stated that it was not clear whether this level of inquiry showed diligence sufficient to constitute good faith, but it could well meet that standard. The district court thus concluded that summary judgment on this issue of whether the transfer from the Fund was in good faith was "improvidently granted."<sup>5</sup> The court explained, "[a]s noted, Bear Stearns took a variety of steps to uncover the truth about the Fund. We cannot say that no reasonable jury could find that Bear Stearns' actions were diligent."<sup>6</sup> In the end, the district court reversed this portion of the bankruptcy court's decision and ordered that a trial be held to determine the good faith issue.

## NOTES

<sup>1</sup> 359 B.R. 510 (Bankr. S.D.N.Y. 2007), *aff'd in part, rev'd in part*, No. 07 Civ. 2511 (NRB), 2007 WL 4440360 (S.D.N.Y. Dec. 17, 2007).

<sup>2</sup> No. 07 Civ. 2511 (NRB), 2007 WL 4440360 (S.D.N.Y. Dec. 17, 2007).

<sup>3</sup> *Id.* at \*6.

<sup>4</sup> 403 F.3d 43 (2d Cir. 2005).

<sup>5</sup> *Id.* at \*18.

<sup>6</sup> *Id.*

# Option to Buy? Reverse Breakup Fees and Termination Provisions in Recent Private Equity Deals

CHRIS E. ABBINANTE AND MATTHEW T. GUNNISON

*The authors discuss the importance of clearly drafted provisions allowing transactions to be terminated without penalty.*

C<sup>u</sup>rrent market conditions affecting private equity buyers and targets have made the provisions governing a buyer's ability to terminate a deal prior to closing a central issue in the negotiation and enforcement of many recent deals. As market and economic conditions have deteriorated and debt financing has become more difficult to secure and less favorable to borrowers, an increasing number of private equity buyers are opting to back out of transactions prior to closing. In a number of these cases, the buyers have asserted that a "material adverse change" or "MAC" has occurred allowing the buyer, pursuant to the terms of the parties' agreement, to terminate the transaction without penalty.<sup>1</sup> Often, depending on the strength of the MAC claim, this strategy results in renegotiation of the deal under terms more favorable to the buyer.

Recently, however, there have been several high-profile examples of private equity buyers relying entirely on reverse termination fees negotiated in the merger agreement to assert a right to walk away absent a MAC or any other breach by the target.<sup>2</sup> These buyers have argued that the

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reverse termination fee in each case represented the target's sole remedy and a cap on the buyer's liability in the event that the buyer was unwilling to proceed with the transaction for any reason whatsoever. The fee is analogous, under such terms, to an option premium paid by the buyer for an option to purchase the target, rather than a means of compensating the target in the event that the buyer *cannot* perform (e.g., due to a failure to secure the required financing).

Until recently, many speculated that the negative effect on a private equity firm's reputation from walking away from a deal absent a MAC or some breach by the target would be sufficient to discourage firms from relying solely on an "option-style" approach to termination. However, in at least the two recent deals noted below, private equity firms have taken exactly that approach.<sup>3</sup> In both cases, the buyer ultimately succeeded in either terminating or renegotiating the transaction based on option-style reverse termination provisions. While both situations were resolved in favor of the buyer, one involved a costly and bitter face-off in Delaware Chancery Court and the other was resolved relatively quickly through renegotiations.

## CLEAR AND CONSISTENT

The most apparent explanation as to why the two deals played out so differently is the relative clarity and consistency of the reverse termination provisions in the GS Capital Partners/Myers merger agreement, limited guaranty and equity commitments compared to the ambiguous reverse termination and specific performance provisions in the corresponding Cerberus/URI documents.

The dispute in Cerberus/URI involved the interpretation of two apparently inconsistent provisions of the merger agreement; one section appeared to limit URI's remedies under the circumstances to a \$100 million termination fee payable by Cerberus, while a different section of the agreement, in apparent contradiction, provided URI with a right to specific performance. Similarly, despite language that seemed to be intended to limit Cerberus' liability to the guaranteed reverse termination fee, the limited guaranty could reasonably have been interpreted as supporting

URI's position on specific performance.

The equity commitment letter from Cerberus to the acquisition vehicle did not contain a "self destruct" provision whereby the commitment would automatically terminate in the event that any party sought to enforce the commitment other than at the direction of Cerberus or brought a claim against Cerberus (or any affiliate thereof) in connection with the transaction. We have seen this type of provision in many deals, particularly in club deals. The self-destruct provision, in those instances, prevents one investor from seeking enforcement of the commitment against the will of the lead investor. However, the self-destruct provision is also applicable and often advisable in single sponsor deals where the parties do not intend to give the target a right to specifically enforce the merger agreement. Including a self-destruct provision in the equity commitment reinforces the parties' intention with respect to specific enforcement because it renders the equity commitment useless in the event that the target seeks to enforce it. Without the equity financing from investors, the transaction will not occur.

The ambiguity of the Cerberus/URI provisions led to the introduction of parole evidence (evidence outside the four corners of the documents) at trial in an attempt to discover the intention of the parties. The court ultimately found that there had been no meeting of the minds with respect to the intended effect of the reverse termination provisions at the time the contract was entered into. However, the court applied a doctrine of contract interpretation known as the forthright negotiator principle in favor of Cerberus after finding that URI and its counsel were aware of Cerberus's option-style interpretation of the provisions and did nothing to correct or address that understanding.

In contrast to Cerberus/URI, the GS Capital Partners/Myers reverse termination provisions were clearly drafted to create an option-style reverse termination fee. The merger agreement, limited guaranty and equity commitment clearly and consistently barred Myers from specific enforcement of the agreements or any remedy in connection therewith other than the reverse termination fee. In addition, the equity commitment letters provided that the commitments would terminate if Myers asserted any claim against the investors or their affiliates relating to the

transaction (thereby eliminating Myers's ability to specifically enforce the equity commitment notwithstanding anything in the merger agreement to the contrary).

## CLEAR DRAFTING

One important lesson that is well underscored by comparing how the URI and Myers deals unfolded is that clear drafting and consistency within and among the agreements and related transaction documents, such as the equity commitment and limited guaranty, are critical. Because reverse termination provisions can either create an option giving the buyer a right to walk away for any reason at all by paying a fee or simply serve to compensate the target in the event that the buyer cannot perform, a clear, mutual understanding among the parties on how the provisions are intended to operate is critical. One particularly good way to accomplish this when the parties intend an option-like approach is to include a self-destruct provision in the investor equity commitment, even in single-sponsor deals.

## CONCLUSION

In the current market, reverse breakup fees and termination provisions are proving increasingly important in providing the leverage for sponsors to renegotiate or walk away from deals. Not surprisingly, these provisions are receiving heavy scrutiny as a result and will likely be an important focus of negotiations for private equity buyers, targets and their advisors for the foreseeable future.

## NOTES

<sup>1</sup> During 2007, buyers attempted to walk away from or renegotiate the following deals, among others, by asserting or threatening to assert a MAC claim: J.C. Flowers & Co./SLM Corp.; Finish Line/Genesco; Bain Capital, Carlyle Group, CD&R/Home Depot Wholesale Supply; Goldman Sachs, KKR/Harman International Industries; Silver Lake, ValueAct/Acxiom; Lone Star/Accredited Home Lenders.

<sup>2</sup> Cerberus Capital Management, L.P. terminated its agreement in November 2007 to acquire United Rentals, Inc. in a transaction valued at approximately \$6.6 billion, and GS Capital Partners' renegotiated its agreement in December 2007 to acquire Myers Industries, Inc. in a transaction valued at approximately \$1.07 billion.

<sup>3</sup> Cerberus terminated its agreement with URI based on the agreement's reverse termination provisions. GS Capital Partners renegotiated its deal with Myers after paying a sum equal to the reverse termination fee that would have been payable had it terminated the parties' agreement.

# Bankruptcy Court Dismisses Involuntary Chapter 11 Case Brought by Holders of U.S. Bonds in Deference to Argentine Reorganization

ANDREW V. TENZER AND LYNETTE C. KELLY

*The Bankruptcy Court for the Southern District of New York recently dismissed an involuntary Chapter 11 case of an Argentine company over the objections of the holders of the company's U.S. bonds. The bankruptcy court held that abstention in deference to the existing Argentine plenary proceeding was warranted under Section 305 of the Bankruptcy Code because, among other things, there was no evidence of endemic corruption in the Argentine system, any attempt at enforcement of a U.S. plan of reorganization in Argentina would be "difficult if not futile," and maintenance of a parallel U.S. reorganization case would serve no legitimate purpose.*

In deference to a pending reorganization proceeding in Argentina, the United States Bankruptcy Court for the Southern District of New York, in *In re Compañía de Alimentos Fargo, S.A.*,<sup>1</sup> dismissed an involuntary Chapter 11 case brought against an Argentine company, Compañía de Alimentos Fargo S.A. ("Fargo"), by holders of its U.S. bonds. The court held that a parallel Chapter 11 case would serve no purpose except to impose the U.S. automatic stay in circumstances where the stay imposed by Argentine law would not apply, and that this benefit is insufficient to warrant maintenance of a Chapter 11 case that serves no other purpose.

## BACKGROUND

Fargo and its subsidiaries, headquartered in Buenos Aires, constitute Argentina's largest commercial producer and distributor of industrialized packaged bread and bread products. The company's operations and employees are located entirely in Argentina, as are 98 percent of its customers and nearly all of its suppliers. Fargo's assets in the United States consist of a single trademark and three pending trademark applications. Fargo's debt consists of:

- (a) general unsecured trade debt,
- (b) unsecured notes (the "Notes"),
- (c) special secured debt, and
- (d) general unsecured debt.

The Notes, in the face amount of US\$120 million, were issued in 1998 and are governed by U.S. law. Fargo has been involved in a plenary restructuring proceeding — a *concurso preventivo* — in Argentina since 2002, and has filed no parallel or ancillary proceedings seeking relief outside Argentina.

The involuntary U.S. Chapter 11 case was commenced in September 2006 by four off-shore investment funds holding a majority in value of the Notes. Fargo moved to dismiss the petition on various grounds, including that the court should abstain in the interests of the debtor and creditors pursuant to Section 305(a)(1) of the Bankruptcy Code, and petitioners

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opposed. The court directed Fargo to submit a motion for summary judgment on the abstention issue to determine whether the case could be decided as a matter of law without the need for a trial.

## THE PARTIES' ARGUMENTS

Fargo argued that dismissal was appropriate because, among other things:

- (a) the concurso had been pending for four years, and the Argentine court had asserted exclusive jurisdiction over Fargo's assets;
- (b) the petitioners had submitted to the jurisdiction of the Argentine court and, through the indenture trustee, were actively litigating in Argentina the very issues they were raising in the U.S. court;
- (c) the Argentine concurso process repeatedly has been recognized as fair and should be afforded comity; and
- (d) a U.S. reorganization case for Fargo would be futile and a waste of resources because substantially all of Fargo's assets are located in Argentina and any plan that contained the relief petitioners sought — subordination or disallowance of the secured creditor's claims — would not be recognized in Argentina.

Fargo submitted expert affidavit testimony that, under Argentine law, special secured claims must be paid in full outside the concurso process and the Argentine court would not recognize a proceeding that petitioners filed in the United States in violation of the Argentine automatic stay.

In opposition to Fargo's motion, petitioners argued, among other things, that proceeding with the U.S. Chapter 11 case, rather than dismissing in deference to the Argentine concurso, was in the interests of the debtor and its creditors because the concurso process was tainted by corruption and was incapable of producing a fair result for the holders of the U.S. Notes. Petitioners argued that Argentine law, while providing for an automatic stay, did not stay the holders of special secured claims from foreclosing on the debtor's Argentine assets during the concurso.

Petitioners further noted that Fargo's equity was held by an affiliate of Fargo's secured creditor, and therefore Fargo might not oppose such a foreclosure on instructions from its shareholder (notwithstanding that Fargo had already opposed such efforts in the Argentine courts). Petitioners argued that the U.S. automatic stay would prevent such foreclosure, and that discovery in the U.S. case might reveal evidence that would warrant subordination of the secured creditor's claim — a remedy not recognized under Argentine law. Finally, petitioners argued that the Argentine court of appeals had erred in issuing a decision limiting the noteholders' claim, for voting purposes only, to the amount of unpaid prepetition interest. This decision had no practical effect in the concurso, as the noteholders controlled the vote for their class in any event. Moreover, the decision was on appeal to the Argentine Supreme Court. However, petitioners argued that the appeal had languished for several years with no decision and in the meantime the Argentine concurso was stayed, thus prejudicing petitioners in their effort to collect on their claim in the concurso.

## BANKRUPTCY COURT'S MEMORANDUM DECISION

In a Memorandum Decision, the court granted dismissal on Section 305(a)(1) grounds, holding that Fargo should be reorganized in Argentina without the "oversight or interference" of the U.S. court. The court noted that the decision whether to abstain pursuant to Section 305(a)(1) is within the court's discretion. When a court is asked to abstain in favor of a foreign proceeding, the question whether that forum will fairly determine the parties' rights "is of paramount importance" and subsumes several of the factors normally considered. Once this factor is satisfied, the court must weigh the relative benefits and burdens of exercising jurisdiction and consider the reason for filing the involuntary petition.

The bankruptcy court determined that all the relevant factors weighed in favor of dismissal. First, the court held that the Argentine courts can determine and adjust the parties' rights in a fair and equitable manner. The court found that there was no endemic corruption in the Argentine system sufficient to warrant a denial of comity, that the

Argentine concurso is similar to a U.S. Chapter 11 case and that differences in the two systems are not at odds with fundamental U.S. notions of fairness. Moreover, the court rejected petitioners' challenge based on the allegedly erroneous ruling of the Argentine court of appeals regarding voting rights. The court noted that "a mistake does not automatically imply partiality, or worse, corruption," that courts often make mistakes and that this matter was on appeal in Argentina. In addition, Fargo had agreed to waive the ruling and to allow the Indenture Trustee to vote the full amount of the debt. Thus, the court noted that the delays in the concurso resulting from the appeal appeared to be over and that, in any event, "it is questionable whether a United States bankruptcy would move any more quickly or serve any purpose."

Second, the court found that a parallel Chapter 11 case would be inefficient, expensive and of questionable benefit. The court noted that all of Fargo's business operations, customers and employees are located in Argentina, as are most of its assets, and found that an attempt by the U.S. court to reorganize Fargo "would certainly be difficult if not futile." The court noted the disagreement between the parties' experts as to whether a U.S. plan of reorganization for Fargo would be enforceable in Argentina, given the differences in the two systems and the pendency of the concurso, but found that it was unnecessary to resolve this disagreement, stating that any attempt at enforcement would be "fraught with uncertainty."

Finally, the court found that a parallel U.S. reorganization case would serve no legitimate purpose. Despite their alleged concerns about the fairness of the concurso, three of the petitioners had purchased substantial amounts of Notes *after* the concurso was pending in Argentina and *after* the court of appeals decision of which they now complained. Thus, although the petitioners argued that hostile interests had "hijacked" the concurso, the court stated that "one could argue, with equal plausibility, that the Petitioners filed this case to hijack the *Concurso* or, at a minimum, increase their leverage in any negotiations." The court also declined petitioners' invitation to suspend rather than dismiss the Chapter 11 case in order to enforce the U.S. automatic stay against Fargo's special secured creditor, stating, "If the reorganization serves no purpose, the automatic stay cannot give it a purpose."

## DISCUSSION

The ruling in this case makes clear that, although the Notes were issued under U.S. law, this fact alone is not sufficient to avoid dismissal of an involuntary Chapter 11 case where there is already a case pending in the debtor's home jurisdiction and the reorganization efforts of the U.S. court would be futile. The decision also indicates that the holders of Notes issued under U.S. law have no special right to seek relief in a U.S. forum when there is a competing plenary proceeding pending elsewhere — at least where, as here, the noteholders are already participating in the foreign proceeding and there is no evidence (as opposed to mere speculation) of corruption or bias in that proceeding.

## NOTE

<sup>1</sup> 376 B.R. 427 (Bankr. S.D.N.Y. 2007). Shearman & Sterling LLP represented the alleged debtor in its successful motion to dismiss the involuntary Chapter 11 case.

# Northern Exposure: A Tale of Two Canadian Recapitalizations with Precedential Value for Future Canadian and U.S. Transactions

EVAN D. FLASCHEN AND KURT A. MAYR

*The authors explain the significance of two recent corporate restructurings.*

Several months ago, Tembec Industries, Inc., successfully completed a recapitalization involving complete conversion of its bond debt to equity and a new money facility provided by existing bondholders on a backstopped basis. Shortly thereafter, Abitibi Consolidated Inc. successfully completed a recapitalization involving an exchange offer for its maturing bond debt and three concurrent new financings. Both recapitalizations involved extraordinary circumstances and novel business and legal strategies that may serve as important precedents for future recapitalization and restructuring transactions both in Canada and in the U.S.

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## TEMBEC INDUSTRIES — A NEW APPROACH TO OLD PROBLEMS

Tembec was hit with a triple whammy. First, the housing slump triggered by the subprime crisis materially reduced demand for Tembec's timber products. Second, the increasing strength of the Canadian dollar reduced the profitability of Tembec's substantial sales into the U.S. market. Third, like so many other companies today, Tembec took advantage of the pre-2007 credit markets to lever up its balance sheet to the point that there was little margin for error.

Tembec's \$1.2 billion in public debt securities consisted of three separate issuances that matured in 2009, 2011 and 2012, respectively. Anticipating that it was unlikely that Tembec could meet its 2009 maturity, a group of 2009 bondholders made a proposal to Tembec that, according to market rumors, would extend the 2009 maturity in exchange for securing the 2009 bonds.

Needless to say, Tembec's 2011 and 2012 bondholders were not enamored with the prospect of securing the 2009 bonds while leaving the 2011 and 2012 bonds outstanding on an unsecured basis. This caused a group of 2011 and 2012 bondholders to approach Tembec with the proposition that Tembec would be better served by a global deleveraging transaction than by a band-aid approach that only addressed the 2009 bonds.

Recognizing that it needed to do "something," Tembec set up a process for interested parties to make "bids" as to a recapitalization and invited both groups of bondholders, as well as Tembec's largest shareholder, to bid against each other.

In formulating their proposal, the 2011/2012 group defined a series of objectives:

- The proposal should address all of Tembec's bonds, rather than just one issue of bonds, because this would be in the best interests not only of the 2011/2012 bonds but also of Tembec itself.
- The proposal should convert 100 percent of the bond debt to equity in order to provide Tembec with the best opportunity for succeeding in the difficult forest products environment, while at the same time

providing bondholders with an equity upside to compensate for their increased risk.

- The proposal should include a commitment for new money in order to incentivize Tembec with “one-stop shopping” convenience while properly capitalizing Tembec for the challenges ahead.
- The proposal needed to incentivize shareholders to support the proposal, both in lieu of the anticipated proposal from Tembec’s largest existing shareholder and with the goal of achieving a fully consensual transaction.
- The proposal needed to be capable of consummation by February 29, 2008, which was the last day of the grace period on an interest payment and, therefore, the last day before the substantial market CDS exposure would be triggered, potentially throwing a monkey wrench into the entire process.
- The proposal needed to reward the group with extra compensation for taking the lead, but without running afoul of indenture “equal treatment” provisions.
- The proposal needed to provide incentives to all bondholders, including the 2009 bondholders, because the 2011/2012 group controlled only 20 percent of the overall bond debt but needed two-thirds of the bonds to consent to the recapitalization.

A tall order indeed, but it was an order that the 2011/2012 group was able to fulfill. In summary, the proposal (i) converted all bond debt to equity, but provided just enough new equity to the existing shareholders to obtain their support as well, and (ii) included a commitment to a new \$300 million secured facility.

The two most important features of the proposal were the backstopped nature of the new facility and the novel utilization of a Canadian corporate recapitalization regime rather than the more typical insolvency regime.

The backstop feature provided the members of the 2011/2012 group with both a cash fee and an equity fee for backstopping the \$300 million commitment. At the same time, all other bondholders were also invited

to backstop the \$300 million commitment in exchange for a healthy fee, but less than was payable to the group members. Also, in order to reduce the extent to which the backstops were actually called upon, the new \$300 million facility was offered to all bondholders with both a market rate of interest and a substantial share of the new equity. This approach presented other bondholders with a choice. On the one hand, they could participate in the proposal and receive both a backstop fee and substantial compensation for participating in the new facility. On the other hand, they could fight the proposal and take the risk that the proposal would still obtain approval, in which case they would lose out on both the backstop fee and the extra compensation. In the end, the requisite percentage of bondholders chose to support the proposal.

The statutory feature focused on the Canada Business Corporations Act ("CBCA"). Pursuant to the CBCA, a solvent Canadian corporation can restructure certain financial debt obligations pursuant to a creditor vote that binds hold-out creditors subject to shareholder approval and to court approval for general fairness. The CBCA is not an "insolvency" statute and, in fact, is not available to insolvent companies. For insolvent companies, the typical approach would be to use the Companies' Creditors Arrangement Act ("CCAA"), but CCAA proceedings take longer, are more court intensive, are more expensive and implicate more contractual rights. For example, a CCAA filing triggers "bankruptcy defaults" under a company's contracts with major vendors. However, by proceeding under the CBCA, Tembec was able to equitize 100 percent of its bond debt without disrupting key trade relationships and governmental licenses (particularly critical in the highly-regulated forest products industry). The disadvantages, as alluded to above, were that shareholder approval was needed and that the process was open to dissenting creditors to assert that Tembec was insolvent and, therefore, not eligible for a CBCA transaction. However, the built-in incentives of the Tembec recapitalization proposal paved the way for a quick and smooth process that did not meet with material opposition at the end of the day.

Before the Tembec recapitalization, the CBCA had not been used to implement a financial restructure of a company of Tembec's magnitude. After Tembec, one should expect to see more use of the CBCA for pre-

negotiated deleveraging transactions, particularly when the transaction appropriately incentivizes other bondholders, lenders and shareholders to support the transaction.

## ABITIBI CONSOLIDATED — OVERCOMING THE ODDS

In late 2007, Abitibi Consolidated merged with Bowater to form AbitibiBowater, one of the world's largest news print and timber products companies. Both Abitibi and Bowater brought substantial debt to the merger, making it almost inevitable that Abitibi would need to recapitalize its balance sheet prior to its 2008 and 2009 bond maturities. Unfortunately, there were substantial delays in obtaining audited financials for the merged companies, thus effectively precluding Abitibi from accessing the capital markets on a timely basis. This problem was compounded by the same factors that affected Tembec – weakening demand for timber, unfavorable exchange rate movements, very high leverage and a concurrent crisis in the credit markets.

Unable to wait any longer for its audited financials and in light of the weakening credit markets, Abitibi announced in early March 2008 a proposed recapitalization that would involve a new short-term bank facility, a substantial issue of new high-yield senior secured notes, a major convertible note placement, and an exchange of the 2008 and 2009 bonds for cash and longer-maturity unsecured bonds. The bond exchange offer was clearly well below par, resulting in a group of 2008 and 2009 bondholders forming to discuss their options.

All of this needed to be consummated prior to the April 1 maturity of a substantial portion of the 2008 bonds, otherwise all \$5 billion of Abitibi's bonds, regardless of maturity date, could have cross-accelerated, not to mention the substantial turmoil that would have been caused as a result of the multiple billions of CDS exposure written on Abitibi's bonds. And all aspects of the transaction needed to be consummated in the context of the continuing credit crunch, compounded by the Bear Stearns melt-down in the middle of the capital raising efforts.

The bondholder group was thus faced with several major challenges. First, they needed to persuade Abitibi to amend the exchange offer to pro-

vide appropriate consideration. As challenging as such a negotiation is in a bilateral context, the challenges were compounded by the need for Abitibi to raise the bank, secured note and convertible financing, all of which were dependent on approval of the terms of any amended exchange offer.

Second, the bondholder group needed to deliver 90 percent of the 2008 bonds and 75 percent of the 2009 bonds into the offer in order to minimize the risk of “free riders.” This presented the logistical problem of identifying the holders of the widely-held public bonds, as well as ensuring that bonds on loan were recalled so that they could be tendered in time.

Third, they needed the other components of the recapitalization transaction to fall into place prior to the April 1 bond maturity.

As reflected in the low trading price of the bonds, the market bet heavily against the likelihood that all of this could be achieved within three weeks. Nevertheless, the bond group proceeded with its efforts to negotiate an improved exchange offer, on the theory that slim odds were better than no odds at all. At the same time, the group privately engaged in substantial contingency planning, including the possibility of providing interim funding in order to refinance the near-term maturities so that Abitibi would have a breathing space in which to raise the financing for a longer-term recapitalization.

The good news was that the bondholder group was able to negotiate a substantially improved exchange offer — \$550 in cash and \$550 in new 15.5 percent notes for each \$1000 of the April maturity bonds — and Abitibi obtained its audited financials and was able to raise the new bond, note and convertible financing, all in compliance with Canadian and U.S. legal requirements and all consummated within the space of three weeks from the date of Abitibi’s original proposal. In addition, the new bonds received the benefit of enhanced guarantees and the same tight high-yield covenant package provided for the new senior secured notes.

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