UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS
EASTERN DIVISION

In re **CHARLES STREET AFRICAN METHODIST EPISCOPAL CHURCH OF BOSTON,** **Debtor**	**Chapter 11** **Case No. 12-12292-FJB**

MEMORANDUM OF DECISION ON
REQUEST OF DEBTOR TO PROHIBIT CREDIT BIDDING

In conjunction with its proposed sale of certain real property, the debtor and debtor-in-possession, Charles Street African Methodist Episcopal Church of Boston ("CSAME"), has moved for an order prohibiting OneUnited Bank ("OneUnited"), which holds mortgages on the properties in question, from credit bidding at the sale. CSAME would have the Court deny the option of credit bidding "for cause" within the meaning of 11 U.S.C. § 363(k), the cause being that OneUnited's secured claims are subject to bona fide dispute by virtue of CSAME's assertion of counterclaims that, by setoff, would reduce the amount of those claims to zero. OneUnited and the United States Trustee have objected to the request. For the reasons set forth below, the Court will deny the request except as to the first $50,000 of the sale price, which is needed to fund payment of the break-up fee that would be payable were OneUnited the successful bidder. As to the balance of the purchase price, the Court holds that OneUnited has not established cause to limit or deny OneUnited's prerogative under § 363(k).

FACTS AND PROCEDURAL HISTORY

a. The Sale Motion

CSAME owns two contiguous parcels of real property known as the RRC Property and the Storefronts (collectively, the "Assets") and has moved for authority to sell them together to its stalking-

horse bidder, Action for Boston Community Development, Inc., ("ABCD"), a Massachusetts nonprofit corporation, or the high bidder at a proposed auction. The proposed sale would be free and clear of all liens, claims, and encumbrances. Under an agreement with ABCD (the "Stalking Horse Purchase Agreement"), CSAME will be obligated to pay to ABCD a $50,000 break-up fee if ABCD is not ultimately the successful bidder. ABCD's stalking horse bid is in the amount of $2,000,000. Other prospective purchasers may bid for the Assets at a final auction provided they satisfy certain requirements, including the timely submission of a counteroffer of at least $2,100,000 with a cash deposit of $210,000. Another nonprofit corporation, Horizons for Homeless Children, Inc. ("Horizons"), has indicated its intent to bid for the Assets.

CSAME's motion to approve the sale (the "Sale Motion") included a request for a preliminary order to, among other things, (i) approve the break-up fee, (ii) approve proposed bidding procedures, and (iii) prohibit OneUnited from credit bidding for the Assets. By a separate memorandum of decision, the Court has indicated that it will approve the break-up fee and bidding procedures and schedule a final hearing on the Sale Motion in time to close the sale by the end of June 2014. The Court indicated in that memorandum of decision that it would address the credit bidding issue separately.

b. Claims of OneUnited

OneUnited filed a proof of claim, asserting secured claims based on two loans made by OneUnited to CSAME on October 3, 2006: the "Church Loan," under which CSAME borrowed $1,115,000, with principal and unpaid interest due in full on December 1, 2011; and the "Construction Loan" (together with the Church Loan, "the Loans"), an 18-month non-revolving line of credit of up to $3,652,000 for the purpose of constructing a community center, the Roxbury Renaissance Center ("RRC"). OneUnited claims that the balances on the petition date were $1,188,562.90 on the Church Loan and $3,815,795.70 on the Construction Loan, including "default/maturity interest" of $792,425.92 on the Construction Loan and $58,416 on the Church Loan. In addition to the prepetition balances,

OneUnited also asserts entitlement to "post-petition interest, attorney's fees and costs, pursuant to 11 U.S.C. § 506(b)." CSAME objected to the default/maturity interest component of OneUnited's claim. After an evidentiary hearing, the Court sustained that objection; OneUnited appealed, and on September 30, 2013, the District Court affirmed; a further appeal to the Court of Appeals was dismissed by agreement.

The OneUnited Claims are also subject to other counterclaims in state court litigation between CSAME and OneUnited, which litigation was automatically stayed upon CSAME's bankruptcy filing. In the plans of reorganization it has filed to date, including one recently filed and still pending, CSAME proposed that it would retain and litigate these counterclaims after confirmation of the plan. Proceeds from the prepetition sale of the properties securing OneUnited's claim would be held in escrow until the state court litigation was completed.

The Loans are secured by CSAME's real property. The Church Loan is secured by mortgages on the Storefronts and two other properties. The Construction Loan is secured by mortgages on the RRC Property and two other properties. The properties that secure the Construction Loan do not also secure the Church Loan, and the properties that secure the Church Loan do not also secure the Construction Loan.

c. CSAME's Second Objection to Proof of Claim of OneUnited

Eight days after filing the Sale Motion, CSAME filed a second objection to OneUnited's Proof of Claim (the "Second Objection"). The Second Objection was filed in conjunction with the Sale Motion for the express purpose of demonstrating that OneUnited's claim is in bona fide dispute. The Second Objection essentially interposes, by way of setoff, three counterclaims against OneUnited that, if successful, would wholly eliminate OneUnited's claim. Each counterclaim is asserted under Mass. Gen. Laws ch. 93A; one is also asserted under contract law. The first two counterclaims are reiterations of

counterclaims that CSAME asserted in the state court litigation between CSAME and OneUnited. As most-concisely articulated by CSAME, the counterclaims are as follows:

- "OneUnited willfully and knowingly structured the Construction Loan so that the RRC construction project was substantially underfunded from the beginning, leading predictably to the Church's [CSAME's] inability to finish the project and default on the Loan. The Church thus seeks damages under ch. 93A against the Bank for unfair and deceptive origination of the Construction Loan."
- "[CSAME] further seeks damages, under contract law and ch. 93A, for the Bank's refusal to fund the tenth draw request to Thomas [CSAME's general contractor] under the Construction Loan, which led to a failure to complete construction on the RRC."
- "[OneUnited] acted in an unfair and deceptive manner, entitling the Church to damages under ch. 93A, by prosecuting the state court action against the Church to collect on the Construction Loan and by initiating a foreclosure action on the Church Loan collateral with no intent to pursue those actions to completion." "OneUnited's commercially unreasonable foreclosure action, along with the Bank's prior collection activities, led directly to the filing of this Chapter 11 case and very substantial diminishment in the financial stability of [CSAME], which had previously been raising funds from the congregation at a significantly higher level. It also caused a very significant delay in the construction of the RRC, with attendant diminishment in value."

CSAME filed the Second Objection only on April 30, 2014. It has not been scheduled for adjudication and cannot reasonably be adjudicated in advance of the proposed sale, which at present must occur before the end of June. CSAME does not seek to have the Second Objection decided before the sale. OneUnited states that, if the Court is inclined to deny it leave to credit bid, the Second Objection should be adjudicated before the sale.

d. Arguments of the Parties

CSAME seeks a prohibition of credit bidding on a single, narrow basis: that OneUnited's claim is subject to bona fide dispute, which bona fide dispute constitutes "cause" under 11 U.S.C. § 363(k) to prohibit credit bidding. CSAME does not advance, as cause to prohibit credit bidding, that OneUnited's claim is not an "allowed" claim within the meaning of § 363(k). CSAME does contend that other grounds exist on which a prohibition on credit bidding might be predicated here: (i) concern that OneUnited's ability to credit bid would chill the bidding or depress interest in the Assets and (ii) concern that OneUnited may be interested in bidding for improper, ulterior motives. But CSAME hastens to add that, for tactical reasons—especially a desire to avoid the need for a long evidentiary hearing and to present the issue in such a way as the Court can make an up or down decision simply as a matter of law, on undisputed facts—it is *not* relying on these alternate grounds. CSAME expressly disavows any reliance on *In re Fisker Automotive Holdings, Inc.*, 2014 WL 210593 (Bankr. D. Del. 2014) and its rationale, and therefore this motion presents no occasion to address *Fisker*'s rationale and the types of "cause" at issue there.

OneUnited objects, arguing that the right to credit bid is too important to be taken from a creditor by the filing of a last-minute objection that cannot be adjudicated before the sale. OneUnited disputes the merits of the counterclaims on which the Second Objection is based and suggests that if the counterclaims had merit, they would have been asserted and litigated earlier in the case, and that this is nothing but a cynical ploy to disenfranchise OneUnited by underhanded means. The United States Trustee—whose purpose in weighing in on this issue is unclear—argues that the existence of a bona fide dispute as to a secured claim is not necessarily "cause" within the meaning of § 363(k) and, for a host of reasons, does not here amount to cause to prohibit credit bidding by OneUnited.

DISCUSSION

Section 363(k) of the Bankruptcy Code states:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. § 363(k). Under this subsection, the holder of an allowed claim that is secured by a lien on property being sold in bankruptcy may, if it is the purchaser of the property at sale and "unless the court for cause orders otherwise," pay the purchase price by offset against its claim.[1] That is, the claim holder may pay the purchase price with its claim, which is what is meant by the non-statutory term "credit bid." This right of a secured creditor to credit bid is subject to two express limitations: it applies only where the creditor's lien secures an "allowed" claim; and even where the claim is allowed, the court "for cause" may order otherwise. The statute does not define cause for denying leave to credit bid.

Notwithstanding the filing of its Second Objection, CSAME does not contend (either in its brief or in its oral arguments), as a basis for disallowing credit bidding, that OneUnited's secured claims are, by virtue of the pending objection, *not* "allowed" within the meaning of this subsection. Accordingly, for purposes of the present motion, I need not and do not decide that issue. CSAME instead argues only that the counterclaims articulated in the Second Objection are "cause" within the meaning of § 363(k) to disallow credit bidding.

I agree with the United States Trustee that the standard here is the existence or not of "cause," and that the existence of a bona fide dispute as to the secured claim is not necessarily cause. In many cases, the existence of a bona fide dispute as to the secured claim is cause. Here, however, I conclude that the counterclaims do not amount to cause to prohibit credit bidding.

[1] The right in question is only a right to pay a successful bid by offsetting the creditor's claim against the purchase price. The credit bidder does not otherwise enjoy special consideration in the bidding process. If, for example, the final round of bidding is by sealed bids, the creditor may submit a final sealed bid but is not entitled to a special opportunity to top a higher bid than its own.

I rest this decision primarily on the nature of the objections articulated in the Second Objection. They do not challenge OneUnited's underlying claims[2] but instead interpose counterclaims as the basis of a defense of setoff. Of course, setoff is a valid defense, but it is an affirmative defense. The burden of proving it rests on CSAME. And the defense is not one that undercuts the existence of the primary claim; CSAME does not dispute the validity of the underlying loan agreements, the validity, perfection, or priority of OneUnited's mortgages, the amounts claimed to be due, or anything intrinsic to either of OneUnited's claims. Nor does CSAME allege that the mortgages or loan agreements may be avoided. Rather, CSAME asserts claims of its own that it would satisfy by setoff against OneUnited's otherwise valid claims. In short, there is no dispute about the validity or extent of OneUnited's secured claims.

CSAME expresses a concern that, if OneUnited is permitted to credit bid, then any judgment that CSAME may ultimately obtain on the counterclaims will or may be uncollectible; credit bidding would create a credit risk. The claim against which the counterclaim would be satisfied would already have been expended, at least in part.

While I agree that credit risk is sometimes cause to disallow credit bidding, I disagree that it is a valid basis here. Credit risk is cause for disallowance of credit bidding when the creditor's own claim is in dispute. As a general rule, a secured creditor should not receive payment on its claim before objections to the claim are resolved; otherwise, estate assets may be distributed in satisfaction of a claim that may later be deemed invalid, at which point the "creditor" may be unable or unwilling to return the distribution to the estate, and the estate may have to expend scarce funds to recover it—if it is able to mount such an effort at all. Here, there is no risk of a distribution on an invalid claim; instead there is a risk that an untested counterclaim will go unsatisfied. CSAME would be using a denial of credit bidding as, in essence, a form of prejudgment security, a purpose that I doubt it was intended to serve.

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[2] OneUnited has filed only one proof of claim, but the proof of claim in fact asserts two separate secured claims, one arising from the Church Loan, the other from the Construction Loan, each being secured by its own separate set of assets. It is therefore more accurate to speak of OneUnited as having two claims.

Insofar as CSAME may be concerned about credit risk and prejudgment security, it may yet seek security by the usual means, such as an attachment of free assets to secure the counterclaims.[3] Moreover, it is unlikely that, even if OneUnited is the successful bidder, it will expend all of both of its claims in acquiring the Assets. CSAME will have the balance of these claims to look to for satisfaction of its counterclaims. For these reasons, I conclude that, except to the limited extent set forth in the following paragraph, CSAME has not established cause to prohibit credit bidding for the Assets.

In the alternative, CSAME has asked for a narrower limitation on credit bidding. CSAME points out that, under bid procedures that the Court has indicated it will approve, bids at the Auction must include at least $210,000 in cash as a deposit, to be used in part to pay the break-up fee to ABCD, if triggered. Therefore, to the extent the Court permits OneUnited to credit bid, CSAME requests that the Court require OneUnited, in any credit bid, to submit at least $210,000 in cash as a deposit, and to order that such deposit will be used in part to pay the break-up fee to ABCD if OneUnited should prevail at the Auction with its credit bid. OneUnited has not opposed this request and has not disputed that the need to fund the break-up fee is cause to limit the right to credit bid. I agree that the need to fund the break-up fee is cause to limit the right to credit bid. However, I see no reason to require that the cash portion of any bid by OneUnited exceed the $50,000 needed to fund the break-up fee should OneUnited prevail at the auction. Accordingly, I will limit the right to credit bid by requiring that the deposit that OneUnited must submit in order to participate in the auction must include cash of $50,000. The balance of the deposit and, if OneUnited is the successful bidder, of the purchase price may be paid by credit bid.

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[3] I make no findings as to OneUnited's creditworthiness or solvency or the extent of its unencumbered assets. The present motion raises the issue of credit risk in only a general way, as the reason why a bona fide dispute as to a secured claim creates cause to deny leave to credit bid.

I do not suggest that an attachment is available in conjunction with a simple objection to claim. An attachment could be sought in the pending state court litigation or, if CSAME would convert its counterclaims from defenses to affirmative demands for relief in this court, in an adversary proceeding under Fed. R. Bankr. P. 7001 *et seq.* See Fed. R. Bankr. P. 3007(b).

To avoid later confusion, I add one final word about credit bidding. The properties being sold include one that secures the Church Loan and another that secures the Construction Loan. They are being sold as a unit. Section 363(k) permits a secured creditor to credit bid for an asset with the claim for which the asset serves as collateral—and only with that claim. If OneUnited elects to credit bid, it will have to do so with a portion of each of its secured claims, and it will have to specify in its bid the amount of each claim that makes up the total bid.

A separate order will enter consistent with the above rulings.

Date: May 14, 2014

Frank J. Bailey
United States Bankruptcy Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
Richmond Division

DSP Acquisition, LLC,	)	
	)	
Appellant,	)	
	)	
v.	)	Civil Action Nos. 3:14cv303–HEH
	)	and 3:14cv304–HEH
Free Lance-Star Publishing Co. of Fredericksburg, VA and Official Committee of Unsecured Creditors	)	
	)	
Appellees.	)	

MEMORANDUM OPINION
(Emergency Motion to Expedite and Motion to Strike)

This matter is before the Court on Appellant DSP Acquisition, LLC's ("DSP") Amended Emergency Motion for Expedited Consideration of its Motion for Certification and for Leave to Appeal and the Appeals from the Orders Pursuant to 28 U.S.C. § 158(d)(2) (ECF No. 24 in Case No. 3:14cv303 and ECF No. 24 in Case No. 3:14cv304), filed on April 25, 2014. The Free Lance Star-Publishing Co. of Fredericksburg, Va, *et. al* ("Debtors") filed an Answer and Opposition to DSP's Motion[1] on April 25, 2014.[2] Also before the Court is the Joint Motion of the Debtors and the Official Committee of

[1] The Official Committee of Unsecured Creditors of the Free Lance-Star Publishing Co. of Fredericksburg, Va, *et al.* filed an Answer and Opposition as well, but this document has not been designated on appeal, and therefore, is not before the Court.

[2] The ECF filing numbers associated with DSP's Motion and Debtors' Answer and Opposition do not reflect their filing dates. DSP's Motion was originally filed with the U.S. Bankruptcy Court for the Eastern District of Virginia on April 15, 2014 and the Answer and Opposition was filed on April 24, 2014. All of these documents were designated to this Court on appeal on April 25, 2014. The Clerk of Court later refiled these two documents in separate ECF filings to clarify which filings include pending matters before this Court.

Unsecured Creditors of the Free Lance-Star Publishing Co. of Fredericksburg, Va, *et al.* ("the Committee") (collectively "Appellees") to Strike Verified Reply of DSP (ECF No. 22 in Case No. 3:14cv303 and ECF No. 23 in Case No. 3:14cv304), filed on April 28, 2014. The time for DSP to file a response to Appellees' Motion has not yet expired.[3] In the interest of resolving this matter quickly and in advance of the May 15, 2014 auction, this Court exercises its discretion to decline oral argument. For the reasons that follow, the Court denies DSP's Motion and Appellees' Motion.

I. Background

The U.S. Bankruptcy Court for the Eastern District of Virginia ("the Bankruptcy Court") issued three opinions and accompanying orders on April 14, 2014 (collectively "the Bankruptcy Court opinions"). In one of the opinions, the Bankruptcy Court denied DSP's Motion for Summary Judgment and granted partial summary judgment in favor of the Debtors on their Cross Motion for Summary Judgment. In that opinion, the Bankruptcy Court ruled that DSP does not have a valid perfected security interest in all of the assets upon which it claims such interest. *DSP Acquisition, LLC v. Free Lance-Star Publ. Co.* (*In re Free Lance-Star Publ. Co.*), 2014 Bankr. LEXIS 1644 at *27-28 (Bankr. E.D. Va. Apr. 14, 2014). The Bankruptcy Court did not reach the questions of which parties own which liens and the amount of those liens.

In an associated April 14, 2014 opinion, the Bankruptcy Court found that DSP engaged in inequitable conduct when it urged the Court "to grant it liens on" assets over

[3] It is moot that DSP has not had a chance to respond to Appellees' Motion because the Court is denying the Motion.

which it knew "it did not have a valid lien," but nonetheless had recorded such liens in its Financing Statements. *In re Free Lance-Star Publ'g Co., 2014 Bankr.* LEXIS 1611 at *21-22 (Bankr. E.D. Va. Apr. 14, 2014). After assessing the uncontroverted evidence, particularly that pertaining to limitation on DSP's credit bid (and the method for doing so), the Bankruptcy Court ruled that DSP's credit bid would be "limited to $1,200,000 for assets related to the Debtors' radio business on which DSP has a valid, properly perfected lien and $12,700,000 for assets related to the Debtors' newspaper and printing business on which DSP has a valid, properly perfected lien." *Id.* at *24, 26-27. In support of this decision, the Bankruptcy Court emphasized "[t]he confluence of (i) DSP's less than fully-secured lien status; (ii) DSP's overly zealous loan-to-own strategy; and (iii) the negative impact DSP's misconduct has had on the auction process [which] has created the perfect storm, requiring curtailment of DSP's credit bid rights." *Id.* at *25.

In the third of the April 14, 2014 opinions, the Bankruptcy Court denied DSP's Emergency Motion for Reconsideration of the Court's March 24, 2014 ruling that excluded certain documentary evidence submitted during the hearing on DSP's Motion for Summary Judgment. *DSP Acquisition, LLC v. Free Lance-Star Publ. Co.* (*In re Free Lance-Star Publ. Co.*), 2014 Bankr. LEXIS 1643 at *15-16 (Bankr. E.D. Va. Apr. 14, 2014).

DSP now seeks this Court's review of the following Bankruptcy Court decisions: (1) denial of DSP's motion for summary judgment, (2) grant of partial summary judgment in favor of the Debtors on their cross-motion for summary judgment, (3) limit of the extent and validity of DSP's liens and limit of DSP's credit bid, and (4)

establishment of the amount of DSP's allowable credit bid. (DSP Mot. at 3.) DSP requests consideration of these issues in advance of an auction of Debtors' assets that is scheduled for May 15, 2014. DSP brings its Motion pursuant to Federal Rules of Bankruptcy Procedure 8011(d) and 8019. Federal Rule of Bankruptcy Procedure 8011(d) allows for the expedited consideration of an emergency motion "to avoid irreparable harm." Federal Rule of Bankruptcy Procedure 8019 permits the district court to suspend procedural rules governing appeals "[i]n the interest of expediting decision or for other cause." Debtors oppose DSP's Motion by refuting DSP's arguments under Federal Rule of Bankruptcy Procedure 8011 and by further addressing the typical issues considered in an interlocutory appeal—finality and the elements required to justify consideration of such an appeal.

II. Analysis

A. Irreparable Harm Under Fed. R. Bankr. P. 8011(d)[4]

DSP argues that the issues it wishes to appeal are at the heart of the Debtors' sale process and the upcoming May 15, 2014 auction, and, thus, these issues must be resolved prior to the auction. If the issues are not resolved in advance, DSP contends it will be permanently deprived of its right to appellate review, irreparable harm will occur, and the integrity of the sales process (the efficiency of the process and the certainty of what assets are properly subject to sale) will be jeopardized.

[4] Debtors argue that DSP did not comply with Fed. R. Bankr. P. 8011(d) because they did not specifically state in their Motion that all avenues in support of its requested relief to avoid irreparable harm were first presented to the Bankruptcy Court. This Court does not find DSP's possible failure to comply with Fed. R. Bankr. P. 8011(d) significant and will address DSP's arguments regardless of the fact that it did not seek a stay or may not have made the required statement in its Motion.

As more fully discussed *infra*, the Court agrees with Debtors that there is no risk of irreparable harm if the issues are not resolved before the auction because there is no pending issue regarding the assets subject to sale and the Bankruptcy Court will determine who receives the proceeds (and how much) *after* the sale. Thus, if the Bankruptcy Court determines that the amount of DSP's credit bid was incorrect, it can accordingly adjust the payment to DSP at a later stage of the proceedings.

B. Finality of the Bankruptcy Court's Opinions

Even if there were an arguable risk of irreparable harm, there is a competing risk to the progression of the litigation if this Court were to consider an interlocutory appeal. Under 28 U.S.C. § 158(a)(1), "a district court for the judicial district in which the bankruptcy judge is serving" has mandatory jurisdiction to hear appeals from "final judgments, orders, and decrees" of the bankruptcy judge. While "district courts should be pragmatic in their interpretation of finality in bankruptcy cases because of the protracted nature of the proceedings . . . 'the general antipathy toward piecemeal appeals still prevails in individual adversary actions . . . [and] inefficient use of judicial resources is as objectionable in bankruptcy appeals as in other fields.'" *Hybrid Tech Holdings, LLC v. Official Comm. of Unsecured Creditors of Fisker Auto. Holdings, Inc.* (*In re Fisker Auto. Holdings*), 2014 U.S. Dist. LEXIS 15497 at *7-8 (D. Del. Feb. 7, 2014) (internal citations omitted).

Because the Bankruptcy Court's opinions did not dispose of the adversary and core proceedings pending in the Bankruptcy Court, the Court is of the opinion that they are interlocutory.

This case is strikingly similar to *Hybrid Tech Holdings, LLC*, where the U.S. District Court for the District of Delaware denied an Emergency Motion for Leave to Appeal Decision Limiting Credit Bid. *Id.* at *1. The court determined that the bankruptcy court's decision to limit the secured lender's credit bid was interlocutory because the secured lender would still have a remedy if the emergency motion were denied because the secured lender "could then either receive a cash return of the difference between the full credit entitled, or if a third-party bidder won the auction, [the secured lender] could receive its entitlement out of the cash paid by this party." *Id.* at *12. The court in *Hybrid Tech Holdings, LLC* further found that the secured lender's rights had not been fully adjudicated because "there is much work left for the Bankruptcy Court" and "[a]s case law establishes, a bankruptcy order that requires further development to fully dispose of the issues is not final." *Id.* at *13 (citing *In re Truong*, 513 F.3d 91, 94 (3d Cir. 2008)).

Similarly, the Bankruptcy Court's opinions in the case at bar are not dispositive. Who has liens, the amounts of those liens, the full extent of DSP's liens, and other issues remain to be determined. The trial in the underlying adversary proceeding and the upcoming auction will move forward regardless of the final disposition of the matters addressed in Bankruptcy Court's opinions. Accordingly, this Court finds that the Bankruptcy Court's opinions are not final, and will now turn to whether it is appropriate to grant leave for an interlocutory appeal.

C. Interlocutory Appeals

28 U.S.C. § 1292 governs interlocutory appeals, generally, and should be applied by a district court in determining whether to grant an interlocutory appeal of a bankruptcy order. *See KPMG Peat Marwick, L.L.P. v. Estate of Nelco*, 250 B.R. 74, 78 (E.D. Va. 2000). 28 U.S.C. § 1292 essentially provides that leave to appeal an interlocutory order should only be granted when (1) the order involves a controlling question of law, (2) for which there is substantial grounds for a difference of opinion, and (3) immediate appeal of the order would materially advance the termination of the litigation. 28 U.S.C. § 1292(b); *In re Swyter*, 263 B.R. 742, 749 (E.D. Va. 2001); *see KPMG*, 250 B.R. at 78. In addition, the party seeking to appeal an interlocutory order must show "that exceptional circumstances justify a departure from the basic policy of postponing appellate review until after the entry of a final judgment." *Coopers & Lybrand v. Livesay*, 437 U.S. 463, 475 (1978). Further, the Fourth Circuit has stated that "[28 U.S.C.] § 1292(b) should be used sparingly and thus that its requirements must be strictly construed." *Myles v. Laffitte*, 881 F.2d 125, 127 (4th Cir. 1989).

The issues DSP wishes to appeal in this case turn on the following threshold questions: whether the Bankruptcy Court erred in (1) limiting the extent and validity of DSP's liens, and (2) limiting DSP's credit bid to its valid liens. These threshold questions do not hinge on a controlling question of law. "The Fourth Circuit has stated regarding the term 'controlling question of law' that 'certainly the kind of question best adapted to discretionary interlocutory review is a narrow question of pure law whose resolution will be completely dispositive of the litigation, either as a legal or practical

matter, whichever way it goes.'" *KPMG Peat Marwick, L.L.P. v. Estate of Nelco*, 250 B.R. 74, 78 (E.D. Va. 2000) (quoting *Fannin v. CSX Transp. Inc.*, 873 F.2d 1438, 1989 WL 42583, at *5 (4th Cir. 1989) (unpublished)). DSP has not shown that there is a "narrow question of pure law whose resolution will be completely dispositive of the litigation." *Id.*

Moreover, in the comparable case of *Hybrid Tech Holdings, LLC*, the court was not convinced that the secured lender established the factors required to justify an interlocutory appeal. 2014 U.S. Dist. LEXIS 15497 at *14. Specifically, it found that there was no controlling question of law as to which there is substantial grounds for difference of opinion – given that the Third Circuit has expressly "recognized that one of the reasons for which a Bankruptcy Court may deny a lender the right to credit bid is the exact reason that the Bankruptcy Court in the instant case cited in its order – 'to foster a competitive bidding environment.'" *Id.* at *16 (quoting the opinion from the bankruptcy court in that case). Similarly, the Bankruptcy Court here not only sought "a robust and competitive bidding environment" at the auction, *In re Free Lance-Star Publ'g Co., 2014 Bankr.* LEXIS 1611 at *26, but also a *preliminary* resolution of the extent of some of DSP's liens[5] that would allow the auction to move forward.

[5] The Bankruptcy Court has only addressed the extent of DSP's liens in part – for the purpose of appropriately determining DSP's credit bid at the auction. The Bankruptcy Court specifically held that

> DSP does not have valid, properly perfect liens on or security interests in the Debtors' Tower Assets, motor vehicles, FCC licenses, insurance policies, or bank account deposits. DSP's lien on general intangibles does not give it a lien on the proceeds derived from a sale of assets under 11 U.S.C. § 363 on which assets it

Obviously, without a controlling question of law affected by the appeal, there cannot be substantial grounds for a difference of opinion on that legal issue. Assuming *arguendo* that the Bankruptcy Court made a legal error in invalidating particular lien rights, these determinations were not dispositive. In addition to the reasons discussed *supra*, the fact that the adversary proceeding is continuing after summary judgment shows that the disposition of that motion will not fully determine DSP's rights.

Furthermore, there would be neither material advancement of the ultimate termination of the litigation nor savings of judicial or estate resources if the interlocutory appeals were granted. The Court adopts the well reasoned material advancement analysis in the analogous case of *Hybrid Tech Holdings, LLC*. In that case, the court concluded there was no evidence that the capping of the secured lender's credit bid is an issue that "must be resolved in order for the sale of the Debtors' assets to proceed," and, thus

> there is no reason why the auction contemplated by the Committee and the Bankruptcy Court cannot proceed with [the secured lender] bidding alongside other parties and [the secured lender] receiving a cash adjustment should the Bankruptcy Court ultimately decide [the secured lender's credit bid should not have been capped. The fact that [the secured lender] can be reimbursed out of the proceeds of the auction should the Bankruptcy Court ultimately decide that [the secured lender's] credit bid should not have been capped weighs against permitted the interlocutory appeal.

> does not have valid, properly perfected liens. DSP does not have a right to assert a credit bid on assets that do not secure DSP's allowed claim.

DSP Acquisition, LLC, 2014 Bankr. LEXIS 1644 at *27-28. The Bankruptcy Court then limited DSP's credit bid accordingly. *In re Free Lance-Star Publ'g Co., 2014 Bankr.* LEXIS 1611 at *26-27.

2014 U.S. Dist. LEXIS 15497 at *17-18. There is simply no reason that the secured creditor here, DSP, cannot seek the same remedy from the Bankruptcy Court, if necessary, after the auction.

Finally, it is clear that DSP has not shown exceptional circumstances justifying an interlocutory appeal and the record suggests none. DSP has not even addressed the presence of such circumstances in its Motion. It is difficult to imagine a compelling argument of exceptional circumstances – given the Bankruptcy Court's finding that DSP engaged in inequitable conduct and that DSP expressly consented to the sales procedures and timeline when its counsel endorsed the Sale Procedures Orders.

III. Conclusion

In sum, the Court is of the opinion that granting an immediate appeal of the Bankruptcy Court's April 14, 2014 opinions and corresponding orders "is more likely to impede, rather than hasten, resolution of the cases by delaying, for instance, the Bankruptcy Court's ability to resolve the issues remaining." *Id.* at *18. Therefore, the Court exercises its discretion and denies DSP's Motion. In addition, the Court denies Appellees' Motion to Strike Verified Reply of DSP as moot because consideration of the documents previously excluded by the Bankruptcy Court would not change the Court's determination that the Bankruptcy Court's opinions are not final and the issues raised do not merit interlocutory appeal.

An appropriate Order will accompany this Memorandum Opinion.

/s/
Henry E. Hudson
United States District Judge

Date: May 7 2014
Richmond, Virginia

Delaware Court Finds "Cause" to Limit Credit-Bid to Facilitate Bankruptcy Auction

Ben Rosenblum

In *In re Fisker Automotive Holdings, Inc.*, 2014 BL 13998 (Bankr. D. Del. Jan. 17, 2014), *leave to app. denied*, 2014 BL 33749 (D. Del. Feb. 7, 2014), *certification denied*, 2014 BL 37766 (D. Del. Feb. 12, 2014), a Delaware bankruptcy court limited a creditor's ability to credit bid its debt in connection with the sale of a hybrid car manufacturer's assets. Although the court limited the amount of the credit-bid to the distressed purchase price actually paid for the debt, the court's focus was on the prospect that the credit-bid would chill bidding and that the full scope of the underlying lien was as yet undetermined. The court also expressed concern as to the expedited nature of the sale, which in the court's view was never satisfactorily explained.

After the distressed debt buyer's credit-bid was limited by the court, an auction ensued and a third-party strategic purchaser prevailed over the distressed debt buyer. Given the importance of credit bidding as a distressed acquisition tool, and the court's ruling limiting the credit-bid to the amount paid for the debt, distressed debt purchasers are sure to focus on how subsequent courts interpret and apply *Fisker*.

Credit Bidding Under the Bankruptcy Code

Section 363(b) of the Bankruptcy Code allows for the sale of a debtor's assets outside the ordinary course of its business, including the sale of all or substantially all of those assets. Subject to certain requirements, section 363(f) of the Bankruptcy Code provides that such a sale may be made "free and clear" of all liens, claims, and encumbrances. That is, the sale can be

consummated, notwithstanding the fact that a party other than the debtor asserts an interest in the property up for sale.

The Bankruptcy Code recognizes that a creditor with a lien on the assets for sale may "credit bid" its indebtedness in connection with such a sale, "unless the court for cause orders otherwise." This authorization applies to both a sale outside a chapter 11 plan and a sale pursuant to a nonconsensual plan. Specifically, section 363(k) of the Bankruptcy Code provides:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

As set forth above, a credit-bid is nothing more than the offset of a claim against the property's purchase price. That is, rather than having (i) the creditor pay the purchase price to the debtor, and (ii) the debtor return the purchase price to the creditor as proceeds of its collateral, the creditor can make a bid that would simply cancel out the two obligations and short-cut the back-and-forth payment of cash. The U.S. Supreme Court recently explained in *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2070 n.2 (2012), that "[t]he ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price[,]" and "[i]t enables the creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan."

Section 363(k) of the Bankruptcy Code assumes a valid lien on the property being purchased—specifically, it refers to "property that is subject to a lien that secures an allowed claim."

However, even where a valid lien exists, the court may nonetheless prohibit credit bidding "for cause."

The holding in *Fisker* provides some guidance regarding the meaning of "for cause" for purposes of section 363(k), in the context of that case.

Fisker

Prior to filing for chapter 11 protection in 2013, Fisker Automotive ("Fisker") manufactured hybrid electric cars in the U.S. In 2010, Fisker received a loan from the U.S. Department of Energy ("DOE") in order to fund the development, commercial production, sale, and marketing, as well as all related engineering integration, of various of Fisker's hybrid electric cars.

Business did not go well for Fisker, which had to deal with the bankruptcy filing of a key battery supplier, with product recalls, and with other adverse incidents. In 2012, Fisker was substantially impacted by the effects of Hurricane Sandy, losing a material portion of its existing unsold-vehicle inventory.

In October 2013, the DOE auctioned off Fisker's senior indebtedness. At the auction, Hybrid Tech Holdings, LLC ("Hybrid") was the prevailing bidder and purchased all of Fisker's outstanding senior loan facility debt ($168.5 million face amount) from the DOE for $25 million—approximately 15 cents on the dollar.

On November 22, 2013, Fisker filed for bankruptcy relief in Delaware and initially sought to sell its assets to Hybrid by means of a private sale. As proposed, Hybrid would acquire substantially

all of Fisker's assets in exchange for $75 million in the form of a credit-bid of the debt acquired from the DOE.

Pressing for an auction instead of a private sale, the official committee of unsecured creditors (the "committee") opposed Fisker's proposed deal with Hybrid and sought to limit Hybrid's ability to credit bid its debt. The committee strongly endorsed an auction process in which at least one third-party strategic purchaser, Wanxiang America Corporation ("Wanxiang"), would participate.

For its part, Wanxiang had recently purchased certain assets of bankrupt A123 Systems, LLC, which produced a primary component of Fisker's electric cars—namely, the lithium ion batteries. This made Wanxiang a potentially highly attractive auction participant. However, there was a catch—Wanxiang refused to participate in any auction process unless Hybrid's ability to credit bid was capped at $25 million.

More *Fisker* Facts

On January 10, 2014, the bankruptcy court held a hearing to consider Fisker's motion to approve the proposed private sale of assets to Hybrid. Fisker and the committee stipulated to the relevant facts, which included the following:

- "[I]f at any auction Hybrid either would have no right to credit bid or its credit bidding were capped at $25 million, there is a strong likelihood that there would be an auction that has a material chance of creating material value for the estate over and above the present Hybrid bid."
- "[I]f Hybrid's ability to credit bid is not capped, it appears to both the Debtors and the Committee that there is no realistic possibility of an auction . . . ."

- "[The] limiting of Hybrid's ability to credit bid . . . would likely foster and facilitate a competitive bidding environment . . . ."
- "[W]ithin th[e] entirety of the assets offered for sale are (i) material assets that . . . consist of properly perfected Hybrid collateral, (ii) material assets that are not subject to properly perfected liens in favor of Hybrid and (iii) material assets where there is a dispute as to whether Hybrid has a properly perfected lien . . . ."
- If "the Court rules that there is no basis to limit Hybrid's ability to credit bid as proposed, the Committee will withdraw all of its oppositions to the Debtors' present sale . . . ."

The Bankruptcy Court's Ruling

The bankruptcy court, reciting the language of section 363(k), acknowledged that the Bankruptcy Code gives a secured creditor the right to credit bid its claim. However, the court also observed that the provision expressly gives it the power to limit that right "for cause."

To determine what "cause" means in this context, the court turned to the Third Circuit's ruling in *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010). There, the Third Circuit held that the "right to credit bid is not absolute." Further, in a footnote, the court of appeals observed that imposing a limit on credit bidding "for cause" does not require that the secured creditor "engage[] in inequitable conduct." *Id.* at 315 n.14. On the contrary, according to the Third Circuit, "[a] court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." *Id.*

Picking up on this language, the court in *Fisker* held that the stipulated evidence showed that there would be *no* bidding (not merely the *chilling* of bidding) if limits were not placed on Hybrid's ability to credit bid.

The bankruptcy court further reasoned that the holder of a lien whose validity has yet to be determined may not credit bid a claim secured by such a lien. Emphasizing that the parties had stipulated that Hybrid had a valid lien on some Fisker assets, did not have a valid lien on other assets, and had a lien of uncertain status on the remainder, the court concluded that no one could know the scope of Hybrid's collateral or what portion of Hybrid's claim would ultimately be allowed as a secured claim.

In reaching this conclusion, the bankruptcy court expressly distinguished the Third Circuit's decision in *In re Submicron Systems Corp.*, 432 F.3d 448 (3d Cir. 2006), explaining that the issue there was one of value, not of validity. In other words, it is one thing to allow credit bidding where the collateral's *value* is undetermined—indeed, one of the principal benefits of credit bidding is that it protects a creditor against the risk that collateral will be sold at a depressed price. It is another thing, however, to allow credit bidding where the validity of the lien is at issue, because the statute itself contemplates that a valid lien exists.

On the basis of this reasoning, the bankruptcy court in *Fisker* allowed Hybrid to credit bid but held that cause existed to limit its credit-bid to the $25 million it paid for the distressed debt. The court, however, did not explain why it selected $25 million as the amount of the limitation.

The After Story

After the adverse ruling, Hybrid sought leave to appeal to the district court as well as certification of a direct appeal to the Third Circuit. The district court denied both requests. In doing so, it determined that the bankruptcy court's order limiting the credit-bid was not a final

order. While not strictly tasked with deciding the merits, the district court by its opinions generally reinforced the view that, under *Philadelphia Newspapers*, bankruptcy judges have the authority to limit credit bidding in order to foster a competitive bidding environment.

After Hybrid's ability to credit bid was limited to $25 million, a competitive auction between Hybrid and Wanxiang ensued. Wanxiang prevailed, the aggregate value of its bid reported at $149.2 million. Now the battle has shifted to the portion of the sales proceeds to which Hybrid, as secured creditor, is entitled.

The Takeaway

At least in Delaware, *Fisker* helps to clarify what can constitute "cause" for purposes of limiting a party's right to credit bid its secured claims. The lede touting this ruling—namely, "court limits credit bid to distressed debt price"—is undoubtedly troubling to some distressed debt investors. However, it is far from clear how subsequent courts will interpret and apply the case.

For one thing, *Fisker* is an unpublished ruling that arguably has limited precedential effect. Moreover, although the court explains in some detail why imposing a limit on credit bidding was appropriate under the circumstances, it is unclear why the court chose $25 million—Hybrid's debt acquisition price—as the appropriate cap. One might argue that the $25 million cap was driven by the parties' stipulation that limiting the credit-bid to that amount would foster bidding and, therefore, the amount of the cap approved by the court was unrelated to the purchase price of the debt. It seems more than coincidental, however, that the $25 million was equal to the debt purchase price. In either event, the principal focus of the decision was whether the court could

limit credit bidding under the specific circumstances presented. The bankruptcy court answered that question with a resounding "yes."

The *Fisker* bankruptcy court expressed its displeasure with what it perceived as the rushed nature of the sale process. In the opinion, the court complained that the schedule proposed by Fisker afforded only 24 business days for the parties to challenge the sale and that Fisker failed to provide satisfactory reasons why the private sale of a nonoperating debtor required such speed. The court further cautioned against the creation of artificial deadlines that put unnecessary pressure on bankruptcy judges and creditors. Accordingly, *Fisker* also acts as a reminder from the Delaware bankruptcy court that, while there are appropriate circumstances to conduct expedited section 363 sales in bankruptcy, the reasons for doing so must be clearly articulated to the court.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re	)	Chapter 11
	)	
FISKER AUTOMOTIVE HOLDINGS, INC., *et al.*,	)	
	)	Case No. 13-13087(KG)
Debtors.	)	
	)	**Re: Dkt. Nos. 13 & 265**

MEMORANDUM OPINION

INTRODUCTION

The Court's Memorandum Opinion will address the Debtors' Motion . . . Authorizing the Sale of Substantially All of the Debtors' Assets . . . (the "Sale Motion") (D.I. 13). Also before the Court is the Motion of the Creditors' Committee . . . Approving Bid Procedures . . . (the "Bidding Procedures Motion") (D.I. 265).

The Debtors[1] were founded in 2007 with the goal of designing, assembling, and manufacturing premium plug-in hybrid electric vehicles in the United States. Debtors faced many difficulties that prevented the Debtors from operating as planned. The challenges included safety recalls related to battery packs supplied by a third party vendor, the loss of a material portion of their existing unsold vehicle inventory in the United States during Hurricane Sandy in 2012, and the loss of their lending facility provided through the United States Department of Energy ("DOE").

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[1] The Debtors are Fisker Automotive Holdings, Inc. and Fisker Automotive, Inc.

JURISDICTION

1. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334 and the Amended Standing Order of Reference from the United States District Court for the District of Delaware, dated February 29, 2012. This matter is a core proceeding within the meaning of 28 U.S.C. § 157(b)(2), and the Court may enter a final order consistent with Article III of the United States Constitution.

2. Venue is proper pursuant to 28 U.S.C. §§ 1408 and 1409.

3. The statutory bases for the relief requested are Sections 105, 363 and 265 of the Bankruptcy Code, and Bankruptcy Rules 2002, 6004 and 6006.

UNCONTESTED FACTS

The following facts are uncontested and will describe the origination and essence of the conflict at hand.

1. The Debtors expressly filed these cases to accomplish the sale of substantially all their assets to Hybrid Tech Holdings, LLC (“Hybrid”) and then to administer these chapter 11 estates through the Debtors’ proposed chapter 11 plan of liquidation.

2. As of the Petition Date, November 22, 2013, the Debtors had approximately $203.2 million in indebtedness and related obligations outstanding. As of the Petition Date, the obligations outstanding under these facilities, excluding accrued interest, were estimated at the following amounts:

	$ millions	
Senior Loan Agreement (DOE)	168.5	
Silicon Valley Bank Working Capital Facility	6.6	
Delaware Economic Development Agency	12.5	
Related Party Notes	15.6	
	Total	$203.2

3. Debtors and the United States of America, through DOE, are parties to that certain Loan Arrangement and Reimbursement Agreement, dated as of April 22, 2010 (as amended, supplemented or otherwise modified, "Senior Loan Agreement"). Pursuant to the Senior Loan Agreement, DOE agreed to, among other things: (a) arrange for the Federal Financing Bank ("FFB") to purchase notes from Fisker Automotive in an amount not to exceed $169.3 million to fund the development, commercial production, sale and marketing, and all related engineering integration of the Debtors' "Karma" model automobile, the Debtors' premium-priced PHEV (the "Karma Lending Facility"); and (b) arrange for FFB to purchase notes from Fisker Automotive in an amount not to exceed $359.4 million to fund the development, commercial production, sale and marketing of the Debtors' "Nina" model automobile, a moderately priced version of the Karma, including the establishment and construction of an assembly and production site in the United States (the "Nina Lending Facility," and together with the Karma Lending Facility, the "Senior Loan Facility").

4. On October 11, 2013, Hybrid purchased DOE's position of outstanding principal of $168.5 million ($.15/$1.00) under the Senior Loan Facility for $25 million and, for all practicable purposes, succeeded to DOE's position as the Debtors' senior secured lender.

5. With the Senior Loan sale by DOE to Hybrid, the Debtors entered into discussions with Hybrid regarding Hybrid's potential acquisition of the Debtors' assets through a credit bid of all or part of the Senior Loan. These discussions led to the Asset Purchase Agreement, pursuant to which Hybrid proposes to acquire substantially all of the assets of Debtors for consideration which includes $75 million in the form of a credit bid. The Debtors determined that a sale to a third party other than Hybrid was not reasonably likely to generate greater value than the Debtors' proposed sale transaction or advisable under the facts and circumstances of these chapter 11 cases. The DOE Loan purchase made Hybrid the Debtors' senior secured lender holding approximately $168.5 million in claims. What collateral is thereby secured remains at issue.

6. The Debtors decided that the cost and delay arising from a competitive auction process or pursuing a potential transaction with an entity other than Hybrid would be reasonably unlikely to increase value for the estates. The Sale Motion therefore reflects Debtors' decision to sell its assets to Hybrid through a private sale.

7. The Official Committee of Unsecured Creditors (the "Committee" opposes the Sale Motion and is seeking an auction along the lines contained in the Bidding Procedures Motion. In particular, the Committee opposes Hybrid's right to credit bid. The Committee

has proposed an alternative to the Hybrid private sale: an auction with Wanxiang America Corporation ("Wanxiang").

8. While the offers are evolving and improving, the Wanxiang proposal at the time the Sale Motion was pending was extremely attractive both economically and in its significant non-economic terms. The Committee strongly endorsed Waxiang's participation in an auction.

9. At the hearing on January 10, 2014, at which the Court was to consider the Sale Motion and the Bidding Procedures Motion, the Debtors and the Committee announced on the record an agreement to limit the areas of dispute. The Debtors and the Committee agreed that (emphasis supplied):

Stipulated Agreements

> First, **the Debtors and the Committee agree** that, based on all the events that have transpired since the commencement of these cases, and especially the recent bid by Wanxiang, it now does appear to both parties that if Hybrid's ability to credit bid is limited as the Committee has asked, specifically that **if at any auction Hybrid either would have no right to credit bid or its credit bidding were capped at $25 million, there is a strong likelihood that there would be an auction that has a material chance of creating material value for the estate over and above the present Hybrid bid**. That auction would, of course, be open to all qualified bidders, and certainly to include Hybrid and Wanxiang and possibly others.
>
> Second, **if Hybrid's ability to credit bid is not capped, it appears to both the Debtors and the Committee that there is no realistic possibility of an auction**, as we have no reason to believe that Wanxiang or anyone else would bid more than the amount of Hybrid's asserted secured claims.
>
> Third, **we agree that limiting of Hybrid's ability to credit bid, for these reasons alone, would likely foster and facilitate a competitive bidding environment,** as those words were used by the Third Circuit in Philadelphia

Newspapers, and that such a competitive bidding environment would likely result in material benefit to the estate.

Fourth, all of the work here has shown to both the Debtors and the Committee that the highest and best value for the estate is achieved only in the sale of all of the Fisker assets as an entirety.

Fifth, based on all the work that has been done by all parties and a constructive and collaborative exchange of views and information as appropriate in Chapter 11, we each also believe that **within that entirety of the assets offered for sale are (i) material assets that we believe consist of properly perfected Hybrid collateral, (ii) material assets that are not subject to properly perfected liens in favor of Hybrid and (iii) material assets where there is a dispute as to whether Hybrid has a properly perfected lien,** which dispute is not likely subject to quick or easy resolution. We may not agree on exactly where those lines are drawn between those three groups in certain respects. And we may not agree as to the allocation of value between these groups in all respects. But we agree that there are material assets in each category.

* * *

As our eighth agreement, the Committee agrees that if, based on these agreements and such other evidence and argument by all parties at today's hearing consistent in respects with these agreements, **the Court rules that there is no basis to limit Hybrid's ability to credit bid as proposed, the Committee will withdraw all of its oppositions to the Debtors' present sale,** DIP loan, plan and related motions as they are currently proposed, conditioned of course on Hybrid confirming its most recent proposal still stands and is not conditioned in any respect on plan acceptance or other such formality.

Finally, Judge, as to our ninth and final agreement . . .

> Based upon the agreements reached, the Debtors and the Committee ask the Court to rule on whether Hybrid's ability to credit bid should be limited exclusively based on the Committee's positions that: (i) credit bidding should not be permitted here given that a material portion of the assets to be sold in their entirety are not subject to a property perfected lien in favor of Hybrid or are subject to lien in favor of Hybrid which is in bona fide dispute, which dispute cannot be quickly

> and easily resolved or (ii) "cause" exists because limiting the credit bid will facilitate an open and fully competitive cash auction or (iii) "cause" exists because the Debtors' assets to be sold in their entirety include encumbered, unencumbered and disputed assets. The Committee will not seek a limitation on the credit bid for any other basis. To be clear, there is a disagreement between the parties on whether, as a matter of law, the Court can limit the credit bid under these circumstances. Based upon the agreements reached, the Debtors and the Committee will not present further argument or evidence on these issues, but will be able to respond to direct inquiries from the Court. Moreover, the Debtors and the Committee may also respond to oppositions to their respective positions; however, the Committee's response to an opposition by a third party shall not in and of itself constitute an opposition to the Debtors' position.

10. The Stipulated Agreements are highly significant to the credit bidding issue. If Hybrid is entitled to credit bid more than $25 million at an auction, Wanxiang will not participate - and there will be no auction.

11. Wanxiang has made it clear it is prepared to increase its bid if there is an auction.

DISCUSSION

The Sale Motion and the Bidding Procedures Motion require the Court to determine whether Hybrid is entitled to credit bid its claim and, if so, whether the Court may properly limit, or cap, the amount that Hybrid may credit bid. If the answer to the second question, the capping of the credit bid, is "no," it is clear there will be no auction. The Committee will withdraw its objection to the Sale Motion and Hybrid will have a clear path to purchase the Debtors' assets in a private sale, subject to the Court's approval.

It is beyond peradventure that a secured creditor is entitled to credit bid its allowed claim. 11 U.S.C. § 363(k) provides that:

> (k) At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

See Radlax Gateway Hotel, LLC v. Amalgamated Bank, 132 S.Ct. 2065 (2012); *In re Philadelphia Newspapers, LLC*, 599 F.3d 298 (3d Cir. 2010). Hybrid paid $25 million for its claim. It will be entitled to credit bid. The only question is: in what amount.[2]

The law is equally clear, as Section 363(k) provides, that the Court may "for cause order[] otherwise." *In Philadelphia Newspapers*, the Third Circuit Court of Appeals captured the law as follows:

> As an initial matter, the Code plainly contemplates situations in which assets encumbered by liens are sold without affording secured lenders the right to credit bid. The most obvious example arises in the text of § 363(k), under which the right to credit bid is not absolute. A secured lender has the right to credit bid "unless the court for cause orders otherwise." 11 U.S.C. § 363(k). In a variety of cases where a debtor seeks to sell assets pursuant to § 363(b), courts have denied secured lenders the right to bid their credit. *See In re Aloha Airlines*, No. 08-00337, 2009 WL 1371950, at *8 (Bankr.D.Hawaii May 14, 2009) (determining that "cause exists to deny the credit bid" under § 363(k); *Greenblatt v. Steinberg*, 339 B.R. 458, 463 (N.D.Ill.2006) (holding the "bankruptcy court did not err in refusing to allow [a secured creditor] to credit bid"); *In re Antaeus Technical Servs., Inc.*, 345 B.R. 556, 565 (Bankr.W.D.Va.2005) (denying the right to credit bid to facilitate "fully competitive" cash auction); *In re Theroux*, 169 B.R.

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[2] The Committee argues Hybrid should not be permitted to credit bid at all, or in any event no more than the $25 million it paid for the $168.5 million claim Hybrid purchased from DOE. Hybrid insists on credit bidding $75 million.

> 498, 499 n. 3 (Bankr.D.R.I.1994) (noting that 'there is no absolute entitlement to credit bid").[FN14]
>
> > FN14. The Lenders argue that the "for cause" exemption under § 363(k) is limited to situations in which as secured creditor has engaged in inequitable conduct. That argument has no basis in the statute. A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment. *See*, *e.g.*, 3 Collier on Bankruptcy 363.09[1] ("the Court might [deny credit bidding] if permitting the lienholder to bid would chill the bidding process.").

Philadelphia Newspapers, 599 F.3d at 315-16.

The evidence in this case is express and unrebutted that there will be <u>no</u> bidding - not just the chilling of bidding - if the Court does not limit the credit bid. The Committee, which strongly opposes any credit bidding by Hybrid, will abandon its opposition to the Sale Motion if there is no auction - and there will be no auction if the credit bid is not capped. It is through the Committee's efforts that Wanxiang is now prepared to bid. Waxiang is also prepared to increase its offer in an auction.

Wanxiang is a highly attractive and capable participant. Wanxiang recently purchased in bankruptcy, through an auction, certain assets of A123 Systems[3] for almost $300 million, most importantly, the primary component of the Fisker electric cars, which is the lithium ion battery. This means that Wanxiang has a vested interest in purchasing Fisker.

Thus, the "for cause" basis upon which the Court is limiting Hybrid's credit bid is that bidding will not only be chilled without the cap; bidding will be frozen.

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[3] The bankruptcy case is *In re B456 Systems, Inc. (f/k/a A123 Systems, Inc)*, Case No. 12-12859 (Bankr.D.Del. 2013)(KJC). The Sale Order is at Docket No. 640.

Hybrid if unchecked of its purchase, might well have frozen out other suitors for Fisker's assets. Debtors filed these cases on Friday, November 22, 2013, a mere three business days before the Thanksgiving holiday, and insisted that the Sale Motion and confirmation hearings occur not later than January 3, 2014, i.e., immediately after the New Year holiday[4]. The schedule therefore allowed only 24 business days for parties to challenge the Sale Motion and even less time for the Committee, which was not appointed until December 5, 2013, to represent the interests of unsecured creditors. Neither Debtors nor Hybrid, when the Court asked, ever provided the Court with a satisfactory reason why the sale of the non-operating Debtors required such speed. Nor did Debtors or Hybrid respond to the Court's repeated admonition that the timing of the Sale Motion was troublesome. It is the Court's view that Hybrid's rush to purchase and to persist in such effort is inconsistent with the notions of fairness in the bankruptcy process. The Fisker failure has damaged too many people, companies and taxpayers to permit Hybrid to short-circuit the bankruptcy process.

Finally, the Committee has raised concerns that the amount of Hybrid's secured claim is uncertain. In their Stipulated Agreements, the Debtors and the Committee agree that Hybrid's claim is partially secured, partially unsecured and of uncertain status for the remainder. Hybrid argues that under case law in this Circuit, Hybrid is yet entitled to credit bid its entire claim. Hybrid cites *In re Submicron Systems Corp.*, 432 F.3d 448 (3d Cir.

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[4] It is now clear that Hybrid's "drop dead" date of January 3, 2014, was pure fabrication, designed to place maximum pressure on creditors and the Court. Today is January 17, 2014. Hybrid is still working to acquire Debtors' assets.

2006). In *Submicron* the issue was not the classification of the claim but the value of the collateral the claim secured. The Court of Appeals held that although the secured debt had no actual/economic value, the secured creditor was nonetheless entitled to credit bid its entire secured claim. The *Submicron* facts are distinctly different than the facts here. In *Submicron* the classification of the claim to be credit bid was clear. The claim was secured, albeit the secured collateral was deficient as to the entirety of the claim. But here we do not yet know how much of Hybrid's claim is secured. The law leaves no doubt that the holder of a lien the validity of which has not been determined, as here, may not bid its lien. *In re Danfuskie Isl. Props., LLC*, 441 B.R. 60 (Bankr. D.S.C. 2010). *Submicron* addresses an allowed claim. No one knows how much of the claim Hybrid purchased from DOE will be *allowed* as a secured claim.

CONCLUSION

As discussed, the Court will limit, for cause, Hybrid's credit bid to $25 million. To do otherwise would freeze bidding. Hybrid as the proposed sale purchaser insisted on an unfair process, i.e., a hurried process, and the validity of its secured status has not been determined. In reaching its decision, the Court has followed precedent. A decision to authorize an uncapped credit bid under the facts of this case would be unprecedented and unacceptable. An Order will issue.

Dated: January 17, 2014

KEVIN GROSS, U.S.B.J.

316 B.R. 772
United States Bankruptcy Court,
S.D. New York.

In re AMES DEPARTMENT STORES, INC., et al., Debtor.
Hannaford Bros. Co., Plaintiff,
v.
Ames Department Stores, Inc., Ames Realty II, Inc., The Stop & Shop Supermarket Co. LLC, Vickerry Realty Co. Trust, and Coliseum Vickerry Realty Co. Trust, Defendant.

Bankruptcy No. 01–42217 (REG). | Adversary. No. 04–2829. | Oct. 14, 2004.

Synopsis

Background: Supermarket operator whose property was adjacent to property leased by Chapter 11 debtor-retailer filed adversary complaint against debtor and entity that acquired the right to take over debtor's interest in lease, seeking to enforce “supermarket use restriction” contained in deed of declaration, which, so long as a shopping center was operated on the land subject to the declaration, prohibited the operation of a competing supermarket on debtor's tract while plaintiff continued to operate a supermarket on its parcel.

Holdings: On plaintiff's motion for summary judgment, the Bankruptcy Court, Robert E. Gerber, J., held that:

[1] plaintiff had standing to enforce its legal rights;

[2] plaintiff's objections to debtor's assignment of its rights to entity were timely;

[3] under New Hampshire law, the covenants in the deed of declaration ran with the land and could be enforced so long as the declaration's requirements were satisfied;

[4] state law, not federal law, applied in determining the intent of the deed of declaration's signatories;

[5] under New Hampshire law, the requirement for operation of a “shopping center” on the premises continued to be satisfied; and

[6] the supermarket use restriction was not an unenforceable anti-assignment provision under the Bankruptcy Code.

Motion granted.

See also 287 B.R. 112.

West Headnotes (35)

[1] **Bankruptcy**
Proceedings

Supermarket operator whose property was adjacent to property leased by Chapter 11 debtor-retailer, which filed adversary complaint against debtor and entity that acquired the right to take over debtor's interest in lease, seeking to enforce “supermarket use restriction” contained in deed of declaration, had standing to enforce its legal rights; plaintiff was not seeking to raise another person's legal rights, but was seeking enforcement of its own, and in arguing that plaintiff lacked standing, defendant entity disregarded the unquestioned ability of the signatories to deeded restrictions, and their successors in interest, to enforce them under New Hampshire law.

Cases that cite this headnote

[2] **Bankruptcy**
Proceedings

Supermarket operator's objections to Chapter 11 debtor's assignment of its rights in lease to another entity, which, allegedly in violation of restrictive covenants contained in deed of declaration, wished to operate a competing supermarket on debtor's tract, were not untimely, despite operator's failure to object to bankruptcy court's earlier designation rights order; although order provided that debtor's sale of any lease would be free and clear of all liens, claims, encumbrances, and interests, there was an exception for restrictions of record that did not materially impair properties' existing uses, and operator had no occasion to object upon entry of order, as debtor's operation of retail store was

an existing use, operator did not anticipate that debtor or assignee would exceed their authority under the order, and operator was not seeking an interest, lien, claim, or encumbrance in the lease, but merely was seeking to enforce supermarket use restriction with respect to debtor's tract.

2 Cases that cite this headnote

[3] **Covenants**
Nature and essentials in general

Under New Hampshire law, a "covenant" in a deed is an agreement to either do or not do particular acts with respect to land.

Cases that cite this headnote

[4] **Covenants**
Covenants as to Use of Property

To enforce the terms of a restrictive covenant under New Hampshire law, plaintiff must show that the benefit or burden of the promise was intended to run with the land, that the promise substantially altered the legal relations of the parties with respect to the land, that is, the promise must "touch and concern" the land, and that a succession of interest existed between the promisor and the promisee; if these requirements are satisfied, the benefit of the covenant is said to run with the land, and the landowner of a parcel benefited by the covenant may enforce its terms.

Cases that cite this headnote

[5] **Covenants**
Nature and operation in general

For purposes of determining whether a restrictive covenant may be enforced under New Hampshire law, intent to benefit or burden a parcel of land is to be ascertained from the language of the instrument imposing the use restriction, the conduct of the parties, and other surrounding circumstances.

Cases that cite this headnote

[6] **Covenants**
Covenants as to Use of Property

Under New Hampshire law, the inclusion of use restrictions in deeds conveying property is a clear way for the parties to manifest their intent to create a covenant that runs with the land.

Cases that cite this headnote

[7] **Covenants**
Presumptions and burden of proof

Under New Hampshire law, the burden of establishing that a use restriction was intended to run with the land was upon the party seeking to enforce the covenant, and it would not be implied upon doubtful evidence.

Cases that cite this headnote

[8] **Covenants**
Nuisances and particular occupations

Under New Hampshire law, covenants in deed of declaration which, so long as shopping center was operated on the land subject to the declaration, prohibited the operation of a competing supermarket on lessee's tract while supermarket operator continued to operate a supermarket on its adjoining parcel, ran with the land and could be enforced so long as the declaration's requirements were satisfied; grantors' intention that declaration run with the land was explicit and unequivocal, declaration did not contain a condition subsequent, as it was silent in providing for a reversion, for a discharge of a duty of performance, or for any other consequence if the condition of failure to satisfy the declaration's requirements were not satisfied, and even if declaration were deemed to have a condition subsequent, that would not have trumped the unambiguous stated intention of the declaration's signatories.

Cases that cite this headnote

[9] **Deeds**
Nature and Creation of Conditions

"Condition subsequent" is something that, if it occurs, will bring something else to an end.

Cases that cite this headnote

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[10] **Bankruptcy**
Debtor's Contracts and Leases

Bankruptcy court would apply New Hampshire state law, and not federal bankruptcy law, in determining the intent of a deed of declaration's signatories and whether the requirements of the deed of declaration, which, so long as a "shopping center" was operated on the land subject to the declaration, prohibited the operation of a competing supermarket on Chapter 11 debtor-lessee's tract while plaintiff-supermarket operator continued to operate a supermarket on its parcel, were satisfied; construction of deed of declaration, whether deemed to raise issues of contract law or of property law, was a matter of state law, and federal criteria for determining existence of a "shopping center" was created some 18 years after the subject deed of declaration was executed and was applied for an entirely different purpose. Bankr.Code, 11 U.S.C.A. § 365(b)(3).

Cases that cite this headnote

[11] **Bankruptcy**
Application of state or federal law in general

When a bankruptcy court adjudicates a dispute arising from a contract claim, it must apply state law unless the Bankruptcy Code provides otherwise.

Cases that cite this headnote

[12] **Bankruptcy**
Effect of state law in general

Property interests are created and defined by state law, and, unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding, as uniform treatment of property interests by both state and federal courts within a state serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy.

Cases that cite this headnote

[13] **Bankruptcy**
Effect of state law in general

Bankruptcy courts look to state law even for the purpose of determining what is property of the estate under the Bankruptcy Code. Bankr.Code, 11 U.S.C.A. § 541.

Cases that cite this headnote

[14] **Bankruptcy**
Effect of state law in general

With the exception of Bankruptcy Code provisions dealing with fraudulent conveyances and preferences, Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law.

Cases that cite this headnote

[15] **Contracts**
Intention of Parties

When interpreting a contract under New Hampshire law, the court focuses on the intent of the contracting parties at the time they entered into the agreement.

Cases that cite this headnote

[16] **Contracts**
Questions for Jury

Deeds
Questions for jury

Under New Hampshire law, the proper interpretation of a contract, such as a deed, is a question of law for the court.

Cases that cite this headnote

[17] **Contracts**
Language of Instrument

In reaching the proper interpretation of a contract under New Hampshire law, the court must determine the common meaning of the words and

phrases used, based on the understanding that a reasonable person would attach to them.

Cases that cite this headnote

[18] **Evidence**
Grounds for admission of extrinsic evidence

Under New Hampshire law, if the language of a contract is clear and unambiguous, the court must interpret it without resort to any sort of extrinsic evidence.

Cases that cite this headnote

[19] **Constitutional Law**
General Rules of Construction
Contracts
Language of Instrument
Statutes
Natural, obvious, or accepted meaning
Statutes
Grammar, spelling, and punctuation

Under New Hampshire law, to get at the thought or meaning expressed in a statute, contract, or constitution, the first resort, in all cases, is to the natural signification of the words, in the order of grammatical arrangement in which the framers of the instrument have placed them; if the words convey a definite meaning which involves no absurdity, nor any contradiction of other parts of the instrument, then that meaning, apparent on the face of the instrument, must be accepted, and neither the courts nor the legislature have the right to add to it or take from it.

Cases that cite this headnote

[20] **Contracts**
Subject, object, or purpose as affecting construction
Contracts
Language of contract
Contracts
Extrinsic circumstances

Under New Hampshire law, in its search for the interpretation of a contract that will best reflect the parties' intention, court should consider the written agreement of these parties, all of its provisions, its subject matter, the situation of the parties at the time, and the object intended.

Cases that cite this headnote

[21] **Contracts**
Construing whole contract together

Under New Hampshire law, where various documents together constitute the contract between the parties, the parties' intent must be ascertained from all the instruments read together as a whole.

Cases that cite this headnote

[22] **Contracts**
Construction as a whole
Contracts
Construing instruments together

Under New Hampshire law, in interpreting a multiple-document agreement, court must harmonize the provisions of various documents so that none will be rendered meaningless.

Cases that cite this headnote

[23] **Covenants**
Nature and operation in general

In interpreting deed of declaration under New Hampshire law, court was to look to the intended purpose of the declaration in accordance with the common meaning of the language used, and the meaning that would be attributed to it by a reasonable person.

Cases that cite this headnote

[24] **Covenants**
Nuisances and particular occupations

Under New Hampshire law, deed of declaration's requirement for operation of “shopping center” on the subject premises continued to be satisfied, and so covenant contained in declaration, which, so long as shopping center was operated on the site, prohibited operation of a competing supermarket on lessee's tract while

supermarket operator continued to operate a supermarket on its adjoining parcel, could be enforced; though term “shopping center” was not expressly defined in the declaration, term was not ambiguous, and definition urged by supermarket operator based on common definition, namely, a group of retail stores and service establishments, was consistent with both plain meaning of expression and meaning that a reasonable person would ascribe to it, through various amendments to the declaration, its signatories repeatedly confirmed their belief that a “shopping center” existed, and retail stores and service establishments continued to be operated on each component of the premises.

Cases that cite this headnote

[25] Covenants

Covenants as to Use of Property

Under New Hampshire law, when subsequent deeds expressly make the conveyances subject to the deed of declaration's original use restrictions, the intent of the parties for the restrictions to run with the land is reaffirmed.

Cases that cite this headnote

[26] Covenants

Nuisances and particular occupations

Under New Hampshire law, even assuming, arguendo, that expression “shopping center,” as used in covenant contained in deed of declaration, was not unambiguous, miscellaneous documents unrelated to the declaration and executed nearly 20 years later could not reasonably be found to bear on signatories' intent with respect to the language they used in the declaration; rather, in determining whether a shopping center continued to be operated on the premises, and thus whether the deed's supermarket use restriction was enforceable, the court would rely on specific things the signatories said with respect to the declaration, at execution and when its various amendments were executed.

Cases that cite this headnote

[27] Bankruptcy

Contracts Assumable; Assignability

Bankruptcy

Leases

Section of the Bankruptcy Code allowing a trustee to assign an executory contract or unexpired lease notwithstanding the existence of a contractual provision prohibiting, restricting, or conditioning such an assignment performs an important function for maximizing the value in an estate for creditors: it protects the body of creditors as a whole from provisions, typically in leases, that frustrate the estate's ability to convert the economic value in leases into cash that can increase creditor recoveries. Bankr.Code, 11 U.S.C.A. § 365(f).

Cases that cite this headnote

[28] Bankruptcy

Leases

In the bankruptcy context, Congress has provided that the value in a debtor's unexpired leases should enure for the benefit of all of a debtor's creditors, and has provided that subject to the procedural safeguards of the Bankruptcy Code, principally in the section governing executory contracts and unexpired leases, debtors may assume and assign their interests in leases even without lessor consent, and that notwithstanding any provisions in leases that prohibit, restrict, or condition the assignment of those leases, they may nevertheless be assigned. Bankr.Code, 11 U.S.C.A. § 365.

Cases that cite this headnote

[29] Bankruptcy

Leases

Using the power conferred under the section of the Bankruptcy Code governing executory contracts and unexpired leases to assign leases even without lessor consent, debtor-lessees can sell the their interests in such leases to those willing to pay for them, converting, for their creditors, into the much more liquid asset of cash,

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the economic value in the leases. Bankr.Code, 11 U.S.C.A. § 365.

Cases that cite this headnote

[30] **Bankruptcy**
Contracts Assumable; Assignability
Bankruptcy
Leases

While the section of the Bankruptcy Code allowing a trustee to assign an executory contract or unexpired lease notwithstanding the existence of a contractual provision prohibiting, restricting, or conditioning such an assignment can, and should, be used to invalidate provisions that frustrate the goals of maximizing the value in an estate for creditors and protecting creditors from lease provisions that frustrate the estate's ability to convert the economic value in leases into cash, bankruptcy court nevertheless must be attentive to the facts of the particular case to ensure that the statute is not used indiscriminately. Bankr.Code, 11 U.S.C.A. § 365(f).

1 Cases that cite this headnote

[31] **Bankruptcy**
Leases

While the Bankruptcy Code gives a bankruptcy court the clear power to invalidate provisions in leases assigned by debtors even when those provisions indirectly restrict the debtors' ability to assign the leases, the court retains discretion in determining whether a lease provision hinders the possibility of assignment to a sufficient degree to render it unenforceable. Bankr.Code, 11 U.S.C.A. § 365(f).

1 Cases that cite this headnote

[32] **Bankruptcy**
Leases

In determining whether a lease clause is an unenforceable anti-assignment clause, bankruptcy court must examine the particular facts and circumstances of the transaction to determine whether the clause restricts or conditions assignment, including the extent to which the provision hampers a debtor's ability to assign, whether the provision would prevent the bankruptcy estate from realizing the full value of its assets, and the economic detriment to the non-debtor party. Bankr.Code, 11 U.S.C.A. § 365(f).

1 Cases that cite this headnote

[33] **Bankruptcy**
Leases

In determining whether a lease clause is an unenforceable anti-assignment clause, bankruptcy court must consider the details of the proposed lease assumption and assignment to ensure that a proper balance is reached between the interests of the debtor-tenant and the economic detriment to the non-debtor. Bankr.Code, 11 U.S.C.A. § 365(f).

1 Cases that cite this headnote

[34] **Bankruptcy**
Contracts Assumable; Assignability

Invalidation of a bargained-for element of a contract under the section of the Bankruptcy Code allowing a trustee to assign an executory contract or unexpired lease notwithstanding the existence of a contractual provision prohibiting, restricting, or conditioning such an assignment plainly is permissible, but the modification of a contracting party's rights is not to be taken lightly. Bankr.Code, 11 U.S.C.A. § 365(f).

Cases that cite this headnote

[35] **Bankruptcy**
Leases

Supermarket use restriction contained in deed of declaration to which Chapter 11 debtor-lessee's lease was subject was not an unenforceable anti-assignment provision under the Bankruptcy Code; restriction neither foreclosed assignment nor resulted in forfeiture of the leasehold but, instead, merely prohibited one of the many uses to which the leased store could be put, because the store could still be used for many purposes other than the operation of a

supermarket, enforcing the restriction did not thwart the fundamental policy of maximizing estate assets for the benefit of all creditors, and invalidation of the restriction would have caused significant economic harm to the supermarket operator who sought to enforce the restriction, as debtor's proposed assignee would have opened a competing supermarket on an adjoining tract, and it would have negated a bargained-for element in operator's purchase of its parcel of land. Bankr.Code, 11 U.S.C.A. § 365(f).

Cases that cite this headnote

Attorneys and Law Firms

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Otterbourg, Steindler, Houston & Rosen, P.C., by Todd M. Goren (argued), New York, NY, for the Official Committee of Unsecured Creditors.

DECISION ON MOTION FOR SUMMARY JUDGMENT

ROBERT E. GERBER, Bankruptcy Judge.

This adversary proceeding arises under the umbrella of the jointly administered chapter 11 cases of debtor Ames Department Stores and its affiliates ("Ames"), one of the defendants in this action. A second defendant, the Stop & Shop Supermarket Company ("Stop & Shop") acquired the right, by earlier order of this Court, to take over Ames's tenant interest in the lease (the "Ames Lease") of an Ames store in Nashua, New Hampshire (the "Ames Store"), situated on a tract that was developed as part of a "community shopping center." Plaintiff Hannaford Bros. Co. ("Hannaford") is the operator of a supermarket on an adjacent tract that likewise was said to be part of that shopping center.

Stop & Shop proposes to operate the former Ames Store as a supermarket on the adjacent tract. But Hannaford points to a "Deed of Declaration" (the "Declaration"), initially executed in 1972 and thereafter amended in 1994 to provide additional protection for Hannaford, which imposes restrictions that, by the Declaration's terms, run with the land, so long as a shopping center is operated on the land subject to the Declaration. The Declaration expressly prohibits the operation of a competing supermarket on the site of the Ames Store, so long as Hannaford continues to operate a supermarket on its parcel—which Hannaford, without dispute, now does. In its adversary complaint, Hannaford seeks a ruling from this Court enforcing the Declaration, and ruling that a competing supermarket cannot be operated on the site of the Ames Store.

Hannaford now moves for summary judgment in its favor. In opposition, Stop & Shop does not dispute the existence of ***779** the Declaration, or what it says. But Stop & Shop, joined by Ames (which supports Stop & Shop in this action), opposes summary judgment, principally contending that the requirement for operating a "shopping center" has not been satisfied. Stop & Shop and Ames contend, as their main argument, that in determining whether what was said to be a "shopping center" is in fact a "shopping center" (and thus whether the Declaration runs with the land), this Court may construe the Declaration only after a factual inquiry. They argue that the Court should not focus on the intent of the Declaration's signatories when they drafted the Declaration in 1972, as would be appropriate under New Hampshire law. Instead, Stop & Shop and Ames argue that this Court should decide whether the "shopping center" is such only after applying criteria (involving a weighing of factual factors) that evolved in the federal courts after the enactment of the Bankruptcy Code's 1984 "Shopping Center Amendments" for use in determining whether premises are subject to additional federal requirements that are applicable to premises in a "shopping center" under section 365(b)(3) of the Code. Application of the standards laid out in that federal caselaw, they argue, raises issues of fact.

Then Ames (but not Stop & Shop) makes a number of additional arguments to defeat the enforceability of the Declaration, including contentions that Hannaford lacks standing to protect its interests here; that Hannaford's claims are untimely; that the Declaration, by reason of its inclusion of an alleged "condition subsequent," is incapable of running with the land under New Hampshire law; and

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that under section 365(f) of the Code and caselaw decisions that invalidate so called "anti-assignment clauses," the Declaration is unenforceable, because it is "tantamount" to an anti-assignment clause.

For reasons set forth more fully below, the Court rules that:

(1) Hannaford has standing here to protect its interests;

(2) Hannaford's objection was timely;

(3) the Declaration does indeed run with the land and is enforceable under New Hampshire law;

(4) in determining what the Declaration's signatories intended when it was executed in 1972, federal criteria that were created and applied years later, and for a different purpose, are not applicable, and that, as a matter of law —state law—the requirement for operation of a "shopping center" continues to be satisfied; and

(5) the Declaration is not an unenforceable anti-assignment provision under section 365(f) of the Code.

On none of these matters is there a material disputed issue of fact. Accordingly, Hannaford's motion is granted.

Facts

Though Stop & Shop and Ames assert that if their legal contentions are accepted, material disputed issues of fact exist, the core facts are undisputed.

Background

Until it became clear, in the course of its chapter 11 case, that Ames could not successfully reorganize as an ongoing business and would have to liquidate, Ames was a discount retailer, operating hundreds of stores in leased premises. Its store leases—many of which were executed years ago in environments of lower rental rates—had substantial value, and an important aspect of the Ames chapter 11 case has been its efforts to derive value from its store leases by "assume and assign" transactions following the sale of ***780** leases or of the rights to designate leases for "assume and assign" transactions.

After Ames's sale of such "designation rights" was approved by this Court, Ames sought to assume and assign the lease for its store in Nashua, New Hampshire to defendant Stop & Shop. Stop & Shop wishes to develop and operate a "prototypical Stop & Shop superstore"—which means, as a practical matter, a competing supermarket.

Execution of the Declaration in 1972

The Ames store is situated on one of two tracts of land that originally constituted a single tract (then called "Tract # 2"), which, along with still another tract ("Tract # 1"), were developed in 1972, when the Declaration was initially drafted and recorded. On October 20, 1972, the holders of the interests in the real property covered by the Declaration—Vickerry Realty Co. Trust ("Vickerry"), Coliseum Vickerry Realty Co. Trust ("Coliseum"), and Fleurette D. Fournier, as trustee—signed the Declaration in an effort to develop Tracts # 1 and # 2 as an integrated shopping center. [1] The stated purpose of the Declaration was to facilitate the development of Tract # 1 and Tract # 2 as a "community shopping center" by subjecting the tracts to certain easements, restrictions and obligations pursuant to a "general scheme or plan." [2]

The recitals to the Declaration stated that Vickerry was the owner of 33 acres of land on the east side of Coliseum Avenue in Nashua (Tract # 1), [3] and that Coliseum was the holder of the lessee interest in real estate (of an unstated size) on the west side of Coliseum Avenue (Tract # 2). [4] The recitals continued by establishing a defined term: the "Entire Premises," which as thereafter used would refer to Tract # 1 and Tract # 2 jointly. [5]

The recitals went on to provide that "Vickerry and Coliseum propose to improve the *Entire Premises* as a community *shopping center,*" and that the declarants desired to create and establish "certain easements, restrictions and obligations, pursuant to such general plan or scheme, with respect to such *Entire Premises,*" [6] *i.e.,* Tracts # 1 and # 2. One of those restrictions, set forth in Paragraph 7 of the Declaration, provided in substance that the owners would not use any portion of the building areas that were portions of the Entire Premises, or lease such or permit their use, for any entity that would violate "an exclusive business right, a limitation on competition or use, or any restriction upon co-tenancy now contained in any lease of the Building Areas, without the prior written consent of the tenant or tenants ... under all such leases containing any such limitation or restriction."

And the Declaration further provided, in relevant part:

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> That the easements, restrictions, benefits and obligations hereunder shall create mutual and reciprocal benefits and servitudes upon the Entire Premises, ***781** running with the land thereof, and which shall continue so long as Coliseum and/or Vickerry, their heirs, administrators, executors, successors or assigns shall operate a shopping center upon the Entire Premises. [7]

In 1972, a shopping mall called the Nashua Mall was built on Tract # 1. [8] The Ames Store was built in or about 1972, on Tract # 2. [9]

Hannaford's Purchase of Tract # 2–A in 1994

In 1994, Hannaford became interested in acquiring an undeveloped portion of Tract # 2 in order to develop and operate a supermarket. [10] Thereafter, Vickerry and Hannaford reached an agreement on this acquisition, and in December 8, 1994, this transaction closed. [11] On that date, Vickerry conveyed a portion of Tract # 2—what is now designated as Tract # 2–A—to Hannaford, in fee. [12] Hannaford's agreement to purchase this parcel was conditioned upon obtaining assurance from Vickerry that no other entity would be permitted to develop or operate a supermarket business on either Tract # 1 or the remainder of Tract # 2—what is now designated as Tract # 2–B. [13]

Vickerry provided this assurance by adopting and having Coliseum adopt and record a Third Amendment to the Declaration (the "Third Amendment") on December 8, 1994. [14] The Third Amendment documented the division of Tract # 2 into Tract # 2–A (the portion to be sold to Hannaford) and Tract # 2–B (upon which the Ames Store rests). [15] Further, the Third Amendment, in its Paragraph 4, also amended Section 7 of the Declaration. The Third Amendment added, immediately after the portion of Paragraph 7 quoted above, in relevant part:

> Notwithstanding anything in the foregoing paragraph [the part of the original Paragraph 7 quoted above], or elsewhere in this Deed of Declaration, to the contrary, Tract # 2–A [the tract acquired by Hannaford] may be used for the operation of a retail supermarket business.... [16]

And significantly for the purposes of this dispute, the Third Amendment then went on to say (again in relevant part):

> [S]o long as Tract # 2–A is thereafter being used for the operation of a retail supermarket business ... no part of the Entire Premises, other than Tract # 2–A, shall be permitted to be occupied or used for (i) the operation of a food supermarket.... [17]

The Third Amendment concluded by saying that except as specifically set forth in the Third Amendment, the provisions of the Declaration remained unchanged, and in full force and effect.

Vickerry expressly referred to the Declaration in the deed conveying Tract # 2–A ***782** to Hannaford. Vickerry conveyed Tract # 2–A to Hannaford "subject to and together with the benefit of the rights, obligations, easements, covenants and restrictions contained in [the Declaration]," [18] which, included, of course, the Supermarket Use Restriction. Upon purchasing Tract # 2–A, Hannaford developed a supermarket (the "Hannaford Store"), which Hannaford continues to own and operate. [19]

The Ames Lease

Before Ames occupied it, the Ames Store was leased by Montgomery Ward, and was in the portion of Tract # 2 that was redesignated in 1994 as Tract # 2–B. [20] Before Hannaford's acquisition of Tract # 2–A closed, Vickerry provided Montgomery Ward with notice of the terms of the Hannaford transaction, including, in particular, the adoption of the Supermarket Use Restriction. [21] Montgomery Ward, in turn, consented to the Third Amendment and entered into a Common Operating Agreement with Hannaford, expressly agreeing to abide by the Supermarket Use Restriction. [22]

The Ames Lease was executed on or about October 28, 1999. Section V.1(b) of the Ames Lease expressly incorporated the restrictions and covenants set forth in the Declaration, stating that the lessee could change the use of the leased premises provided that the principal use "shall not conflict with ... any then existing restrictive covenants regarding the use of the Shopping Center, the Premises or the Common Areas." [23] At

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the time Ames entered into the Ames Lease, Ames had at least constructive notice of the Supermarket Use Restriction, as it was duly recorded in the county Registry of Deeds. [24]

On December 2, 2002, Ames sought an order from this Court approving Ames's sale to Stop & Shop of the rights to designate whether a number of Ames's unexpired leases (including the one in controversy here) would be rejected or assumed and assigned in accordance with a "Designation Rights Agreement," pursuant to which Stop & Shop paid Ames $20 million and other consideration. [25] This Court granted that motion shortly thereafter. [26] Thereafter, pursuant to a Notice dated June 30, 2003 (the "Assignment Notice"), Ames, at Stop & Shop's request, notified Hannaford, Vickerry and Coliseum of the proposed assignment to Stop & Shop, and of the use to which Stop & Shop proposed to develop the Ames Store. [27] Hannaford then filed an objection to the Notice, and commenced this action.

Discussion

I.

Summary Judgment Standards

Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories ***783** and admissions on file, together with affidavits ... show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." [28] The moving party bears the initial burden of showing that the undisputed facts entitle the movant to judgment as a matter of law. [29] Then, if the movant carries this initial burden, the nonmoving party must set forth specific facts to show there are triable issues of fact, and cannot rely on pleadings containing mere allegations or denials. [30]

In determining a summary judgment motion, it is well settled that the court should not weigh the evidence or determine the truth of any matter, and must resolve all ambiguities and draw all reasonable inferences against the moving party. [31] A fact is material if it "might affect the outcome of the suit under the governing law." [32] An issue of fact is genuine if "the evidence is such that a reasonable jury could return a verdict for the nonmoving party." [33]

II.

Threshold Matters

Ames makes a number of arguments that might be regarded as threshold matters. The Court addresses them first.

A.

Standing

[1] Ames initially argues that Hannaford lacks standing to protect its interests in this controversy. [34] The Court cannot agree. Ames disregards the unquestioned ability of the signatories to deeded restrictions, [35] and their successors in interest, to enforce them under New Hampshire law. [36]

***784** Ames's reliance on *In re Martin Paint Stores* [37] is misplaced. There, a clothing retailer tenant in a building where a debtor had a lease objected to the assignment of a debtor's lease to another clothing retailer, based on an anti-competition provision in its own lease with the common landlord, and on a "use clause" within the debtor's own lease that would be violated if the assignment occurred. [38] The *Martin Paint Stores* landlord itself did not object, and the district court, affirming the bankruptcy court, found that the objecting neighbor tenant did not have standing to object to the assignment because the neighbor tenant's only legal rights were against the landlord directly. [39] While the *landlord* would have had standing to object to the assignment, the neighbor tenant could not establish standing by "raising another person's legal rights." [40]

Here, by contrast, Hannaford is not seeking to "rais[e] another person's legal rights"; it is seeking enforcement of its own. *Martin Paint Stores* is inapplicable for that reason. Hannaford has standing to enforce whatever legal rights it has.

B.

Timeliness

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[2] Ames also argues, though not at length, that in December 2002, Ames "sold the right to designate the Lease to Stop & Shop free and clear of any liens, claims, encumbrances, or interests in such property, including Hannaford's claims," under the Designation Rights Agreement. Ames goes on to argue that because none of Vickerry, Coliseum or Hannaford objected to the Designation Rights Order, Hannaford's objections to the actual assignment (in which Vickerry and Coliseum join) are untimely.[41] Once more, the Court cannot agree.

Ames relies on the portion on the Designation Rights Order that assertedly provided that:

> [P]ursuant to section 363(f) of the Bankruptcy Code, the sale of any Lease to any Designee shall be free and clear of all liens, claims, encumbrances, and interests, ... with such liens, claims, encumbrances, and interests to attach to the proceeds of the sale....[42]

But the portion quoted by Ames is not complete. Ames fails to address the portion of the order that continued with an exception for "Permitted Exceptions." The "Permitted Exceptions," as defined in the Designation Rights Agreement, included "covenants, conditions *and restrictions of record,* which do not prevent in any material way, prohibit or materially impair the use of the Properties for their *existing* uses and purposes."[43] The "existing uses" included, of course, the operation of a department store, and the "existing purposes" included operations within the shopping center that were being conducted on the Entire Premises, and which, under the Declaration, included both Tract # 1 and Tract # 2. Hannaford did not then have to anticipate that Stop & Shop or Ames would exceed the authority they had under the Court's order. Additionally, Hannaford was not (and is not) seeking an interest (or lien, claim or encumbrance) in ***785** the Ames lease; it has merely been seeking to enforce the use restriction with respect to Tract # 2–B, which is an element of, and limited, Ames's property interest in the first place.

Hannaford had no occasion to object under such circumstances, and its failure to object to the Designation Rights Order is immaterial to the claims Hannaford asserts now.[44]

III.

Enforceability of the Declaration

The Court now turns to the substantive matter that is the enforceability of the Declaration before considering the extent, if any, to which enforceability is trumped by the statutory provisions of the Bankruptcy Code.

A.

Covenant Running With the Land

[3] **[4]** Under New Hampshire state law, a covenant in a deed is an agreement to either do or not do particular acts with respect to land.[45] To enforce the terms of a restrictive covenant, a plaintiff must show "that the benefit or burden of the promise was intended to run with the land, that the promise substantially altered the legal relations of the parties with respect to the land (*i.e.* the promise must 'touch and concern' the land), and that a succession of interest existed between the promisor and the promisee."[46] If these requirements are satisfied, the benefit of the covenant is said to run with the land, and the landowner of a parcel benefited by the covenant may enforce its terms.[47]

[5] **[6]** **[7]** **[8]** Under New Hampshire law, intent to benefit or burden a parcel of land is to be ascertained from the language of the instrument imposing the use restriction, the conduct of the parties and other surrounding circumstances.[48] The inclusion of use restrictions in deeds conveying property is a clear way for the parties to manifest their intent to create a covenant that runs with the land.[49] Although the burden of establishing that the Declaration was intended to run with the land is upon Hannaford, and it should not be implied upon doubtful evidence,[50] in this case there is no doubt whatsoever as to the grantors' intent that it run with the land. The intention that the Declaration run with the land, so long as its requirements were ***786** satisfied, was explicit and unequivocal.[51]

But Ames argues, notwithstanding the language of the Declaration and of the deed to Hannaford expressly referring to the Declaration, that the Supermarket Restriction does not

run with the land under New Hampshire law. That is so, Ames argues, because the Supermarket Restriction assertedly is "dependent on fulfilling a condition subsequent"—*i.e.,* requiring operation of a shopping center upon the Entire Premises. [52] The Court once more disagrees. The Declaration does not have a condition subsequent, in that respect or in any other, and even if the Declaration were deemed to have one, that would not trump the unambiguous stated intention of the Declaration's signatories.

[9] Ames cited no New Hampshire case law in its brief or at oral argument to support its argument that the language of the Declaration created a condition subsequent, and the Court disagrees that one exists here. "A condition subsequent is something that, if it occurs, will bring something else to an end." [53] That is not what is present here. Of course it is true that if the requirements of the Declaration were not satisfied, the Declaration could not be enforced, but the Declaration was conspicuously silent in providing for a reversion, for a discharge of a duty of performance, or for any other consequence if the condition of failure to satisfy the Declaration's requirements were not satisfied. Satisfaction of the requirements of the Declaration was a condition precedent to the Declaration's enforcement, but the failure to satisfy the Declaration's requirements did not create a condition subsequent.

Additionally, assuming, *arguendo,* that the requirement for operation of a shopping center upon the Entire Premises were deemed to create a condition subsequent, that would not provide a sufficient basis for undermining an expressly stated intention by the Declaration's signatories that the Declaration run with the land. Ames's reliance on *Nashua Hospital Ass'n v. Gage* [54] is misplaced. While the *Gage* court began by setting forth a supposed principal of law upon which Ames relies, [55] the *Gage* court ultimately dismissed that approach and held that the restriction *did* run with the land—but had been abandoned. [56] At the risk of stating the obvious, the Court observes that in order for the restriction to have been abandoned, it ***787** must have been in effect at one point, even if the restriction had been (as there, but not here) paired with a condition subsequent that provided for a defeasible fee —*i.e.,* for forfeiture of the entire interest of the property upon non-occurrence of the condition. [57]

Finally, the New Hampshire courts have moved away from rigidly imposing requirements for the enforcement of deeded restrictions, as they have come to recognize the value of deeded restrictions as land use planning devices. [58] The New Hampshire cases no longer support the notion, if they ever did, that a stated intention that a deeded restriction run with the land becomes void simply because it can be enforced only when its requirements are satisfied.

The Court concludes, accordingly, that the covenants in the Declaration *did* run with the land, and could be enforced so long as the Declaration's requirements were satisfied.

B.

Satisfaction of the Declaration's Requirements

The Court then must determine whether material issues of fact exist as to whether the Declaration's requirements were satisfied. Stop & Shop and Ames base their opposition on contentions that disputed material issues of fact exist as to whether a "shopping center" is still being operated on the "Entire Premises." In this connection, they make two arguments. They first urge the Court to march through the multi-factor test articulated by the Third Circuit in the 1990 case of *In re Joshua Slocum Ltd.,* [59] a case construing rights under section 365 of the Bankruptcy Code, to determine if what is being operated upon the "Entire Premises" is a "shopping center." They additionally urge the Court to look to certain events years after the drafting of the Declaration, where the expression "shopping center" was used, though in a wholly different context. Neither point is persuasive.

1.

The Joshua Slocum Argument

[10] The first of the two Stop & Shop/Ames arguments rests on the notion that New Hampshire state law should be disregarded, and that the Court should instead look to federal caselaw that came down years later, for an entirely different purpose. Hannaford disputes that premise, and the Court agrees with Hannaford.

In 1984, Congress enacted major amendments to the Bankruptcy Code and other bankruptcy-related provisions of federal law, [60] which included, among a fair number of other things, amendments to section 365 of the Code. [61]

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The amendments to section 365 emerged from legislation ***788** first introduced by Senator Hatch to address problems perceived by shopping center landlords and solvent tenants concerning the bankruptcies of other tenants.[62] Those amendments are frequently referred to as the "Shopping Center Amendments." The amendments to section 365 included, as relevant here, amendments to section 365(b)(3) and 365(h) that applied only to leases of real property in a shopping center.

But neither Bankruptcy Code section 365, nor Bankruptcy Code section 101 (which sets forth definitions for terms used elsewhere in the Code) defined "shopping center."[63] "Rather, the proper definition of this term '[was] left to case-by-case interpretation.' "[64] To deal with the omission in the statutory drafting process, the Third Circuit, in its 1990 decision in *Joshua Slocum,* articulated a multi-factor test for determining what is a "shopping center" within the meaning of section 365(b)(3) of the Code. The factors set forth in *Joshua Slocum* and its progeny are regularly used by bankruptcy courts in determining whether or not premises are a "shopping center" when disputes arise as to that issue under section 365(b)(3).

But neither Stop & Shop nor Ames offers any case law or rationale to support the notion that the *Joshua Slocum* standards, created to fill a statutory gap with respect to the meaning of "shopping center" in federal determinations under section 365 of the Code, are appropriate for a wholly different determination, under state law, as to the construction of a deed—particularly one executed 18 years before *Joshua Slocum* was decided, and 12 years before the Shopping Center Amendments even came into being. To the contrary, it is clear to the Court that the matter of construction of the Declaration, whether deemed to raise issues of contract law or of property law, is a matter of *state* law.

[11] [12] [13] [14] To the extent that the construction of the Declaration is a matter of contract interpretation—in this case, construction of a deed—it is plainly governed by state law. "When a bankruptcy court adjudicates a dispute arising from a contract claim, it must apply state law unless the bankruptcy code provides otherwise."[65] Likewise, if the Court regards construction of the Declaration as a matter of property law, once more state law, and not federal law, applies. As the United States Supreme Court held in its familiar decision in *Butner v. United States:*[66]

> Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by ***789** reason of the happenstance of bankruptcy."[67]

Indeed, bankruptcy courts look to state law even for the purpose of determining what is property of the estate under Bankruptcy Code section 541, a federal statutory provision. As noted in *Butner*, with the exception of Bankruptcy Code provisions dealing with fraudulent conveyances and preferences, "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."[68] That should, at the least, be no less true when bankruptcy courts are asked to determine the property rights of non-debtors.

[15] Finally, the notion of applying interpretative standards that came into being years after the drafting of the instrument to be construed is particularly illogical. That is squarely inconsistent with the direction of the New Hampshire Supreme Court: "When interpreting a contract, we focus on the intent of the contracting parties *at the time they entered into the agreement.*"[69]

Thus the Court rules that in determining what the Declaration's signatories intended when the Declaration was executed in 1972, federal criteria created and applied years later, and for a different purpose—interpretation of Bankruptcy Code section 365(b)(3)—are not germane.

2.

Standards For Construction of the Declaration Under New Hampshire Law

New Hampshire's interpretive rules with respect to the construction of the Declaration are straightforward.

[16] Under New Hampshire state law, the proper interpretation of a contract, such as a deed,[70] is a question of law for the court.[71] When interpreting a contract, as

previously noted, the court's focus must be on the intent of the contracting parties at the time they entered the agreement. [72]

[17] **[18]** **[19]** In reaching the proper interpretation, the court must determine the common meaning of the words and phrases used based on the understanding that a reasonable person would attach to them. [73] If the language of the contract is clear and unambiguous, the court must interpret it without resort to any sort of extrinsic evidence. [74] The New Hampshire Supreme Court has further stated, in this connection:

> To get at the thought or meaning expressed in a statute, a contract or a constitution, the first resort, in all cases, is to the natural signification of the words, in the order of grammatical arrangement ***790** in which the framers of the instrument have placed them. If the words convey a definite meaning which involves no absurdity, nor any contradiction of other parts of the instrument, then that meaning, apparent on the face of the instrument, must be accepted, and neither the courts nor the legislature have the right to add to it or take from it. [75]

[20] **[21]** **[22]** The New Hampshire cases further provide that in its search for the interpretation that will best reflect the parties' intention, a court should consider "the written agreement of these parties, all of its provisions, its subject matter, the situation of the parties at the time, and the object intended." [76] Where various documents together constitute the contract between the parties, the parties' intent must be ascertained from all the instruments read together as a whole. [77] In interpreting a multiple document agreement, a court must harmonize the provisions of various documents so that none will be rendered meaningless. [78]

3.

Application of the New Hampshire Interpretive Standards

Applying these principles to the facts of this case, the Court finds no material issues of fact with respect to the enforceability of the Declaration. As an initial matter, there is no ambiguity as to what the parties meant when the Declaration referred to the "Entire Premises." They expressly defined "Entire Premises" to consist of Tracts # 1 and # 2—the latter of which was later subdivided into Tract # 2–A and Tract # 2–B with the Third Amendment.

However, the term "shopping center" was not likewise expressly defined in the Declaration, so it is instead necessary to determine whether it is unambiguous, or, if not, to construe it by other means.

[23] **[24]** Under New Hampshire law, a court is to look to the intended purpose of the Declaration in accordance with the common meaning of the language used, and the meaning that would be attributed to it by a reasonable person. [79] Applying that standard, the Court does not find "shopping center" to be in any way ambiguous, and finds no basis for concluding that what was referred to as a shopping center in 1972 ceased to be such in 1994 or 2004. The definition of "shopping center" argued by Hannaford, "a group of retail stores and service establishments," based on the common definition of that term, [80] is consistent with both the plain meaning of ***791** the expression and the meaning that a reasonable person would ascribe to it.

That is particularly so since in or about 1972, retail establishments were constructed on each of Tract # 1 and Tract # 2, and each tract continued to have undeveloped land. The Declaration does not require that a shopping center be operated on the *entirety* of the Entire Premises. Instead, the Declaration's plain meaning is that if a shopping center is operated on any portion thereof, that is sufficient, and even under Stop & Shop's arguments, the Nashua Mall on Tract # 1 satisfies that requirement; just as in 1972, 1994 and 2001, Vickerry continues to own Tract # 1 and continues to lease portions of that parcel to numerous retail stores and service establishments.

But the Court need not even reach that issue. Without factual dispute, retail stores and service establishments continue to be operated on each of the components of the Entire Premises—Tract # 1, Tract # 2–A, and Tract # 2–B—so once more the Declaration would be satisfied even if, contrary to the Court's reading, operation on each of Tract # 1 and Tract # 2 or even on every tract within the Entire Premises were deemed to be required.

Because the Court finds "shopping center" in the Declaration to be unambiguous and to be satisfied based on undisputed facts, it does not need to reach the other indicia of the parties' intent, such as the provisions in the documents as a whole, the subject matter of the Declaration, the situation of the parties

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at the time, and the object intended. Nor does it have to try to construe the provisions of the Declaration and its amendments to avoid making any of them meaningless. But if the Court nevertheless engages in such an analysis, the Court likewise must find, without any issue of fact, that a "shopping center" continued to be operated on the Entire Premises.

As noted above, the original purpose of the Declaration was to develop the "Entire Premises" as a "community shopping center" by subjecting the tracts to restrictions pursuant to a "general scheme" or plan.[81] Retail establishments were constructed in or about 1972 on parts of each of Tract # 1 and Tract # 2, while other parts of each tract remained undeveloped. The Declaration's signatories expressly contemplated the construction of more buildings and stores upon the "Entire Premises," and that such would be in furtherance of the general scheme.[82] Similarly, it is clear that the signatories intended for the restrictions and the general scheme to remain in effect whether or not Vickerry or Coliseum owned the entirety of the "Entire Premises"—as the condition referred to (and contemplated) the operation of a shopping center not just by Vickerry and Coliseum, but also by (among others) their successors or assigns. Given this background, it is clear that the Declaration's signatories anticipated—in fact planned—that there would be changes in the use of the property, yet that the signatories would still consider it to be a "shopping center" such that all the restrictions would apply.

But most significant to the Court are the acts of the Declaration's signatories when amending the Declaration after its initial execution in 1972, and the words they used when they did so. Through the amendments to the Declaration, the parties repeatedly ***792** confirmed their belief that a "shopping center" existed, and confirmed their collective desire to keep the restrictions in the Declaration in effect. When Vickerry conveyed Tract # 2–A to Hannaford in 1994, the Declaration was amended with the Third Amendment to include the Supermarket Use Restriction. It would make no sense whatsoever, and would render much of the Declaration meaningless, to say that at the very time the Declaration was amended to accommodate the conveyance to Hannaford, the Declaration signatories intended to take an action—the *end* of the continued operation of a "shopping center"—such that the provisions of the Declaration would no longer remain in effect. These circumstances compel the conclusion that the parties thought a shopping center continued to exist in 1994 at the time of the Third Amendment —even though Tract # 2 would now become Tract # 2–A and Tract # 2–B, and even though a supermarket, on a separate fee parcel, would be operated on Tract # 2–A.

[25] The Court has been careful, in determining the intent of the Declaration, not to weigh opposing facts, but instead to look to the words used by the Declaration's signatories in 1994 and thereafter. The Third Amendment explicitly stated that "[e]xcept as specifically set forth in this Third Amendment, all the declarations and provisions contained in the Deed of Declaration shall remain unchanged and in full force and effect and are hereby confirmed."[83] The Hannaford Deed specifically provided that the conveyance of Tract # 2–A was subject to "the benefit of the rights, obligations, easements, covenants and restrictions" contained in the Declaration.[84] These matters, particularly collectively, confirm the intent of the parties, since the New Hampshire courts have held that when subsequent deeds expressly make the conveyances subject to the original restrictions, the intent of the parties for the restrictions to run with the land is reaffirmed.[85] When the Third Amendment was executed, the Declaration's signatories thought that a "shopping center" continued to exist, and would continue to exist. Otherwise, the Declaration could not continue "in full force and effect." Accepting the Stop & Shop / Ames argument would require the Court to conclude that the Third Amendment was *void ab initio.* That would be an absurd result.

Likewise, similar language was used at the time of the Fourth Amendment in 2001.[86] The same conclusion is appropriate with respect to that time as well.

The remaining question for the Court, then, is whether the circumstances that existed in 2001—when it was plain that a shopping center was being operated upon the Entire Premises—continue to exist today. There is no evidence to suggest a ***793** contrary conclusion. Neither Stop & Shop nor Ames introduced any evidence on this motion to suggest that retailing ceased at either the Nashua Mall or the other establishments on Tract # 1 or # 2, or that their uses changed in any material way—as they might, for example, if the land had ceased to be used for retail purposes, and had become devoted instead to manufacturing or residential uses. While Stop & Shop and Ames spoke of evolutionary changes in the Entire Premises—such as changes in parking arrangements, easements, particular retailers, and particular successors and assigns taking portions in fee—their evidence was significantly devoid of any showing of any change, and particularly, any material change, in the principal use and

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character of the Entire Premises during the operative periods in this case.

The Court reaches its conclusions well aware that as Stop & Shop states, a piece of Tract # 1, another component of the Entire Premises, was conveyed in fee to Home Depot in 2001 for the operation of a Home Depot Store. But the fact that Vickerry conveyed a portion of Tract # 1 to Home Depot is not relevant, as Home Depot—aside from being another retailer—clearly was a "successor or assign" of Vickerry's.[87] New Hampshire courts have consistently found that a grantee of a parcel of land is a successor in interest of the grantor.[88]

4.

Reference to Other Leases and Agreements

Ames argues that the expression "shopping center" in the original document is ambiguous because the Ames lease, executed 17 years after the original Declaration, contains a different definition of the expression "shopping center"—one which includes the Nashua Mall and the Ames Store, but which does not include the Hannaford Store.[89] Similarly, Stop & Shop argues that since later agreements entered into by Vickerry referred to the "shopping center" as the Nashua Mall on Tract # 1 (and not also Tract # 2–A, containing the Hannaford Store), Tract # 2–A cannot be deemed to be part of the "Entire Premises."[90] Neither argument supports conclusions any different than those set forth in Part III(B)(3) above.

[26] As noted, the expression "shopping center," as used in the Declaration in 1972, is unambiguous. But assuming, *arguendo,* that it were not, miscellaneous documents unrelated to the Declaration and executed nearly 20 years later cannot reasonably be found to bear on the signatories' intent with respect to the language they used in the Declaration. Rather, as the Court has noted, the specific things the signatories said *with respect to the Declaration,* at execution and when its various amendments were executed—most significantly, the statements that the Declaration continued "in full force and effect"—must be relied on instead.

Finally, Stop & Shop's contentions miss the mark. The issue is not one of defining the Entire Premises, which, as noted, was explicitly defined in the Declaration as Tract # 1 and Tract # 2. The issue is ***794** rather whether a "shopping center," as that expression was used in the Declaration, continued to be operated on the Entire Premises. Definitions used in documents unrelated to the Declaration, for different purposes, are not germane to that inquiry.

IV.

Effect, if Any, of Code Section 365(f)

As the last of the major objections to enforcement of the Declaration,[91] Ames argues further that even if the Supermarket Use Restriction did run with the land and the lease was subject to it, the Supermarket Restriction is unenforceable under 365(f) of the Bankruptcy Code because it is tantamount to an anti-assignment clause. Once more the Court must disagree.

With exceptions not relevant here, Bankruptcy Code section 365(f) provides, in relevant part:

> (1) ... [N]otwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection....

[27] [28] [29] [30] Section 365(f) performs an important function for maximizing the value in an estate for creditors. It protects the body of creditors as a whole from provisions, typically in leases, that frustrate the estate's ability to convert the economic value in leases into cash that can increase creditor recoveries.[92] But while section 365(f) can, and should, be used to invalidate provisions that frustrate those goals, a bankruptcy court nevertheless must be attentive to the facts of the particular case to ensure that section 365(f) is not used indiscriminately.

[31] [32] [33] [34] Thus, while section 365(f) gives a bankruptcy court the clear power to invalidate provisions in leases assigned by debtors even when those provisions indirectly restrict the debtors' ability to assign the leases, a bankruptcy court retains discretion in determining whether a lease ***795** provision hinders the possibility of assignment to

a sufficient degree to render it unenforceable.[93] Sometimes such a provision will, and sometimes it will not:

> A court must examine the particular facts and circumstances of the transaction to determine whether a lease clause restricts or conditions assignment including the extent to which the provision hampers a debtor's ability to assign, whether the provision would prevent the bankruptcy estate from realizing the full value of its assets, and the economic detriment to the non-debtor party.[94]

In making such a determination, a court must consider the details of the proposed lease assumption and assignment to ensure that a proper balance is reached between the interests of the debtor-tenant and the economic detriment to the non-debtor.[95] Invalidation of a bargained-for element of a contract under section 365(f) plainly is permissible, but "the modification of a contracting party's rights is not to be taken lightly."[96]

[35] The Court does not need to decide, and does not decide, whether provisions in deeded restrictions, like leases, are subject to invalidation under section 365(f) in appropriate cases.[97] For assuming, *arguendo,* that they are, the Court believes that the Supermarket Use Restriction nevertheless should not be invalidated here. The Supermarket Use Restriction here does not foreclose assignment, or result in a forfeiture of the leasehold for the Ames Store. It merely prohibits one of the many uses to which the Ames Store could be put. When a use provision is as limited as the one here, where its purpose and effect is to protect a neighboring business from a single prohibited use, and where, under the express provisions of the Code, it could not be invalidated if in a lease to which the Shopping Center amendments apply,[98] the Court believes that it would ***796** be inappropriate to invoke section 365(f) in the extraordinarily broad manner urged by Ames. Here, the uses to which the property can be put are not materially limited, and assignment to Stop & Shop (if for uses other than a supermarket) or to Stop & Shop's designee (for many uses other than a supermarket) is not foreclosed.

Cases cited by Ames do not hold to the contrary. In *U.L. Radio,*[99] the court struck down a use clause limiting the use of the property to the sale of television service or the sale of electrical appliances *only.*[100] Similarly, the leases invalidated in *Rickel Home Centers*[101] provided, variously, that they could be used only for a "Home Improvement Center" or a "typical Channel Home Improvement Center" (in the face of evidence that the "typical Channel Home Improvement Center" had either become obsolete, or was struggling to remain in existence, as a result of the advent of warehouse type home improvement stores like Home Depot) or, even that the store could be used only by a "Channel Home Center."[102] The practical prohibition of assignment in those cases was much more draconian than that here. In this case, since the Ames Store can still be used for many purposes other than the operation of a supermarket, the enforceability of the Supermarket Use Restriction does not thwart the fundamental policy of maximizing estate assets for the benefit of all creditors.

Additionally, and as noted above, the harm to other, non-debtor, parties must be considered as well.[103] Here, the harm to Hannaford would be significant. If the Supermarket Use Restriction were invalidated, Stop & Shop would open a competing supermarket on the adjoining tract. The enforcement of the Supermarket Use Restriction would not interfere in a material way with the maximization of debtor Ames's assets. But invalidating the Supermarket Use Restriction would cause significant economic harm to Hannaford, and negate a bargained-for element in Hannaford's purchase of Tract # 2–A.

The Court concludes, accordingly, that section 365(f) cannot be used to prevent the enforcement of the Supermarket Use Restriction.

Conclusion

With the Court finding irrelevant to the Declaration's enforceability all of the allegedly material facts that Ames and Stop & Shop claim are disputed, Hannaford's motion for summary judgment is granted. The Court concludes that Hannaford is ***797** entitled to judgment confirming the existence of the deeded restriction in the Declaration, and to judgment enforcing the Supermarket Restriction. Stop & Shop may not operate a supermarket on Tract # 2–B as long as Hannaford continues to operate a supermarket on Tract # 2–A.

Hannaford is to settle an order and judgment, on notice, in accordance with the foregoing. The time to appeal will of course run from the date of entry of that order and judgment, and not from the date of this decision.

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Parallel Citations

43 Bankr.Ct.Dec. 211

Footnotes

1 Hannaford Statement of Undisputed Material Facts ("HSMF") ¶¶ 6–8.

2 HSMF ¶ 9. The quotes are from the third recital to the Declaration, at 1.

3 Declaration recitals at page 1.

4 *Id.* Coliseum held its interest under a long term ground lease (covering Tract # 2 and other land not subject to the Declaration) under which Fournier was lessor. Vickerry and Coliseum, while named as nominal defendants in this adversary proceeding, support plaintiff Hannaford on this motion.

5 *Id.* ("[B]oth of the above-described premises jointly to be hereinafter called the 'Entire Premises.' ").

6 *Id.* (emphasis added).

7 *Id.* ¶ 13.

8 Stop & Shop Answer at 6.

9 *Id.*

10 HSMF ¶ 15.

11 HSMF ¶ 16.

12 *Id.*

13 HSMF ¶ 18.

14 HSMF ¶ 21. The First and Second Amendments to the Declaration are not material to this dispute.

15 HSMF ¶ 20.

16 HSMF ¶ 21.

17 *Id.;* Third Amendment ¶ 4. Hannaford has referred to this use restriction as the "Supermarket Use Restriction," and this Court will too.

18 HSMF ¶¶ 16, 25.

19 HSMF ¶ 32.

20 HSMF ¶ 28.

21 HSMF ¶ 29.

22 HSMF ¶¶ 29–31.

23 HSMF ¶ 35. "Shopping Center," as defined in the Ames Lease in Article I at page 1 (a definition for "Shopping Center" that is not necessarily the same as that of "Shopping Center" in the Declaration), included the "Project" and the Building in which the "Premises" were located, "including all structures, parking facilities, grounds and other improvements build thereon, as the same may hereafter be built out or changed from time to time ...," and also the entire Nashua Mall.

24 HSMF ¶ 36.

25 HSMF ¶ 37.

26 HSMF ¶ 38.

27 HSMF ¶¶ 39–40.

28 Fed.R.Civ.P. 56 (made applicable to this adversary proceeding by Fed. R. Bankr.P. 7056).

29 *Rodriguez v. City of New York,* 72 F.3d 1051, 1060–61 (2d Cir.1995); *Ferrostaal, Inc. v. Union Pacific R. Co.,* 109 F.Supp.2d 146, 148 (S.D.N.Y.2000) (The initial burden rests on the moving party to demonstrate the absence of a genuine issue of material fact ....").

30 Fed.R.Civ.P. 56(e); *See also Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574, 586–87, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986); *Celotex Corp. v. Catrett,* 477 U.S. 317, 324, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); *Kittay v. Peter D. Leibowits Co. (In re Duke & Benedict, Inc.),* 265 B.R. 524, 529 (Bankr.S.D.N.Y.2001) ("[T]he nonmoving party must set forth specific facts that show triable issues, and cannot rely on pleadings containing mere allegations or denials.").

31 *See Matsushita,* 475 U.S. at 587, 106 S.Ct. 1348 (holding that summary judgment is appropriate "[w]here the record taken as a whole could not lead a rational trier of fact to find for the nonmoving party"); *Virgin Atlantic Airways Ltd. v. British Airways PLC,* 257 F.3d 256, 262 (2d Cir.2001); *Lovejoy–Wilson v. NOCO Motor Fuel, Inc.,* 263 F.3d 208, 212 (2d Cir.2001) ("We ... constru[e] the evidence in the light most favorable to the non-moving party.").

32 *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 248, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986).

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33 *Id.*

34 Ames Br. at 20–21.

35 At least as relevant here, the Court regards "restrictive covenants," when recorded or in deeds, and "deeded restrictions" as interchangeable. Because restrictive covenants historically were often used for improper purposes, having nothing to do with this controversy, the Court prefers to use the expression "deeded restrictions" here.

36 *See Traficante v. Pope,* 115 N.H. 356, 341 A.2d 782, 784 (1975) ("Promises imposing restrictions on the use of land may be enforced at law and in equity between the original parties and their successors depending on the nature of the promise itself and on the type of relief requested.").

37 207 B.R. 57 (S.D.N.Y.1997).

38 *Id.* at 59.

39 *Id.* at 61–63.

40 *See Allen v. Wright,* 468 U.S. 737, 751, 104 S.Ct. 3315, 82 L.Ed.2d 556 (1984).

41 Ames Br. at 6.

42 Designation Rights Order at 7.

43 Designation Rights Agreement at 3 (emphasis added).

44 Stop & Shop asserted as an affirmative defense in its Answer, though not on this motion, that the Designation Rights Order provided it with a substantive defense to Hannaford's claims. *See* Answer at 7–8. For the reasons just stated, the Court disagrees.

45 *See Arnold v. Chandler,* 121 N.H. 130, 428 A.2d 1235, 1237 (1981).

46 *Traficante v. Pope,* 115 N.H. 356, 341 A.2d 782, 784 (1975).

47 *Id.*

48 *See id.,* 341 A.2d at 785; *Carroll v. Schechter,* 112 N.H. 216, 293 A.2d 324, 326 (1972); *Bouley v. City of Nashua,* 106 N.H. 74, 205 A.2d 34, 37 (1964).

49 *See Nashua Garden Corp. v. Gordon,* 118 N.H. 379, 386 A.2d 1278, 1280 (1978) ("[I]ntent that they run with the land is further evidenced by the inclusion of the restrictions in the deeds from Fournier as trustee."); *DeBlois v. Crosley Bldg. Corp.,* 117 N.H. 626, 376 A.2d 143, 145 (1977) (finding that the parties to a conveyance of land intended for a covenant to run with the land based on inclusion of the restrictions in the deed).

50 *See Sun Valley Beach, Inc. v. Watts,* 98 N.H. 428, 102 A.2d 504, 507 (1954) (finding that the burden of proving the existence of a restrictive covenant lies on the party that is asking the Court to enforce it).

51 *See supra,* note 7 and accompanying text ("[T]he ... restrictions ... hereunder shall create mutual and reciprocal benefits and servitudes upon the Entire Premises, *running with the land thereof* ....") (emphasis added).

52 Ames Br. at 21. The argument appears at Ames Br. at 16–17.

53 Bryan A. Garner, *A Dictionary of Modern Legal Usage,* 197 (2d ed.1995). *Accord Black's Law Dictionary,* 289 (7th ed. 1999) ("A condition that, if it occurs, will bring something else to an end; an event the existence of which, by agreement of the parties, discharges a duty of performance that has arisen.").

54 85 N.H. 335, 159 A. 137 (1932).

55 The portion of the decision cited by Ames stated:

> [W]here the agreement is stated as a preamble to a condition subsequent, based upon restrictions upon the use of property conveyed and with a provision for a forfeiture to the grantor and his heirs, there is nothing which runs with the land, and the rights against the grantee are only such as are personal to the grantor and his heirs.

159 A. at 139. It should be noted in this connection, supplementing observations above with respect to whether or not a condition subsequent exists here, that the Declaration here does not include a provision "for a forfeiture to the grantor and his heirs," or, for that matter, to anyone.

56 *Id.,* 159 A. at 141.

57 Since Vickerry conveyed Tract # 2–A to Hannaford in fee simple and not through a defeasible fee, *Gage* is also factually distinguishable on this basis.

58 *See Joslin v. Pine River Dev't Corp.,* 116 N.H. 814, 367 A.2d 599, 601 (1976) ("The former prejudice against restrictive covenants which led courts to strictly construe them is yielding to a gradual recognition that they are valuable land use planning devices."); *Traficante v. Pope,* 115 N.H. 356, 341 A.2d 782, 784 (1975) ("Restrictions on the use of land by private parties have been particularly important in the twentieth century when the value of property often depends in large measure upon maintaining the character of the neighborhood in which it is situated.").

59 922 F.2d 1081 (3d Cir.1990).

60 *See* The Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub.L. No. 98–353, 98 Stat. 333.

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61 *Id.* sec. 362.

62 *See* 130 Cong.Rec. S8895 (daily ed. June 29, 1984) (statement of Sen. Hatch), *reprinted in* App. E Collier on Bankruptcy, at App. Pt. 6–173 (Lawrence P. King et al. eds., 15th ed. rev.2001).

63 *See Joshua Slocum,* 922 F.2d at 1086.

64 *Id.* (quoting *In re Goldblatt Brothers, Inc.,* 766 F.2d 1136, 1140 (7th Cir.1985)).

65 *In re New England Fish Co.,* 749 F.2d 1277, 1280 (9th Cir.1984); *In re Sparkman,* 703 F.2d 1097, 1099 (9th Cir.1983); *In re Wingspread Corp.,* 145 B.R. 784, 787 (S.D.N.Y.1992) (Leval, J., then a district judge) (quoting *New England Fish Co.*).

66 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979).

67 *Id.* at 55, 99 S.Ct. 914 (quoting *Lewis v. Manufacturers National Bank,* 364 U.S. 603, 609, 81 S.Ct. 347, 5 L.Ed.2d 323 (1961)).

68 *Id.* at 54, 99 S.Ct. 914.

69 *West v. Turchioe,* 144 N.H. 509, 761 A.2d 382, 387 (1999) (emphasis added).

70 While the Declaration is, technically speaking, a deeded (and recorded) restriction and not a conveyance as such, neither Stop & Shop nor Ames contends that such a distinction is relevant.

71 *Baker v. McCarthy,* 122 N.H. 171, 443 A.2d 138, 140 (1982); *Catamount Constr., Inc. v. Town of Milford,* 121 N.H. 781, 435 A.2d 123, 124 (1981).

72 *See supra,* notes 56–61, 63 and accompanying text.

73 *Murphy v. Doll–Mar, Inc.,* 120 N.H. 610, 419 A.2d 1106, 1108 (1980); *Kilroe v. Troast,* 117 N.H. 598, 376 A.2d 131, 133 (1977).

74 *See* Petition of *Rattee,* 145 N.H. 341, 761 A.2d 1076, 1080 (2000); *Flanagan v. Prudhomme,* 138 N.H. 561, 644 A.2d 51, 60 (1994).

75 *New Hampshire Municipal Trust Workers' Compensation Fund v. Flynn,* 133 N.H. 17, 573 A.2d 439, 441–42 (1990).

76 *Thiem v. Thomas,* 119 N.H. 598, 406 A.2d 115, 118 (1979) (quoting *Griswold v. Heat Inc.,* 108 N.H. 119, 229 A.2d 183, 186 (1967)).

77 *Bellak v. Franconia College,* 118 N.H. 313, 386 A.2d 1266, 1268 (1978).

78 *West v. Turchioe,* 144 N.H. 509, 761 A.2d 382, 387 (1999).

79 *See Murphy v. Doll–Mar, Inc.,* 120 N.H. 610, 419 A.2d 1106, 1108 (1980) ("In reaching the proper interpretation we require that the words and phrases used by the parties be given their common meaning, and this court will determine the meaning of the contract based upon the meaning that would be attached to it by a reasonable person.") (internal citation omitted); *Kilroe v. Troast,* 117 N.H. 598, 376 A.2d 131, 133 (1977) ("[T]he contract will be given a meaning that would be attached to it by a reasonable person.").

80 *See Webster's New Collegiate Dictionary,* 1072 (1975), a reference work published fairly close in time to the time of the Declaration's execution.

81 HSMF ¶ 9.

82 Declaration fourth recital at page 1 ("WHEREAS, Vickerry and Coliseum have erected and/or will erect various buildings upon, and have set aside for possible future construction certain portions of the Entire Premises....").

83 Declaration Third Amendment ¶ 7.

84 HSMF ¶ 25. Indeed, even the Ames Lease—which was executed in 1999, years after the original Declaration was executed and after the conveyance to Hannaford—made reference to the existing deeded restrictions in the shopping center.

85 *See De Blois v. Crosley Bldg. Corp. of Maine, Inc.,* 117 N.H. 626, 376 A.2d 143, 145 (1977); *Traficante v. Pope,* 115 N.H. 356, 341 A.2d 782, 785 (1975).

86 It proceeded:

> Except as specifically set forth in this Fourth Amendment to Deed of Declaration all the declarations and provisions contained in the Deed of Declaration shall remain unchanged and in full force and effect and are hereby confirmed. Except as herein specifically provided otherwise, all the declarations, provisions, benefits and burdens contained in the Deed of Declaration as amended hereby, shall be applicable to each and every Owner of a tract in the Entire Premises, and to any successors or assigns thereof.
>
> Declaration Fourth Amendment ¶ 17.

87 *See, e.g., Black's Law Dictionary* 114, 1446 (7th ed.1999).

88 *See Johnson v. Shaw,* 101 N.H. 182, 137 A.2d 399, 402 (1957) (grantee of parcel "is admittedly a successor in interest" of grantor).

89 Ames Br. at 10, 18–19.

90 Stop & Shop Resp. ¶ 30.

91 The Court has considered the remaining arguments advanced by Stop & Shop and Ames and finds them to be without merit. They include Stop & Shop's contentions that Hannaford has failed to satisfactorily plead the continued operation of a "shopping center" on the "Entire Premises" (an argument inconsistent with modern pleading requirements); that the Court cannot decide the motion without further discovery (which would focus on the *Joshua Slocum* factors, which this Court has found are not germane); and Ames's contention that the Ames Lease could be sold free and clear of the Supermarket Restriction under Bankruptcy Code section 363(f).

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As Hannaford properly points out, none of section 363(f)'s enumerated bases for selling property free and clear of liens or interests has been satisfied.

92 As this Court stated in its earlier decision in Ames's chapter 11 case approving Ames's sale of designation rights:

> In the bankruptcy context, Congress has provided that the value in a debtor's unexpired leases should enure for the benefit of all of a debtor's creditors, and has provided that subject to the procedural safeguards of the Code (principally in section 365), debtors may assume and assign their interests in leases even without lessor consent, and that notwithstanding any provisions in leases that prohibit, restrict, or condition the assignment of those leases, they may nevertheless be assigned. Using that power conferred under section 365 to assign leases even without lessor consent, debtor lessees can sell the lessee's interests in such leases to those willing to pay for them—converting, for their creditors, into the much more liquid asset of cash, the economic value in the leases.

In re Ames Department Stores, Inc., 287 B.R. 112, 118–19 (Bankr.S.D.N.Y.2002) (Gerber, J.) (internal footnote reference to section 365(f) omitted).

93 *See In re E–Z Serve Convenience Stores, Inc.,* 289 B.R. 45, 50 (Bankr.M.D.N.C.2003) ("[T]he court retains some discretion in determining whether a lease provision that does not explicitly prohibit assignment qualifies as a de facto anti-assignment clause thereby rendering it unenforceable.") (citing *In re Joshua Slocum, Ltd.,* 922 F.2d 1081, 1092 (3d Cir.1990); *In re Village Rathskeller, Inc.,* 147 B.R. 665, 672 (Bankr.S.D.N.Y.1992) (Brozman, C.J.); *In re Mr. Grocer, Inc.,* 77 B.R. 349, 355 (Bankr.D.N.H.1987) (Yacos, J.)).

94 *E–Z Serve Convenience Stores,* 289 B.R. at 50.

95 *Id.*

96 *Joshua Slocum,* 922 F.2d at 1091.

97 Ames's contentions here arise in a variant of the way this issue usually appears. The restriction on use here—prohibiting operation of a competing supermarket—is not in the lease, as it is in most of the cases considering the application of section 365(f). It is instead in a deeded restriction that is no less binding on Ames's landlord than it is on Ames as lessee. Accordingly, to the extent section 365(f) applies, it is because "applicable law"—New Hampshire state law—makes deeded restrictions enforceable.

98 Section 365(b)(3)(C) of the Code imposes requirements for providing adequate assurance of future performance for assumption when property is in a shopping center, which would include, among other things, showings that "assumption or assignment of such lease is subject to all the provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center...." Similarly, section 365(b)(3)(D) requires a showing "that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center." Of course, for determining whether there is a "shopping center" within the meaning of section 365(b)(3), the *Joshua Slocum* standards *would* be applicable.

99 *In re U.L. Radio Corp.,* 19 B.R. 537 (Bankr.S.D.N.Y.1982) (Galgay, J.).

100 *Id.* at 539.

101 Ames cited the Third Circuit decision in Rickel Home Centers, *L.R.S.C. Co. v. Rickel Home Centers, Inc. (In re Rickel Home Centers),* 209 F.3d 291 (3rd Cir.), *cert. denied,* 531 U.S. 873, 121 S.Ct. 175, 148 L.Ed.2d 120 (2000), a mootness case that, in the course of its discussion, noted the importance of assignability in the context of a lower court's utilization of section 365(f). The more significant decision, however, is the decision below, that of District Judge Joseph Farnan (sitting as a bankruptcy court), in *In re Rickel Home Centers,* 240 B.R. 826, 830–832 (D.Del.1998), *app. dismissed,* 209 F.3d 291 (3rd Cir.), *cert. denied,* 531 U.S. 873, 121 S.Ct. 175, 148 L.Ed.2d 120 (2000). The district court decision, with respect to which the Third Circuit dismissed the appeal, lays out the facts of that case in detail, and the reasons for which Judge Farnan invalidated the lease provisions there.

102 240 B.R. at 831.

103 *See also U.L. Radio,* 19 B.R. at 545 (weighing the adverse effect on other tenants in the debtor's building as one of the factors to be weighed in determining the enforceability of a clause in an assigned lease).

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922 F.2d 1081
United States Court of Appeals,
Third Circuit.

In re JOSHUA SLOCUM LTD d/b/a JS Acquisition Corporation.
Appeal of George DENNEY, Party In Interest.

No. 90-1072. | Argued July 31, 1990. | Decided Dec. 31, 1990. | Rehearing and Rehearing In Banc Denied Jan. 28, 1991.

Chapter 11 trustee sought to assume and assign debtor's lease of retail space. The United States Bankruptcy Court for the Eastern District of Pennsylvania, authorized assumption and assignment and deleted average sales clause from lease over landlord's objections. The District Court, James McGirr Kelly, J., affirmed, and landlord appealed. The Court of Appeals, A. Leon Higginbotham, Jr., Chief Circuit Judge, held that: (1) three buildings owned by single landlord and filled with retail stores selling variety of goods ranging from footwear to wallpaper constituted a "shopping center" within meaning of the Bankruptcy Code provision imposing heightened restrictions on assumption and assignment of leases for shopping centers, and (2) provision in debtor's lease authorizing either party to terminate lease if debtor's gross sales for first six lease years did not average $711,245 per year could not be excised by bankruptcy court.

Vacated and remanded.

Sloviter, Circuit Judge, filed dissenting opinion.

West Headnotes (11)

[1] **Bankruptcy**
Supersedeas or Stay

Party seeking to challenge Bankruptcy Code authorization of assignment of lease, on appeal, is not required to seek stay of assignment pending appeal in order to avoid dismissal of appeal as moot once assignment has been made to good-faith assignee. Bankr.Code, 11 U.S.C.A. §§ 363(m), 364(e), 365.

11 Cases that cite this headnote

[2] **Bankruptcy**
Moot Questions

Landlord's failure to obtain stay pending appeal of Chapter 11 trustee's assignment of shopping center lease, and assignment of lease to good-faith assignee, did not render moot landlord's appeal, which did not challenge assignment of lease itself, but bankruptcy court's excisement of lease provision permitting either party to terminate lease if tenants' gross sales for first six months did not average $711,245 per lease year. Bankr.Code, 11 U.S.C.A. §§ 363(m), 364(e), 365.

15 Cases that cite this headnote

[3] **Bankruptcy**
Leases

Although a shopping mall is the archetypal "shopping center," all shopping centers do not necessarily take the form of shopping malls, for purposes of Bankruptcy Code provision imposing heightened restrictions on assumption and assignment of leases for shopping centers. Bankr.Code, 11 U.S.C.A. § 365(b)(3).

8 Cases that cite this headnote

[4] **Bankruptcy**
Leases

Factors more significant than location in determining whether group of stores can properly be described as "shopping center" under Bankruptcy Code provision imposing heightened restrictions on assumption and assignment of shopping center leases are: combination of leases; a lease that is held by single landlord; all tenants engaged in commercial retail distribution of goods; common parking area; purposeful development of premises as shopping center; existence of master lease; fixed hours during which all stores are opened; existence of joint advertising; contractual interdependence of tenants as evidenced by restrictive use provisions in leases;

percentage of rent provisions in leases; tenants' right to terminate leases if anchor tenant terminates its lease; joint tenant participation in trash removal and maintenance; existence of tenant mix; and contiguity of stores. Bankr.Code, 11 U.S.C.A. § 365(b)(3).

8 Cases that cite this headnote

[5] **Bankruptcy**
Leases

Three buildings owned by single landlord and filled with retail stores selling variety of goods ranging from footwear to wallpaper constituted a "shopping center" within meaning of the Bankruptcy Code provision imposing heightened restrictions on assumption and assignment of leases for shopping centers; all of stores, except to extent they were separated by common areas, were contiguous, stores shared and provided support for maintenance of common areas, and common parking lot was available for customers, although by local ordinance lot was required to be open to public. Bankr.Code, 11 U.S.C.A. § 365(b)(3).

11 Cases that cite this headnote

[6] **Bankruptcy**
Curing Defaults; Adequate Assurance

Provision in Chapter 11 debtor's lease of space at shopping center authorizing either party to terminate lease if debtor's gross sales for first six lease years did not average $711,245 per year could not be excised by bankruptcy court, in authorizing assignment of lease; rent was calculated as percentage of sales, so that provision fell within statutory meaning of "other consideration due" for which debtor must give adequate assurance as to future performance in order for assignment to be allowed. Bankr.Code, 11 U.S.C.A. § 365(b)(3), (b)(3)(A).

12 Cases that cite this headnote

[7] **Bankruptcy**
"Ipso Facto" Clauses

Bankruptcy court has some latitude in waiving contractual provision when authorizing trustee to assume and assign unexpired lease, and may ignore "ipso facto" and forfeiture clauses. Bankr.Code, 11 U.S.C.A. §§ 365, 365(b)(2).

3 Cases that cite this headnote

[8] **Bankruptcy**
"Ipso Facto" Clauses

Although bankruptcy court's authority to waive strict enforcement of lease provisions is further qualified by Bankruptcy Code in context of shopping center leases, even under tightly drawn definition of "adequate assurance" required in shopping center context, Congress did not envision literal compliance with all lease provisions; insubstantial disruptions in, inter alia, tenant mix, and insubstantial breaches in other leases or agreements were contemplated and allowed. Bankr.Code, 11 U.S.C.A. § 365(b)(3), (b)(3)(D).

2 Cases that cite this headnote

[9] **Bankruptcy**
"Ipso Facto" Clauses

Bankruptcy court's authority to waive strict enforcement of lease provisions in nonshopping center cases will permit deviations which exceed those permitted in shopping center cases. Bankr.Code, 11 U.S.C.A. §§ 365, 365(b)(2, 3).

8 Cases that cite this headnote

[10] **Bankruptcy**
"Ipso Facto" Clauses

Modification of contracting party's rights is not to be taken lightly; rather, bankruptcy court in authorizing assumption and assignment of unexpired lease must be sensitive to rights of nondebtor contracting party and the policy requiring that nondebtor receive full benefit of his or her bargain. Bankr.Code, 11 U.S.C.A. § 365.

14 Cases that cite this headnote

[11] Bankruptcy
"Ipso Facto" Clauses

Provision of lease of retail space authorizing landlord or Chapter 11 debtor to terminate lease if debtor did not achieve stated average sales was "material and economically significant clause" in lease, and thus, such clause would be enforceable in bankruptcy context, even if leased space were not in a shopping center; rent received under percentage rent clause was determined by debtor's sales. Bankr.Code, 11 U.S.C.A. § 365.

11 Cases that cite this headnote

Attorneys and Law Firms

***1083** George J. Marcus (argued), Jacob A. Manheimer, Pierce, Atwood, Scribner, Allen, Smith & Lancaster, Portland, Me., for appellant.

Robert F. Salvin (argued), Lashner & Lashner, Philadelphia, Pa., for appellee.

Before HIGGINBOTHAM, Chief Judge, and SLOVITER and ALITO, Circuit Judges.

OPINION OF THE COURT

A. LEON HIGGINBOTHAM, JR., Chief Judge.

This case concerns the power of the bankruptcy court to excise a paragraph from a shopping center lease. On November 21, 1988 (the "Filing Date"), Joshua Slocum, Ltd., a Pennsylvania corporation (the "Debtor"), filed a voluntary petition for relief under chapter 11 of the United States Code with the bankruptcy court. On February 16, 1989, the bankruptcy court appointed Melvin Lashner (the "Trustee") to act as trustee in the case pursuant to 11 U.S.C. § 1104. Appellant George Denney ("Denney") contends that the bankruptcy court erred in entering its orders excising paragraph 20 of the lease in question, and then authorizing the assumption and assignment of that lease, without paragraph 20, over his objections. He also maintains that the district court erred in affirming the bankruptcy court's decision. We agree with the appellant and therefore will reverse the district court's summary affirmance of the bankruptcy court's judgment.

I. FACTS AND PROCEDURAL HISTORY

The Debtor, Joshua Slocum, Ltd., d/b/a JS. Acquisition Corporation, began its relationship with Landlord, George Denney, in May of 1983 when Debtor signed a ten year lease for retail space at the Denney Block in Freeport, Maine. The Denney Block, which consisted of three buildings containing seven stores, was developed in two phases commencing in 1982 and completed in 1983. The first phase was undertaken by Cole Haan, a manufacturer and retailer of fine men's and women's shoes, of which Denney is the President. Cole Haan purchased and renovated a building on Main Street in Freeport, Maine, and gave Denney the option to purchase the building in the event that the stock of Cole Haan was acquired by a third person. When the capital stock of Cole Haan was purchased by Nike, George Denney exercised ***1084** his option to purchase the Cole Haan building.

Shortly thereafter, Denney purchased the building immediately adjoining the Cole Haan building and a third building separated from the second building by a courtyard. Architectural plans to develop the two new buildings in a manner consistent with the Cole Haan building as a common scheme were commissioned by Denney and presented to the Freeport, Maine planning board for approval.

The buildings comprising Denney Block front on Main Street and are part of the downtown shopping district in Freeport. The shopping district consists of a number of streets lined with stores. In addition to the Landlord's three buildings, the Denney Block has a courtyard located between two of its buildings and a parking lot behind the stores. George Denney owns the parking lot which is primarily for the use of patrons of the Denney Block, although according to local ordinance it is also open to the public (thus, it can be used by all persons who shop in the stores along Main Street, Freeport).

Debtor's lease, signed in 1983, along with the leases of some or all of the other Denney Block tenants, contains an average sales clause. This clause allows for Debtor or Landlord to terminate the lease if, after six years, Debtor's average yearly sales are below $711,245. A similar option also existed after the third year of the lease. At that point, either party held the power to terminate the lease if the tenant's average yearly sales were below $602,750.

The lease also contains a percentage rent clause. For the years currently remaining in the lease, this clause requires the tenant to pay additional rent in the amount of four percent of gross sales in excess of $1,175,362. Otherwise, the base rent due in the final five years of the lease is $3,917.88 per month. The leases also require the tenants to provide Landlord with financial information concerning their business so that these lease provisions can be implemented.

Joshua Slocum, Ltd. filed a voluntary petition for relief under chapter 11 of the United States Bankruptcy Code with the bankruptcy court. By application to the bankruptcy court dated February 2, 1989 (the "Application"), the Trustee requested authorization to assume and assign the Lease pursuant to 11 U.S.C. § 365. In March 1989, Denney filed written objections and a memorandum of law in opposition to the application with the bankruptcy court.

By opinion (the "opinion") and order both dated March 29, 1989 (the "interim order"), 99 B.R. 250, the bankruptcy court granted the relief requested in the Application and authorized the Trustee to assume and assign the Lease to European Collections, Inc. (the "assignee"). The bankruptcy court entered another Order on April 11, 1989 (the "final order"), setting forth fully the rights and obligations of the parties. In the opinion and the final order, the bankruptcy court held unenforceable and excised paragraph 20 of the Lease ("paragraph 20"), which provides that "in the event that Tenant's gross sales for the first six (6) lease-years of the term of this Lease do not average Seven Hundred Eleven Thousand Two Hundred Forty Five and 00/100 Dollars ($711,245.00) per lease-year either Landlord or Tenant may elect to terminate this Lease."

The court approved the assignment of the lease without paragraph 20 to European Collections. European Collection has begun occupancy and operation of a store in George Denney's premises in Freeport, Maine. Denney's consolidated appeals followed.

On May 31, 1989, the Trustee filed a motion to dismiss George Denney's appeal as moot. By Order dated December 21, 1989 the district court affirmed without opinion the bankruptcy court's opinion and final order and denied Trustee's motion to dismiss. On January 22, 1990, Denney appealed the district court order.

II. DISCUSSION

A. *Mootness*

[1] Before we can turn to our discussion of the merits we must address the threshold issue of whether we have appellate ***1085** jurisdiction. Appellee asks this court to dismiss this appeal as moot due to the landlord-appellant, George Denney's failure to obtain a stay pending appeal. Trustee argues that the principle of finality embodied in § 363(m) of the Bankruptcy Code should be applied to assignments under § 365 of that same statute. Further, Trustee maintains that such assignments, if made to good faith assignees, should not be subject to invalidation on appeal. We find the Trustee's argument inapposite to the situation presented. Denney has not challenged the assignment of the lease to European Collections. Accordingly, the issue before us is not the assignment of the lease, as the Trustee asserts, but rather whether the bankruptcy court had the authority to excise paragraph 20 of that lease. The request to dismiss as moot must be denied, because we find that under the facts of this case Denney was under no obligation to obtain a stay.

We note that only two provisions of the Bankruptcy Code, 11 U.S.C. §§ 363(m) and 364(e), specifically require that a party seek a stay pending appeal. [1] Appellee concedes that § 363(m) of the Bankruptcy Code does not apply to assignments of leases under § 365. We decline to interpret the mootness principles in such a way that would, in effect, create a third situation where parties are required to seek a stay, i.e., the assignment of leases under § 365. While § 363(m) contains a provision requiring a stay, the section that applies in this case, § 365, does not.

[2] We have been willing to go beyond the statutory framework and dismiss an appeal as moot, where, *during the pendency of the appeal,* events occurred preventing the appellate court from granting effective relief. *See, e.g., In re Cantwell,* 639 F.2d 1050 (3d Cir.1981); *In re Highway Truck Drivers,* 888 F.2d 293 (3d Cir.1989). In *Cantwell,* the creditors appealed an order of the district court that dissolved a stay of discharge. The discharge appellants sought to be stayed was granted during the pendency of the appeal. The order granting the discharge had not been appealed. The sole issue before the court was the district court's order dissolving the stay. As Judge Sloviter noted, "even if we vacate that order-the relief appellant requests-it will not change the fact that the discharge, the act appellants sought to delay has been granted.... Hence, the propriety of the stay of discharge is

moot." 639 F.2d at 1054. *Cantwell* is inapposite to the present situation. In *Cantwell,* unlike the matter at hand, the discharge of bankruptcy, i.e., the event occurring during the pendency of the appeal, had not been appealed. This Court's grant of a stay of that discharge would have been an empty gesture. Therefore, the court could not provide effective relief in that instance.

Similarly, in *Highway Truck Drivers,* during the pendency of the appeal, the state Supreme Court relieved the debtor of all liability. The state Supreme Court's decision was not before this court. Because no stay had been requested, no relief could be granted. "To hold otherwise would allow the district court to nullify retroactively a validly entered state court judgment, thereby emasculating the fundamental doctrines of federalism and comity." *Highway Truck Drivers,* 888 F.2d at 299. No such concern is present in the case *sub judice.*

In both *Cantwell* and *Highway Truck Drivers,* the event occurring during the pendency of appeal was a decision of a court. We do not imply that only an intervening judicial decree will moot an appeal. However, in neither *Cantwell* nor *Highway Truck Drivers* was the intervening court decision reviewable by this Court, thus in neither case could the appellant obtain effective relief in this forum.

***1086** In the matter at hand, there has been no intervening event that altered the rights of the Trustee *vis-a-vis* Denney. The action the Trustee claims to have mooted this case, i.e., the assignment of the lease, is not the action appealed from, and not the action upon which we base our decision. The excisement of paragraph 20 is the action presently before us, and the Trustee has presented no argument to the effect that that issue has been mooted during the pendency of the appeal. Thus, effective relief can be granted in this case. [2]

In this instance, we find that no event has occurred during the pendency of the appeal to render Denney's appeal moot, nor are we precluded from granting effective relief. We find that we have appellate jurisdiction to hear the merits of this appeal. Accordingly, what has been done can be undone, if necessary, we can and will reverse the bankruptcy court's decision to hold unenforceable and to excise paragraph 20 of the Lease.

B. *Shopping Center*

The Bankruptcy Code imposes heightened restrictions on the assumption and assignment of leases for shopping centers. *See* 11 U.S.C. § 365(b)(3). [3] A debtor in a bankruptcy proceeding can raise working capital by assuming and assigning executory leases and contracts. *See* 11 U.S.C. § 365. Ordinarily to obtain the bankruptcy court's permission to assign a lease a debtor need only provide assurance that the assignee will perform under the lease's terms. *See* 11 U.S.C. § 365(f)(2)(B). However, Congress in 1978 and again in 1984 placed additional restrictions on assignment of shopping center leases in order to protect the rights of the lessors and the center's other tenants. *See* S.Rep. Nos. 98-70, 98th Cong. 1st Sess. (1983). Congress recognized that unlike the usual situation where a lease assignment affects only the lessor, an assignment of a shopping center lease to an outside party can have a significant detrimental impact on others, in particular, the center's other tenants. *Id.* However, the Bankruptcy Code does not define "shopping center." Rather, the proper definition of this term "is left to case-by-case interpretation." *In re Goldblatt Brothers, Inc.,* 766 F.2d 1136, 1140 (7th Cir.1985).

George Denney, the landlord of the Denney Block, wishes to take advantage of these heightened restrictions in order to block the assignment of the lease to European Collections. Thus, appellant Denney ***1087** contends that the Denney Block is a "shopping center" within the meaning of 11 U.S.C. § 365(b)(3). We agree.

However, the bankruptcy court agreed with the appellee, Trustee, and found that Denney Block was not a "shopping center" within the meaning of 11 U.S.C. § 365(b)(3). The court looked to *Collier on Bankruptcy* and two cases addressing the question of whether a particular arrangement of stores constitutes a "shopping center" for purposes of § 365(b)(3). *See In re Goldblatt Bros., Inc.,* 766 F.2d 1136, 1140-41 (7th Cir.1985); *In re 905 Int'l Stores, Inc.,* 57 B.R. 786, 788-89 (E.D.Mo.1985). Both of these appellate decisions affirm bankruptcy court determinations that the respective premises in question were not in "shopping centers."

In *Goldblatt,* although the court found the common ownership of contiguous parcels, the presence of an "anchor tenant" (Goldblatt) and joint off street parking adjacent to all stores was significant in deciding whether the arrangement at issue was a shopping center, those factors were not determinative. The court was persuaded by the absence of other typical indicia of shopping centers, i.e., a master lease, fixed hours during which the stores are all open, common areas and joint advertising, and particularly whether the stores were developed to be a shopping center. *See* 766 F.2d at 1141.

In *905 Int'l,* the court, in finding that the arrangement at issue in that case was not a "shopping center," was impressed with "the absence of contractual interdependence among tenants." 57 B.R. at 788. That case, like *Goldblatt,* also sets out several objective criteria in determining whether an arrangement is a "shopping center." In addition to contractual interdependence, these factors include the existence of percentage rent clauses, anchor tenant clauses, joint contribution to trash and maintenance needs, contiguous grouping of stores, a tenant mix, and restrictive clauses. Relying on the indicia pointed to in *Goldblatt,* the court found that only one of the four, joint advertising, was satisfied, and concluded the stores did not comprise a shopping center.

[3] The bankruptcy court utilized the correct criteria for determining what constitutes a "shopping center." The court's focus on the physical attributes of the Denney Block, however, i.e., the fact that it was located on a typical "Main St." in a downtown district, is not a factor laid out as dispositive in the Bankruptcy Code, Collier's treatise, or either of the above cited cases. Nor is there any intrinsic sense to the bankruptcy court's conclusion that the Denney Block's location makes it fall outside the purview of the definition of "shopping center." The court noted that "a shopping center brings to mind a configuration of stores which are not free-standing or detached in the sense that stores appear in a typical 'Main St.' downtown shopping district. Such a downtown shopping district is usually considered in many communities, as the *alternative* (emphasis in original) to the archetypal 'shopping center,' i.e., the large enclosed shopping mall." Bankruptcy Court Opinion (Appendix at 218). While it is true that the mall *is* the archetypal "shopping center," all shopping centers do not necessarily take the form of shopping malls.

[4] Location is only one element in the determination of whether a group of stores can properly be described as a "shopping center." However, more significant are the following criteria sketched in Collier, *Goldblatt* and *905 Int'l:*

(a) A combination of leases;

(b) All leases held by a single landlord;

(c) All tenants engaged in the commercial retail distribution of goods;

(d) The presence of a common parking area;

(e) The purposeful development of the premises as a shopping center;

(f) The existence of a master lease;

(g) The existence of fixed hours during which all stores are open;

(h) The existence of joint advertising;

(j) Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases;

***1088** (k) The existence of percentage rent provisions in the leases;

(*l*) The right of the tenants to terminate their leases if the anchor tenant terminates its lease;

(m) Joint participation by tenants in trash removal and other maintenance;

(n) The existence of a tenant mix; and

(*o*) The contiguity of the stores.

[5] We do not think that the bankruptcy court gave adequate consideration to all of the factors described above and gave undue weight to the testimony that the Denney Block does not look like a shopping center. *See* Appendix at 98, 219. The bankruptcy court placed what it termed "the physical configuration" of the Denney Block at the center of its analysis, *see id.* at 219-20: "we find that the physical characteristics of the Denney Block *preclude* its characterization as a 'shopping center.' " *Id.* at 218. We are not convinced that the physical configuration of the property plays such a prominent role. Indeed, Collier notes that "the most important characteristic will be a combination of leases held by a single landlord, leased to commercial retail distributors of goods, with the presence of a common parking area." 2 Collier on Bankruptcy ¶ 365.04[3]. Except for contiguity of stores criterion listed above, the appearance of premises or their location within a downtown shopping district has not been cited as a factor in the determination of whether a group of stores is a "shopping center." All of the stores of Denney Block, except to the extent that they are separated by common areas, are contiguous.

Moreover, George Denney is the sole landlord of all the stores in the Denney Block. Those stores share and provide support for the maintenance of common areas. The stores are all retail distributors of goods subject to substantially similar leases which include both percentage rent provisions and clauses for the benefit of other tenants that restrict the type of goods

that a tenant may sell. There is a mix of tenants at Denney Block. Cole Haan primarily sells footwear, Laura Ashley sells a variety of goods including clothing, wall paper and linens, Jones New York sells men's and women's clothing, Benneton sells sports wear, Class Perfume sells perfume and Christmas Magic sells Christmas decorations and ornaments. The plot plan for Denney Block was presented to the Freeport planning board as a common scheme.

The bankruptcy court found that there was no common parking because customers of stores other than those shops in the Denney Block also use parking lot located directly behind it. That common parking is available at the Denney Block is not obviated by the fact that according to local ordinance the public must also have access to that lot. Hence, the Denney Block satisfies, with the exception of joint advertising, the existence of a master lease and the right of a tenant to terminate the lease if the anchor tenant does so, all of the criteria for determining what constitutes a "shopping center," and all of the "most important" characteristics listed by Collier. Because the bankruptcy court did not adequately consider each of the factors enumerated above its reading of the Act was overly restrictive.

The provisions of Section 365 are intended to remedy three "serious problems caused shopping centers and their solvent tenants by the administration of the bankruptcy code." 130 Cong.Rec. S8891 (statement by the Hon. Orrin G. Hatch, a ranking majority member of the Senate Committee on the Judiciary and a Senate conferee), *reprinted in* 1984 U.S.Code Cong. & Admin.News 590, 598. Congress wished to alleviate the hardship caused landlord and tenant resulting from vacancy or partial operation of the debtor's space in the shopping center. Section 365 also insures that the landlord will continue to receive payments due under the lease. Finally, the statute guarantees to the landlord and remaining tenants that the tenant mix will not be substantially disrupted. Each of these serious problems was faced by Denney and the remaining shops after Joshua Slocum, Ltd. went bankrupt. We conclude that in light of the harms Section 365 was ***1089** intended to remedy, and after application of all relevant criteria, denying Denney and his tenants the protections of Section 365 would not further the congressional will.

Additionally, the legislative history of the Bankruptcy Reform Act of 1978 briefly addresses the definition of a "shopping center."

> A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, *often* subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus, a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement.

H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 348 (1977), *reprinted in* 1978 U.S.Code Cong. & Admin.News 5787, 6305 (emphasis added).

We think that the Denney Block fits within Congress' conceptualization of a shopping center. The use of the term "often" in the above quoted passage indicates that the existence of a master lease should not be determinative in this court's analysis. We also note that a "single unit" as described above does not have to be an enclosed mall as the bankruptcy court would have it, but rather could be properly conceived of as a cluster of three relatively contiguous buildings as with the Denney Block.

We conclude that Denney Block is a "shopping center" within the meaning of 11 U.S.C. § 365(b)(3) and should be entitled to its special protections.

C. *Bankruptcy Court's Power to Excise Paragraph 20 of the Lease*

[6] The bankruptcy court, in considering the motion of the Trustee, Melvin Lashner to allow the Debtor, Joshua Slocum, Ltd. to assume and assign its store lease with the Denney Block (*see* 11 U.S.C. § 365(a)), held that the average sales clause in paragraph 20 of that lease unenforceable because it is not material or economically significant to the landlord and/or landlord's other tenants. The bankruptcy court granted Trustee's motion to assume and assign the lease and deleted the average sales clause. Appellant, George Denney takes issue with the court's authority to excise paragraph 20 of his leasehold with Joshua Slocum, Ltd. We shall defer the issue of whether that clause was material until later in our discussion.

However, we now turn our attention to the question of the bankruptcy court's authority to delete paragraph 20.

Paragraph 20 of Joshua Slocum, Ltd.'s lease at the Denney Block provides as follows:

> Paragraph 20 ("average sales"):
>
> *Option to Terminate.* In the event that Tenant's gross sales for the first three (3) lease-years of the term of this Lease do not average at lease Six Hundred Thousand Seven Hundred Fifty and 009/100 Dollars ($602,750.00) per lease-year, either Landlord or Tenant may elect to terminate this Lease; and in the event that Tenant's gross sales for the first six (6) lease-years of the term of this lease do not average Seven Hundred Eleven Thousand Two Hundred Forty Five Dollars and 00/100 Dollars ($711,245.00) per lease-year, either Landlord or Tenant may elect to terminate this Lease. Such election must be made, if at all, by written notice to the other party received within thirty (30) days from the date of receipt by Landlord of the accountant's statement described in Paragraph 4(b) hereinabove; and termination shall become effective ninety (90) days after receipt of such notice....

Appendix at 15-16.

The bankruptcy court viewed this average sales provision as a cleverly disguised anti-assignment clause. The court stated:

> Perhaps the most novel issue raised by this motion is the enforceability of the "minimum sales" provision which, if enforced, would probably allow Denney to terminate the Lease in July, 1989. If ***1090** this provision were enforced, with EC having to incorporate the Debtor's sales record through February 20, 1989, the value of the Lease would obviously be nominal. EC's offer to pay $77,000 for the right to obtain an assignment of the Lessee was expressly predicated on its receiving the right to utilize the Debtor's former Freeport store for at least the remaining four years of the lease. It is certainly questionable whether, in the short time before EC could open the store and July, 1989, it could attain a sales volume, when combined with the Debtor's interrupted sales record, sufficient to meet that required as the minimum in the first six lease-years of the Debtor's lease.

Appendix at 227 (Bankruptcy Court Opinion). Working from the premise that Denney Block is not a "shopping center," the bankruptcy court held that the heightened protection accorded to non-debtor contractual rights under § 365(b)(3) [4] of the Bankruptcy Code does not apply and turned its attention to § 365(f) dealing with assumptions and assignments of lease in non-shopping center cases. [5] However, as discussed above, Denney Block is a "shopping center" and thus, § 365(f) does not apply.

[7] **[8]** **[9]** The bankruptcy court does have some latitude in waiving contractual provisions when authorizing a trustee to assume and assign an unexpired lease. Section 365(b)(2) [6] on its face permits the court to ignore so-called *ipso facto* and forfeiture clauses. *See In re TSW Stores of Nanuet, Inc.,* 34 B.R. 299, 305 (Bankr.S.D.N.Y.1983); *In re U.L. Radio Corp.,* 19 B.R. 537 (Bankr.S.D.N.Y.1982). However, the court's authority to waive the strict enforcement of lease provisions in the context of shopping center cases like this one is further qualified by § 365(b)(3) of the Bankruptcy Code. [7] Even under the tightly drawn definition of "adequate assurance" in the shopping center context, Congress did not envision literal compliance with all lease provisions; insubstantial disruptions in, *inter alia,* tenant mix, and insubstantial breaches in other leases or agreements were contemplated and allowed. [8] ***1091** 11 U.S.C. § 365(b)(3)(C), (D); *see also U.L. Radio Corp.,* 19 B.R. 537, 544; *TSW Stores,* 34 B.R. 299.

In this case, however, the bankruptcy court did not have the authority to excise paragraph 20 of the shopping center lease which addresses the landlord and/or tenant's option to terminate dependent upon the average sales generated by the tenant. We note that even if the Denney Block were not a shopping center, the bankruptcy court's authority to excise paragraph 20 of the lease is questionable. That paragraph must be read in conjunction with paragraph 4, the percent rent clause of the lease which provides a formula requiring Joshua Slocum, Ltd. to pay a percentage of the lease as specified on any amount in excess of the designated gross sales threshold for a given lease-year (*See* Appendix at pp. 3-4). These two clauses taken together clearly indicate that

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a bargained for element in this contract was that tenant, Joshua Slocum, Ltd., average a certain volume of sales as specified in paragraph 20 of the lease so that the Landlord could accurately calculate the minimum total rent expected pursuant to paragraph 4 of the lease. Even standing alone, paragraph 20 is an essential bargained for element of this lease agreement because it governs occupancy. We also note that paragraph 20 of the lease falls within the statutory meaning of "other consideration due" [9] under the lease, and without this clause the trustee could not give adequate assurance as to its future performance.

[10] Congress has suggested that the modification of a contracting party's rights is not to be taken lightly. Rather, a bankruptcy court in authorizing assumptions and assignment of unexpired leases must be sensitive to the rights of the non-debtor contracting party (here, George Denney) and the policy requiring that the non-debtor receive the full benefit of his or her bargain. *See U.L. Radio Corp.,* 19 B.R. 537; *TSW Stores of Nanuet,* 34 B.R. 299. Congress' solicitous attitudes toward shopping centers is reflected in the legislative history regarding § 365(b)(3), which states:

> A shopping center is often a carefully planned enterprise, and though it consists of numerous individual tenants, the center is planned as a single unit, often subject to a master lease or financing agreement. Under these agreements, the tenant mix in a shopping center may be as important to the lessor as the actual promised rental payments, because certain mixes will attract higher patronage of the stores in the center, and thus a higher rental for the landlord from those stores that are subject to a percentage of gross receipts rental agreement. Thus, in order to assure a landlord of his bargained for exchange, the court would have to consider such factors as the nature of the business to be conducted by the trustee or his assignee, whether that business complies with the requirements of any master agreement, whether the kind of business proposed will generate gross sales in an amount such that the percentage rent specified in the lease is substantially the same as what would have been provided by the debtor, and whether the business proposed to be conducted would result in a breach of other causes in master agreements relating, for example to tenant mix and location.

H.R.Rep. No. 595, 95th Cong., 1st Session 348-49, *reprinted* in 1978 U.S.Code Cong. & Admin.News 5963, 6305; *see also* S.R.Rep. No. 95-989, *reprinted* in *id.* at 5787, 5845.

In excising paragraph 20, the bankruptcy court undermined both the Congressional policy and the statutory requirement under § 365(b)(3)(A) that the trustee give adequate assurance of "other consideration due" under an unexpired lease. We find that the bankruptcy court did not have the authority to excise paragraph 20 of the lease.

*1092 D. *Materiality*

[11] Appellant takes issue with the bankruptcy court's conclusion that paragraph 20 of the lease at issue, allowing for the termination of the lease by either the landlord, Denney or the debtor-tenant, Joshua Slocum, Ltd., if certain minimum sales figure were not realized, was not enforceable. Central to the bankruptcy court's view was the notion that unless the landlord establishes that a leasehold is in a "shopping center," such a restrictive clause is only enforceable if the landlord is able to establish that such terms are material and jeopardize the economic position of the landlord and/or the landlord's other tenants. The bankruptcy court, working from the premise that the Denney Block is not a "shopping center," looked to case law interpreting § 365 of the Bankruptcy Code and distilled the concepts of "materiality and economic significance." Those cases state that "the [bankruptcy] court does retain some discretion in determining that lease provisions ... may still be refused enforcement in a bankruptcy context in which there is no substantial economic detriment to the landlord shown, and in which enforcement would preclude the bankruptcy estate from realizing the intrinsic value of its assets." *In re Mr. Grocer, Inc.,* 77 B.R. 349, 354 (Bankr.D.N.H.1987); *see also In re Tech Hifi, Inc.,* 49 B.R. 876, 879 (Bankr.D.Mass.1985).

Again, we note our disagreement with the bankruptcy court's premise that the Denney Block is not a "shopping center" within the meaning of 11 U.S.C. § 365(b)(3). We find that although the bankruptcy court was correct in its reliance on those legal precepts in this context, it was incorrect in finding

that on these facts, paragraph 20 of the lease, addressing the right of the parties to terminate the leasehold is not "material or economically significant." That conclusion flies in the face of logic and simple common sense. The average sales provision of the lease is material in the sense that it goes to the very essence of the contract, i.e., the bargained for exchange. This clause, intended to benefit both the landlord and the tenant, was negotiated at arms length to accommodate the commercial expectations of the parties. This average sales provision is also reflective of the economic terms of the lease agreement governing occupancy. However, most importantly, the materiality and economic significance of paragraph 20 turn on the fundamental right to remain in or end a contractual relationship.

We find that the average sales provision of paragraph 20 was not merely inserted as an escape hatch in the event that the location became unprofitable for the protection of the tenant. But rather, that particular clause is of financial import to the landlord in insuring occupancy by high volume sales, viable businesses, thus increasing the rent received under the percentage rent clause. The combination of paragraph 4 and paragraph 20 acts as a minimum income guarantee for the landlord. Certainly nothing could be as material or economically significant to landlords as some minimal assurance that there will be a positive return on their investments. The clause is also significant to landlord as well as the other tenants because customers will be attracted to stores where business is perceived as booming. We conclude, therefore, paragraph 20 is a material and economically significant clause in the leasehold at issue.

III. CONCLUSION

In conclusion, having satisfied ourselves that we have appellate jurisdiction, we hold that the Denney Block, a contiguous grouping of stores, is subject to the heightened restrictions on the assumption and assignment of leases of real property in shopping centers. *See* 11 U.S.C. § 365(b)(3). We find that the district court erred in affirming the bankruptcy court's approval of the assignment of the leasehold at issue without paragraph 20, an average sales clause, to European Collections. The bankruptcy court did not have authority to excise paragraph 20, a material provision governing the terms of occupancy under the lease. Therefore, we will vacate the judgment of the district court and remand to the district court for further proceedings consistent with this opinion.

***1093** SLOVITER, Circuit Judge, dissenting.

I would not reach the majority's plausible view of the merits because I believe that the appeal is moot. I recognize that such a determination may let stand trial court errors, but that inevitable byproduct of an order dismissing an appeal as moot does not relieve us of the compulsion to restrain ourselves when there is no longer a case to decide. Moreover, in this case the majority's decision to ignore the mootness of the appeal overturns a transaction that has long since been consummated involving a non-party, good-faith purchaser. Thus, the requirement that we refrain from deciding this appeal because of mootness is also the better policy because it places the consequences on the party that could have prevented this situation by moving to stay the transaction during the pendency of this appeal.

I am concerned that the decision of the majority to proceed to the merits will undermine the finality of bankruptcy lease assignments, which may lower the value of debtors' estates and thereby reduce the amount available to satisfy creditors. Declining to correct lower court errors, when weighed against this result, is less onerous. *Cf. In re Sax,* 796 F.2d 994, 997-98 (7th Cir.1986) ("At this juncture, it matters not whether the authorization [by the bankruptcy court] was correct or incorrect. The point is that the proper procedures must be followed to challenge an authorization....").

Section 363(m) provides that good-faith purchasers are protected from the reversal of a sale or lease of property on appeal unless there is a stay pending appeal. 11 U.S.C. § 363(m) (1988). Although the assignment of leases is covered by section 365 rather than 363, and thus the language of section 363(m), which governs only "authorization under [363(b) or (c)] of a sale or lease of property," is inapplicable, some circuits have used section 363(m) to hold that the assignment of a lease is moot as well. *See, e.g., In re Stadium Management Corp.,* 895 F.2d 845 (1st Cir.1990); *In re Exennium,* 715 F.2d 1401 (9th Cir.1983); *see also American Grain Ass'n v. Lee-Vac, Ltd.,* 630 F.2d 245 (5th Cir.1980) (mootness found under Rule 805, predecessor to section 363(m)). I agree with the majority that we should not stretch the language of section 363(m) so far. However, I think well-established rules of justiciability found in the cases of this court and others, along with the particular need for finality in bankruptcy, require that we find the appeal of a completed lease assignment to a non-party moot unless the appellant has sought a stay pending appeal.

This court has long held in non-bankruptcy contexts that challenges to transactions consummated after the approval of a district court are moot if the appellant has not sought a stay of the transaction. In *Brill v. General Indus. Enter.,* 234 F.2d 465 (3d Cir.1956), plaintiff shareholders sought to enjoin the sale of a corporation's assets on the ground that the sale would violate the antitrust laws. The district court refused to grant the injunction, the sale was then consummated, and plaintiffs appealed. We held that the appeal was moot because "[n]o order was sought by the plaintiffs to maintain the existing status pending their appeal." *Id.* at 469. "[W]here the act sought to be restrained has been performed, the appellate courts will deny review on the ground of mootness." *Id.*

Our decision in a bankruptcy case, *In re Cantwell,* 639 F.2d 1050 (3d Cir.1981), relied on *Brill* for the proposition that "where, pending appeal, an act or event sought to be enjoined has been performed or has occurred, an appeal from the denial of the injunction will be dismissed as moot." *Id.* at 1054. We held that because the creditors who sought a stay of the bankrupt's discharge failed to appeal the discharge, an appeal from the district court's order dissolving the stay was moot. We stated, "[g]enerally, an appeal will be dismissed as moot when events occur during the pendency of the appeal which prevent the appellate court from granting any effective relief." *Id.* at 1053; *see also In re Highway Truck Drivers,* 888 F.2d 293 (3d Cir.) (appeal from grant of relief from automatic stay mooted when state supreme court order relieved debtor from liability to ***1094** appellants), *cert. denied,* 490 U.S. 1022, 109 S.Ct. 1748, 104 L.Ed.2d 185 (1989).

The majority apparently seeks to distinguish *Cantwell* and *Highway Truck Drivers* on, *inter alia,* the ground that in this case the assignment of the lease did not occur during the pendency of the appeal. *See* Maj.Op. at 1085. Although the precise date of the assignment of the lease to European Collections is not in the appendix, it clearly occurred subsequent to the bankruptcy court's decision. Therefore, there is no basis for the technical distinction the majority seeks to make, and the rationale of *Cantwell* and *Highway Truck Drivers* applies whether the lease assignment occurred during the brief period between the bankruptcy court's order and the appeal to the district court, during the appeal to the district court, or during this appeal.

The majority argues, however, that the assignment of the lease "is not the action appealed from and not the action upon which [it bases its] decision." Maj.Op. at 1086. The majority characterizes the issue before us narrowly as the power of the bankruptcy court to excise paragraph 20 of the lease.

The order from which Denney appeals is the district court's order affirming the bankruptcy court's final order titled "Order Authorizing Trustee's Application to Assume and Assign Lease," which granted the trustee's motion to assume and assign the lease. Although the excision of paragraph 20 is appellant's principal objection to the bankruptcy court's order, his appeal is not so limited. Indeed, in his initial brief appellant states that this case "concerns the assumption and assignment of a lease," and he contends that the Bankruptcy Court "erred in entering its orders authorizing the assumption and assignment of a certain lease over Denney's objections." Appellant's Brief at 4. In response to the appellee's strong argument that the appeal is moot, the appellant, in apparent recognition of the force of that argument, retracted somewhat by arguing that "*[e]ven if* Denny's appeal is moot with respect to the assignment of the lease, it is not moot with respect to the excision of Paragraph 20." Reply Brief at 9 (emphasis added).

Thus, it is misleading to state that "Denney has not challenged the assignment of the lease." Maj.Op. at 1085. The excision was an integral part of the authorization. The bankruptcy court concluded that without excising paragraph 20 "the value of the Lease would obviously be nominal," and that European Collection's offer to pay for the right to obtain the lease "was expressly predicated on its receiving the right to utilize the ... store for at least the remaining four years of the lease," which it would be unlikely to be able to do if it had to meet the terms of paragraph 20 based on the debtor's poor sales record. App. at 227.

Moreover, the practicalities of the situation make clear why the issue of paragraph 20 cannot be divorced from that of the assignment of the lease. Paragraph 20 provides that if annual gross sales for the first six years do not average $711,245, appellant Denny, the landlord, *inter alia,* could terminate the lease. In light of the poor sales by the debtor during its years of operation, the bankruptcy court found that "a new tenant in the Debtor's store would be compelled to generate about $400,000 gross sales by July, 1989" to meet the requirement of paragraph 20. App. at 213. It continued, "[t]he parties all apparently agreed that accomplishing such a volume of sales in this time-frame would be a difficult proposition for any new store." *Id.*

Although the majority asserts that this appeal does not require us to reach the issue of the assignment, Maj.Op. at 1086 n. 2,

its decision will undeniably have the effect of fundamentally changing the terms of the assignment and thereby effectively rescinding it. The assignee relied on the excision of paragraph 20 just as it relied on the assignment of the lease in general. Regardless of whether the appellant challenges the power to authorize the lease assignment or challenges the assignment only because it excluded paragraph 20, the appellant had an obligation to seek a stay pending appeal to prevent the substantial reliance of a non-party on the bankruptcy court's final order.

***1095** Another ground on which the majority seeks to distinguish *Cantwell* as well as *Highway Truck Drivers* is that in those cases we were unable to review the intervening court decisions that permitted the actions which rendered the appeals moot, and thus we "could not provide effective relief." Majority Op. at 1085. This reasoning fails to account for our decision on mootness in *Brill,* a case where we had direct review of the district court decision which permitted the consummated sales transaction that mooted the appeal. In any event, I believe that *Cantwell* and *Highway Truck Drivers* are closer analogs to this case than the majority acknowledges because the only way we can provide relief here is to annul a transaction which involves an entity over which we do not have jurisdiction. The majority cites no cases, and I have found none, in which a consummated sale or assignment to a non-party purchaser has been vitiated on appeal.

Moreover, the majority's position is in stark contrast to the position this court has taken on the necessity of stays to prevent mootness. We stated in *Highway Truck Drivers* that "in addition to those situations covered under 11 U.S.C. § 363(m) and § 364(e), a myriad of circumstances can occur that would necessitate the grant of a stay pending appeal in order to preserve a party's position." 888 F.2d at 298. Those situations are by no means limited to cases in which we could not review intervening court decisions. It is a general principle of law that when a stay is not obtained, the prevailing party may treat the judgment of the district court as final. *Id.* at 297-98. In *Highway Truck Drivers,* 888 F.2d at 298, we quoted at length from *In re Kahihikolo,* 807 F.2d 1540, 1542 (11th Cir.1987) (per curiam), which in turn cited *American Grain Ass'n,* 630 F.2d 245, 247 (5th Cir.1980), for the proposition that,

> in the absence of a stay, action of a character which cannot be reversed by the court of appeals may be taken in reliance on the lower court's decree. As a result, the court of appeals may become powerless to grant the relief requested by the appellant.

In *Kahihikolo,* the bankruptcy court lifted an automatic stay and thereby permitted a creditor to repossess the debtor's automobile, even though the court had approved the debtor's plan under Chapter 13 under which the creditor would have been repaid in full. The trustee appealed the lifting of the automatic stay, but did not seek to stay the bankruptcy court's decision. The court of appeals ruled the appeal moot because the creditor, after the bankruptcy court's decision, sold the automobile. 807 F.2d at 1541-42.

In *Highway Truck Drivers,* we observed that "[t]here are decisions in other circuits in which events not identified as requiring a stay in the Bankruptcy Code occurred while the automatic stay had been lifted thereby rendering the pending appeal moot." 888 F.2d at 297. Among the cases we cited was *Central States Pension Fund v. Central Transp., Inc.,* 841 F.2d 92 (4th Cir.1988), where an appeal of a reorganization plan was held to be moot because the plan had been substantially implemented and thus reversal "would require undoing financial transactions involving third parties, not participants in this litigation." *Id.* at 96. The court declined to do so when the appellant could have halted implementation of the bankruptcy court decision by obtaining a stay.

The need for finality of transactions involving parties in bankruptcy which underlay these decisions is also the premise behind section 363(m). That section "reflects the salutary policy of affording finality to judgments approving sales in bankruptcy by protecting good faith purchasers, the innocent third parties who rely on the finality of bankruptcy judgments in making their offers and bids.... The finality and reliability of the judicial sales enhance the value of the assets sold in bankruptcy." *In re Stadium Management Corp.,* 895 F.2d at 847. "This policy concern is implicated not only when property is sold to a third party but also when a lease or option is granted to a third party in reliance on an order of a bankruptcy court." *American Grain Ass'n,* 630 F.2d at 248.

***1096** Moreover, the general rule long predates both section 363(m) and its predecessor, Rule 805. As the court noted in *Algeran, Inc. v. Advance Ross Corp.,* 759 F.2d 1421, 1424 (9th Cir.1985), "[t]he rule that failure to obtain a stay pending appeal renders the issue moot did not originate in the Bankruptcy Rules. Rather, it is a judicial doctrine which developed from the general rule that the occurrence of events which prevent an appellate court from granting effective relief

renders an appeal moot, and the particular need for finality in orders regarding stays in bankruptcy."

There is no contention that European Collections was not a good faith purchaser in this case. And though it purchased a lease rather than purchased or leased property (which would have put it within section 363(m)), the same policy concerns are equally applicable to lease assignments and to sales or leases of property. Assignment of a lease is, after all, simply the purchase of a right to lease property, albeit not that of the debtor. European Collections paid substantial consideration for that right in reliance on the finality of the bankruptcy court's decision to permit the assignment. It then moved into the premises and established its business, creating the same reliance interest as if it had leased or purchased the property directly from the landlord.

Similar policy considerations may have led to the decisions of those courts holding section 363(m) or its predecessor applicable to lease assignments. *See Stadium Management,* 895 F.2d at 848-49 (holding appeal moot in absence of stay after trustee, with approval of bankruptcy court, sold debtor's stadium pursuant to section 363(b) and assigned debtor's lease for the land underneath it pursuant to section 365); *In re Exennium,* 715 F.2d 1401, 1404 (9th Cir.1983) (assignment of lease could not be voided because appellant had not obtained a stay); *see also American Grain Ass'n,* 630 F.2d at 247-48.

The general principle that appeals are moot in the absence of a stay is broadly applied to bankruptcy orders other than assignment of leases. In *Miami Center Ltd. Partnership v. Bank of New York,* 838 F.2d 1547 (11th Cir.1988), the court stated, "[t]he Eleventh Circuit, like other circuits, has recognized the continuing viability and applicability of the mootness standard in situations other than transfers by a trustee under § 363(b) or (c)." *Id.* at 1553 (citations omitted). The court found the appeal from the confirmation of a liquidation plan was moot even though the transaction was not governed by section 363(m). *Miami Center* relied in part on *Markstein v. Massey Assoc.,* 763 F.2d 1325 (11th Cir.1985), where the court held that it could not rescind a foreclosure sale on the debtor's property, which was permitted after the bankruptcy court lifted an automatic stay on the property because the debtor did not obtain a stay. The sale did not come under section 363(m), but the court nevertheless invoked the "rule of law" that "a court is powerless to rescind the sale on appeal." *Id.* at 1327; *see also In re Sun Valley Ranches, Inc.,* 823 F.2d 1373, 1374-75 (9th Cir.1987) (to the general rule that "the debtor's failure to obtain a stay pending appeal renders an appeal moot after assets ... are sold," the court "carved out a narrow exception ... where real property is sold to a creditor who is a party to the appeal").

In this case, the appellants had the opportunity to seek a stay pursuant to Bankruptcy Rule 8005 and thereby halt the transaction that European Collections justifiably believed was final. The court's decision today will permit the appellant landlord effectively to evict European Collections from the property it has now occupied for several months in reliance on the bankruptcy court's final order. The decision will send a signal to future purchasers of assets from debtors' estates that their purchases may be revoked long after they receive approval by the bankruptcy court and after they have placed substantial reliance on the finality of that approval. That can only have the effect of lowering the value of the debtors' estate. *See Stadium Management,* 895 F.2d at 847; *In re Sax,* 796 F.2d 994, 998 (7th Cir.1986). It also effectively expands this court's jurisdiction beyond its previous limits, because ***1097** the court today fashions a remedy which we formerly considered ourselves powerless to compel. Because I believe the majority's decision to overlook the mootness of the issue it reaches is in derogation of our prior precedent and is not consistent with the policy considerations that have informed the Bankruptcy Code and cases here and elsewhere, I respectfully dissent.

Parallel Citations

117 A.L.R. Fed. 725, 24 Collier Bankr.Cas.2d 581, 21 Bankr.Ct.Dec. 361, Bankr. L. Rep. P 73,769

Footnotes

1 11 U.S.C. § 363(m) provides:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pending of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

Section 364(e) concerns the validity of debts and liens. *See* 11 U.S.C. § 364(e).

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2 While we are essentially in agreement with the dissent's well-reasoned analysis, we differ as to the appropriate starting point of the inquiry. If we started our analysis with the assignment, and not with excisement of paragraph 20, we would probably reach the same result. However, we do not accept the proposition that the action at issue in this case is the assignment of the lease. Indeed, the appellant states that the scope of review is limited to "whether the Bankruptcy Court has authority to excise Paragraph 20 of the lease and whether the Denney Block is a shopping center." Appellant's Brief at 8.

Nor do we, in this opinion, overturn "a transaction that has long since been consummated," dissenting opinion ("dis. op.") at 1093, or "annul a transaction which involves an entity over which we do not have jurisdiction." Dis. op. at 1095. We differ with the dissent's willingness to draw factual conclusions concerning the effect of this decision, when, in light of the bankruptcy court's decision to excise paragraph 20, neither the bankruptcy nor district court had an opportunity to consider the question. The bankruptcy court's observation that "[t]he parties all apparently agreed that accomplishing such a volume of sales in this time-frame would be a difficult proposition" is inadequate support for the dissent's conclusion that our decision will undeniably have the effect of rescinding the lease.

3 That Bankruptcy Code provision addresses executory contracts and unexpired leases and provides in relevant part:

(3) For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance-

(A) of the source of rent and other consideration due under such lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use or exclusivity provision, in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center.

4 *See supra* note 3.

5 That provision provides in relevant part:

(f)(1) Except as provided subsection (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

(2) The trustee may assign an executory contract or unexpired lease of the debtor only if-

(A) the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

6 Executory contracts and unexpired leases.

(b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee-

(A) cures, or provides, adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and

(C) provides adequate assurance of future performance under such contract or lease.

(2) Paragraph (1) of this subsection does not apply to a default that is a breach of a provision relating to-

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

11 U.S.C. § 365(b)(1), (2).

7 *See supra* note 3 for the language of this provision.

8 The court's authority to waive strict enforcement of lease provision in the non-shopping center cases will permit deviations which exceed those permitted in shopping center cases. *U.L. Radio,* 19 B.R. 537, 544. *See also In re Peterson's Ltd., Inc.,* 31 B.R. 524 (Bankr.S.D.N.Y.1983) (a change in use was authorized to permit an assignment of a so-called high class tobacco shop to an assignee who sold discounted cigars); *In re Fifth Avenue Originals,* 32 B.R. 648 (Bankr.S.D.N.Y.1983) (a lease assumption and assignment from a high-class boutique selling clothing and accessories for both sexes to Diane von Furstenberg, a designer offering women's clothing and accessories, was approved).

9 *See* 11 U.S.C. § 365(b)(3)(A), *supra,* p. 1086.

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67 A.3d 496
Court of Chancery of Delaware.

In re MFW SHAREHOLDERS LITIGATION.

C.A. No. 6566–CS. | Submitted: March 11, 2013. | Decided: May 29, 2013.

Synopsis
Background: Stockholders brought breach of fiduciary duty action against controlling stockholder and corporate directors, alleging unfairness in going private merger. Directors moved for summary judgment.

Holdings: The Court of Chancery, Strine, Chancellor, held that:

[1] corporate special committee formed to consider going private merger was sufficiently empowered so as to support finding that use of special committee to protect minority stockholders in merger was entitled to cleansing effect under business judgment rule;

[2] members of committee were independent;

[3] as a matter of first impression, business judgment rule was correct standard of review.

Motion granted.

West Headnotes (12)

[1] **Corporations and Business Organizations**
Duties of directors and officers in general; business judgment rule

Corporate special committee formed to consider going private merger was sufficiently empowered so as to support finding that use of special committee to protect minority stockholders in merger was entitled to cleansing effect under business judgment rule, in determining standard of review applicable to stockholders' action against controlling stockholder and directors alleging unfairness in merger; committee was empowered to hire its own legal and financial advisors and actually did so, committee was empowered not simply to evaluate offer but to negotiate with controlling stockholder over terms of its offer to buy out noncontrolling stockholders, and committee considered whether there were other buyers who might be interested in purchasing corporation.

2 Cases that cite this headnote

[2] **Corporations and Business Organizations**
Business judgment rule in general

In evaluating whether business judgment rule applies to decision of corporate directors, there is a presumption that directors are independent; to show that a director is not independent, a plaintiff must demonstrate that the director is beholden to the controlling party or so under the controller's influence that the director's discretion would be sterilized.

5 Cases that cite this headnote

[3] **Corporations and Business Organizations**
Duties of directors and officers in general; business judgment rule

Member of corporate special committee formed to consider going private merger was sufficiently independent so as to support finding that use of special committee to protect minority stockholders in merger was entitled to cleansing effect under business judgment rule, in determining standard of review applicable to stockholders' action against controlling stockholder and directors alleging unfairness in merger, despite argument that member had personal and business relationship with director who was sole owner of controlling stockholder; allegations of friendliness between member and director were insubstantial, only asserting that member had been to director's house, allegation as to business relationship consisted only of vague claim that member would "come into contact" with director in business capacity, and there was no evidence of any emotional depth to relationship.

2 Cases that cite this headnote

[4] Corporations and Business Organizations
Duties of directors and officers in general; business judgment rule

Member of corporate special committee formed to consider going private merger was sufficiently independent so as to support finding that use of special committee to protect minority stockholders in merger was entitled to cleansing effect under business judgment rule, in determining standard of review applicable to stockholders' action against controlling stockholder and directors alleging unfairness in merger, even though member's firm had received approximately $200,000 in fees for work done for controlling stockholder or entity in which controlling stockholder had interest; there was no evidence that fee in that amount was material to member personally, and there was no evidence that member, in role as professor at law school, had any role in raising funds from alumni or other possible donors.

2 Cases that cite this headnote

[5] Corporations and Business Organizations
Duties of directors and officers in general; business judgment rule

Member of corporate special committee formed to consider going private merger was sufficiently independent so as to support finding that use of special committee to protect minority stockholders in merger was entitled to cleansing effect under business judgment rule, in determining standard of review applicable to stockholders' action against controlling stockholder and directors alleging unfairness in merger, despite argument that member had economic relationship with director who was sole owner of controlling stockholder, where there was no evidence that economic relationship was material to member, given member's existing wealth.

Cases that cite this headnote

[6] Corporations and Business Organizations
Duties of directors and officers in general; business judgment rule

Corporate special committee formed to consider going private merger satisfied duty of care, so as to support finding that use of special committee to protect minority stockholders in merger was entitled to cleansing effect under business judgment rule, in determining standard of review applicable to stockholders' action against controlling stockholder and directors alleging unfairness in merger; committee met frequently and was presented with rich body of relevant financial information, and committee was composed entirely of independent directors.

3 Cases that cite this headnote

[7] Corporations and Business Organizations
Business judgment rule in general

If the business judgment rule applies to review of corporate directors' action, the claims against the directors must be dismissed unless no rational person could have believed that the action was favorable to minority stockholders.

2 Cases that cite this headnote

[8] Courts
Highest appellate court

If the Supreme Court has clearly spoken on a question of law necessary to deciding a case before it, the Court of Chancery must follow its answer.

3 Cases that cite this headnote

[9] Courts
Dicta

“Dictum,” or judicial statements on issues that would have no effect on outcome of case, is without precedential effect, and thus broad judicial statements, when taken out of context, do not constitute binding holdings.

3 Cases that cite this headnote

[10] Courts
Dicta

If an issue is not presented to a court with the benefit of full argument and record, any statement on that issue by that court is not a holding with binding force.

Cases that cite this headnote

[11] Corporations and Business Organizations
Duties of directors and officers in general; business judgment rule

Business judgment rule was correct standard of review of going private merger between controlling stockholder and its subsidiary, where merger was conditioned on approval of independent, adequately-empowered special committee that fulfilled duty of care and on the uncoerced, informed vote of majority of minority stockholders.

5 Cases that cite this headnote

[12] Corporations and Business Organizations
Fiduciary Duties as to Management of Corporate Affairs in General

The application of fiduciary duty principles to corporate directors must be influenced by current corporate practices.

Cases that cite this headnote

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OPINION

STRINE, Chancellor.

I. *Introduction*

This case presents a novel question of law. Here, MacAndrews & Forbes—a holding company whose equity is solely owned by defendant Ronald Perelman—owned 43% of M & F Worldwide ("MFW"). MacAndrews & Forbes offered to purchase the rest of the corporation's equity in a going private merger for $24 per share. But upfront, MacAndrews & Forbes said it would not proceed with any going private transaction that was not approved: (i) by an independent special committee; and (ii) by a vote of a majority of the stockholders unaffiliated with the controlling stockholder (who, for simplicity's sake, are termed the "minority"). A special committee was formed, which picked its own legal and financial advisors. The committee met eight times during the course of three months and negotiated with MacAndrews & Forbes, eventually getting it to raise its bid by $1 per share, to $25 per share. The merger was then approved by an affirmative vote of the majority of the minority MFW stockholders, with 65% of them approving the merger.

MacAndrews & Forbes, Perelman, and the other directors of MFW were, of course, sued by stockholders alleging that the merger was unfair. After initially seeking a preliminary injunction hearing in advance of the merger vote with

agreement from the defendants and receiving a good deal of expedited discovery, the plaintiffs changed direction and dropped their injunction motion in favor of seeking a post-closing damages remedy for breach of fiduciary duty.

The defendants have moved for summary judgment as to that claim. The defendants argue that there is no material issue of fact that the MFW special committee was comprised of independent directors, had the right to and did engage qualified legal and financial advisors to inform itself whether a going private merger was in the best interests of MFW's minority stockholders, was fully empowered to negotiate with Perelman over the terms of his offer and to say no definitively if it did not believe the ultimate terms were fair to the MFW minority stockholders, and after an extensive period of deliberation and negotiations, ***500** approved a merger agreement with Perelman. The defendants further argue that there is no dispute of fact that a majority of the minority stockholders supported the merger upon full disclosure and without coercion. Because, the defendants say, the merger was conditioned up front on two key procedural protections that, together, replicate an arm's-length merger—the employment of an active, unconflicted negotiating agent free to turn down the transaction and a requirement that any transaction negotiated by that agent be approved by the disinterested stockholders—they contend that the judicial standard of review should be the business judgment rule. Under that rule, the court is precluded from inquiring into the substantive fairness of the merger, and must dismiss the challenge to the merger unless the merger's terms were so disparate that no rational person acting in good faith could have thought the merger was fair to the minority. [1] On this record, the defendants say, it is clear that the merger, which occurred at a price that was a 47% premium to the stock price before Perelman's offer was made, cannot be deemed waste, a conclusion confirmed by the majority-of-the-minority vote itself.

In other words, the defendants argue that the effect of using both protective devices is to make the form of the going private transaction analogous to that of a third-party merger under Section 251 of the Delaware General Corporation Law. The approval of a special committee in a going private transaction is akin to that of the approval of the board in a third-party transaction, and the approval of the noncontrolling stockholders replicates the approval of all the stockholders.

The question of what standard of review should apply to a going private merger conditioned upfront by the controlling stockholder on approval by *both* a properly empowered, independent committee and an informed, uncoerced majority-of-the-minority vote has been a subject of debate for decades now. For various reasons, the question has never been put directly to this court or, more important, to our Supreme Court.

This is in part due to uncertainty arising from a question that has been answered. Almost twenty years ago, in *Kahn v. Lynch,* our Supreme Court held that the approval by *either* a special committee *or* the majority of the noncontrolling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff. [2] Although *Lynch* did not involve a merger conditioned by a controlling stockholder on both procedural protections, statements in the decision could be, and were, read as suggesting that a controlling stockholder who consented to both procedural protections for the minority would receive no extra legal credit for doing so, and that regardless of employing both procedural protections, the merger would be subject to review under the entire fairness standard.

Uncertainty about the answer to a question that had not been put to our Supreme Court thus left controllers with an incentive system all of us who were adolescents (or are now parents or grandparents of adolescents) can understand. Assume you have a teenager with math *and* English ***501** assignments due Monday morning. If you tell the teenager that she can go to the movies Saturday night if she completes her math *or* English homework Saturday morning, she is unlikely to do both assignments Saturday morning. She is likely to do only that which is necessary to get to go to the movies—*i.e.,* complete one of the assignments—leaving her parents and siblings to endure her stressful last-minute scramble to finish the other Sunday night.

For controlling stockholders who knew that they would get a burden shift if they did one of the procedural protections, but who did not know if they would get any additional benefit for taking the certain business risk of assenting to an additional and potent procedural protection for the minority stockholders, the incentive to use both procedural devices and thus replicate the key elements of the arm's-length merger process was therefore minimal to downright discouraging.

Because of these and other incentives, the underlying question has never been squarely presented to our courts,

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and lawyers, investment bankers, managers, stockholders, and scholars have wondered what would be the effect on the standard of review of using *both* of these procedural devices. [3] In this decision, Perelman and his codefendants ask this court to answer that question by arguing that because the merger proposal that led to the merger challenged here was conditioned from the time of its proposal on both procedural protections, the business judgment rule standard applies and requires a grant of summary judgment against the plaintiffs' claims.

In this decision, the court answers the question the defendants ask, but only after assuring itself that an answer is in fact necessary. For that answer to be necessary, certain conditions have to exist.

First, it has to be clear that the procedural protections employed qualify to be given cleansing credit under the business judgment rule. For example, if the MFW special committee was not comprised of directors who qualify as independent under our law, the defendants would not be entitled to summary judgment under their own argument. Likewise, if the majority-of-the-minority vote were tainted by a disclosure violation or coercion, the defendants' motion would fail.

The court therefore analyzes whether the defendants are correct that the MFW special committee and the majority-of-the-minority vote qualify as cleansing devices under our law. As to the special committee, the court concludes that the special committee does qualify because there is no triable issue of fact regarding (i) the independence of the special committee, (ii) its ability to employ financial and legal advisors and its exercise of that ability, and (iii) its empowerment to negotiate the merger and definitively to say no to the transaction. The special committee met on eight occasions and there are no grounds for the plaintiffs to allege that the committee did not fulfill its duty of care. As to the majority-of-the-minority vote, the plaintiffs admit that it was a fully informed vote, as they fail to point to any failure of disclosure. ***502** Nor is there any evidence of coercion of the electorate.

Second, the court has to satisfy itself that our Supreme Court has not already answered the question. If our Supreme Court has done so, this court is bound by that answer, which may only be altered by the Supreme Court itself or by legislative action. Therefore, the court considers whether the plaintiffs are correct in saying that the Supreme Court has held, as a matter of law, that a controlling stockholder merger conditioned up front on special committee negotiation and approval, and an informed, uncoerced majority-of-the-minority vote must be reviewed under the entire fairness standard, rather than the business judgment rule standard. Although admitting that there is language in prior Supreme Court decisions that can be read as indicating that there are no circumstances when a merger with a controlling stockholder can escape fairness review, the court concludes that this language does not constitute a holding of our Supreme Court as to a question it was never afforded the opportunity to answer. In no prior case was our Supreme Court given the chance to determine whether a controlling stockholder merger conditioned on both independent committee approval and a majority-of-the-minority vote should receive the protection of the business judgment rule. Like the U.S. Supreme Court, our Supreme Court treats as dictum statements in opinions that are unnecessary to the resolution of the case before the court. [4] The plaintiffs here admit that under this definition of what constitutes binding precedent, our Supreme Court has not spoken to the question, because it has never been asked to answer the question. After reading the prior authority again, the court concludes that the question remains open and that this court must give its own answer in the first instance, while giving important weight to the reasoning of our Supreme Court in its prior jurisprudence.

After resolving these two predicate issues, the court answers the important question asked by the defendants in the affirmative. Although rational minds may differ on the subject, the court concludes that when a controlling stockholder merger has, from the time of the controller's first overture, been subject to (i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors, the business judgment rule standard of review applies. This conclusion is consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion. Not only that, the adoption of this rule will be of benefit to minority stockholders because it will provide a strong incentive for controlling stockholders ***503** to accord minority investors the transactional structure that respected scholars believe will provide them the best protection, [5] a structure where stockholders get the benefits of independent, empowered negotiating agents to bargain for the best price and say no if the agents believe the deal is not advisable for

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any proper reason, plus the critical ability to determine for themselves whether to accept any deal that their negotiating agents recommend to them. A transactional structure with both these protections is fundamentally different from one with only one protection. A special committee alone ensures only that there is a bargaining agent who can negotiate price and address the collective action problem facing stockholders, but it does not provide stockholders any chance to protect themselves. A majority-of-the-minority vote provides stockholders a chance to vote on a merger proposed by a controller-dominated board, but with no chance to have an independent bargaining agent work on their behalf to negotiate the merger price, and determine whether it is a favorable one that the bargaining agent commends to the minority stockholders for acceptance at a vote. These protections are therefore incomplete and not substitutes, but are complementary and effective in tandem.

Not only that, a controller's promise that it will not proceed unless the special committee assents ensures that the committee will not be bypassed by the controller through the intrinsically more coercive setting of a tender offer. It was this threat of bypass that was of principal concern in *Lynch* and cast doubt on the special committee's ability to operate effectively.[6] Precisely because the controller can only get business judgment rule treatment if it foregoes the chance to go directly to stockholders, any potential for coercion is minimized. Indeed, given the high-profile promise the controller has to make not to proceed without the committee's approval, any retributive action would be difficult to conceal, and the potent tools entrusted to our courts to protect stockholders against violations of the duty of loyalty would be available to police retributive action. As important, market realities provide no rational basis for concluding that stockholders will not vote against a merger they do not favor. Stockholders, especially institutional investors who dominate market holdings, regularly vote against management on many issues, and do not hesitate to sue, or to speak up. Thus, when such stockholders are given a free opportunity to vote no on a merger negotiated by a special committee, and a majority of them choose to support the merger, it promises more cost than benefit to investors generally in terms of the impact on the overall cost of capital to have a standard of review other than the business judgment rule. That is especially the case because stockholders who vote no, and do not wish to accept the merger consideration in a going private transaction despite the other stockholders' decision to support the merger, will typically have the right to seek appraisal.[7]

In addition, if the approach taken were applied consistently to the equitable review ***504** of going private transactions proposed by controllers through tender offers, an across-the-board incentive would be created to provide minority stockholders with the best procedural protections in all going private transactions. Whether proceeding by a merger or a tender offer, a controlling stockholder would recognize that it would face entire fairness review unless it agreed not to proceed without the approval of an independent negotiator with the power to say no, and without the uncoerced, fully informed consent of a majority of the minority. This approach is consistent with *Lynch* and its progeny, as a controller who employed only one of the procedural protections would continue to get burden-shifting credit within the entire fairness rubric, but could not escape an ultimate judicial inquiry into substantive fairness. Importantly, by also providing transactional planners with a basis to structure transactions from the beginning in a manner that, if properly implemented, qualifies for the business judgment rule, the benefit-to-cost ratio of litigation challenging controlling stockholders for investors in Delaware corporations will improve, as suits will not have settlement value simply because there is no feasible way for defendants to get them dismissed on the pleadings.

This approach promises minority stockholders a great deal in terms of increasing the prevalence of employing both fairness-enhancing protections in more transactions—most notably, by giving investors a more constant chance to protect themselves at the ballot box through more prevalent majority-of-the-minority voting conditions. It also seems to come at very little cost, owing to the lack of evidence that entire fairness review in cases where both procedural protections are employed adds any real value that justifies the clear costs to diversified investors that such litigation imposes. Thus, respected scholars deeply concerned about the well-being of minority stockholders support this approach as beneficial for minority stockholders.[8] For the same reason, the court embraces it, and therefore grants the defendants' motion for summary judgment.

II. *The Structure Of This Decision*

Consistent with the introduction, this opinion will first address whether, under the undisputed facts of record, the defendants are correct that the MFW special committee and the majority-of-the minority provision qualify as cleansing

devices under Delaware's approach to the business judgment rule. After addressing that issue, the court then considers whether our Supreme Court has answered the question of what judicial standard of review applies to a merger with a controlling stockholder conditioned upfront on a promise that no transaction will proceed without (i) special committee approval, and (ii) the affirmative vote of a majority of the minority stockholders. Finally, having concluded that the question has not been answered by our Supreme Court, this court answers the question itself.

In keeping with this structure, therefore, the court begins by discussing the undisputed facts that are relevant to deciding the legal issues raised by the pending motion for summary judgment, applying the familiar procedural standard. [9] That ***505** motion seeks summary judgment on the ground that the two procedural devices in question qualify as cleansing devices and, taken together, warrant application of the business judgment rule. Because the merger's terms are indisputably ones that a rational person could think fair to the minority stockholders, the defendants say that summary judgment is warranted. [10]

For their part, the plaintiffs argue that there are material questions of fact regarding the independence of the special committee. The plaintiffs also raise debatable issues of valuation, similar to those that are typically addressed in an appraisal or in the part of entire fairness analysis dealing with the substantive fairness of a merger price. Most important, however, the plaintiffs argue that regardless of whether the MFW special committee and the majority-of-the-minority vote qualify as cleansing devices, this court must still hold a trial and determine for itself whether the merger was entirely fair. At best, the defendants are entitled to a shift in the burden of persuasion on that point at trial under the preponderance of the evidence standard. But that slight tilt is all, the plaintiffs say, that is permitted under prior precedent.

III. *The Procedural Devices Used To Protect The Minority Are Entitled To Cleansing Effect Under Delaware's Traditional Approach To The Business Judgment Rule*

Determining whether the defendants are entitled to judgment that, as a matter of law, the MFW special committee and the majority-of-the-minority vote condition should be given cleansing effect, necessitates a discussion of how the merger came about.

A. *MacAndrews & Forbes Proposes To Take MFW Private*

MFW is a holding company incorporated in Delaware. Before the merger that is the subject of this dispute, MFW was 43.4% owned by MacAndrews & Forbes, which is entirely owned by Ron Perelman. [11] MFW had four business segments. Three of these were owned through a holding company, Harland Clarke Holding Corporation ("HCHC"). These are the Harland Clarke Corporation ("Harland"), which printed bank checks; [12] Harland Clarke Financial Solutions, which provided technology products and services to financial services companies; [13] and Scantron Corporation, which manufactured scanning equipment used for educational and other purposes. [14] The fourth segment, which was not part of HCHC, was Mafco Worldwide Corporation, a manufacturer of licorice flavorings. [15]

The MFW board had thirteen members. The members were Ron Perelman, Barry Schwartz, William Bevins, Bruce Slovin, Charles Dawson, Stephen Taub, John Keane, Theo Folz, Philip Beekman, Martha Byorum, Viet Dinh, Paul Meister, and Carl Webb. [16] Perelman, Schwartz, and Bevins had roles at both MFW and MacAndrews & Forbes. Perelman was the Chairman of MFW, and the Chairman and CEO of MacAndrews & Forbes; Schwartz was the President and CEO of MFW, and ***506** the Vice Chairman and Chief Administrative Officer of MacAndrews & Forbes; and Bevins was a Vice President at MacAndrews & Forbes. [17]

In May 2011, Perelman began to explore the possibility of taking MFW private. At that time, MFW's stock price traded in the $20 to $24 range. [18] MacAndrews & Forbes engaged the bank Moelis & Company to advise it. Moelis prepared valuations based on projections that had been supplied to lenders by MFW in April and May 2011. [19] Moelis valued MFW at between $10 and $32 a share. [20]

On June 10, 2011, MFW's shares closed on the New York Stock Exchange at $16.96. [21] The next business day, June 13, 2011, Schwartz sent a proposal to the MFW board to buy the remaining shares for $24 in cash. [22] The proposal stated, in relevant part:

> The proposed transaction would be subject to the approval of the Board of Directors of the Company [*i.e.,* MFW] and the negotiation and execution of mutually acceptable definitive transaction documents. It is our expectation that the Board of Directors will appoint a special committee of independent directors to consider our proposal and make a recommendation to the Board of Directors. *We will not move forward with the transaction unless it is approved by such a special committee. In addition, the transaction will be subject to a non-waivable condition requiring the approval of a majority of the shares of the Company not owned by M & F or its affiliates. ...*
>
> ... In considering this proposal, you should know that in our capacity as a stockholder of the Company we are interested only in acquiring the shares of the Company not already owned by us and that in such capacity we have no interest in selling any of the shares owned by us in the Company nor would we expect, in our capacity as a stockholder, to vote in favor of any alternative sale, merger or similar transaction involving the Company. If the special committee does not recommend or the public stockholders of the Company do not approve the proposed transaction, such determination would not adversely affect our future relationship with the Company and we would intend to remain as a long-term stockholder.
>
> ....
>
> In connection with this proposal, we have engaged Moelis & Company as our financial advisor and Skadden, Arps, Slate, Meagher & Flom LLP as our legal advisor, and we encourage the special committee to retain its own legal and financial advisors to assist it in its review. [23]

MacAndrews & Forbes filed this letter with the SEC and issued a press release containing substantially the same information. [24]

B. *The MFW Board Forms A Special Committee Of Independent Directors To Consider The Offer*

The MFW board met the following day ***507** to consider the proposal. [25] At the meeting, Schwartz presented the offer on behalf of MacAndrews & Forbes. Schwartz and Bevins, as the two directors present who were also on the MacAndrews & Forbes board, then recused themselves from the meeting, as did Dawson, the CEO of HCHC, who had previously expressed support for the offer. [26] The independent directors then invited counsel from Willkie Farr & Gallagher, which had recently represented a special committee of MFW's independent directors in relation to a potential acquisition of a subsidiary of MacAndrews & Forbes, to join the meeting. The independent directors decided to form a special committee, and resolved further that:

> [T]he Special Committee is empowered to: (i) make such investigation of the Proposal as the Special Committee deems appropriate; (ii) evaluate the terms of the Proposal; (iii) negotiate with Holdings [*i.e.,* MacAndrews & Forbes] and its representatives any element of the Proposal; (iv) negotiate the terms of any definitive agreement with respect to the Proposal (it being understood that the execution thereof shall be subject to the approval of the Board); (v) report to the Board its recommendations and conclusions with respect to the Proposal, including a determination and recommendation as to whether the Proposal is fair and in the best interests of the stockholders of the Company other than Holdings and its affiliates and should be approved by the Board; and (vi) determine to elect not to pursue the Proposal....
>
> ....
>
> ... [T]he Board shall not approve the Proposal without a prior favorable recommendation of the Special Committee....
>
> ... [T]he Special Committee [is] empowered to retain and employ legal counsel, a financial advisor, and such other agents as the Special Committee shall deem necessary or desirable in connection with these matters.... [27]

The special committee consisted of Byorum, Dinh, Meister (the chair), Slovin, and Webb. [28] The following day, Slovin recused himself because, although the board had determined that he qualified as an independent director under the rules of the New York Stock Exchange, he had "some current relationships that could raise questions about his independence for purposes of serving on the special committee." [29]

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C. ***The Special Committee Was Empowered To Negotiate And Veto The Transaction***

[1] It is undisputed that the special committee was empowered to hire its own legal and financial advisors. Besides hiring Willkie Farr as its legal advisor, the special committee engaged Evercore Partners as its financial advisor.

It is also undisputed that the special committee was empowered not simply to "evaluate" the offer, like some special committees with weak mandates, [30] but to negotiate ***508** with MacAndrews & Forbes over the terms of its offer to buy out the noncontrolling stockholders. Critically, this negotiating power was accompanied by the clear authority to say no definitively to MacAndrews & Forbes. Thus, unlike in some prior situations that the court will discuss, MacAndrews & Forbes promised that it would not proceed with any going private proposal that did not have the support of the special committee. Therefore, the MFW committee did not have to fear that if it bargained too hard, MacAndrews & Forbes could bypass the committee and make a tender offer directly to the minority stockholders. Rather, the special committee was fully empowered to say no and make that decision stick.

Although the special committee had the authority to negotiate and say no, it did not have the practical authority to market MFW to other buyers. In its announcement, MacAndrews & Forbes plainly stated that it was not interested in selling its 43% stake. Under Delaware law, MacAndrews & Forbes had no duty to sell its block, [31] which was large enough, as a practical matter, to preclude any other buyer from succeeding unless it decided to become a seller. And absent MacAndrews & Forbes declaring that it was open to selling, it was unlikely that any potentially interested party would incur the costs and risks of exploring a purchase of MFW. This does not mean, however, that the MFW special committee did not have the leeway to get advice from its financial advisor about the strategic options available to MFW, including the potential interest that other buyers might have if MacAndrews & Forbes was willing to sell. The record is undisputed that the special committee did consider, with the help of its financial advisor, whether there were other buyers who might be interested in purchasing MFW, [32] and whether there were other strategic options, such as asset divestitures, that might generate more value for minority stockholders than a sale of their stock to MacAndrews & Forbes. [33]

For purposes of this motion, therefore, there is undisputed evidence that the special committee could and did hire qualified legal and financial advisors; that the special committee could definitely say no; that the special committee could and did study a full range of financial information to inform itself, including by evaluating ***509** other options that might be open to MFW; and that the special committee could and, as we shall see, did negotiate with MacAndrews & Forbes over the terms of its offer.

D. ***The Independence Of The Special Committee***

One of the plaintiffs' major arguments against summary judgment is that the MFW special committee was not comprised of directors who meet the definition of independence under our law. Although the plaintiffs concede the independence of the special committee's chairman (Meister), they challenge the independence of each of the other three members, contending that various business and social ties between these members and MacAndrews & Forbes render them beholden to MacAndrews & Forbes and its controller Perelman, or at least create a permissible inference that that is so, thus defeating a key premise of the defendants' summary judgment motion.

[2] To evaluate the parties' competing positions, the court applies settled authority of our Supreme Court. Under Delaware law, there is a presumption that directors are independent. [34] To show that a director is not independent, a plaintiff must demonstrate that the director is "beholden" to the controlling party "or so under [the controller's] influence that [the director's] discretion would be sterilized." [35] Our law is clear that mere allegations that directors are friendly with, travel in the same social circles, or have past business relationships with the proponent of a transaction or the person they are investigating, are not enough to rebut the presumption of independence. [36] Rather, the Supreme Court has made clear that a plaintiff seeking to show that a director was not independent must meet a materiality standard, under which the court must conclude that the director in question's material ties to the person whose proposal or actions she is evaluating are sufficiently substantial that she cannot objectively fulfill her fiduciary duties. [37] Consistent with the overarching requirement that any disqualifying tie be material, the simple fact that there are some financial ties between the interested party and the director is not disqualifying. Rather, the question is whether those ties are

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material, in the sense that the alleged ties could have affected ***510** the impartiality of the director.[38] Our Supreme Court has rejected the suggestion that the correct standard for materiality is a "reasonable person" standard; rather, it is necessary to look to the financial circumstances of the director in question to determine materiality.[39]

Before examining each director the plaintiffs challenge as lacking independence, it is useful to point out some overarching problems with the plaintiffs' arguments. Despite receiving the chance for extensive discovery, the plaintiffs have done nothing, as shall be seen, to compare the actual economic circumstances of the directors they challenge to the ties the plaintiffs contend affect their impartiality. In other words, the plaintiffs have ignored a key teaching of our Supreme Court, requiring a showing that a specific director's independence is compromised by factors material to her.[40] As to each of the specific directors the plaintiffs challenge, the plaintiffs fail to proffer any real evidence of their economic circumstances. Furthermore, MFW was a New York Stock Exchange-listed company. Although the fact that directors qualify as independent under the NYSE rules does not mean that they are necessarily independent under our law in particular circumstances,[41] the NYSE rules governing director independence were influenced by experience in Delaware and other states and were the subject of intensive study by expert parties. They cover many of the key factors that tend to bear on independence, including whether things like consulting fees rise to a level where they compromise a director's independence,[42] and they are a useful source for this court to consider when assessing an argument that a director lacks independence. Here, as will be seen, the plaintiffs fail to argue that any of the members of the special committee did not meet the specific, detailed independence requirements of the NYSE.

With those overarching considerations in mind, the court turns to a consideration of the plaintiffs' challenge to the members of the special committee. Here, an application of our Supreme Court's teachings to the challenged directors in alphabetical order reveals that the defendants are correct, and that there is no dispute of fact that the MFW special committee was comprised solely of directors who were independent under our Supreme Court's jurisprudence.

1. *Byorum*

[3] Director Byorum is a vice president and co-head of the international group at Stephens, an investment bank.[43] She was a director of MFW from 2007, and served on the audit committee.[44] As was mentioned, the plaintiffs do nothing to illustrate ***511** the actual economic circumstances of Byorum, other than say she has worked in finance. Thus, the plaintiffs do nothing to show that there is a triable issue of fact that any of the factors they focus on were material to Byorum based on her actual economic circumstances.

The plaintiffs allege, in a cursory way, that Byorum has a personal relationship with Perelman, and that she had a business relationship with him while she worked at Citibank in the nineties.[45] Byorum got to know Barry Schwartz, the CEO of MFW, and Howard Gittis, Perelman's close aide and the CEO of MacAndrews & Forbes, while working at Citibank in the nineties.[46] Gittis asked her to serve on the MFW board.[47] In 2007, Byorum, while working on behalf of Stephens Cori, an affiliate of Stephens, initiated a project for Scientific Games, an entity in which MacAndrews & Forbes owns a 37.6% stake.[48] Stephens Cori received a $100,000 retainer fee for this work, and, if the project had been successful, would have received more.[49]

Taken together, these allegations and the record facts on which they are based do not create a triable issue of fact regarding Byorum's independence. The allegations of friendliness—for example, that Byorum has been to Perelman's house—are exactly of the immaterial and insubstantial kind our Supreme Court held were not material in *Beam v. Stewart.*[50] The plaintiffs do not specify the nature of the business relationship between Byorum and Perelman during Byorum's time at Citigroup, beyond claiming that Byorum would "come into contact" with him in her capacity as a senior executive.[51] This vague relationship does not cast her independence into doubt: the plaintiffs have made no showing that Byorum has an ongoing relationship with Perelman that was material to her in any way.[52] The plaintiffs even admit the unsurprising fact that Perelman had multiple dealings with the financial giant Citigroup over the years, thus undermining the relative importance of any connection that Byorum personally had with him.[53] And, the plaintiffs do not allege that Byorum has a deeper friendship with Schwartz and Gittis than she does with Perelman, and no facts in the record suggest any emotional depth to these relationships at all. Therefore, these allegations do not undermine her independence either.

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More important, the plaintiffs have not made any genuine attempt to show that the $100,000 fee that Stephens Cori earned was material to Stephens Cori, much less to Byorum on a personal level given her ***512** personal economic and professional circumstances. [54] Nor have the plaintiffs tried to show that this modest transactional fee—which is only one tenth of the $1 million that Stephens Cori would have had to have received for Byorum not to be considered independent under the NYSE rules—created a "sense of beholdenness" on the part of Byorum. [55] Thus, there is no genuine issue of material fact as to Byorum's independence.

2. *Dinh*

[4] The plaintiffs next challenge the independence of Dinh, who was a member of MFW's Nominating and Corporate Governance Committees. [56] Dinh is a professor at the Georgetown University Law Center and a co-founder of Bancroft, a Washington D.C. law firm. [57] Aside from these facts about Dinh's professional activities, the plaintiffs have not explained how they relate to Dinh's economic circumstances. The concept of materiality is an inherently comparative one, requiring consideration of whether something is material to something else. [58] As a result, the plaintiffs have done nothing to demonstrate that there is a triable issue of fact based on any of the factors they have brought up.

Dinh's firm, Bancroft, has advised MacAndrews & Forbes and Scientific Games since 2009, and it is undisputed that Bancroft received approximately $200,000 in fees in total from these two companies between 2009 and 2011. [59] The plaintiffs have also alleged that Dinh had a close personal and business relationship with Schwartz. [60] Schwartz sits on the Board of Visitors of the Georgetown University Law Center, where Dinh is a tenured professor, and Schwartz requested that Dinh join the board of another Perelman corporation, Revlon, in 2012. [61]

But these allegations do not create any issue of fact as to Dinh's independence. As is the case with Byorum, the plaintiffs have not put forth any evidence that tends to show that the $200,000 fee paid to Dinh's firm was material to Dinh personally, given his roles at both Georgetown and ***513** Bancroft. [62] The fees paid to Bancroft are, as in the case of the fees paid to Scientific Games on account of Byorum's work, a fraction of what would need to be paid for Dinh no longer to be considered an independent director under the New York Stock Exchange rules, and would not fund Bancroft's total costs for employing a junior associate for a year. Nor have the plaintiffs offered any evidence that might show that this payment was material in any way to Dinh, given his personal economic circumstances.

Furthermore, Dinh's relationship with Schwartz does not cast his independence into doubt. Dinh was a tenured professor long before he knew Schwartz. [63] And there is no evidence that Dinh has any role at Georgetown in raising funds from alumni or other possible donors, or any other evidence suggesting that the terms or conditions of Dinh's employment at Georgetown could be affected in any way by his recommendation on the merger. [64] Likewise, the fact that Dinh was offered a directorship on the board of Revlon, another Perelman company, *after* he served on the MFW special committee does not create a genuine issue of fact regarding his independence. [65]

3. *Webb*

[5] Finally, the plaintiffs challenge the independence of Webb, who was a member of MFW's audit committee. [66] Webb was, at the time of the MFW transaction, a banking executive. [67] The plaintiffs allege that Webb has known Perelman since at least 1988, when Perelman invested in failed thrifts with the banker Gerald J. Ford, and that Webb was President and Chief Operating Officer of their investment vehicles. [68] According to the plaintiffs, Webb and Perelman both made a "significant" amount of money in turning around the thrifts, which they sold to Citigroup for $5 billion in 2002. [69] But, once ***514** again, the plaintiffs have ignored Webb's economic circumstances in attempting to create a triable issue of fact about his independence. Despite touting the business success that Webb enjoyed alongside Perelman, counsel for the plaintiffs claimed at oral argument that his wealth was *not* relevant to his independence, and only begrudgingly conceded that Webb might be "seriously rich." [70]

The profit that Webb realized from coinvesting with Perelman nine years before the transaction at issue in this case does not call into question his independence.

In fact, it tends to strengthen the argument that Webb is independent, because his current relationship with Perelman would likely be economically inconsequential to him. And, there is no evidence that Webb and Perelman had any economic relationship in the nine years before this merger that was material to Webb, given his existing wealth. Therefore, the only challenge that the plaintiffs may make to Webb's independence is the existence of a distant business relationship—which is not sufficient to challenge his independence under our law. [71]

For all these reasons, therefore, the MFW special committee was, as a matter of law, comprised entirely of independent directors.

E. *There Is No Dispute Of Fact That The MFW Special Committee Satisfied Its Duty Of Care*

[6] The plaintiffs do not make any attempt to show that the MFW special committee failed to meet its duty of care, in the sense of making an informed decision regarding the terms on which it would be advantageous for the minority stockholders to sell their shares to MacAndrews & Forbes. [72] At its first meeting, the special committee interviewed four financial advisors, before hiring Evercore Partners. [73] Such an interview process not only lets the client consider a number of qualified advisors and, one hopes, therefore get better financial terms from the winner because the winner knows it has competition. The process has another utility, which is that each of the pitching firms present "pitch books" relevant to the potential engagement, and give the committee a chance to hear preliminary thoughts from a variety of well qualified financial advisors, a process that therefore helps the committee begin to get fully grounded in the relevant economic factors.

From the outset, the special committee and Evercore had projections that had been prepared by MFW's business segments in April and May 2011. [74] Early in its process, Evercore and the special committee requested MFW to produce new projections that reflected the management's ***515** most up-to-date, and presumably most accurate, thinking. [75] Mafco, the licorice business, told Evercore that all of its projections would remain the same. [76] Harland Clarke updated its projections. [77] On July 22, Evercore received new projections from HCHC, which incorporated the updated projections from Harland Clarke, and Evercore constructed a valuation model based on them. [78]

The updated projections forecast EBITDA for MFW of $491 million in 2015, as opposed to $535 million under the original projections. [79] On August 10, Evercore produced a range of valuations for MFW, based on the updated projections, of $15 to $45 per share. [80] Evercore valued MFW using a variety of accepted methods, including a DCF model, which generated a range of fair value of $22 to $38 per share, and a premiums paid analysis, with a resulting value range of $22 to $45. [81] MacAndrews & Forbes's $24 offer fell within the range of values produced by each of Evercore's valuation techniques. [82]

The special committee asked Evercore to analyze how the possible sale of Harland to a rival check printing company might affect the valuation. [83] Evercore produced this analysis a week later, at the next meeting of the special committee, on August 17. [84] Evercore opined that such a sale would not produce a higher valuation for the company. [85] The special committee rejected the $24 proposal, and countered at $30 a share. [86] MacAndrews & Forbes was disappointed by this counteroffer. [87] On September 9, 2011, MacAndrews & Forbes rejected the special committee's $30 counteroffer, and reiterated its $24 offer. [88] Meister informed Schwartz that he would not recommend the $24 to the special committee. [89] Schwartz then obtained approval from Perelman to make a "best and final" offer of $25 a share. [90] At their eighth, and final, meeting, on September 10, 2011, Evercore opined that the price was fair, and the special committee unanimously decided to accept the offer. [91]

The MFW board then discussed the offer. Perelman, Schwartz, and Bevins, the three directors affiliated with MacAndrews & Forbes, and Dawson and Taub, the ***516** CEOs of HCHC and Mafco, recused themselves. [92] The remaining eight directors voted unanimously to recommend the offer to the stockholders. [93]

In their briefs, the plaintiffs make a number of arguments in which they question the business judgment of the special committee, in terms of issues such as whether the special committee could have extracted another higher bid from MacAndrews & Forbes if it had said no to the $25 per share

offer, and whether the special committee was too conservative in valuing MFW's future prospects. These are the sorts of questions that can be asked about any business negotiation, and that are, of course, the core of an appraisal proceeding and relevant when a court has to make a determination itself about the financial fairness of a merger transaction under the entire fairness standard.

What is not in question is that the plaintiffs do not point to any evidence indicating that the independent members of the special committee did not meet their duty of care in evaluating, negotiating and ultimately agreeing to a merger at $25 per share. The record is clear that the special committee met frequently and was presented with a rich body of financial information relevant to whether and at what price a going private transaction was advisable, and thus there is no triable issue of fact as to its satisfaction of its duty of care. [94] Because the special committee was comprised entirely of independent directors, there is no basis to infer that they did not attempt in good faith to obtain the most favorable price they could secure for the minority or believe they had done so.

F. *A Fully Informed, Uncoerced Majority Of The Minority Votes To Support The Merger*

On November 18, 2011, the stockholders were provided with a proxy statement containing the history of the merger and recommending that they vote in favor of the transaction. The proxy statement made clear, among other things, that the special committee had countered at $30 per share, but only was able to get a final offer of $25 per share. [95] The proxy statement indicated that the MFW business divisions discussed with Evercore whether the initial projections that Evercore received reflected management's latest thinking, and that plainly stated that the new projections were lower. [96] The proxy also gave the five separate ranges for the value of MFW's stock that Evercore had produced with different analyses. [97]

When the votes were counted on December 21, 2011, stockholders representing 65% of the shares not owned by MacAndrews & Forbes voted to accept the offer. [98] The merger closed that same day. [99]

Under settled authority, the uncoerced, fully informed vote of disinterested stockholders is entitled to substantial weight ***517** under our law. Traditionally, such a vote on a third-party merger would, in itself, be sufficient to invoke the business judgment standard of review. [100] In the controlling stockholder merger context, it is settled that an uncoerced, informed majority-of-the-minority vote, without any other procedural protection, is itself sufficient to shift the burden of persuasion to the plaintiff under the entire fairness standard. [101]

Here, therefore, it is clear that as a matter of law, the majority-of-the-minority vote condition qualifies as a cleansing device under traditional Delaware corporate law principles. The consequences of these determinations for the resolution of this motion are important. Absent both of the procedural protections qualifying as a cleansing device, there would be no reason to answer the ultimate question the defendants pose, because that question depends on both of the protections having sufficient integrity to invoke the business judgment standard.

The court concludes here that there is no triable issue of fact regarding the operation of these devices. For the reasons stated, the plaintiffs themselves do not dispute that that majority-of-the-minority vote was fully informed and uncoerced, because they fail to allege any failure of disclosure or any act of coercion.

As to the special committee, the court has rejected the plaintiffs' challenge to the independence of the committee membership. The court also finds, as a matter of law, that there is no issue that the special committee was sufficiently empowered to hire its own advisors, inform itself, negotiate, and to definitively say no. Lastly, there is no triable issue of fact regarding whether the special committee fulfilled its duty of care.

These conditions are sufficient, under a traditional approach, to be effective in influencing the intensity of review, and as to a conflict transaction not involving a controlling stockholder, to invoke the business judgment rule standard of review.

***518** The court gives the committee such effect here. In doing so, the court eschews determining that the special committee was "effective" in a more colloquial sense. Although prior cases can potentially be read as requiring an assessment of whether a special committee was effective in the sense of being substantively good at its appointed task, [102] such a precondition is fundamentally inconsistent with the application of the business judgment rule standard of review. For a court to determine whether a special committee was

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effective in obtaining a good economic outcome involves the sort of second-guessing that the business judgment rule precludes. When a committee is structurally independent, has a sufficient mandate and cannot be bypassed, and fulfills its duty of care, it should be given standard-shifting effect. Any other approach as a matter of fact involves the application of a form of entire fairness review or at least the type of heightened reasonableness scrutiny required under the *Unocal* or *Revlon* standards, *i.e.,* standards that intentionally involve judges in reviewing director behavior in a manner not permitted under the business judgment rule. [103] Furthermore, adhering to this approach is consistent with a close reading of prior cases. In many of the cases where special committees were not given cleansing effect, the reason was not that the court second-guessed tactical decisions made by a concededly independent committee with a sufficient mandate to protect the minority investors. [104] Rather, it was precisely because the special committee lacked one of these essential attributes that the committee was not given weight. For example, in *Lynch,* the committee's effectiveness was undermined because the controller made plain that if the committee did not consensually agree to a transaction, the controller would end-run the committee and go to the stockholders with a tender offer, a form of transaction that is generally considered intrinsically more coercive than one preceded by a merger vote. [105] Likewise, in *Tremont,* the committee was ineffective because two of the three directors breached their duty of care by "abdicat[ing] their responsibility" in favor of the chair, who had been lucratively employed as a consultant by the controller and did not come close to the standard of independence required of what was for practical purposes a one-person committee. [106]

To the extent that the fundamental rule is that a special committee should be given standard-influencing effect if it replicates arm's-length bargaining, that test is met if the committee is independent, can hire its own advisors, has a sufficient mandate to negotiate and the power to say no, and meets its duty of care. Under that approach, the MFW special committee qualifies.

*519 G. *There Is No Triable Issue Of Fact That The Merger Was A Transaction That A Rational Person Could Believe Was Favorable To MFW's Minority Stockholders*

[7] If the business judgment rule standard of review applies, the claims against the defendants must be dismissed unless no rational person could have believed that the merger was favorable to MFW's minority stockholders. [107] Although the plaintiffs raise arguments as to why the merger should have been at a higher price, these arguments, and the scant facts supporting them, do not raise a triable issue of fact under the business judgment rule. [108] The merger was effected at a 47% premium to the closing price before MacAndrews & Forbes's offer. A financial advisor for the special committee found that the price was fair in light of various analyses, including a DCF analysis, which mirrors the valuation standard applicable in an appraisal case. MFW's businesses faced long-term challenges, particularly its check-printing business, Harland Clarke, which faced serious pricing pressure as its primary contract was put out to bid by the grantor and a seemingly irrevocable long-term decline in its industry because of global trends to eliminate as many checks as possible and conduct all transactions online. After disclosure of the material facts, 65% of the minority stockholders decided for themselves that the price was favorable. [109]

***520** The plaintiffs' argument that many of these stockholders were arbitrageurs who had bought from longer-term stockholders and whose views should be discounted has a fundamental logical problem. The fact that long-term MFW stockholders sold at a price that was substantially higher than the market price when MacAndrews & Forbes made its offer but less than $25 per share merger price does not suggest that the price was one that long-term stockholders viewed as unfavorable. Rather, it suggests the opposite. The value of most stocks is highly debatable. What is not debatable here is that a rational mind could have believed the merger price fair, and that is what is relevant under the business judgment rule, which precludes judicial second-guessing when that is the case.

IV. *The Supreme Court Has Never Had A Chance To Answer The Question The Defendants Now Pose And Therefore It Remains Open For Consideration*

The next issue the court must determine is whether the question that the defendants pose has already been answered in a binding way by our Supreme Court. The defendants accurately argue, as will be explained, that the Supreme Court has never been asked to consider whether the business judgment rule applies if a controlling stockholder conditions the merger upfront on approval by an adequately empowered independent committee that acts with due care, and on the

informed, uncoerced approval of a majority of the minority stockholders. To their credit, the plaintiffs admit that the defendants are correct in their argument that the Supreme Court has never been asked this question and that none of its prior decisions hinged on this question. [110]

But the plaintiffs, also accurately, note that there are broad statements in certain Supreme Court decisions that, if read literally and as binding holdings of law, say that the entire fairness standard applies to any merger with a controlling stockholder, regardless of the circumstances. In particular, the plaintiffs rely on language from the Supreme Court's decision in *Lynch,* which, they say, requires this court to review the MFW transaction under the entire fairness standard: "A controlling or dominating shareholder standing on both sides of a transaction, as in a parent-subsidiary context, bears the burden of proving its entire fairness." [111] The plaintiffs claim that this general principle controls this case. They then claim that our Supreme Court has affirmed this principle three times, in *Kahn v. Tremont Corp.,* [112] *Emerald Partners v. Berlin,* [113] and most recently in *Americas Mining Corp. v. Theriault.* [114]

[8] There is no question that, if the Supreme Court has clearly spoken on a question of law necessary to deciding a case before it, this court must follow its answer. But, when the Supreme Court has not had a chance to answer the question in a case where the answer matters—or in this situation, a chance to answer the question at all—there is no answer for the trial courts to follow. As will be shown, our Supreme Court has never had the opportunity to decide what should be the correct standard of review in a situation like this, because it has never been presented with the question.

***521** **[9]** **[10]** Our Supreme Court follows the traditional definition of "dictum," describing it as judicial statements on issues that "would have no effect on the outcome of [the] case." [115] In Delaware, such dictum is "without precedential effect." [116] Thus, broad judicial statements, when taken out of context, do not constitute binding holdings. [117] In addition, the Supreme Court treats as dictum language on an issue if the record before the court was "not sufficient to permit the question to be passed on." [118] If an issue is not presented to a court with the benefit of full argument and record, any statement on that issue by that court is not a holding with binding force. [119]

Both parties agree that no case has turned on the question of the effect of conditioning a merger upfront on the approval of a special committee and a majority of the noncontrolling stockholders. And, the parties agree that this issue has never been briefed or argued to a Delaware court. Therefore, under the Supreme Court's definition of dictum, the question in this case is still open.

The plaintiffs, although admitting that the question presented to the court here was never squarely presented to the Supreme Court, argue that three prior cases nonetheless preclude the application of any standard of review other than entire fairness. But, a close, if terse, discussion of them in chronological order shows that none of them constitutes binding precedent on the novel question now presented.

The plaintiffs rely most heavily on *Lynch* itself because of the broad statement previously quoted. There is a transactional similarity to the context here. The transaction that gave rise to the *Lynch* case was a merger between a parent corporation, Alcatel, and the subsidiary that it controlled, Lynch. Alcatel owned 43% of Lynch, and sought to obtain the rest of Lynch through a cash-out merger. And Lynch created a special committee to negotiate with Alcatel. But that is the critical point where the similarity ends.

In this case, MacAndrews & Forbes made two promises that were not made in *Lynch.* MacAndrews & Forbes said it would not proceed with any transaction unless the special committee approved it, and that it would subject any merger to a majority-of-the-minority vote condition. [120] In *Lynch,* the conduct was of a very different ***522** and more troubling nature, in terms of the effectiveness of the special committee and the ability of the minority stockholders to protect themselves. Instead of committing not to bypass the special committee, Alcatel *threatened* to proceed with a hostile tender offer at a lower price if the special committee did not recommend the transaction to the board. [121] The special committee, which the Supreme Court perceived to be itself coerced by this threat, recommended the offer and signed up a merger agreement, and the stockholders voted in favor of the transaction. [122] A stockholder objected to the price paid, and brought an action for breach of fiduciary duty. The question of the equitable standard of review of the transaction was raised on appeal, and the Supreme Court stated: "Entire fairness remains the proper focus of judicial analysis in examining an interested merger, irrespective of whether the burden of proof remains upon or is shifted away from the controlling or dominating shareholder, because the

unchanging nature of the underlying 'interested' transaction requires careful scrutiny." [123] This language, the plaintiffs say, dictates the standard of review to be applied to this case.

But, as indicated, the situation in *Lynch* was very different from the transaction in this case. The *Lynch* merger was conditioned only on the approval of the special committee, *not* on the approval of the non-Alcatel stockholders as well. Furthermore, the special committee in *Lynch* was not empowered to say no, because Alcatel reserved the right to and did in fact threaten to approach the stockholders with a tender offer at a lower price. The Lynch CEO testified that one Alcatel representative on the Lynch board "scared [the non-Alcatel directors] to death," and one of the three directors on the special committee testified that he thought that the price paid was unfair. [124] In this case, by contrast, there is no dispute that the special committee did have the power to say no to the transaction. And, unlike in *Lynch,* the transaction in this case was conditioned upfront on the approval of both the special committee and the majority of the noncontrolling stockholders; in *Lynch,* by contrast, the transaction was conditioned on neither.

Moreover, as the defendants point out, even if the special committee in *Lynch* was entitled to credit for purposes of establishing the standard of review or the burden of proof within a standard of review, the Supreme Court was only asked to determine what the standard of review was when a merger was approved by a special committee, not by a special committee *and* a non-waivable majority-of-the-minority vote. Thus, the defendants accurately point out that the binding holding of *Lynch* is narrower and consists in this key statement from the decision: "[E]ven when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders *or* an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of judicial review." [125] The plaintiffs might wish the disciplined use of "or" by our Supreme Court was inadvertent, but this court does not believe that was the case.

***523** Neither of the decisions succeeding *Lynch* that the plaintiffs rely upon speaks to the question presented here. [126] For example, *Kahn v. Tremont* was a derivative suit in which this court evaluated whether a corporation, Tremont, had overpaid for stock owned by its controlling stockholder. [127] As in *Lynch,* Tremont formed a special committee of three independent directors to determine whether it should carry out the purchase, and the committee approved the transaction. [128] As in *Lynch,* the transaction was not conditioned on the approval of the minority stockholders. As in *Lynch,* the Supreme Court held that the entire fairness standard would apply because it was an interested transaction involving a controlling stockholder, and that the special committee's role would at most serve to shift the burden of persuasion on the ultimate question of fairness. [129] As in *Lynch,* the Supreme Court viewed there to be serious issues regarding whether the special committee should be given even burden-shifting credit because two of the directors abdicated their duties, and the third had been a well-paid consultant to one of the controlling stockholder's companies. [130] Thus, unlike this case, both of the procedural protections were not used. Unlike this case, the independence of the special committee was in doubt. As with *Lynch,* therefore, *Tremont* did not present our Supreme Court with any occasion to speak to whether the use of both a properly empowered, careful, and independent special committee and a non-waivable condition that an informed, uncoerced majority of the minority approve the transaction would invoke the business judgment rule standard. Because of this, the broad language in *Tremont* that suggests that whenever a controlling stockholder stands on both sides of a transaction, entire fairness is the correct standard of review, does not, in the court's view, decide this case. [131]

The third case the plaintiffs quote is *Southern Peru.* [132] In *Southern Peru,* the Supreme Court affirmed this court's finding that a merger with a controlling stockholder was not entirely fair to the noncontrolling stockholders. The Supreme Court discussed at what point the burden of proof should shift in a transaction with a controlling stockholder, and, in that context, stated: "When a transaction involving self-dealing by a controlling shareholder is challenged, the applicable standard of judicial review is entire fairness, with the defendants having the burden of persuasion." [133] But it did so in a case where the ***524** defendants had expressly eschewed any argument that any standard of review other than entire fairness applied. [134] Given that concession, there was no need to address the question now presented and no answer was given by this court or the Supreme Court in that case.

Admittedly, there is broad language in each of these decisions, and in some other cases, that can be read to control the question asked in this case. [135] But this, like all judicial language, needs to be read in full context, as

our Supreme Court itself has emphasized.[136] Of course, the ultimate authority regarding the Supreme Court's prior decisions, and whether they constitute a binding holding that the employment of two potent procedural protections on behalf of the minority has no greater effect than employing one of those, is the Supreme Court itself. If this court is incorrect and the Supreme Court believes that it has answered this question in the prior cases, it will doubtless say so. But, given that no prior case's outcome turned on that issue, and no prior case involved any party who asked the question now posed, this court concludes that under traditional jurisprudential principles, the question remains an open one for this court to address in the first instance.[137]

That conclusion, of course, does not mean that the decisions dealing with similar contexts have no relevance.[138] To the contrary, this court must and will give heavy consideration to the reasoning of our Supreme Court's prior decisions. In particular, the prior cases make emphatic the strong public policy interest our common law of corporations has in the fair treatment of minority stockholders and the need to ensure that controlling stockholders do not extract unfair rents using their influence. Fidelity to not just *Lynch,* but cases like *Weinberger,* requires that the question before the court receive an answer that gives that public policy interest heavy weight.[139] With that in mind, the court turns to the task of answering the question posed now.

V. *The Business Judgment Rule Governs And Summary Judgment Is Granted*

[11] This case thus presents, for the first time, the question of what should be the correct standard of review for mergers between a controlling stockholder and its subsidiary, when the merger is conditioned ***525** on the approval of both an independent, adequately empowered special committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders.

In prior cases, this court has outlined the development of the case law in this area,[140] as have distinguished scholars,[141] and there is no need to repeat that recitation. The core legal question is framed by the parties' contending positions. For their part, the defendants say that it would be beneficial systemically to minority stockholders to review transactions structured with both procedural protections under the business judgment rule. Absent an incentive to do so, the defendants argue that controlling stockholders will not agree upfront to both protections, thus denying minority stockholders access to the transaction structure most protective of their interests—one that gives them the benefit of an active and empowered bargaining agent to negotiate price and to say no, plus the ability to freely decide for themselves on full information whether to accept any deal approved by that agent. This structure is not common now because controlling stockholders have no incentive under the law to agree to it, and such an incentive is needed because it involves the controller ceding potent power to the independent directors and minority stockholders.[142] The defendants argue that the benefits of their preferred approach are considerable, and that the costs are negligible because there is little utility to having an expensive, judicially intensive standard of review when stockholders can protect themselves by voting no if they do not like the recommendation of a fully empowered independent committee that exercised due care. In support of that argument, the defendants can cite to empirical evidence showing that the absence of a legally recognized transaction structure that can invoke the business judgment rule standard of review has resulted not in litigation that generates tangible positive results for minority stockholders in the form of additional money in their pockets, but in litigation that is settled for fees because there is no practical way of getting the case dismissed at the pleading stage and the costs of discovery and entanglement in multiyear litigation exceed the costs of paying attorneys' fees.[143] Finally, the defendants note that Delaware law on controlling stockholder going private transactions is now inconsistent, with the intrinsically more coercive route of using a tender offer to accomplish a going private transaction escaping the full force of equitable review, when a similarly structured merger where a less coercive chance to say no exists would not.[144]

***526** In response, the plaintiffs argue that a requirement that every controlling stockholder transaction be subject to fairness review is good for minority stockholders. The plaintiffs, rather surprisingly, argue that giving stockholders the protection of a majority-of-the-minority vote in addition to a special committee adds little value because, in their view, stockholders will always vote for a good premium deal, and long-term stockholders will sell out to arbitrageurs in advance of the vote, leaving the minority vote in the hands of stockholders who will invariably vote for the deal.[145] That said, the plaintiffs conceded in their briefing that minority stockholders would benefit if more controlling stockholders

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would use a structure that gave minority stockholders an independent bargaining and veto agent as well as a majority-of-the-minority vote. [146] But they contend that the cost of not having an invariable judicial inquiry into fairness outweighs that benefit.

After considering these arguments, the court concludes that the rule of equitable common law that best protects minority investors is one that encourages controlling stockholders to accord the minority this potent combination of procedural protections.

There are several reasons for this conclusion. The court begins with a Delaware tradition. Under Delaware law, it has long been thought beneficial to investors for courts, which are not experts in business, to defer to the disinterested decisions of directors, who are expert, and stockholders, whose money is at stake. [147] Thus, when no fiduciary has a personal self-interest adverse to that of the company and its other stockholders, the fiduciary is well-informed, and there is no statutory requirement for a vote, the business judgment rule standard of review applies and precludes judicial second-guessing so long as the board's decision "can be attributed to any rational business purpose." [148] Outside ***527** the controlling stockholder merger context, it has long been the law that even when a transaction is an interested one but not requiring a stockholder vote, Delaware law has invoked the protections of the business judgment rule when the transaction was approved by disinterested directors acting with due care. [149]

This tradition of respecting the value of impartial decisionmaking by disinterested fiduciaries was maintained even when Delaware confronted the takeover boom that started in the late 1970s. The innovative standards that emerged in *Unocal* and *Revlon* required more judicially intensive review, but gave heavy credit for empowering the independent elements of the board. [150] And when arm's-length cash mergers were approved by fully informed, uncoerced votes of the disinterested stockholders, the business judgment rule standard of review was applied to any class-action claim for monetary relief based on the inadequacy of the merger price. [151]

But tradition should admittedly not persist if it lacks current value. [152] If providing an incentive for a disinterested bargaining agent and a disinterested approval vote are of no utility to minority investors, it would not make sense to shape a rule that encourages their use.

But even the plaintiffs here admit that this transactional structure is the optimal one for minority stockholders. [153] They just claim that there is some magical way to have it spread that involves no cost. [154] That is not so, however. Absent doing ***528** something that is in fact inconsistent with binding precedent—requiring controlling stockholders to use both protections in order to get *any* credit under the entire fairness standard—there is no way to create an incentive for the use of both protections other than to give controllers who grant both protections to the minority the benefit of business judgment rule review.

A choice about our common law of corporations must therefore be made, and the court is persuaded that what is optimal for the protection of stockholders and the creation of wealth through the corporate form is adopting a form of the rule the defendants advocate. By giving controlling stockholders the opportunity to have a going private transaction reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests. In fact, this incentive may make this structure the common one, which would be highly beneficial to minority stockholders. That structure, it is important to note, is critically different than a structure that uses only *one* of the procedural protections. The "or" structure does not replicate the protections of a third-party merger under the DGCL approval process, because it only requires that one, and not both, of the statutory requirements of director and stockholder approval be accomplished by impartial decisionmakers. [155] The "both" structure, by contrast, replicates the arm's-length merger steps of the DGCL by "requir[ing] two independent approvals, which it is fair to say serve independent integrity-enforcing functions." [156]

When these two protections are established up-front, a potent tool to extract good value for the minority is established. From inception, the controlling stockholder knows that it cannot bypass the special committee's ability to say no. And, the controlling stockholder knows it cannot dangle a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move. From inception, the controller has had to accept that any deal agreed to by the special committee will also have

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to be supported by a majority of the minority stockholders. That understanding also affects the incentives of the special committee in an important way. The special committee will understand that those for whom it is bargaining will get a chance to express whether they think the special committee did a good or poor job. Although it is possible that there are independent directors who have little regard for their duties or for being perceived by their company's stockholders (and the larger network of institutional investors) as being effective at protecting public stockholders, the court thinks they are likely to be exceptional, and certainly our Supreme Court's jurisprudence does not embrace such a skeptical view. [157] The Supreme Court has held that independent directors are presumed to be motivated to do their duty with fidelity, like most other ***529** people, [158] and has also observed that directors have a more self-protective interest in retaining their reputations as faithful, diligent fiduciaries. [159] The requirement that a majority of the minority approve the special committee's recommendation enhances both motivations, because most directors will want to procure a deal that their minority stockholders think is a favorable one, and virtually all will not want to suffer the reputational embarrassment of repudiation at the ballot box. [160] That is especially so in a market where many independent directors serve on several boards, and where institutional investors and their voting advisors, such as ISS and Glass Lewis, have computer-aided memory banks available to remind them of the past record of directors when considering whether to vote for them or withhold votes at annual meetings of companies on whose boards they serve. [161]

The premise that independent directors with the right incentives can play an effective role on behalf of minority investors is one shared by respected scholars sincerely concerned with protecting minority investors ***530** from unfair treatment by controlling stockholders. Their scholarship and empirical evidence indicates that special committees have played a valuable role in generating outcomes for minority investors in going private transactions that compare favorably with the premiums received in third-party merger transactions. [162]

But, like these scholars, the court is aware that even impartial directors acting in good faith and with due care can sometimes come out with an outcome that minority investors themselves do not find favorable. Conditioning the going private transaction's consummation on a majority-of-the-minority vote deals with this problem in two important and distinct ways. The first was just described. Because a special committee in this structure knows from the get-go that its work will be subject to disapproval by the minority stockholders, the special committee has a strong incentive to get a deal that will gain their approval. And, critically, so does another key party: the controlling stockholder itself, which will want to close the deal, having sunk substantial costs into the process.

But the second is equally important. If, despite these incentives, the special committee approves a transaction that the minority investors do not like, the minority investors get to vote it down, on a full information base and without coercion. In the *Unitrin* case nearly a generation ago, our Supreme Court noted the prevalence of institutional investors in the target company's stockholder base in concluding that a proxy contest centering on the price of a takeover offer was viable, despite insiders having increased their stock ownership to 28%, stating that "[i]nstitutions are more likely than other shareholders to vote at all [and] more likely to vote against manager proposals." [163] Market developments in the score of years since have made it far easier, not harder, for stockholders to protect themselves. With the development of the internet, there is more public information than ever about various commentators', analysts', institutional investors', journalists' and others' views about the wisdom of transactions. Likewise, the internet facilitates campaigns to defeat management recommendations. Not only that, institutional investor holdings have only grown since 1994, making it easier for a blocking position of minority investors to be assembled. [164] Perhaps most important, it is difficult to look at the past generation of experience and conclude that stockholders are reluctant to express positions contrary to those espoused by company management. Stockholders have been effective in using their voting rights to adopt precatory proposals that have resulted ***531** in a sharp increase in so-called majority voting policies and a sharp decrease in structural takeover defenses. [165] Stockholders have mounted more proxy fights, and, as important, wielded the threat of a proxy fight or a "withhold vote" campaign to secure changes in both corporate policies and the composition of corporate boards. [166] Stockholders have voted against mergers they did not find favorable, or forced increases in price. [167] Nor has timidity characterized stockholder behavior in companies with large blockholders or even majority stockholders; such companies still face stockholder activism in various forms, and are frequently the subject of lawsuits if stockholders suspect wrongdoing. [168]

[12] As our Supreme Court has recognized more than once, the application of fiduciary duty principles must be influenced by current corporate practices. [169] ***532** Given the evident and growing power of modern stockholders, there seems to be little basis to doubt the fairness-assuring effectiveness of an upfront majority-of-the-minority vote condition when that condition is combined, as it was here, by a promise that the controller would not proceed with a transaction without both the approval of the special committee and the approval of a majority of the minority. Although one of the rationales identified in *Lynch* for fairness review of a going private merger with only one of the protections was that minority stockholders might be too afraid in any circumstance to vote freely, that rationale was one advanced in the context of a deal structure where the minority was expressly faced with a situation where a controller informed the special committee that it would put a lower priced offer directly to the stockholders in the intrinsically more coercive form of a tender offer. [170] One of the things two very distinguished but very different corporate governance experts —Lucian Bebchuk and Marty Lipton—agree upon is that a tender offer, particularly one where there is the possibility that a non-tendering stockholder will be left as part of a stub minority or receive an even lower value than if she tenders, is intrinsically more coercive than a merger vote where a stockholder can vote no and still get the merger consideration if the other stockholders vote in sufficient numbers to approve the deal. [171] The "both" structure limits coercion like this because the controller cannot end run the special committee in this way, and thus addresses the rationale advanced in *Lynch.*

So does another element of the structure. *Lynch* suggested that minority stockholders might be inhibited from voting freely because the controller could engage in retribution. The upfront promise not to bypass the special committee or the majority-of-the-minority condition limits the potential for any retributive going private effort. A controller who violated this promise would face withering scrutiny from stockholders. As important, the past generation has demonstrated, time and again, the willingness of the Delaware Supreme Court to uphold strong medicine against violations of the duty of loyalty, [172] ***533** and even to reverse this court when it failed to deliver a remedy the Supreme Court viewed as sufficient. [173] Given the increasing concentration of institutional investors and the demonstrated willingness of stockholders to vote against management's recommended course of actions, the potency of remedies available under our law, and statutory protections that prevent controlling stockholders from discriminating against minority stockholders and thus require them to engage in nihilism if they wish to try to starve minority investors who are probably more diversified than themselves and thus less dependent on the cash flows from the controlled company, there seems no rational reason to conclude that a majority-of-the-minority condition employed in the manner described will not provide an extremely valuable, fairness-assuring protection to minority investors. Again, distinguished scholars known for being skeptical of managerial authority in the M & A arena agree, and support using the business judgment rule standard of review when a going private merger is conditioned upfront on both the negotiation and approval of an empowered independent committee and an uncoerced, fully informed majority-of-the-minority vote. [174] And to their credit, the plaintiffs themselves do not argue that minority stockholders will vote against a going private transaction because of fear of retribution, they just believe that most investors like a premium and will tend to vote for a deal that delivers one and that many long-term investors will sell out when they can obtain most of the premium without waiting for the ultimate vote. [175] But that argument is not one that suggests that the voting decision is not voluntary, it is simply an editorial about the motives of investors and ***534** does not contradict the premise that a majority-of-the-minority condition gives minority investors a free and voluntary opportunity to decide what is fair for themselves.

Of course, as with any choice in making common law, there are costs. The loss from invoking the business judgment rule standard of review is whatever residual value it provides to minority investors to have the potential for a judicial review of fairness even in cases where a going private transaction has been conditioned upfront on the approval of a special committee comprised of independent directors with the absolute authority to say no and a majority-of-the-minority vote, that special committee has met its duty of care and negotiated and approved a deal, and the deal is approved by the minority stockholders on fair disclosures and without coercion. The difficulty for the plaintiffs is that what evidence exists suggests that the systemic benefits of the possibility of such review in cases like this are slim to non-existent. [176] Indeed, the evidence that the possibility of such review provides real benefits to stockholders even in cases where a special committee is the only procedural protection is very slim at best, and there is a good case to be made that it is negative overall. [177] The lack of demonstrable

benefit is contrasted with the clear evidence of costs, because, absent the ability of defendants to bring an effective motion to dismiss, every case has settlement value, not for merits reasons, but because the cost of paying an attorneys' fee to settle litigation and obtain a release without having to pay the minority stockholders in excess of the price agreed to by the special committee exceeds the cost in terms of dollars and time consumed of going through the discovery process under a standard of review in which a substantive review of financial fairness is supposedly inescapable. [178] This incentive structure has therefore resulted in frequent payouts of attorneys' fees but without anything close to a corresponding record of settlements or litigation results where the minority stockholders got more than the special committee had already secured. In fact, it is easier to find a case where a special committee got more than the price at which plaintiffs were willing to settle than it is to find the opposite. [179] And it is unavoidable that it is investors themselves who are injured if the litigation system does not function with a rational benefit-to-cost ratio. Ultimately, litigation costs are borne by investors in the form of higher D & O insurance fees and other costs of capital to issuers that reduce the return to diversified investors. If those ***535** costs are not justified in a particular context by larger benefits, stockholders are hurt, not aided. Relatedly and as important, if no credit is given for the use of both procedural protections in tandem, minority investors will be denied access to the transactional structure that gives them the most power to protect themselves. Without any clear benefit to controllers for the clear costs of agreeing upfront to a majority-of-the-minority condition—a condition that controllers know creates uncertainty for their ability to consummate a deal and that puts pressure on them to put more money on the table—those conditions are now much less common than special committees, [180] and when used are often done as part of a late stage deal-closing exercise in lieu of price moves. [181] Under an approach where the business judgment rule standard is available if a controller uses a majority-of-the-minority condition upfront, minority investors will have an incentive for this potent fairness protection to become the market standard and to be able more consistently to protect themselves in the most cost-effective way, at the ballot box. [182]

Nor are the litigation rights of minority investors unimportant even under this structure. The business judgment rule is only invoked if: (i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority. A plaintiff that can plead facts supporting a rational inference that any of those conditions did not exist could state a claim and go on to receive discovery. If, after discovery, triable issues of fact remain about any of those conditions, the plaintiff can go to trial and if those conditions are not found to exist by the court, the court will conduct a substantive fairness review. And any minority stockholder who voted no on a going private merger where appraisal is available, which is frequently the case, may also exercise her appraisal rights. [183] Although appraisal is not a cost-free remedy, institutional ownership concentration has made it an increasingly effective one, and there are obvious examples of where it has been used effectively. [184]

Importantly, this incentive structure can be made even more effective as an efficient and powerful way of ensuring fair treatment of the minority in going private transactions. [185] In the area of takeover defense, Delaware jurisprudence has not ***536** varied the power or equitable duties of directors because an acquirer has made an acquisition bid directly to stockholders through a tender offer not requiring director action to be consummated. Rather, our Supreme Court has made clear that the directors have the duty to respond to any takeover they believe threatens the corporation and its stockholders by reasonable means, regardless of the form of the offer. [186] In the going private area, it is not clear that a controlling stockholder who proceeds by the more coercive route of a tender offer is subject to the same equitable duties as a controller that proceeds in the manner less coercive to the minority stockholders, a merger. [187] That is so even though stockholders would seem to need the protection of independent directors more when responding to a self-interested offer by a controller than in reacting to a third party's tender offer. As this court has pointed out, if the equitable duties of controlling stockholders seeking to acquire the rest of the controlled company's shares were consistent, regardless of transactional method, a sensible, across-the-board incentive system would be created to ensure fair treatment of minority stockholders. [188]

When all these factors are considered, the court believes that the approach most consistent with Delaware's corporate law tradition is the one best for investors in Delaware

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corporations, which is the application of the business judgment rule. That approach will provide a strong incentive for the wide employment of a transactional structure highly beneficial to minority investors, a benefit that seems to far exceed any cost to investors, given the conditions a controller must meet in order to qualify for business judgment rule protection. Obviously, rational minds can disagree about this question, and our Supreme Court will be able to bring its own judgment to bear if the plaintiffs appeal. But, this court determines that on the conditions employed in connection with MacAndrews & Forbes's acquisition by merger of MFW, the business judgment rule applies and summary judgment is therefore entered for the defendants on all counts. IT IS SO ORDERED.

Footnotes

1 *E.g., Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 720 (Del.1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose.").

2 *Kahn v. Lynch Commc'n Sys. (Lynch I),* 638 A.2d 1110, 1117 (Del.1994).

3 *See, e.g.,* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders,* 152 U. Pa. L.Rev. 785, 839–40 (2003) [hereinafter Gilson & Gordon, *Controlling Shareholders*]; Peter V. Letsou & Steven M. Haas, *The Dilemma That Should Never Have Been: Minority Freeze–Outs in Delaware,* 61 Bus. Law. 25, 81–93 (2005) [hereinafter Letsou & Haas, *Dilemma*]; Guhan Subramanian, *Fixing Freezeouts,* 115 Yale L.J. 2, 60–61 (2005) [hereinafter Subramanian, *Fixing Freezeouts*]; *see also* William T. Allen et al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law,* 56 Bus. Law. 1287, 1306–09 (2001) [hereinafter Allen et al., *Function over Form*].

4 *See, e.g., Seminole Tribe of Fla. v. Florida,* 517 U.S. 44, 66–67, 116 S.Ct. 1114, 134 L.Ed.2d 252 (1996) (defining the binding holding of an opinion as "the result [and] also those portions of the opinion necessary to that result," and contrasting it with dictum); *Brown v. United Water Del., Inc.,* 3 A.3d 272, 276 & n. 17 (Del.2010) (describing as dictum judicial statements that "would have no effect on the outcome of the case") (citation and internal quotation omitted); *Crown EMAK P'rs, LLC v. Kurz,* 992 A.2d 377, 398 (Del.2010) (noting that a lower court ruling was "unnecessary ... to decide [the] issue," and thus dictum "without precedential effect"); *Black's Law Dictionary* (9th ed.2009) (illustrating dictum in opinions as "passages [that] are not essential to the deciding of the very case" (quoting William M. Lile et al., *Brief Making and the Use of Law Books* 307 (3d ed.1914))).

5 *E.g.,* Gilson & Gordon, *Controlling Shareholders,* at 839–40; Subramanian, *Fixing Freezeouts,* at 60–61.

6 *Lynch I,* 638 A.2d 1110; *see also, e.g., Am. Gen. Corp. v. Tex. Air Corp.,* 1987 WL 6337, at *181 (Del.Ch. Feb. 5, 1987) (noting, on an application for a preliminary injunction, that when the special committee members were told that they must accept the controller's proposal or the transaction would proceed without their input, the burden to prove the entire fairness of the transaction likely would not shift at trial).

7 *See* 8 *Del. C.* § 262.

8 Gilson & Gordon, *Controlling Shareholders,* at 839–40; Subramanian, *Fixing Freezeouts,* at 60–61.

9 "Summary judgment may be granted if there are no material issues of fact in dispute and the moving party is entitled to judgment as a matter of law. The facts, and all reasonable inferences, must be considered in the light most favorable to the nonmoving party." *Lyondell Chem. Co. v. Ryan,* 970 A.2d 235, 241 (Del.2009) (citation omitted).

10 *See, e.g., Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 720 (Del.1971).

11 Defs.' Ex. 2, at 18 (M & F Worldwide Corp., Proxy Statement (Schedule 14A) (Nov. 18, 2011)) [hereinafter Proxy].

12 *Id.* at 97.

13 *Id.*

14 *Id.*

15 *Id.*

16 *Id.* at 97–100.

17 *Id.*

18 *Id.* at 39.

19 Defs.' Ex. 17 (Moelis discussion materials (June 9, 2011)).

20 *Id.*

21 Proxy 50.

22 Defs.' Ex. 18 (MacAndrews & Forbes proposal letter (June 13, 2011)).

23 *Id.* (emphasis added).

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24 *See id.*

25 Defs.' Ex. 19 (MFW board minutes (June 14, 2011)).

26 *See id.*

27 *Id.*

28 *Id.*

29 Defs.' Ex. 28 (email from Michael Schwartz to the special committee (June 15, 2011)).

30 *See, e.g., Ams. Mining Corp. v. Theriault,* 51 A.3d 1213, 1244–46 (Del.2012) (noting that a special committee that could only "evaluate" an offer had a "narrow mandate"); *Brinckerhoff v. Tex. E. Prods. Pipeline Co., LLC,* 986 A.2d 370, 381 (Del.Ch.2010) (observing that a special committee should have the mandate to "review, evaluate, negotiate, and to recommend, or reject, a proposed merger").

31 *E.g., Bershad v. Curtiss–Wright Corp.,* 535 A.2d 840, 844–45 (Del.1987).

32 Meister Dep. 116:3–117:9 (testifying that Evercore analyzed the possibility of selling MFW to a private equity buyer, and that, after this analysis, the special committee did not believe that such a sale was likely to create value); *id.* at 118:23–119:12 (testifying that Evercore had received "one or two ... fishing expedition phone calls," but that Evercore did not believe that they had been from anyone "capable or interested"); Defs.' Ex. 24 (minutes of special committee (Aug. 10, 2011)) (stating that Evercore and the special committee discussed the option of selling MFW).

33 Defs.' Ex. 13 (Evercore discussion materials (June 20, 2011)) (stating that the special committee had leverage by being able to "explor [e] alternative paths to value creation, such as breaking up the Company or sale of selected assets"); Defs.' Ex. 31 (Evercore discussion materials (Aug. 17, 2011)) (illustrative transaction of value of company if Harland Clarke payments business was sold to a competitor, for cash); Defs.' Ex. 25 (minutes of special committee (Aug. 17, 2011)) (stating that Evercore informed the special committee that Harland Clarke's main competitor, Deluxe, would not make a bid for Harland Clarke that would increase MFW's stock price); Dinh Dep. 168:6–14 (testifying that Evercore informed the special committee that financial buyers would be unlikely to want to bid for parts of MFW).

34 *Aronson v. Lewis,* 473 A.2d 805, 815 (Del.1984).

35 *Rales v. Blasband,* 634 A.2d 927, 936 (Del.1993) (citing *Aronson,* 473 A.2d at 815).

36 *Beam ex rel. Martha Stewart Living Omnimedia v. Stewart,* 845 A.2d 1040, 1051–52 (Del.2004).

37 *Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1156, 1167 (Del.1995) ("[A] shareholder plaintiff [must] show the materiality of a director's self-interest to the ... director's independence....") (citation omitted); *see Brehm v. Eisner,* 746 A.2d 244, 259 n. 49 (Del.2000) ("The term 'material' is used in this context to mean relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking.").

Even in the context of personal, rather than financial, relationships, the materiality requirement does not mean that the test cannot be met. For example, it is sometimes blithely written that "mere allegations of personal friendship" do not cut it. More properly, this statement would read "mere allegations of mere friendship" do not qualify. If the friendship was one where the parties had served as each other's maids of honor, had been each other's college roommates, shared a beach house with their families each summer for a decade, and are as thick as blood relations, that context would be different from parties who occasionally had dinner over the years, go to some of the same parties and gatherings annually, and call themselves "friends." *See, e.g., Telxon Corp. v. Meyerson,* 802 A.2d 257, 264 (Del.2002) (noting that a director may lack independence on account of a "close personal or familial relationship").

38 *E.g., Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 363 (Del.1993) (affirming Court of Chancery's requirement that a "a shareholder show ... the materiality of a director's self-interest to the given director's independence" as a "restatement of established Delaware law"); *see also, e.g., Grimes v. Donald,* 673 A.2d 1207, 1216 (Del.1996) (stating, in the context of demand futility, that a stockholder must show that "a majority of the board has a *material* financial or familial interest" (emphasis added and citation omitted)).

39 *Cede,* 634 A.2d at 364.

40 *King v. VeriFone Hldgs., Inc.,* 12 A.3d 1140, 1145 n. 24 (Del.2011) (citation omitted); *Grimes,* 673 A.2d at 1216.

41 *In re Oracle Corp. Deriv. Litig.,* 824 A.2d 917, 941 n. 62 (Del.Ch.2003).

42 *See* N.Y. Stock Exchange, *Listed Company Manual* § 303A.02 (2013), http://nysemanual.nyse.com/lcm [hereinafter NYSE Rules] ("Independence Tests").

43 Byorum Dep. 11:17–21.

44 *Id.* at 13:15–16, 88:20–23.

45 Pls.' Br. in Opp'n 13–14; Byorum Dep. 56:6–60:3.

46 Byorum Dep. 14:2–9.

47 *Id.* at 20:15–20.

48 *Id.* at 57:12–17, 60:22–61:4.

49 *Id.* at 59:14–20.

50 *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart,* 845 A.2d 1040, 1050–54 (Del.2004); *see* Byorum Dep. 19:4–6.

51 Byorum Dep. 16:5–9.

52 *See, e.g., Crescent/Mach I P'rs, L.P. v. Turner,* 846 A.2d 963, 980–81 (Del.Ch.2000) (holding that an allegation that there was a "long-standing 15–year professional and personal relationship" between the controlling stockholder and a director "alone fails to raise a reasonable doubt that [the director] could not exercise his independent business judgment in approving the transaction"); *State of Wisc. Inv. Bd. v. Bartlett,* 2000 WL 238026, at *6 (Del.Ch. Feb. 24, 2000) ("Evidence of personal and/or past business relationships does not raise an inference of self-interest.").

53 Pls.' Br. in Opp'n 13.

54 The plaintiffs acknowledge that Byorum is wealthy: they describe her as a banking "big shot" and point out that she owns a house in the Hamptons. *Id.* at 13–14.

55 Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty,* 11 U. Pa. J. Bus. L. 675, 688 (2009) (citation and quotation marks omitted); *see Beam,* 845 A.2d at 1054 & n. 37 (discussing the concept of beholdenness); Byorum Dep. 56:6–60:3; NYSE Rules § 303A.02(b)(v) (providing that a director is not independent if he or she "is a current employee ... of a company that has ... received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million, or 2% of such other company's consolidated gross revenues"). And, even if the amount paid to Stephens Cori exceeded $1 million, Byorum would still be considered independent under the NYSE rules, because that relationship is stale (*i.e.,* she was paid over three years before the MFW transaction).

56 Dinh Dep. 173:4–10.

57 *Id.* at 14:8–15:4, 80:17–24.

58 *See Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1156, 1167 (Del.1995); *see also, e.g., Gantler v. Stephens,* 965 A.2d 695, 708 (Del.2009) (holding that the plaintiffs had adequately alleged that a defendant director was not disinterested on account of his business relationship with the company whose board he sat on, because he was a "man of comparatively modest means").

59 Dinh Dep. 72:5–75:21.

60 Pls.' Br. in Opp'n 15–16.

61 Dinh Dep. 18:25–19:7, 23:15–17, 80:17–81:5.

62 *See, e.g., In re Freeport–McMoran Sulphur, Inc. S'holders Litig.,* 2001 WL 50203, at *4–5 (Del.Ch. Jan. 11, 2001) (finding that a consulting fee of $230,000, increased to $330,000 after the merger, did not cast doubt on a director's independence, where the plaintiffs had not alleged that the fee was material to the director); *In re Walt Disney Co. Deriv. Litig.,* 731 A.2d 342, 360 (Del.Ch.1998), *rev'd in part on other grounds sub nom. Brehm v. Eisner,* 746 A.2d 244 (Del.2000) (finding that legal and consulting fees of $175,000 paid by Disney to Senator George Mitchell and his law firm did not cast doubt on his independence, where the plaintiffs had not alleged that the fees were material to Mitchell).

63 Dinh Dep. 80:25–81:5.

64 If Dinh were the Dean, that fact would be contextually important. Likewise, if Dinh were the head of a distinct organization within the law school (*e.g.,* a center for corporate governance or for the study of some subject in which he has an interest) that sought funds from alumni such as Schwartz, that context would be important to consider in applying the Supreme Court's materiality test. But even then, that relationship would have to be contextually material. *See In re Oracle Corp. Deriv. Litig.,* 824 A.2d 917, 930 & n. 21 (Del.Ch.2003) (discussing cases in which this court has decided the independence of directors with fundraising responsibilities at universities).

65 If Dinh's directorship of Revlon were to be relevant to his independence at the time of the MFW transaction, the plaintiffs would need to provide record evidence creating a triable issue of fact that he was offered the directorship *before* the special committee approved the deal, or that it had at least been discussed with him before this time. The only record evidence is to the contrary. Dinh Dep. 24:6–9.

66 Pls.' Br. in Opp'n 15–18.

67 Webb Dep. 19:18–22.

68 Pls.' Br. in Opp'n 15–18; Webb Dep. 7:8–9:5.

69 Pls.' Br. in Opp'n 17; Webb Dep. 15:16–17.

70 Oral Arg. Tr. 115:4–7.

71 *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart,* 845 A.2d 1040, 1051 (Del.2004) ("Allegations that [the controller] and the other directors ... developed business relationships before joining the board ... are insufficient, without more, to rebut the presumption of independence."); *see also Crescent/Mach I P'rs, L.P. v. Turner,* 846 A.2d 963, 980 (Del.Ch.2000).

72 "[A] director's duty to exercise an informed judgment is in the nature of a duty of care...." *Smith v. Van Gorkom,* 488 A.2d 858, 872–73 (Del.1985); *see also* *Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 367 (Del.1993) ("[W]e find the defendant directors, as a board, to have breached their duty of care by reaching an uninformed decision....").

73 Defs.' Ex. 20 (minutes of MFW special committee (June 21, 2011)); Defs.' Ex. 33 (Evercore engagement letter (June 22, 2011)).

74 Defs.' Ex. 16 (email to Evercore with HCHC and Mafco lending projections (June 27, 2011)).

75 Defs.' Ex. 22 (minutes of MFW special committee (July 13, 2011)); Defs.' Ex. 34 (email from Gus Christensen, Evercore, to Charles Dawson and Stephen Taub, MFW (July 15, 2011)).

76 Defs.' Ex. 38 (email from Gus Christensen to Paul Meister (July 18, 2011)).

77 *Id.*

78 Proxy 23.

79 *Id.* at 59–60.

80 Defs.' Ex. 45 (Evercore discussion materials (Aug. 10, 2011)).

81 *Id.*

82 *Id.*

83 Defs.' Ex. 24 (minutes of MFW special committee (Aug. 10, 2011)).

84 Defs.' Ex. 25 (minutes of MFW special committee (Aug. 17, 2011)); Defs.' Ex. 45 (Evercore discussion materials (Aug. 17, 2011)).

85 Defs.' Ex. 25.

86 *Id.*

87 Defs.' Ex. 26 (minutes of MFW special committee (Sept. 6, 2011)).

88 Defs.' Ex. 27 (minutes of MFW special committee (Sept. 10, 2011)).

89 Meister Dep. 160:3–9.

90 Schwartz Dep. 31:21–32:5.

91 Defs.' Ex. 27; Defs.' Ex. 32 (letter to the special committee from Evercore (Sept. 10, 2011)).

92 Defs.' Ex. 51 (MFW board minutes (Sept. 11, 2011)).

93 *Id.*

94 *See* *Smith v. Van Gorkom,* 488 A.2d 858, 873 (Del.1985) ("In the specific context of a proposed merger of domestic corporations, a director has a duty ... to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders.").

95 Proxy 24–25.

96 *Id.* at 23–24, 59–63.

97 *Id.* at 41–48.

98 Defs.' Br. in Supp. 23.

99 Defs.' Ex. 12 (M & F Worldwide Corp., Current Report (Form 8–K) (Dec. 22, 2011)).

100 *Smith v. Van Gorkom,* 488 A.2d 858, 890 (Del.1985) (stating that the "settled rule" was that if fully informed stockholders approved a transaction approved by even interested directors, the business judgment rule standard would be invoked, but that in the case of a third-party cash merger before the court, the stockholders' vote did not qualify because of disclosure inadequacies (citing *Gerlach v. Gillam,* 139 A.2d 591, 593 (Del.Ch.1958))). This rule has deep roots in the common law. *See, e.g.,* *Cole v. Nat'l Cash Credit Ass'n,* 156 A. 183, 187 (Del.Ch.1931) ("As long as [the directors] act in good faith, with honest motives, for honest ends, the exercise of their discretion will not be interfered with.... The same presumption of fairness that supports the discretionary judgment of the managing directors must also be accorded to the majority of stockholders whenever they are called upon to speak for the corporation in matters assigned to them for decision, as is the case at one stage of the proceedings leading up to a sale of assets or a merger." (citation omitted)); *see also* *In re Lukens Inc. S'holders Litig.,* 757 A.2d 720, 736–38 (Del.Ch.1999) (applying the rule in *Van Gorkom* to invoke the business judgment standard of review, and dismiss a claim that the directors of a corporation breached their duty of care in selling the corporation, where the stockholders were fully informed and voted to approve the deal); *Harbor Fin. P'rs v. Huizenga,* 751 A.2d 879, 890 (Del.Ch.1999) ("[T]he effect of untainted stockholder approval of the Merger is to invoke the protection of the business judgment rule and to insulate the Merger from all attacks other than on the ground of waste." (citation omitted)); *In re Wheelabrator Techs., Inc. S'holders Litig.,* 663 A.2d 1194, 1196 (Del.Ch.1995) (ruling that a fully informed, non-coercive stockholder vote on a merger extinguishes a duty of a care claim, and causes a duty of loyalty claim to be reviewed under the business judgment standard).

101 *Lynch I,* 638 A.2d at 1117; *see also* *Bershad v. Curtiss–Wright Corp.,* 535 A.2d 840, 846 (Del.1987); *Rosenblatt v. Getty Oil Co.,* 493 A.2d 929, 937 (Del.1985).

102 *See Kahn v. Tremont Corp.,* 694 A.2d 422, 433–34 (Del.1997) (Quillen, J., concurring); *see also In re S. Peru Copper Corp.,* 52 A.3d 761, 790–91 (Del.Ch.2011), *aff'd sub nom. Ams. Mining Corp. v. Theriault,* 51 A.3d 1213 (Del.2012) (discussing *Tremont*).

103 *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del.1985); *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.,* 506 A.2d 173 (Del.1986).

104 *E.g., Tremont,* 694 A.2d at 429–30; *Lynch I,* 638 A.2d at 1118–19; *see also In re Loral Space & Commc'ns Inc.,* 2008 WL 4293781, at *22–26 (Del.Ch. Sept. 19, 2008); *Gesoff v. IIC Indus. Inc.,* 902 A.2d 1130, 1150–52 (Del.Ch.2006); *In re Tele–Commc'ns, Inc. S'holders Litig.,* 2005 WL 3642727, at *4–6 (Del.Ch. Jan. 10, 2006); *In re Emerging Commc'ns, Inc. S'holders Litig.,* 2004 WL 1305745, at *33 (Del.Ch. June 4, 2004).

105 *Lynch I,* 638 A.2d at 1118–19.

106 *Tremont Corp.,* 694 A.2d at 429–30.

107 *E.g., In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27, 74 (Del.2006) ("[W]here business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.' " (quoting *Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 720 (Del.1971))); *Brehm v. Eisner,* 746 A.2d 244, 264 (Del.2000) ("We do not even decide if [directors' decisions] are *reasonable* in this context." (emphasis added)); *see generally* Stephen Bainbridge, *The Business Judgment Rule as Abstention Doctrine,* 57 Vand. L.Rev. 83 (2004) [hereinafter Bainbridge, *Abstention Doctrine*].

108 The plaintiffs have not produced a valuation report by an expert opining that the merger price was unfair. The defendants make much of this, but, at oral argument, the plaintiffs explained that the defendants did not move for summary judgment on the fundamental issue of fairness. Oral Arg. Tr. 64:20–65:7. Rather, the motion and opening brief in support of the motion for summary judgment only argued that judgment in favor of the defendants should be granted because the effective special committee and the majority-of-the-minority vote invoked the business judgment rule standard of review, and the merger survived that standard as a matter of law; or, in the alternative and as a minimum, that the defendants were entitled to the benefit of a burden shift if the entire fairness standard applied. Although the defendants tried in their reply brief to broaden their motion to contend that there was no triable issue of fact regarding the substantive fairness of the merger, the plaintiffs are correct that this was procedurally unfair and improper. *See PharmAthene, Inc. v. SIGA Techs., Inc.,* 2011 WL 6392906, at *2 (Del.Ch. Dec. 16, 2011) ("[A] party waives any argument it fails properly to raise...."), *rev'd in part on other grounds,* 67 A.3d 330, 2013 WL 2303303 (Del.2013).

Nonetheless, the plaintiffs knew that they needed to point to record facts supporting a triable issue of fact that the merger's terms constituted waste, such that they could not be terms that a rational fiduciary could accept in good faith. Oral Arg. Tr. 67:13–68:3. They have not come close to meeting that burden.

109 *See Harbor Fin. P'rs v. Huizenga,* 751 A.2d 879, 901 (Del.Ch.1999) ("[It is] logically difficult to conceptualize how a plaintiff can ultimately prove a waste or gift claim in the face of a decision by fully informed, uncoerced, independent stockholders to ratify the transaction. The test for waste is whether any person of ordinary sound business judgment could view the transaction as fair. If fully informed, uncoerced, independent stockholders have approved the transaction, they have ... made the decision that the transaction is a fair exchange.") (citing *Saxe v. Brady,* 184 A.2d 602, 611–12 (Del.Ch.1962) (observing that a stockholder vote approving of a transaction and authorizing future similar ones was "[s]urely ... some indication" that the transaction was reasonable)).

110 Oral Arg. Tr. 128:22–130:12.

111 *Lynch I,* 638 A.2d at 1115.

112 694 A.2d 422 (Del.1997).

113 726 A.2d 1215 (Del.1999).

114 51 A.3d 1213 (Del.2012).

115 *Brown v. United Water Del., Inc.,* 3 A.3d 272, 276 & n. 17 (Del.2010) (citation and internal quotation omitted); *see also Seminole Tribe of Fla. v. Florida,* 517 U.S. 44, 66–67, 116 S.Ct. 1114, 134 L.Ed.2d 252 (1996); *Black's Law Dictionary* (9th ed.2009).

116 *Crown EMAK P'rs, LLC v. Kurz,* 992 A.2d 377, 398 (Del.2010); *United Water,* 3 A.3d at 275.

117 *E.g., Loudon v. Archer–Daniels–Midland Co.,* 700 A.2d 135, 142–43 (Del.1997) (describing as dictum language in *In re Tri–Star Pictures, Inc. Litig.,* 634 A.2d 319 (Del.1993), and ruling that it "should not be read to stand for any broader proposition" than the context permitted); *see also Cohens v. Virginia,* 19 U.S. (6 Wheat.) 264, 399–400, 5 L.Ed. 257 (1821) ("It is a maxim not to be disregarded, that general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used.").

118 *State ex rel. State Highway Dep't v. 9.88 Acres of Land,* 253 A.2d 509, 511 (Del.1969).

119 *E.g., Gatz Props., LLC v. Auriga Capital Corp.,* 59 A.3d 1206, 1218 (Del.2012) (statements on issues "no[t] contested by the parties" are dictum) (internal quotation marks omitted); *see also Cent. Va. Cmty. Coll. v. Katz,* 546 U.S. 356, 363, 126 S.Ct. 990, 163 L.Ed.2d 945 (2006) ("[W]e are not bound to follow our dicta in a prior case in which the point now at issue was not fully debated.") (citing *Cohens,* 19 U.S. (6 Wheat.) at 399–400).

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120 Defs.' Ex. 18 (MacAndrews & Forbes proposal letter (June 13, 2011)).

121 *Lynch I,* 638 A.2d at 1120–21.

122 *Kahn v. Lynch Commc'n Sys.,* 669 A.2d 79, 89 (Del.1995).

123 *Lynch I,* 638 A.2d at 1116.

124 *Id.* at 1114, 1118 (quoting *Kahn v. Lynch Commc'n Sys.,* 1993 WL 290193, at *789 (Del.Ch. July 9, 1993)).

125 *Id.* at 1117 (emphasis added); Oral Arg. Tr. 16:14–19.

126 The plaintiffs do not rely upon *Emerald Partners v. Berlin,* except to note that in that case, the Supreme Court upheld the application of the entire fairness standard to a merger between a Delaware corporation and other corporations owned by the same controlling stockholder. 726 A.2d 1215 (Del.1999); Pls.' Br. in Opp'n 40. The plaintiffs quote no language from that case, and it did not present the question posed now.

127 *See Kahn v. Tremont Corp.,* 694 A.2d 422 (Del.1997).

128 *Id.* at 426.

129 *Id.* at 428–29.

130 *Id.* at 429–30.

131 The plaintiffs do not rely on the actual holding of the court necessary to address the precise issues raised in *Tremont,* but instead quote this sentence: "Regardless of where the burden lies, when a controlling shareholder stands on both sides of the transaction the conduct of the parties will be viewed under the more exacting standard of entire fairness as opposed to the more deferential business judgment standard." *Id.* at 428.

132 *Ams. Mining Corp. v. Theriault,* 51 A.3d 1213 (Del.2012).

133 *Id.* at 1239.

134 *In re S. Peru Copper Corp. S'holder Litig.,* 52 A.3d 761, 766 (Del.Ch.2011) ("The parties agree that the appropriate standard of review is entire fairness.").

135 *E.g., Weinberger v. UOP, Inc.,* 457 A.2d 701, 710 (Del.1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

136 *See, e.g., Sternberg v. O'Neil,* 550 A.2d 1105, 1116 (Del.1988) (noting that statements from *Shaffer v. Heitner,* 433 U.S. 186, 97 S.Ct. 2569, 53 L.Ed.2d 683 (1977), must be "read in context"); *Rabkin v. Philip A. Hunt Chem. Corp.,* 498 A.2d 1099, 1104 (Del.1985) (holding that it is necessary "to take account of the entire context" of *Weinberger,* 457 A.2d 701, when determining remedies in a cash-out merger).

137 *See In re CNX Gas Corp. S'holders Litig.,* 4 A.3d 397 (Del.Ch.2010) (reviewing cases, and concluding that the question of the standard of review is an open one).

138 *See, e.g., Hoffman Plastic Compounds, Inc. v. NLRB,* 535 U.S. 137, 147, 122 S.Ct. 1275, 152 L.Ed.2d 271 (2002) (noting that even "isolated sentences" may be considered "persuasive authority"); *Bata v. Bata,* 163 A.2d 493, 510 (Del.1960) (finding dictum "none the less persuasive").

139 *Lynch I,* 638 A.2d 1110; *Weinberger,* 457 A.2d 701.

140 *E.g., In re Pure Res., Inc., S'holders Litig.,* 808 A.2d 421 (Del.Ch.2002); *In re Cysive, Inc. S'holders Litig.,* 836 A.2d 531 (Del.Ch.2003); *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604 (Del.Ch.2005); *CNX,* 4 A.3d 397; *see also* Allen et al., *Function over Form,* at 1306–09; Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations,* 27 Del. J. Corp. L. 499, 506–13 (2002).

141 *E.g.,* Gilson & Gordon, *Controlling Shareholders,* at 796–803, 805–27; Subramanian, *Fixing Freezeouts,* at 11–22.

142 *See, e.g.,* Subramanian, *Fixing Freezeouts,* at 59.

143 *See generally* Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions,* 57 Vand. L.Rev. 1797 (2004) [hereinafter Weiss & White, *File Early*]; *see also Cox,* 879 A.2d at 613–14 (discussing Weiss & White, *File Early*); Aff. of Lawrence J. White, *Cox,* C.A. No. 613–N (Del. Ch. Jan. 13, 2005) (summarizing Weiss & White, *File Early*).

144 *Compare In re Siliconix Inc. S'holders Litig.,* 2001 WL 716787 (Del.Ch. June 21, 2001), *with Lynch I,* 638 A.2d 1110. The implication of the Supreme Court's decision in *Solomon v. Pathe* and cases following it, such as *Siliconix,* is that a going private transaction proposed by a controller by the tender offer method is not subject to equitable review. *Solomon v. Pathe Commc'ns Corp.,* 672 A.2d 35 (1996). Although this implication has been affected by later cases such *Pure* and *Cox,* it remains the case that it is not certain that a controlling stockholder owes the same equitable obligations when it seeks to acquire the rest of a corporation's equity by a tender offer, rather than by a statutory merger. *See* Gilson & Gordon, *Controlling Shareholders,* at 796–832; Subramanian, *Fixing Freezeouts,* at 11–22.

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145 Oral Arg. Tr. 80:12–18.

146 Pls.' Br. in Opp'n 46.

147 *E.g., Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.,* 906 A.2d 168, 205 (Del.Ch.2006), *aff'd,* 931 A.2d 438 (Del.2007) (TABLE) (describing the business judgment rule as being designed to "provid[e] directors with sufficient insulation so that they can seek to create wealth through the good faith pursuit of business strategies that involve a risk of failure"); *Gagliardi v. TriFoods Int'l, Inc.,* 683 A.2d 1049, 1052 (Del.Ch.1996) ("[The business judgment rule] *protects shareholder investment interests* against the uneconomic consequences that the presence of judicial second-guessing risk would have on director action and shareholder wealth in a number of ways."); Bainbridge, *Abstention Doctrine,* at 110 (describing part of the role of the business judgment rule as "encouraging optimal risk taking").

148 *Sinclair Oil Corp. v. Levien,* 280 A.2d 717, 720 (Del.1971); *see Cede & Co. v. Technicolor, Inc.,* 634 A.2d 345, 361 (Del.1993) ("To rebut the [business judgment] rule, a shareholder plaintiff assumes the burden of providing evidence that directors, in reaching their challenged decision, breached [the duties of] loyalty or due care. If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments." (citations omitted)).

149 *E.g., Beard v. Elster,* 160 A.2d 731, 737 (Del.1960) ("Implicit in the [court's decision in *Gottlieb v. Heyden Chemical Corp.,* 90 A.2d 660 (Del.1952), not to grant business judgment review to a board's decision to approve a stock option plan] is, of course, that a different situation would have presented itself had the Board of Directors been in fact disinterested. It follows that in such cases the sound business judgment rule might well have come to the aid of the proponents of the plan."); *Blish v. Thompson Automatic Arms Corp.,* 64 A.2d 581, 603 (Del.1948) (finding that disinterested directors had the power to approve a grant of stock to other directors, and that, "in the absence of fraud, ... their unanimous action [was] final"); *Puma v. Marriott,* 283 A.2d 693, 696 (Del.Ch.1971) ("[S]ince the transaction complained of was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uninformed opinion for that of the experienced, independent board members....").

150 *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 955 (Del.1985) (holding that as part of a new standard of review requiring directors taking defensive actions to show that those actions were reasonable in relation to threat posed, "such proof is materially enhanced ... by the approval of a board comprised of a majority of outside independent directors" (citations omitted)); *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.,* 506 A.2d 173, 176 n. 3 (Del.1986) (noting that the Revlon board was not "entitled to certain presumptions that generally attach to the decisions of a board whose majority consists of truly outside independent directors").

151 *In re Lukens Inc. S'holders Litig.,* 757 A.2d 720, 736–38 (Del.Ch.1999); *Harbor Fin. P'rs v. Huizenga,* 751 A.2d 879, 890 (Del.Ch.1999); *In re Wheelabrator Techs., Inc. S'holders Litig.,* 663 A.2d 1194, 1205 (Del.Ch.1995); *see also Smith v. Van Gorkom,* 488 A.2d 858, 890 (Del.1985).

152 The Supreme Court has noted the wisdom of not following a rule simply because it was "laid down in the time of Henry IV." *Keeler v. Harford Mut. Ins. Co.,* 672 A.2d 1012, 1017 n. 6 (Del.1996) (quoting Oliver Wendell Holmes, *The Path of the Law,* 10 Harv. L.Rev. 457, 469 (1897)).

153 Pls.' Br. in Opp'n 46; *see also* Oral Arg. Tr. 102:13–18 (plaintiffs' counsel acknowledging that majority-of-the-minority conditions have been used to block going private transactions).

154 Oral Arg. Tr. 80:2–4.

155 8 *Del. C.* § 251(b)-(c) (requiring that mergers be approved by the board of directors and the stockholders of each merging corporation).

156 *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604, 618 (Del.Ch.2005).

157 *See, e.g., Aronson v. Lewis,* 473 A.2d 805, 814–15 (Del.1984) (holding that independent directors can be entrusted with the decision to sue other directors on behalf of the corporation); *Weinberger v. UOP, Inc.,* 457 A.2d 701, 709 n. 7 (Del.1983) ("[T]he result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length.").

158 *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart,* 845 A.2d 1040, 1048 (Del.2004) ("[D]irectors are entitled to a *presumption* that they were faithful to their fiduciary duties." (citing *Aronson,* 473 A.2d at 812)).

159 *Id.* at 1052 ("To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that ... the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director." (citation omitted)).

160 A 2006 amendment to the DGCL provides that stockholders may, by bylaw, specify "the votes that shall be necessary for the election of directors." 75 Del. Laws ch. 306, § 5 (2006) (amending 8 *Del. C.* § 216). Majority voting provisions, allowing stockholders to run withhold vote campaigns and unseat particular directors, have become standard in recent years, especially in large companies. Marcel Kahan & Edward Rock, *The Insignificance of Proxy Access,* 97 Va. L.Rev. 1347, 1359–60 (2011) [hereinafter Kahan & Rock, *Proxy Access*]; Claudia H. Allen, *Study of Majority Voting in Director Elections* (Nov. 12, 2007), http://www.ngelaw. com/

files/Uploads/Documents/majoritystudy111207.pdf. Professors Kahan and Rock analyzed majority withhold votes at Russell 3000 companies in 2008 and 2009. They found that, of the companies whose directors did not leave the board within one year of a majority withhold vote and that were not acquired in that time, two-thirds addressed the issues motivating the withhold vote to the satisfaction of stockholders, and large companies were particularly responsive. Kahan & Rock, *Proxy Access,* at 1420–22; *see also 2012 Proxy Season Review: World Markets,* Inst. S'holder Servs. (Feb. 27, 2013), at 178–85, http://www.issgovernance.com/files/private/2012 Combined PostseasonReport.pdf (detailing the increased use of proxy contests and withhold campaigns in recent years, and the ability of activist investors to not only prevail at the actual ballot box in contested situations, but to use the threat of a proxy contest or withhold campaign as a successful method to procure changes in corporate strategy and board composition, even at large cap companies).

161 *E.g., Proxy Paper Guidelines: 2013 Proxy Season,* Glass Lewis & Co. (2012), at 1, http://www.glasslewis. com/assets/ uploads/2012/02/Guidelines_UnitedStates_2013_Abridged.pdf ("[W]hen assessing the independence of directors we will also examine when a director's service track record on multiple boards indicates a lack of objective decision-making."); *2012–2013 Policy Survey Summary of Results,* Inst. S'holder Servs. (Jan. 31, 2013), at 3, http://www.issgovernance. com/files/private/ ISSPolicySurveyResults2012.pdf (reporting that 61% of ISS survey respondents stated that a director's track record on other boards was "very important" in voting for a new board nominee); *2013 U.S. Proxy Voting Summary Guidelines,* Inst. S'holder Servs. § 2.1.19 (Jan. 31, 2013), http://www.issgovernance.com/files/2013ISSUSSummaryGuidelines1312013.pdf (providing for a withhold vote recommendation on account of "[e]gregious actions related to a director's service on other boards").

162 *See, e.g.,* Guhan Subramanian, *Post–Siliconix Freeze–Outs: Theory and Evidence,* 36 J. Legal Stud. 1, 13 tbl. 1 (2007) [hereinafter, Subramanian, *Post*–Siliconix] (reporting long-term cumulative abnormal returns of 39% in completed going private transactions between 2001 and 2005, almost all of which used a special committee).

163 *Unitrin, Inc. v. Am. Gen. Corp.,* 651 A.2d 1361, 1382 (Del.1995) (citation and internal quotation marks omitted).

164 *See, e.g.,* Marshall E. Blume & Donald B. Keim, *Institutional Investors and Stock Market Liquidity: Trends and Relationships* (Aug. 21, 2012), at 4, http://www.wharton.upenn.edu/jacobslevycenter/files/14.12. Keim.pdf (showing that institutional investors by the end of 2010 held 67% of equities, compared with only about 5% in 1945); Matteo Tonello & Stephan Rabimov, *The 2010 Institutional Investment Report: Trends In Asset Allocation and Portfolio Composition,* Conference Bd. (2009), at 26, http:// www.conferenceboard.org/retrievefile. cfm?filename =Institutional% 20 Investment% 20Report.pdf&type=subsite (showing that institutional ownership of equities in the 1,000 largest U.S. companies increased from 57% in 1994 to 69% in 2008).

165 *See, e.g., 2012 Report,* S'holder Rights Project, http://srp. law. harvard.edu/releases/SRP–2012–Annual–Report.pdf (noting that, from the beginning of 1999 to the beginning of 2012, the number of S & P 500 companies with staggered boards declined from 303 to 126, and that over 40 of these 126 companies declassified their boards in 2012 alone); Andrew L. Bab & Sean P. Neenan, *Poison Pills in 2011,* Conference Bd. (Dec.2011), at 2, http://www.conference-board.org/retrievefile.cfm?filename=TCB% 20DN–V3N5–11.pdf & type=subsite (finding that, between 2001 and 2011, the number of companies with poison pills declined from 2,200 to 900).

166 Kahan & Rock, *Proxy Access,* at 1420–25; *accord* Diane Del Guercio et al., *Do Boards Pay Attention When Investor Activists "Just Vote No"?,* 90 J. Fin. Econ. 84 (2008) (noting that withhold campaigns have become more frequent over time, and finding that withhold campaigns with 20% or more support often result in the board implementing all specific requests made by stockholders).

167 A non-exclusive sampling from this court's own memory provides many examples of transactions that have been voted down, or come close to being voted down, by the stockholders. In 2007, stockholders voted down Carl Icahn's buyout of Lear Group, after this court issued a limited preliminary injunction requiring further disclosures. *In re Lear Corp. S'holder Litig.,* 967 A.2d 640, 641 (Del.Ch.2008). Again in 2007, stockholders in Inter–Tel threatened to vote down a merger with Mitel on the ground that the price was inadequate, forcing the stockholder vote to be delayed, until it appeared from new information about the capital markets that the Mitel offer was a good one. *Mercier v. Inter–Tel. (Del.), Inc.,* 929 A.2d 786 (Del.Ch.2007). In 2010, the stockholders of Dollar Thrifty voted down a merger with Hertz, only to accept a higher offer from Hertz two years later. Michael J. De La Merced & Peter Lattman, *After Long Pursuit, Hertz To Buy Dollar Thrifty for $2.3 Billion,* N.Y. Times, Aug. 26, 2012, http:// dealbook.nytimes.com/2012/08/26/ hertz-on-the-verge-ofbuying-dollar-thrifty; *see In re Dollar Thrifty S'holder Litig.,* 14 A.3d 573 (Del.Ch.2010) (denying a motion to preliminarily enjoin the 2010 stockholder vote).

In fact, as this decision was being finalized, the telecommunications company Sprint was attempting to cash out the minority stockholders in Clearwire as part of its own sale to Softbank. The press reported that, faced with considerable opposition by the minority, Sprint raised its offer from $2.97 per share to $3.40, and delayed the vote on the transaction. Sinead Carew, *Clearwire, Shareholders Brace for Fight over Sprint Bid* (May 22, 2013), http://www.reuters.com/article/2013/05/22/usclearwire-sprint- id USBRE94K0JY20130522.

168 For example, the minority Class A stockholders of Revlon, another Perelman-controlled corporation, twice rejected an exchange offer by Revlon that was premised on a non-waivable majority-of-the-minority condition. *In re Revlon, Inc. S'holders. Litig.,* 990 A.2d 940, 950–51 (Del.Ch.2010). As a further example, in 2007, Cablevision stockholders rejected the controller's (the Dolan family)

$10.6 billion buyout. Andrew Ross Sorkin, *Dolans' Bid To Take Cablevision Private Is Rejected by Shareholders,* N.Y. Times, Oct. 25, 2007, http://www.nytimes. com/2007/10/25/business/media/25cable.html.

169 *Moran v. Household Int'l, Inc.,* 500 A.2d 1346, 1351 (Del.1985) ("[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs." (quoting *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 957 (Del.1985))); *see also* Jack B. Jacobs, *Does the New Corporate Shareholder Profile Call for a New Corporate Law Paradigm?,* 18 Fordham J. Corp. & Fin. L. 19, 31 (2012) (discussing going private transactions, and proposing that "the new shareholder profile is an irrefutable reality that justifies inquiring into whether courts should take that into account in formulating and applying fiduciary duty principles").

170 *Lynch I,* 638 A.2d at 1116–17 (citations omitted).

171 *See* Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers,* 95 Harv. L.Rev. 1028, 1039–40 (1982); Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers,* 98 Harv. L.Rev. 1695, 1708–13 (1985); Martin Lipton, *Takeover Bids in the Target's Boardroom,* 35 Bus. Law. 101, 114 (1979).

172 *E.g., Ams. Mining Corp. v. Theriault,* 51 A.3d 1213 (Del.2012), *aff'g* 52 A.3d 761 (Del.Ch.2011) (awarding damages of over $2 billion to minority stockholders for unfair dealing in merger); *Quickturn Design Sys., Inc. v. Shapiro,* 721 A.2d 1281 (Del.1998), *aff'g on other grounds* 728 A.2d 25 (Del.Ch.1998) (invalidating a slow-hand poison pill under 8 *Del. C.* § 141(a)); *Paramount Commc'ns Inc. v. QVC Network, Inc.,* 637 A.2d 34 (Del.1994), *aff'g* 635 A.2d 1245 (Del.Ch.1993) (enjoining most of Paramount's measures protecting its merger with Viacom in the face of a bid by QVC); *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.,* 506 A.2d 173 (Del.1986), *aff'g* 501 A.2d 1239 (Del.Ch.1985) (enjoining Revlon's measures protecting its transaction with Forstmann Little in face of a bid by MacAndrews & Forbes).

And, of course, not all cases involving strong remedies are reviewed by the Supreme Court. *E.g., In re Del Monte Foods Co. S'holders Litig.,* 25 A.3d 813 (Del.Ch.2011) (preliminarily enjoining a stockholder vote on an LBO where the sell-side bank manipulated the buy-out to generate buy-side fees, thereby extending the contractual go-shop period for an additional twenty days to allow the company to further shop itself); *In re Loral Space & Commc'ns Inc. Cons. Litig.,* 2008 WL 4293781 (Del.Ch. Sept. 19, 2008) (reforming the terms of preferred stock acquired in an interested transaction by converting those shares into non-voting common shares, a remedy that was worth at least $100 million); *Carmody v. Toll Bros., Inc.,* 723 A.2d 1180 (Del.Ch.1998) (suggesting that a so-called dead hand pill was invalid under Delaware law).

173 *E.g., Omnicare, Inc. v. NCS Healthcare, Inc.,* 818 A.2d 914 (Del.2003), *rev'g* 825 A.2d 240 *and* 825 A.2d 264 (Del.Ch.2002) (invalidating a vote lock-up); *Thorpe v. CERBCO, Inc.,* 676 A.2d 436 (Del.1996), *rev'g* 1995 WL 478954 (Del.Ch. Aug. 9, 1995) (granting a remedy for a breach of the duty of loyalty where the Court of Chancery had declined to do so on the ground that the corporation had suffered no transactional damages, and requiring the Court of Chancery to assess the interested party for the legal and other costs its actions imposed on the company); *Mills Acquisition Co. v. Macmillan, Inc.,* 559 A.2d 1261 (Del.1988), *rev'g* 1988 WL 108332 (Del.Ch. Oct. 18, 1988) (enjoining the lock-up granted by the Macmillan publishing company to Kohlberg Kravis Roberts in a unfair auction for the company); *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del.1983), *rev'g* 426 A.2d 1333 (Del.Ch.1981) (finding that UOP had to establish the entire fairness of the cash-out of the minority UOP stockholders). Famously, such strong medicine is not confined solely to enforce the duty of loyalty. *Smith v. Van Gorkom,* 488 A.2d 858 (Del.1985), *rev'g Smith v. Pritzker,* 1982 WL 8774 (Del.Ch. July 6, 1982) (requiring the imposition of monetary damages upon independent directors who approved the sale of the Trans Union company at $55 per share, a premium of 47% over the closing price of the stock the day before the merger's announcement).

174 Gilson & Gordon, *Controlling Shareholders,* at 839–40; Subramanian, *Fixing Freezeouts,* at 60–61.

175 Pls.' Br. in Opp'n 46–50; Oral Arg. Tr. 80:12–18.

176 *See In re Cox Commc'ns, Inc., S'holders Litig.,* 879 A.2d 604, 626–34 (Del.Ch.2005) (explaining that the empirical evidence offered in that case and later published in Subramanian, *Post*–Siliconix tended to show that the bargaining power of the special committee is what drives the consideration paid in going private transactions, not the standard of judicial review).

177 Weiss & White, *File Early,* at 1856–62; *see also* Suneela Jain et al., *Examining Data Points in Minority Buy–Outs: A Practitioners' Report,* 36 Del. J. Corp. L. 939 (2011) (examining twenty-seven going private transactions worth over $50 million between 2006 and 2010, and drawing conclusions consistent with Weiss & White, *File Early*).

178 *Cox,* 879 A.2d at 630–31; *In re Cysive, Inc. S'holders Litig.,* 836 A.2d 531, 550–51 (Del.Ch.2003).

179 *See, e.g.,* Settlement Hr'g, *In re Donna Karan Int'l Inc. S'holders Litig.,* C.A. No. 18559–VCS (Del. Ch. Sept. 10, 2002) (where, following an initial proposal of $8.50 per share, plaintiffs agreed to settle at $10.50 per share, but the special committee refused to consummate the transaction at that price and ultimately secured a price of $10.75 per share).

180 *See, e.g.,* Subramanian, *Post*–Siliconix, at 11 & fig. 1.

181 For example, such a condition was added at the last moment in the *Cox Communications* transaction. *Cox,* 879 A.2d at 609–12.

182 *See Williams v. Geier,* 671 A.2d 1368, 1381 (Del.1996) ("[T]he stockholders control their own destiny through informed voting. This is the highest and best form of corporate democracy.").

183 8 *Del. C.* § 262(a).

184 *E.g., Golden Telecom, Inc. v. Global GT LP,* 11 A.3d 214 (Del.2010) (affirming appraisal remedy award of $125.49 per share, as opposed to merger consideration of $105 per share); *Montgomery Cellular Hldg. Co. v. Dobler,* 880 A.2d 206 (Del.2005) (affirming appraisal remedy award of $19,621.74 per share for stockholders in short-form merger, as opposed to $8,102.23 per share in merger consideration); *M.G. Bancorporation, Inc. v. Le Beau,* 737 A.2d 513 (Del.1999) (affirming appraisal remedy award of $85 per share for dissenting minority stockholders in short-form merger, as opposed to merger consideration of $41 per share).

185 *See generally Cox,* 879 A.2d at 642–48 (suggesting why controlling stockholders can be encouraged to condition a transaction on both a vote of the minority stockholders and the approval of a special committee); *In re Pure Res., Inc., S'holders Litig.,* 808 A.2d 421, 443–44 & n. 43 (Del.Ch.2002) (same).

186 *See Moran v. Household Int'l, Inc.,* 500 A.2d 1346, 1350 (Del.1985) ("When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders...." (quoting *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946, 954 (Del.1985))).

187 *See Pure,* 808 A.2d at 445–46 (explaining the reason for this lack of clarity); Gilson & Gordon, *Controlling Shareholders,* at 805–27 (same); Subramanian, *Fixing Freezeouts,* at 11–22 (same).

188 *Cox,* 879 A.2d at 642–48; *see also In re CNX Gas Corp. S'holders Litig.,* 4 A.3d 397, 406–14 (Del.Ch.2010); *Pure,* 808 A.2d at 443–44.

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599 F.3d 298
United States Court of Appeals,
Third Circuit.

In re PHILADELPHIA NEWSPAPERS, LLC, et al.
Citizens Bank of Pennsylvania; Steering Group of Prepetition Secured Lenders, Appellants.
In re Philadelphia Newspapers, Inc.,
Official Committee of Unsecured Creditors,
Citizens Bank of Pennsylvania; Steering Group of Prepetition Secured Lenders,
Official Committee of Unsecured Creditors,
Appellant.

Nos. 09–4266, 09–4349. | Argued Dec. 15, 2009. | Filed March 22, 2010. | As Amended May 7, 2010.

Synopsis

Background: Chapter 11 debtors in possession moved for approval of bid procedures for auction sale of debtors' assets as part of liquidating Chapter 11 plan. The Bankruptcy Court, Stephen Raslavich, Chief Judge, 2009 WL 3242292, denied motion, and debtors appealed. The United States District Court for the Eastern District of Pennsylvania, Eduardo C. Robreno, J., 418 B.R. 548, reversed, and secured lenders appealed.

Holdings: The Court of Appeals, Fisher, Circuit Judge, held that:

[1] cramdown provision permitted debtors to satisfy lenders' liens against assets of bankruptcy estate by conducting sale of collateral free and clear of liens and providing secured lenders with "indubitable equivalent" of their secured claims, and

[2] cramdown provision's "indubitable equivalent" subsection unambiguously excluded lenders' right to credit bid at asset sale.

Affirmed.

Smith, Circuit Judge, filed an opinion concurring in part.

Ambro, Circuit Judge, dissented.

West Headnotes (12)

[1] **Bankruptcy**
Conclusions of law; de novo review

On appeal from district court's decision in its bankruptcy appellate capacity, the Court of Appeals exercises plenary review over the district court's conclusions of law, including matters of statutory interpretation.

1 Cases that cite this headnote

[2] **Bankruptcy**
Conclusions of law; de novo review
Bankruptcy
Discretion
Bankruptcy
Clear error

On appeal from district court's decision in its bankruptcy appellate capacity, the Court of Appeals reviews the bankruptcy court's legal determinations de novo, its factual findings for clear error, and its exercises of discretion for abuse thereof.

3 Cases that cite this headnote

[3] **Bankruptcy**
In general; nature and purpose

Chapter 11 of the Bankruptcy Code strikes a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors' interests by maximizing the value of the bankruptcy estate.

2 Cases that cite this headnote

[4] **Statutes**
Language

A court conducting statutory interpretation must begin with the statutory language.

14 Cases that cite this headnote

[5] **Statutes**
Absence of Ambiguity; Application of Clear or Unambiguous Statute or Language
Statutes
Language

Courts must presume that a legislature says in a statute what it means and means in a statute what it says there; when the words of a statute are unambiguous, then this first canon is also the last: judicial inquiry is complete.

11 Cases that cite this headnote

[6] **Statutes**
Purpose and intent; unambiguously expressed intent
Statutes
Plain, literal, or clear meaning; ambiguity

Where the statutory language is unambiguous, the court should not consider statutory purpose or legislative history.

19 Cases that cite this headnote

[7] **Statutes**
What constitutes ambiguity; how determined

In determining whether statutory language is ambiguous, the court reads the statute in its ordinary and natural sense; a provision is ambiguous only where the disputed language is reasonably susceptible of different interpretations.

12 Cases that cite this headnote

[8] **Bankruptcy**
Secured creditors, protection of

The “cramdown” process by which a reorganization plan can be confirmed over the objection of secured creditors reduces the secured claims to the present value of the collateral, while the remainder of the debt becomes unsecured, forcing the secured creditor to accept less than the full value of its claim and thereby allowing the plan to be crammed down the throats of objecting creditors. 11 U.S.C.A. § 1129(b).

6 Cases that cite this headnote

[9] **Bankruptcy**
Secured creditors, protection of

Chapter 11 cramdown provision permits debtor to satisfy lenders’ liens against assets of bankruptcy estate by conducting sale of collateral free and clear of liens and providing secured lenders with “indubitable equivalent” of their secured claims, rather than only by conducting asset sale at which lender has opportunity to “credit bid” by offsetting bid with value of lender’s secured interest in collateral; plain meaning of cramdown provision’s disjunctive language is that credit bid and “indubitable equivalent” methods are alternative paths to meeting fair and equitable test for reorganization plan’s treatment of secured claims, and although only credit bid subsection specifically mentions sales, permitting sale under broader “indubitable equivalent” method does not conflict with or render more specific credit bid subsection superfluous, but allows for other methods of conducting asset sales so long as those methods sufficiently protect the secured lenders’ interests. 11 U.S.C.A. § 1129(b)(1), (b)(2)(A).

28 Cases that cite this headnote

[10] **Statutes**
General and specific terms and provisions; ejusdem generis
Statutes
General and specific statutes

Specific statutory provisions prevail over more general provisions.

4 Cases that cite this headnote

[11] **Bankruptcy**
Secured creditors, protection of

Chapter 11 cramdown provision's "indubitable equivalent" subsection unambiguously excludes lender's right to credit bid at sale of bankruptcy estate's collateral free and clear of liens when lender is provided with the indubitable equivalent of its secured claim by reorganization plan; subsection provides no explicit right of lender to credit bid at collateral sale by offsetting bid with value of lender's secured interest, and phrase "indubitable equivalent," while broad in scope, is not unclear and means that a reorganization plan is fair and equitable if it provides the unquestionable value of a lender's secured interest in the collateral, which can come from not only cash generated by collateral sale, but other forms of compensation or security under plan of reorganization. 11 U.S.C.A. § 1129(b)(1), (b)(2)(A).

27 Cases that cite this headnote

[12] **Statutes**
What constitutes ambiguity; how determined

A term in a statute is not ambiguous merely because it is broad in scope.

1 Cases that cite this headnote

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Before AMBRO, SMITH and FISHER, Circuit Judges.

OPINION

FISHER, Circuit Judge.

We are asked in this appeal to decide whether Section 1129(b)(2)(A) of the Bankruptcy Code requires that any debtor who proposes, as part of its plan of reorganization, a sale of assets free of liens must allow creditors whose loans are secured by those assets to bid their credit at the

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auction. Because subsection (iii) of Section 1129(b)(2)(A) unambiguously permits a debtor to proceed with any plan that provides secured lenders with the "indubitable equivalent" of their secured interest in the assets and contains no statutory right to credit bidding, we will affirm the District Court's approval of the proposed bid procedures.

I.

Philadelphia Newspapers, LLC (the "Debtors[1]") own and operate the print newspapers the *Philadelphia Inquirer* and *Philadelphia Daily News* and the online publication philly.com. The Debtors acquired these assets in July 2006 for $515 million as part of an acquisition of the businesses by an investor group led by Philadelphia PR executive, Brian Tierney. $295 million of this purchase price came from a consortium of lenders who are collectively the appellants in this action (the "Lenders").[2] This loan was made pursuant to a Credit and Guaranty Agreement dated June 29, 2006, between the Lenders and the Debtors (the "Loan Agreement"). The Loan Agreement and other loan documents provide that the Lenders hold first priority liens in substantially all of the Debtors' real and personal property. The present value of the loan is approximately $318 million.

The Debtors were in default under covenants in the Loan Agreement as of December 31, 2007, and defaulted on a loan payment in September 2008. All of the Debtors besides PMH Holdings filed voluntary petitions under Chapter 11 of the Bankruptcy Code on February 22, 2009. PMH Holdings, the parent company, filed in June 2009. Currently, the Debtors control their businesses and property as debtors in possession.

On August 20, 2009, the Debtors filed a joint Chapter 11 plan of reorganization (the "Plan"). The Plan provides that substantially all of the Debtors' assets will be sold at a public auction and that the assets would transfer free of liens. Debtors simultaneously signed an asset purchase agreement with Philly Papers, LLC (the "Stalking Horse Bidder"). A majority interest in the Stalking Horse Bidder is held by the Carpenters Pension and Annuity Fund of Philadelphia and Vicinity ("Carpenters") and Bruce Toll. The Carpenters own approximately 30% of the equity in debtor PMH Holdings, LLC and Toll owned approximately 20% of the equity in PMH Holdings, LLC until the day before the asset purchase agreement was signed.

***302** Under the Plan, the purchase will generate approximately $37 million in cash for the Lenders. Additionally, the Lenders will receive the Debtors' Philadelphia headquarters which the Debtors have valued at $29.5 million, subject to a two-year rent free lease for the entity that will operate the newspapers. The Lenders would receive any cash that is generated by a higher bid at the public auction.[3]

The Debtors filed a motion for approval of bid procedures on August 28, 2009. As part of the motion, the Debtors sought to preclude the Lenders from "credit bidding" for the assets.[4] Instead, the Debtors insisted that any qualified bidder fund its purchase with cash. In their motion to the Court, Debtors stated the basis for their procedures:

> The Plan sale is being conducted under section 1123(a) and (b) of the Bankruptcy Code, and not section 363 of the Bankruptcy Code. As such, no holder of a lien on any asset of the Debtors shall be permitted to credit bid pursuant to section 363(k) of the Bankruptcy Code.
> (App.1291.) Objections to the motion were filed by the Lenders, the Creditors' Committee, the Office of the United States Trustee, the Pension Benefit Guaranty Corporations, and other creditors and debtor pension plans.

On October 8, 2009, the Bankruptcy Court issued an order refusing to bar the lenders from credit bidding. *In re Philadelphia Newspapers, LLC,* No. 09–11204, 2009 WL 3242292 (Bankr.E.D.Pa. Oct. 8, 2009). The Court reasoned that while the Plan proceeded under the "indubitable equivalent" prong of § 1129(b)(2)(A)(iii), it was structured as a § 1129(b)(2)(A)(ii) plan sale in every respect other than credit bidding. Reading § 1129(b)(2)(A) in light of other provisions of the Code—specifically §§ 363(k) and 1111(b)—the Court determined that any sale of the Debtors' assets required that a secured lender be able to participate in a sale by credit bidding its debt.

The Bankruptcy Court then approved a revised set of bid procedures without the ban on credit bidding on October 15, 2009. The revised bid procedures specifically allowed the Lenders to bid their secured debt up to $318,763,725. The Bankruptcy Court's ruling was appealed to the District Court.

On November 10, 2009, the District Court reversed the Bankruptcy Court. *In re Philadelphia Newspapers, LLC,* 418 B.R. 548 (E.D.Pa.2009) [hereinafter *Dist. Ct. slip op*.]. It disagreed with the Bankruptcy Court's interpretation of § 1129(b)(2)(A) and held that the Code provides no legal entitlement for secured lenders to credit bid at an auction sale pursuant to a reorganization plan.

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The District Court relied on the plain language of § 1129(b)(2)(A), which provides three distinct routes to plan confirmation—retention of liens and deferred cash payments under subsection (i), a free and clear sale of assets subject to credit bidding under subsection (ii), or provision ***303** of the "indubitable equivalent" of the secured interest under subsection (iii). The Court reasoned that these three routes were independent prongs, separated by the disjunctive "or," and therefore each was sufficient for confirmation of a plan as "fair and equitable" under the Code. Because the right to credit bid was not incorporated into subsection (iii), as it was in subsection (ii), Congress did not intend that a debtor who proceeded under the third prong would be required to permit credit bidding. Instead, subsection (iii) required only that a debtor provide secured lenders with the "indubitable equivalent" of their secured interest in the assets. The District Court pointed out that this broad language served as an "invitation to debtors to craft an appropriate treatment of a secured creditor's claim, separate and apart from the provisions of subsection (ii)." *Dist. Ct. slip op.* at 568. As such, "a plan sale is potentially another means to satisfy this indubitable equivalent standard." *Id.* at 568–69.

The District Court's order was appealed to us along with a motion for a stay. We granted the stay on November 17, 2009, pending resolution of this appeal on the merits.

II.

The District Court had jurisdiction under 28 U.S.C. § 158(a)(3) over the appeal from the Bankruptcy Court,[5] which had jurisdiction under 28 U.S.C. § 157(b). We have jurisdiction under 28 U.S.C. § 158(d).

[1] [2] We exercise plenary review over the District Court's conclusions of law, including matters of statutory interpretation. *In re Tower Air, Inc.,* 397 F.3d 191, 195 (3d Cir.2005) (citing *In re Prof'l Ins. Mgmt.,* 285 F.3d 268, 282–83 (3d Cir.2002)). Because the District Court sat as an appellate court to review the Bankruptcy Court's ruling, we review the Bankruptcy Court's legal determinations de novo, its factual findings for clear error, and its exercises of discretion for abuse thereof. *Id.* (citing *In re Engel,* 124 F.3d 567, 571 (3d Cir.1997)).

III.

[3] Chapter 11 of the Bankruptcy Code strikes a balance between two principal interests: facilitating the reorganization and rehabilitation of the debtor as an economically viable entity, and protecting creditors' interests by maximizing the value of the bankruptcy estate. *See In re Integrated Telecom Express, Inc.,* 384 F.3d 108, 119 (3d Cir.2004) (citing *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship,* 526 U.S. 434, 453, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1999)). In furtherance of those objectives, the Code permits a debtor preparing a Chapter 11 reorganization plan to "provide adequate means for the plan's implementation" including arranging for the "sale of all or any part of the property of the estate, either subject to or free of any lien[.]" 11 U.S.C. § 1123(a)(5)(D). We are asked in this appeal to determine what rights a secured lender has when its collateral is sold pursuant to § 1123(a)(5)(D).

As a starting point for our analysis, we note that the "plan sale" authorized by § 1123(a)(5)(D) contains no explicit procedures for the sale of assets that secure debts of the estate. Lacking direct authority, we look to the plan confirmation provision of the Code, § 1129(b), to determine what requirements the court will later have to find are satisfied in order to ***304** confirm the plan, including the asset sale. The meaning of § 1129(b), and what rights it confers on secured lenders as a matter of law, is thus the central question in this appeal. Because § 1129(b) unambiguously permits a court to confirm a reorganization plan so long as secured lenders are provided the "indubitable equivalent" of their secured interest, we will affirm the District Court.

The Lenders offer three principal arguments in support of their right to credit bid at the auction of the assets securing their loan: First, they contend that the plain language of § 1129(b)(2)(A), in light of applicable canons of statutory interpretation, requires that all sales of assets free and clear of liens must proceed under subsection (ii) of that provision, which includes the right to credit bid. Second, they argue that subsection (iii) calling for the "indubitable equivalent" of a lender's secured interest is ambiguous, requiring resort to other provisions of the Code that purportedly confirm the Lenders' right to credit bid. Finally, they argue that denying secured lenders a right to credit bid is inconsistent with other provisions of the Bankruptcy Code. We will address each argument in turn.

A. The Plain Meaning of Section 1129(b)(2)(A) Permits a Debtor to Conduct an Asset Sale Under Subsection (iii) Without Allowing Secured Lenders to Credit Bid

[4] [5] [6] It is the cardinal canon of statutory interpretation that a court must begin with the statutory language. "[C]ourts must presume that a legislature says in a statute what it means and means in a statute what it says there. When the words of a statute are unambiguous, then this first canon is also the last: judicial inquiry is complete." *Conn. Nat'l Bank v. Germain,* 503 U.S. 249, 253–54, 112 S.Ct. 1146, 117 L.Ed.2d 391 (1992) (internal citations and quotations omitted); *see also Price v. Del. State Police Fed. Credit Union,* 370 F.3d 362, 368 (3d Cir.2004) ("We are to begin with the text of a provision and, if its meaning is clear, end there."). Where the statutory language is unambiguous, the court should not consider statutory purpose or legislative history. *See AT&T, Inc. v. F.C.C.,* 582 F.3d 490, 498 (3d Cir.2009).

[7] In determining whether language is unambiguous, we "read the statute in its ordinary and natural sense." *Harvard Secured Creditors Liquidation Trust v. I.R.S.,* 568 F.3d 444, 451 (3d Cir.2009). A provision is ambiguous only where the disputed language is "reasonably susceptible of different interpretations." *Dobrek v. Phelan,* 419 F.3d 259, 264 (3d Cir.2005) (quoting *Nat'l R.R. Passenger Corp. v. Atchinson Topeka & Santa Fe Ry. Co.,* 470 U.S. 451, 473 n. 27, 105 S.Ct. 1441, 84 L.Ed.2d 432 (1985)).

[8] [9] With that framework in mind, we turn to the language of § 1129(b)(2)(A). Section 1129(b) provides circumstances under which a reorganization plan can be confirmed over the objection of secured creditors—a process referred to as a "cramdown" because the secured claims are reduced to the present value of the collateral, while the remainder of the debt becomes unsecured, forcing the secured creditor to accept less than the full value of its claim and thereby allowing the plan to be "crammed down the throats of objecting creditors." *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting,* 908 F.2d 1351, 1359 (7th Cir.1990) (Easterbrook, J.). Section 1129(b)(1) requires the court to assess whether the proposed treatment of the secured claims is "fair and equitable." 11 U.S.C. § 1129(b)(1).

***305** Section 1129(b)(2)(A) provides three circumstances under which a plan is "fair and equitable" to secured creditors:

> (A) With respect to a class of secured claims, the plan provides—
>
> > (i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property.
> >
> > (ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; **or**
> >
> > (iii)for the realization by the holders of the indubitable equivalent of such claims.

11 U.S.C. § 1129(b)(2)(A)(i)-(iii) (emphasis added).

The three subsections of § 1129(b)(2)(A) each propose means of satisfying a lender's lien against assets of the bankruptcy estate. Subsection (i) provides for the transfer of assets with the liens intact and deferred cash payments equal to the present value of the lender's secured interest in the collateral. Subsection (ii) provides for the sale of the collateral that secures a lender free and clear of liens so long as the lender has the opportunity to "credit bid" at the sale (*i.e.,* offset its bid with the value of its secured interest in the collateral) with the liens to attach to the proceeds of the sale.[6] Subsection (iii) provides for the realization of the claim by any means that provides the lender with the "indubitable equivalent" of its claim.

The Lenders concede, as they must, that § 1129(b)(2)(A) is phrased in the disjunctive. The use of the word "or" in this provision operates to provide alternatives—a debtor may proceed under subsection (i), (ii), *or* (iii), and need not satisfy more than one subsection. This approach is consistent with the definitions provided by the Code. Section 102(5) provides "that 'or' is not exclusive[.]" 11 U.S.C. § 102(5). The statutory note to § 102(5) further explains that "if a party 'may do (a) or (b)', then the party may do either or both. The party is not limited to a mutually exclusive choice between the two alternatives." 11 U.S.C. § 102 hist. n. (West 2004) (Revision Notes and Legislative Reports); *see also* H.R.Rep. No. 95–595, at 315 (1977) *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6272; S.Rep. No. 95–989, at 28 (1978) *as reprinted in* 1978 U.S.C.C.A.N. 5787, 5814. Thus, any doubt as to whether subsections (i), (ii), and (iii) were meant to be alternative paths to meeting the fair and equitable test of § 1129(b)(2)(A) is resolved by the Bankruptcy Code itself, and courts have followed this uncontroversial mandate. ***306** *See, e.g., Pacific Lumber,* 584 F.3d at 245 (affirming "the obvious proposition that because the three

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subsections of § 1129(b)(2)(A) are joined by the disjunctive 'or,' they are alternatives"); *Wade v. Bradford,* 39 F.3d 1126, 1130 (10th Cir.1994) ("These requirements [of § 1129(b)(2)(A)] are written in the disjunctive, requiring the plan to satisfy only one before it could be confirmed over creditor's objection."); *In re Brisco Enters., Ltd. II,* 994 F.2d 1160, 1168 (5th Cir.1993) (holding that the court "has not transformed the 'or' in 1129(b)(2)(A) to an 'and' "); *accord Corestates Bank, N.A. v. United Chem. Techs., Inc.,* 202 B.R. 33, 50 (E.D.Pa.1996) ("Courts consider Congresses' use of the disjunctive 'or' between subsections (i), (ii), and (iii) indicative of Congressional intent that only one of the three subsections need be satisfied in order to find a plan fair and equitable.").

Though the ordinary operation of the word "or" is not genuinely disputed among the parties,[7] the Lenders rely on a traditional canon of statutory interpretation—that the specific term prevails over the general term—to argue that a plan sale of assets free and clear of liens must comply with the more specific requirements of subsection (ii). In other words, the proposed treatment of collateral determines which of the § 1129(b)(2)(A) alternatives is applicable. Under this interpretation, any Chapter 11 plan proposing the transfer of assets encumbered by their original liens must proceed under subsection (i), any plan proposing the free and clear sale of assets must proceed under subsection (ii), and only those plans proposing a disposition not covered by subsections (i) and (ii), most notably the substitution of collateral, may then proceed under subsection (iii). This reasoning dictates that, because the Plan includes a sale of collateral free and clear of liens, the Lenders would have a statutory right to credit bid pursuant to the express terms of subsection (ii).

[10] It is "a well-settled maxim that specific statutory provisions prevail over more general provisions." *In re Combustion Eng'g,* 391 F.3d 190, 237 n. 49 (3d Cir.2004). In *Combustion Engineering,* we applied this principle to hold that the broad equitable authority granted to bankruptcy courts by § 105(a) to issue "any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title," 11 U.S.C. § 105(a), could not be used to circumvent the express limitations of § 524(g), which enumerated limited circumstances under which the court could enjoin suits against non-debtors whose asbestos liabilities were derivative of the debtor's, ***307** 11 U.S.C. § 524(g)(4)(a)(ii). Accordingly, we vacated an injunction precluding suit against non-debtors whose liabilities did not fall within those articulated in § 524(g), notwithstanding the court's more general equitable authority under § 105(a).

However, the Supreme Court has cautioned that "[t]o apply a canon properly one must understand its rationale." *Varity Corp. v. Howe,* 516 U.S. 489, 511, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996). The principle motivating the outcome in *Combustion Engineering* was "a warning against applying a general provision when doing so would undermine *limitations* created by a more specific provision." 391 F.3d at 237 n. 49 (quoting *Varity Corp.,* 516 U.S. at 511, 116 S.Ct. 1065) (emphasis added). Thus, the principle is only applicable here if we find that the specificity of subsection (ii) operates as a limitation on the broader language in subsection (iii). We believe it does not.

The Supreme Court has addressed a nearly identical argument, albeit under a different statutory scheme, and held that a specific enumeration followed by a broader "catchall" provision does not require application of the more specific provision. *Varity Corp.,* 516 U.S. at 511–12, 116 S.Ct. 1065. The question in *Varity Corp.* was whether § 502(a)(3) of ERISA authorized individual relief when plan beneficiaries sued for breach of fiduciary duty. ERISA's remedial provision provides, in relevant part:

> Sec. 502. (a) A civil action may be brought—...
>
> (2) by the Secretary, or by a participant, beneficiary or fiduciary for appropriate relief under section 1109 of this title; [or]
>
> (3) by a participant, beneficiary, or fiduciary (A) to enjoin any act or practice which violates any provision of this subchapter or the terms of the plan, or (B) to obtain other appropriate equitable relief (i) to redress such violations or (ii) to enforce any provisions of this subchapter or the terms of the plan[.]

29 U.S.C. § 1132(a). Section 1109, describing the relief available under subsection (2), is titled "Liability for Breach of Fiduciary Duty" and provides that any individual who breaches a fiduciary duty is personally liable to "make good to such plan any losses to the plan." 29 U.S.C. § 1109(a). Prior Supreme Court analysis made clear that this language limited relief to restitution to the plan, and thereby precluded individual relief under § 1109(a). *See Mass. Mut. Life Ins. Co. v. Russell,* 473 U.S. 134, 144, 105 S.Ct. 3085, 87 L.Ed.2d 96 (1985). Plaintiffs, as participants and beneficiaries of the plan, sued Varity under subsection (3) alleging breach of fiduciary duty and seeking individual equitable relief.

The argument advanced by Varity mirrored the argument advanced by the Lenders here: Varity argued that, because subsection (2) specifically pertains to breaches of fiduciary duty, and because it incorporates the § 1109(a)

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prohibition on individual recovery, the plaintiffs could not avail themselves of the more general subsection (3) when their suit was premised on breach of fiduciary duty. To permit as much, Varity argued, was to allow a circumvention of subsection (2)'s restrictions on individual relief.

The Supreme Court rejected this argument. Considering the application of the canon "the specific governs the general," the Court reasoned that it only applied where the more specific provision clearly placed a limitation on the general. 516 U.S. at 511, 116 S.Ct. 1065. The Court observed no such limitation in the narrower provision of subsection (2):

> To the contrary, one can read [§ 1109] as reflecting a special congressional concern ***308** about plan asset management without also finding that Congress intended that section to contain the exclusive set of remedies for every kind of fiduciary breach.... Why should we not conclude that Congress provided yet other remedies for yet other breaches of other sorts of fiduciary obligations in another, "catchall" remedial section?

Id. at 511–12, 116 S.Ct. 1065. The plaintiffs were thus permitted to proceed under subsection (3) and seek individual equitable relief for the alleged breach of fiduciary duty.

The Court's reasoning in *Varity Corp.* helps to resolve our inquiry into the relationship between the subsections of § 1129(b)(2)(A). Although subsection (ii) specifically refers to a "sale" and incorporates a credit bid right under § 363(k), we have no statutory basis to conclude that it is the only provision under which a debtor may propose to sell its assets free and clear of liens. While the proposed disposition of assets in subsection (ii) may reflect "a special congressional concern" about the free and clear transfer of collateral that secures a loan, *Varity Corp.,* 516 U.S. at 511, 116 S.Ct. 1065, this does not lead inexorably to the conclusion that Congress meant for subsection (ii) to be the exclusive means through which such collateral is transferred. Just as the Court in *Varity Corp.* concluded that the "catchall" provision permitted "yet other remedies for yet other breaches of other sorts of fiduciary obligations," 516 U.S. at 512, 116 S.Ct. 1065, it is apparent here that Congress' inclusion of the indubitable equivalence prong intentionally left open the potential for yet other methods of conducting asset sales, so long as those methods sufficiently protected the secured creditor's interests. *Accord In re CRIIMI MAE, Inc.,* 251 B.R. 796, 807 (Bankr.D.Md.2000) ("11 U.S.C. § 1129(b)(2)(A) plainly indicates that subsections (i), (ii) and (iii) are to be treated as distinct alternatives. As a result, the provisions are not in conflict and the ['specific governs the general'] rule of construction is inapplicable.").[8]

The Lenders' argument in this regard elevates form over substance. A proposed plan of reorganization, even one that fully compensates lenders for their secured interest, would necessarily fail under their ***309** reading if the plan proposed a free and clear asset sale without complying with the additional requirements of subsection (ii). Reading the statute in this manner significantly curtails the ways in which a debtor can fund its reorganization—an outcome at odds with the fundamental function of the asset sale, to permit debtors to "provide adequate means for the plan's implementation." 11 U.S.C. § 1123(a)(5)(D); *see also Varity Corp.,* 516 U.S. at 513, 116 S.Ct. 1065 (rejecting a limited reading of the "catchall" provision because "ERISA's basic purposes favor a reading of the third subsection that provides the plaintiffs with a remedy").

The Fifth Circuit in *Pacific Lumber,* 584 F.3d 229, reached this same conclusion. The transaction in *Pacific Lumber* was an inside transfer of assets to the reorganized entities, free and clear of the liens, which the Fifth Circuit determined was a sale under the Code. *Id.* at 245. In exchange, the secured lenders received the full cash equivalent of their undersecured claims but were not permitted to bid their credit to attain possession of the assets. The secured lenders objected to the confirmation of the plan based on their inability to credit bid.

In analyzing the confirmation, the Fifth Circuit required the creditors to "do more than show that Clause (ii) theoretically applied to this transaction. They have to demonstrate its exclusive applicability." *Id.* The court reasoned that the creditors could not demonstrate the exclusive application of subsection (ii) because the three subsections of § 1129(b)(2)(A) were "alternatives" and "not even exhaustive" of the ways in which a debtor might satisfy the "fair and equitable" requirement. *Id.* Thus, even though the debtors' proposed asset transfer was a "sale" under the Code, the court did not limit the debtors to confirmation under subsection (ii). *Id.* at 245–46. Rather, the court looked to whether the transaction satisfied the requirements of subsection (iii). *Id.* at 246. Because the proposed cash payout of the value of the collateral provided the secured lenders with the "indubitable equivalent" of their claims, the plan was confirmable under subsection (iii) notwithstanding its

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structure as an asset sale and the exclusion of the secured lenders' right to credit bid. *Id.* at 246–47.

The court's approach in *Pacific Lumber* focuses on fairness to the creditors over the structure of the cramdown. Under the scheme proposed by the Lenders, because the *Pacific Lumber* plan involved a sale of assets, the debtor would be *required* to proceed under subsection (ii); and, if it could not meet the subsection (ii) requirements, then the plan could not be confirmed. The Fifth Circuit instead took the more flexible approach, consistent with the disjunctive nature of the statute, that a plan could be confirmed so long as it met any one of the three subsections' requirements, regardless of whether the plan's structure more closely resembled another subsection. *Id.; accord Corestates Bank,* 202 B.R. at 50 (holding that a plan permitting retention of liens on some but not all collateral could not proceed under subsection (i) and remanding for consideration of whether the plan provided the indubitable equivalent under subsection (iii)); *CRIIMI MAE,* 251 B.R. at 806 (rejecting argument that "no plan that contemplates the sale of collateral of a dissenting class of secured claims can be found 'fair and equitable' unless it complies with section 1129(b)(2)(A)(ii)").

This approach recognizes that Congress' use of "or" in § 1129(b)(2)(A) was not without purpose. A plan of reorganization cannot be confirmed over the objection of secured lenders unless it is "fair and equitable." 11 U.S.C. § 1129(b)(1). To guide ***310** courts in interpreting that standard, Congress provided examples: a transfer of lien-encumbered assets with deferred cash payments, a free and clear sale of assets subject to credit bidding, or any other disposition that provides lenders with the "indubitable equivalent" of their secured interest. The final option elevates fair return to the lenders over the methodology the debtor selects to achieve that return, and invites debtors "to craft an appropriate treatment of a secured creditor's claim, separate and apart from the provisions of subsection (ii)." *Dist. Ct. slip op.* at 568. We have no statutory basis for concluding that such flexibility, consistent with both the language and purpose of the Code, should be curtailed.

B. Subsection (iii)'s "Indubitable Equivalent" Language Unambiguously Excludes the Right to Credit Bid

[11] Next, the Lenders argue that the term "indubitable equivalent" is ambiguously broad and we should therefore resort to other canons of statutory construction to determine whether a sale of collateral in the absence of credit bidding can ever provide the "indubitable equivalent" of the secured interest.

The term "indubitable equivalent," while infrequently employed in popular parlance, was not plucked from the congressional ether. Judge Learned Hand first coined the phrase "indubitable equivalent" in his opinion *In re Murel Holding Corp.,* 75 F.2d 941, 942 (2d Cir.1935). In that opinion, Judge Hand rejected a debtor's offer to repay the balance of a secured debt in a balloon payment ten years after plan confirmation with interim interest payments but no requirements to protect the collateral. Judge Hand reasoned that, under the Bankruptcy Act of 1898, a secured creditor could not be deprived of his collateral "unless by a substitute of the most indubitable equivalence." *Id.* This phrase was later added to the Bankruptcy Code. The phrase, as the Fifth Circuit noted, is "rarely explained in caselaw, because most contested reorganization plans follow familiar paths outlined in Clauses (i) and (ii)." *Pacific Lumber,* 584 F.3d at 246.

[12] As a general matter of statutory construction, a term in a statute is not ambiguous merely because it is broad in scope. *See Penn. Dep't of Corrections v. Yeskey,* 524 U.S. 206, 212, 118 S.Ct. 1952, 141 L.Ed.2d 215 (1998). In employing intentionally broad language, Congress avoids the necessity of spelling out in advance every contingency to which a statute could apply. *See Sedima, S.P.R.L. v. Imrex Co.,* 473 U.S. 479, 499, 105 S.Ct. 3275, 87 L.Ed.2d 346 (1985) (holding that the fact that a statute can be "applied in situations not expressly anticipated by Congress does not demonstrate ambiguity. It demonstrates breadth.").

Though broad, the phrase "indubitable equivalent" is not unclear. Indubitable means "not open to question or doubt," *Webster's Third New Int'l Dictionary* 1154 (1971), while equivalent means one that is "equal in force or amount" or "equal in value," *id.* at 769. The Code fixes the relevant "value" as that of the collateral. *See* 11 U.S.C. § 1129(b)(2)(A)(iii) (requiring the "indubitable equivalent" of the secured claim); *id.* § 506(a) (defining a secured claim as "the extent of the value of such creditor's interest in the estate's interest in such property"). Thus the "indubitable equivalent" under subsection (iii) is the unquestionable value of a lender's secured interest in the collateral.

Further, the scope of the "indubitable equivalent" prong is circumscribed by the same principles that underlie subsections (i) and (ii), specifically, the protection of a ***311** fair return to secured lenders.[9] As the Fifth Circuit reasoned:

> Congress did not adopt indubitable equivalent as a

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> capacious but empty semantic vessel. Quite the contrary, these examples focus on what is really at stake in secured credit: repayment of principal and the time value of money. Clauses (i) and (ii) explicitly protect repayment to the extent of the secured creditors' collateral value and the time value compensating for the risk and delay of repayment. Indubitable equivalent is therefore no less demanding a standard than its companions.
>
> *Pacific Lumber,* 584 F.3d at 246.

Applying this standard, courts have concluded in a variety of circumstances that a debtor has provided the "indubitable equivalent" of a secured lender's claim. *See id.* at 246 (holding a cash payout satisfied the "indubitable equivalent" prong); *In re Sun Country,* 764 F.2d 406, 409 (5th Cir.1985) (holding 21 notes secured by 21 lots of land was the "indubitable equivalent" of a first lien on a 200 acre lot); *accord CRIIMI MAE,* 251 B.R. at 807–08 (holding exchange of collateral satisfied the "indubitable equivalent" prong); *see also* Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down under the Bankruptcy Code,* 53 Am. Bankr.L.J. 133, 156 (1979) (hypothesizing that "[a]bandonment of the collateral to the class would satisfy [indubitable equivalent], as would a replacement lien on similar collateral").

Because we decline to hold that subsection (iii) is ambiguous, the Lenders may only assert a right to credit bid under subsection (iii) if that right is contained in the plain language of the statute. Section 1129(b)(2)(A)(iii) states that a plan of reorganization is fair and equitable if it provides "for the realization by the holders of the indubitable equivalent of [allowed secured] claims." Subsection (iii), unlike subsection (ii), incorporates no reference to the right to credit bid created in § 363(k). A plain reading of § 1129(b)(2)(A)(iii) therefore compels the conclusion that, when a debtor proceeds under subsection (iii), Congress has provided secured lenders with no right to credit bid at a sale of the collateral.

The Lenders counter this conclusion by arguing that, even if subsection (iii) contains no explicit right to credit bid, that right is necessary to providing secured lenders with the "indubitable equivalent" of their claims. This argument is premised on our decision in *In re SubMicron Systems Corp.,* 432 F.3d 448 (3d Cir.2006), where we held that credit bidders in a § 363(b) sale could bid up to the full value of their loan, and that the amount of the credit bid became the value of the lender's secured interest in the collateral. In light of *SubMicron,* the Lenders ask us to hold that a secured lender who is not allowed to credit bid can never receive the "indubitable equivalent" of its secured interest because its credit bid sets the value of the collateral.

The Lenders' argument is well-taken that determining whether a secured lender has received the full value of its interest in the collateral is more complicated when the collateral undersecures the debt. To illustrate the distinction: A lender who makes a loan of $100 secured by a lien against a truck worth $500 indisputably has a secured interest of $100. If the value of the truck depreciates such that, at the time of bankruptcy, the truck is worth ***312** less than $100, then the lender has a secured interest only up to the "value" of the truck. The source of this "value" is central to this dispute to the extent that it informs whether a lender has received the indubitable equivalent of its secured interest.

SubMicron is consistent with our analysis in this case. Our holding that a credit bid sets the value of a lender's secured interest in collateral does not equate to a holding that a credit bid must be the successful bid at a public auction. Rather, a court is called at plan confirmation to determine only whether a lender has received the "indubitable equivalent" of its secured interest. Logically, this can include not only the cash value generated by the public auction, but other forms of compensation or security such as substituted collateral or, as here, real property. In other words, it is the plan of reorganization, and not the auction itself, that must generate the "indubitable equivalent." For this reason, the District Court noted that Lenders "retain the right to argue at confirmation, if appropriate, that the restriction on credit bidding failed to generate fair market value at the Auction, thereby preventing them from receiving the indubitable equivalent of their claim." *Dist. Ct. slip op.* at 574–75.

Although the Lenders contend that our approach here is anomalous, the case law favors the Debtors. While the reasoning in the myriad cases touching upon this issue is admittedly inconsistent, no case cited by the Lenders reaches the conclusion they advance here: that credit bidding is required when confirmation is sought under subsection (iii). *See, e.g., In re River Village,* 181 B.R. 795, 805 (E.D.Pa.1995) (permitting credit bidding in a § 363(b) pre-confirmation sale but confirming the reorganization under subsection (i)); *In re California Hancock,* 88 B.R. 226, 230 (9th Cir.BAP1988) (requiring credit bidding where confirmation was sought under subsection (i)). Rather, most cases addressing the right to credit bid have concluded, in keeping with the express language of the statute, that such right arises when confirmation is sought under subsection (ii). *See, e.g., In re Kent Terminal,* 166 B.R. 555, 566–67 (Bankr.S.D.N.Y.1994) (holding that "the lienholder has the unconditional right to bid in its lien" under subsection

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(ii)).

On the other hand, the Fifth Circuit has specifically addressed whether a lender had a right to credit bid under subsection (iii) and concluded that it did not. *See Pacific Lumber,* 584 F.3d at 246. As discussed above, the court in *Pacific Lumber* confirmed a sale of assets at private auction by determining that the cash payout to the noteholders provided the "indubitable equivalent" of their secured interest in the assets, notwithstanding a provision barring secured lenders from credit bidding. 584 F.3d at 246. Though *Pacific Lumber* was a plan confirmation case, its holding on the threshold requirements of § 1129(b)(2)(A) speaks to our inquiry here—specifically, that a debtor may proceed with a sale under subsection (iii) without permitting secured lenders to credit bid. *Accord CRIIMI MAE,* 251 B.R. at 807 (reasoning that § 1129(b)(2)(A) permitted a debtor to proceed with a sale free and clear of liens under subsection (ii) or (iii), and that because only subsection (ii) required credit bidding, a sale that proceeded under subsection (iii) need only satisfy the "indubitable equivalent" requirement).

This rule, which proceeds from the plain language of the statute, is not akin to guaranteeing plan confirmation. We are asked here not to determine whether the "indubitable equivalent" would necessarily be satisfied by the sale; rather, we are ***313** asked to interpret the requirements of § 1129(b)(2)(A) as a matter of law. This distinction is critical. The auction of the Debtors' assets has not yet occurred. Other public bidders may choose to submit a cash bid for the assets. The value of the real property that the Lenders will receive, in addition to cash, under the terms of the proposed plan has not yet been established. And the secured claim itself has not yet been judicially valued under § 506(a).[10] We are simply not in a position at this stage to conclude, as a matter of law, that this auction cannot generate the indubitable equivalent of the Lenders' secured interest in the Debtors' assets. We approve the proposed bid procedures with full confidence that such analysis will be carefully and thoroughly conducted by the Bankruptcy Court during plan confirmation, when the appropriate information is available.

Finally, in holding that § 1129(b)(2)(A) is not ambiguous, we are cognizant of our dissenting colleague's strenuous admonition that two esteemed courts below have reached opposite, and presumably "reasonable," interpretations of this statutory language. *Dissent op.* Part II. However, as Justice Thomas has observed, "[a] mere disagreement among litigants over the meaning of a statute does not itself prove ambiguity; it usually means that one of the litigants is simply wrong." *Bank of A. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship,* 526 U.S. 434, 461, 119 S.Ct. 1411, 143 L.Ed.2d 607 (1991) (Thomas, J., concurring). The same is true of disagreements among courts. *See, e.g., In re Ford,* 574 F.3d 1279, 1293 (10th Cir.2009) ("Case law (including this very opinion) shows that courts can reasonably disagree on the meaning of the term under various state laws. But the plain language of [this provision] is clear, making resort to its legislative history unnecessary and potentially misleading."). We decline to hold that a statutory provision is ambiguous as a matter of law merely because two admittedly well-reasoned opinions below reached opposite conclusions. Were this the case, this Court would never be permitted to reverse on plain language grounds a district court's holding that a provision is ambiguous because the district court's reasonable disagreement would itself create an ambiguity. Clearly this is not the case. *See, e.g., First Merchants Acceptance Corp. v. J.C. Bradford & Co.,* 198 F.3d 394, 398 (3d Cir.1999) (reversing district court holding, following California Bankruptcy Court opinion, that 11 U.S.C. § 503(b)(4) was ambiguous, holding instead that statutory language was subject to only one reasonable interpretation).

Because the language of § 1129(b)(2)(A) is unambiguous—both as to the non-exclusive enumeration of permissible treatments of secured claims, and the inclusion of a broad but not meaningless option to ***314** provide the "indubitable equivalent" of secured interests—we will affirm the District Court.

C. The Plain Meaning of § 1129(b)(2)(A) is Not Inconsistent with Congressional Intent

Our opinion could stop with a plain language analysis, however, we are cognizant that the Supreme Court has recognized a narrow exception to the plain meaning rule in the "rare cases [where] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." *United States v. Ron Pair Enters., Inc.,* 489 U.S. 235, 242, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989); *see also Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 571, 102 S.Ct. 3245, 73 L.Ed.2d 973 (1982) (permitting a "restricted rather than a literal or usual meaning of [statutory] words where acceptance of that meaning ... would thwart the obvious purpose of the statute"); *Morgan v. Gay,* 466 F.3d 276, 277–78 (3d Cir.2006) (noting "in that rare instance where it is uncontested that legislative intent is at odds with the literal terms of the statute, then a court's primary role is to effectuate the intent of Congress even if a word in the statute instructs otherwise").[11] Generally, where the text of a statute is unambiguous, the statute should be enforced as written and "[o]nly the most extraordinary showing of contrary intentions in the legislative history will justify a

departure from that language." *United States v. Albertini,* 472 U.S. 675, 680, 105 S.Ct. 2897, 86 L.Ed.2d 536 (1985) (internal quotation omitted). We find no extraordinary showing of contrary intent that warrants deviation from the plain text of the statute.

The bulk of the Lenders' arguments, as well as the weight of the Bankruptcy Court's reasoning, rely on the way in which §§ 1111(b) and 363(k) inform a lender's right to credit bid at the sale of the debtor's assets. The Lenders argue that the Code guarantees a secured lender one of two rights—either the right to elect to treat their deficiency claims as secured under § 1111(b) or the right to bid their credit under § 363(k). Because the Lenders are statutorily precluded from making a § 1111(b) election,[12] they contend that they must be afforded the right to credit bid at the auction.

A summary of the relevant statutory provisions informs our analysis. Section 363 establishes certain rights and procedures in connection with, *inter alia,* the sale of debtor assets. Section 363(b) provides that the trustee "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b). Such a sale is subject to the secured lender protections of § 363(k), which provide that:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. § 363(k). As discussed above, this is commonly referred to as the right ***315** to "credit bid" and is incorporated by reference into § 1129(b)(2)(A)(ii).

Section 1111(b) covers the treatment of certain claims and interests of bankruptcy creditors, and provides unique protections to undersecured lenders.[13] Specifically § 1111(b)(1)(A) is an exception to the general rule that creditors who do not have recourse to the debtor are entitled to nothing more than the realization of their collateral. Under § 1111(b), Congress provided the option for nonrecourse creditors to have their deficiency claims treated as secured debt. This is a deviation from the process provided for in § 506(a), under which the claim of an undersecured creditor is divided into: (1) a secured claim equal to the court-determined value of the collateral securing the claim, and (2) an unsecured claim for the deficiency. 11 U.S.C. § 506(a)(1). A nonrecourse creditor who makes a § 1111(b) election would be permitted to treat its deficiency claim as secured. 11 U.S.C. § 1111(b)(2).

The § 1111(b) election is not available to recourse creditors when the property is sold under § 363 or under a plan of reorganization. 11 U.S.C. § 1111(b)(1)(B)(ii). As recourse creditors whose collateral is being sold under a plan, the Lenders are not eligible to make a § 1111(b) election. They argue that the exemption of secured recourse creditors from the § 1111(b) election is limited to situations in which they have the opportunity to credit bid: specifically, a § 363 sale, under which their right to credit bid is preserved by § 363(k), and a plan of reorganization, under which their right to credit bid is incorporated into § 1129(b)(2)(A)(ii). The import of these two exceptions, according to the Lenders, is that Congress clearly intended that any sale of collateral—whether under § 363 or a plan of reorganization—would permit credit bidding by secured lenders.

This argument fails in light of the plain language and operation of the Code. As an initial matter, the Code plainly contemplates situations in which estate assets encumbered by liens are sold without affording secured lenders the right to credit bid. The most obvious example arises in the text of § 363(k), under which the right to credit bid is not absolute. A secured lender has the right to credit bid "unless the court for cause orders otherwise." 11 U.S.C. § 363(k). In a variety of cases where a debtor seeks to sell assets pursuant to § 363(b), courts have denied secured lenders the right to bid their credit. *See In re Aloha Airlines,* No. 08–00337, 2009 WL 1371950, at *8 (Bankr.D.Hawaii May 14, 2009) (determining that "cause ***316** exists to deny the credit bid" under § 363(k)); *Greenblatt v. Steinberg,* 339 B.R. 458, 463 (N.D.Ill.2006) (holding the "bankruptcy court did not err in refusing to allow [a secured creditor] to credit bid"); *In re Antaeus Technical Servs., Inc.,* 345 B.R. 556, 565 (Bankr.W.D.Va.2005) (denying right to credit bid to facilitate "fully competitive" cash auction); *In re Theroux,* 169 B.R. 498, 499 n. 3 (Bankr.D.R.I.1994) (noting that "there is no absolute entitlement to credit bid").[14]

At the heart of the Lenders' argument is the notion that the combined import of § 1111(b) and § 363(k) is a special protection afforded to secured lenders to recognize some value greater than their allowed secured claim—either by treating their unsecured claim as a secured deficiency claim under § 1111(b), or bidding their

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credit under § 363(k) in hopes of realizing a potential upside in the collateral. Asserting an absolute right to such preferential treatment is plainly contrary to other provisions of the Code, which limit a secured lender's recovery to the value of its secured interest even when it is not permitted to make a § 1111(b) election.[15] For instance, if a debtor proceeds with a sale of encumbered assets under subsection (i), there is no § 1111(b) election because the assets are "sold under the plan." 11 U.S.C. § 1111(b)(1)(a)(ii). However, § 1129(b)(2)(A)(i)(I) still caps the transferred lien at the value of the lender's allowed secured claim, as established by judicial valuation under § 506(a). The deferred cash payments under § 1129(b)(2)(A)(i)(II), are also limited to the present value of the deferred payments. Thus when a debtor proceeds under subsection (i), a lender who is ineligible to make a § 1111(b) election is still limited in its recovery to the judicial valuation of its secured interest in the collateral.

As the court noted in *Pacific Lumber,* a secured lender's expectation of benefitting from the eventual appreciation of collateral (the so-called "upside" of the collateral) is not an entitlement when the property is part of a bankruptcy estate:

> The Bankruptcy Code ... does not protect a secured creditor's upside potential; it protects the "allowed secured claim." If a creditor were over-secured, it could not demand to keep its collateral rather than be paid in full simply to protect the "upside potential."

Pacific Lumber, 584 F.3d at 247. Rather, the Code provides for a variety of treatments of secured claims, all of which are calculated to balance the interests of the secured lender and the protection of the ***317** reorganized entity, and none of which ensure an advantageous return on a secured investment. These powers are necessary to allow the debtor to "emerge from bankruptcy with property cleansed of all hidden liens, ensuring that future businesses will transact with the reorganized entity without fear that an unanticipated creditor will emerge with a superior interest in purchased property." *In re Airadigm Comms., Inc.,* 519 F.3d 640, 649 (7th Cir.2008).

Because our plain reading of § 1129(b)(2)(A) is not at odds with the operation of §§ 1111(b) and 363(k), we may only consider the legislative history advanced by the Lenders if it evidences an "extraordinary showing of contrary intentions" by Congress. *Albertini,* 472 U.S. at 680, 105 S.Ct. 2897; *see also Hay Group, Inc. v. E.B.S. Acquisition Corp.,* 360 F.3d 404, 406 (3d Cir.2004) ("The Supreme Court has repeatedly explained that recourse to legislative history or underlying legislative intent is unnecessary when a statute's text is clear and does not lead to an absurd result." (internal citation omitted)). There is no such "extraordinary showing" here.

The specific history on which the Lenders rely is a congressional statement made in connection with the enactment of § 1111(b). In that statement, Representative Edwards noted:

> Sale of property under section 363 or under a plan is excluded from treatment under section 1111(b) because of the secured party's right to credit bid in the full amount of its allowed claim at any sale of collateral under section 363(k) of the House Amendment.

124 Cong. Rec. 31795, 32407 (Sept. 28, 1978); 124 Cong. Rec. 33130, 34007 (identical remarks of Senator DeConcini). The Lenders contend that this statement reflects Congressional intent to ensure that secured lenders who could not make a § 1111(b) election had the ability to credit bid under § 363(k).

The present dispute aside, this statement ignores at least two uncontroverted circumstances, explained above, where a secured creditor has neither a right to make a § 1111(b) election, nor a right to credit bid under § 363(k): a transfer of encumbered assets under § 1129(b)(2)(A)(i)(I) and a for-cause exception to credit bidding under § 363(k). Given that this legislative history ignores these vital functions of the Code, we cannot credit it over the plain language of the statute to confer an absolute right to credit bid on all asset sales under § 1129(b)(2)(A).

Ultimately, we are left where we began—where the statutory directive is clear we are bound to enforce that directive. To the extent this holding permits a course of conduct not contemplated or not desirable under the Code, as the Lenders argue it does, it is the sole province of Congress to amend a statute that carries out by its plain language an undesirable end. *See Lamie v. U.S. Trustee,* 540 U.S. 526, 538, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004) ("Our unwillingness to soften the import of Congress' chosen words even if we believe the words lead to a harsh outcome is longstanding.").

Finally, our holding here only precludes a lender from

asserting that it has an absolute right to credit bid when its collateral is being sold pursuant to a plan of reorganization. Both the District Court below and the Fifth Circuit in *Pacific Lumber* contemplated that, in some instances, credit bidding may be required. *See* 584 F.3d at 247. In addition, a lender can still object to plan confirmation on a variety of bases, including that the absence ***318** of a credit bid did not provide it with the "indubitable equivalent" of its collateral.[16]

IV.

Accordingly, we agree with the District Court and the Fifth Circuit that § 1129(b)(2)(A) is unambiguous and that a plain reading of its provisions permits the Debtors to proceed under subsection (iii) without allowing the Lenders to credit bid. Because we are directed to cease our inquiry when we are satisfied that the applicable statutory language is unambiguous, we will affirm the District Court on those grounds.

SMITH, Circuit Judge, concurring.

Judge Fisher has written well, and convincingly, and I join his opinion without reservation—save for section III(C). I write separately because recourse to legislative history, as occurs in section III(C), is unnecessary as the statutory language of § 1129(b)(2)(A) is unambiguous. "[R]ecourse to legislative history or underlying legislative intent is unnecessary when a statute's text is clear and does not lead to an absurd result." *Hay Group, Inc. v. E.B.S. Acquisition Corp.,* 360 F.3d 404, 406 (3d Cir.2004) (internal quotation marks omitted); *Lamie v. United States Tr.,* 540 U.S. 526, 534, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004); *AT&T Inc. v. Fed. Commc'ns Comm'n,* 582 F.3d 490, 496–98 (3d Cir.2009); *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery,* 330 F.3d 548, 559 (3d Cir.2003) (en banc); *United States ex rel. Mistick PBT v. Housing Auth. of the City of Pittsburgh,* 186 F.3d 376, 395 (3d Cir.1999); *see United States v. Terlingo,* 327 F.3d 216, 221 n. 1 (3d Cir.2003) (Becker, J.) ("[W]e may only look to legislative history if [the] plain meaning produces a result that is not just unwise but is clearly absurd.") (internal quotation marks omitted); *see also* *Mitchell v. Horn,* 318 F.3d 523, 535 (3d Cir.2003) (Ambro, J.) ("We do not look past the plain meaning unless it produces a result demonstrably at odds with the intentions of its drafters ... or an outcome so bizarre that Congress could not have intended it [.]") (internal quotation marks and citations omitted). This approach to statutory interpretation "respects the words of Congress" and "avoid[s] the pitfalls that plague too quick a turn to the more controversial realm of legislative history." *Lamie,* 540 U.S. at 536, 124 S.Ct. 1023.

I sympathize with the dissent's desire to honor what it believes was Congress's intent in codifying § 1129(b)(2)(A).[1] But the ***319** near-gymnastics required to reach its conclusion reveal the tenuous nature of this approach. As sensible as the dissent's approach to credit bidding may be, I simply cannot look past the statutory text, which plainly supports the conclusion that § 1129(b)(2)(A) does not require credit bidding in plan sales of collateral free of liens. Section 1129(b)(2)(A) uses the word "or" to separate its subsections. " '[O]r' is not exclusive[.]" 11 U.S.C. § 102(5). Thus, satisfaction of *any* of the three subsections is sufficient to meet the fair and equitable test of § 1129(b)(2)(A). "Congress, of course, remains free to change [our] conclusion [regarding § 1129(b)(2)(A)] through statutory amendment." *Small v. United States,* 544 U.S. 385, 394, 125 S.Ct. 1752, 161 L.Ed.2d 651 (2005); *Lamie,* 540 U.S. at 542, 124 S.Ct. 1023 ("If Congress enacted into law something different from what it intended, then it should amend the statute to conform it to its intent."). For now, we are required to apply the statute as written, and I am satisfied that its plain text amply supports the result reached by the majority.

AMBRO, Circuit Judge, dissenting.

Although few in the first 30 years of Bankruptcy Code jurisprudence read it that way, the majority today holds that 11 U.S.C. § 1129(b)(2)(A)(ii) is not the exclusive method through which a debtor can cram down a plan calling for the sale of collateral free of liens. I am convinced this is not what Congress intended when it drafted the Bankruptcy Code.

Though I do not impugn as implausible my colleagues' reasoning otherwise, I cannot agree that the plain language of § 1129(b)(2)(A) is unambiguous and compels the sole interpretive conclusion they see as the plain meaning of the words. There is more than one reasonable reading of the statute, and thus we cannot simply look to its text alone in determining what Congress meant in enacting it. When we apply long-established canons of statutory interpretation to § 1129(b)(2)(A), examine it in the context of the entire Bankruptcy Code, and look at the section's legislative history and the comments of Code drafters, they all point to the conclusion that the Code requires cramdown plan sales free of liens to fall under the specific requirements of § 1129(b)(2)(A)(ii) and not to the general requirement of subsection (iii). Thus I would

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reverse the judgment of the District Court and restore the presumptive right to "credit bid" provided in subsection (ii).

I. Background Matters

A. Factual Background

The debtors seek to sell their assets free of liens and to stop their secured lenders from bidding at sale up to the full credit they have extended. To understand why, we need to know the backstory. While the majority summarizes many of the relevant facts, I highlight a few that were omitted with respect to the apparent motivations behind the attempt to deny credit bidding here.

As part of a high-stakes game of chicken, the debtors have engaged in an extensive advertising campaign related to the proposed auction that promotes the message "Keep it Local." This is apparently a reference that the Stalking Horse Bidder—largely composed of and controlled by the debtors' current and former management and equityholders—is the favored suitor.[1] Perhaps the most striking example ***320** of the type of game the debtors are playing is the two-years of *free rent* on the building to be leased to the Stalking Horse Bidder, while ostensibly "surrendering" the building to the secured lenders.

This did not go unnoticed by the Bankruptcy Court. It observed that, on the facts of the case, credit bidding appeared necessary to ensure fairness in light of the insider nature of the Stalking Horse Bidder, the extensive "Keep it Local" campaign, and its perception that the debtors' strategies were designed "not to produce the highest and best offer...."[2] *In re Philadelphia Newspapers, LLC,* No. 09–11204, 2009 WL 3242292, *10 (Bankr.E.D.Pa. Oct. 8, 2009). Indeed, the Bankruptcy Court noted that there was "little that points to a different conclusion." *Id.* The Court gave the debtors "the benefit of the doubt as to their motives," yet still could "discern no plausible business justification for the restriction [on credit bidding] which Debtors [sought] to include in the Bid Procedures." *Id.* at *11.

The Stalking Horse Bidder is seeking to pay as little as possible to obtain the assets "on the cheap" in a Circuit where secured lenders are allowed to bid up to the full amount of their debt owed despite Bankruptcy Code § 506(a) (which when applicable "split[s] ... partially secured claims into their secured claim and unsecured claim components"). *See Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.),* 432 F.3d 448, 461 (3d Cir.2006). What typically occurs is that, if there are no other bidders, the secured lenders get the assets rather than the Stalking Horse Bidder (unless, of course, the Stalking Horse Bidder increases its bid to a number that is the secured lenders' "reservation price," *i.e.,* the price they are willing to have the Stalking Horse pay cash that will essentially be transferred to them). If credit bidding is denied, however, the debtors' insiders stand to benefit by having more leverage to steer the sale to a favored purchaser (here, the Stalking Horse Bidder). This is explained below.

B. Credit Bidding

Though the majority does not discuss it at length, an understanding of credit bidding is helpful. A credit bid allows a secured lender to bid the debt owed it in lieu of other currency at a sale of its collateral. In *SubMicron,* we discussed the rationale behind credit bidding in the context of a sale of debtors' property outside the ordinary course of business under § 363 of the Bankruptcy Code. 432 F.3d at 459–61. We held that a secured creditor can "credit bid" the entire face value of its secured claim, including the unsecured deficiency portion. The reason behind this was that a credit bid "by definition ... ***321** *becomes* the value of [the] [l]ender's security interest in [the collateral]." *Id.* at 460 (emphasis in original).

The practical rationale for credit bidding is that a secured lender would "not outbid [a] [b]idder unless [the] [l]ender believe[d] it could generate a greater return on [the collateral] than the return for [the] [l]ender represented by [the] [b]idder's offer." *Id.* Conversely, if a bidder believed that a secured lender was attempting to swoop in and take the collateral below market value and keep the upside for itself, that bidder presumably would make a bid exceeding the credit bid. In this manner, credit bidding is a method of ensuring to a secured lender proper valuation of its collateral at sale.[3]

Although some may argue that credit bidding chills cash bidding, that argument underwhelms; credit bidding chills cash bidding no more than a deep-pocketed cash bidder would chill less-well-capitalized cash bidders.[4] Having the ability to pay a certain price does not necessarily mean there is a willingness to pay that price.

C. Cramdown

An understanding of cramdown is also helpful. Section

1129 of the Bankruptcy Code addresses the confirmation of Chapter 11 plans, including plans that involve the sale of property of the estate. Subsection 1129(a) provides the requirements that a plan must meet in order to gain confirmation from the Bankruptcy Court. 11 U.S.C. § 1129(a) ("The court shall confirm a plan only if all of the following requirements are met...."). Included is the requirement in § 1129(a)(8) that each class of claims or interests either accept the plan or not be impaired under it. *Id.* § 1129(a)(8). However, the debtor can "cram down" the plan over the objections of an impaired class by satisfying the requirements of § 1129(b).

The principal touchstone of cramdown under § 1129 is that "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." *Id.* § 1129(b)(1). The requirements for what is "fair and equitable" for secured claims are stated in subsection (b)(2)(A):

> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements ... (A) With respect to a class of secured claims, the plan provides—
>
> > (i)
> >
> > ***322** (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
> >
> > (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;
> >
> > (ii) for the sale, subject to section 363(k)[5] of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or
> >
> > (iii) for the realization by such holders of the indubitable equivalent of such claims.
> >
> > *Id.* § 1129(b)(2)(A). At issue for us is whether, when a plan provides for a sale of secured property free of liens, subsection (ii) is the sole point of reference for what is required to cram down a plan on the secured creditor.

II. Section 1129(b)(2)(A) Has More Than One Plausible Interpretation.

Though the majority attempts to use literal text in isolation to support its conclusion, that reading cannot be the only plausible reading of § 1129(b)(2)(A). Indeed, both the District Court and the Bankruptcy Court read the statute in a plausible fashion, yet came to opposite conclusions. Reasonable minds can differ on the interpretation of § 1129(b)(2)(A) as it applies to plan sales free of liens. This indicates that the provision is ambiguous when read in isolation and does not have a single plain meaning.[6]

A. The more-recent interpretation of § 1129(b)(2)(A) adopted by the majority

To recap my colleagues' reasoning, § 1129(b)(2)(A)(iii) can be used to cram down a plan sale free of liens, without credit bidding, over the objections of creditors because they read the plain text as unambiguous. In support of their position, they cite to a recent decision by the Fifth Circuit Court of Appeals, authored by its Chief Judge, a highly respected former bankruptcy lawyer. *See Bank of N.Y. Trust Co., NA v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.),* 584 F.3d 229 (5th Cir.2009) (Jones, C.J.).[7] ***323** That case reasons that because "or" is disjunctive, the three clauses of § 1129(b)(2)(A) are "alternatives" that "are not even exhaustive." *Id.* at 245. (The latter is because the word "includes" in § 1129(b)(2) "is not limiting." *Id.* (*citing* 11 U.S.C. § 102(3)).) It thereby concluded that the clauses were not compartmentalized alternatives. *Id.* at 245–46. As a result, clause (iii) could be analyzed in isolation and could provide a means of confirmation without regard to clauses (i) and (ii). *Id.* at 246–47.

The Court next determined that clause (iii) did not render clause (ii) superfluous facially or as applied to the plan before it. Although it recognized that "a credit bid option might render Clause (ii) imperative in some cases," *id.* at 246, it determined that a payment of sale proceeds to the secured lenders was an "indubitable equivalent" because "paying off secured creditors in cash can hardly be improper if the plan accurately reflected the value of the ... collateral," *id.* at 247. Thus, the Court rejected the secured lenders' right to credit bid because the plan accomplished its sale through clause (iii) (which does not mention credit bidding), not clause (ii) (which does).

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With *Pacific Lumber* as authority, my colleagues reason that § 1129(b)(2)(A) provides three distinct alternatives for a plan sale.[8] Finding Congress's use of "or" in ***324** § 1129(b)(2)(A) "not without purpose," the majority reads the statute to "elevate[ ] fair return to the lenders over the methodology the debtor selects to achieve that return." Maj. Op. at 310. Even though clause (ii) specifically refers to a sale free of liens and incorporates a general credit bid right, the majority permits plans proposing a free and clear asset sale to fall under clause (iii) because a contrary outcome would be "at odds with the fundamental function of the asset sale, to permit debtors to 'provide adequate means for the plan's implementation.' " *Id.* at 309 (*citing* 11 U.S.C. § 1123(a)(5)(D)).

B. The longer-lived interpretation of § 1129(b)(2)(A)

The majority presents one reading. Another (the one I subscribe to and, as noted below, the longer-lived reading) exists. It restricts plan sales free of liens to clause (ii).

While the Code states that " 'or' is not exclusive" in § 102(5) (and that is true as a general proposition), it is not always the case in practice. Numerous sections of the Bankruptcy Code employ the disjunctive "or" in a context where the alternative options render the "or" exclusive. *See, e.g.,* 11 U.S.C. § 365(g)(2)(B)(i)-(ii) (assumption of executory contract before or after conversion), 506(d)(1)-(2) (voiding liens for disallowed claims for one of two reasons), 1112(b)(1) (conversion or dismissal of a Chapter 11 case), 1325(a)(5)(B)-(C) (requirements for confirmation of a Chapter 13 plan), 1325(b)(3)(A)-(C) (means test categories), 1325(b)(4)(A)(i)-(ii) (same); *see also Williams v. Tower Loan of Miss., Inc. (In re Williams),* 168 F.3d 845, 847–48 (5th Cir.1999) (holding that § 1325(a)(5)(B) & (C) required an exclusive-or construction to avoid creating an option that Congress did not intend to create); 2 *Collier on Bankruptcy* ¶ 102.06 & n. 1, at 102–13 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.2009) (noting that a non-exclusive reading is permissible only "if context and practicality allow" and citing to § 1112(b) as an example where "[i]t would be impossible for the court to do both."). Nor is an exclusive-or in our particular context inconsistent with the cases cited by the majority, Maj. Op. at 305–06, for those cases hold only that the word is the disjunctive "or," not the conjunctive "and." The lesson is that we "do not read [the Bankruptcy Code] with the ease of a computer." *Kelly v. Robinson,* 479 U.S. 36, 49, 107 S.Ct. 353, 93 L.Ed.2d 216 (1986) (*citing Bank of Marin v. England,* 385 U.S. 99, 103, 87 S.Ct. 274, 17 L.Ed.2d 197 (1966) (interpreting its predecessor, the Bankruptcy Act)).

Turning to the statutory text, the operative verb in § 1129(b)(2)(A) is not "includes," as the *Pacific Lumber* panel ***325** believed, but "provides" (that is, "[w]ith respect to a class of secured claims, the plan provides ..."). *Cf. In re Pacific Lumber Co.,* 584 F.3d at 245–46. The majority relies on this section of *Pacific Lumber* to support its view of clauses (i)-(iii) as non-exhaustive alternatives when applied to plan sales free of liens. Maj. Op. at 309–10. *Pacific Lumber* looked to the verb "includes," but that verb attaches to § 1129(b)(2), not (b)(2)(A). "Includes" is the verb that applies in (b)(2) because it covers not only secured claims in subsection (A), but also unsecured claims in subsection (B) and classes of interests in subsection (C). In contrast, once we delve into (b)(2)(A), we are solely concerned with the treatment of a class of secured claims, and the relevant verb is "provides," whereby Congress prescribes specific treatments for specific scenarios of secured-claim treatment. By way of example, this is similar to "provided," the verb used in § 1325(a)(5) and construed to require an exclusive-or construction in *In re Williams,* 168 F.3d at 846–47.

The language employed by Congress in clauses (i), (ii), and (iii) of subsection (A) thus is susceptible to another plausible reading: Congress did not list the three alternatives as routes to cramdown confirmation that were universally applicable to any plan, but instead as distinct routes that apply specific requirements[9] depending on how a given plan proposes to treat the claims of secured creditors. In contrast, the majority, in effect, "assume [s] that the plan proponent can simply choose which of these three disjunctive specifications of the requirement it wishes to satisfy." Ralph Brubaker, *Cramdown of an Undersecured Creditor Through Sale of the Creditor's Collateral: Herein of Indubitable Equivalence, the § 1111(b)(2) Election, Sub Rosa Sales, Credit Bidding, and Disposition of Sale Proceeds,* 29 No. 12 Bankruptcy Law Letter 1, 7–8 (Dec.2009). But

> [a] perfectly (and perhaps even more) plausible alternative reading of the disjunctive specification of three means of satisfying the requirement ... is that the plan's proposed treatment of the secured claim determines which of the three alternative specifications of the requirement must be satisfied....
>
> *Id.* at 8. While "or" may be non-exclusive in the ordinary course, the latter interpretation supports a reading of exclusivity as applied to plan sales, with the applicable clause tied to what a particular plan proposes.

That reading plays out as follows. Clause (i) applies to a situation where the secured creditor retains the lien

securing its claim in a given class.[10] 11 U.S.C. § 1129(b)(2)(A)(i).

Clause (ii) applies to a situation where the plan "provides ... for the sale ... of any property that is subject to the liens securing such claims, free and clear of such liens."[11] *Id.* § 1129(b)(2)(A)(ii). It requires that the sale be "subject to ***326** section 363(k) of [the Bankruptcy Code]," the provision that gives a secured creditor the presumptive right to credit bid at the sale. *Id.* (I say "presumptive" because the "court [can] for cause order[ ] otherwise." *Id.* § 363(k).) Furthermore, the provision requires that the stripped liens move from the sold property and "attach to the proceeds of such sale." *Id.* § 1129(b)(2)(A)(ii). Finally, it directs that the liens transferred to the proceeds be given "treatment ... under either clause (i) or clause (iii) of [§ 1129(b)(2)(A)]."[12] *Id.*

Clause (iii) applies whenever the plan "provides ... for the realization ... of the indubitable equivalent" of a secured creditor's claim. *Id.* § 1129(b)(2)(A)(iii). Examples of these situations include abandonment of property and providing substitute collateral (also known as a replacement lien).[13] *See* 7 *Collier* ¶ 1129.04[2][c] & nn. 38, 52 at 1129–127, –129. "Indubitable equivalent" is not defined in the Code, but there can be no doubt that the secured creditor receives consideration equal to its claim in value or amount. *See Webster's Third New Int'l Dictionary* 1154 (1971) (indubitable means "not open to question or doubt" or "too evident to be doubted"); *id.* at 769 (equivalent means one that is "equal in force or amount" or "equal in value"). Although the language of clause (iii) is broad, as discussed below it is a "catch-all" not designed to supplant clauses (i) and (ii) where they plainly apply.

The reading of § 1129(b)(2)(A) just noted prescribes a specific treatment that a ***327** plan must afford to secured creditors if it allows them to retain the liens securing property. This is clause (i). Likewise, this reading of the statute prescribes a specific treatment if a plan sells property free and clear of a secured creditor's lien. This is clause (ii). And clause (iii) prescribes a specific treatment for situations not addressed by either clause (i) or clause (ii).

Proponents of this view believe Congress has prescribed the full range of possible treatments of secured claims under a plan in a compartmentalized fashion. *See, e.g., In re SunCruz Casinos, LLC,* 298 B.R. 833, 838 (Bankr.S.D.Fla.2003); *In re Kent Terminal Corp.,* 166 B.R. 555, 566–67 (Bankr.S.D.N.Y.1994). Moreover, this interpretation is supported by academic discourse. *See, e.g.,* Brubaker, *supra,* at 8 ("The obvious disjunctive specification of alternative requirements, therefore, does not unambiguously permit the plan proponent to simply choose the requirement that it wishes to satisfy and bypass a requirement that specifically addresses, on its face, the treatment that the plan proposes.").

III. Principles of Statutory Interpretation Decide Which of Two Reasonable Readings Is the More Plausible.

My colleagues' reading of § 1129(b)(2)(A) is not a trip to the twilight zone. Neither is mine. We must choose between two plausible readings of § 1129(b)(2)(A): one that allows sales of collateral free of liens under clause (iii) without credit bidding, and another that only allows such sales under clause (ii) with credit bidding generally available. With these competing maps, we need a compass pointing to the right interpretive result. In this context, I review the protocols for how courts interpret statutes. This includes applying canons of statutory interpretation, examining the context of related statutory provisions, and, when appropriate, looking to legislative history and comments of Code drafters to help understand a statute's literal words.

To know as best we can what a law means is to know as best we can what those who wrote it meant when they did so. Meaning equals intent, and intent paves the path for our interpretation.

Our search for knowledge of intent begins with the law's language. *In re Armstrong World Indus., Inc.,* 432 F.3d 507, 512 (3d Cir.2005) (*citing United States v. Ron Pair Enters., Inc.,* 489 U.S. 235, 241, 109 S.Ct. 1026, 103 L.Ed.2d 290 (1989)). "[W]e begin with the understanding that Congress says in a statute what it means and means in a statute what it says there." *Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel. Cybergenics Corp. v. Chinery,* 330 F.3d 548, 559 (3d Cir.2003) (en banc) (*citing Hartford Underwriters Ins. Co. v. Union Planters Bank,* 530 U.S. 1, 6, 120 S.Ct. 1942, 147 L.Ed.2d 1 (2000)). "When 'the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.' " *Id.* (*citing Hartford Underwriters,* 530 U.S. at 6, 120 S.Ct. 1942); *see also Ron Pair,* 489 U.S. at 241, 109 S.Ct. 1026. "We should prefer the plain meaning since that approach respects the words of Congress. In this manner we avoid the pitfalls that plague too quick a turn to the more controversial realm of legislative history." *Lamie v. U.S. Tr.,* 540 U.S. 526, 536, 124 S.Ct. 1023, 157 L.Ed.2d 1024 (2004).

Yet words that may seem plain often are not. *See United Parcel Serv., Inc. v. U.S. Postal Serv.,* 455 F.Supp. 857, 865 (E.D.Pa.1978) (Becker, J.) ("Although it is received wisdom that when a statute's plain meaning ***328** is clear 'the duty of interpretation does not arise and the rules which are to aid doubtful meanings need no discussion,' it is also an endorsed caveat to this rule that '[w]hether ... the words of a statute are clear is itself not always clear.' ") (citations omitted); *see also Tex. State Comm'n for the Blind v. United States,* 796 F.2d 400, 406 (Fed.Cir.1986) (en banc) (same).

Canons of statutory interpretation counsel courts to read the statutory scheme in a manner that gives effect to every provision Congress enacted and avoids general provisions swallowing specific provisions, especially when to do so makes the specific superfluous. *See TRW Inc. v. Andrews,* 534 U.S. 19, 31, 122 S.Ct. 441, 151 L.Ed.2d 339 (2001); *D. Ginsberg & Sons v. Popkin,* 285 U.S. 204, 208, 52 S.Ct. 322, 76 L.Ed. 704 (1932). In addition, any search for the meaning of words needs context for understanding intent, particularly when dealing with the Bankruptcy Code. *Cybergenics,* 330 F.3d at 559 ("[S]tatutory construction is a holistic endeavor ....") (*citing United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.,* 484 U.S. 365, 371, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988))). A court "must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law and to its object and policy." *Id.* (*citing Kelly v. Robinson,* 479 U.S. 36, 43, 107 S.Ct. 353, 93 L.Ed.2d 216 (1986)). Indeed, "[a] provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme ... because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law." *Timbers,* 484 U.S. at 371, 108 S.Ct. 626. If ambiguity in statutory text remains, a court may inquire beyond the plain language into the legislative history. *See Blum v. Stenson,* 465 U.S. 886, 896, 104 S.Ct. 1541, 79 L.Ed.2d 891 (1984).

Congress worked on drafting the Bankruptcy Code for nearly a decade, and it "intended 'significant changes from [prior] law in ... the treatment of secured creditors and secured claims.' " *Ron Pair,* 489 U.S. at 240, 109 S.Ct. 1026 (citations omitted). "[A]s long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of a statute." *Id.* at 240–41, 109 S.Ct. 1026. This plain meaning "should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.' " *Id.* at 242, 109 S.Ct. 1026 (citation omitted). A result may be demonstrably at odds with the intentions of the Code's drafters if it "conflict[s] with any other section of the Code, or with any important state or federal interest ... [or] a contrary view suggested by the legislative history." *Id.* at 243, 109 S.Ct. 1026.

With this in mind, applying well-established principles of statutory interpretation leads me to conclude that § 1129(b)(2)(A)(ii) is the sole provision applicable to plan sales free of liens.

A. Canons of Statutory Construction

1. Specific provisions prevail over general provisions.

Statutory Construction 101 contains the canon that a specific provision will prevail over a general one. *See* Norman J. Singer & J.D. Shambie Singer, 2A *Sutherland Statutes and Statutory Construction* § 46:5 ("Where there is inescapable conflict between general and specific terms or provisions of a statute, the specific will prevail."). This canon long predates both the Bankruptcy Code and the prior Bankruptcy Act, and Congress no doubt was well aware of it when crafting the Code. "General language of a statutory provision, although broad enough to include it, will ***329** not be held to apply to a matter specifically dealt with in another part of the same enactment. Specific terms prevail over the general in the same or another statute which otherwise might be controlling." *Popkin,* 285 U.S. at 208, 52 S.Ct. 322 (construing sections of the Bankruptcy Act of 1898) (citations omitted); *see also Nat'l Cable & Telecomms. Ass'n, Inc. v. Gulf Power Co.,* 534 U.S. 327, 335–36, 122 S.Ct. 782, 151 L.Ed.2d 794 (2002) ("It is true that specific statutory language should control more general language when there is a conflict between the two ... [, unless] there is no conflict [and][t]he specific controls ... only within its self-described scope."); *Fourco Glass Co. v. Transmirra Prods. Corp.,* 353 U.S. 222, 228–29, 77 S.Ct. 787, 1 L.Ed.2d 786 (1957) ("However inclusive may be the general language of a statute, it will not be held to apply to a matter specifically dealt with in another part of the same enactment.") (citations omitted); *Clifford F. MacEvoy Co. v. United States ex rel. Calvin Tomkins Co.,* 322 U.S. 102, 107, 64 S.Ct. 890, 88 L.Ed. 1163 (1944) (same) (*citing Popkin,* 285 U.S. at 208, 52 S.Ct. 322).

There are two specific clauses in the context of the "fair and equitable" requirements of a plan and one general clause. To repeat, clause (i) applies to all situations, including plan sales, where the lien on the sold collateral is retained. Clause (ii) applies to all plan sales that sell the collateral lien-free. It provides specific requirements to apply when a plan proposes such a sale. Clause (iii) is a

general provision often regarded as a residual "catch-all"[14] that applies to the balance of situations not addressed by clauses (i) and (ii).

To use clause (iii) to accomplish a sale free of liens, but without following the specific procedures prescribed by clause (ii), undoubtedly places the two clauses in conflict. It seems Pickwickian to believe that Congress would expend the ink and energy detailing procedures in clause (ii) that specifically deal with plan sales of property free of liens, only to leave general language in clause (iii) that could sidestep entirely those very procedures. Unlike the majority, I do not read the language to signal such a result; I read the text to show congressional intent to limit clause (iii) to those situations not already addressed in prior, specifically worded clauses.[15]

***330** Inasmuch as the majority argues that clause (ii) does not operate as a limitation on clause (iii) because they are not in conflict, Maj. Op. at 308–09 & n. 8, I do not understand how that can be the case here. Clause (ii) *requires* a presumptive right to credit bid at a plan sale free of liens; as construed by the majority, clause (iii) can be used in a plan sale free of liens without a right to credit bid. When one clause makes the right presumptive, and the other makes that right nonexistent, and both are believed to govern an otherwise identical sale scenario, there is undisputably a conflict between the construction of the provisions. Indeed, the majority later contradicts itself when it states that "the scope of the 'indubitable equivalent' prong is circumscribed by the same principles that underlie subsections (i) and (ii)." *Id.* at 310. As I understand it, to circumscribe the scope is to limit that scope. *See Webster's Third New Int'l Dictionary* 410 (defining circumscribe as "to surround by or as if by a boundary ... [or] to set limits or bounds to ... [or] to constrict the range or activity of ... [or] to define, mark off, or demarcate carefully").

Although it may be facile to conclude that the general language of clause (iii) is applicable to plan sales free of liens, such a result ignores the specific language Congress enacted in clause (ii).

2. The majority's reading violates the anti-superfluousness canon.

A "cardinal principle of statutory interpretation" is that no provision "shall be superfluous, void, or insignificant." *TRW,* 534 U.S. at 31, 122 S.Ct. 441; *see Gustafson v. Alloyd Co.,* 513 U.S. 561, 574, 115 S.Ct. 1061, 131 L.Ed.2d 1 (1995) ("[T]he Court will avoid a reading which renders some words altogether redundant."); *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana,* 472 U.S. 237, 249, 105 S.Ct. 2587, 86 L.Ed.2d 168 (1985) (applying the "elementary canon of construction that a statute should be interpreted so as not to render one part inoperative" (citations omitted)).

As noted above, § 1129(b)(2)(A) has two specific clauses and one general clause in the context of the "fair and equitable" requirements of a plan. Clause (iii) cannot apply where clause (i) or clause (ii) apply, as otherwise those clauses become no more than measures seen only as overmuch. The Bankruptcy Code would not need the "intricate phraseology," *Timbers,* 484 U.S. at 373, 108 S.Ct. 626, of the three clauses under § 1129(b)(2)(A), but instead would simply have said that, "[w]ith respect to a class of secured claims, the plan provides for the realization by such holders of the indubitable equivalent of such claims." A presumptive right to credit bid would not need to be specifically mentioned if, as the majority believes, it was not a requirement of a plan sale free of liens.

Because "[i]t is our duty 'to give effect, if possible, to every clause ... of the [s]tatute,' " I do not read clause (iii) in a fashion that renders clauses (i) and (ii) unnecessary. *Duncan v. Walker,* 533 U.S. 167, 174, 121 S.Ct. 2120, 150 L.Ed.2d 251 (2001) (citations omitted); *Gustafson,* 513 U.S. at 574, 115 S.Ct. 1061. To do so would render clause (ii) "a practical nullity." *Timbers,* 484 U.S. at 375, 108 S.Ct. 626. I know no reason why Congress would want to allow the more general language of clause (iii) to reach an outcome ***331** contrary to the express terms of a provision in the same subsection of § 1129(b)(2)(A)—clause (ii). Thus, the anti-superfluous canon supports a reading that restricts to clause (ii) plan sales free of liens.

B. Context can give clarity to statutes.

Disputed laws set in context may "clarif[y] ... the remainder of the statutory scheme." *Timbers,* 484 U.S. at 371, 108 S.Ct. 626. As context colors text, we look beyond the individual provision and consider § 1129(b)(2)(A) as a part of a coherent whole—the Bankruptcy Code. The Code recognizes that secured lenders have bargained for a property interest in the collateral. Under longstanding nonbankruptcy law they are entitled to foreclose on the collateral by selling it and keeping the proceeds up to the amount of the debt secured by the collateral. *See, e.g., Louisville Joint Stock Land Bank v. Radford,* 295 U.S. 555, 594–95, 55 S.Ct. 854, 79 L.Ed. 1593 (1935) (Brandeis, J.) ("[T]he [secured lender] [has] the following property rights recognized by [state

law]: ... The right to protect its interest in the property by bidding at such sale whenever held, and thus to assure having the mortgaged property devoted primarily to the satisfaction of the debt, either through receipt of the proceeds of a fair competitive sale or by taking the property itself.").

Congress extended this protection within bankruptcy and, in keeping with the *Butner* principle, intended to preserve the presumptive right of a secured creditor under applicable state law to take the property to satisfy the debt. *See Butner v. United States,* 440 U.S. 48, 55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979) (holding that, "[u]nless some federal interest requires a different result," bankruptcy law requires "[u]niform treatment of property interests by both state and federal courts"). In circumstances where this was not possible, Congress provided other protections in the Bankruptcy Code for the secured creditor. These other provisions explain the object and policy of the Bankruptcy Code when addressing the "cramdown" of a plan over a secured creditor's objection.

Other sections of the Code related to plan sales of encumbered property free of its liens, as well as sections concerning the protection afforded to secured creditors, support a reading of § 1129(b)(2)(A) that clause (ii) is the exclusive way to confirm cramdown plan sales of property free of liens. Of particular note are three related provisions in the Code— §§ 1123(a)(5)(D), 363(k), and 1111(b). Those sections, in conjunction with § 1129(b)(2)(A), are integrated parts of congressional policy pertaining to secured creditors' rights when their collateral is sold, as recognized in bankruptcy's leading treatise and in academic literature. *See* 7 *Collier* ¶¶ 1129.04[2][b][i], [ii] & n. 33, at 1129–125 to –126; Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code,* 53 Am. Bankr.L.J. 133, 155 (1979).[16]

1. Section 1123(a)(5)(D)

Bankruptcy Code § 1123 governs the contents of a Chapter 11 plan, and it allows plans to provide adequate means for implementation, including the "sale of all or any part of the property of the estate, either subject to or free of any lien." 11 U.S.C. § 1123(a)(5)(D). Plans can provide for sales of collateral in one of two fashions: (1) subject to lien, or (2) free of any lien. As to the liens themselves, there are ***332** two types: (a) the original lien securing a claim, or (b) a replacement lien securing a claim. Accordingly, we have three ways in which a plan can provide for the sale of collateral: (i) subject to the initial lien retained by the secured creditor, (ii) free of any lien, or (iii) after providing a replacement lien on different collateral (such that the previously liened collateral is sold unencumbered). These three possibilities correspond to clauses (i), (ii), and (iii), and help to clarify the three alternatives in § 1129(b)(2)(A).[17] Section 1123(a)(5)(D) thus appears to place all plan sales of property securing debt, which are sold clear of liens, within the purview of § 1129(b)(2)(A).

I disagree with the majority that § 1123(a)(5)(D), in permitting debtors to "provide adequate means for the plan's implementation," allows them to craft a means (a cramdown plan sale free of liens without credit bidding) that is contrary to the express text of the Bankruptcy Code. The majority argues that to "read the statute in [a limiting] manner significantly curtails the ways in which a debtor can fund its reorganization" and thereby is at odds with § 1123(a)(5)(D). Maj. Op. at 309. Taken to its logical conclusion, this argument would allow debtors to disregard the statutory requirements of the plan approval process so long as the motivation was to ensure "adequate means" to implement a plan. This is a road too far. In contrast, the reading of § 1123(a)(5)(D) I propose with respect to plan sales is consistent with the text and the principles of the Bankruptcy Code.

2. Section 363(k)

Section § 363 (and thus § 363(k)) applies to sales of property outside the ordinary course of business, but § 363(k) has been imported into § 1129(b)(2)(A)(ii). Notably, § 363 does not specify a particular method of sale, but it does specify in subsection (k) that a secured creditor has the right to credit bid its debt, subject to the power of the court for cause to order otherwise. Congress deems the ability of secured creditors to credit bid so important that it applies as well to sales of collateral via plans of reorganization that strip those liens.

To avoid undervaluation at a sale free of liens under either § 363 or § 1129, a secured creditor has the option of bidding its debt. *See* 7 *Collier* ¶ 1129.04[2][b][ii], at 1129–125. Indeed, while many of the valuation mechanisms (such as judicial valuation or market auction) may theoretically result in a perfect valuation, Congress has provided the credit bid mechanism as insurance for secured creditors to protect against an undervaluation of assets sold.[18] ***333** Secured creditors who believe their collateral is being sold for too low a price may bid it higher and use as credit the dollars they have already extended (together with interest and other secured costs) to debtors. The benefit to debtors is that every additional dollar of value realized by sale of the collateral is one less

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dollar that needs to come out of the rest of the bankruptcy estate. This effect is evidence of Congress's intent to protect secured creditors and maximize recovery at any sale free of liens, under the plan or under § 363, through § 363(k)'s credit bidding requirement. It also supports the reading of exclusivity for clause (ii). To hold otherwise would make an anomalous distinction between those sales free of liens conducted prior to plan confirmation under § 363 and those sales free of liens conducted as part of a cramdown plan under § 1129(b)(2)(A).

3. Section 1111(b)

Section 1111(b)[19] is another path by which secured creditors may protect themselves, this time from undervaluation of the collateral securing their claims when the collateral is *not* sold. Its protections have two facets. First, it allows a non-recourse secured creditor to be treated as a creditor with recourse against the debtor for any debt deficiency that exists because the collateral is worth less than the debt it secures. 11 U.S.C. § 1111(b)(1)(A); *see also* 7 *Collier* ¶ 1111.03[1][a][ii][B] at 1111–16 to –17. Second, it allows a secured creditor to forgo that deficiency claim and instead elect to have its claim treated as if it were fully secured. 11 U.S.C. § 1111(b)(2); *see also* 7 *Collier* ¶ 1111.03[2][a] at 1111–22. Like the credit bidding provided for in § 363(k), this election provision helps to minimize the deficiency claims that can be asserted against the rest of the bankruptcy estate and other unencumbered assets, maximizing recovery for all creditors.

A § 1111(b) election is not available to a secured creditor, however, if it is a recourse creditor and the property securing the lien is to be sold "under section 363 of [the Code] or ... under the plan," ***334** 11 U.S.C. § 1111(b)(1)(B)(ii). Thus, while not directly referencing § 1129(b)(2)(A) in the text of the former provision, it does make direct reference to the sale of property under a plan, an act specifically contemplated by § 1129(b)(2)(A). Sections § 1129(b)(2)(A)(ii) and 1111(b) are thus best understood as alternative protections for the secured creditor: one to apply when its collateral is sold free and clear of liens, and the other to apply when its collateral is treated other than as a sale.[20]

As the two protections are opposite sides of the same coin, both focused on protecting the secured creditor's interest in property ordinarily protected under nonbankruptcy law from being undervalued, this suggests that Congress intended to channel all plan sales free of liens through § 1129(b)(2)(A)(ii). *See* Klee, *supra,* at 153 n. 127 ("The collateral will be sold under ... § 363(k) or under the plan. In either event the recourse lender has a right to bid at the sale [free of liens] and to offset his full allowed claim against the purchase price."); *see also* Brubaker, *supra,* at 11 ("Thus the protection against being cashed out at an unfairly low valuation that the § 1111(b)(2) election provides is, in the event of a sale of the collateral [free of liens], provided instead by the right to credit bid at the sale."). If plan sales free of liens were permitted outside of clause (ii), the secured creditor would not only lose the undervaluation protection afforded in non-plan-sale situations, but it would lose the only undervaluation protection Congress provided and considered in the sale-free-of-liens scenario.

* * * * * *

Considering § 1129(b)(2)(A) in conjunction with §§ 363(k), 1111(b), and 1123(a)(5)(D), their text expresses the overall policy of Congress with respect to secured creditors whose collateral is to be sold free of liens. They are part of a comprehensive arrangement enacted by Congress to avoid the pitfalls of undervaluation, regardless of the mechanism chosen, and thereby ensure that the rights of secured creditors are protected while maximizing the value of the collateral to the estate and minimizing deficiency claims against other unencumbered assets. Taken as a whole, the Code supports the reading that funnels all plan sales free of liens into clause (ii). *See* Klee, *supra,* at 155 n. 136 ("If the collateral is sold free and clear of the lien, then ... § 1129(b)(2)(A)(ii) is the controlling provision."). This is the only reading that "produces a substantive effect ... compatible with the rest of the law." *Timbers,* 484 U.S. at 371, 108 S.Ct. 626.

C. Legislative history, at the right time, gives keys to comprehension of statutes.

Some may think that seeking to know laws by their legislative history is simply shading their shadows, resulting in ever more confusion. But when there is no consensus about what a law means, we ignore at our peril statements of intent put out by the branch of government that drafted that law. *See Blum,* 465 U.S. at 896, 104 S.Ct. 1541 ("Where, as here, resolution of a question of federal law turns on ***335** a statute and the intention of Congress, we look first to the statutory language and then to the legislative history if the statutory language is unclear."); *In re Mehta,* 310 F.3d 308, 311 (3d Cir.2002) (same). I thus turn to legislative history.

Section 1129(b) was new to bankruptcy law when the Bankruptcy Code was enacted in 1978. *See* 124 Cong.

Rec. 31,795, 32,406 (1978) (statement of Rep. Edwards)[21] *reprinted in* 1978 U.S.C.C.A.N. 6436, 6474; *see also* Klee, *supra,* at 143 & n. 82 ("[T]he test for secured claims [under § 1129(b)(2)(A)] is completely novel, affording protection for classes of secured claims that is not provided under present law."); *see also Ron Pair,* 489 U.S. at 240, 109 S.Ct. 1026 ("[Congress] intended 'significant changes from current law in ... the treatment of secured creditors and secured claims.' ") (citations omitted). This new section was not enacted in isolation, but was instead enacted in conjunction with section 1111(b):

> Together with section 1111(b) ..., this section [1129(b)] provides when a plan may be confirmed notwithstanding the failure of an impaired class to accept the plan under section 1129(a)(8). Before discussing section 1129(b)[,] an understanding of section 1111(b) is necessary.
>
> 124 Cong. Rec. at 32,406. Accordingly, it is necessary to read § 1129(b)(2)(A) not in isolation, but (as noted above) as a complement to § 1111(b). The latter was drafted with § 1129(b)'s operation in mind: "Sale of property under section 363 or *under the plan* is excluded from treatment under section 1111(b) *because of* the secured party's right to bid in the full amount of his allowed claim at any sale of the collateral under section 363(k)...." *Id.* at 32,407 (emphases added). Those who drafted the Bankruptcy Code tell us straight out that subsection 1129(b)'s operation contemplates credit bidding for sales "under the plan."

Not only was § 1129(b) a new provision, it signaled a change from prior practice. The prior Bankruptcy Act only required "adequate protection"—such as court determination of fair market value of collateral after its appraisal and payment in cash of the appraised amount—to confirm a plan over the dissent of a secured creditor. *See* Klee, *supra,* at 143 & n. 83 (citing to numerous provisions of the Bankruptcy Act). Instead of the court-determined standard of the prior Bankruptcy Act, the Bankruptcy Code created stronger creditor safeguards and protections in § 1129(b)(2)(A). Part of this protection was the ability of secured creditors to credit bid at any sale of collateral free of liens.

In this context, it would be anomalous for Congress to draft a specific provision, clause (ii), providing protections above and beyond those given to secured creditors under the prior Bankruptcy Act, only to allow clause (iii) to be used to circumvent those protections and return to the precise mechanism used prior to the Code. We have "been admonished not to 'read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure,' " *In re Montgomery Ward Holding Corp.,* 268 F.3d 205, 211 (3d Cir.2001) (citation omitted). ***336** I thus also do not presume that Congress enacted a nullity when it changed prior practice by enacting a statutory provision.

The legislative history provides examples of the types of situations in which clauses (ii) and (iii) would apply. Notably, clause (ii) was termed "*self-explanatory.*" 124 Cong. Rec. at 32,407 (emphasis added). It allows confirmation of a plan when the "plan *proposes* to sell the property free and clear of the secured party's lien." *Id.* (emphasis added).

The legislative history also provides two examples where a court could confirm under clause (iii)—"[a]bandonment of the collateral to the creditor" and "a lien on similar collateral." *Id.* While it notes that an immediate cash payment less than the secured claim would not satisfy the requirement, *id.,* presumably an immediate cash payment equal to the secured claim would. What it does not say is that a *sale* of collateral free and clear of liens can be accomplished through clause (iii); indeed, the only example mentioned of sales free and clear of liens is through clause (ii).

In enacting the Code to provide enhanced protections to secured creditors, Congress only contemplated sales through the "self-explanatory" procedures of clause (ii), not clause (iii), as the latter was intended for situations of abandonment or substitute collateral. Thus, I believe it is inconsistent with the entirety of § 1129(b)(2)(A) to allow plan sales free of liens through clause (iii).

IV. The Consequences of Applying Clause (iii) to Plan Sales Free of Liens Are Contrary to the Settled Expectations of Debtors and Lenders Bargaining in the Shadow of the Bankruptcy Code.

If the debtors here prevail, a direct consequence is that debtors generally would pursue confirmation under clause (ii) only if they somehow concluded that providing a right to credit bid as required by that clause would be more advantageous to them than denying that right. This is illogical when one considers that credit bidding is a form of protection for the secured creditor, not the debtor. In our case, the secured lenders are owed over $300 million secured by substantially all of the debtors' assets. Instead of allowing the lenders their presumptive right to credit bid, debtors wish to confirm a plan that sells the collateral without the procedural safeguard against undervaluation contemplated by the Code's drafters. Any undervaluation of the collateral does not benefit the secured lenders here, as they only receive the sale proceeds plus a building

encumbered by a two-year, *rent-free* lease (chutzpah to the core). It does not even benefit the unsecured creditors, as their recovery is independent of the sale price. The only party that stands to benefit from any undervaluation is the purchaser of the assets, ostensibly the Stalking Horse Bidder with substantial insider and equity ties.

Moreover, this is not the "loan-to-own" scenario that was mentioned by debtors' counsel at oral argument. *See* Oral Arg. Tr. 42:10–19. In that situation, the "lender's primary incentive is acquiring the debtor's assets as cheaply as possible rather than maximizing the recovery on its secured loan." Brubaker, *supra,* at 12. By contrast, in our case the secured lenders have already loaned hundreds of millions of dollars in an arms-length transaction, and there is no plausible assertion that this was an attempt to "acquir[e] the debtor's assets as cheaply as possible." *Id.* The Stalking Horse Bidder's bid is only expected to yield gross proceeds to the estate of approximately $41 million. ***337** *In re Philadelphia Newspapers, LLC,* 418 B.R. 548, 554 (E.D.Pa.2009) ("The Plan contemplates that the Stalking Horse Bidder will pay a cash purchase price of $30 million, plus a combination of payment of certain expenses and assumption of liabilities that will yield gross proceeds to the Debtors' estates of approximately $41 million."). This is small fraction of the secured lenders' implied loan-to-own purchase price ($295 million initial loan plus interest and costs). A winning credit bid is hardly an acquisition "on the cheap."

If anything, this presents the opposite situation: the Stalking Horse Bidder appears to be attempting to acquire the debtor's assets as cheaply as possible by "seizing upon coordination difficulties inherent in the administration of a large syndicated loan that might actually prevent the multiple secured lenders from writing a check to themselves, in which case someone else is trying to acquire the debtor's assets on the cheap by preventing the secured lenders from credit bidding." Brubaker, *supra,* at 12. Such a result would undermine the Bankruptcy Code by skewing the incentives of the debtor to maximize benefits for insiders, not creditors.

Secured creditors "have lawfully bargained prepetition for unequal treatment" by obtaining a property interest in debtors' property. *In re Owens Corning,* 419 F.3d 195, 216 (3d Cir.2005). However unfair the debtors believe the credit bid right to be, it is an important consequence of this lawful bargaining under the Bankruptcy Code.

The secured lenders relied on their ability to credit bid in extending credit to the debtors, reducing their costs and pricing in accordance with their bargain. "[S]ecured credit lowers the costs of lending transactions not only by increasing the strength of the lender's legal right to force the borrower to pay, but also ... by limiting the borrower's ability to engage in conduct that lessens the likelihood of repayment." Ronald J. Mann, *Explaining the Pattern of Secured Credit,* 110 Harv. L.Rev. 625, 683 (1997). As discussed above, Congress has determined that credit bidding is necessary to ensure proper valuation of the collateral at a sale free of liens. Denying secured creditors the right to credit bid in those cases allows debtors to lessen the likelihood of repayment of the full value of the collateral.

Instead of giving secured creditors the benefit of the bargain struck with debtors, the debtors' proposed reading uproots settled expectations of secured lending. Whereas a secured creditor ordinarily would be assured of (1) retaining its lien on collateral and a payment stream, (2) a sale of collateral free of its liens with a corresponding right to credit bid, or (3) equivalent substitute collateral or the ability to take abandoned collateral, there is now a new possibility: a sale free of its liens without a right to credit bid. Allowing this possibility (outside of the bargained-for loan) forces future secured creditors to adjust their pricing accordingly, potentially raising interest rates or reducing credit availability to account for the possibility of a sale without credit bidding. As noted, secured creditors are deprived of some of the presumed benefits associated with secured lending. The Bankruptcy Code does not intend this; it preserves the bargains for treatment made under state law unless a federal interest directs a different result. *Butner,* 440 U.S. at 55, 99 S.Ct. 914. I see no such interest here, and debtors have not advanced any federal interest supporting the consequences of their interpretation.

V. Conclusion

Section 1129(b)(2)(A) permits the cramdown of objections by secured creditors to plans of reorganization when to do so is ***338** "fair and equitable." To be fair and equitable, the Bankruptcy Code sets markers that must be met. One (clause (ii)) is that sales of collateral free of secured creditors' liens come with a condition: those creditors have the right at the sale to bid up to the full amount of the credit they extended (absent cause to take away this right). The text gives this specific right when collateral is sold free of liens, and the question for us is whether it can be disregarded by a general provision, nowhere mentioning sales of collateral, that allows secured creditors' plan objections to be overcome when the plan provides those creditors the "indubitable equivalent" of their claims. I believe the answer is "No."

Allowing a plan sale free of liens under the general provision (clause (iii)) is not implausible were we to make the "or" between clause (ii) and clause (iii) a textual show-stopper. But that would make us the standard-bearers of a purism that here would ignore an equally, I suggest more, plausible reading that plan sales of collateral are confined specifically either to clause (i) (sales subject to liens) or clause (ii) (sales free of liens).

Two plausible readings point me to those signposts a court can fix on to wend its way to what Congress intended. Each signpost—be it a canon of construction, the design and function of the Bankruptcy Code, every signal of intent contained in the legislative record, and commentary made by those with the power of the pencil who were present at the Code's creation—steers me to a reading that clause (ii) covers exclusively plan sales of assets free of liens. (In effect, a single "or" becomes the bell, book, and candle that excommunicates congressional intent from the Bankruptcy Code.) Moreover, the consequences of a contrary reading include upsetting three decades of secured creditors' expectations, thus increasing the cost of credit.

I conclude that Congress intended to protect secured creditors at a plan sale of collateral free of liens by providing them a means to control undervaluations of secured assets. Accordingly, I would hold that § 1129(b)(2)(A)(ii) is exclusively applicable to the proposed plan sale in this case, and with it comes a presumptive right to credit bid by the secured lenders. The debtors of course would remain free to argue in the Bankruptcy Court that there is cause to preclude credit bidding under § 363(k) or propose an alternative plan under clause (i) or (iii) of § 1129(b)(2)(A) that does not involve the sale of property free of liens.[22]

Because I believe the Bankruptcy Code requires all cramdown plan sales free of liens to be channeled through § 1129(b)(2)(A)(ii), I respectfully dissent.

Parallel Citations

52 Bankr.Ct.Dec. 255, Bankr. L. Rep. P 81,719

Footnotes

1 The Debtors include PMH Acquisition, LLC; Broad Street Video, LLC; Philadelphia Newspapers, LLC; Philadelphia Direct, LLC; Philly Online, LLC; PMH Holdings, LLC; Broad Street Publishing, LLC; and Philadelphia Media, LLC. PMH is the parent company of all other debtors.

2 The parties to this appeal are the Steering Group of Prepetition Secured Lenders, Citizens Bank of Pennsylvania as their agent, and the Official Committee of Unsecured Creditors.

3 The plan also establishes a $750,000 to $1.2 million liquidating trust fund in favor of general unsecured trade creditors and provides for a distribution of 3% ownership in the successful purchaser to other general unsecured creditors if the senior lenders waive their deficiency claims. Only the plan treatment of secured lenders is the subject of this appeal, though unsecured lenders assert that they have an interest in the treatment of secured lenders under the Plan because the Lenders have agreed to waive deficiency claims if they are permitted to credit bid. (Official Committee of Unsecured Creditor's Opening Br. 23.)

4 A credit bid allows a secured lender to bid its debt in lieu of cash.

5 The District Court construed the filing of the appeal as an appropriate motion for leave to appeal pursuant to Fed. R. Bankr.P. 8003(c). This vested the District Court with jurisdiction over the interlocutory order. *See Dist. Ct. slip op.* at 556–57.

6 The right to credit bid is found in § 363(k) and explicitly incorporated into subsection (ii). Section 363(k) provides:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. § 363(k).

7 We do note, with some confusion, our dissenting colleague's discussion of the "exclusive" nature of "or" under certain circumstances. *See Dissent op.* Part II.B. We readily concede that there are circumstances where the enumerated options, though separated by "or," necessarily preclude the selection of both—such as where a statute calls for distinct treatments "before" or "after" a specified event. *See, e.g.,* 11 U.S.C. § 365(g)(2)(B)(i)-(ii). We also agree that a list of three options, separated by "or," creates a type of exclusivity in that it does not permit the selection of a fourth non-enumerated option. *See, e.g., Williams v. Tower Loan of Miss., Inc. (In re Williams),* 168 F.3d 845, 847–48 (5th Cir.1999) (holding that where Congress has provided three

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permissible treatments of secured claims under 11 U.S.C. § 1325(a)(5) the parties may not construct a fourth extra-statutory option). None of these observations, however, inform our analysis here. Section 1129(b)(2)(A) provides three treatments of secured claims, none of which facially preclude the selection of any one treatment (as in the case of a statute addressing "before" and "after"). The Debtors here seek to elect one of those enumerated treatments, subsection (iii), not invent a fourth option not intended by Congress. We thus fail to see how an "exclusive" reading of "or" aids the Lenders' position in this case.

8 The Court's reasoning in *Varity Corp.* also makes abundantly clear that application of a broader provision, which the court self-terms a "catchall," 516 U.S. at 512, 116 S.Ct. 1065, does not automatically render narrower provisions superfluous. Such would only be the case where the narrower provision facially precludes application of that broader provision. Though our dissenting colleague would hold otherwise, permitting a sale of assets under subsection (iii) is not "contrary to the express terms" of subsection (ii), *dissent op.* Part III.A.2. Subsection (ii) provides a specific, though non-exclusive, route to a "fair and equitable" plan of reorganization. Subsection (iii) provides a more open-ended directive towards the same goal. The selection of one option does not facially negate the other (as in the case of provisions directing conduct "before" or "after," *see supra* note 7). Rather, the dissent suggests that the proposed plan in this case—a free and clear sale of assets under the "indubitable equivalent" prong—will have the effect of denying secured creditors the established "fair and equitable" treatment of subsection (ii), thus demonstrating statutory conflict. This argument is not directed at the statute; it is directed at the ultimate outcome. The question of whether a particular asset sale is "fair and equitable" is a question for plan confirmation and cannot be answered at this stage by manufacturing extra-textual statutory constraints. *See Pacific Lumber,* 584 F.3d at 246 ("Clause (iii) does not render Clause (ii) superfluous facially or as applied to the MRC/Marathon plan. Although a credit bid option might render Clause (ii) imperative in some cases, it is unnecessary here because the plan offered a cash payment to the Noteholders. Clause (iii) thus affords a distinct basis for confirming a plan if it offered the Noteholders the 'realization ... of the indubitable equivalent of such claims.' ").

9 The dissent misunderstands this point. *See Dissent op.* Part III.A.1. Subsections (i) and (ii) do not, as noted *supra,* operate as limitations on subsection (iii). Rather, the requirement that the disposition of assets is "fair and equitable" to secured lenders acts as an equal limitation on *all* subsections.

10 Section 506(a) bifurcates claims into secured and unsecured claims based on judicial valuation of the collateral securing the claim. The statute directs that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a)(1). Prior to plan confirmation the Lenders' present loan value will be bifurcated into a secured claim—based on valuation of the collateral—and an unsecured claim for the deficiency. The "indubitable equivalent" standard is tied only to the value of the secured claim. Thus, any present comparison between the $295 million loan and the value of the Stalking Horse Bid is irrelevant; the Lenders are only entitled to recover the portion of the loan that is presently secured by the value of the collateral. For this reason, we decline to engage in the dissent's attempt to assess the "value" of the proposed plan relative to the amount of the original loan. *See Dissent op.* Part IV. This comparison is both premature and misleading.

11 In addition, we believe it is necessary to at least answer the points raised by the Lenders and relied upon by our colleague in his well-written dissent.

12 Recourse lenders are exempted from making a § 1111(b) election. *See* 11 U.S.C. § 1111(b)(1)(B)(ii) (exempting secured lenders from exemption if "the holder of a [secured claim] has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan").

13 The full text of § 1111(b) reads:

(b)(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if—

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

14 The Lenders argue that the "for cause" exemption under § 363(k) is limited to situations in which a secured creditor has engaged in inequitable conduct. That argument has no basis in the statute. A court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding

environment. *See, e.g.,* 3 Collier on Bankruptcy 363.09[1] ("The Court might [deny credit bidding] if permitting the lienholder to bid would chill the bidding process.").

15 It is perhaps this point upon which our opinion and the dissent most fundamentally diverge. The dissent notes a variety of rights enjoyed by secured creditors under "longstanding nonbankruptcy law"—most notably the right to foreclose in the event of default—and then argues that "Congress extended this protection within bankruptcy." *Dissent op.* Part III.B. While we agree that Congress set out certain specific protections for secured lenders, we view these protections as more evenly balanced with the overarching purpose of the Chapter 11—to preserve the Debtor as a viable economic entity post-reorganization. Tellingly in this regard, among the immediate effects of the filing of a bankruptcy petition is a stay of all creditors' rights to foreclose on property of the debtor. *See* 11 U.S.C. § 362(a).

16 For instance, the Lenders argue here that the Bankruptcy Court made a factual finding that the exclusion of credit bidding was not a legitimate exercise of the Debtors' business judgment. Because the question before us is a purely legal one, and because we find no basis in the record for concluding that the Bankruptcy Court's observation was a finding of fact, we decline to address that argument here.

1 That being said, I fear that the dissent's interest in the policy underlying § 1129(b)(2)(A), as evidenced by its reliance on an unpublished manuscript, Dissenting Op. Section I(A), and a trade publication article, *id.* at Section II(B), both of which prescribe a disposition for the very appeal we are tasked with deciding, has led it astray. There may be sound policy reasons for the dissent's approach, but such reasons cannot overcome the plain meaning of § 1129(b)(2)(A). *See DiGiacomo v. Teamsters Pension Trust Fund of Philadelphia and Vicinity,* 420 F.3d 220, 228 (3d Cir.2005). "We do not sit here as a policy-making or legislative body." *Id.; Cybergenics Corp.,* 330 F.3d at 587 (Fuentes, J., dissenting) (joined by Sloviter, Alito, Smith, JJ.) ("[T]he Supreme Court has rejected the notion that the federal courts have any policy-making role in construing clear statutory language."); *see Lamie,* 540 U.S. at 538, 124 S.Ct. 1023 ("Our unwillingness to soften the import of Congress' chosen words even if we believe the words lead to a harsh outcome is longstanding.").

1 Judge Raslavich of the Bankruptcy Court picked up on this in noting of the "Keep it Local" campaign that

> there's a lot of personal pronouns in those ads that refer[ ] to "our plan" and "our retention of ownership," and arguably a reasonable reader of that does come away with the notion that it's slanted not towards even another local bidder[,] but to the [Stalking Horse Bidder]. That's the fairest impression of those ads that it is endorsing the retention of the newspaper by the stalking horse bidder.

App. 1500a–01a (Hr'g Tr. 17:22–18:4, Sept. 9, 2009).

2 *See also* Vincent S.J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions* at 18 (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1545423 (last accessed Mar. 5, 2010) ("Because corporations and the people who manage them often have misaligned interests, it is hardly implausible that a debtor's officers would seek to sell the bankrupt's business to a low-value bidder in exchange for some personal remuneration that does not redound to the benefit of the enterprise as a whole.... [K]eeping willing buyers from casting bids is the most effective means for management to steer the debtor's assets to a favored, low-value purchaser.").

3 Like the majority's reading of *SubMicron,* my reading of that opinion (which I authored) also "does not equate to a holding that a credit bid must be the successful bid at a public auction." Maj. Op. at 312. *SubMicron*'s logic presumes that the credit bidder will not be the buyer if another bidder values the assets more highly. It is curious why the majority even brings up this point, for no doubt the credit bid need not be the winning bid; rather, the presumptive right to credit bid must be afforded the secured creditor.

4 *See also* Buccola & Keller, *supra,* at 20–21 ("For instance, if a would-be bidder knows that Warren Buffett plans to attend an auction, she is also surely aware that Buffett can top her reservation price for any or all of the assets on the block. Yet nobody proposes to ban wealthy *cash* bidders from participating in a bankruptcy auction.... Would-be bidders understand that a deep-pocketed player's *ability* to top their reservation price does not imply a *willingness* to do so. Warren Buffett did not become wealthy by overpaying for things, so it is possible, indeed, probable, that his reservation price for an asset at auction will be beneath that of another buyer. And buyers know this in advance. The same logic holds for secured creditors.") (emphasis in original).

5 Section 363(k) of the Bankruptcy Code provides the right to credit bid, and it reads as follows:

> (k) At a sale under subsection (b) of this section [a sale other than in the ordinary course of business] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. § 363(k).

6 In no way am I suggesting that disagreement between the District Court and the Bankruptcy Court is dispositive of ambiguity. Nor do I suggest that, when disagreement among courts exists, we "would never be permitted to reverse [a District Court] on plain language grounds." Maj. Op. at 313. I merely point out that each reasonable interpretation has been adopted during the course of this litigation. The ambiguity is tied to the susceptibility of the statutory text to two reasonable interpretations and not that two courts have seen the issue differently.

7 This is the only appellate decision to my knowledge holding that plan sales free of liens may be accomplished through clause (iii). My colleagues and the debtors also refer to a Bankruptcy Court decision of recent vintage, *In re CRIIMI MAE, Inc.,* 251 B.R. 796 (Bankr.D.Md.2000), but the plan in that case is easily distinguishable. Although it involved a plan sale of collateral free of liens and without credit bidding, there was also substitute collateral provided to help make up for any shortfall from the proceeds of sale. Indeed, the *CRIIMI MAE* Court made note of the distinction between a plan without substitute collateral under clauses (i) or (ii), and a plan with substitute collateral under clause (iii). 251 B.R. at 807.

8 The majority also relies heavily on a case interpreting ERISA § 502(a), *Varity Corporation v. Howe,* 516 U.S. 489, 116 S.Ct. 1065, 134 L.Ed.2d 130 (1996), to support its textual analysis of the Bankruptcy Code. *Varity* held that ERISA § 502(a)(3) (allowing actions to remedy violations of the terms of the benefit plan or subchapter I of ERISA) could be used to redress some breaches of fiduciary duty to plan participants because, even though § 502(a)(2) already addressed fiduciary duties, it merely "reflect[ed] a special congressional concern about plan asset management." 516 U.S. at 511, 116 S.Ct. 1065. That holding does not apply to our case, and in any event does not lead inexorably to the majority's conclusion.

Unlike the majority, I see no way to read clause (ii) of Bankruptcy Code § 1129(b)(2)(A) as a "special congressional concern" without also concluding that Congress intended clause (ii) to be exclusively applicable to plan sales free of liens. Clause (ii) is a broad statement that any time a plan proposes a sale free of liens, regardless of the precise method (judicial sale, auction, *etc.*), it must conform to the prescriptions of that provision. While the majority is correct that "Congress' inclusion of the indubitable equivalence prong intentionally left open the potential for yet other methods of conducting asset sales," Maj. Op. at 308, the Bankruptcy Code does not make clear that a debtor has options "other than, and in addition to," 516 U.S. at 511, 116 S.Ct. 1065, clause (ii) for a plan sale *free of liens.* Certainly a debtor has the option to use other methods of plan sales (such as a sale subject to lien or with a replacement lien), but a plan sale free of liens goes to the heart of clause (ii). As discussed below, it is illogical to think that Congress had a "special concern" only with respect to plan sales free of liens and subject to credit bidding, and not *all* plan sales free of liens. The majority is missing a step in the logical progression when it glosses over this fact without offering a compelling reason why the provision should be read in a manner that effectively reads out clause (ii).

Although the majority ostensibly uses *Varity* to hew to the plain text, I believe the reason why the dissenting view in *Varity* was rejected is instructive. Justice Thomas found that the *Varity* majority's holding "cannot be squared with the text or structure of ERISA." 516 U.S. at 516, 116 S.Ct. 1065 (Thomas, J., dissenting). Applying the same two canons of statutory interpretation I apply below (the specific governs the general and anti-superfluousness), Justice Thomas reached the textual conclusion that the specific provision of § 502(a)(2) provided the "exclusive mechanism for bringing claims of breach of fiduciary duty." *Id.* at 520, 521.

The *Varity* Court reached its unique interpretive result over Justice Thomas's dissent because of particular idiosyncracies in the text of ERISA § 502(a), none of which exists here (such as the narrow construction of § 502(a)(2) by the Supreme Court in *Massachusetts Mutual Life Insurance Company v. Russell,* 473 U.S. 134, 142, 105 S.Ct. 3085, 87 L.Ed.2d 96 (1985)). Clause (ii) of § 1129(b)(2)(A) embodies a congressional concern about *all* plan sales free of liens, and clause (iii) is the general provision enacted by Congress for plan sales not otherwise accounted for. Unlike ERISA § 502(a)(2), there is no "remainder" in the universe of plan sales free of liens. As such, there is no need to take the extra step the *Varity* Court did and provide a statutory hook through clause (iii).

9 I note that § 1129(b)(2) states "the condition that a plan be fair and equitable with respect to a class includes the following *requirements* ...." 11 U.S.C. § 1129(b)(2). These are not mere examples, but specific requirements to be applied to distinct scenarios.

10 By the very terms of clause (i), it applies "whether the property subject to liens is retained by the debtor or transferred to another entity." 11 U.S.C. § 1129(b)(2)(A)(i)(I). This includes sales of property where the secured creditor retains the lien securing its claim because "transferred" encompasses sales.

11 I wonder if my colleagues' conclusion is driven in part by a misreading of clause (ii). They consider it as an "example" provided by Congress and characterize it as "a free and clear sale of assets subject to credit bidding." Maj. Op. at 310. The words "free and clear of such liens" in the clause modify the noun "sale" and lead me to believe that clause (ii) is not merely an example, but an entire category of sales that is prescribed a specific treatment. Treating "sale ... free and clear of such liens" as an example as opposed to a prescription may explain why my colleagues decline to apply the canons of statutory interpretation I apply below. *See* 11 U.S.C. § 1129(b)(2)(A)(ii) ("for the *sale,* subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, *free and clear of such liens* ") (emphases added).

12 This provision also helps to understand in context the hypothetical posed by the debtors' counsel at oral argument. *See* Oral Arg. Tr. at 39:23–40:22, 49:24–50:10. In this hypothetical, a debtor has only two assets: a truck worth $100, and a truck worth $500. The $500 truck is unencumbered, while the $100 truck is encumbered by a $200 lien. Counsel argued that the only way to confirm a plan that sells the $100 truck free and clear of liens, and instead gives the secured creditor a $100 lien on the $500 truck, is to proceed directly through clause (iii) to confirm the plan sale.

This is incorrect. The correct analysis is that the $100 truck is sold under clause (ii), and the $100 lien attaches to the proceeds. The lien on the *proceeds* is then treated under clause (iii), and substitute collateral is provided in the form of a $100 lien on the $500 truck. Thus, clause (ii) ably handles this hypothetical, and further obviates plan sales through clause (iii).

Alternatively, if the debtor wanted to avoid credit bidding in that scenario, it could change the order of operations. The debtor would *first* give the secured creditor for the $100 truck the indubitable equivalent under clause (iii) by providing a replacement lien in the unencumbered $500 truck. It would *then* sell the now-unencumbered $100 truck, and because there is no longer a lien on that truck securing a claim, the debtor need not worry about the credit bid provision of § 1129(b)(2)(A)(ii).

13 Even a more complicated scheme such as the *Corestates* plan discussed by the debtors' counsel at oral argument, Oral Arg. Tr. 34:14–35:5, fits under this paradigm because it can be classified as a plan providing for a replacement lien or some combination of the clauses on a collateral-by-collateral basis. *Corestates Bank, N.A. v. United Chem. Techs., Inc.,* 202 B.R. 33, 49–51 (E.D.Pa.1996) (leaving open the possibility of confirmation under clause (iii) even though clause (i) requirements were not met in a plan that did not call for the sale of collateral, but instead provided for a combination of reduced collateral and partial immediate payment).

14 In the similar context of adequate protection under § 361, we have held that the phrase "indubitable equivalent" in the third of § 361's three subclauses is "*regarded as a catch all,* allowing courts discretion in fashioning the protection provided to a secured party." *Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.),* 16 F.3d 552, 564 (3d Cir.1994) (en banc) (emphasis added).

15 Nor is clause (ii) so specific so as to render itself inconsequential even though it includes a proviso set off by commas from the rest of the clause—"subject to section 363(k) of this title." 11 U.S.C. § 1129(b)(2)(A)(ii). The grammatical structure of a statute, including the positioning of commas, should be considered in statutory interpretation, and indeed, it can "mandate" a particular reading of a statute. *Ron Pair,* 489 U.S. at 241–42, 109 S.Ct. 1026. Mirroring *Ron Pair,* which concerned the construction of another provision in the Bankruptcy Code (§ 506(b)), we are confronted by a "phrase ... set aside by commas" from the balance of the sentence. *Id.* at 241, 109 S.Ct. 1026.

Without the commas here, the object of the sentence is no longer a "sale," but is instead a "sale subject to section 363(k)." Such a grammatical structure would mean that clause (ii) only applies to the narrow class of sales that are subject to § 363(k). This makes no sense, inasmuch as § 363(k) on its own swims only in the lane of non-plan sales outside the ordinary course of business. It expands its coverage to plan sales by virtue of § 1129(b)(2)(A)(ii).

Thus, I believe we cannot ignore the punctuation and the "natural reading" that Congress has provided us and limit the scope of clause (ii). "[S]ubject to section 363(k)" is a non-restrictive clause specifying the requirements to be followed under clause (ii), not the scope of the clause's applicability. With this understanding, clause (ii) is applicable to all sales free and clear of liens securing claims, and all sales under clause (ii) must comply with the requirements outlined in § 363(k).

16 Professor Klee served as associate counsel to the Committee on the Judiciary, U.S. House of Representatives, and was one of the principal drafters of the Bankruptcy Code.

17 Clause (iii) also applies to abandonment of property, but that application is not implicated when the collateral is sold. *See In re Sandy Ridge Dev. Corp.,* 881 F.2d 1346, 1350 (5th Cir.1989). Likewise, clause (i)'s applicability to non-sale transfers is not implicated when the collateral is sold.

18 To support its interpretation, the majority notes that § 363(k) is the "most obvious example ... under which the right to credit bid is not absolute." Maj. Op. at 315. My colleagues argue that because "[a] court may deny a lender the right to credit bid in the interest of any policy advanced in the Code" through § 363(k)'s "for cause" exception, *id.* at 316 n. 14, clause (iii) must be available as well to circumvent the credit bid requirements of clause (ii). This thought-track is twisted.

Whereas the default rule under clause (ii), as the majority must concede, is presumptively to allow credit bidding "unless the court for cause orders otherwise," 11 U.S.C. § 363(k), the majority's approach allows the debtor to decide unilaterally to deny credit bidding, with only a belated court inquiry at confirmation to determine whether the denial of credit bidding was "fair and equitable" to the secured lenders. The burden to show cause that Congress carefully placed on the debtor through clause (ii) has been shifted to the creditors through my colleagues' interpretation of clause (iii). See Maj. Op. at 317–18 ("[A] lender can still object to plan confirmation on a variety of bases, including that the absence of a credit bid did not provide it with the 'indubitable equivalent' of its collateral."). To be sure, the "fair and equitable" test at confirmation will be formidable, but the majority implicitly presumes the propriety of denying credit bidding instead of presuming the right to credit bid.

19 Section 1111(b) reads as follows:

(1)

(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless—

(i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or

(ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(B) A class of claims may not elect application of paragraph (2) of this subsection if—

(i) the interest on account of such claims of the holders of such claims in such property is of inconsequential value; or

(ii) the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

11 U.S.C. § 1111(b).

20 This is not to say that the two clauses cover all scenarios. Though not in play here, when collateral is sold *subject to the original lien,* § 1129(b)(2)(A)(ii) does not apply because the sale is not free and clear of all liens, while § 1111(b) does not apply because the collateral nonetheless is sold. Because this scenario falls squarely under § 1129(b)(2)(A)(i), a clause not implicated in this case, and its associated protections, I do not address it here. Likewise, when collateral is sold *subject to a replacement lien,* § 1129(b)(2)(A)(ii) does not apply, but that scenario falls under § 1129(b)(2)(A)(iii) and the "indubitable equivalent" language.

21 In the specific case of the Bankruptcy Code, the Supreme Court "ha[s] treated [Rep. Edwards's] floor statements on the Bankruptcy Reform Act of 1978 as persuasive evidence of congressional intent," *Begier v. IRS,* 496 U.S. 53, 64 n. 5, 110 S.Ct. 2258, 110 L.Ed.2d 46 (1990), and most cases interpreting § 1129(b)(2)(A) have referred to those statements, as has *Collier. See, e.g., In re SunCruz Casinos, LLC,* 298 B.R. at 839; *In re Kent Terminal Corp.,* 166 B.R. at 565; *In re 222 Liberty Assocs.,* 108 B.R. 971, 977–78 (Bankr.E.D.Pa.1990); 7 *Collier* ¶ 1129.04[1] n. 1, at 1129–119.

22 In any event, I do not take the majority opinion to preclude the Bankruptcy Court from finding, as a factual matter, that the debtors' plan is a thinly veiled way for insiders to retain control of an insolvent company minus the debt burden the insiders incurred in the first place. Nor do I take the majority opinion to preclude the Bankruptcy Court from concluding, at the confirmation hearing, that the plan (and resulting proposed sale of assets free of liens and without credit bidding) does not meet the overarching "fair and equitable" requirement.

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103 A.3d 515 (Table)
Unpublished Disposition
This unpublished disposition is
referenced in the Atlantic Reporter.
Supreme Court of Delaware.

In the matter of Pro Hac Vice Counsel
Supreme Court of the State of Delaware:
Alex J. BROWN, Respondent.

No. 544, 2014. | Board No. 111845–B.
| Submitted: Oct. 17, 2014. | Decided:
Oct. 21, 2014. | Corrected: Oct. 22, 2014.

Synopsis

Background: Office of Disciplinary Counsel filed petition alleging professional misconduct by attorney. The Board of Professional Responsibility filed report recommending public reprimand.

Holding: The Supreme Court, Henry Dupont Ridgely, J., held that attorney's conduct in knowingly violating injunction warranted public reprimand.

Public reprimand ordered.

West Headnotes (1)

[1] **Attorney and Client**
Public Reprimand; Public Censure; Public Admonition

Attorney's conduct in violating injunction placing insurance company under control of Delaware Insurance Commission and enjoining filing of litigation against insurance company in any other litigation, by filing suit against insurance company in other forum, in violation of rule of professional conduct prohibiting knowing violation of obligation under rules of the tribunal and rule prohibiting conduct prejudicial to administration of justice, warranted public reprimand; although attorney acted intentionally, insurance company and Insurance Department were harmed by having to respond to suit, attorney had substantial experience in practice of law, and attorney acted partly with selfish motive, attorney acknowledged wrongful nature of conduct, attorney made timely good faith effort to rectify situation by withdrawing suit and terminating representation of client, attorney had no prior disciplinary history, attorney had reputation as having good moral character, monetary sanctions had been imposed, and attorney expressed remorse for conduct. Rules of Prof.Conduct, Rules 3.4(c), 8.4(d).

Cases that cite this headnote

Before HOLLAND, RIDGELY, and VALIHURA, Justices.

ORDER

HENRY DuPONT RIDGELY, Justice.

***1** This 21st day of October 2014, it appears to the Court that:

(1) This is a lawyer disciplinary proceeding. On September 25, 2014, the Board on Professional Responsibility filed a report with this Court recommending, among other things, that the respondent, Alex J. Brown, be publicly reprimanded and pay the costs of the proceeding. A copy of the Board's report is attached to this order. Neither the Office of Disciplinary Counsel nor Slanina has filed any objections to the Board's report.

(2) The Court has considered the matter carefully. We find the Board's recommendation of a public reprimand to be appropriate. We, therefore, accept the Board's findings and recommendation for discipline and incorporate the Board's findings and recommendation by reference.

NOW, THEREFORE, IT IS ORDERED that the Board's September 25, 2014 report is hereby ACCEPTED. The Office of Disciplinary Counsel shall disseminate this Order in accordance with Rule 14 of the Delaware Lawyers' Rules of Disciplinary Procedure.

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CONFIDENTIAL

BOARD REPORT AND RECOMMENDATION OF SANCTION

Before a panel of the Board of Professional Responsibility is a Petition for Discipline. The Respondent, Alex J. Brown, Esquire, a member of the Maryland Bar, was admitted *pro hac vice* by the Court of Chancery and is subject to the jurisdiction of the Supreme Court of Delaware for disciplinary action. [1]

Respondent represented several parties before the Court of Chancery where the court entered a Seizure and Injunction Order placing an insurance company under control of the Delaware Insurance Commissioner. The court enjoined the filing of litigation against the insurance company in any other forum. Respondent acted in contempt of the Seizure and Injunction Order by filing suit in Maryland state court against the insurance company after the injunction had been entered.

The Office of Disciplinary Counsel has brought a Petition alleging professional misconduct under Rules 3.4(c) and 8.4(d) of the Delaware Lawyers' Rules of Professional Conduct. Respondent admitted that he acted in contempt of the Court of Chancery injunction, and violated these Rules. Therefore, the issue for the Panel is the appropriate sanction.

The Panel has reviewed the hearing evidence using the framework from the Standards for Imposing Lawyer Sanctions adopted by the American Bar Association Standing Committee on Professional Discipline. We have also considered Supreme Court case law on sanctions and other authorities. The Panel recommends that a public reprimand be imposed, and that Respondent pay the costs of this proceeding.

I. Procedural Background

The Office of Disciplinary Counsel ("ODC") filed the Petition for Discipline ("Petition") on June 19, 2014. Respondent, through his counsel, filed an answer to the Petition on July 7, 2014 ("Answer") and admitted all facts alleged in the Petition except one limited allegation. [2] The Respondent also admitted violating the Delaware Rules of Professional Conduct ("Rules") alleged in Counts I and II.

***2** On August 19, 2014, the Panel heard evidence and argument regarding sanctions. Appendix A lists the joint exhibits and additional hearing exhibits admitted into evidence, all without objection. At the hearing ODC called Philip Metcalf, Esquire, General Counsel of Indemnity Insurance Corporation, RRG ("Indemnity"); W. Harding Drane, Jr., Esquire, an attorney formerly with the Delaware Department of Justice Civil Division; and Respondent. Respondent called Theodore A. Kittila, Esquire, an attorney with the Greenhill Law Group, LLC and Respondent's Delaware counsel for part of the Court of Chancery proceedings; [3] and Respondent's law partner, Brian Thompson, Esquire with the law firm Silverman, Thompson, Slutkin, & White LLC in Baltimore, Maryland. Respondent also testified as part of his defense. Counsel for the parties concluded the hearing with closing arguments.

II. Factual Findings

The following factual findings are determined from the admissions in the Answer to Petition for Discipline, the hearing exhibits, and the testimony at the hearing.

Indemnity is a Delaware domiciled risk retention group that sells insurance policies to restaurants and nightclubs and for special events. [4] Jeffrey Cohen founded Indemnity and served as its president, chairman and chief executive officer. [5] Indemnity is subject to the regulatory authority of the Delaware Department of Insurance ("Department"). The Department is charged with protecting insurance consumers by making sure that insurance companies are able to pay claims as well as investigate and prosecute insurance fraud. [6]

On May 30, 2013, the Department filed a seizure petition in the Court of Chancery because of its concern about Indemnity's financial viability and its suspicion that Jeffrey Cohen had engaged in fraud. [7] The Court of Chancery reviewed the seizure petition *ex parte,* found it to be supported by sufficient evidence and entered a confidential seizure and injunction order on the same day ("Seizure Order"). [8]

The Seizure Order enjoined persons with notice of the Seizure Order from bringing claims relating to Indemnity, except in the Court of Chancery:

> 10. All persons and entities having notice of these proceedings or of this Seizure and Injunction Order,

> are hereby enjoined and restrained from asserting any claim against the Commissioner, her authorized agents, or IICRRG in connection with their duties as such, or against the Assets, except insofar as such claims are brought in the [sic] these seizure proceedings or any subsequent delinquency proceedings pursuant to 18 *Del. C.* ch. 59.[9]

On August 9, 2013, the court extended the Seizure Order, and on September 10, 2013, amended the Seizure Order to address violations by Jeffrey Cohen.[10] Following an evidentiary hearing the court imposed sanctions against Jeffrey Cohen on September 25, 2013 and permitted limited discovery to determine whether further sanctions were warranted against Cohen for violating the Seizure Order ("Sanctions Order").[11]

***3** At the time of the disciplinary violations, Respondent was a member of the Maryland Bar and practicing with the Baltimore, Maryland law firm Silverman, Thompson, Slutkin & White, LLC.[12] During June, July and August 2013, Respondent advised Indemnity as its counsel with respect to at least the following matters: the Department's investigation of Indemnity leading up to the Seizure Order, the Court of Chancery seizure action, and a lawsuit Respondent filed on behalf of Indemnity in September 2012 against the Department and others arising out of the Department's oversight of Indemnity.[13]

On August 2, 2013, Delaware counsel for Indemnity moved to admit Respondent *pro hac vice* as counsel for Indemnity in the Court of Chancery proceeding.[14] On August 6, 2013, Delaware counsel for Indemnity voluntarily withdrew Brown's motion for admission *pro hac vice* as counsel of record for Indemnity in the Court of Chancery.[15]

On August 15, 2013, Delaware counsel for the proposed intervener RB Entertainment Ventures, LLC ("RB Entertainment") moved to admit Respondent *pro hac vice* as counsel of record for RB Entertainment in the Court of Chancery proceeding.[16] RB Entertainment is an entity controlled by Jeffrey Cohen and holds 99% of the equity of Indemnity.[17] Hr'g Ex. A(2). The Court granted the motion.[18]

On October 11, 2013, Respondent filed an action in the Maryland Circuit Court of Baltimore County on behalf of a number of entities owned by or affiliated with Jeffrey Cohen, against Indemnity and a number of Indemnity's directors, officers and employees (the "Maryland Action").[19] The Maryland Action related to the Department's oversight of Indemnity, and was adverse to Indemnity's interests.[20] Filing the Maryland Action violated the Seizure Order. The Maryland Action also contained a number of volatile allegations against Indemnity and the Department, its agents and the individual defendants.[21]

On October 30, 2013 Indemnity moved to disqualify Respondent in the Delaware action and to revoke his admission *pro hac vice* on the grounds that Respondent's representation of RB Entertainment violated the Delaware Rules of Professional Conduct and that Respondent violated the Seizure Order by filing the Maryland Action.[22] On October 31, 2013, Delaware counsel for RB Entertainment, a company controlled by Jeffrey Cohen, represented to the Court of Chancery that Respondent would be withdrawing his appearance for Indemnity.[23] The Court of Chancery issued an order noting that under Court of Chancery Rule 5(aa) Respondent could not withdraw his appearance without leave of court.

As part of the same order the Court of Chancery issued a rule to show cause that required Respondent to appear and show cause why he should not be held in contempt of the Seizure Order, why his admission *pro hac vice* should not be revoked, and why other sanctions should not be ordered. The court also found as a preliminary matter that the filing of the Maryland Action constituted a knowing violation of paragraphs 9, 10, and 15 of the Seizure Order, paragraphs 2 and 3 of the Amended Seizure Order, and paragraphs 1, 6, 7, and 8 of the Sanctions Order. Such violations, according to the court, established a *prima facie* case for both civil and criminal contempt.[24]

***4** Shortly after the October 31, 2013 show cause order, Respondent dismissed the Maryland Action.[25] On January 10, 2014, after briefing on the show cause order, the Court of Chancery held an evidentiary hearing. Respondent appeared with counsel and testified at the hearing, as did Indemnity representatives. Respondent admitted that by filing the Maryland action he acted in contempt of the Seizure Order.[26] The Court of Chancery found that Respondent

"testified credibly that he was under great pressure from his client to file the Maryland Action, that he knew that it violated the Seizure Order, but that he chose to carry out his client's wishes rather than respect the Seizure Order." [27]

On January 13, 2014, the Court of Chancery issued an Order granting Respondent's motion to withdraw as counsel for Indemnity. The court also held:

> Brown's filing of the Maryland Action was contumacious and violated the Seizure Order. That act and Brown's representation of Indemnity at the same time he sued Indemnity in the Maryland Action threatened to prejudice the fairness of this proceeding. Brown mitigated his contempt by dismissing the Maryland Action promptly after the issuance of the Show Cause Order. The dismissal of the Maryland Action also mitigated the representation issue, which Brown further addressed by seeking to withdraw his appearance in this proceeding. [28]

The Court of Chancery fined Respondent and required Respondent to self-report his actions to the disciplinary authorities in Maryland and Delaware. [29]

III. Violation of the Rules

Delaware Professional Conduct Rule 3.4(c) states that "[a] lawyer shall not knowingly disobey an obligation under the Rules of the tribunal, except for an open refusal based on an assertion that no valid obligations exists." Respondent has admitted a violation of Rule 3.4(c). By filing the Maryland Action, Respondent admits that he knowingly violated the Seizure Order that enjoined persons with notice of the Seizure Order from bringing claims against Indemnity in any court other than the Court of Chancery. [30]

Delaware Professional Conduct Rule 8.4(d) states that it is professional misconduct for a lawyer to "engage in conduct that is prejudicial to the administration of justice." Respondent has admitted that by knowingly disobeying the Seizure Order, he engaged in conduct that is prejudicial to the administration of justice in violation of Rule 8.4(d). [31]

IV. Recommended Sanctions

To determine the appropriate sanctions, the Panel starts with the four part test set forth in the American Bar Association Standards for Imposing Lawyer Sanctions ("ABA Standards"). [32] At the outset the Panel makes a preliminary determination of the appropriate sanction by assessing the first three prongs of the test: (1) the ethical duty violated; (2) the lawyer's state of mind; and (3) the actual or potential injury caused by the lawyer's conduct. Following the preliminary determination, the Panel decides whether an increase or decrease in the preliminary sanction is justified because of mitigating or aggravating factors. The Panel must also consider Supreme Court of Delaware precedent for similar violations.

(1) *The ethical duties violated.*

***5** Respondent has admitted violating Rules 3.4(c) and 8.4(d).

(2) *State of mind.*

Under Delaware Professional Conduct Rule 1.0(f), an attorney acts "knowingly" when one has "actual knowledge of the fact in question." The Rule violations charged here required "knowing" conduct, which Respondent admitted.

(3) *Injury caused by the misconduct.*

Under the ABA Standards, "Injury" is defined as "harm to a client, the public, the legal system, or the profession which results from a lawyer's misconduct. The level of injury can range from 'serious' injury to 'little or no' injury; a reference to 'injury' alone indicates any level of injury greater than 'little or no' injury." ' "Potential injury' is the harm to a client, the public, the legal system or the profession that is reasonably foreseeable at the time of the lawyer's misconduct, and which, but for some intervening factor or event, would probably have resulted from the lawyer's misconduct." [33]

Respondent argues that there was little or no actual or potential harm because Jeffrey Cohen had filed a case *pro se* against Indemnity in Maryland in violation of the Seizure Order before Respondent filed his case. Respondent also claims that his case was never made public and was quickly withdrawn. [34]

The Panel finds to the contrary.[35] The testimony of the witnesses demonstrated actual harm to the parties and prejudice to the administration of justice. Indemnity, who was then Respondent's client, had to take actions to respond to the Maryland Action, including appointment of outside counsel to defend the action and interacting with its insurance carrier.[36] The Insurance Department also had to address the Maryland Action in the Delaware case, by filing motions, briefing the rule to show cause issues, and conducting the hearing.[37] The Court of Chancery had to review the submissions, conduct a hearing, and write an opinion, where it found that Respondent's actions violated the Seizure Order.[38] Standards 6.22 and 6.23 both speak in terms of injury or potential injury, meaning only a minimal amount of injury under the definitions. The Panel determines that there was actual injury and prejudice to the administration of justice.[39]

The Presumptive Sanction

The parties agree that ABA Standard 6.2 applies to determine the presumptive sanction. Under 6.2, there are an array of possible sanctions for failure to obey the rules of the tribunal, depending on the attorney's state of mind and seriousness of the harm. For purposes of determining the presumptive sanction, the parties dispute whether suspension or reprimand is appropriate. ABA Standards 6.22 and 6.23 provide as follows:

> *6.22* Suspension is generally appropriate when a lawyer knows that he or she is violating a court order or rule, and causes injury or potential injury to a client or a party, or causes interference or potential interference with a legal proceeding.
>
> ***6** *6.23* Reprimand is generally appropriate when a lawyer negligently fails to comply with a court order or rule, and causes injury or potential injury to a client or other party, or causes interference or potential interference with a legal proceeding.

The parties do not dispute that Respondent's state of mind was “knowing.” Respondent argues, however, that knowing conduct is not the same as intentional conduct. Because he was not charged with “intentional” conduct, the presumptive sanction according to Respondent should be reprimand not suspension.

The argument is a bit hard to follow. ABA Standard 6.22 requires “knowing” conduct, which Respondent has admitted. The Panel believes Respondent is conflating the definition of “knowing” for purposes of establishing a Rule violation, with the definition of “knowing” when applying the ABA Standards to determine the appropriate discipline. Delaware Professional Conduct Rule 1.0(f) does not distinguish between knowing and intentional conduct. Under the Rules, one acts “knowingly” when one has “actual knowledge of the fact in question.” Knowing and intentional conduct are the same for purposes of charging a Rule violation.

In contrast, the ABA Standards distinguish between the two mental states and add a third. “Intent” is defined as “the conscious objective or purpose to accomplish a particular result.” “Knowledge” is defined as “the conscious awareness of the nature or attendant circumstances of the conduct but without the conscious objective or purpose to accomplish a particular result.” There is also the lesser standard of “Negligence”—“the failure of a lawyer to heed a substantial risk that circumstances exist or that a result will follow, which failure is a deviation from the standard of care that a reasonable lawyer would exercise in the situation.”[40]

Respondent acted with the most culpable state of mind when filing the Maryland Action. Admittedly aware of the Seizure Order, he filed the Maryland Action to exert leverage over Indemnity and its counsel .[41] Respondent hoped to get the attention of his former colleague in Maryland, thinking that he could make an end run around the Delaware proceedings and counsel.[42] He also saw the Maryland Action as a way to get Jeffrey Cohen an audience with new attorneys who might see the wisdom of allowing Cohen back in the doors of Indemnity.[43] Finally, he wanted the Maryland court to review the scope of the companion order filed in Maryland, claiming it was broader than authorized by the Delaware court.[44]

Applying the three factors of Standard 3.0, the Panel finds that Respondent acted intentionally in violation of the Rules, caused actual injury to a party, interfered with a legal proceeding, and caused prejudice to the administration of justice. The presumptive sanction is suspension.

Aggravating and Mitigating Factors

Following the determination of the presumptive sanction of suspension, the Panel must consider aggravating and mitigating circumstances before recommending the final sanction to be imposed.[45] Aggravating factors or circumstances are those that might justify an increase, and mitigating factors are those that might justify a decrease, in the degree of discipline to be imposed. From the list of factors included in ABA Standard 9.22, ODC has raised three aggravating factors:

9.22(b) dishonest or selfish motive

***7** ODC argues that Respondent acted with a selfish motive when intentionally violating the Seizure Order. Respondent was brought in to his new firm to develop the firm's commercial litigation practice, and specifically to represent Jeffrey Cohen and his businesses.[46] Although Respondent had for the most part terminated his professional relationship with Cohen several months before the Delaware proceedings due to nonpayment and other issues, he resumed the representation when Cohen called desperate for representation.[47] According to ODC, Respondent violated the Seizure Order on Cohen's orders in the hopes of collecting unpaid fees and collecting future fees for the Maryland Action.

The Panel heard Respondent's testimony and assessed his credibility at the hearing. We conclude that this aggravating factor should be applied, but not with full force. Respondent had in mind the substantial overdue fees when he decided to represent Cohen in the Delaware proceedings. He may also have had these fees in mind when filing the Maryland Action. The Panel also finds, however, that Cohen was a demanding and difficult client, and no doubt exerted extreme pressure on Respondent.[48] Although client pressure is neither an aggravating nor mitigating factor under the ABA Standards, the Panel does find it to be a partial explanation for Respondent's violation of the Seizure Order rather than solely selfishness.

9.22(g) refusal to acknowledge wrongful nature of conduct

ODC also argues that Respondent has hedged when it comes to acknowledging the wrongfulness of his conduct. The Panel finds that Respondent took responsibility for his actions in the Answer and also at the hearing.[49] The Panel concludes that this aggravating factor should not be applied.

9.22(i) substantial experience in the practice of law

The parties agree that Respondent has substantial experience in the practice of law.[50] He also has particular experience with insurance proceedings, having spent a number of years in both public and private practice dealing with insurance regulatory matters.[51] Therefore the Panel finds that Respondent's substantial experience is an aggravating factor.[52]

Respondent argues for a number of mitigating factors to consider when determining the appropriate sanction.

9.32(a) absence of a prior disciplinary record

The parties agree that Respondent has no prior disciplinary record.

9.32(b) absence of a dishonest or selfish motive

The Panel has previously found that Respondent may have acted partly with a selfish motive. As with the aggravating factor, the Panel will not apply this mitigating factor with full force.

9.32(c) personal or emotional problems

Respondent argues that Jeffrey Cohen was a bully, harassed Respondent, and caused him emotional distress leading to the filing of the Maryland Action. From this, Respondent apparently argues that Cohen's harassment caused Respondent personal or emotional problems which led him to violate the Seizure Order.

***8** Respondent did not present any testimony from a professional that the client's behavior caused Respondent to suffer from personal or emotional problems. It also appears that this mitigating factor is reserved for personal or emotional problems unrelated to the conduct that led the attorney to commit the ethical violation. Finally, as discussed previously, dealing with a difficult client is neither an aggravating nor a mitigating factor.

9.32(d) timely good faith effort to make restitution or to rectify consequences of misconduct

Once Respondent became aware of the court's displeasure with the filing of the Maryland Action, Respondent immediately dismissed the Maryland Action.[53] He withdrew from the case, paid the costs assessed by the court, and

apologized to the court.[54] He also terminated Jeffrey Cohen as a client. The Panel finds this to be a mitigating factor.

9.32(e) full and free disclosure to disciplinary board or cooperative attitude toward proceedings

The parties agree that Respondent was forthcoming with ODC and cooperated with these proceedings.

9.32(f) inexperience in the practice of law

As discussed previously, Respondent has substantial experience in the practice of law. His inexperience in liquidation proceedings is not a mitigating factor.

9.32(g) character or reputation

Respondent's character witnesses testified that Respondent is of good moral character and reputation at the bar, and has had a successful practice as a public and private lawyer.

9.32(k) imposition of other penalties or sanctions

The Court of Chancery has imposed a monetary sanction on Respondent for his contumacious conduct. The Maryland disciplinary authority has issued Respondent a warning.[55]

9.32(l) remorse

The Panel finds that Respondent has expressed remorse for his actions.

After reviewing the aggravating and mitigating factors, the Panel finds that the mitigating factors outweigh the aggravating factors, and that the presumptive sanction of suspension should be reduced to public reprimand. It is important to note that much of the case presented by Respondent revolved around the difficulties he had with Jeffrey Cohen as a client. Respondent and his other witnesses testified convincingly that Cohen exceeded every standard of appropriate client conduct towards his attorney. But, as all parties agreed at the hearing, a difficult or impossible client is neither an aggravating nor mitigating factor.[56] The reason for this hard and fast rule is apparent. The lawyer owes duties not just to the client, but to the legal system. As the Supreme Court of Delaware said in *In re Abbott,* "[t]his responsibility to the 'Court' takes precedence over the interests of the client because officers of the Court are obligated to represent these clients zealously *within* the bounds of both the positive law and the rules of ethics."[57]

Delaware Disciplinary Decisions

***9** Although the ABA Standards are used as a guide to determine the appropriate sanction, Delaware precedent must also be considered. ODC cites a number of Supreme Court of Delaware decisions where public reprimands were ordered for Rule 3.4(c) and 8.4(d) violations .[58]

Respondent attempts to distinguish the foregoing cases on their facts. The Panel finds, however, that regardless of the particular facts of these cases, the common thread is a public reprimand for violation of court rules or orders where the attorney acted with a culpable state of mind when disregarding court orders or interfering with the judicial process.

Respondent submitted to the Panel summaries of a number of disciplinary cases where private admonitions were imposed for Rule 3 .4(c) violations. After reviewing each of these cases, the Panel finds them all distinguishable. Many involved a failure to comply with mandatory continuing legal education requirements[59] or resulted from transgressions much less serious than the conduct in this case, or personal issues unrelated to an attorney's professional judgment.[60] Here, the Respondent intentionally violated a court order to benefit his client, causing injury to Indemnity and the Insurance Commissioner, and caused prejudice to the judicial system.

CONCLUSION

After applying the ABA Standards, weighing the aggravating and mitigating factors, and considering the Delaware case law and other authorities, the Panel recommends that Respondent be publicly reprimanded, and pay the costs of this proceeding.

APPENDIX A

JOINT EXHIBITS

Ex. A Documents related to *In the Matter of State of Delaware, ex rel., The Honorable Karen Weldin Stewart, CIR–M–L Insurance Commissioner of the State of Delaware v. Indemnity Insurance Corporation, RRG,* C.A. No. 8601–VCL

A(1) Confidential Seizure and Injunction Order (May 30, 2013)

A(2) Order Regarding Hearing on November 1, 2013 (Rule to Show Cause)

A(3) Alex J. Brown's Response to Show Cause Order

A(4) Order Granting Motion to Withdraw (January 13, 2014)

A(5) Transcript—Oral Argument on Jeffrey B. Cohen's Motion to Stay Pending Appeal and on the Court's Order to Show Cause Regarding Alex J. Brown (January 10, 2014)

A(6) Theodore A. Kittila, Esquire's letter to The Honorable J. Travis Laster (October 31, 2013)

A(7) Motion for Admission *Pro Hac Vice* (August 15, 2013)

A(8) In the Matter of Rehabilitation of Indemnity Insurance Corporation, 2014 WL 185017 (Del.Ch. Jan.16, 2014)

A(9) Cohen, et al. v. State of Delaware, 89 A.3d 65 (Del.2014)

Ex. B Documents related to *IDG Companies, LLC, et al. v. Indemnity Insurance Corporation, RRG, et al.*

B(1) Complaint filed in the Circuit Court for Baltimore County (October 11, 2013)

B(2) Email from Alex J. Brown, Esquire to Phillip Metcalf (October 11, 2013)

Ex. C Respondent's correspondence to ODC (January 16, 2014)

***10** *Ex. D* Maryland Dismissal With Warning

Ex. E College Bound Foundation/About Us

Ex. F Super Lawyers: Rating a Lawyer

Ex. G A.M. Best Press Release

Ex. H Complaint (October 8, 2013)

Ex. I Motion to Unseal Record or Permit Access to Court File

Ex. J Order Unsealing Court Record

Parallel Citations

2014 WL 5408405 (Del.Supr.)

Footnotes

1 Delaware Lawyers' Rules of Disciplinary Procedure 5(a).

2 Respondent denied part of paragraph eight of the Petition where the Insurance Commissioner claimed that Respondent “kept secret and never served” a lawsuit filed in September 2012 against the Insurance Department and others arising from their oversight of Indemnity, the insurance company. The record shows, however, that the Court made a finding consistent with the allegation. Hearing Exhibit A(4) at ¶ C (“[T]he court has found the following facts to be true ... a lawsuit that Brown had filed on behalf of Indemnity in September 2012 against the. Commissioner and others arising from their oversight of Indemnity, but which Brown had filed under seal, kept secret, and never served....” Because this earlier lawsuit did not form the basis for any of the current disciplinary charges, the Panel does not find Respondent's denial material to this proceeding.

3 Wilks, Lukoff & Bracegirdle moved for Respondent's admission *pro hac vice.* After the court granted the Wilks' firm's motion to withdraw, the Greenhill Law Group substituted for the Wilks firm. By the time of the substitution of counsel, Respondent had committed the act leading to this disciplinary proceeding. August 19, 2014 Hearing Transcript (abbreviated “Hr'g Tr.”) at 139.

4 Petition ¶ 3.

5 *Id.* ¶ 4.

6 *Id.* ¶ 3.

7 *In the Matter of the Rehabilitation of Indemnity Insurance Corporation, RRG,* C.A. No. 8601–VCL.

8 Hearing Exhibit (abbreviated “Hr'g Ex.”) A(1).

9 *Id.*

10 Hr'g Ex. A(2).

11 *Id.*

12 Petition ¶¶ 1–2.

13 *Id.* at ¶ 8; Hr'g Ex. A(4).

14 Hr'g Ex. A(4).

15 *Id.*

16 *Id.*

17 Hr'g Ex. A(8), at *2; Hr'g Ex. A(2).

18 Hr'g Ex. A(4).

19 *Id.;* Ex. B(1).

20 Because the Maryland Action was adverse to Indemnity, the Panel raised a possible Rule violation relating to conflicts of interest. The Office of Disciplinary Counsel had considered the charge, but did not bring disciplinary charges for this potential violation, claiming that the Maryland disciplinary authorities had jurisdiction over this charge. Hr'g Tr. 9.

21 Hr'g Ex. B(1).

22 Hr'g Ex. A(4).

23 *Id.*

24 Hr'g Ex. A(2).

25 Petition ¶ 13.

26 Answer ¶ 15.

27 Hr'g Ex. A(4).

28 *Id.*

29 *Id.*

30 Answer ¶ 19.

31 *Id.* ¶ 21.

32 *In re Steiner,* 817 A.2d 793, 796 (Del.2003).

33 1991 ABA Standards as amended 1992—Definitions. It appears that the American Bar Association re-adopted in 2012 the ABA Standards, but rescinded the adoption of the commentary to the ABA Standards. See ABA Resolution 107, available at http://www.americanbar.org/news/abanews/aba-news-archives/ 2013/08/107_-_adopted_-_reaf.html.

34 Although the Maryland Action was not initially filed under seal, the record is conflicting on whether Respondent did so intentionally, or whether there were issues with the clerk's office in applying to file under seal. There was also a dispute as to whether the Maryland Action ever became public. The Panel does not need to resolve this dispute as part of its sanction recommendation.

35 The parties dispute whether the Maryland Action filed by Respondent was ever made public before it was withdrawn. Respondent claims that he made every effort to file the complaint under seal, but issues with the clerk's office caused a delay in sealing the complaint. ODC maintains that the complaint became public because news sources reported the details in articles about Indemnity. The Panel need not resolve this factual dispute because the filing of the complaint, even if kept confidential from the public, still caused Indemnity and the Insurance Commissioner harm, as well as prejudice to the administration of justice.

36 Hr'g Tr. 30–34; 38–41.

37 *Id.* at 66–69.

38 Hr'g Ex. A(4).

39 See also *In re Abbott,* 925 A.2d 482, 486–87 (Del.2007) (Superior Court was required to strike brief containing inflammatory and unprofessional writing, wasting judicial resources and describing behavior as prejudicial to the administration of justice); *In re Shearan,* 765 A.2d 930, 939 (Del.2000) (filing of a lawsuit in contradiction to a court order was prejudicial to the administration of justice).

40 ABA Standards—Definitions.

41 Hr'g Tr. 94–95;

42 *Id.* at 112–14.

43 *Id.* at 107–08; 167.

44 *Id.* at 115–16.

45 ABA Standard 9.1.

46 Hr'g Tr. 154–55.

47 *Id.* at 162–63.

48 *Id.* at 140–43

49 *Id.* at 168–71.

50 *Id.* at 158–62.

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51 *Id.* at 101–03.

52 Respondent argues that he had no experience in liquidation proceedings, and therefore he should not be viewed as an experienced practitioner. Under Delaware law, however, the inquiry primarily centers on years in practice, rather than expertise in any particular area of the law. *See In re Murray,* 2012 WL 2324172, at *32 (Del. June 18, 2012) (aggravating factor found even though disciplinary violation arose in an area of practice outside attorney's main practice area); *In re Melvin,* 807 A.2d 550, 554 (Del.2002) (inexperience with area of the law not a mitigating factor).

53 Hr'g Tr. 171.

54 *Id.* at 168–70.

55 Hr'g Ex. D. The Attorney Grievance Commission of Maryland dismissed the complaint made by Bar Counsel. As part of the dismissal, the Grievance Commission found that Respondent violated Maryland Rule of Professional Conduct 1.9 by filing suit against a former client, and Rule 8.4(d) by violating the Court of Chancery Seizure Order. The Grievance Commission issues a warning for these violations, which under Maryland rules, is not discipline. The parties to this proceedings agree that the Panel is not bound by Maryland's determination.

56 ABA Standard 9.4 provides as follows: "The following factors should not be considered as either aggravating or mitigating: ... (b) agreeing to the client's demand for certain improper behavior or result...."

57 925 A.2d at 487–88 (citing *Nix v. Whiteside,* 475 U.S. 157, 168, 106 S.Ct. 988, 89 L.Ed.2d 123 (1986)).

58 *See In re Guy,* 1994 WL 202279 (Del. May 5, 1994) (public reprimand for acting in contempt of court in violation of Rule 3.4(c)); *In re Mekler,* 1993 WL 61674 (Del. Feb.9, 1993) (public reprimand for disobeying court rules in violation of Rule 3.4(c)); *In re Abbott,* 925 A.2d 482 (public reprimand for filing briefs containing undignified, discourteous, and degrading language); *In re Murray,* 2012 WL 2324172 (engaging in conduct prejudicial to the administration of justice warranted a public reprimand); *In re Wilson,* 2005 WL 3485738 (Del. Nov.9, 2005) (public reprimand for disobeying rules of a tribunal in violation of Rule 3.4(c)).

59 Board Case No. 1, 1995; Board Case No. 10, 1995; Board Case No.2007–0338–B; Board Case No. 23, 1997; Board Case No. 44, 1993; Board Case No. 9, 1995; Board Case No. 96, 1997.

60 Supreme Court No. 62, 2013 (failed to dismiss an appeal or prosecute an appeal); Board Case Nos. 46, 2006 and 26, 2007; Board Case No. 309, 2007 (failed to appear for court and meet court deadlines); Board Case No. 47, 2005; Board Case No. 46, 2005 (failure to comply with efiling directives); Board Case Nos. 42 and 43, 2001 (advising client not to comply with court order until adversary complied); Board Case No. 41, 1992 (failing to pay child support and ignoring ODC requests for information); Board Case No. 24, 2003 (failing to probate estate in a timely manner); Board Case No.2012–0307–B (appearing without Delaware counsel during a court call); Board Case No. 746, 2010 (violating protection from abuse order).

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52 A.3d 761
Court of Chancery of Delaware.

In re SOUTHERN PERU COPPER CORPORATION SHAREHOLDER DERIVATIVE LITIGATION.

C.A. No. 961–CS. | Submitted: July 15, 2011. | Decided: Oct. 14, 2011. | Revised: Dec. 20, 2011.

Synopsis
Background: Plaintiff representing minority shareholder of corporation brought derivative suit against controlling shareholder, affiliated directors, and others, alleging that merger with mining company that was owned by subsidiary of controlling shareholder was entirely unfair to corporation and its minority shareholders.

Holdings: The Court of Chancery, Strine, Chancellor, held that:

[1] plaintiff was adequate representative of minority shareholders;

[2] burden of persuasion under entire fairness review was on defendants;

[3] merger was unfair to corporation; and

[4] damage award of $1.263 billion was warranted.

Ordered accordingly.

West Headnotes (12)

[1] Corporations and Business Organizations
Ability to represent other shareholders

A derivative plaintiff must be qualified to serve in a fiduciary capacity as a representative of the class of stockholders, whose interest is dependent upon the representative's adequate and fair prosecution of the action.

Cases that cite this headnote

[2] Corporations and Business Organizations
Presumptions and burden of proof

In challenging the adequacy of a derivative plaintiff, the defendant bears the burden to show a substantial likelihood that the derivative action is not being maintained for the benefit of the shareholders.

Cases that cite this headnote

[3] Corporations and Business Organizations
Ability to represent other shareholders

That derivative plaintiff became a plaintiff only because he inherited the claims as successor trustee upon the death of his father, was absent from trial, lacked a fully developed knowledge about all of the litigation details, and engaged in a pattern of delay did not establish that there was a substantial likelihood that the derivative action was not being maintained for the benefit of the shareholders, as required to show that plaintiff was not adequate representative in suit arising from corporation's purchase of mining company owned by controlling shareholder's subsidiary, absent evidence of an economic conflict between the plaintiff and other shareholders such that he would act in furtherance of his own self-interest at their expense.

Cases that cite this headnote

[4] Corporations and Business Organizations
Dealings with corporation

Under the entire fairness standard of review, when a controlling stockholder stands on both sides of a corporate transaction, the interested defendants are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain; that is, the defendants with a conflicting self-interest must demonstrate that the deal was entirely fair to the other stockholders.

6 Cases that cite this headnote

[5] Corporations and Business Organizations
Fairness of transaction

In considering a corporate merger under the entire fairness standard of review, there are two basic aspects of fairness: process (fair dealing), which embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained, and price (fair price), which relates to the economic and financial considerations of the proposed merger, including the relevant factors of assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.

1 Cases that cite this headnote

[6] Corporations and Business Organizations
Dealings with corporation

When the entire fairness standard applies to review of a corporate transaction, controlling stockholders can never escape entire fairness review, but they may shift the burden of persuasion by one of two means: they may show that the transaction was approved either by an independent board majority (or in the alternative, a special committee of independent directors) or, assuming certain conditions, by an informed vote of the majority of the minority shareholders.

9 Cases that cite this headnote

[7] Corporations and Business Organizations
Entire fairness of transaction in general
Corporations and Business Organizations
Evidence

Under the entire fairness review of a decision of a board of directors, in order for the defendant to obtain a shift in the burden of proof to the plaintiff based on the use of an independent special committee under circumstances in which the board is controlled by a controlling shareholder with an interest in the transaction, the special committee must function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power at an arms-length; the inquiry must focus on how the special committee actually negotiated the deal—was it well functioning—rather than just how the committee was set up.

8 Cases that cite this headnote

[8] Corporations and Business Organizations
Fairness of transaction

Burden of persuasion under entire fairness review, of decision by corporation's board to merge with a mining company owned by a controlling shareholder's subsidiary, remained on controlling shareholder and affiliated directors, and did not shift to plaintiff representing minority shareholders, in derivative action challenging merger, although merger vote was approved by a vote of shareholders, where at time of vote it was known that majority shareholder held sufficient votes to approve merger, so the vote had little meaning, and the proxy statement issued prior to the vote omitted material information about the negotiation process.

Cases that cite this headnote

[9] Corporations and Business Organizations
Fairness of transaction

Decision by corporation's board to merge with a mining company owned by a controlling shareholder was unfair, to extent value given by corporation was significantly more than mining company was worth; although special committee was formed to evaluate merger, committee's focus was on finding a way to justify terms proposed by controlling shareholder, committee reworked their approach to meet those terms and rationalize paying the asking price, corporation was effectively undervalued, controlling shareholder made only weak concessions that did not close fairness gap, and special committee did not update its analysis based on changed conditions.

Cases that cite this headnote

[10] Fraud

Measure in General

Fraud

Elements of compensation

Unlike the more exact process followed in an appraisal action, damages resulting from a breach of fiduciary duty are liberally calculated; as long as there is a basis for an estimate of damages, and the plaintiff has suffered harm, mathematical certainty is not required.

1 Cases that cite this headnote

[11] **Interest**

Prejudgment Interest in General

Interest

Interest from date of judgment or decree

In awarding damages resulting from a breach of fiduciary duty, in addition to an actual award of monetary relief, the court has the authority to grant prejudgment and post-judgment interest, and to determine the form of that interest.

1 Cases that cite this headnote

[12] **Corporations and Business Organizations**

Damages or amount of recovery

Damages award of $1.263 billion, representing difference between what corporation paid for controlling shareholder's mining company and mining company's actual value at time of merger, was warranted in derivative action against controlling shareholder and affiliated directors, for breach of fiduciary duty of loyalty in agreeing to merger with mining company.

Cases that cite this headnote

Attorneys and Law Firms

***763** Ronald A. Brown, Jr., Esquire, Marcus E. Montejo, Esquire, Prickett, Jones & Elliott, P.A., Wilmington, Delaware; Lee D. Rudy, Esquire, Eric L. Zagar, Esquire, James H. Miller, Esquire, Kessler Topaz Meltzer & Check, LLP, Radnor, Pennsylvania, Attorneys for Plaintiff.

S. Mark Hurd, Esquire, Kevin M. Coen, Esquire, Morris, Nichols, Arsht & Tunnell LLP, Wilmington, Delaware; Alan J. Stone, Esquire, Douglas W. Henkin, Esquire, Mia C. Korot, Esquire, Milbank, Tweed, Hadley & McCloy LLP, New York, New York, Attorneys for Defendants.

OPINION

STRINE, Chancellor.

I. *Introduction*

This is the post-trial decision in an entire fairness case. The controlling stockholder of an NYSE-listed mining company came to the corporation's independent directors with a proposition. How about you buy my non-publicly traded Mexican mining company for approximately $3.1 billion of your NYSE-listed stock? A special committee was set up to "evaluate" this proposal and it retained well-respected legal and financial advisors.

The financial advisor did a great deal of preliminary due diligence, and generated valuations showing that the Mexican mining company, when valued under a discounted cash flow and other measures, was not worth anything close to $3.1 billion. The $3.1 billion was a real number in the crucial business sense that everyone believed that the NYSE-listed company could in fact get cash equivalent to its stock market price for its shares. That is, the cash value of the "give" was known. And the financial advisor told the special committee that the value of the "get" was more than $1 billion less.

Rather than tell the controller to go mine himself, the special committee and its advisors instead did something that is indicative of the mindset that too often afflicts even good faith fiduciaries trying to address a controller. Having been empowered only to evaluate what the controller put on the table and perceiving that other options were off the menu because of the controller's own objectives, the special committee put itself in a world where there was only one strategic option to consider, the one proposed by the controller, and thus entered a dynamic where at best it had two options, either figure out a way to do the deal the controller wanted or say no. Abandoning a focus on whether the NYSE-listed mining company would get $3.1 billion in value in the exchange, the special committee embarked on a "relative valuation" approach. Apparently perceiving that

its own company was overvalued and had a fundamental value less than its stock market trading price, the special committee assured itself that a deal could be fair so long as the "relative value" of the two companies was measured on the same metrics. Thus, its financial advisor ***764** generated complicated scenarios pegging the relative value of the companies and obscuring the fundamental fact that the NYSE-listed company had a proven cash value. These scenarios all suggest that the special committee believed that the standalone value of the Mexican company (the "get") was worth far less than the controller's consistent demand for $3.1 billion (the "give"). Rather than reacting to these realities by suggesting that the controller make an offer for the NYSE-listed company at a premium to what the special committee apparently viewed as a plush market price, or making the controller do a deal based on the Mexican company's standalone value, the special committee and its financial advisor instead took strenuous efforts to justify a transaction at the level originally demanded by the controller.

Even on that artificial basis, the special committee had trouble justifying a deal and thus other measures were taken. The cash flows of the Mexican company, but not the NYSE-listed company, were "optimized." The facts that the Mexican company was having trouble paying its bills, that it could not optimize its cash flows with its current capital base, and that, by comparison, the NYSE-listed company was thriving and nearly debt-free, were slighted. The higher multiple of the NYSE-listed company was used as the bottom range of an exercise to value the Mexican company, thus topping up the target's value by crediting it with the multiple that the acquiror had earned for itself, an act of deal beneficence not characteristic of Jack Welch, and then another dollop of multiple crème fraiche was added to create an even higher top range. When even these measures could not close the divide, the special committee agreed to pay out a special dividend to close the value gap.

But what remained in real economic terms was a transaction where, after a bunch of back and forth, the controller got what it originally demanded: $3.1 billion in real value in exchange for something worth much, much less—hundreds of millions of dollars less. Even worse, the special committee, despite perceiving that the NYSE-listed company's stock price would go up and knowing that the Mexican company was not publicly traded, agreed to a fixed exchange ratio. After falling when the deal was announced and when the preliminary proxy was announced, the NYSE-listed company's stock price rose on its good performance in a rising market for commodities. Thus, the final value of its stock to be delivered to the controller at the time of the actual vote on the transaction was $3.75 billion, much higher than the controller's original demand. Despite having the ability to rescind its recommendation and despite the NYSE-listed company having already exceeded the projections the special committee used for the most recent year by 37% and the Mexican company not having done so, the special committee maintained its recommendation and thus the deal was voted through.

Although the plaintiff in this case engaged in a pattern of litigation delay that compromised the reliability of the record to some extent and thus I apply a conservative approach to shaping a remedy, I am left with the firm conclusion that this transaction was unfair however one allocates the burden of persuasion under a preponderance of the evidence standard. A focused, aggressive controller extracted a deal that was far better than market, and got real, market-tested value of over $3 billion for something that no member of the special committee, none of its advisors, and no trial expert was willing to say was worth that amount of actual cash. Although directors are free in some situations to act on the belief that the market is wrong, they are not free to believe that they can in fact get $3.1 billion in cash for their own stock but then use that stock to ***765** acquire something that they know is worth far less than $3.1 billion in cash or in "fundamental" or "intrinsic" value terms because they believe the market is overvaluing their own stock and that on real "fundamental" or "intrinsic" terms the deal is therefore fair. In plain terms, the special committee turned the "gold" it was holding in trust into "silver" and did an exchange with "silver" on that basis, ignoring that in the real world the gold they held had a much higher market price in cash than silver. That non-adroit act of commercial charity toward the controller resulted in a manifestly unfair transaction.

I remedy that unfairness by ordering the controller to return to the NYSE-listed company a number of shares necessary to remedy the harm. I apply a conservative metric because of the plaintiff's delay, which occasioned some evidentiary uncertainties and which subjected the controller to lengthy market risk. The resulting award is still large, but the record could justify a much larger award.

II. *Factual Background*

An overview of the facts is perhaps useful.

The controlling stockholder in this case is Grupo México, S.A.B. de C.V. The NYSE-listed mining company is Southern Peru Copper Corporation. [1] The Mexican mining company is Minera México, S.A. de C.V. [2]

In February 2004, Grupo Mexico proposed that Southern Peru buy its 99.15% stake in Minera. At the time, Grupo Mexico owned 54.17% of Southern Peru's outstanding capital stock and could exercise 63.08% of the voting power of Southern Peru, making it Southern Peru's majority stockholder.

Grupo Mexico initially proposed that Southern Peru purchase its equity interest in Minera with 72.3 million shares of newly-issued Southern Peru stock. This "indicative" number assumed that Minera's equity was worth $3.05 billion, because that is what 72.3 million shares of Southern Peru stock were worth then in cash. [3] By stark contrast with Southern Peru, Minera was almost wholly owned by Grupo Mexico and therefore had no market-tested value.

Because of Grupo Mexico's self-interest in the merger proposal, Southern Peru formed a "Special Committee" of disinterested directors to "evaluate" the transaction with Grupo Mexico. [4] The Special Committee spent eight months in an awkward back and forth with Grupo Mexico over the terms of the deal before approving Southern Peru's acquisition of 99.15% of Minera's stock in exchange for 67.2 million newly-issued shares of Southern Peru stock (the "Merger") on October 21, 2004. That same day, Southern Peru's board of directors (the "Board") unanimously approved the Merger and Southern Peru and Grupo Mexico entered into a definitive agreement (the "Merger Agreement"). On October 21, 2004, the market ***766** value of 67.2 million shares of Southern Peru stock was $3.1 billion. When the Merger closed on April 1, 2005, the value of 67.2 million shares of Southern Peru had grown to $3.75 billion.

This derivative suit was then brought against the Grupo Mexico subsidiary that owned Minera, the Grupo Mexico-affiliated directors of Southern Peru, and the members of the Special Committee, alleging that the Merger was entirely unfair to Southern Peru and its minority stockholders. The parties agree that the appropriate standard of review is entire fairness.

[1] [2] [3] The crux of the plaintiff's argument is that Grupo Mexico received something demonstrably worth more than $3 billion (67.2 million shares of Southern Peru stock) in exchange for something that was not worth nearly that much (99.15% of Minera). [5] The plaintiff points to the fact that Goldman Sachs, which served as the Special Committee's financial advisor, never derived a value for Minera that justified paying Grupo Mexico's asking price, instead relying on a "relative" valuation analysis that involved comparing the discounted cash flow ("DCF") values of Southern Peru and Minera, and a contribution analysis that improperly applied Southern Peru's own market EBITDA multiple (and even higher multiples) to Minera's EBITDA projections, to determine ***767** an appropriate exchange ratio to use in the Merger. The plaintiff claims that, because the Special Committee and Goldman abandoned the company's market price as a measure of the true value of the give, Southern Peru substantially overpaid in the Merger.

The defendants remaining in the case are Grupo Mexico and its affiliate directors who were on the Southern Peru Board at the time of the Merger. [6] These defendants assert that Southern Peru and Minera are similar companies and were properly valued on a relative basis. In other words, the defendants argue that the appropriate way to determine the price to be paid by Southern Peru in the Merger was to compare both companies' values using the same set of assumptions and methodologies, rather than comparing Southern Peru's market capitalization to Minera's DCF value. The defendants do not dispute that shares of Southern Peru stock could have been sold for their market price at the time of the Merger, but they contend that Southern Peru's market price did not reflect the fundamental value of Southern Peru and thus could not appropriately be compared to the DCF value of Minera.

With this brief overview of the basic events and the parties' core arguments in mind, I turn now to a more detailed recitation of the facts as I find them after trial. [7]

*768 A. *The Key Players*

Southern Peru operates mining, smelting, and refining facilities in Peru, producing copper and molybdenum as well as silver and small amounts of other metals. Before the Merger, Southern Peru had two classes of stock: common shares that were traded on the New York Stock Exchange; and "Founders Shares" that were owned by Grupo Mexico, Cerro Trading Company, Inc., and Phelps Dodge

Corporation (the "Founding Stockholders"). Each Founders Share had five votes per share versus one vote per share for ordinary common stock. Grupo Mexico owned 43.3 million Founders Shares, which translated to 54.17% of Southern Peru's outstanding stock and 63.08% of the voting power. Southern Peru's certificate of incorporation and a stockholders' agreement also gave Grupo Mexico the right to nominate a majority of the Southern Peru Board. The Grupo Mexico-affiliated directors who are defendants in this case held seven of the thirteen Board seats at the time of the Merger. Cerro owned 11.4 million Founders Shares (14.2% of the outstanding common stock) and Phelps Dodge owned 11.2 million Founders Shares (13.95% of the outstanding common stock). Among them, therefore, Grupo Mexico, Cerro, and Phelps Dodge owned over 82% of Southern Peru.

Grupo Mexico is a Mexican holding company listed on the Mexican stock exchange. Grupo Mexico is controlled by the Larrea family, and at the time of the Merger defendant Germán Larrea was the Chairman and CEO of Grupo Mexico, as well as the Chairman and CEO of Southern Peru. Before the Merger, Grupo Mexico owned 99.15% of Minera's stock and thus essentially was Minera's sole owner. Minera is a company engaged in the mining and processing of copper, molybdenum, zinc, silver, gold, and lead through its Mexico-based mines. At the time of the Merger, Minera was emerging from—if not still mired in—a period of financial difficulties, [8] and its ability to exploit its assets had been compromised by these financial constraints. [9] By contrast, Southern Peru was in good financial condition and virtually debt-free. [10]

B. ***Grupo Mexico Proposes That Southern Peru Acquire Minera***

In 2003, Grupo Mexico began considering combining its Peruvian mining interests with its Mexican mining interests. In ***769** September 2003, Grupo Mexico engaged UBS Investment Bank to provide advice with respect to a potential strategic transaction involving Southern Peru and Minera.

Grupo Mexico and UBS made a formal presentation to Southern Peru's Board on February 3, 2004, proposing that Southern Peru acquire Grupo Mexico's interest in Minera from AMC in exchange for newly-issued shares of Southern Peru stock. In that presentation, Grupo Mexico characterized the transaction as "[Southern Peru] to acquire Minera [ ] from AMC in a stock for stock deal financed through the issuance of common shares; initial proposal to issue 72.3 million shares." [11] A footnote to that presentation explained that the 72.3 million shares was "an indicative number" of Southern Peru shares to be issued, assuming an equity value of Minera of $3.05 billion and a Southern Peru share price of $42.20 as of January 29, 2004. [12] In other words, the consideration of 72.3 million shares was indicative in the sense that Grupo Mexico wanted $3.05 billion in dollar value of Southern Peru stock for its stake in Minera, and the number of shares that Southern Peru would have to issue in exchange for Minera would be determined based on Southern Peru's market price. As a result of the proposed merger, Minera would become a virtually wholly-owned subsidiary of Southern Peru. The proposal also contemplated the conversion of all Founders Shares into a single class of common shares.

C. ***Southern Peru Forms A Special Committee***

In response to Grupo Mexico's presentation, the Board met on February 12, 2004 and created a Special Committee to evaluate the proposal. The resolution creating the Special Committee provided that the "duty and sole purpose" of the Special Committee was "to evaluate the [Merger] in such manner as the Special Committee deems to be desirable and in the best interests of the stockholders of [Southern Peru]," and authorized the Special Committee to retain legal and financial advisors at Southern Peru's expense on such terms as the Special Committee deemed appropriate. [13] The resolution did not give the Special Committee express power to negotiate, nor did it authorize the Special Committee to explore other strategic alternatives.

For the purposes relevant to this decision, the Special Committee's makeup as it was finally settled on March 12, 2004 was as follows:

- Harold S. Handelsman: Handelsman graduated from Columbia Law School and worked at Wachtell, Lipton, Rosen & Katz as an M & A lawyer before becoming an attorney for the Pritzker family interests in 1978. The Pritzker family is a wealthy family based in Chicago that owns, through trusts, a myriad of businesses. Handelsman was appointed to the Board in 2002 by Cerro, which was one of those Pritzker-owned businesses.

- Luis Miguel Palomino Bonilla: Palomino has a Ph.D in finance from the Wharton School at the University of Pennsylvania and worked as an economist, analyst and consultant for various banks and financial institutions. Palomino was nominated to the Board by Grupo Mexico upon the recommendation of certain Peruvian pension funds that held a large portion of Southern Peru's publicly traded stock.

***770** • Gilberto Perezalonso Cifuentes: Perezalonso has both a law degree and an MBA and has managed multi-billion dollar companies such as Grupo Televisa and AeroMexico Airlines. Perezalonso was nominated to the Board by Grupo Mexico.

- Carlos Ruiz Sacristán: Ruiz, who served as the Special Committee's Chairman, worked as a Mexican government official for 25 years before co-founding an investment bank, where he advises on M & A and financing transactions. Ruiz was nominated to the Board by Grupo Mexico. [14]

D. *The Special Committee Hires Advisors And Seeks A Definitive Proposal From Grupo Mexico*

The Special Committee began its work by hiring U.S. counsel and a financial advisor. After considering various options, the Special Committee chose Latham & Watkins LLP and Goldman, Sachs & Co. The Special Committee also hired a specialized mining consultant to help Goldman with certain technical aspects of mining valuation. Goldman suggested consultants that the Special Committee might hire to aid in the process; after considering these options, the Special Committee retained Anderson & Schwab ("A & S").

After hiring its advisors, the Special Committee set out to acquire a "proper" term sheet from Grupo Mexico. [15] The Special Committee did not view the most recent term sheet that Grupo Mexico had sent on March 25, 2004 as containing a price term that would allow the Special Committee to properly evaluate the proposal. For some reason the Special Committee did not get the rather clear message that Grupo Mexico thought Minera was worth $3.05 billion.

Thus, in response to that term sheet, on April 2, 2004, Ruiz sent a letter to Grupo Mexico on behalf of the Special Committee in which he asked for clarification about, among other things, the pricing of the proposed transaction. On May 7, 2004, Grupo Mexico sent to the Special Committee what the Special Committee considered to be the first "proper" term sheet, [16] making even more potent its ask.

E. *The May 7 Term Sheet*

Grupo Mexico's May 7 term sheet contained more specific details about the proposed consideration to be paid in the Merger. It echoed the original proposal, but increased Grupo Mexico's ask from $3.05 billion worth of Southern Peru stock to $3.147 billion. Specifically, the term sheet provided that:

> The proposed value of Minera [ ] is US$4,3 billion, comprised of an equity value of US$3,147 million [sic] and US$1,153 million [sic] of net debt as of April 2004. The number of [Southern Peru] shares to be issued in respect to the acquisition of Minera [ ] would be calculated by dividing 98.84% of the equity value of Minera [ ] by the 20–day average closing share price of [Southern ***771** Peru] beginning 5 days prior to closing of the [Merger]. [17]

In other words, Grupo Mexico wanted $3.147 billion in market-tested Southern Peru stock in exchange for its stake in Minera. The structure of the proposal, like the previous Grupo Mexico ask, shows that Grupo Mexico was focused on the dollar value of the stock it would receive.

Throughout May 2004, the Special Committee's advisors conducted due diligence to aid their analysis of Grupo Mexico's proposal. As part of this process, A & S visited Minera's mines and adjusted the financial projections of Minera management (*i.e.,* of Grupo Mexico) based on the outcome of their due diligence.

F. *Goldman Begins To Analyze Grupo Mexico's Proposal*

On June 11, 2004, Goldman made its first presentation to the Special Committee addressing the May 7 term sheet. Although Goldman noted that due diligence was still ongoing, it had already done a great deal of work and

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was able to provide preliminary valuation analyses of the standalone equity value of Minera, including a DCF analysis, a contribution analysis, and a look-through analysis.

Goldman performed a DCF analysis of Minera based on long-term copper prices ranging from $0.80 to $1.00 per pound and discount rates ranging from 7.5% to 9.5%, utilizing both unadjusted Minera management projections and Minera management projections as adjusted by A & S. The only way that Goldman could derive a value for Minera close to Grupo Mexico's asking price was by applying its most aggressive assumptions (a modest 7.5% discount rate and its high-end $1.00/lb long-term copper price) to the unadjusted Minera management projections, which yielded an equity value for Minera of $3.05 billion. By applying the same aggressive assumptions to the projections as adjusted by A & S, Goldman's DCF analysis yielded a lower equity value for Minera of $2.41 billion. Goldman's mid-range assumptions (an 8.5% discount rate and $0.90/lb long-term copper price) only generated a $1.7 billion equity value for Minera when applied to the A & S-adjusted projections. That is, the mid-range of the Goldman analysis generated a value for Minera (the "get") a full $1.4 billion less than Grupo Mexico's ask for the give.

It made sense for Goldman to use the $0.90 per pound long term copper price as a mid-range assumption, because this price was being used at the time by both Southern Peru and Minera for purposes of internal planning. The median long-term copper price forecast based on Wall Street research at the time of the Merger was also $0.90 per pound.

Goldman's contribution analysis applied Southern Peru's market-based sales, EBITDA, and copper sales multiples to Minera. This analysis yielded an equity value for Minera ranging only between $1.1 and $1.7 billion. Goldman's look-through analysis, which was a sum-of-the-parts analysis of Grupo Mexico's market capitalization, generated a maximum equity value for Minera of $1.3 billion and a minimum equity value of only $227 million.

Goldman summed up the import of these various analyses in an "Illustrative Give/Get Analysis," which made patent the stark disparity between Grupo Mexico's asking price and Goldman's valuation of Minera: Southern Peru would "give" stock ***772** with a market price of $3.1 billion to Grupo Mexico and would "get" in return an asset worth no more than $1.7 billion. [18]

The important assumption reflected in Goldman's June 11 presentation that a bloc of shares of Southern Peru could yield a cash value equal to Southern Peru's actual stock market price and was thus worth its market value is worth pausing over. At trial, the defendants disclaimed any reliance upon a claim that Southern Peru's stock market price was not a reliable indication of the cash value that a very large bloc of shares—such as the 67.2 million paid to Grupo Mexico—could yield in the market. [19] Thus, the price of the "give" was always easy to discern. The question thus becomes what was the value of the "get." Unlike Southern Peru, Minera's value was not the subject of a regular market test. Minera shares were not publicly traded and thus the company was embedded in the overall value of Grupo Mexico.

The June 11 presentation clearly demonstrates that Goldman, in its evaluation of the May 7 term sheet, could not get the get anywhere near the give. Notably, that presentation marked the *first and last time* that a give-get analysis appeared in Goldman's presentations to the Special Committee.

***773** What then happened next is curious. The Special Committee began to *devalue* the "give" in order to make the "get" look closer in value.

The DCF analysis of the value of Minera that Goldman presented initially caused concern. As Handelsman stated at trial, "when [the Special Committee] thought that the value of Southern Peru was its market value and the value of Minera [ ] was its discounted cash flow value ... those were very different numbers." [20] But, the Special Committee's view changed when Goldman presented it with a DCF analysis of the value of Southern Peru on June 23, 2004.

In this June 23 presentation, Goldman provided the Special Committee with a preliminary DCF analysis for Southern Peru analogous to the one that it had provided for Minera in the June 11 presentation. But, the discount rates that Goldman applied to Southern Peru's cash flows ranged from 8% to 10% instead of 7.5% to 9.5%. Based on Southern Peru management's projections, the DCF value generated for Southern Peru using mid-range assumptions (a 9% discount rate and $0.90/lb long-term copper price) was $2.06 billion. This was about $1.1 billion shy of Southern Peru's market capitalization as of June 21, 2004 ($3.19 billion). Those values "comforted" the Special Committee. [21]

Again, one must pause over this. "Comfort" is an odd word in this context. What Goldman was basically telling the Special

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Committee was that Southern Peru was being overvalued by the stock market. That is, Goldman told the Special Committee that even though Southern Peru's stock was worth an obtainable amount in cash, it really was not worth that much in fundamental terms. Thus, although Southern Peru had an actual cash value of $3.19 billion, its "real," "intrinsic," [22] or "fundamental" value was only $2.06 billion, and giving $2.06 billion in fundamental value for $1.7 billion in fundamental value was something more reasonable to consider.

Of course, the more logical reaction of someone not in the confined mindset of directors of a controlled company may have been that it was a good time to capitalize on the market multiple the company was getting and monetize the asset.

A third party in the Special Committee's position might have sold at the top of the market, or returned cash to the Southern Peru stockholders by declaring a special dividend. For example, if it made long-term strategic sense for Grupo Mexico to consolidate Southern Peru and Minera, there was a logical alternative for the Special Committee: ask Grupo Mexico to make a premium to market offer for Southern Peru. Let Grupo Mexico be the buyer, not the seller. If the Special Committee's distinguished bankers believed that Southern Peru was trading at a premium to fundamental value, why not ask Grupo Mexico to make a bid at a premium to that price? By doing so, the Special Committee would have also probed Grupo Mexico about its own weaknesses, including the fact that Minera seemed to be ***774** cash-strapped, having trouble paying its regular bills, and thus unable to move forward with an acquisition of its own. That is, if Grupo Mexico could not buy despite the value it held in Minera, that would bespeak weakness and cast doubt on the credibility of its ask. And if it turned out that Grupo Mexico would buy at a premium, the minority stockholders of Southern Peru would benefit.

In other words, by acting like a third-party negotiator with its own money at stake and with the full range of options, the Special Committee would have put Grupo Mexico back on its heels. Doing so would have been consistent with the financial advice it was getting and seemed to accept as correct. The Special Committee could have also looked to use its market-proven stock to buy a company at a good price (a lower multiple to earnings than Southern Peru's) and then have its value rolled into Southern Peru's higher market multiple to earnings. That could have included buying Minera at a price equal to its fundamental value using Southern Peru's market-proven currency.

Instead of doing any of these things, the Special Committee was "comforted" by the fact that they could devalue that currency and justify paying *more* for Minera than they originally thought they should. [23]

G. *The Special Committee Moves Toward Relative Valuation*

After the June 23, 2004 presentation, the Special Committee and Goldman began to embrace the idea that the companies should be valued on a relative basis. In a July 8, 2004 presentation to the Special Committee, Goldman included both a revised standalone DCF analysis of Minera and a "Relative Discounted Cash Flow Analysis" in the form of matrices presenting the "indicative number" of Southern Peru shares that should be issued to acquire Minera based on various assumptions. [24] The relative DCF analysis generated a vast range of Southern Peru shares to be issued in the Merger of 28.9 million to 71.3 million. Based on Southern Peru's July 8, 2004 market value of $40.30 per share, 28.9 million shares of Southern Peru stock had a market value of $1.16 billion, and 71.3 million shares were worth $2.87 billion. [25] In other words, even the highest equity value yielded for Minera by this analysis was short of Grupo Mexico's actual cash value asking price.

The revised standalone DCF analysis applied the same discount rate and long-term copper price assumptions that Goldman had used in its June 11 presentation to updated projections. This time, by applying a 7.5% discount rate and $1.00 per pound long-term copper price to Minera management's projections, Goldman was only able to yield an equity value of $2.8 billion for Minera. Applying the same aggressive assumptions to the projections as adjusted by A & S generated a standalone equity value for Minera of only $2.085 billion. Applying mid-range assumptions (a discount rate of 8.5% and $0.90/lb long- ***775** term copper price) to the A & S-adjusted projections yielded an equity value for Minera of only $1.358 billion.

H. *The Special Committee Makes A Counterproposal And Suggests A Fixed Exchange Ratio*

After Goldman's July 8 presentation, the Special Committee made a counterproposal to Grupo Mexico that was (oddly) not mentioned in Southern Peru's proxy statement describing the Merger (the “Proxy Statement”). In this counterproposal, the Special Committee offered that Southern Peru would acquire Minera by issuing 52 million shares of Southern Peru stock with a then-current market value of $2.095 billion. [26] The Special Committee also proposed implementation of a fixed, rather than a floating, exchange ratio that would set the number of Southern Peru shares issued in the Merger. [27]

From the inception of the Merger, Grupo Mexico had contemplated that the dollar value of the price to be paid by Southern Peru would be fixed (at a number that was always north of $3 billion), while the number of Southern Peru shares to be issued as consideration would float up or down based on Southern Peru's trading price around the time of closing. But, the Special Committee was uncomfortable with having to issue a variable amount of shares in the Merger. Handelsman testified that, in its evaluation of Grupo Mexico's May 7 term sheet, “it was the consensus of the [Special Committee] that a floating exchange rate was a nonstarter” because “no one could predict the number of shares that [Southern Peru] would have to issue in order to come up with the consideration requested.” [28] The Special Committee wanted a fixed exchange ratio, which would set the number of shares that Southern Peru would issue in the Merger at the time of signing. The dollar value of the Merger consideration at the time of closing would vary with the fluctuations of Southern Peru's market price. According to the testimony of the Special Committee members, their reasoning was that both Southern Peru's stock and the copper market had been historically volatile, and a fixed exchange ratio would protect Southern Peru's stockholders from a situation in which Southern Peru's stock price went down and Southern Peru would be forced to issue a greater number of shares for Minera in order to meet a fixed dollar value. [29] As I will discuss later, that position is hard to square with the Special Committee and Southern Peru's purported bullishness about the copper market in 2004. [30]

I. *Grupo Mexico Sticks To Its Demand*

In late July or early August, Grupo Mexico responded to the Special Committee's counterproposal by suggesting that Southern Peru should issue in excess of 80 million shares of common stock to purchase Minera. It is not clear on the record exactly when Grupo Mexico asked for 80 million shares, but given Southern Peru's trading history at that time, the market value of that consideration would have been close to $3.1 billion, basically the same place where Grupo Mexico had started. ***776** [31] The Special Committee viewed Grupo Mexico's ask as too high, which is not surprising given that the parties were apparently a full billion dollars in value apart, and negotiations almost broke down.

But, on August 21, 2004, after what is described as “an extraordinary effort” in Southern Peru's Proxy Statement, Grupo Mexico proposed a new asking price of 67 million shares. [32] On August 20, 2004, Southern Peru was trading at $41.20 per share, so 67 million shares were worth about $2.76 billion on the market, a drop in Grupo Mexico's ask. [33] Grupo Mexico's new offer brought the Special Committee back to the negotiating table.

After receiving two term sheets from Grupo Mexico that reflected the 67 million share asking price, the second of which was received on September 8, 2004, when 67 million shares had risen to be worth $3.06 billion on the market, [34] Goldman made another presentation to the Special Committee on September 15, 2004. In addition to updated relative DCF analyses of Southern Peru and Minera (presented only in terms of the number of shares of Southern Peru stock to be issued in the Merger), this presentation contained a “Multiple Approach at Different EBITDA Scenarios,” which was essentially a comparison of Southern Peru and Minera's market-based equity values, as derived from multiples of Southern Peru's 2004 and 2005 estimated (or “E”) EBITDA. [35] Goldman also presented these analyses in terms of the number of Southern Peru shares to be issued to Grupo Mexico, rather than generating standalone values for Minera. The range of shares to be issued at the 2004E EBITDA multiple (5.0x) was 44 to 54 million; at the 2005E multiple (6.3x) Goldman's analyses yielded a range of 61 to 72 million shares of Southern Peru stock. [36] Based on Southern Peru's $45.34 share price as of September 15, 2004, 61 to 72 million shares had a cash value of $2.765 billion to $3.26 billion. [37]

The Special Committee sent a new proposed term sheet to Grupo Mexico on September 23, 2004. That term sheet provided for a fixed purchase price of 64 million shares of Southern Peru (translating to a $2.95 billion market value based on Southern Peru's then-current closing price). [38] The

Special Committee's proposal contained two terms that would protect the minority stockholders of Southern Peru: (1) a 20% collar around the purchase price, which gave both the Special Committee and Grupo Mexico the right to walk away from the Merger if Southern Peru's stock price went outside of the collar before the stockholder vote; and (2) a voting provision requiring that a majority of the minority ***777** stockholders of Southern Peru vote in favor of the Merger. Additionally, the proposal called for Minera's net debt, which Southern Peru was going to absorb in the Merger, to be capped at $1.105 billion at closing, and contained various corporate governance provisions.

J. *Grupo Mexico Rejects Many Of The Special Committee's Proposed Terms But The Parties Work Out A Deal*

On September 30, 2004, Grupo Mexico sent a counterproposal to the Special Committee, in which Grupo Mexico rejected the Special Committee's offer of 64 million shares and held firm to its demand for 67 million shares. Grupo Mexico's counterproposal also rejected the collar and the majority of the minority vote provision, proposing instead that the Merger be conditioned on the vote of two-thirds of the outstanding stock. Grupo Mexico noted that conditioning the Merger on a two-thirds shareholder vote obviated the need for the walk-away right requested by the Special Committee, because Grupo Mexico would be prevented from approving the Merger unilaterally in the event the stock price was materially higher at the time of the stockholder vote than at the time of Board approval. Grupo Mexico did accept the Special Committee's proposed $1.05 billion debt cap at closing, which was not much of a concession in light of the fact that Minera was already contractually obligated to pay down its debt and was in the process of doing so.[39]

After the Special Committee received Grupo Mexico's September 30 counterproposal, the parties reached agreement on certain corporate governance provisions to be included in the Merger Agreement, some of which were originally suggested by Grupo Mexico and some of which were first suggested by the Special Committee. Without saying these provisions were of no benefit at all to Southern Peru and its outside investors, let me just say that they do not factor more importantly in this decision because they do not provide any benefit above the protections of default law that were economically meaningful enough to close the material dollar value gap that existed.

On October 5, 2004, members of the Special Committee met with Grupo Mexico to iron out a final deal. At that meeting, the Special Committee agreed to pay 67 million shares, dropped their demand for the collar, and acceded to most of Grupo Mexico's demands. The Special Committee justified paying a higher price through a series of economic contortions. The Special Committee was able to "bridge the gap"[40] between the 64 million and the 67 million figures by decreasing Minera's debt cap by another $105 million, and by getting Grupo Mexico to cause Southern Peru to issue a special dividend of $100 million, which had the effect of decreasing the value of Southern Peru's stock. According to Special Committee member ***778** Handelsman, these "bells and whistles"[41] made it so that "the value of what was being ... acquired in the merger went up, and the value of the specie that was being used in the merger went down ...,"[42] giving the Special Committee reason to accept a higher Merger price.

The closing share price of Southern Peru was $53.16 on October 5, 2004, so a purchase price of 67 million shares had a market value of $3.56 billion,[43] which was higher than the dollar value requested by Grupo Mexico in its February 2004 proposal or its original May 7 term sheet.

At that point, the main unresolved issue was the stockholder vote that would be required to approve the Merger. After further negotiations, on October 8, 2004, the Special Committee gave up on its proposed majority of the minority vote provision and agreed to Grupo Mexico's suggestion that the Merger require only the approval of two-thirds of the outstanding common stock of Southern Peru.[44] Given the size of the holdings of Cerro and Phelps Dodge,[45] Grupo Mexico could achieve a two-thirds vote if either Cerro or Phelps Dodge voted in favor of the Merger.

K. *The Multi–Faceted Dimensions Of Controlling Power: Large Stockholders Who Want To Get Out Support A Strategic, Long–Term Acquisition As A Prelude To Their Own Exit As Stockholders*

Human relations and motivations are complex. One of the members of the Special Committee, Handelsman, represented a large Founding Stockholder, Cerro. This might be seen in some ways to have ideally positioned Handelsman to be a very aggressive negotiator. But Handelsman had a problem

to deal with, which did not involve Cerro having any self-dealing interest in the sense that Grupo Mexico had. Rather, Grupo Mexico had control over Southern Peru and thus over whether Southern Peru would take the steps necessary to make the Founding Stockholders' shares marketable under applicable securities regulations. [46] Cerro and Phelps Dodge, consistent with its name, wanted to monetize their investment in Southern Peru and get out.

Thus, while the Special Committee was negotiating the terms of the Merger, Handelsman was engaged in negotiations of his own with Grupo Mexico. [47] Cerro and ***779** Phelps Dodge had been seeking registration rights from Grupo Mexico (in its capacity as Southern Peru's controller) for their shares of Southern Peru stock, which they needed because of the volume restrictions imposed on affiliates of an issuer by SEC Rule 144. [48]

It is not clear which party first proposed liquidity and support for the Founding Stockholders in connection with the Merger. But it is plain that the concept appears throughout the term sheets exchanged between Grupo Mexico and the Special Committee, and it is clear that Handelsman knew that registration rights would be part of the deal from the beginning of the Merger negotiations and that thus the deal would enable Cerro to sell as it desired. The Special Committee did not take the lead in negotiating the specific terms of the registration rights provisions—rather, it took the position that it wanted to leave the back-and-forth over the agreement details to Cerro and Grupo Mexico. Handelsman, however, played a key role in the negotiations with Grupo Mexico on Cerro's behalf. [49]

At trial, Handelsman explained that there were two justifications for pursuing registration rights—one offered benefits exclusive to the Founding Stockholders, and the other offered benefits that would inure to Southern Peru's entire stockholder base. The first justification was that Cerro needed the registration rights in order to sell its shares quickly, and Cerro wanted "to get out" of its investment in Southern Peru. [50] The second justification concerned the public market for Southern Peru stock. Granting registration rights to the Founding Stockholders would allow Cerro and Phelps Dodge to sell their shares, increasing the amount of stock traded on the market and thus increasing Southern Peru's somewhat thin public float. This would in turn improve stockholder liquidity, generate more analyst exposure, and create a more efficient market for Southern Peru shares, all of which would benefit the minority stockholders. Handelsman thus characterized the registration rights situation as a "win-win," because "it permitted us to sell our stock" and "it was good for [Southern Peru] because they had a better float and they had a more organized sale of shares." [51]

Handelsman's tandem negotiations with Grupo Mexico culminated in Southern Peru giving Cerro registration rights for its shares on October 21, 2004, the same day that the Special Committee approved the Merger. In exchange for registration rights, Cerro expressed its intent to vote its shares in favor of the Merger if the Special Committee recommended it. If the Special Committee made a recommendation against the Merger, or withdrew its recommendation in favor of it, Cerro was bound by the agreement to vote against the Merger. Grupo Mexico's initial proposal, which Handelsman received on October 18, 2004—a mere three days before ***780** the Special Committee was to vote on the Merger—was that it would grant Cerro registration rights in exchange for Cerro's agreement to vote in favor of the Merger. The Special Committee and Handelsman suggested instead that Cerro's vote on the Merger be tied to whether or not the Special Committee recommended the Merger. After discussing the matter with the Special Committee, Grupo Mexico agreed.

On December 22, 2004, after the Special Committee approved the Merger but well before the stockholder vote, Phelps Dodge entered into an agreement with Grupo Mexico that was similar to Cerro's, but did not contain a provision requiring Phelps Dodge to vote against the Merger if the Special Committee did. By contrast, Phelps Dodge's agreement only provided that, [t]aking into account that the Special Committee ... did recommend ... the approval of the [Merger], Phelps Dodge "express[es] [its] current intent, to [ ] submit its proxies to vote in favor of the [Merger]...." [52] Thus, in the event that the Special Committee later withdrew its recommendation to approve the Merger, Cerro would be contractually bound to vote against it, but Grupo Mexico could still achieve the two-thirds vote required to approve the Merger solely with Phelps Dodge's cooperation. Under the terms of the Merger Agreement, the Special Committee was free to change its recommendation of the Merger, but it was not able to terminate the Merger Agreement on the basis of such a change. [53] Rather, a change in the Special Committee's recommendation only gave Grupo Mexico the power to terminate the Merger Agreement. [54]

This issue again warrants a pause. Although I am not prepared on this record to find that Handelsman consciously agreed to a suboptimal deal for Southern Peru simply to achieve liquidity for Cerro from Grupo Mexico, there is little doubt in my mind that Cerro's own predicament as a *stockholder dependent on Grupo Mexico's whim as a controller for registration rights* influenced how Handelsman approached the situation. That does not mean he consciously gave in, but it does means that he was less than ideally situated to press hard. Put simply, Cerro was even more subject to the dominion of Grupo Mexico than smaller holders because Grupo Mexico had additional power over it because of the unregistered nature of its shares.

Perhaps most important, Cerro's desires when considered alongside the Special Committee's actions illustrate the tendency of control to result in odd behavior. During the negotiations of the Merger, Cerro had no interest in the long-term benefits to Southern Peru of acquiring Minera, nor did Phelps Dodge. Certainly, Cerro did not want any deal so disastrous that it would tank the value of Southern Peru completely, but nor did it have a rational incentive to say no to a suboptimal deal if that risked being locked into its investments. Cerro wanted to *sell* and *sell then and there.* But as a Special Committee member, Handelsman did not act consistently ***781** with that impulse for all stockholders. He did not suggest that Grupo Mexico make an offer for Southern Peru, but instead pursued a long-term strategic transaction in which Southern Peru was the buyer. A short-term seller of a company's shares caused that company to be a long-term buyer.

L. *After One Last Price Adjustment, Goldman Makes Its Final Presentation*

On October 13, 2004, Grupo Mexico realized that it owned 99.15% of Minera rather than 98.84%, and the purchase price was adjusted to 67.2 million shares instead of 67 million shares to reflect the change in size of the interest being sold. On October 13, 2004, Southern Peru was trading at $45.90 per share, which meant that 67.2 million shares had a dollar worth of $3.08 billion. [55]

On October 21, 2004, the Special Committee met to consider whether to recommend that the Board approve the Merger. At that meeting, Goldman made a final presentation to the Special Committee. The October 21, 2004 presentation stated that Southern Peru's implied equity value was $3.69 billion based on its then current market capitalization at a stock price of $46.41 and adjusting for debt. Minera's implied equity value is stated as $3.146 billion, which was derived entirely from multiplying 67.2 million shares by Southern Peru's $46.41 stock price and adjusting for the fact that Southern Peru was only buying 99.15% of Minera.

No standalone equity value of Minera was included in the October 21 presentation. [56] Instead, the presentation included a series of relative DCF analyses and a "Contribution Analysis at Different EBITDA Scenarios," both of which were presented in terms of a hypothetical number of Southern Peru shares to be issued to Grupo Mexico for Minera. [57] Goldman's relative DCF analyses provided various matrices showing the number of shares of Southern Peru that should be issued in exchange for Minera under various assumptions regarding the discount rate, the long-term copper price, the allocation of tax benefits, and the amount of royalties that Southern Peru would need to pay to the Peruvian government. As it had in all of its previous presentations, Goldman used a range of long-term copper prices from $0.80 to $1.00 per pound. The DCF analyses generated a range of the number of shares to be issued in the Merger from 47.2 million to 87.8 million. Based on the then-current stock price of $45.92, this translated to $2.17 billion to $4.03 billion in cash value. [58] Assuming the mid-range figures of a discount rate of 8.5% and a long-term copper price of $0.90 per pound, the ***782** analyses yielded a range of shares from 60.7 to 78.7 million.

Goldman's contribution analysis generated a range of 42 million to 56 million shares of Southern Peru to be issued based on an annualized 2004E EBITDA multiple (4.6x) and forecasted 2004E EBITDA multiple (5.0x), and a range of 53 million to 73 million shares based on an updated range of estimated 2005E EBITDA multiples (5.6x to 6.5x). Notably, the 2004E EBITDA multiples did not support the issuance of 67.2 million shares of Southern Peru stock in the Merger. But, 67.2 million shares falls at the higher end of the range of shares calculated using Southern Peru's 2005E EBITDA multiples. As notable, these multiples were not the product of the median of the 2005E EBITDA multiples of comparable companies identified by Goldman (4.8x). Instead, the multiples used were even higher than Southern Peru's own higher 2005E EBITDA Wall Street consensus (5.5x)—an adjusted version of which was used as the bottom end of the range. These higher multiples were then attributed to Minera, a non-publicly traded company suffering from a variety of financial and operational problems.

Goldman opined that the Merger was fair from a financial perspective to the stockholders of Southern Peru, and provided a written fairness opinion.

M. *The Special Committee And The Board Approve The Merger*

After Goldman made its presentation, the Special Committee voted 3–0 to recommend the Merger to the Board. At the last-minute suggestion of Goldman, Handelsman decided not to vote in order to remove any appearance of conflict based on his participation in the negotiation of Cerro's registration rights, despite the fact that he had been heavily involved in the negotiations from the beginning and his hands had been deep in the dough of the now fully baked deal. [59]

The Board then unanimously approved the Merger and Southern Peru entered into the Merger Agreement.

N. *The Market Reacts To The Merger*

The market reaction to the Merger was mixed and the parties have not presented any reliable evidence about it. That is, neither party had an expert perform an event study analyzing the market reaction to the Merger. Southern Peru's stock price traded down by 4.6% when the Merger was announced. When the preliminary proxy statement, which provided more financial information regarding the Merger terms, became public on November 22, 2004, Southern Peru's stock price again declined by 1.45%. But the stock price increased for two days after the final Proxy Statement was filed.

Determining what effect the Merger itself had on this rise is difficult because, as the plaintiff points out, this was not, as the defendants contend, the first time that Southern Peru and Minera's financials were presented together. Rather, the same financial statements were in the preliminary Proxy Statement and the stock price fell.

But, as noted, the plaintiff also offers no evidence that these stock market fluctuations provide a reliable basis for assessing ***783** the fairness of the deal because it did not conduct a reliable event study.

In fact, against a backdrop of strong copper prices, the trading price of Southern Peru stock increased substantially by the time the Merger closed. By April 1, 2005, Southern Peru's stock price had a market value of $55.89 per share, an increase of approximately 21.7% over the October 21, 2004 closing price. But lest this be attributed to the Merger, other factors were in play. This includes the general direction of copper prices, which lifted the market price of not just Southern Peru, but those of its publicly traded competitors. [60] Furthermore, Southern Peru's own financial performance was very strong, as will soon be discussed.

O. *Goldman Does Not Update Its Fairness Analysis*

Despite rising Southern Peru share prices and performance, the Special Committee did not ask Goldman to update its fairness analysis at the time of the stockholder vote on the Merger and closing—nearly five months after the Special Committee had voted to recommend it. At trial, Handelsman testified that he called a representative at Goldman to ask whether the transaction was still fair, but Handelsman's phone call hardly constitutes a request for an updated fairness analysis. [61]

The Special Committee's failure to determine whether the Merger was still fair at the time of the Merger vote and closing is curious for two reasons.

First, for whatever the reason, Southern Peru's stock price had gone up substantially since the Merger was announced in October 2004. In March 2005, Southern Peru stock was trading at an average price of $58.56 a share. The Special Committee had agreed to a collarless fixed exchange ratio and did not have a walk-away right. To my mind, an adroit Special Committee would have recognized the need to re-evaluate the Merger in light of Southern Peru's then-current stock price.

Second, Southern Peru's actual 2004 EBITDA became available before the stockholder vote on the Merger took place, and Southern Peru had smashed through the projections that the Special Committee had used for it. [62] In the October ***784** 21 presentation, Goldman used a 2004E EBITDA for Southern Peru of $733 million and a 2004E EBITDA for Minera of $687 million. Southern Peru's actual 2004 EBITDA was $1.005 billion, 37% more and almost $300 million more than the projections used by Goldman. Minera's actual 2004 EBITDA, by contrast, was $681 million, 0.8% less than the projections used by Goldman. As I mentioned earlier, in its contribution analysis Goldman relied on the values (measured in Southern Peru shares) generated by applying an aggressive

range of Southern Peru's 2005E EBITDA multiples to Minera's A & S-adjusted and unadjusted projections, not the 2004E EBITDA multiple, but the inaccuracy of Southern Peru's estimated 2004 EBITDA should have given the Special Committee serious pause. If the 2004 EBITDA projections of Southern Peru—which were not optimized and had been prepared by Grupo Mexico-controlled management —were so grossly low, it provided reason to suspect that the 2005 EBITDA projections, which were even lower than the 2004 EBITDA projections, were also materially inaccurate, and that the assumptions forming the basis of Goldman's contribution analysis should be reconsidered. Moreover, Southern Peru made $303.4 million in EBITDA in the first quarter of 2005, over 52% of the estimate in Goldman's fairness presentation for Southern Peru's 2005 full year performance. Although the first-quarter 2005 financial statements, which covered the period from January 1, 2005 to March 31, 2005, would not have been complete by the time of the stockholder vote, I can reasonably assume that, as directors of Southern Peru, the Special Committee had access to non-public information about Southern Peru's monthly profit and loss statements. Southern Peru later beat its EBITDA projections for 2005 by a very large margin, 135%,[63] a rate well ahead of Minera's 2005 performance, which beat the deal estimates by a much lower 45%.[64]

The Special Committee's failure to get a fairness update was even more of a concern because Cerro had agreed to vote against the Merger if the Special Committee changed its recommendation. The Special Committee failed to obtain a majority of the minority vote requirement, but it supposedly agreed to a two-thirds vote requirement instead because a two-thirds vote still prevented Grupo Mexico from unilaterally approving the Merger. This out was only meaningful, however, if the Special Committee took the recommendation process seriously. If the Special Committee maintained its recommendation, Cerro had to vote for the Merger, and its vote combined with Grupo Mexico's vote would ensure passage. By contrast, if the Special Committee changed its recommendation, Cerro was obligated to vote against the Merger.

The tying of Cerro's voting agreement to the Special Committee's recommendation was somewhat odd, in another respect. In a situation involving a third-party merger sale of a company without a controlling stockholder, the third party will often want to lock up some votes in support of a deal. A large blocholder and the target board might therefore negotiate a compromise, whereby the blocholder agrees to vote yes if the target board or special committee maintains a recommendation in favor of the transaction. In this situation, however, there is a factor not present here. In an arm's-length deal, the target usually ***785** has the flexibility to change its recommendation or terminate the original merger upon certain conditions, including if a superior proposal is available, or an intervening event makes the transaction impossible to recommend in compliance with the target's fiduciary duties. Here, by contrast, Grupo Mexico faced no such risk of a competing superior proposal because it controlled Southern Peru. Furthermore, the fiduciary out that the Special Committee negotiated for in the Merger agreement provided only that the Special Committee could change its recommendation in favor of the Merger, not that it could terminate the Merger altogether or avoid a vote on the Merger. The only utility therefore of the recommendation provision was if the Special Committee seriously considered the events between the time of signing and the stockholder vote and made a renewed determination of whether the deal was fair. There is no evidence of such a serious examination, despite important emerging evidence that the transaction's terms were skewed in favor of Grupo Mexico.

P. *Southern Peru's Stockholders Approve The Merger*

On March 28, 2005, the stockholders of Southern Peru voted to approve the Merger. More than 90% of the stockholders voted in favor of the Merger. The Merger then closed on April 1, 2005. At the time of closing, 67.2 million shares of Southern Peru had a market value of $3.75 billion.[65]

Q. *Cerro Sells Its Shares*

On June 15, 2005, Cerro, which had a basis in its stock of only $1.32 per share, sold its entire interest in Southern Peru in an underwritten offering at $40.635 per share. Cerro sold its stock at a discount to the then-current market price, as the low-high trading prices for one day before the sale were $43.08 to $44.10 per share. This illustrates Cerro's problematic incentives.

R. *The Plaintiff Sues The Defendants And The Special Committee*

This derivative suit challenging the Merger, first filed in late 2004, moved too slowly, and it was not until June 30, 2010 that the plaintiff moved for summary judgment. [66] On August 10, 2010, the defendants filed a cross-motion for summary judgment, or in the alternative, to shift the burden of proof to the plaintiff under the entire fairness standard. On August 11, 2010, the individual Special Committee defendants cross-moved for summary judgment on all claims under Southern Peru's exculpatory provision adopted under 8 *Del. C.* § 102(b)(7). At a hearing held on December 21, 2010, I dismissed the Special Committee defendants from the case because the plaintiff had failed to present evidence supporting a non-exculpated breach of their fiduciary duty of loyalty, and I denied all other motions for summary judgment. This, of course, did not mean that the Special Committee had acted adroitly or that the remaining defendants, Grupo Mexico and its affiliates, were immune from liability.

In contrast to the Special Committee defendants, precisely because the remaining directors were employed by Grupo Mexico, which had a self-dealing interest directly in conflict with Southern Peru, the ***786** exculpatory charter provision was of no benefit to them at that stage, given the factual question regarding their motivations. At trial, these individual Grupo Mexico-affiliated director defendants made no effort to show that they acted in good faith and were entitled to exculpation despite their lack of independence. In other words, the Grupo Mexico-affiliated directors did nothing to distinguish each other and none of them argued that he should not bear liability for breach of the duty of loyalty if the transaction was unfairly advantageous to Grupo Mexico, which had a direct self-dealing interest in the Merger. Their liability therefore rises or falls with the issue of fairness. [67]

In dismissing the Special Committee members on the summary judgment record, I necessarily treated the predicament faced by Cerro and Handelsman, which involved facing additional economic pressures as a minority stockholder as a result of Grupo Mexico's control, differently than a classic self-dealing interest. I continue, as you will see, to hold that view. Although I believe that Cerro, and therefore Handelsman, were influenced by Cerro's desire for liquidity as a stockholder, it seems to me counterproductive to equate a legitimate concern of a stockholder for liquidity from a controller into a self-dealing interest. [68] I therefore concluded that there had to be a triable issue regarding whether Handelsman acted in subjective bad faith to force him to trial. I concluded then on that record that no such issue of fact existed and even on the fuller trial record (where the plaintiff actually made much more of an effort to pursue this angle), I still could not find that Handelsman acted in bad faith to purposely accept an unfair deal. But Cerro, and therefore Handelsman, did have the sort of economic concern that ideally should have been addressed upfront and forthrightly in terms of whether the stockholder's interest well positioned its representative to serve on a special committee. Put simply, although I continue to be unpersuaded that one can ***787** label Handelsman as having acted with the state of mind required to expose him to liability given the exculpatory charter protection to which he is entitled, I am persuaded that Cerro's desire to sell influenced how Handelsman approached his duties and compromised his effectiveness.

III. *Legal Analysis*

A. *The Standard Of Review Is Entire Fairness*

[4] Consistent with the Supreme Court's decision in *Kahn v. Tremont,* both the plaintiff and the defendants agree that the appropriate standard of review for the Merger is entire fairness, regardless of the existence of the Special Committee. [69] Given this agreement, there is no need to consider whether room is open under our law for use of the business judgment rule standard in a circumstance like this, if the transaction were conditioned upon the use of a combination of sufficiently protective procedural devices. [70] Absent some argument by a party to that effect, judicial restraint counsels my accepting the parties' framework. Where, as here, a controlling stockholder stands on both sides of a transaction, the interested defendants are “required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.” [71] In other words, the defendants with a conflicting self-interest must demonstrate that the deal was entirely fair to the other stockholders. [72]

[5] The entire fairness standard is well-known and has “two basic aspects” of fairness: process (“fair dealing”) and price (“fair price”). [73] As explained by our Supreme Court, fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the ***788** approvals of the directors and the stockholders were obtained,” and fair price “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value,

earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." [74]

Although the concept of entire fairness has two components, the entire fairness analysis is not bifurcated. Rather, the court "determines entire fairness based on all aspects of the entire transaction." [75] Our Supreme Court has recognized, however, that, at least in non-fraudulent transactions, "price may be the preponderant consideration...." [76] That is, although evidence of fair dealing may help demonstrate the fairness of the price obtained, what ultimately matters most is that the price was a fair one. [77]

Of course, under our law, the defendants may shift the burden of persuasion on entire fairness to the plaintiff in certain circumstances. I now turn to the defendants' arguments about that issue.

B. *Are The Defendants Entitled To Shift The Burden Of Persuasion?*

[6] Having served as a trial judge for many years now, it is with some chagrin that I admit that I tried this case without determining in advance which side had the burden of persuasion. But I did not do so lightly. Under the *Lynch* doctrine, [78] when the entire fairness standard applies, controlling stockholders can never escape entire fairness review, [79] but they may shift the burden of persuasion by one of two means: they may show that the transaction was approved either by an independent board majority (or in the alternative, a special committee of independent directors) or, assuming certain conditions, by an informed vote of the majority of the minority shareholders. [80]

1. *Is The Burden Shifted Because Of The Special Committee Process?*

In this case, the defendants filed a summary judgment motion arguing that the ***789** Special Committee process was entitled to dignity under *Lynch* and shifted the burden of persuasion under the preponderance standard to the plaintiff. I found the summary judgment record insufficient to determine that question for the following reason. *Lynch* and its progeny leave doubt in my mind about what is required of a Special Committee to obtain a burden shift. For their part, the defendants argue that what is required is a special committee comprised of independent directors who selected independent advisors and who had the ability to negotiate and reject a transaction. This is, of course, consistent with what one would expect in determining a standard of review that would actually be used in deciding a case. By contrast, the plaintiff stresses that only an effective special committee operates to shift the burden of persuasion, [81] and that a factual determination must be made regarding whether the special committee in fact operated with the degree of ardor and skill one would have expected of an arms-length negotiator with true bargaining power.

[7] To my mind, which has pondered the relevant cases for many years, there remains confusion. In the most relevant case, *Tremont,* the Supreme Court clearly said that to obtain a burden shift, however slight those benefits may be, [82] the special committee must "function in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arms-length.' " [83] A close look at *Tremont* suggests that the inquiry must focus on how the special committee actually negotiated the deal—was it "well functioning" [84] —rather than just how the committee was set up. [85] The test, therefore, seems to contemplate a look back at the substance, and efficacy, of the special committee's negotiations, rather than just a look at the composition and mandate of the special committee. [86] That interpretation is confirmed by a closer look at the Supreme Court's treatment of the factors that the ***790** Court found indicated that the special committee "did not operate in an independent or informed manner...." [87] Although the notion of an "independent" and "informed manner" might suggest that the only relevant factors to that inquiry are those that speak to the special committee's ties with the controlling stockholder (i.e., its independence) and its ability to retain independent advisors and say no, the majority and concurring decisions in *Tremont* seem to reveal that was not the approach taken by the Court. *Tremont* seems to focus both on indicia of independence and indicia of procedural and even substantive fairness. For example, the Supreme Court found problematic the supposedly outside directors' previous business relationships with the controlling stockholder that resulted in significant financial compensation or influential board positions [88] and their selection of advisors who were in

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some capacity affiliated with the controlling stockholder, [89] both of which are factors that speak to the special committee's facial independence.

But, the Supreme Court also seems to call into question the substance of the special committee's actual efforts, noting the special committee directors' heavy reliance on projections prepared by the controlling stockholder, [90] their perfunctory effort at scheduling and attending committee meetings, [91] and the limitation on the exchange of ideas that resulted from the directors' failure to fully participate in an active process. [92]

Judge Quillen's concurring opinion [93] most clearly contemplates a focus on both indicia of independence and indicia of substantive fairness in the negotiation process. In confirming the majority's ruling to deny the defendants the benefit of the burden shift, Judge Quillen begins by reviewing the special committee's ties to the controlling stockholder and its selection of questionable advisors (i.e., factors that could be applied early in a case to determine the burden allocation), but then he moves into a discussion where he points to deficiencies in the substance of the special committee's negotiations, which cannot in any easy way be separated from an examination of fairness. The concurrence questions the special committee's failure to take advantage of certain opportunities to exert leverage over the controlling stockholder [94] as well as its failure to negotiate the price of the stock purchase downward when there was indicia of price manipulation, ***791** [95] when the controlling stockholder's chief negotiator knew that the stock was worth less than the market, [96] and when the target's stock price dropped precipitously before the date of signing. [97] The concurrence also questions the ultimate fairness of the price and other terms agreed to by the special committee, noting that the substance of the negotiations is "not self-verifying on the independence issue." [98] These references in the concurrence echo the majority opinion itself, which uses phrases like "real bargaining power" [99] and "well functioning" [100] to describe what is required of the special committee to merit a burden shift, which seem to get at whether the special committee in fact simulated the role that a third-party with negotiating power would have played. [101] Thus, to my mind, *Tremont* implies that there is no way to decide whether the defendant is entitled to a burden shift without taking into consideration the substantive decisions of the special committee, a fact-intensive exercise that overlaps with the examination of fairness itself.

As a trial judge, I note several problems with such an approach. Assuming that the purpose of providing a burden shift is not only to encourage the use of special committees, [102] but also to provide a reliable pre-trial guide to the burden of persuasion, [103] the factors that give rise to the burden shift must be determinable early in the litigation and not so deeply enmeshed in the ultimate fairness analysis. Thus, factors like the independence of the committee and the adequacy of its mandates (i.e., was it given blocking and negotiating power) would be the trigger for the burden shift.

Because the only effect of the burden shift is to make the plaintiff prove unfairness under a preponderance standard, the benefits of clarity in terms of trial presentation and for the formation of special committees would seem to outweigh the costs of such an upfront approach focusing on structural independence. To be clear, such an allocation would still allow the plaintiff to go to trial so long as there was a triable issue regarding fairness. Further, ***792** because the burden becomes relevant only when a judge is rooted on the fence post and thus in equipoise, it is not certain that there is really a cost. [104]

By contrast, the alternative approach leads to situations like this and *Tremont* itself, where the burden of proof has to be determined during the trial, and where that burden determination is enmeshed in the substantive merits. [105] As a trial judge, I take very seriously the standard of review as a prism through which to determine a case. When a standard of review does not function as such, it is not clear what utility it has, and it adds costs and complication to the already expensive and difficult process of complex civil litigation. [106] Subsuming within the burden shift analysis questions of whether the special committee was substantively effective in its negotiations with the controlling stockholder —questions fraught with factual complexity—will, absent unique circumstances, guarantee that the burden shift will rarely be determinable on the basis of the pre-trial record alone. [107] If we take seriously the notion, as I do, that a standard of review is meant to serve as the framework through which the court evaluates the parties' evidence and trial testimony in reaching a decision, and, as important, the framework through which the litigants determine how best to prepare their cases for trial, [108] it is problematic to ***793** adopt an analytical approach whereby the burden allocation

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can only be determined in a post-trial opinion, after all the evidence and all the arguments have been presented to the court. [109]

But, I am constrained to adhere faithfully to *Tremont* as written, and I read it and some of its progeny [110] as requiring a factual look at the actual effectiveness of the special committee before awarding a burden shift. For that reason, I will, as you will see, find that the burden of persuasion remained with the defendants, because the Special Committee was not "well functioning." [111] And I will also find, however, that this determination matters little because I am not stuck in equipoise about the issue of fairness. Regardless of who bears the burden, I conclude that the Merger was unfair to Southern Peru and its stockholders.

2. *Did The Burden Of Persuasion Shift Because Of The Stockholder Vote?*

[8] With much less passion, the defendants also seek to obtain a burden shift by arguing that the Merger ultimately received super-majority support of the stockholders other than Grupo Mexico, and a majority support of the stockholders excluding all of the Founding Stockholders.

The defendants have failed to earn a burden shift for the following reasons. First, in a situation where the entire fairness standard applies because the vote is controlled by an interested stockholder, any burden-shifting should not depend on the after-the-fact vote result but should instead require that the transaction has been conditioned up-front on the approval of a majority of the disinterested stockholders. Chancellor Chandler, in his *Rabkin v. Olin Corp.* decision, [112] took that view and was affirmed by our Supreme Court, and it remains sound to me in this context. [113] It is a very different thing for ***794** stockholders to know that their vote is in fact meaningful and to have a genuine chance to disapprove a transaction than it is to be told, as they were in this case, that the transaction required a two-thirds vote, which would be satisfied certainly because Grupo Mexico, Cerro, and Phelps Dodge had the voting power to satisfy that condition and were clearly intent on voting yes. [114] In the latter situation, the vote has little meaning except as a form of protest, especially in a situation like this when there were no appraisal rights because Southern Peru was the buyer.

Second, the defendants have not met their burden to show that the vote was fully informed. [115] The Proxy Statement left out a material step in the negotiation process, to wit, the Special Committee's July counteroffer, offering to give Grupo Mexico only $2.095 billion worth of Southern Peru stock for Minera in response to Grupo Mexico's ask of $3.1 billion in its May 7, 2004 term sheet. What lends credibility to this counteroffer is that it was made after the Special Committee's July 8, 2004 meeting with Goldman, where Goldman had presented to the Special Committee Minera's operating projections, metal price forecasts, and other valuation metrics. After reviewing this information, the Special Committee was still $1 billion short of Grupo Mexico's ask with an offer that was at the high end of Minera's standalone value but at the low end of its "relative" value. [116] This step showed how deep the value gap was in real cash terms. The minority stockholders were being asked to make an important voting decision [117] about an acquisition that would nearly double the size of the Company and materially increase the equity stake of the controlling ***795** stockholder [118]—they should have been informed of the value that the Special Committee placed on Minera at a point in the negotiations when it had sufficient financial information to make a serious offer.

That omission combines with less than materially clear disclosure about the method by which Goldman concluded the Merger was fair. In particular, the Proxy Statement did not disclose the standalone implied equity values for Minera generated by the DCF analyses performed in June 2004 and July 2004, which look sound and generated mid-range values of Minera that were far less than what Southern Peru was paying in the Merger, [119] nor did it disclose the standalone implied equity values of either Southern Peru or Minera that were implied by the inputs used in Goldman's relative DCF analysis underlying the fairness opinion. [120] The Proxy Statement thus obscured the fact that the implied equity value of Southern Peru that Goldman used to anchor the relative valuation of Minera was nearly $2 billion less than Southern Peru's *actual* market equity value at the time of signing. [121] There were additional obscurities in connection with the Southern Peru multiples that Goldman used to support its fairness opinion.

The Proxy Statement did disclose that Minera was valued using multiples tied to Southern Peru's own multiples, although it was less than clear as to what those multiples were. The Proxy Statement listed a Wall Street consensus

EV/2005E EBITDA multiple for Southern Peru of 5.5x in Goldman's comparable companies chart, [122] but it did not disclose the full range of EV/2005E EBITDA multiples for Southern Peru that Goldman actually used in its contribution analysis to justify the fairness of the relative valuation. The *bottom* of the range was 5.6x, or Southern Peru's EV/2005E multiple listed in the comparable companies analysis as apparently adjusted for the dividend, which itself was much higher than the median comparable companies multiple, which was listed at 4.8x [123] and critically absent from this generous bottom of the contribution analysis. ***796** The range of multiples then proceeded northward, to 6.3x, 6.4x, and 6.5x, with a median of 6.4x. [124] These inflated multiples were based not on real market metrics, but on various scenarios using Southern Peru's internal pessimistic projections for its 2005E EBITDA. [125] By failing to disclose the full range of multiples used in the contribution analysis, the Proxy obscured the fact that only these inflated multiples would justify an issuance of over 67 million shares in exchange for Minera, [126] multiples that were nearly 33% higher than the Wall Street consensus median multiple of the comparable companies used by Goldman for 2005, [127] and 16% higher than the Wall Street consensus multiple for Southern Peru. [128]

Moreover, Grupo Mexico went on a road show to its investors, bankers, and other members of the financial community in November 2004 to garner support for the Merger, during which Grupo Mexico presented materials stating that a “Key Term” of the Merger was that the Merger implied a Minera EV/2005E EBITDA of 5.6x. [129] This 5.6x multiple was derived from an enterprise value for Minera that itself was calculated by multiplying the 67.2 million shares to be issued by Southern Peru by the stock price of Southern Peru as of October 21, 2004, and then adding Minera's debt. This calculation obscures the fact that in order to justify the fairness of the 67.2 million share issuance in the first place, Goldman's fairness presentation did not rely on a 5.6x multiple, but a much higher median multiple of 6.4x. [130] Also, the assumptions behind the road show's advertised 5.6x multiple were not consistent with the assumptions underlying Goldman's financial opinion. Namely, Grupo Mexico was able to “employ” (to use a non-loaded term) a Wall Street consensus multiple only by inflating Minera's estimated 2005 EBITDA over what had been used in the Goldman fairness analysis, [131] a feat ***797** accomplished by assuming a higher copper production than the production figures provided by the A & S adjusted projections as well as Minera's *own* unadjusted projections, both of which Goldman used in its final presentation to the Special Committee. [132] Put bluntly, Grupo Mexico went out to investors with information that made the total mix of information available to stockholders materially misleading.

For these reasons, I do not believe a burden shift because of the stockholder vote is appropriate, and in any event, even if the vote shifted the burden of persuasion, it would not change the outcome I reach.

C. *Was The Merger Entirely Fair?*

[9] Whether the Merger was fair is the question that I now answer.

I find, for the following reasons, that the process by which the Merger was negotiated and approved was not fair and did not result in the payment of a fair price. Because questions as to fair process and fair price are so intertwined in this case, I do not break them out separately, but rather treat them together in an integrated discussion.

1. *The Special Committee Gets Lost In The Perspective–Distorting World Of Dealmaking With A Controlling Stockholder*

I start my analysis of fairness with an acknowledgement. With one exception, which I will discuss, the independence of the members of the Special Committee has not been challenged by the plaintiff. The Special Committee members were competent, well-qualified individuals with business experience. Moreover, the Special Committee was given the resources to hire outside advisors, and it hired not only respected, top tier of the market financial and legal counsel, but also a mining consultant and Mexican counsel. Despite having been let down by their advisors in terms of record keeping, there is little question but that the members of the Special Committee met frequently. Their hands were on the oars. So why then did their boat go, if anywhere, backward?

This is a story that is, I fear, not new.

From the get-go, the Special Committee extracted a narrow mandate, to “evaluate” a transaction suggested by the

majority stockholder.[133] Although I conclude that the Special Committee did in fact go further and engage in negotiations, its approach to negotiations was stilted and influenced by its uncertainty about whether it was actually empowered to negotiate. The testimony on the Special Committee members' understanding of their mandate, for example, evidenced their lack of certainty about whether the Special Committee could do more than just evaluate the Merger.[134]

***798** Thus, from inception, the Special Committee fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the Merger. The Special Committee did not insist on the right to look at alternatives; rather, it accepted that only one type of transaction was on the table, a purchase of Minera by Southern Peru. As we shall see, this acceptance influences my ultimate determination of fairness, as it took off the table other options that would have generated a real market check and also deprived the Special Committee of negotiating leverage to extract better terms.

With this blinkered perspective, the first level of rationalization often begins. For Southern Peru, like most companies, it is good to have growth options. Was it rational to think that combining Southern Peru and Minera might be such a growth option, if Southern Peru's stronger balance sheet and operating capabilities could be brought to bear on Minera? Sure. And if no other opportunities are available because we are a controlled company, shouldn't we make the best of this chance? Already, the mindset has taken a dangerous path.[135]

The predicament of Handelsman helps to illustrate this point. Clearly, from the weak mandate it extracted and its failure to push for the chance to look at other alternatives, the Special Committee viewed itself as dealing with a majority stockholder, Grupo Mexico, that would seek its own advantage. Handelsman, as a key representative of Cerro, was even more susceptible to Grupo Mexico's dominion, precisely because Cerro wanted to be free of its position as a minority stockholder in Grupo Mexico-controlled Southern Peru. Although I am chary to conclude that the desire of a stockholder to be able to sell its shares like other holders is the kind of self-dealing interest that should deem someone like Handelsman interested in the Merger,[136] Handelsman was operating under a constraint that was not shared by all stockholders, which was his employer's desire to sell its holdings in Southern Peru.[137] ***799** It follows that Handelsman may not have been solely focused on paying the best price in the Merger (even though all things being equal, Cerro, like any stockholder, would want the best possible price) because he had independent reasons for approving the Merger. That is, as between a Merger and no Merger at all, Handelsman had an interest in favoring the deal because it was clear from the outset that Grupo Mexico was using the prospect of causing Southern Peru to grant registration rights to Cerro (and Phelps Dodge) as an inducement to get them to agree to the Merger.[138] Thus, Handelsman was not well-incentivized to take a hard-line position on what terms the Special Committee would be willing to accept, because as a stockholder over whom Grupo Mexico was exerting another form of pressure, he faced the temptation to find a way to make the deal work at a sub-optimal price if that would facilitate liquidity for his stockholding employer.[139]

I thus face the question of whether Cerro's liquidity concern and short-term interests—ones not shared with the rest of the non-founding minority stockholders—should have disabled Handelsman from playing any role in the negotiation process. On the one hand, Cerro's sale of a majority of its shares at below market price shortly after it obtained registration rights suggests that its interest in liquidity likely dampened its concern for achieving a fair price for its shares, especially given its low tax basis in the shares. On the other hand, as a large blocholder representative and experienced M & A practitioner, Handelsman had knowledge and an employer with an economic investment that in other respects made him a valuable Special Committee member. After hearing Handelsman's testimony at trial, I cannot conclude that he consciously acted in less than good faith. Handelsman was not in any way in Grupo Mexico's pocket, and I do not believe that he purposely tanked the negotiations. But, Cerro's important liquidity concern had the undeniable effect of extinguishing much of the appetite that one of the key negotiators of the Merger had to say no. Saying no meant no liquidity.

Likewise, Cerro had no intent of sticking around to benefit from the long-term benefits of the Merger, and thus Handelsman was in an odd place to recommend to other stockholders to make a long-term strategic acquisition. In sum, when all these factors are considered, Handelsman was not the ideal candidate to serve as the “defender of interests of minority shareholders ***800** in the dynamics of fast moving negotiations.”[140] The fact that the Special Committee's investment bankers pointed out the pickle he was in late in the game and that Handelsman abstained from voting

fail to address this concern because the deal was already fully negotiated with Handelsman's active involvement.

To my mind, the more important point that Handelsman's predicament makes plain is the narrow prism through which the Special Committee viewed their role and their available options. For example, consider the misalignment between Cerro's interest in selling its equity position in Southern Peru as soon as possible and the fact that the Merger was billed as a long-term, strategic acquisition for the company. What would have been an obvious solution to this mismatch of interests—where both Cerro and Phelps Dodge wanted to get out of Southern Peru and where Grupo Mexico wanted to stay in—would have been for the Special Committee to say to Grupo Mexico: "Why don't you buy Southern Peru, since you want to increase your equity ownership in this company and everyone else wants to get out?" This simple move would have immediately aligned the interests and investment horizons of Cerro and the rest of the minority shareholders, thus positioning Handelsman as the ideal Special Committee candidate with a maximized level of negotiating gusto. But, the Special Committee did not suggest such a transaction, nor did it even appear to cross the directors' mind as a possibility.

Why was this so? Because the Special Committee was trapped in the controlled mindset, where the only options to be considered are those proposed by the controlling stockholder.[141] When a special committee confines itself to this world, it engages in the self-defeating practice of negotiating with itself—perhaps without even realizing it—through which it nixes certain options before even putting them on the table. Even if the practical reality is that the controlling stockholder has the power to reject any alternate proposal it does not support, the special committee still benefits from a full exploration of its options. What better way to "kick the tires" of the deal proposed by the self-interested controller than to explore what would be available to the company if it were not constrained by the controller's demands? Moreover, the very process of the special committee asking the controlling stockholder to consider alternative options can change the negotiating dynamic. That is, when the special committee engages in a meaningful back-and-forth with the controlling stockholder to discuss the feasibility of alternate terms, the Special Committee might discover certain weaknesses of the controlling stockholder, thus creating an opportunity for the committee to use this new-found negotiating leverage to extract benefits for the minority.

Here, for instance, if the Special Committee had proposed to Grupo Mexico that it buy out Southern Peru at a premium to its rising stock price, it would have opened up the deal dynamic in a way that gave the Special Committee leverage and that was consistent with the Special Committee's sense of the market. Perhaps Grupo Mexico would have been open to the prospect and there would have been a valuable chance for all of the Southern Peru's stockholders to obtain liquidity at a premium to a Southern Peru market price that the Special Committee saw as was high in comparison to Southern Peru's fundamental value. At the very least, it would force ***801** Grupo Mexico to explain why it—the party that proposed putting these assets together under its continued control—could not itself be the buyer and finance such a transaction. Was that because it was cash-strapped and dealing with serious debt problems, in part because Minera was struggling? If you need to be the seller, why? And why are you in a position to ask for a high price? *If Minera is so attractive, why are you seeking to reduce your ownership interest in it?* Part of the negotiation process involves probing and exposing weaknesses, and as a result putting the opponent back on his heels.

In sum, although the Special Committee members were competent businessmen and may have had the best of intentions, they allowed themselves to be hemmed in by the controlling stockholder's demands. Throughout the negotiation process, the Special Committee's and Goldman's focus was on finding a way to get the terms of the Merger structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption that the Merger was a good idea in the first place.

2. *The Special Committee Could Never Justify The Merger Based On Standalone Valuations Of Minera*

This mindset problem is illustrated by what happened when Goldman could not value the "get"—Minera—anywhere near Grupo Mexico's asking price, the "give." From a negotiating perspective, that should have signaled that a strong response to Grupo Mexico was necessary and incited some effort to broaden, not narrow, the lens. Instead, Goldman and the Special Committee went to strenuous lengths to equalize the values of Southern Peru and Minera. The onus should have been on Grupo Mexico to prove Minera was worth $3.1 billion, but instead of pushing back on Grupo Mexico's analysis, the Special Committee and Goldman devalued Southern Peru and topped up the value of Minera. The

actions of the Special Committee and Goldman undermine the defendants' argument that the process leading up to the Merger was fair and lend credence to the plaintiff's contention that the process leading up to the Merger was an exercise in rationalization.

The plaintiff argues that, rather than value Minera so as to obtain the best deal possible for Southern Peru and its minority stockholders, the Special Committee "worked and reworked" their approach to the Merger to meet Grupo Mexico's demands and rationalize paying Grupo Mexico's asking price. [142] The defendants concede that, before settling on relative valuation, Goldman performed a number of other financial analyses of Minera to determine its value, including a standalone DCF analysis, a sum-of-the-parts analysis, a contribution analysis, comparable companies analysis and an ore reserve analysis, and that the results of all of these analyses were substantially lower than Grupo Mexico's asking price of $3.1 billion.

A reasonable special committee would not have taken the results of those analyses by Goldman and blithely moved on to relative valuation, without any continuing and relentless focus on the actual give-get involved in real cash terms. But, this Special Committee was in the altered state of a controlled mindset. Instead of pushing Grupo Mexico into the range suggested by Goldman's analysis of Minera's fundamental value, the Special Committee went backwards to accommodate Grupo Mexico's asking price—an asking price *that never really changed.* As part of its backwards shuffle, the Special Committee compared unstated DCF values of Southern Peru and Minera and applied Southern Peru's own EBITDA multiples to Minera's ***802** projections to justify a higher share issuance.

3. *The Relative Valuation Technique Is Not Alchemy That Turns A Sub–Optimal Deal Into A Fair One*

The defendants portray relative valuation as the only way to perform an "apples-to-apples" comparison of Southern Peru and Minera. [143] But, the evidence does not persuade me that the Special Committee relied on truly equal inputs for its analyses of the two companies. When performing the relative valuation analysis, the cash flows for Minera were optimized to make Minera an attractive acquisition target, but no such dressing up was done for Southern Peru. [144] Grupo Mexico hired two mining engineering firms, Winters, Dorsey & Company and Mintec, Inc., to update Minera's life-of-mine plans and operations. When A & S began conducting due diligence on Minera, it tested the plans prepared by Winters and Mintec for reasonableness. [145] After A & S knocked down some of Minera's projections, Mintec revised its analyses to produce a new optimization plan for Minera's Cananea mine ("Alternative 3") that added material value to Minera's projections. [146] By contrast, no outside consultants were hired to update Southern Peru's life-of-mine plans, although A & S did review Southern Peru management's projections. [147] Goldman's presentations to the Special Committee indicate that any A & S adjustments to Southern Peru projections were relatively minor. [148] The record does not reveal any comparable effort to update and optimize Southern Peru's projections as if it were being sold, as was being done for Minera. In fact, there is evidence to the contrary: no additional analyses were performed on Southern Peru despite A & S informing the Special Committee that there was "expansion potential" at Southern Peru's Toquepala and Cuajone mines and "the conceptual studies should be expanded, similar to Alternative 3 ... There is no ***803** doubt optimization that can be done to the current thinking that will add value at lower capital expenditures." [149] Also, as of the relevant time period, Minera was emerging from—if not still in—a period of financial distress. [150] The Minera projections used in Goldman's final fairness evaluation were further optimized in that they assumed that the deal would take place, [151] which meant that the projections took into account the benefits that Minera would gain by becoming part of Southern Peru. In other words, the process was one where an aggressive seller was stretching to show value in what it was selling, and where the buyer, the Special Committee, was not engaging in a similar exercise regarding its own company's value despite using a relative valuation approach, where that mattered.

As is relevant in other respects, too, before the Merger vote, the Special Committee had evidence that this approach had resulted in estimated cash flows for Southern Peru that were too conservative. For 2004, Goldman projected EBITDA for Southern Peru that turned out to be almost $300 million lower than the EBITDA that Southern Peru actually attained. By contrast, Minera's were close to, but somewhat lower than, the mark.

As another technique of narrowing the value gap, Goldman shifted from using Southern Peru's 2004E EBITDA multiple to a range of its 2005E EBITDA multiples in the contribution

analyses of the Merger, which also helped to level out the "give" and the "get" and thereby rationalize Grupo Mexico's asking price. As described previously, applying Southern Peru's 2004E EBITDA multiples did *not* yield a range of values encompassing 67.2 million shares. Instead, Goldman relied on applying Southern Peru's higher 2005E multiples to Minera to justify such a figure.

Goldman's decision to apply Southern Peru's EBITDA multiples to Minera was questionable in the first place. Valuing Minera by applying Southern Peru's multiple was a charitable move on the part of the Special Committee, and reasonable third-party buyers are generally not charitable toward their acquisition targets. [152] Unlike Southern Peru, a Delaware corporation listed on the New York Stock Exchange, Minera was unlisted, subject to Mexican accounting standards, and was not being regulated and overseen by the Securities and Exchange Commission. Moreover, Minera was not in sound financial condition. Why did the Special Committee top up Minera's multiple to Southern Peru's own, instead of exploiting for Southern Peru the market-tested value of its acquisition currency? One of the advantages of overvalued stock is that it is cheap acquisition currency; if an acquiror is trading at a higher multiple than the target, it generally takes advantage of that multiple in the acquisition. The Special Committee's charitable multiple migration is highly suspicious given the involvement of a controlling stockholder on both sides of the deal.

***804** In these respects, the Special Committee was not ideally served by its financial advisors. Goldman dropped any focus on the value of what Southern Peru was giving from its analyses. Taking into account all the testimony and record evidence, both Goldman and the Special Committee believed that Southern Peru's market price was higher than its fundamental value. But instead of acting on that belief, they did something very unusual, in which Goldman shifted its client's focus to an increasingly non-real world set of analyses that obscured the actual value of what Southern Peru was getting and that was inclined toward pushing up, rather than down, the value in the negotiations of what Grupo Mexico was seeking to sell. In fairness, I cannot attribute Goldman's behavior to a fee incentive, because Goldman did not have a contingent fee right based on whether or not the Merger was consummated. [153] But Goldman appears to have helped its client rationalize the one strategic option available within the controlled mindset that pervaded the Special Committee's process.

4. *The Special Committee Should Not Have Discounted Southern Peru's Market Price*

A reasonable third-party buyer free from a controlled mindset would not have ignored a fundamental economic fact that is not in dispute here—in 2004, Southern Peru stock could have been sold for price at which it was trading on the New York Stock Exchange. That is, for whatever reasons, the volatile market in which public companies trade was generating a real-world cash value for Southern Peru's acquisition currency. The defendants concede that whatever bloc of stock Southern Peru gave to Grupo Mexico could have been sold for its market price in American currency, i.e., dollars. Grupo Mexico knew that. The record is clear that Grupo Mexico itself relied on the market price of Southern Peru all along —during the negotiation process, Grupo Mexico kept asking again and again to be paid in approximately $3.1 billion worth of Southern Peru stock measured at its market price.

It has, of course, been said that under Delaware law fair value can be determined "by any techniques or methods which are generally considered acceptable in the financial community," [154] and "[i]t is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock." [155] As former Chancellor Allen wrote in his *Time–Warner* decision, which was affirmed by the Delaware Supreme Court, "[J]ust as the Constitution does not enshrine Mr. Herbert's social statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text." [156] But, there are critical differences between this case and *Time–Warner.* In *Time–Warner,* the board of Time, however wrongly, believed that the value of the *Time–Warner* combination would exceed the value offered by the $200 per share Paramount tender offer when the dust on the Texas deal range ultimately settled. [157]

Here, the Special Committee did not believe that Southern Peru was being undervalued ***805** by the stock market. To the contrary, its financial advisor Goldman, after months of study, rendered analyses suggesting that Southern Peru was being overvalued by the market. The corresponding fundamental analyses of Minera showed that Minera was worth nowhere close to the $3.1 billion in real value that Grupo Mexico was demanding. This was not a situation where Goldman and the Special Committee believed that

Minera was being undervalued even more than Southern Peru and therefore that Southern Peru would be getting more than $3.1 billion in value for giving up stock it could sell for $3.1 billion in real cash.

In other words, the Special Committee did not respond to its intuition that Southern Peru was overvalued in a way consistent with its fiduciary duties or the way that a third-party buyer would have. As noted, it did not seek to have Grupo Mexico be the buyer. Nor did it say no to Grupo Mexico's proposed deal. What it did was to turn the gold that it held (market-tested Southern Peru stock worth in cash its trading price) into silver (equating itself on a relative basis to a financially-strapped, non-market tested selling company), and thereby devalue its own acquisition currency. Put bluntly, a reasonable third-party buyer would only go behind the market if it thought the fundamental values were on its side, not retreat from a focus on market if such a move disadvantaged it. If the fundamentals were on Southern Peru's side in this case, the DCF value of Minera would have equaled or exceeded Southern Peru's give. But Goldman and the Special Committee could not generate any responsible estimate of the value of Minera that approached the value of what Southern Peru was being asked to hand over.

Goldman was not able to value Minera at more than $2.8 billion, no matter what valuation methodology it used, even when it based its analysis on Minera management's unadjusted projections. [158] As the plaintiff points out, Goldman never advised the Special Committee that Minera was worth $3.1 billion, or that Minera could be acquired at, or would trade at, a premium to its DCF value if it were a public company. Furthermore, the defendants' expert did not produce a standalone equity value for Minera that justified issuing shares of Southern Peru stock worth $3.1 billion at the time the Merger Agreement was signed.

5. *Can It All Be Explained By The Mysterious $1.30 Long–Term Copper Price?*

At trial, there emerged a defense of great subtlety that went like this. In reality, the Special Committee and Goldman did believe that Minera was worth more than $3.1 billion. Deep down, the Special Committee believed that the long-term direction of copper prices was strongly northward, and that as of the time of the deal were more like $1.30 per pound than the $1.00 that was the high range of Goldman's analysis for the Special Committee. This was, of course, a full $0.40 per pound higher than the $0.90 number used by Southern Peru in its own internal planning documents and its publicly disclosed financial statements, higher than the $0.90 used by Minera in its internal planning process, ***806** and higher than the $0.90 median of analyst price estimates identified by Goldman and relied on by Goldman in issuing its fairness opinion.

According to the defendants, as effective negotiators, the Special Committee and Goldman perceived that if one applied this "real" long-term copper price trend to Minera, it would generate very high standalone values for Minera and thus be counterproductive from a negotiating standpoint. Hence, the Special Committee did not use these prices, but rather focused on a relative valuation approach, not because it obscured that Southern Peru was not obtaining a get as good as the give, but so Grupo Mexico would not recognize how great a deal that Southern Peru was getting.

In support of this theory, the defendants presented a qualified academic, Eduardo Schwartz, who testified that if one valued Southern Peru and Minera on a relative valuation basis using the ultimate Goldman assumptions and a $1.30 copper price, Southern Peru actually paid far too little. [159] The theory of this expert and the defendants is that a rising copper price would have benefited Minera far more than it did Southern Peru. [160] Schwartz also says that Southern Peru's stock market trading price had to be explained by the fact that the stock market was actually using a long-term copper price of $1.30, despite the lower long term price that Southern Peru, other companies, and market analysts were using at the time. [161]

But what the defendants' expert did not do is telling. Despite his eminent qualifications, Schwartz would not opine on the standalone value of Minera, he would not lay his marker down on that. Furthermore, the implication that Minera would benefit more than Southern Peru from rising copper prices resulted from taking the assumptions of the Special Committee process itself, [162] in which great efforts had been made by Grupo Mexico and the Special Committee to optimize Minera's value and nothing comparable had been done to optimize Southern Peru's value. The defendants' expert appears to have given no weight to the nearly $300 million EBITDA underestimate in the 2004 Southern Peru cash flow estimates, or to the fact that the 2005 estimates for Southern Peru also turned out to be close to $800 million less than estimated, whereas Minera did not outperform the 2004 estimates used in the deal and outperformed the 2005

estimates ***807** by a far lower percentage than Southern Peru. The defendants' position that the Merger was fair in light of rising copper prices is also, as we shall see, undermined by evidence that they themselves introduced regarding the competitive performance of Southern Peru and Minera from 2005 onward to 2010. That evidence illustrates that in terms of generating EBITDA, Southern Peru continued to be the company with the comparatively strong performance, while Minera lagged behind.

Even more important, I can find no evidence in the actual record of deal negotiations of any actual belief by the Special Committee or Goldman that long-term copper prices were in fact $1.30, that it would be easy to rationalize a deal at the price Grupo Mexico suggested at copper prices of $1.30, but that for sound negotiating reasons, they would not run DCF analyses at that price, but instead move to a relative valuation approach. There is just nothing in the record that supports this as a contemporaneous reality of the negotiating period, as supposed to an after-the-fact rationalization conceived of for litigation purposes. [163]

The Special Committee members who testified admitted that they were taken aback by Goldman's analysis of Minera's standalone value. None said that they insisted that Goldman run models based on higher long-term copper prices or that they believed the long-term price that Southern Peru was using in its public filings was too low. It is hard to believe that if the Special Committee felt deep in its deal bones that the long-term copper price was higher than $1.00, it would not have asked Goldman to perform a DCF analysis on those metrics. Importantly, Southern Peru continued to use a long-term copper price of $0.90 per pound for internal planning purposes until December 31, 2007, when it changed to $1.20. [164] In terms of the negotiating record itself, the only evidence is that a long-term copper price of $1.00 was deemed aggressive by the Special Committee and its advisors and $0.90 as the best estimate. [165] Thus, Schwartz's conclusion that the market was assuming a long-term copper price of $1.30 in valuing Southern Peru appears to be based entirely on post-hoc speculation. Put simply, there is no credible evidence of the Special Committee, in the heat of battle, believing that the long-term copper price was actually $1.30 per pound but using $0.90 instead to give Southern Peru an advantage in the negotiation process.

Furthermore, the Special Committee engaged in no serious analysis of the differential effect, if any, on Southern Peru and Minera of higher copper prices. [166] That is ***808** a dynamic question that involves many factors and, as I have found, the Special Committee did not attempt to “optimize” Southern Peru's cash flows in the way it did Minera's. The plaintiff argues that by simply re-running his DCF analyses using a long-term copper price assumption of $1.30, Schwartz glosses over key differences in the effect of an increase in long-term copper prices on the reserves of Minera and Southern Peru. Primarily, the plaintiff argues that if the long-term copper price assumption is increased to $1.30, then Southern Peru's reserves would have increased far more dramatically than Minera's and, therefore, the relative value of the two companies would not remain constant at a higher long-term copper price. The defendants, as discussed above, respond that Minera, not Southern Peru was more sensitive to increases in copper price assumptions, and thus, if higher copper prices are used the deal becomes even more favorable for Southern Peru. It is not clear if anybody really knew, at the time of the Merger, the extent to which the projections of Southern Peru or Minera would have changed in the event that the companies regarded $1.30 per pound as a reliable long-term copper price. But, the parties' arguments with respect to the relative effects of changes in the long-term copper price on Minera and Southern Peru's reserves end up being of little importance, because there is no evidence in the record that suggests that anyone at the time of the Merger was contemplating a $1.30 long-term copper price.

The idea that the Special Committee and Goldman believed that copper prices were going steeply higher also makes its decision to seek a fixed exchange ratio odd, because the likely result of such price movements would have been, as things turned out, to result in Southern Peru delivering more, not less, in value to Grupo Mexico as a result of stock market price movements. Remember, the Special Committee said it sought such a ratio to protect against a downward price movement. [167] Perhaps this could be yet another indication of just how deeply wise and clandestine the Special Committee's negotiating strategy was. If the Committee asked for a collar or other limitation on the cash value it would pay in its stock, it would tip off Grupo Mexico that Minera was really worth much more than Southern Peru was paying. This sort of concealed motivation and contradiction is usually the stuff of international espionage, not M & A practice. I cannot say that I find a rational basis to accept that it existed here. To find that the original low standalone estimates, the aggressive efforts at optimizing cash flows, the charitable sharing of Southern Peru's own multiples, and, as we shall next discuss, the last-gasp measures to close the resulting value gap that yet still

remained were simply a cover for a brilliant, but necessarily secret, negotiating strategy by the Special Committee and Goldman is difficult for a mind required to apply secular reasoning, rather than conspiracy theories or mysticism, to the record before me. [168]

809 6. *Grupo Mexico's "Concessions" Were Weak And Did Not Close The Fairness Gap

In their briefs, the defendants point to certain deal terms agreed to by Grupo Mexico as evidence of the Special Committee's negotiating prowess. These provisions include (1) the commitment from Grupo Mexico to reduce Minera's net debt at closing to $1 billion; (2) the $100 million special transaction dividend paid out by Southern Peru as part of the Merger's closing; (3) post-closure corporate governance changes at Southern Peru designed to protect minority stockholders, including a requirement for review of related-party transactions; (4) the super-majority vote required to approve the Merger; and (5) the fixed exchange ratio.

But, these so-called "concessions" did little to justify the Merger terms. Grupo Mexico was contractually obligated to pay down Minera's debt because of rising copper prices, and it had already paid down its debt to $1.06 million as of June 30, 2004. [169] The dividend both reduced the value of Southern Peru's stock price, allowing the Special Committee to close the divide between its 64 million share offer and Grupo Mexico's 67.2 million share asking price *and* paid out cash to Grupo Mexico, which got 54% of the dividend. Many of the corporate governance provisions were first proposed by Grupo Mexico, including the review of related party transactions, so that Southern Peru would remain compliant with applicable NYSE rules and Delaware law. [170] Correctly, Grupo Mexico did not regard the Special Committee's corporate governance suggestions as differing much from the "status quo." [171] After proposing a $500,000 threshold for review of related-party transactions by an independent committee of the board, [172] the Special Committee accepted Grupo Mexico's counterproposal for a $10 million threshold. [173] This was more a negotiation defeat than victory.

As for the two-thirds supermajority vote, the Special Committee assented to it after asking for and not obtaining a majority of the minority vote provision. The Special Committee knew that Cerro and Phelps Dodge wanted to sell, and that along with Grupo Mexico, these large holders would guarantee the vote. At best, the Special Committee extracted the chance to potentially block the Merger if post-signing events convinced it to change its recommendation and therefore wield Cerro's vote against the Merger. [174] But, as I will ***810** discuss in the next section, the Special Committee did not do any real thinking in the period between its approval of the Merger and the stockholder vote on the Merger. Furthermore, as has been noted, several key material facts regarding the fairness of the Merger were not, in my view, fairly disclosed.

The Special Committee's insistence on a fixed exchange ratio, as discussed, is difficult to reconcile with its purported secret belief that copper prices were on the rise. Other than protection against a falling Southern Peru stock price, the only justification for using a fixed versus floating exchange ratio in the Merger was one often cited to when two public companies that are both subject to market price fluctuations announce a merger, which is that because they are similar companies and proposing to merge, the values of Southern Peru and Minera would rise and fall together after the market reacts initially to the exchange ratio. Handelsman referred to this justification in his testimony. [175] In other words, if the stock price of Southern Peru went up, the value of Minera would go up as well, and the relative valuation would stay the same. This would make more sense in a merger between two companies in the same industry with publicly traded stock, because both companies would have actual stock prices that might change because of some of the same industry-wide forces and because both stocks might trade largely on the deal, after the initial exchange ratio is absorbed into their prices. Here, by contrast, only Southern Peru's stock had a price that was subject to market movement. These were not two public companies—changes in Southern Peru's stock price were in an important sense a one-sided risk. A rising market would only lift the market-tested value of one side of the transaction, the Southern Peru side. And, of course, the switch to a fixed exchange ratio turned out to be hugely disadvantageous to Southern Peru. [176]

811 7. *The Special Committee Did Not Update Its Fairness Analysis In The Face of Strong Evidence That The Bases For Its Decision Had Changed

The Special Committee had negotiated for the freedom to change its recommendation in favor of the Merger if its

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fiduciary duties so required, and had the vote of a major minority stockholder (Cerro) tied to a withdrawal of its recommendation, but instead treated the Merger as a foregone conclusion from the time of its October 21, 2004 vote to approve the Merger Agreement. There is no evidence to suggest that the Special Committee or Goldman made any effort to update its fairness analysis in light of the fact that Southern Peru had blown out its EBITDA projections for 2004 and its stock price was steadily rising in the months leading up to the stockholder vote (perhaps because it had greatly exceeded its projections), even though it had agreed to pay Grupo Mexico with a fixed number of Southern Peru shares that *had no collar*. To my mind, the fact that none of these developments caused the Special Committee to consider renegotiating or re-evaluating the Merger is additional evidence of their controlled mindset. Other than Handelsman's phone call to Goldman, no member of the Special Committee made any effort to inquire into an update on the fairness of the Merger. The Special Committee's failure to get a reasoned update, taken together with the negotiation process and the terms of the Merger, was a regrettable and important lapse.

Although an obvious point, it is worth reiterating that the Special Committee was comprised of directors of Southern Peru. Thus, from internal information, they should have been aware that Southern Peru was far outperforming the projections on which the deal was based. This should have given them pause that the exercise in optimizing Minera had in fact optimized Minera (which essentially made its numbers for 2004) but had undervalued Southern Peru, which had beaten its 2004 EBITDA estimates by 37%, some $300 million. This reality is deepened by the fact that Southern Peru beat its 2005 estimates by 135%, while Minera's 2005 EBITDA was only 45% higher than its estimates. These numbers suggest that it was knowable that the deal pressures had resulted in an approach to valuation that was focused on making Minera look as valuable as possible, while shortchanging Southern Peru, to justify the single deal that the Special Committee was empowered to evaluate.

Despite this, Goldman and the Special Committee did not reconsider their contribution analysis, even though Southern Peru's blow-out 2004 performance would suggest that reliance on even lower 2005 projections was unreasonable. [177] Indeed, ***812** the Merger vote was held on March 28, 2005, when the first quarter of 2005 was almost over. In that quarter alone, Southern Peru made $303.4 million in EBITDA, over 52% of what Goldman estimated for the entire year.

This brings me to a final, big picture point. In justifying their arguments, each side pointed in some ways to post-Merger evidence. Specifically, the defendants subjected a chart in support of their argument that rising copper prices would have disproportionately benefited Minera over Southern Peru in the form of having greater reserves, and that this justified the defendants' use of a relative valuation technique, and undercut the notion that Minera's value was dressed up, and Southern Peru's weather beaten during the Special Committee process.

The problem for this argument is that reserves are relevant to value because they should generate cash flow. As has been mentioned, Goldman stretched to justify the deal by using a range of multiples that started at the bottom with Southern Peru's Wall Street consensus multiple for 2005E EBITDA and ended at the top with a management-generated multiple of 6.5x. Both of these were well north of the 4.8x median of Goldman's comparables. And, of course, Goldman estimated that Minera would earn nearly as much as Southern Peru in 2004, and more than Southern Peru in 2005. Neither estimate turned out to be even close to true. Indeed, the Merger was premised on the notion that over the period from 2005 to 2010, Minera would generate $1.35 of EBITDA for every $1.00 of Southern Peru. Using the underlying evidence cited in the defendants' own chart, [178] which came from the public financials of Southern Peru, a company under their continued control, after the Merger, my non-mathematician's evaluation of this estimate reveals that it turned out to be very far off the mark, with Minera generating only $0.67 for every dollar Southern Peru made in EBITDA. Put simply, even in a rising copper price market, Southern Peru seemed to more than hold its own and, if anything, benefit even more than Minera from the general rise in copper prices.

The charts below addressing the companies' performance in generating EBITDA in comparison to the deal assumptions, if anything, confirms my impression that ***813** Minera's value was optimized and Southern Peru's slighted to come to an exchange price no reasonable third party would have supported:

	2005 [179]	2006	2007	2008	2009	2010	Sum
Minera	$ 971.6	$1405.5	$1731.2	$ 856.5	$ 661.9	$1078.3	$ 6705.0

Southern Peru	$1364.8	$1918.4	$2085.4	$1643.5	$1144.8	$1853.8	$10010.7
Ratio MM/SP	.71	.73	.83	.52	.58	.58	.67

For all these reasons, I conclude that the Merger was unfair, regardless of which party bears the burden of persuasion. The Special Committee's cramped perspective resulted in a strange deal dynamic, in which a majority stockholder kept its eye on the ball—actual value benchmarked to cash—and a Special Committee lost sight of market reality in an attempt to rationalize doing a deal of the kind the majority stockholder proposed. After this game of controlled mindset twister and the contortions it involved, the Special Committee agreed to give away over $3 billion worth of actual cash value in exchange for something worth demonstrably less, and to do so on terms that by consummation made the value gap even worse, without using any of its contractual leverage to stop the deal or renegotiate its terms. Because the deal was unfair, the defendants breached their fiduciary duty of loyalty.

I now fix the remedy for this breach.

IV. *Determination Of Damages*

A. *Introduction*

The plaintiff seeks an equitable remedy that cancels or requires the defendants to return to Southern Peru the shares that Southern Peru issued in excess of Minera's fair value. In the alternative, the plaintiff asks for rescissory damages in the amount of the present market value of the excess number of shares that Grupo Mexico holds as a result of Southern Peru paying an unfair price in the Merger. The plaintiff claims, based on Beaulne's expert report, that Southern Peru issued at least 24.7 million shares in excess of Minera's fair value. [181] The plaintiff asserts that, because ***814** Southern Peru effected a 2–for–1 stock split on October 3, 2006 and a 3–for–1 stock split on July 10, 2008, those 24.7 million shares have become 148.2 million shares of Southern Peru stock, and he would have me order that each of those 148.2 million shares be cancelled or returned to Southern Peru, or that the defendants should pay fair value for each of those shares. Measured at a market value of $27.25 per Southern Peru share on October 13, 2011, 148.2 million shares of Southern Peru stock are worth more than $4 billion.

The plaintiff also argues that $60.20 in dividends have been paid on each of the 24.7 million Southern Peru shares (adjusted for stock-splits), and to fully remedy the defendants' breach of fiduciary duty the court must order that the defendants must pay additional damages in the amount of approximately $1.487 billion. Finally, the plaintiff requests pre and postjudgment interest compounded monthly, a request that seems to ignore the effect of the dividends just described.

By contrast, the defendants say that no damages at all are due because the deal was more than fair. Based on the fact that Southern Peru's market value continued on a generally upward trajectory in the years after the Merger—even though it dropped in response to the announcement of the Merger exchange ratio and at the time of the preliminary proxy—the defendants say that Southern Peru stockholders should be grateful for the deal. At the very least, the defendants say that any damage award should be at most a fraction of the amounts sought by the plaintiff, and that the plaintiff has waived the right to seek rescissory damages because of his lethargic approach to litigating the case. The defendants contend that it would be unfair to allow the plaintiff to benefit from increases in Southern Peru's stock price that occurred during the past six years, because Grupo Mexico bore the market risk for so long due to the plaintiff's own torpor. The defendants also argue that the plaintiff's delays warrant elimination of the period upon which pre-judgment interest might otherwise be computed, and that plaintiff should not be entitled to compounded interest.

[10] [11] This court has broad discretion to fashion equitable and monetary relief under the entire fairness standard. [182] Unlike the more exact process followed in an appraisal action, damages resulting from a breach of fiduciary duty are liberally calculated. [183] As long as there is a basis for an estimate of damages, and the plaintiff has suffered harm, "mathematical certainty is not required." [184] In addition to an actual award of monetary relief, this court has the authority to grant pre-and post-judgment interest, and to determine the form of that interest. [185]

The task of determining an appropriate remedy for the plaintiff in this case is difficult, for several reasons. First,

as the defendants point out, the plaintiff caused this case to languish and as a result this litigation has gone on for six years. Second, both parties took an odd approach to presenting valuation evidence, particularly ***815** the defendants, whose expert consciously chose not to give an estimate of Minera's value at the time of the Merger. Although the plaintiff's expert gave no opinion on the fundamental value of Southern Peru, that did not matter as much as the defendants' expert's failure to give such an opinion, because the defendants themselves conceded that Southern Peru's acquisition currency was worth its stock market value. Third, the parties devoted comparatively few pages of their briefs to the issue of the appropriate remedy. Finally, the implied standalone DCF values of Minera and Southern Peru that were used in Goldman's final relative valuation of the companies are hard to discern and have never been fully explained by the source.

These problems make it more challenging than it would already be to come to a responsible remedy. But, I will, as I must, work with the record I have.

In coming to my remedy, I first address a few of the preliminary issues. For starters, I reject the defendants' argument that the post-Merger performance of Southern Peru's stock eliminates the need for relief here. As noted, the defendants did not bother to present a reliable event study about the market's reaction to the Merger, and there is evidence that the market did not view the Merger as fair in spite of material gaps in disclosure about the fairness of the Merger. Furthermore, even if Southern Peru's stock has outperformed comparable companies since the Merger, the company may have performed even better if the defendants had not overpaid for Minera based on its own fundamentals. Notably, Southern Peru markedly outperformed the EBITDA estimates used in the deal for both 2004 and 2005, and the ratio of Southern Peru's EBITDA to Minera's EBITDA over the six years since the Merger suggests that the assumptions on which the Merger was based were biased in Minera's favor. A transaction like the Merger can be unfair, in the sense that it is below what a real arms-length deal would have been priced at, while not tanking a strong company with sound fundamentals in a rising market, such as the one in which Southern Peru was a participant. That remains my firm sense here, and if I took into account the full range of post-Merger evidence, my conclusion that the Merger was unfair would be held more firmly, rather than more tentatively.

By contrast, I do agree with the defendants that the plaintiff's delay in litigating the case renders it inequitable to use a rescission-based approach. [186] Rescissory damages are the economic equivalent of rescission and therefore if rescission itself is unwarranted because of the plaintiff's delay, so are rescissory damages. [187] Instead of entering a rescission-based remedy, I will craft from the "panoply of equitable remedies" within this court's discretion a damage award that approximates the difference between the price that the Special Committee would have approved had the Merger been entirely fair (i.e., absent a breach of fiduciary duties) and the price that the Special Committee actually agreed to pay. [188] In other words, I will take the difference between this fair price and the market value of 67.2 million shares ***816** of Southern Peru stock as of the Merger date. [189] That difference, divided by the average closing price of Southern Peru stock in the 20 trading days preceding the issuance of this opinion, will determine the number of shares that the defendants must return to Southern Peru. Furthermore, because of the plaintiff's delay, I will only grant simple interest on that amount, calculated at the statutory rate since the date of the Merger.

In all my analyses, I fix the fair value of Minera at October 21, 2004, the date on which the Merger Agreement was signed. I do not believe it fair to accord Grupo Mexico any price appreciation after that date due to its own fixation on cash value, the fact that Southern Peru outperformed Minera during this period, and the overall conservatism I employ in my remedial approach, which already reflects leniency toward Grupo Mexico, given the serious fairness concerns evidenced in the record.

B. *The Damages Valuation*

[12] Having determined the nature of the damage award, I must next determine the appropriate valuation for the price that the Special Committee *should* have paid. Of course, this valuation is not a straightforward exercise and inevitably involves some speculation. There are many ways to fashion a remedy here, given that the parties have provided no real road map for how to come to a value, and the analyses performed by Goldman and the Special Committee do not lend themselves to an easy resolution. I will attempt to do my best on the record before me.

Given the difference between the standalone equity values of Minera derived by Goldman and the plaintiff's expert and the actual cash value of the $3.75 billion in Southern Peru stock that was actually paid to Grupo Mexico in the Merger, this record could arguably support a damages award of $2 billion or more. My remedy calculation will be more conservative, and in that manner will intentionally take into account some of the imponderables I previously mentioned, which notably include the uncertainties regarding the market's reaction to the Merger and the reality that the Merger did not stop Southern Peru's stock price from rising over the long term. [190]

To calculate a fair price for remedy purposes, I will balance three values: (1) a standalone DCF value of Minera, calculated by applying the most aggressive discount rate used by Goldman in its DCF analyses (7.5%) and a long-term copper price of $1.10 per pound to the DCF model presented by the plaintiff's expert, Beaulne; (2) the market value of the Special Committee's 52 million share counteroffer made in July 2004, which was sized ***817** based on months of due diligence by Goldman about Minera's standalone value, calculated as of the date on which the Special Committee approved the Merger; and (3) the equity value of Minera derived from a comparable companies analysis using the comparable companies identified by Goldman.

1. *A Standalone DCF Value*

The only standalone DCF value for Minera in the record that clearly takes into account the projections for Minera that Goldman was using on October 21, 2004 is Beaulne's DCF analysis of Minera, which yielded an equity value as of October 21, 2004 of $1.838 billion. [191] Beaulne used the same A & S-adjusted projections for Minera that Goldman used in its October 21, 2004 presentation to calculate his standalone DCF value for Minera. [192] He assumes a long-term copper price of $0.90 per pound, which was also relied on by Goldman. [193] The major difference between Beaulne's DCF analysis and the Goldman DCF analysis, other than the fact that Goldman gave up on deriving a standalone equity value for Minera, is that Beaulne uses a lower discount rate than Goldman did—6.5% instead of 8.5%. [194]

Because Beaulne used the same underlying projections in his analysis, and his inputs are not disputed by the defendants or the defendants' expert, I am comfortable using his DCF valuation model. But, I am not at ease with using his discount rate of 6.5%, because it is outside the range of discount rates used by Goldman and seems unrealistically low. Instead, I will apply Goldman's lowest discount rate, 7.5%. In the spirit of being conservative in my remedy, I will, by contrast, apply a long-term copper price of $1.10 per pound, which is $0.10 more than the highest long-term copper price used by Goldman in its valuation matrices ($1.00) and is halfway between Goldman's mid-range copper price assumption of $0.90 and the $1.30 per pound long-term copper price that the defendants contend was their secretly held assumption at the time of the Merger. In other words, I use the discount rate assumption from the Goldman analyses that is most favorable to the defendants and a long-term copper price assumption that is even more favorable to the defendants than Goldman's highest long-term copper price, and apply them to the optimized cash flow projections of Minera. Under these defendant-friendly assumptions, a standalone equity value for Minera as of October 21, 2004 of $2.452 billion results. [195]

***818** 2. *The Value Of The Special Committee's July Proposal*

The counteroffer made by the Special Committee in July 2004, in which they proposed to pay for Grupo Mexico's stake in Minera with 52 million shares of Southern Peru stock, is arguably the last proposal made by the Special Committee while they still had some vestige of a "give/get" analysis in mind that a reasonable, uncontrolled Special Committee would have remained in during the entire negotiation process. I therefore believe that the then-current value of 52 million shares is indicative of what the Special Committee thought Minera was really worth.

The Special Committee's July proposal was made between July 8, 2004 and July 12, 2004. The stock price of Southern Peru on July 8, 2004 was $40.30 per share, so the 52 million shares of Southern Peru stock then had a market price of $2.095 billion. Because Grupo Mexico wanted a dollar value of stock, I fix the value at what 52 million Southern Peru shares were worth as of October 21, 2004, the date on which the Special Committee approved the Merger, $2.388 billion, [196] giving Minera credit for the price growth to that date.

3. *A Comparable Companies Approach*

In its October 21, 2004 presentation, Goldman identified comparable companies and deduced a mean and median 2005 EBITDA multiple (4.8x) that could have been applied Minera's EBITDA projections to value Minera. The comparable companies used by Goldman were Antofagasta, Freeport McMoRan, Grupo Mexico itself, Phelps Dodge and Southern Peru. Goldman did not use this multiple to value Minera. As discussed earlier in this opinion, Goldman instead opted to apply a range of pumped-up Southern Peru 2005E EBITDA multiples to Minera's EBITDA projections so as to generate a value expressed only in terms of the number of Southern Peru shares to be issued. [197]

Applying the median 2005E EBITDA multiple for the comparable companies identified by Goldman to Minera's 2005 EBITDA projections as adjusted by A & S ($622 million) [198] was the reasonable and fair valuation approach. Doing so yields a result of $1.986 billion. [199]

When using the comparable companies method, it is usually necessary to adjust for the fact that what is being sold is different (control of the entire company and thus over its business plan and full cash flows) than what is measured by the multiples (minority trades in which the buyer has no expectancy of full control over the company's strategy and thus influence over the strategy to maximize and spend its cash flows). [200] That is, the comparable companies method of analysis produces an equity valuation that includes an inherent minority trading discount because all of the data used for purposes of comparison is derived from minority trading values of the companies being used. [201] In appraisal cases, the court, in determining the fair value of the equity under a comparable companies method, must correct this minority discount by adding back a premium. [202]

***819** An adjustment in the form of a control premium is generally applied to the equity value of the company being valued to take into account the reality that healthy, solvent public companies are usually sold at a premium to the unaffected trading price of everyday sales of the company's stock. This method must be used with care, especially as to unlisted companies that have not proven themselves as standalone companies. For that reason, it is conservative that I add a control premium for Minera, given its financial problems and its lack of history as an independent public company. Using the median premium for merger transactions in 2004 calculated by Mergerstat of 23.4%, [203] and applying that premium to the value derived from my comparable companies analysis yields a value of $2.45 billion.

4. *The Resulting Damages*

Giving the values described above equal weight in my damages analysis (($2.452 billion + $2.388 billion + $2.45 billion) / 3), results in a value of $2.43 billion, which I then adjust to reflect the fact that Southern Peru bought 99.15%, not 100%, of Minera, which yields a value of $2.409 billion. The value of 67.2 million Southern Peru shares as of the Merger Date was $3.756 billion. [204] The remedy, therefore, amounts to $1.347 billion. [205] The parties shall implement my remedy as follows. They shall add interest at the statutory rate, without compounding, to the value of $1.347 billion from the Merger date, and that interest shall run until time of the judgment and until payment.

Grupo Mexico may satisfy the judgment by agreeing to return to Southern Peru such number of its shares as are necessary to satisfy this remedy. Any attorneys' fees shall be paid out of the award. [206]

Within fifteen days, the plaintiff shall present an implementing order, approved as to form, or the parties' proposed plan to reach such an order. Too much delay has occurred in this case, and the parties are expected to bring this case to closure promptly, at least at the trial court level.

V. *Conclusion*

For all these reasons, the defendants breached their fiduciary duty of loyalty and judgment will be entered against them on the basis outlined in this decision.

Footnotes

1 On October 11, 2005, Southern Peru changed its name to “Southern Copper Corporation” and is currently traded on the NYSE under the symbol “SCCO.”

2 Grupo Mexico held—and still holds—its interest in Southern Peru through its wholly-owned subsidiary Americas Mining Corporation ("AMC"). Grupo Mexico also held its 99.15% stake in Minera through AMC. AMC, not Grupo Mexico, is a defendant to this action, but I refer to them collectively as Grupo Mexico in this opinion because that more accurately reflects the story as it happened.

3 JX–108 (UBS presentation to the Board (February 3, 2004)) at AMC0019912.

4 JX–16 (resolutions on the establishment of the Special Committee (February 12, 2004)) at SP COMM 000441.

5 The remaining plaintiff in this action is Michael Theriault, as trustee of and for the Theriault Trust. The defendants contend that the plaintiff does not qualify as an adequate fiduciary representative. This argument is premised largely on what the defendants see as the plaintiff's lack of familiarity with and understanding of the case. The plaintiff's less than active role in connection with this case, as evidenced by his absence at trial and lack of a fully developed knowledge about all of the litigation details, can in part be explained, though not be excused, by the protracted nature of these proceedings. This case lurched forward over a period of six years largely because of the torpor of the plaintiff's counsel, and the passage of time has had the regrettable effect of producing some turnover within the plaintiffs' ranks. Two of the original plaintiffs are no longer parties, and the remaining plaintiff, Michael Theriault, only became a party in 2008 because he inherited the claims as successor trustee upon the death of his father, an original plaintiff who had brought suit in his trustee capacity. It is against this regrettable backdrop that the defendants challenge Michael Theriault's adequacy as a derivative plaintiff.

A derivative plaintiff "must be qualified to serve in a fiduciary capacity as a representative of the class of stockholders, whose interest is dependent upon the representative's adequate and fair prosecution of the action." *Emerald Partners v. Berlin,* 564 A.2d 670, 673 (Del.Ch.1989) (citation omitted). The defendant, however, bears the burden to show "a substantial likelihood that the derivative action is not being maintained for the benefit of the shareholders." *Id.* at 674. Although a number of factors may be relevant to the adequacy determination, *see In re Fuqua Indus., S'holder Litig.,* 752 A.2d 126, 130 (Del.Ch.1999) (citing factors), our Supreme Court has made clear that this is a very difficult burden unless the plaintiff has an actual economic conflict of interest or has counsel who is incompetent and suffers from such a conflict. *See In re Infinity Broad. Corp. S'holders Litig.,* 802 A.2d 285, 291 (Del.2002); *see also In re Fuqua Indus., S'holder Litig.,* 752 A.2d at 130 (expressing principle); *Kahn v. Household Acquisition Corp.,* 1982 WL 8778 (Del.Ch. Jan. 19, 1982); *see generally* Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery,* § 9.02(b)(1), at 9–32 (2009). The defendants have not met this burden. The defendants offer no evidence of an economic conflict between the plaintiff and the rest of the Southern Peru stockholders such that he would act in furtherance of his own self-interest at their expense. Although the plaintiff's failure to get himself up to speed is not laudable, neither was it such an egregious abdication of his role to supply a basis for disqualification, especially given the absence of facts suggesting an otherwise improper motive for maintaining the suit and the vigor with which his counsel have prosecuted the case since it was transferred to my docket.

6 These individual defendants are Germán Larrea Mota–Velasco, Genaro Larrea Mota–Velasco, Oscar González Rocha, Emilio Carrillo Gamboa, Jaime Fernandez Collazo Gonzalez, Xavier García de Quevedo Topete, Armando Ortega Gómez and Juan Rebolledo Gout.

7 The record in this case was made less reliable by the conduct of both sides. On the plaintiff's side, the prosecution moved slowly. Eventually, the banker from Goldman who worked for the Special Committee, Martin Sanchez, refused to come to Delaware to testify at trial, even though he had sat for a deposition in New York in 2009. Although one would hope that an investment banker would recognize a duty to a former client to come and testify, that expectation might be thought a bit unreasonable as Sanchez, who lives in Latin America, was being asked to testify in 2011 about a deal that closed in 2005, and he had left the employ of Goldman in 2006. His absence is as much or more the fault of the plaintiff's slow pace as it is of the defendants. Another issue seems more the defendants' fault, or at least the fault of the former defendants, who were members of the Special Committee. Many of the minutes of the Special Committee meetings, including all minutes of any Special Committee meeting held after July 20, 2004, were not admitted into evidence by agreement of the parties. The defendants failed to produce minutes of these Special Committee meetings during fact discovery in this case, which ended on March 1, 2010. Then, on January 23, 2011, the defendants produced nearly all of the minutes of the Special Committee meetings that took place between July 20, 2004 and October 21, 2004. These minutes were rather obviously responsive to the discovery requests made by the plaintiff and there was no reasonable excuse for their non-production, which seems to have resulted from the migration of an attorney for the Special Committee to another job and a lack of diligence, rather than a lack of good faith, in the production process. The plaintiff moved to strike this post cut-off production, and an oral argument was held on the motion to strike on April 25, 2011. *In re Southern Peru S'holders Litig.,* C.A. No. 961 (Del. Ch. Apr. 25, 2011) (TRANSCRIPT). At argument, the plaintiff's counsel admitted that he had not pressed for discovery of the missing minutes because the defendants' failure to produce them was advantageous to his case. Because the defendants produced the additional Special Committee meeting minutes only a few months before trial and the plaintiff was unwilling to re-depose witnesses and depose new witnesses based on this new information, the parties agreed to stipulate that such meetings occurred but not to admit them into evidence. The defendants never produced minutes for meetings of the Special Committee that defendants allege took place on August 5, 2004 and August 25, 2004. I am therefore missing important evidence which may have helped to inform my analysis of the Special Committee's deliberations.

8 *See* JX–125 (Mining Mexico Form 20–F (July 14, 2004)) at 9 ("Our results were adversely affected in 2001 and 2002 by decreases in copper prices ... [U]nder pressure due to low metals prices and the resulting drop in liquidity, we restructured our debt in 2003 because of our failure to make scheduled payments and our noncompliance with certain financial covenants contained in our credit agreements."); *id.* at 19 (stating that in the "several year period prior to 2004," Minera's "competitive and financial position had been negatively influenced" by low metal prices and that Minera had "changed its business plan, including the cessation of all but critically necessary capital expenditures ... and took several steps to downsize its operations in order to preserve cash resources," but noting that the copper market had improved, which allowed Minera to "increase [its] levels of capital expenditures to levels consistent with [its] anticipated increased earnings growth."); *see also* Tr. at 98 (Palomino) ("Minera [ ] had been in pretty difficult financial conditions until 2002 or beginning of 2003.").

9 Parker Dep. at 50 ("It was apparent that the Minera properties had been severely cash constrained. There were large pieces of equipment that were parked because they were broken down and there weren't spare parts to repair them.").

10 *See* JX–105 (Goldman presentation to the Special Committee (September 15, 2004)) at SP COMM 006787 (showing net debt of Southern Peru was $15 million).

11 JX–108 at AMC0019912.

12 *Id.*

13 JX–16 at SP COMM 000441.

14 Although both Perezalonso and Ruiz were appointed to the Board by Grupo Mexico, the plaintiff does not contest that they were independent and unaffiliated with Grupo Mexico. *See Aronson v. Lewis,* 473 A.2d 805, 816 (Del.1984) ("[I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence.").

15 *See* Tr. at 21 (Palomino); *see also* JX–83 (minutes of Special Committee meeting (April 1, 2004)) (discussing the problems with the term sheet that the Special Committee had received on March 25, 2004).

16 Tr. at 27 (Palomino).

17 JX–156 (term sheet from Grupo Mexico to the Special Committee (May 7, 2004)) at SP COMM 007078. At this point in the negotiation process, Grupo Mexico mistakenly believed that it only owned 98.84% of Minera. As I will note, it later corrects for this error, and the final Merger consideration reflected Grupo Mexico's full 99.15% equity ownership stake in Minera.

18 JX–101 (Goldman presentation to the Special Committee (June 11, 2004)) at SP COMM 003381.

19 *See* Tr. at 221–222 (Handelsman) ("Q [the court].... But again I just want to be clear, I am not here—when I am ultimately looking at them, I am not looking at there is some sort of thing where, you know, the market was somehow overvaluing Southern Peru and that you have to sort of normalize for that. That's not what the committee ever considered. A. No. Q. Right. I just want you to understand there is obviously arguments you can make with respect to a thinly traded security like Southern Peru with the overhang of control that the trading price might not be as informative as something where there is a much more liquid float. A. Oh, I think there would have been a robust market for Southern Peru Copper in the copper industry at or better than the price that it traded at."). Even though Handelsman testified that the Special Committee did not "seriously" consider whether Southern Peru could have sold 67 million shares into the market for some amount of money, because 67 million shares was close to 85% of the then outstanding Southern Peru stock, *id.* at 202 (Handelsman), when questioned by the court, he conceded that the market price of Southern Peru was a reliable measure of Southern Peru's worth. At the post-trial oral argument, the defendants' counsel further clarified Handelsman's belief that the market price was reliable. *See In re Southern Peru S'holders Litig.,* C.A. No. 961, at 98 (Del. Ch. July 12, 2011) (TRANSCRIPT) ("A. [T]he [market] price [of Southern Peru] was what it was and [Handelsman] believed it ..."). In further exchange with the court, the defendants' counsel never contested that the market price was not a reliable indicator of Southern Peru's value. *See e.g., id.* at 99 ("Q. ... [I]f your clients basically tell me the market price is the market price, and the market price is 3.1 billion and you are only up to 2.7 billion, and you are trading at a multiple to DCF and you are buying something else at a multiple to DCF, that sounds like a pretty classic dumb deal. A. That's not what my clients believed ... [t]hey believed, as they testified, that they were getting a bargain; that Minera was worth more than the consideration that Grupo [Mexico] received.); *id.* at 105 ("Q. Let me just say my simplistic view of this is if your clients are not going to challenge, as they did not challenge, the market value of Southern Peru stock, then Southern Peru, the stock they gave up was basically worth the market price ... A. Right ..."). It is also worth noting that the Special Committee's advisors never advised it that Southern Peru's stock should be valued at a discount to its market value, that the defendants do not challenge the market price of Southern Peru in their briefs, and that the defendants' trial expert did nothing to question the reliability of the then-current market price. *See* Tr. at 464 (Schwartz) ("I didn't look at the liquidity, I didn't look at the control issues, I didn't look at other issues. I didn't look at other corporate companies that were trading.").

20 Tr. at 157 (Handelsman).

21 Tr. at 159 (Handelsman) ("I think the committee was somewhat comforted by the fact that the DCF analysis of Minera [ ] and the DCF analysis of [Southern Peru] were not as different as the discounted cash flow analysis of Minera [ ] and the market value of Southern Peru.").

22 This is a word I do not use when I have to conduct a necessarily imperfect valuation of an asset. The word itself implies a certainty better attributed to an omniscient creator than a flawed human.

23 *See* Tr. at 42 (Palomino) ("Q. ... [A]s of ... June 11, 2004, what was the special committee's view of the transaction that had been proposed by Grupo Mexico? A. That the figures that they were asking were too high ..."); Tr. at 156–57 (Handelsman) ("Q. What did you learn from these preliminary analyses that Goldman Sachs performed? A. That their results showed that the value of Minera [ ] was substantially less than the asked price of Grupo Mexico by a substantial margin ...").

24 JX–103 (Goldman presentation to the Special Committee (July 8, 2004)) at SP COMM 006896–SP COMM 006898.

25 JX–18 (list of historical stock prices of Southern Peru) at 9 ($40.30 x 28,900,000 = $1,164,670,000; $40.30 x 71,300,000 = $2,873,390,000).

26 *Id.* ($40.30 x 52,000,000 = $2,095,600,000).

27 The exact terms of the Special Committee's proposed fixed exchange ratio are unclear on this record.

28 Tr. at 155 (Handelsman).

29 *Id.*

30 *See id.* at 48 (Palomino) (explaining that his impression at the time negotiations began was that Southern Peru was doing well in the market because "the market was estimating higher ore grades and higher copper prices than we thought were in fact going to be maintained in the long run"); *id.* at 313 (Jacob) (discussing rising copper prices in 2004).

31 Between July 20, 2004 and August 21, 2004, the average closing price of Southern Peru stock was $38.28. JX–18 at 8–9 ($38.28 x 80,000,000 = $3,062,400,000).

32 JX–129 (Southern Peru Copper Corporation Schedule 14A (February 25, 2005) (Proxy Statement)) at 22.

33 JX–18 at 8 ($41.20 x 67,000,000= $2,760,400,000).

34 *Id.* ($45.72 x 67,000,000 = $3,063,240,000).

35 JX–105 at SP COMM 006805.

36 The EV/2005E EBITDA multiple of 6.3x used in this presentation was not a real market multiple, or even a Wall Street analysis consensus multiple, but an internal Southern Peru management number supposedly based on Southern Peru's internal projections for its 2005E EBITDA, unadjusted for royalty tax owed to the Peruvian government. As will be discussed, it seems aggressive, at the very least.

37 JX–18 at 8 ($45.34 x 61,000,000 = $2,765,740,000; $45.34 x 72,000,000 = $3,264,480,000).

38 *Id.* at 8 ($46.22 x 64,000,000 million = $2,958,080,000).

39 Minera was contractually obligated to make mandatory prepayments on its long-term credit facilities when, among other things, the price of copper exceeded $0.88 per pound. *See* JX–125 at 55 ("when the price[ ] of copper ... exceed[s] $0.88 per pound ... we will pay an amount equal to 75% of the excess cash flow generated by the sales of such metals at the higher metal price, which will be applied first, to the amortization of Tranche B, then to the amortization of Tranche A."). The price of copper went north of $0.88 per pound on October 15, 2003. The record shows that Minera was paying down its debt, presumably in compliance with its prepayment obligation. *See* JX–103 at SP COMM 006861 (Minera's net debt as of May 31, 2004 was $1.189 million); JX–107 (road show presentation (November 2004)) at SP COMM 006674 (Minera's net debt as of June 30, 2004 was $1.06 billion).

40 Tr. at 175 (Handelsman).

41 *Id.* at 185 (Handelsman).

42 *Id.* at 176 (Handelsman).

43 JX–18 at 8 ($53.16 x 67,000,000 = $3,561,720,000).

44 The parties further agreed that for the purposes of the two-thirds vote, each share would only be entitled to one vote. Thus, Grupo Mexico could only vote its 54.17% equity ownership, not the 63.08% voting power it ordinarily held due to the super-voting rights of the Founders Shares.

45 14.2% and 13.95% respectively.

46 The Founders Shares held by Cerro and Phelps Dodge were unregistered and thus could not be publicly sold in the marketplace. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (2010). SEC Rule 144 provides an exemption from the registration requirements and allows public resale of restricted securities if certain conditions are met. But, Rule 144 contains volume restrictions that made it impossible for Cerro or Phelps Dodge to sell a bloc of their shares. Specifically, Cerro and Phelps Dodge, as "affiliates" of Southern Peru, were prevented from selling an amount greater than one percent of the outstanding Founders Shares in any three-month period. 17 C.F.R. § 230.144(e) (2010). Absent registration, Cerro and Phelps Dodge faced a prolonged goodbye.

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47 Tr. at 182 (Handelsman) ("I had talked to the general counsel both of Grupo Mexico and Southern Peru about registration rights from the time of the first term sheet that Grupo Mexico sent.").

48 *Id.* at 167 (Handelsman) ("[W]e were all long-term holders, and we all had directors, so we were all affiliates. So none of us could really sell our shares."); *cf. id.* at 184 (Handelsman) (discussing market difficulties of selling stock even if Cerro could cease to be an affiliate for purposes of the volume restrictions of Rule 144).

49 *See id.* at 205 (Handelsman) ("Q. Do you know whether there were other people on behalf of Cerro that were speaking to Mr. Larrea at about that time [of the agreement to vote Cerro's shares in accordance with the Special Committee in exchange for registration rights] about Cerro's interest in selling its shares? A. I am sure there weren't.").

50 *Id.* at 168 (Handelsman) ("And both we and Phelps Dodge wanted to get out."); *id.* at 167 (Handelsman) ("And quite frankly, we had an interest in selling our shares.").

51 *Id.* at 184–85 (Handelsman).

52 JX–15 (letter agreement between AMC and Phelps Dodge (December 22, 2004)) at AMC0024877.

53 JX–13 (Agreement and Plan of Merger (October 21, 2004)) § 5.9(b) ("In the event that, prior to the Effective Time the Special Committee believes, in its good faith judgment, after receiving the advice of its outside legal counsel, that failing to do so would create a reasonable likelihood of breaching its fiduciary duties under applicable law, the Special Committee ... may ... withdraw or modify its approval or recommendation in favor of the [Merger].").

54 *Id.*

* * *

55 JX–18 at 7 ($45.90 x 67,200,000 = $3,084,480,000).

56 During discovery, two Microsoft Excel worksheets were unearthed that appear to suggest the implied equity values of Minera and Southern Peru that underlie Goldman's October 21 presentation. One worksheet, which contains the Minera model, indicates an implied equity value for Minera of $1.25 billion using a long-term copper price of $0.90/lb and a discount rate of 8.5%. The other worksheet, which contains the Southern Peru model, indicates an implied equity value for Southern Peru of $1.6 billion using a copper price of $0.90 and a discount rate of 9.0%, and assuming a royalty tax of 2%. Both the plaintiff's expert and the defendants' expert relied on the projections contained in these worksheets in their reports. The defendants have also not contested the plaintiff's expert's contention that these worksheets include Goldman's discounted cash flow estimates as of October 21, 2004.

57 JX–106 (Goldman presentation to the Special Committee (October 21, 2004)).

58 JX–18 at 7 ($45.92 x 47,200,000 = $2,167,424,000; $45.92 x 87,800,000 = $4,031,776,000).

59 *See* Tr. at 181–82 (Handelsman) ("We were sitting in Goldman Sachs' office in Mexico City on this October day, and a lawyer from Goldman's counsel called Goldman and said that—did they recognize that I had something that was the appearance of a conflict. And everybody looked at each other, and it was sort of incredulous about this and how it would come up on the morning of the date that the committee was supposed to vote. And I looked at it and I said, Well, if I have a conflict or they think I have a conflict or this is a potential for a conflict or there is an appearance of a conflict, then I won't vote.").

60 *See, e.g.,* List of Historical Stock Prices of Antofagasta (October 21, 2004 to April 1, 2005), http://uk.finance.yahoo.com/q/hp?s=ANTO. L&b=21&a=09&c=2004&e=1&d=03&f =2005&g=d; List of Historical Stock Prices of FreeportMcMoRan (October 21, 2004 to April 1, 2005), http:// finance.yahoo. com/q/hp?s=FCX&a=09&b=21&c=2004&d=03&e=1&f=2005&g=d; List of Historical Stock Prices of Grupo Mexico (October 21, 2004 to April 1, 2005), http:// finance.yahoo.com/q/hp?s=GMEXICOB. MX&a=09&b =21&c =2004&d=03&e=1&f=2005&g=d.

61 Tr. at 187 ("Q. ... [b]efore the transaction closed at the end of April 2005, did the special committee do anything to determine whether the transaction was still fair? A. Well, I don't know what the special committee did, but I called a representative at Goldman and said, Has anything happened since the transaction was approved by the board that would suggest to you that this transaction was not fair? And I got the answer, no, nothing like that has happened.").

62 Southern Peru's 2004 full financial performance was publicly disclosed in its 2004 10–K, which was filed on March 16, 2005; the stockholder vote took place on March 28, 2005. Southern Peru's previously filed quarterly reports did not indicate that it would achieve such a high EBITDA. *See, e.g.,* Southern Peru Copper Corporation 10–Q for the quarter ending September 30, 2004 (November 9, 2004) at 3, *available at* http://sec. gov/Archives/edgar/data/1001838/000110465904034621/a04–13088_110q.htm, (showing 2004 EBITDA for the last nine months of $597.8 million). But, the members of the Special Committee, as directors of the company, would have had access to the basic information contained in the 2004 10–K before it became public. Either way, the results were out 12 days before the Merger vote.

63 Southern Peru's actual 2005 EBITDA was $1.365 billion, as compared to Southern Peru's 2005E EBITDA based on unadjusted management projections of $581 million.

64 Minera's actual 2005 EBITDA was $971.6 million, as compared to Minera's 2005E EBITDA based on unadjusted management projections of $672 million.

65 JX–18 at 5 ($55.89 x 67,200,000 = $3,755,808,000).

66 When Vice Chancellor Lamb left the Court in 2009, this case was reassigned to me. By that time, Vice Chancellor Lamb had already admonished the plaintiff for its torpid pace in prosecuting the case. *In re Southern Peru S'holders Litig.,* C.A. No. 961 at 20 (Del. Ch. July 1, 2009) (TRANSCRIPT) ("I can't quite strongly enough express my displeasure at how delayed this litigation has been and the fact that it wasn't prepared for trial two or three years ago.").

67 *Cf. In re Loral Space & Commc'ns Inc.,* 2008 WL 4293781, at *33 (Del.Ch. Sept. 19, 2008) ("For example, being a non-independent director who approved a conflict transaction found unfair does not make one, without more, liable personally for the harm caused. Rather, the court must examine that director's behavior in order to assess whether the director breached her fiduciary duties and, if a § 102(b)(7) clause is in effect, acted with the requisite state of mind to have committed a non-exculpated breach.").

68 I recognize that this is a close question. The bottom line requirement of loyalty is that a director act in the best interests of the company and its stockholders, rather than for any other reason. *See In re RJR Nabisco, Inc. S'holders Litig.,* 1989 WL 7036, at *15 (Del.Ch. Jan. 31, 1989). Myriad interests have caused fiduciaries to stray from the straight path. What I struggle with here is that a director would be considered interested because he (or in this case, his employer) desired the liquidity available to the other stockholders. Although I do not struggle with finding that a stockholder-representative in this situation has difficult incentives, I believe it would be mistaken to consider this sort of interest as constituting an interest in the formal sense of imposing liability for breach of the duty of loyalty absent a showing that the director in bad faith subordinated the best interests of the company in getting a fair price to his desire to have the liquidity available to other stockholders. Given that summary judgment in Handelsman's favor has already been granted and given the resources of Grupo Mexico and its affiliated defendants, this interesting question does not seem likely to have a real world effect. In view of that, I am even more reluctant to call a stockholder's desire for liquidity an interest, because there is likely utility in having directors who represent stockholders with a deep financial stake that gives them an incentive to monitor management and controlling stockholders closely. In a real way, Cerro and Phelps Dodge were seeking the same liquidity as other minority stockholders, although I realize Handelsman's service on the board was a choice that exacerbated Cerro's problem.

69 *See Kahn v. Tremont Corp.,* 694 A.2d 422, 428–29 (Del.1997) (applying entire fairness review to an interested transaction where the controlling shareholder of a corporation caused it to purchase shares of a second controlled corporation); *Emerald Partners v. Berlin,* 726 A.2d 1215, 1221 (Del.1999) (applying entire fairness review to a merger whereby a controlled corporation acquired thirteen corporations controlled by the same shareholder); Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations,* 27 Del. J. Corp. L. 499, 510 (2002).

70 In *In re Pure Res., Inc., S'holders Litig.,* 808 A.2d 421, 443–46 (Del.Ch.2002); *In re Cysive, Inc. S'holders Litig.,* 836 A.2d 531, 547–51 (Del.Ch.2003), *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604, 617 (Del.Ch.2005), and more recently, *In re CNX Gas Corp. S'holders Litig.,* 4 A.3d 397, 406–14 (Del.Ch.2010), the Court of Chancery has explained why there might be utility to having further guidance from the Supreme Court in this sensitive area of the law and the reasons why the standard articulated in *Kahn v. Lynch Communication Systems, Inc.,* 638 A.2d 1110, 1117 (Del.1994), makes it difficult for parties to actually present questions regarding the standard to the Supreme Court. *See In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d at 619–22 (explaining why this is so).

71 *Weinberger v. UOP, Inc.,* 457 A.2d 701, 710 (Del.1983) (citation omitted).

72 Caution is required here. The entire fairness standard ill suits the inquiry whether *disinterested directors* who approve a self-dealing transaction and are protected by an exculpatory charter provision authorized by 8 *Del. C.* § 102(b)(7) can be held liable for breach of fiduciary duties. Unless there are facts suggesting that the directors consciously approved an unfair transaction, the bad faith preference for some other interest than that of the company and the stockholders that is critical to disloyalty is absent. The fact that the transaction is found to be unfair is of course relevant, but hardly sufficient, to that separate, individualized inquiry. In this sense, the more stringent, strict liability standard applicable to interested parties such as Grupo Mexico is critically different than that which must be used to address directors such as those on the Special Committee.

73 *See Weinberger,* 457 A.2d at 711.

74 *Id.*

75 *In re John Q. Hammons Hotels Inc. S'holder Litig.,* 2009 WL 3165613, at *13 (Del.Ch. Oct. 2, 2009) (citing *Valeant Pharm. Int'l v. Jerney,* 921 A.2d 732, 746 (Del.Ch.2007)).

76 *Weinberger,* 457 A.2d at 711.

77 *See, e.g., Valeant Pharm. Int'l,* 921 A.2d at 746 ("The two components of the entire fairness concept are not independent, but rather the fair dealing prong informs the court as to the fairness of the price obtained through that process.").

78 *Kahn v. Lynch Commc'n Sys., Inc.,* 638 A.2d 1110 (Del.1994).

79 *See id.* at 1117 ("Nevertheless, even when an interested cash-out merger transaction receives the informed approval of a majority of minority stockholders or an independent committee of disinterested directors, an entire fairness analysis is the only proper standard of review."); *see also In re Pure Res., Inc., S'holders Litig.,* 808 A.2d 421, 435–36 (Del.Ch.2002) (explaining this reality); *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604, 617 (Del.Ch.2005) (same); *see also id.* at 617 ("All in all, it is perhaps fairest and more

sensible to read *Lynch* as being premised on a sincere concern that mergers with controlling stockholders involve an extraordinary potential for the exploitation by powerful insiders of their informational advantages and their voting clout. Facing the proverbial 800 pound gorilla who wants the rest of the bananas all for himself, chimpanzees like independent directors and disinterested stockholders could not be expected to make sure that the gorilla paid a fair price. Therefore, the residual protection of an unavoidable review of the financial fairness whenever plaintiffs could raise a genuine dispute of fact about that issue was thought to be a necessary final protection.") (citations omitted).

80 *See Lynch,* 638 A.2d at 1117 (citation omitted).

81 *See* Pl. Op. Post–Tr. Br. at 14 (citing *Kahn v. Tremont Corp.,* 694 A.2d 422, 429 (Del.1997); *Gesoff v. IIC Indus.,* 902 A.2d 1130, 1148 (Del.Ch.2006); *Rabkin v. Olin Corp.,* 1990 WL 47648, at *6 (Del.Ch. Apr. 17, 1990)).

82 As I have noted before, it is unclear to me if there is much, if any, practical implication of a burden shift. *See In re Cysive, Inc. S'holders Litig.,* 836 A.2d 531, 548 (Del.Ch.2003) ("The practical effect of the *Lynch* doctrine's burden shift is slight. One reason why this is so is that shifting the burden of persuasion under a preponderance standard is not a major move, if one assumes, as I do, that the outcome of very few cases hinges on what happens if ... the evidence is in equipoise.").

83 *Tremont,* 694 A.2d at 429 (Del.1997) (citation omitted).

84 *Id.* at 428.

85 *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604, 617 (Del.Ch.2005) ("But, in order to encourage the use of procedural devices such as special committees and Minority Approval Conditions that tended to encourage fair pricing, the Court [in *Lynch*] did give transactional proponents a modest procedural benefit—the shifting of the burden of persuasion on the ultimate issue of fairness to the plaintiffs—if the transaction proponents proved, in a factually intensive way, that the procedural devices *had, in fact, operated with integrity.*") (emphasis added) (citation omitted).

86 *Accord Kahn v. Lynch Commc'n Sys., Inc.,* 638 A.2d 1110, 1121 ("[U]nless the controlling or dominating shareholder can demonstrate that it has not only formed an independent committee but also replicated a process 'as though each of the contending parties had in fact exerted its bargaining power at arm's length,' the burden of proving entire fairness will not shift.") (citing *Weinberger v. UOP, Inc.,* 457 A.2d 701, 709–10 n. 7 (Del.1983)).

87 *Tremont,* 694 A.2d at 424.

88 *Id.* at 426 ("Although the three men were deemed 'independent' for purposes of this transaction, all had significant prior business relationships with Simmons or Simmons' controlled companies."); *id.* at 429–30 (exploring the significance of the ties).

89 *Id.* at 426–27 (discussing that the financial advisor was affiliated with the controlling stockholder, that the legal advisor was selected by the general counsel of both the company and the controlling stockholder, that the conflict check was performed by the general counsel, and that the legal advisor had represented the controlling stockholder's company in prior business deals).

90 *Id.* at 427.

91 *Id.* (noting that the special committee only met four times, that only one director was able to attend all the meetings, and that he was also the only director to attend the review sessions with the advisors).

92 *Id.* at 430.

93 Judge Quillen was then a member of the Superior Court and was sitting on the Supreme Court by designation. *Id.* at 423 n. *.

94 *Id.* at 433 (Quillen, J., concurring) (noting the value of the deal to the controlling stockholder, the difficulties the controlling stockholder would face in trying to accomplish a similar deal with a non-affiliated entity, and the time constraint the controlling stockholder was under to achieve the tax savings).

95 *Id.*

96 *Id.*

97 *Id.* (falling from $16 per share to $12.75 per share).

98 *Id.*

99 *Id.* (majority opinion) at 429.

100 *Id.* at 428.

101 *See also Kahn v. Lynch Commc'n Sys., Inc.,* 638 A.2d 1110, 1121 (Del.1994) (discussing with approval the Supreme Court's conclusion in *Rabkin v. Philip A. Hunt Chem. Corp.* that "the majority stockholder's 'attitude towards the minority,' coupled with the 'apparent absence of any meaningful negotiations as to price,' did not manifest the exercise of arm's length bargaining by the independent committee" and that "the burden on entire fairness would not be shifted by the use of an independent committee which concluded its processes with 'what could be considered a quick surrender' to the dictated terms of the controlling shareholder.") (citing *Rabkin v. Philip A. Hunt Chem. Corp.,* 498 A.2d 1099, 1106 (Del.1985)).

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102 *See, e.g., In re Cysive, Inc. S'holders Litig.,* 836 A.2d 531, 548 (Del.Ch.2003) ("Because these devices are thought, however, to be useful and to incline transactions towards fairness, the *Lynch* doctrine encourages them by giving defendants the benefits of a burden shift if either one of the devices is employed.").

103 *See* William T. Allen et. al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law,* 56 Bus. L. 1287, 1297 (2001) (explaining that standards of review should be functional, in that they should serve as a "useful tool that aids the court in deciding the fiduciary duty issue" rather than merely "signal the result or outcome.").

104 Obviously, if a more important shift was contingent upon this factor, the cost-benefit analysis would be closer. In part for that reason and, as importantly, because the role of an independent negotiating agent is different from that of an approving principal (to use economic, not legal concepts), *see In re John Q. Hammons Hotels Inc. S'holder Litig.,* 2009 WL 3165613, at *12 (Del.Ch. Oct. 2, 2009); *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604, 645 (Del.Ch.2005), and because our statute often contemplates both the requirements of board and stockholder approval in third-party mergers, 8 *Del. C.* § 251, I am more comfortable according business judgment rule standard of review treatment to an interested transaction only if a transaction is contingent in advance on both: i) the negotiation, approval and veto authority of an independent board majority or special committee; and ii) the approval of a majority of the uncoerced, fully informed, and disinterested stockholders. *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d at 643 (noting that such an alteration would "mirro[r] what is contemplated in an arms-length merger under § 251—independent, disinterested director *and* stockholder approval.") (footnote omitted). Absent the assurance that the stockholders themselves have the opportunity to turn down the transaction freely, the costs of such a move would seem to outweigh the benefits. With a standard that would systemically encourage both the employment of an active independent negotiating agent and the empowerment of disinterested stockholders to protect themselves and hold those agents accountable, the benefits to investors could be considerable and there would be a better chance to focus litigation on those transactions that are most questionable, which would also make the cost-benefit ratio of the representative litigation process better for diversified investors. *See id.* at 643–45 (discussing how this reform would eliminate perverse litigation incentives and "encourage the filing of claims only by plaintiffs and plaintiffs' lawyers who genuinely believed that a wrong had been committed.").

105 *See In re Cysive, Inc. S'holders Litig.,* 836 A.2d at 548–49 (explaining why this more searching approach tends to conflate the burden-shifting analysis with that of procedural fairness).

106 *See* Allen et. al., *supra* note 103, at 1297–98.

107 *Cf. In re Cysive, Inc. S'holders Litig.,* 836 A.2d at 549 (noting that "it is unsurprising that few defendants have sought a pre-trial hearing to determine who bears the burden of persuasion on fairness" given "the factually intense nature of the burden-shifting inquiry" and the "modest benefit" gained from the shift).

108 *See* Allen et. al., *supra* note 103, at 1303–04 n. 63 (noting the practical problems litigants face when the burden of proof they are forced to bear is not made clear until after the trial); *cf. In re Cysive, Inc. S'holders Litig.,* 836 A.2d at 549 ("[I]n order to prove that a burden shift occurred because of an effective special committee, the defendants must present evidence of a fair process. Because they must present this affirmatively, they have to act like they have the burden of persuasion throughout the entire trial court process.").

109 *See In re Cysive, Inc. S'holders Litig.,* 836 A.2d at 549 (noting that it is inefficient for defendants to seek a pre-trial ruling on the burden-shift unless the discovery process has generated a sufficient factual record to make such a determination).

110 *See Emerald Partners v. Berlin,* 726 A.2d 1215, 1222–23 (Del.1999) (describing that the special committee must exert "real bargaining power" in order for defendants to obtain a burden shift); *see also Beam v. Stewart,* 845 A.2d 1040, 1055 n. 45 (Del.2004) (citing *Kahn v. Tremont Corp.,* 694 A.2d 422, 429–30 (Del.1997)) (noting that the test articulated in *Tremont* requires a determination as to whether the committee members "*in fact* " functioned independently).

111 *Tremont,* 694 A.2d at 428.

112 *Rabkin v. Olin Corp.,* 1990 WL 47648, at *6 (Del.Ch. Apr. 17, 1990), *aff'd,* 586 A.2d 1202 (Del.1990) (TABLE) ("If an informed vote of a majority of the minority shareholders has approved a challenged transaction, and in fact the merger is *contingent* on such approval, the burden entirely shifts to the plaintiffs to show that the transaction was unfair to the minority." (emphasis added)); *see also In re Wheelabrator Techs., Inc. S'holders Litig.,* 663 A.2d 1194, 1203 (Del.Ch.1995) (same).

113 In a merger where there is no controller and the disinterested electorate controls the outcome from the get go, there is no need to bargain over this element. In such a situation, it has long been my understanding of Delaware law, that the approval of an uncoerced, disinterested electorate of a merger (including a sale) would have the effect of invoking the business judgment rule standard of review. *See, e.g., In re Wheelabrator Techs., Inc. S'holders Litig.,* 663 A.2d at 1201 n. 4, 1202–03 (describing the effect of an informed, uncoerced, and disinterested stockholder approval of a merger not involving a controlling stockholder and finding that such approval invokes the business judgment rule standard of review). It may be that a vote in that context does not involve "pure ratification," *see Gantler v. Stephens,* 965 A.2d 695, 712–13 (Del.2009), but I have long understood that under our law it would invoke the business judgment rule standard of review. *See Harbor Fin. Partners v. Huizenga,* 751 A.2d 879, 890, 895–900 (Del.Ch.1999) (discussing history of the long tradition to invoking the business judgment rule standard when informed, disinterested stockholders approve a

third-party merger and the limited waste exception to this effect); *Solomon v. Armstrong,* 747 A.2d 1098, 1113–17 (Del.Ch.1999), *aff'd,* 746 A.2d 277 (Del.2000) (citing cases to this effect); *see also* Allen et. al., *supra* note 103, at 1307–09 (expressing the policy rationale for giving full "ratification" effect to an uncoerced, disinterested shareholder vote). Perhaps a more nuanced nomenclature is needed to describe the traditional effect that a disinterested stockholder vote has had on the standard of review used to evaluate a challenge to an arm's length, third-party merger and to distinguish it from "classic" or "pure ratification." *See Harbor Finance Partners,* 751 A.2d at 900 n. 78 ("For want of better nomenclature, I use the term ["ratification"] as describing a stockholder vote sufficient to invoke the business judgment rule standard of review."). The key is not what you call it, but rather preserving the utility of a long-standing doctrine of our law.

114 *See In re John Q. Hammons Hotels Inc. S'holder Litig.,* 2009 WL 3165613, at *13 (Del.Ch. Oct. 2, 2009) ("Moreover, a clear explanation of the pre-conditions to the Merger is necessary to ensure that the minority stockholders are aware of the importance of their votes and their ability to block a transaction they do not believe is fair.").

115 *See Bershad v. Curtiss–Wright Corp.,* 535 A.2d 840, 846 (Del.1987) (citations omitted).

116 *See* JX–103 at SP COMM 006886 (generating a high-end standalone value of Minera of $2.085 billion, using the A & S-adjusted projections, a 7.5% discount rate, and a long-term copper price of $1.00/lb); *id.* at SP COMM 006898 (generating a mid-range relative value of 58.8 shares of Southern Peru, using A & S-adjusted projections, a 9.0% discount rate, and a long-term copper price of $0.90/lb).

117 The vote is of no less importance for purposes of the disclosure analysis simply because the result of the vote was effectively a lock. Otherwise, the defendants would reap an analytical benefit from their decision *not* to condition the Merger on a majority of the minority vote.

118 Grupo Mexico's equity share of Southern Peru increased from 54.2% to 75.1% as a result of the Merger. *See* JX–107.

119 In its June 11, 2004 presentation, Goldman presented a DCF analysis that generated a midrange implied equity value for Minera of $1.7 billion, using an 8.5% discount rate, $0.90/lb long-term copper prices, and the A & S adjusted projections. JX–101 at SP COMM 003375. In its July 8, 2004 presentation, Goldman presented a revised DCF analysis, which generated a mid-range implied equity value for Minera of $1.358 billion, using the same 8.5% discount rage, $0.90/lb long-term copper prices, and the A & S adjusted projections. JX–103 at SP COMM 006886.

120 According to Goldman's spreadsheets produced by the plaintiff in discovery, Goldman arrived at a mid-range implied equity value of $1.254 billion for Minera, using an 8.5% discount rate and a $0.90 long-term copper price. The spreadsheets show that Southern Peru's mid-range implied equity value was $1.6 billion, assuming a 9.5% discount rate, a $0.90 long-term copper price, and a royalty tax rate of 2%.

121 At the time of signing on October 21, 2004, Southern Peru shares were trading at $45.92. Given its capitalization of 80 million issued shares, Southern Peru's actual market equity value was $3.67 billion.

122 JX–129 at 34. Southern Peru's EV/2005E EBITDA multiple of 5.5x was based on estimates of future results contained in selected Wall Street research reports, *id.* at 33, and appears to have been unadjusted for the $100 million dividend. *Compare* JX–106 at 24 n. 1 (adjusting the multiple to account for the dividend, which increases Southern Peru's EV/2005E EBITDA multiple based on Wall Street consensus to 5.6x).

123 *Id.* at 34. The comparable company EV/2005E EBITDA multiples were all based on median estimates published by the Institutional Brokers Estimate System. *Id.* at 33.

124 JX–106 at SP COMM 004926. As discussed above, the 5.6x multiple (5.5x if unadjusted for the dividend) used by Goldman was based on estimates of Southern Peru's 2005E EBITDA as contained in Wall Street research reports. The materially higher 6.3x, 6.4x, and 6.5x multiples, however, were based on Southern Peru's internal projections for its 2005E EBITDA, which reduced the 2005E EBITDA figures to questionably low levels, given its strong performance in 2004 coupled with the incentives to decrease the figures in order to arrive at a higher multiple to support a 67.2 million share issuance for Minera.

125 JX–106 at SP COMM 004926 (internal 2005E EBITDA projections ranging from $570 million to $592 million, where Wall Street projections were $664 million and its 2004 YTD annualized EBITDA was at that point $801 million).

126 *Id.* (showing that at minimum, either a combination of a 6.4x multiple multiplied by management's unadjusted 2005E EBITDA for Minera or a 6.5x multiple multiplied by the A & S adjusted 2005E EBITDA for Minera was needed to justify an issuance of over 67 million shares).

127 The 2005E Wall Street consensus median multiple of the comparable companies used by Goldman for 2005 was 4.8x. JX–129 at 34.

128 The 2005E Wall Street consensus multiple of Southern was 5.5x (unadjusted for the dividend) or 5.6x (adjusted for the dividend). JX–129 at 34; JX–106 at 24 n. 1

129 JX–107 (Road Show Presentation) at SP COMM 006674. As I will discuss, this multiple was derived from an enterprise value of Minera of $4.1 billion.

130 JX–106 at SP COMM 004926.

131 Goldman's contribution analysis assumed that Minera's estimated 2005 EBITDA would be $622 million (as adjusted by A & S) or $672 (per the unadjusted management figures). The road show, however, implied an estimated 2005 EBITDA for Minera of $732 million (derived by dividing the listed $4.1 billion enterprise value by the 5.6x EV/2005E EBITDA multiple). JX–107 at SP COMM 006674.

132 The road show assumed an estimated 2005 copper production of 365.4 Mt, JX–107 at SP COMM 006674, whereas, as of October 21, 2004, A & S projected an estimated 2005 copper production of 329.1 Mt, and Minera itself projected an estimated 2005 copper production of 355.0 Mt. JX–106 at SP COMM 004918.

133 JX–16 at SP COMM 000441.

134 *See* Tr. at 14 (Palomino) ("Q. To what extent did the Special Committee have the authority to negotiate with Grupo Mexico? A. Well ... we had to evaluate in any way that deems to be desirable, in such manner as deems to be desirable. While we did not try to make our own proposals to Grupo Mexico, we could negotiate with them in the sense of telling them what it is that we don't agree with; and if we are going to evaluate this in a way that makes this transaction move forward, then you're going to have to change the things that we don't agree with or we won't be able to recommend it."); *id.* at 143–44 (Handelsman) ("Q. To what extent was the Special Committee empowered to negotiate with Grupo Mexico? A. Well, the way I looked at this was that ... the committee was to educate itself and determine whether they believe that the proposed transaction was a good or bad one. If good, then the transaction would progress in its normal course. And if the committee found that the transaction was not beneficial to the shareholders other than Grupo Mexico of Southern Peru, then the committee would say no. And that if Grupo Mexico determined that it wanted to negotiate in the face of a no, it could do so."); Palomino Dep. at 39–40 ("Our mandate was to evaluate the transaction and to—provided that the transaction was beneficial to all shareholders of [Southern Peru] and to minority shareholders in particular, to recommend to the board that the transaction be approved."); *id.* at 106 ("Our mandate was to evaluate and recommend to the board, so we did ... I don't recall exactly what, if any, responsibilities were left or any purpose of the Special Committee was left after that."); *see also* Handelsman Dep. at 34–35 (acknowledging that the resolution creating the Special Committee did not say "negotiate").

135 *See In re Loral Space & Commc'ns Inc.,* 2008 WL 4293781, at *9 (Del.Ch. Sept. 19, 2008).

136 *But cf. Venoco, Inc. v. Eson,* 2002 WL 1288703, at *7 (Del.Ch. June 7, 2002) ("The primary concern for directors, even if they are minority directors and significant shareholders, must be the best interests of the corporation rather than their own interests as shareholders.").

137 The defendants suggest that Handelsman's interest in liquidity had less to do with Cerro's wish for registration rights and more with improving Southern Peru's public float for the benefit of all minority shareholders. I have no doubts that Handelsman rationalized that granting the registration rights would create a better public float and more efficient market for Southern Peru shareholders, but this seems to me more of a high-minded justification rather than the driving reason why Handelsman pursued such rights. Handelsman has been an attorney for the Pritzker interests since 1978 and has represented them in various business transactions, and he admitted that it was very clear to him that the Pritzkers wanted to sell their shares and liquidate their ownership position in Southern Peru. Put simply, I do not decide the case on the inference that Handelsman, with the prospect of registration rights as part of the Merger dangling in front him, put the Pritzkers' interest wholly aside and only considered the benefit the registration rights created for the minority shareholders.

138 The August 21, 2004 term sheet sent by Grupo Mexico to the Special Committee included "Liquidity and Support" provisions that would provide registration rights necessary to allow Cerro and Phelps Dodge to liquidate their holdings in Southern Peru after the close of the Merger. JX–157 at SP COMM 010487. The September 23, 2004 term sheet from the Special Committee stated that as to the possibility of Cerro and Phelps Dodge receiving registration rights for the sale of their shares in Southern Peru, the term sheet provided that such rights would be "[a]s determined in good faith by agreement among the Founding Stockholders, with the consultation of the Special Committee." JX–159 at AMC 0027547.

139 *Cf. Merritt v. Colonial Foods, Inc.,* 505 A.2d 757, 765 (Del.Ch.1986) ("[T]he law, sensitive to the weakness of human nature and alert to the ever-present inclination to rationalize as right that which is merely beneficial, will accord scant weight to the subjective judgment of an interested director concerning the fairness of a transaction that benefits him." (citation omitted)).

140 *Kahn v. Tremont Corp.,* 694 A.2d 422, 429 (Del.1997).

141 *See In re Loral Space & Commc'ns Inc.,* 2008 WL 4293781, at *9, *24–25 (Del.Ch. Sept. 19, 2008).

142 Pl. Op. Pre–Tr. Br. at 3.

143 *See* Tr. at 49 (Palomino) ("[I]f you used these same numbers for Minera [ ] and Southern Peru [ ] and on the same parameters, then you were comparing apples to apples."); *see also* Def. Op. Post–Tr. Br. at 17 (explaining that one of the major reasons the Special Committee used relative valuation was that it allowed Southern Peru and Minera to be evaluated using the same set of assumptions, "*i.e.,* an apples-to-apples comparison.").

144 *See* JX–74 (summary of Grupo Mexico/UBS/GS meeting (March 9, 2004)) at SPCOMM 010049 (noting that "mine studies have recently been completed by third party experts for all of [Minera]'s mines to support their life and quality arguments ... [Grupo

Mexico] is aware of no recent reports on [Southern Peru] mines"); *see also* Tr. at 355–56 (Beaulne) (discussing the differences between Minera's updated and optimized life-of-mine plan and the Southern Peru's stale life-of-mine plan).

145 Parker Dep. at 41.

146 *Compare* JX–103 at SP COMM 006883 (discussing Minera projections and noting that "[n]ew optimization plan for Cananea ('Alternative 3'), recently developed by [Grupo Mexico] and Mintec was not included in the projections at this point. According to Mintec, such a plan could yield US $240mm in incremental value on a pre-tax net present value basis prior to any potential adjustments by [A & S], using a 8.76% real discount rate as per [Minera] management") *with* JX–106 at SP COMM 004917 (noting that Minera projections "include new optimization plan for Cananea ('Alternative 3') developed by [Grupo Mexico] and Mintec.").

147 Parker Dep. at 44.

148 *See, e.g.,* JX–102 (Goldman presentation to the Special Committee (June 23, 2004)) at SP COMM 006976 (discussing Southern Peru projections and noting that "[A & S] changes to [Southern Peru] Case limited to CapEx assumptions; overall NPV impact of [A & S] changes to the model is about 70mm assuming 9% discount rate").

149 JX–75 (A & S comments to Goldman following its meeting with Mintec and Minera (June 25, 2004)) at SP COMM 006957.

150 *See* Parker Dep. at 50; Tr. at 98 (Palomino); *see also* JX–47 (expert report of Daniel Beaulne) (March 16, 2010) ("Beaulne Report") at 17 (discussing adverse effects of depressed metal prices and lower sales volumes on Minera's financial performance in 2001, 2002, and 2003).

151 JX–106 at SP COMM 004917 (noting that Minera projections used in the fairness analysis "assume[ ] that [the Merger] closes on December 31, 2004.").

152 *See In re Loral Space & Commc'ns Inc.,* 2008 WL 4293781, at *24 (Del.Ch. Sept. 19, 2008) (criticizing the special committee for its failure "to respond to the realities as an aggressive negotiator seeking advantage would have").

153 JX–33 (Goldman engagement letter (March 2, 2004)) at SP COMM 014786–SP COMM 014787 (providing for a flat fee structure).

154 *Weinberger v. UOP, Inc.,* 457 A.2d 701, 712–13 (Del.1983).

155 *Paramount Commc'ns, Inc. v. Time Inc.,* 571 A.2d 1140, 1150 n. 12 (Del.1989).

156 *Paramount Commc'ns, Inc. v. Time Inc.,* 1989 WL 79880, at *19 (Del.Ch. July 14, 1984), *aff'd,* 571 A.2d 1140 (Del.1989).

157 *Time,* 571 A.2d at 1149.

158 *See* JX–103 at SP COMM 006886. This value was calculated by applying Goldman's most aggressive assumptions (a $1.00 long-term copper price and 7.5% discount rate) to unadjusted projections provided by Minera management. I am not taking into account the $3 billion valuation that was produced under the same assumptions in Goldman's June 11 presentation because at that point due diligence on Minera was still very much a work in progress. *See also* JX–101 at SP COMM 003338 ("Due diligence process is still ongoing ...").

159 Tr. at 445 (Schwartz). In his report, Schwartz, who used the same relative valuation methodology as Goldman did, sets forth a continuum of valuation results ranging from those based on the $0.90/lb long-term copper price used by Goldman to the $1.30/lb long-term copper price that he considered to be a reasonable assumption at the time. At $0.90/lb Minera was worth approximately 67.6 million shares of Southern Peru stock, with a then-current market value of $1.7 billion; at $1.30 it was worth approximately 80 million shares, with a then-current market value of $3.7 billion. JX–48 (expert report of Eduardo Schwartz) (April 21, 2010) ("Schwartz Report") ¶ 25 at Ex. 2. These dollar values are derived from determining the number of shares that Southern Peru would issue for Minera under a relative DCF analysis using these copper price assumptions, multiplied by the $45.92 closing price of Southern Peru on October 21, 2004.

160 Tr. at 437 (Schwartz) ("In this case, Minera [ ] was more sensitive to the price of copper. When we increase the price of copper, the value, the present value of Minera [ ] went higher than [Southern Peru] ..."); Schwartz Report ¶ 45 ("[A] lower copper price causes the calculated value of Minera to decrease to a greater extent than the value of [Southern Peru] using the same assumptions.").

161 Schwartz Report ¶¶ 36–43.

162 Tr. at 481 (Schwartz) ("I got the Excel file from Goldman Sachs as modified by [A & S], and that's the data that I used to value both Minera [ ] and [Southern Peru].").

163 Defendants point to the testimony of Palomino as evidence of the Special Committee's bargaining strategy. Palomino testified that "strategically, it was to our advantage to try to be conservative with copper prices, because otherwise, the relative valuations would be altered in favor of Minera ... [t]he fact that the lower the price, the better for us, that was quite clear from the beginning." Tr. at 41 (Palomino). But nowhere does any piece of written evidence support this as being a genuine deal dynamic.

164 JX–143 at 66 (Southern Copper Corporation Form 10–K (February 29, 2008)).

165 JX–101; JX–102; JX–103; JX–105; JX–106.

166 The value of copper mining companies is basically related to the reserves they have. A copper mining company's reserves are not fixed based on the amount of ore in the ground, but are rather a representation of how much of that ore can be mined at a profit. That calculation, of course, turns in large part on the long-term copper price. When the long-term copper price goes up, the company's

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reserves will increase without any new ore being discovered because at a higher price more ore can be taken from the mine at a profit. Accordingly, in the long term, the company will take more copper out of the ground and its projections may change to reflect an increase in its reserves.

167 Tr. at 155 (Handelsman).

168 In contrast to Schwartz, the plaintiff's expert Daniel Beaulne determined a standalone fair value for Minera. Using a DCF analysis, Beaulne came up with an enterprise value for Minera of $2.785 billion as of October 21, 2004. *See* Beaulne Report at 42. Using a comparable companies analysis, Beaulne came up with an enterprise value for Minera of $2.831 billion as of October 21, 2004. Beaulne then took the average of the two enterprise values from each of the valuation approaches and added Minera's cash balance and subtracted Minera's debt, concluding that the "indicated equity value" of Minera was $1.854 billion as of October 21, 2004. Operating under the assumption that the "publicly traded share price of [Southern Peru] is a fair and accurate representation of the market value of a share of its common stock," Beaulne multiplied the $1.854 billion equity value of Minera by the 99.15% interest that Southern Peru was purchasing and then divided that amount by the publicly-available share price of Southern Peru as of October 21, 2004 adjusted by the $100 million transaction dividend (which translated to $1.25 per share). Out of conservatism, I adopt a different valuation for remedy purposes, but, if I had to make a binary choice, I would favor Beaulne's DCF analysis as more reliable than the Schwartz approval, which largely accepted (without any gumption check for, say, the $300 million in extra EBITDA Southern Peru earned in 2004) the defendant-friendly inputs of a flawed process and used an after-the fact generated copper price along with them to come to a determination of fairness.

169 JX–125 at 55; JX–107 at SP COMM 006674.

170 JX–156 at SP COMM 007080.

171 JX–118 (UBS presentation to Grupo Mexico (July 2004)) at UBS–SCC00005558.

172 JX–159 at AMC0027547.

173 *Compare* JX–160 at SP COMM 010497 (offering $10 million threshold) *with* Pre–Tr. Stip at 15 (stipulating that parties agreed to $10 million threshold).

174 Cerro's voting agreement required it to vote in accordance with the Special Committee's recommendation, but Phelps Dodge's voting agreement, which was entered into two months after the Merger was signed, did not have a similar provision. Rather, the agreement provided that, given the Special Committee's recommendation in favor of the Merger and the Board's approval of the Merger, Phelps Dodge expressed its current intention to vote in favor of the Merger. Although it seems that Phelps Dodge would be contractually entitled to vote against the Merger if the Special Committee had subsequently withdrawn its recommendation, nowhere does the agreement require such a result. Given Phelps Dodge's independent interest in obtaining the liquidity rights that were tied to the Merger, it is unclear how it would have voted if the Special Committee had changed its mind. Thus, because Phelps Dodge's vote by itself would be sufficient to satisfy the two-thirds supermajority vote condition, it is equally unclear what power the Special Committee actually had to stop the Merger once it was signed.

175 Tr. at 175 (Handelsman) ("I thought the collar had some meaning, but I thought that it was less important because I believed—based on my feeling that a relative value of the two companies made sense, that ships rise with a rising tide and ships fall with a falling tide; and, therefore, the chances of the value of one getting out of sync with the value of the other was a chance that was worth taking, although it certainly would have been better to have the collar.").

176 The switch to a fixed exchange ratio turned out to be hugely disadvantageous to Southern Peru. If the Special Committee had instead accepted Grupo Mexico's original May 7, 2004 proposal for Southern Peru to issue $3.1 billion dollars worth of stock with the number of shares to be calculated based on the 20–day average closing price of Southern Peru starting five days before the Merger closed, Southern Peru would have only had to issue 52.7 million shares of Southern Peru stock, based on the 20–day average price at that time of $59.75 per share. In other words, if the Special Committee had done no negotiating at all and had simply accepted Grupo Mexico's first ask, Southern Peru would have issued about 14.5 million fewer shares to purchase Minera than it did after the Special Committee was finished negotiating.

177 In their papers, both the plaintiff and the defendants point to evidence post-dating the Merger to support their arguments. *See, e.g.,* Pl. Op. Post–Tr. Br. at 7–9, 18 (discussing post-Merger evidence of reported ore reserves for Southern Peru and post-Merger completion of a significant exploration program relating to Southern Peru's mines); Pl. Ans. Post–Tr. Br. at 12 (citing to evidence of Southern Peru and Minera's 2005 EBITDA performance); Def. Op. Post–Tr. Br. at 22 (including chart that shows investment return in Southern Peru and selected comparable companies from October 21, 2004 to June 27, 2011). Def. Ans. Post–Tr. Br. at Ex. A. As their supplemental letters after post-trial argument show, our law is not entirely clear about the extent to which such evidence can be considered. In an appraisal case, it is of course important to confine oneself to only information that was available as of the date of the transaction giving rise to appraisal. 8 *Del. C.* § 262(h) ("[T]he [c]ourt shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."). But even in appraisal, there are situations when post-transaction evidence has relevance. *Cede & Co. v. Technicolor, Inc.,* 758 A.2d 485, 499 (Del.2000) (holding that post-

merger evidence that validated a pre-merger forecast was admissible "to show that plans in effect at the time of the merger have born fruition." (citation omitted)); *Cavalier Oil Corp. v. Harnett,* 1988 WL 15816, at *14 (Del.Ch. Feb. 22, 1988), *aff'd,* 564 A.2d 1137 (Del.1989) ("[p]ost-merger data may be considered" if it meets the *Weinberger* standard pertaining to non-speculative evidence); *see generally* R. Franklin Balotti & Jesse A. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 9.45 (3d ed.1998) (discussing the court's ability to consider post-merger evidence in the appraisal context). In an entire fairness case, where the influence of control is important, there is a sucker insurance purpose to such evidence. *See Gentile v. Rossette,* 2010 WL 2171613, at *2 (Del.Ch. May 28, 2010) (noting that "[s]ome rumination upon the outcome of the fair price and process dynamic ... cannot be avoided"); *Ryan v. Tad's Enters., Inc.,* 709 A.2d 682, 697 (Del.Ch.1996) (considering post-merger events in determining whether merger price was fair). In this case, for example, the estimated cash flows for Southern Peru, which were not optimized, were important in setting the transaction price. As of the Merger date, the Special Committee and Grupo Mexico had access to results of Southern Peru that showed that the estimates for 2004 had been exceeded by a large amount and that Southern Peru was running well ahead of the 2005 estimate, suggesting that Southern Peru's non-optimized cash flow estimates might have been too low, whereas Minera's optimized cash flows seemed about right. The ultimate results from 2005 also cast serious doubt on the fairness of the relative valuation exercise that was used to justify the transaction.

178 Def. Ans. Post–Tr. Br. at Ex. A.

179 All actual EBITDA numbers are drawn from Southern Peru's post-Merger annual reports, which continue to report the results of the Southern Peru and the Minera businesses separately as operating segments. JX–138; JX–142; JX–143; JX–144; JX–146; JX–147. All numbers are in millions.

	2005E [180]	2006E	2007E	2008E	2009E	2010E	Sum
Minera	$622.0	$530.0	$627.0	$497.0	$523.0	$567.0	$3366.0
Southern Peru	$581.0	$436.0	$415.0	$376.0	$350.0	$329.0	$2487.0
Ratio MM/SP	1.07	1.22	1.51	1.32	1.49	1.72	1.35

180 All estimated EBITDA numbers are based on the A & S-adjusted projections used in Goldman's October 21, 2004 presentation. The 2005E EBITDA numbers are based on the A & S-adjusted estimates in Goldman's contribution analysis, JX–106 at SP COMM 004926 (which assume a 2% royalty tax on Southern Peru and certain other additional adjustments) and the 2006E–2010E EBITDA numbers are based on the A & S-adjusted projections underlying Goldman's final relative DCF analyses. *Id.* at SP COMM004918; SP COMM004920.

* * *

181 *See* Beaulne Report at 45. The 24.7 million figure is based on calculations as of the date of closing (April 1, 2005), rather than as of the date of Goldman's fairness opinion and the Special Committee's approval of the Merger (October 21, 2004).

182 *Int'l Telecharge, Inc. v. Bomarko, Inc.,* 766 A.2d 437, 439 (Del.2000) (noting that the Delaware Supreme Court "defer[s] substantially to the discretion of the trial court in determining the proper remedy...."); *Weinberger v. UOP, Inc.,* 457 A.2d 701, 715 (Del.1983) (noting "the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate").

183 *Thorpe v. CERBCO, Inc.,* 676 A.2d 436, 444 (Del.1996).

184 *Bomarko, Inc. v. Int'l Telecharge, Inc.,* 794 A.2d 1161, 1184 (Del.Ch.1999), *aff'd,* 766 A.2d 437 (Del.2000).

185 *Summa Corp. v. Trans World Airlines, Inc.,* 540 A.2d 403, 409 (Del.1988).

186 *Ryan v. Tad's Enters., Inc.,* 709 A.2d 682, 699 (Del.Ch.1996) (highlighting the principle of equity that a plaintiff waives the right to rescission by excessive delay in seeking it, and extending that principle to rescissory damages, based on the policy reason that excessive delay allows plaintiffs to see whether the defendants achieve an increase in the value of the company before deciding to assert a claim).

187 *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.,* 855 A.2d 1059, 1072 (Del.Ch.2003).

188 *Weinberger v. UOP, Inc.,* 457 A.2d 701, 714 (Del.1983); *Ryan,* 709 A.2d at 699.

189 As discussed earlier in this opinion, the Special Committee should have re-evaluated the Merger between signing and the stockholder vote due to changes in Southern Peru's stock price and Southern Peru's projection-shattering 2004 EBITDA and 2005 year to date performances. Instead, the Special Committee's decision to treat the Merger as a foregone conclusion was a-failure in terms of fair process. For this and other related reasons, I am therefore calculating damages with respect to the market value of Southern Peru shares as of the Merger date, April 1, 2005.

190 I say did not stop rather than did not slow, because they are different. By being conservative in my approach to a remedy, I give the defendants credit for some of their market-based arguments, in a manner that one could even say I should not in a duty of loyalty case. *See Thorpe v. CERBCO, Inc.,* 676 A.2d 436, 444 (Del.1996) ("Delaware law dictates that the scope of recovery for a breach of the duty of loyalty is not to be determined narrowly."). But I think this is responsible because the record suffers from some issues, including the absence of a Goldman trial witness and likely diminished memories, that are properly laid at the plaintiff's door.

191 Beaulne Report at 44.

192 *Id.* at 21.

193 Tr. at 340–341 (Beaulne).

194 Beaulne Report at 36. Like Beaulne, I disregard the potential tax benefits of $0–131 million for Minera that Goldman factored in to its valuations as of the date of the fairness opinion. JX106 at SP COMM 004917. The schedules and estimates provided by Minera management to Goldman on the potential tax benefits are not in the record, making them difficult to evaluate. Moreover, Schwartz also disregards these potential tax benefits in his relative valuation analysis, Schwartz Report ¶ 22, and the defendants do not take issue with Beaulne's exclusion of them.

195 Beaulne's model, adjusted to reflect my inputs, yields an enterprise value for Minera of $3.452 billion, from which I subtracted the $1 billion in debt that Southern Peru assumed in the Merger. To the extent the defendants' gripe about the remedy, using the $0.90 per pound long-term copper price they told the investing public was the right number, the equity value of Minera would be only $1.512 million. At the high end of the long-term copper prices used in Goldman's standalone DCF model, or $1.00 per per pound, Minera's value was only $1.982 million. This underscores the conservatism of my approach, given the record evidence.

196 $45.92 closing price x 52,000,000 = $2,387,840,000.

197 *See* JX–106 at SP COMM 004913, SP COMM 004925.

198 *Id.* at SP COMM 004925.

199 $1.986 billion = (4.8 x 622 million)—$1 billion net debt.

200 *Andaloro v. PFPC Worldwide, Inc.,* 2005 WL 2045640, at *16 (Del.Ch. Aug. 19, 2005).

201 *Borruso v. Commc'ns Telesystems Int'l,* 753 A.2d 451, 458 (Del.Ch.1999).

202 *Agranoff v. Miller,* 791 A.2d 880, 893 (Del.Ch.2001).

203 2006 Mergerstat ® Review (Santa Monica: FactSet Mergerstat, LLC, 2006) at 24.

204 $55.89 closing price x 67,200,000 = $3,755,808,000.

205 $3.756 billion - $2.409 billion = $1.347 billion.

206 The plaintiff has not sought to have the defendants pay his attorneys' fees. The parties shall confer regarding whether they can reach agreement on a responsible fee that the court can consider awarding, with the plaintiff's counsel taking into account the reality their own delays affected the remedy awarded and are a basis for conservatism in any fee award.

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UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

Gloria James, on behalf of herself and all others similarly situated, Plaintiffs,
v.
National Financial LLC, and Loan Till Payday LLC, Defendants.

C.A. No. 8931-VCL | Submitted: November 3, 2014 | Decided: December 5, 2014

Attorneys and Law Firms

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MEMORANDUM OPINION

LASTER, Vice Chancellor.

***1** In May 2013, plaintiff Gloria James obtained a short-term, high-interest-rate loan from defendant National Financial LLC ("National"). After defaulting, James sued National on behalf of herself and a class of similarly situated borrowers, alleging that National's loan practices were unconscionable and its loan terms unenforceable.

During discovery, James asked National to provide information about the loans it made between September 20, 2010, and September 30, 2013, including the annual percentage rates ("APRs"). After National moved for a protective order, the court ordered National to produce certain categories of information, including the APRs. National produced a spreadsheet containing some of the categories but not others. When James checked the APRs against the few loan documents she had, they differed. When James deposed National's principal, who created the spreadsheet, he agreed that the data contained errors, and he gave other testimony that called into question the reliability of the spreadsheet.

James amended her complaint to add a claim that, by making loans without disclosing accurate APRs, National had violated the federal Truth in Lending Act (the "TILA"), 15 U.S.C. §§ 1601–1667f. She also moved to compel production of an updated spreadsheet containing accurate information. The court granted the motion and ordered National to produce an updated spreadsheet. The court also ordered National to retain a qualified information technology ("IT") consultant to assist National in exporting the data from its computer system and to provide James with an affidavit from the IT consultant attesting to the procedures used to populate the spreadsheet.

National produced what purported to be an updated spreadsheet, but the spreadsheet omitted information required by the court's order. National did not produce the affidavit. National instead provided James with a letter from an IT consultant that did not address the procedures used to populate the spreadsheet. The letter stated only that it would take many thousands of hours for the IT consultant to transfer paper records into electronic form. It thus answered a question that had not been asked, while failing to address the question that the court had ordered answered. After James objected to the form of the letter, National provided a notarized version.

James has moved for entry of a default judgment as a sanction against National for failing to comply with this court's order. Discovery taken in connection with the motion revealed that (i) National did not ask the IT consultant about populating the spreadsheet, (ii) the IT consultant did not know about the court's order or the requirement of an affidavit, (iii) the conversation with the IT professional about transferring records took about twenty minutes, and (iv) after James objected to the letter, National caused one of its employees to notarize the letter without the IT consultant's knowledge.

This decision holds that as a consequence of National's discovery misconduct, it is deemed established for purposes of trial that the APRs disclosed on the updated spreadsheet were incorrect and fell outside the tolerance permitted by the TILA. Because the positions National took in discovery were not substantially justified, this decision awards James the expenses, including attorneys' fees, that National's discovery failures caused her to incur.

I. FACTUAL BACKGROUND

***2** The factual background is drawn from the pleadings and submissions made in connection with the earlier discovery motions and the current motion for sanctions. The discussion does not comprise findings of fact in the post-trial sense, but rather represents how the record appears at this preliminary stage.

A. The Loan

On May 7, 2013, James borrowed $200 from National, which does business in multiple locations in Delaware under the name Loan Till Payday LLC.[1] National is a Utah limited liability company that advertises, markets, and makes small-dollar, high-interest loans, which are referred to colloquially as "payday loans" because a borrower ostensibly repays the loan on the next payday.

James needed the $200 to pay for rent and groceries. The loan agreement, which consisted primarily of boilerplate provisions, imposed onerous terms. It contemplated *twenty-six* bi-weekly payments of $60 with a final balloon payment of $260. The total repayments add up to $1,620, for a cost of credit of $1,420 and an APR of 838.45%. James did not negotiate the terms of the loan. She avers that she did not understand the loan agreement fully.

James broke her hand on the day after she took out the loan, which limited her ability to work. She made the first $60 payment but missed the second. On June 14, 2013, National withdrew $63 from her bank account, comprising the agreed-to bi-weekly payment of $60 plus a $3 late fee. Ever since, James' inability to work has prevented her from making the bi-weekly payments.

B. James Files Suit

Under National's standard loan agreement, which James signed, a borrower agrees to mandatory arbitration and waives any right to arbitrate on a class-wide basis. The loan agreement gives a borrower sixty days after signing the agreement to opt out of the mandatory arbitration provision.

On June 14, 2013, James sent National a letter opting out of mandatory arbitration. On September 20, 2013, James filed a verified class action complaint in this court against National on behalf of herself and similarly situated borrowers. She alleged that National's lending practices were unconscionable in light of the inequality of bargaining power between National and its customers, the use of boilerplate provisions in the loan documents, and the practice of charging delinquency payments and excessive interest rates. Count I sought a permanent injunction barring National from collecting on the loans made to James and other class members. Count II sought a declaration that the terms of National's loan documents were unenforceable. Count III alleged that National breached the implied covenant of good faith and fair dealing inherent in the loan agreements. Count IV alleged that National unjustly enriched itself at the expense of the class members. Count V alleged violations of the Delaware Consumer Fraud Act, 6 *Del.* C. §§ 2511–2527.

On October 10, 2013, National moved to compel arbitration and to dismiss the Complaint under the creative theory that James could not state a claim for a class action under Rule 23. This court denied the motion to dismiss, noting that James had opted out of arbitration and that National's arguments against class certification were premature.

***3** At the time National moved to compel arbitration, National and its counsel[2] knew that James had opted out of arbitration. National and its counsel had made that point affirmatively as grounds for dismissal of an earlier action under the TILA that James filed in federal court. Because National and its counsel knew that their motion to compel arbitration had no factual basis, James moved for sanctions under Rule 11. The court granted the motion.

C. The First Discovery Order

After the denial of the motion to dismiss, James served document requests and interrogatories. Among other things, the discovery requests sought documents and information relating to the loans offered by National since September 20, 2010, including an electronic copy of the data from any database containing the loan information. National moved for a protective order, contending that the discovery was overbroad.

Although the court partially granted National's motion, finding that certain of James' requests were overbroad, the court's ruling required National to provide discovery in response to other requests or narrowed versions of the requests. *See* Dkt. 44 (the "First Discovery Order"). Most pertinently, the First Discovery Order required National to

provide the following information for the loans made between September 20, 2010, and September 30, 2013:

- The disbursement date of the loan.
- The type of contract.
- Where the loan was initiated (e.g., online, store location, etc).
- The APR.
- The finance charges (as identified on the loan agreement).
- The amount financed.
- The total amount of payments.
- The schedule for payments (weekly, bi-weekly, or monthly).
- The amount of money actually given to the customer, such that if the loan was a refinancing and the customer only received a portion of the funds, the amount the customer received.
- Whether the loan was a rollover or refinancing.
- Whether the customer had borrowed from National before.
- The total payments made by the customer on the loan.
- Whether the loan was paid off.
- Whether the loan was written off.
- Whether the loan was in default.

This decision refers to these categories as the "Loan History Information."

The court rejected National's argument that providing the Loan History Information was overly burdensome given National's failure to support its claim of burden, the standardized nature of the loans, and the need for National to maintain and access loan data in the ordinary course of business and to meet regulatory requirements. The court noted that National could provide the Loan History Information in the form of a spreadsheet. The court expected that National had software that could spit out the information. National's counsel did not contend otherwise.

D. The Initial Spreadsheet

On February 28, 2014, National produced an Excel spreadsheet that purported to provide the Loan History Information (the "Initial Spreadsheet"). Rather than only addressing the period covered by the First Discovery Order, the Initial Spreadsheet provided data for loans going back to January 1, 2006. This confirmed that the data was easily accessible and not burdensome to provide.

***4** The Initial Spreadsheet included a column containing APRs, but the columns labeled "Schedule of Payments," "Total Amount of Payments," and "Finance Charges" were blank. The Initial Spreadsheet therefore did not provide James with all of the information required by the First Discovery Order or enable her to verify the APRs. Her counsel used the few loan documents she had to check the APRs. The figures on the Initial Spreadsheet did not match the loan documents.

James' counsel deposed National's principal, Timothy McFeeters. He testified that he created the Initial Spreadsheet himself, without assistance, by exporting data from National's software system. He explained that the software system had the ability to generate reports and that he could specify the categories to include in the report, such as the borrower's name, amount borrowed, amount repaid, APR, and other types of information. He said that he picked which categories to export. He did not review the data for accuracy or have anyone else check it.

McFeeters acknowledged the discrepancies between the APRs on the Initial Spreadsheet and those in the loan agreements, but he offered no explanation other than it must have been an error on his part when exporting the data. McFeeters [1] at 96 ("Error on Tim."). He suggested that the errors might have occurred because the court ruled when issuing the First Discovery Order that National did not have to provide names of individual borrowers, so he had attempted to enter manually an identifying number for each individual borrower. National had approximately 10,000 customers and over 20,000 loans, making this a tedious task.

McFeeters also testified that the Delaware State Banking Commission (the "Banking Commission") had audited National between four and ten times after he purchased National in January 2013. He said the Banking Commission had expressed concern about inaccurate APRs. McFeeters testified that National changed its method of calculating APRs in response to the Banking Commission's concerns.

After deposing McFeeters, James' counsel asked National's counsel to provide an updated version of the Initial Spreadsheet. National's counsel agreed, but the updated version never followed. When James' counsel pressed the issue, National's counsel reneged, purportedly because McFeeters' deposition testimony adequately explained the reasons for the errors in the Initial Spreadsheet.

On May 6, 2014, James filed an Amended Verified Class Action Complaint (the "Amended Complaint"). The new pleading added Count VI, which alleged that National violated the TILA by failing to disclose accurate APRs in its loan agreements. On June 10, James sought further discovery, including admissions from National that the APRs in its loan agreements executed between September 10, 2010, and December 31, 2013, fell outside the acceptable tolerance under the TILA.

E. The Second Discovery Order

On July 17, 2014, James moved to compel National to provide the Loan History Information. In connection with the motion to compel, James' counsel deposed McFeeters for a second time. During this deposition, McFeeters retreated from his earlier testimony that the discrepancies in the Initial Spreadsheet resulted from his own errors. Instead, McFeeters suggested that the discrepancies resulted from updates made by National's software provider, Infinity Enterprise Lending Software ("Infinity"), to the software National used.

In opposing the motion to compel, National's counsel sought to revisit whether the Loan History Information was relevant and to contend that production would be burdensome. He asserted that because the TILA imposes a one-year statute of limitations, Loan History Information should not be provided for loans issued more than one year before the date of the Amended Complaint. He did not argue that extracting the information from National's software was burdensome. Nor did he dispute that National's software kept track of the APRs and could export the figures.

***5** The court held again that the Loan History Information was relevant and not burdensome to provide. Among other things, the court noted that it had ordered National to produce Loan History Information pursuant to the First Discovery Order, before James ever asserted a TILA claim. The information was relevant and discoverable in light of James' claims about National's unconscionable business practices. The information also was relevant under the TILA to whether National acted with *scienter*.

After granting the motion to compel, the court entered an order requiring National to provide accurate Loan History Information. Dkt. 120 (the "Second Discovery Order"). The Second Discovery Order directed National to produce an updated version of the Initial Spreadsheet. It specified that the updated version "shall contain accurate calculations of the APR for each loan and shall populate with information the columns labeled 'Finance Charges,' 'Total Amount of Payments,' and 'Schedule of Payments' sufficient to support the calculation of the APR." *Id.* ¶ 1. The Second Discovery Order required that the updated version "be produced in native form so that Plaintiff can verify the formulas and calculations." *Id.* ¶ 2.

In light of McFeeters' testimony about how he personally prepared the Initial Spreadsheet, the Second Discovery Order required National to employ an IT consultant who could extract the data in an efficient and accurate manner, without requiring manual inputs. The Second Discovery Order stated:

> In preparing and producing this spreadsheet, Defendant shall employ a qualified IT consultant who can extract the data from the Defendant's system and import it into the spreadsheet in useable form. The IT consultant shall provide the plaintiff with an affidavit describing the procedures followed. The Defendant shall maintain the underlying records and data used to create the spreadsheet so that they can be reviewed, if necessary.

Id. ¶ 4. The Second Discovery Order did not require that the IT consultant be independent or limit the ability of National or its counsel to interact with the IT consultant.

F. The Updated Spreadsheet

On September 29, 2014, National's counsel purported to comply with the Second Discovery Order by emailing James' counsel an Excel spreadsheet (the "Updated Spreadsheet") and a letter from neXVel Solutions ("neXVel"). The cover email stated:

> Attached is a letter from neXVel Solutions, the IT company employed by defendant to assist in the revision of the Excel spreadsheet, relative to the above matter. As I earlier advised, the APR's [sic] appearing on the loan agreements,

> themselves, are not part of the computer system and are not in digital format.
>
> I am asking that you please accept the attached letter in lieu of an affidavit; however, if an affidavit is required, I can arrange for same.

Motion Ex. 5.

The letter from neXVel did not address the creation of the Updated Spreadsheet or the extraction of data from National's computer system. It instead addressed the creation of a new database from paper documents. The text read as follows:

> Thank you for the opportunity to assist you in managing and converting your loan records.
>
> After auditing your existing loan documents by Infinity Software [sic], we have determined the following:
>
> 1.) Your current loan contracts and records that we evaluated and asked us [sic] to convert to excel [sic] are not in any digital format.
>
> 2.) There is no automated way to properly and easily convert these paper records into excel [sic] or any table based [sic] software without avoiding a timely manual process.
>
> ***6** 3.) Any manual data entry process could take an average of 30 minutes per contract based on the amount of manual data entry needed. Taking into consideration [sic] you have over 33,000 plus [sic] loans it would in theory take 16,500 man hours or 687.50 Days [sic] to manually input this data.
>
> Attached to this letter is an invoice for our time and we hope that our analysis assists you moving forward.

Id.

After James' counsel explained that the neXVel letter did not comply with the Second Discovery Order, National's counsel responded with the following email:

> I am informed that National Financial's software company will not allow access by an outside IT consultant. Please see the e-mail below from Infinity to McFeeters, confirming same. This is why we had difficulty obtaining the affidavit although I am told McFeeters is still attempting to obtain an affidavit.

Id. Ex. 6. The statement that National's software vendor would “not allow access by an outside IT consultant” differed in substance from his earlier representation that neXVel had been “employed by defendant to assist in the revision of the Excel spreadsheet, relative to the above matter.” According to the earlier representation, neXVel actually assisted with the process as contemplated by the Second Discovery Order. According the later representation, neXVel was not permitted to assist.

The email from National's counsel contained the following text, ostensibly backing up his representation:

> From: **Shaye Friedman** <*shaye@infinityels.com*>
>
> Date: Mon, Sep 29, 2014 at 4:06 PM
>
> Subject: Report
>
> To: Tim McFeeters <*tim@loantillpaydaydelaware.com*>
>
> Hello Tim,
>
> As far as I can tell the data in the attached report looks accurate. Unfortunately, we do not allow outside sources to program or develop in our software.
>
> Let me know if you have any questions or concerns.
>
> Regards,
>
> Shaye

*Id.*Other than the email address, there was nothing to suggest that Friedman actually worked for Infinity, what her title and position were, or whether she knew about the Second Discovery Order or what National and neXVel were required to do.

The Friedman email did not suggest that Infinity would not permit a third-party IT consultant to use Infinity's software to export data, as McFeeters had done. The email said only that Infinity would not permit an outside source “to program or develop in our software.” The email therefore did not provide a justification for National's failure to retain an IT consultant to assist in extracting and providing the data.

The claim that Infinity would “not allow outside sources to program or develop in our software” conflicted with

National's interrogatory responses, which averred that National previously used Compliance Services, Inc. ("CSI") to modify its software. According to one response,

> **[o]n or about July 26, 2013**, National contracted with [CSI] to assist National in resolving any inaccuracies associated with the APR's [sic] reflected on National's loan agreements including, without limitation, identifying the source of any inaccuracies, or perceived inaccuracies, *and adjusting National's software accordingly....* Through the efforts of CSI, National changed the calculations of its APR's [sic] from a block rate to a daily rate *and adjusted its software accordingly upon which it continued to rely.*

***7** Opposition Ex. C at 2 (second and third emphasis supplied). Yet if the Friedman email was accurate, then Infinity should not have permitted CSI to "adjust" its software.

More importantly, the representation by National's counsel that the APR calculations "were not part of [National's] computer system and are not in digital format" conflicted with at least two of National's interrogatory responses and McFeeters' earlier testimony. The interrogatory response quoted above stated that National relied on its software to make the APR calculations. That was how McFeeters testified during his second deposition, when he contended that changes to the software generated the erroneous APRs in the Initial Spreadsheet. National adopted this account in another interrogatory response, which stated:

> [After his deposition on April 23, 2014], McFeeters contacted [Infinity], the computer and/or software company which supplied and maintained National's computer software, inquiring why the annual percentage rates ("APR's") [sic] reflected on several of National's loan agreements differed from the APR reflected in the computer data. *McFeeters was informed that as Infinity made changes and/or updates to the software, APR data would change.* Thus, while McFeeters initially believed the discrepancies between the APR's [sic] reflected on the loan agreements *and in the computer data* was [sic] solely his error, he subsequently determined that this was not necessarily the reason, but that the data was altered by Infinity.

Id. at 3 (emphasis added).

James' counsel continued to press National about providing an affidavit. Rather than doing so, National's counsel provided a version of the neXVel letter with a notary stamp. When James' counsel asked National's counsel directly about the role neXVel played in preparing the Updated Spreadsheet, National's counsel claimed not to know. National's counsel then took the position that he had tried to stay out of the process of preparing the Updated Spreadsheet because the Second Discovery Order required that the IT consultant be "independent," and he thought that if he inserted himself in the process, it would undermine the consultant's independence. Nothing in the Second Discovery Order spoke in terms of independence or required that the IT consultant be neutral. The Second Discovery Order required that National employ a "qualified" IT consultant to help McFeeters export the data required by the First and Second Discovery Orders. McFeeters chose to prepare the Updated Spreadsheet himself.

G. The Motion For Sanctions

On October 2, 2014, James moved for entry of a default judgment against National as a sanction for National's violation of the Second Discovery Order. Alternatively, James sought a deemed admission that the APR calculations for the loans on the Updated Spreadsheet fell outside the range of tolerances established by the TILA.

On October 16, 2014, National's counsel told James' counsel that he wanted to withdraw the neXVel letter on the ground that Chad Cushner, whose signature appeared on the letter, had not signed in the presence of the notary. The notary who provided the notarization is a National district manager and, ironically, responsible for training employees on proper procedures. National's counsel wrote the court to raise the issue and to express his concern that "this impropriety may have compromised [his] ability to serve as Defendant's counsel." Dkt. 132. At the request of National's counsel, the court held a teleconference on October 21 during which National's counsel reiterated these points. The court declined to make an advisory ruling regarding counsel's ethical obligations.

***8** After the teleconference, James deposed Cushner, whom neXVel had identified as its Rule 30(b)(6) witness. Cushner testified that McFeeters met with neXVel for

approximately one hour on September 24, 2014, and that perhaps twenty minutes was spent discussing the effort involved in converting hard copy documents to a digital format. McFeeters did not mention the Second Discovery Order, much less provide a copy. McFeeters did not explain that National had been ordered to retain an IT consultant to assist in extracting data from National's software system and using it to populate an Excel spreadsheet. Cushner testified that National never gave neXVel an opportunity to look at its software or to speak to anyone from Infinity. Cushner made clear that neXVel was not involved in preparing the Updated Spreadsheet. Cushner testified that neXVel billed McFeeters $60 for the entire meeting, suggesting that McFeeters paid approximately $20 for neXVel's advice about converting hard-copy documents into digital format.

Cushner testified that McFeeters asked neXVel to sign the letter after their initial meeting. Cushner confirmed that no notary was present when he signed the letter, that he did not know how the letter came to be notarized, and that he had not seen the notarized letter until October 29, 2014, during his deposition. Cushner had not known that the Second Discovery Order required National to provide an affidavit from an IT consultant or that National would be using his letter for that purpose.

II. LEGAL ANALYSIS

"Candor and fair-dealing are, or should be, the hallmark of litigation and required attributes of those who resort to the judicial process. The rules of discovery demand no less." *E.I. DuPont de Nemours & Co. v. Fla. Evergreen Foliage,* 744 A.2d 457, 461 (Del.1999). "Discovery abuse has no place in [Delaware] courts, and the protection of litigants, the public, and the bar demands nothing less than that [Delaware] trial courts be diligent in promptly and effectively taking corrective action to 'secure the just, speedy and inexpensive determination of *every* proceeding' before them." *Holt v. Holt,* 472 A.2d 820, 824 (Del.1984) (quoting Rule 1; emphasis in original).

> Trial courts should be diligent in the imposition of sanctions upon a party who refuses to comply with discovery orders, not just to penalize those whose conduct warrants such sanctions, but to deter those who may be tempted to abuse the legal system by their irresponsible conduct.

Hoag v. Amex Assurance Co., 953 A.2d 713, 717 (Del.2008) (internal quotation marks omitted).

"In the event this Court determines that sanctions for discovery abuses are appropriate, the sanction must be tailored to the culpability of the wrongdoer and the harm suffered by the complaining party." *Cartanza v. Cartanza,* 2013 WL 1615767, at *2 (Del. Ch. Apr. 16, 2013), *reargument denied,*2013 WL 3376964 (Del. Ch. July 8, 2013). A trial court "has the power to issue sanctions for discovery abuses under its inherent equitable powers, as well as the Court's inherent power to manage its own affairs." *Beard Research, Inc. v. Kates,* 981 A.2d 1175, 1189 (Del. Ch.2009) (internal quotation marks omitted); *see Hoag,* 953 A.2d at 716–17 (noting court's authority to impose sanctions for discovery abuse under Rule 37 or pursuant to its "inherent authority").

Rule 37(b)(2) identifies potential sanctions that a trial court can impose for violating a discovery order, including but not limited to:

> (A) An order that the matters regarding which the order was made or any other designated facts shall be taken to be established for the purposes of the action in accordance with the claim of the party obtaining the order;
>
> (B) An order refusing to allow the disobedient party to support or oppose designated claims or defenses, or prohibiting that party from introducing designated matters in evidence; [or]
>
> (C) An order striking out pleadings or parts thereof, or staying further proceedings until the order is obeyed, or dismissing the action or proceeding or any part thereof, or rendering a judgment by default against the disobedient party[.]

***9** Ch. Ct. R. 37(b)(2).

Delaware Supreme Court decisions teach that the entry of a default judgment under Rule 37(b)(2)(C) is "*the ultimate sanction* for discovery violations and *should be used sparingly*." *Lehman Capital v. Lofland,* 906 A.2d 122, 131 (Del.2006) (emphasis in original) (internal quotation marks omitted). "[A] default judgment should be granted if no other sanction would be more appropriate under the circumstances." *Hoag,* 953 A.2d at 717. "Judgment by default

is, of course, the extreme remedy and generally speaking the Rule has been interpreted to require some element of willfulness or conscious disregard of the order before such a sanction is imposed." *Sundor Elec., Inc. v. E.J.T. Constr. Co.,* 337 A.2d 651, 652 (Del.1975) (internal quotation marks omitted).

A less final but still serious discovery sanction is the entry of an order under Rule 37(b)(2)(A) that deems designated facts to be established or which draws an inference as to a particular issue that is adverse to the party that failed to comply with its discovery obligations. Delaware decisions have granted adverse inferences in cases involving the spoliation of documents, where the evidence indicates that the party acted with a culpable metal state. *See Sears, Roebuck & Co. v. Midcap,* 893 A.2d 542, 548 (Del.2006); *see alsoCollins v. Throckmorton*, 425 A.2d 146, 150 (Del.1980) (noting adverse inference would be appropriate for spoliation).

A more moderate but still significant discovery sanction is to alter the burden of proof on a particular issue, either by shifting it to the party that failed to comply with its discovery obligations or by increasing or decreasing the relevant standard. *See TR Investors, LLC v. Genger,* 2009 WL 4696062, at *2 (Del. Ch. Dec. 9, 2009) (Strine, V.C.). In *Genger,* the defendant authorized a computer consultant to erase computer files in direct violation of a status quo order. Despite concluding that the defendant intentionally spoliated evidence in violation of a court order, Chief Justice Strine, writing as a Vice Chancellor, declined to impose "the extreme remedy of a default judgment." *Id.* at *19. Choosing instead to "deprive [the defendant] of the advantages of any evidentiary gaps that his own misbehavior might have been caused," the Chief Justice elevated the defendant's burden of proof by one level, increasing it from a preponderance of the evidence to clear and convincing evidence. *Id.* In addition, because the defendant's conduct created serious doubts as to his credibility, the Chief Justice held that the defendant would not be able to establish any material facts by relying solely on his own testimony; he only would be able to establish material facts if he could point to other, additional evidence to corroborate his account. *Id.*

Rule 37(b)(2) further provides that if a defendant has violated a discovery order, the court "*shall* require the party failing to obey the order or the attorney advising that party or both to pay the reasonable expenses, including attorney's fees, caused by the failure." Ch. Ct. R. 37(b)(2) (emphasis added). Under this rule, expenses should be awarded "unless the Court finds that the failure was substantially justified or that other circumstances made an award of expenses unjust." *Id.* The Delaware Supreme Court has explained that under Rule 37, "when a party fails to comply with discovery orders of the Court or otherwise engages in discovery abuses, the award of attorneys' fees and expenses to the opposing party is mandatory, absent a showing by the wrongdoer that his actions were substantially justified or that other circumstances make the award unjust." *Bader v. Fisher,* 504 A.2d 1091, 1096 (Del.1986); *accord Holt,* 472 A.2d at 823.

***10** The presumptive nature of the award under the current version of Rule 37(b)(2) represented a change from prior practice. In 1970, the federal rules were revised to introduce this approach "in order to encourage such sanction under such circumstances and to that end the Rule places a burden on the disobedient party to show that his failure was justified or that the other circumstances exist making an award unjust." *Wileman v. Signal Fin. Corp.,* 385 A.2d 689, 690–91 (Del.1978) (citation omitted).

> A major purpose of the 1970 revision of the discovery rules was to encourage extrajudicial discovery with a minimum of court intervention. One means of accomplishing that was to tighten the judicial sanctions with respect to unjustified insistence upon or objection to discovery. This led the draftsmen to place new emphasis on the availability and compulsory nature of an award of expenses. The potential availability of the award of expenses and fees was therefore broadened.

8B Charles Alan Wright, Arthur R. Miller & Richard L. Marcus, FEDERAL PRACTICE & PROCEDURE § 2288 (3d ed.2010) (citations omitted). The revision represented "an attempt to induce courts to make the award more frequently." *Id.* § 2281 (citations omitted). Rule 37(b)(2) was amended in 1970 to follow the federal model. *See Wileman,* 385 A.2d at 690. As with its federal counterpart, Rule 37 was revised "to encourage such sanctions where appropriate." *Bader,* 504 A.2d at 1096.

A. The Discovery Violations

National violated the First Discovery Order and the Second Discovery Order. Its discovery misconduct has been serious. National not only failed to produce required information; it

also provided a series of evolving explanations about why the information was not produced accurately. It is impossible to reconcile National's various explanations.

The First Discovery Order required that National provide information for the loans it made between September 20, 2010, and September 30, 2013, including the APRs, the finance charges, the schedule for payments, and the total payments made by the borrower. National failed to comply with the First Discovery Order when it produced the Initial Spreadsheet. The Initial Spreadsheet omitted information from the columns labeled “Schedule of Payments,” “Total Amount of Payments,” and “Finance Charges,” and the APRs were not accurate.

The Second Discovery Order required that National produce accurate Loan History Information in the form of the Updated Spreadsheet. In light of McFeeters' self-described technological limitations, the Second Discovery Order required that National retain a qualified IT consultant to assist with extracting the data and creating the Updated Spreadsheet. The Second Discovery Order ordered the IT consultant to provide an affidavit attesting to the procedures it followed. National violated the Second Discovery Order in three ways. The Updated Spreadsheet did not contain all of the required information. It lacked accurate APRs. And National failed to retain a qualified IT consultant and provide the required affidavit.

National is responsible for its discovery violations. When responding to the First Discovery Order, McFeeters knew the specific information that he was obligated to produce. Despite being able to export this information from the Infinity software system, he chose not to select all of the required fields. The Initial Spreadsheet did not provide the finance charges, schedule of payments, or total amount of payments. The Initial Spreadsheet provided APRs, but did not include the information necessary for James to verify the calculations. For those APRs where James had the underlying loan documents, the figures did not match.

***11** When responding to the Second Discovery Order, McFeeters again knew the specific information that he was obligated to produce, and he knew he was required to retain an IT consultant to assist him and provide an affidavit describing the procedures that were followed. He did not retain an IT consultant, did not produce the information, and did not provide the affidavit.

National's discovery violations were not isolated events, but rather part of a pattern. This case began with National and its counsel filing an unfounded motion to compel arbitration, despite knowing that James had opted out of the arbitration agreement. That motion resulted in James moving for Rule 11 sanctions, which this court granted. National next sought a protective order against virtually all discovery, and although the court granted the protective order in part, the First Discovery Order required National to produce a range of materials, including the Loan History Information. National failed to comply with the First Discovery Order, leading to the Second Discovery Order. National failed to comply with the Second Discovery Order, leading to the motion for sanctions.

National's discovery violations appear to have been willful. In addition to the recurring nature of the violations, National has changed position repeatedly and offered inconsistent explanations. National originally asserted that the errors in the APRs on the Initial Spreadsheet were due to mistakes by McFeeters, and National's counsel agreed to produce a corrected version. He reneged. After James filed the second motion to compel, National changed position and claimed that its software package caused the mistakes in the APRs. McFeeters testified to that effect, and National's interrogatory responses espoused that version of events. Then, when the Second Discovery Order specifically called for National to produce the APRs and show how they were calculated, National claimed that its software did not maintain the APRs.

The events surrounding the neXVel letter further evidenced the casual relationship that National and its counsel seem to have with the truth. When National's counsel originally provided the Updated Spreadsheet, his email did not suggest in any way that neXVel had not been able to assist with the data or in its preparation. He referred to neXVel as “the IT company employed by defendant to assist in the revision of the Excel spreadsheet.”

In a separate email, National's counsel sent the letter from neXVel. The contents of the letter told a different story. The letter was not an affidavit, and it did not identify any procedures followed by neXVel. It sounded like a quote for work. When James' counsel pressed for an affidavit, National's counsel sent a notarized version of the letter. It later turned out that the letter had not been signed in the presence of the notary, and neXVel's Rule 30(b)(6) witness did not know how the letter came to be notarized.

The failure to meet the requirements for a valid notarization is a serious issue. "[T]he requirement that the person whose signature is to be notarized personally appear[ ] before the notary is both clear and readily accessible to anyone who undertakes any sort of effort to find out." *Bessenyei v. Vermillion, Inc.,* 2012 WL 5830214, at *8 (Del. Ch. Nov. 16, 2012)*aff'd,*67 A.3d 1022 (Del.2013); *accord Basic Notarial Duties,*AMERICAN SOCIETY OF NOTARIES, http://www.asnnotary.org/?form=basicduties (recognizing that "the 'golden rule' of every notarial act, whether it is paper-based or electronic, is the physical presence of the signer before the notary."). Pennsylvania currently follows the Notary Public Law and Uniform Acknowledgment Act,[3] which requires a notary to "know through personal knowledge or have satisfactory evidence that the person appearing before the notary is the person described in and who is executing the instrument." 57 Pa.C.S. § 158.1. "Under Pennsylvania law, [the signer's] failure to appear before [the notary] at the time the notarizations took place renders the notarizations invalid."[4]

***12** When James' counsel put National's counsel on the spot about neXVel's role, National's counsel claimed ignorance. He asserted for the first time that he tried to stay out of the process of preparing the Updated Spreadsheet because the Second Discovery Order required that the IT consultant be "independent." But the order did not impose that requirement. Then, during the hearing on the motion for sanctions, National's counsel offered a different explanation: "I have to confess to this Court, I am not computer literate. I have not found presence in the cybernetic revolution. I need a secretary to help me turn on the computer. This was out of my bailiwick."

Professed technological incompetence is not an excuse for discovery misconduct. Effective March 1, 2013, the Delaware Supreme Court amended Comment 8 to Rule 1.1 of the Delaware Lawyers' Rules of Professional Conduct, which addresses competence, to include maintaining technological competence. The new comment states that "a lawyer should keep abreast of changes in the law and its practice, *including the benefits and risks* associated with relevant technology...."[5] This language finds parallels in the Pennsylvania Rules of Professional Conduct, where National's counsel is admitted to practice, and the Model Rules of Professional Conduct. Compare id. with Pa. Rules of Prof'l Conduct R. 1.1 cmt. 8 and Model Rules of Prof'l Conduct R. 1.1 cmt. 8. "[D]eliberate ignorance of technology is inexcusable.... [I]f a lawyer cannot master the technology suitable for that lawyer's practice, the lawyer should either hire tech-savvy lawyers tasked with responsibility to keep current, or hire an outside technology consultant who understands the practice of law and associated ethical constraints." Judith L. Maute, *Facing 21st Century Realities,* 32 Miss. C.L.Rev. 345, 369 (2013). Legal publications in Delaware and Pennsylvania have discussed the amendments to Rule 1.1 in similar terms.[6]

In light of this record, the court is forced to conclude that National and its counsel willfully disregarded their discovery obligations and sought to mislead James and her counsel. Sadly, National's Delaware counsel bears some responsibility for the current situation. Even when forwarding counsel has been admitted *pro hac vice* and is taking a lead role in the case, the Court of Chancery does not recognize the role of purely "local counsel." *State Line Ventures, LLC v. RBS Citizens,* 2009 WL 4723372, at *1 (Del. Ch. Dec. 2, 2009). "The admission of an attorney *pro hac vice* shall not relieve the moving attorney from responsibility to comply with any Rule or order of the Court." Del. Ch. Ct. R. 170. "Our rules make clear that the Delaware lawyer who appears in an action always remains responsible to the Court for the case and its presentation." *State Line Ventures,* 2009 WL 4723372, at *1; *accord Hsu v. Great Seneca Fin. Corp.,* 2010 WL 2635771, at *4 (Del.Super. June 29, 2010), *aff'd,*9 A.3d 476 (Del.2010). "As officers of this Court, [ ] Delaware lawyers are ultimately responsible for the documents they file with the Court and serve on the [opposing party]." *Bessenyei,* 2012 WL 5830214, at *7. As such, "Delaware counsel are expected to police the behavior of their out-of-state colleagues and ensure that out-of-state counsel understand the standards expected by Delaware courts." Brian Cheffins, *et al.,Delaware Corporate Litigation and the Fragmentation of the Plaintiffs' Bar,* 2012 Colum. Bus. L.Rev. 427, 463 (2012).

***13** This expectation is particularly important during discovery. The court expects Delaware counsel to play an active role in the discovery process, including in the collection, review and production of documents. If Delaware counsel does not directly participate in the collection, review and production of documents, then at a minimum Delaware counsel should discuss with co-counsel the court's expectations.

In this case, Delaware counsel does not appear to have participated in the discovery violations. Rather, Delaware counsel failed to stay meaningfully involved in the case. There have been a series of indications that caused the

court to suspect that Delaware counsel saw itself as a mail drop, and on at least two occasions, the court cautioned Delaware counsel off the record about the need to play a more substantive role. Delaware counsel does not appear to have heeded those warnings. Had Delaware counsel been more involved, the current regrettable situation might have been avoided.

B. The Appropriate Sanction

National's discovery misconduct calls for serious measures. Although I believe that entry of a default judgment would be warranted on these facts, I will not grant that remedy in light of the Delaware Supreme Court's guidance about invoking the ultimate sanction and the availability of less punitive consequences.

As Chief Justice Strine noted while crafting the sanction in *Genger,* a lesser sanction should "deprive [the defendant] of the advantages of any evidentiary gaps that his own misbehavior might have been caused." 2009 WL 4696062, at *19. Here, as in *Genger,* National's conduct deprived James of the benefit of accurate Loan History Information. At this point, the court lacks confidence that McFeeters and his counsel can or will provide accurate information. To address this failure, an appropriate sanction is an "order that the matters regarding which the order was made or any other designated facts shall be taken to be established for the purposes of the action in accordance with the claim of the party obtaining the order." Ch. Ct. R. 37(b)(2)(A). For purposes of trial, therefore, it is deemed established that the APRs for the loans disclosed on the Updated Spreadsheet fell outside the acceptable range set forth in the TILA.

The deemed admission is not case dispositive. National's counsel has expounded on National's multiple defenses and arguments, including the prospective testimony of an expert who will explain that APRs are inherently unreliable. James still must carry her burden of persuasion, and National still can rely on its other defenses. What National cannot do any longer is contend that the APRs were accurate.

C. Fees And Expenses

Rule 37 contemplates a presumptive award of expenses, including attorneys' fees, "unless the Court finds that the failure was substantially justified or that other circumstances made an award of expenses unjust." Ch. Ct. R. 37(b)(2). James seeks her expenses for (i) preparing for and responding to National's motion for protective order, (ii) reviewing the Initial Spreadsheet and taking the first deposition of McFeeters, (iii) preparing for and arguing her motion to compel, (iv) reviewing the Updated Spreadsheet, (v) taking the second deposition of McFeeters, and (vi) preparing for and arguing the current motion for sanctions. Although not specifically mentioned, the Rule 30(b)(6) deposition of neXVel falls within the scope of her request.

***14** National's failure to comply with the Second Discovery Order was not substantially justified. National did not follow the procedures set forth in the Second Discovery Order and did not produce the information that the Second Discovery Order required. National tried to mislead James into believing that it had attempted in good faith to extract data from its computer system with neXVel's assistance. Only after James pressed the issue did National and its counsel backpedal. The excuses offered by National's counsel conflicted with positions National had taken earlier and with his professional obligations.

Although James is entitled to her expenses, she has sought too expansive an award. Rule 37(b)(2) contemplates an award of the "reasonable expenses, including attorney's fees, caused by the failure" to obey a discovery order. The court did not shift fees or expenses in connection with National's motion for protective order or the motion to compel, and those rulings will not be revisited. James is entitled to the fees and expenses she incurred after the entry of the Second Discovery Order, including in connection with the review of the Updated Spreadsheet, the motion for sanctions, the second deposition of McFeeters, and the Rule 30(b)(6) deposition of neXVel. Each of those categories of expenses was caused by National's failure to comply with the Second Discovery Order.

Rule 37(b)(2) authorizes the court to require that the expenses be paid by "the party failing to obey the order or the attorney advising that party or both." Given the roles played by both McFeeters and National's counsel, the answer here is both.

James shall file a Rule 88 affidavit identifying her expenses and providing supporting documentation. James also shall submit a proposed form of order. If National disputes any of the expenses, then National shall file an opposition within two weeks. James shall have one week to reply.

III. CONCLUSION

The motion for sanctions is granted. It is deemed established for purposes of trial that the APRs for the loans disclosed on the Updated Spreadsheet were incorrect and fell outside the tolerances set forth in the TILA. James is awarded her expenses, including attorneys' fees, incurred due to National's failure to comply with this court's order.

Footnotes

1 James originally sued National and Loan Till Payday LLC, believing them to be separate entities. After discovery revealed that National does business under the name "Loan Till Payday LLC," the court instructed the parties to amend the caption to reflect this reality. Counsel agreed to do so, but they have not been able to accomplish this simple task.

2 Unless otherwise specified, references to National's counsel denote National's forwarding counsel. Although National's Delaware counsel has played a minimal, base-tending role that is inconsistent with the Court of Chancery's expectations, National's Delaware counsel does not appear to have participated actively in sanctionable discovery misconduct.

3 In October 2013, the Pennsylvania General Assembly adopted the Revised Uniform Law on Notarial Acts ("RULONA"), which will take effect after the Pennsylvania Department of State has approved basic and continuing notary education courses. *See* New Pennsylvania Notary Public Law (Dec. 5, 2013) (noting that "Pennsylvania notary public practice and procedure will most likely not take effect until 2015."), *available at* http://www.portal.state.pa.us/portal/http;//www.portal.state.pa.us; 80/portal/http;/www.portal.state.pa.us;80/portal/server.pt/gateway/PTARGS_ 0_244608_1372259_0_0_18/Preliminary#ebsitep0#posting0#for0#when0#RULONAp#. Like the current Pennsylvania notary statute, RULONA requires the signer's personal presence before a notary. *Compare*57 Pa.C.S. § 158.1 ("The officer notarizing the instrument shall know through personal knowledge or have satisfactory evidence that the person appearing before the notary is the person described in and who is executing the instrument.") *with* 57 Pa.C.S. Ann. § 306 ("If a notarial act relates to a statement made in or a signature executed on a record, the individual making the statement or executing the signature shall appear personally before the notarial officer.").

4 *Bessenyei,* 2012 WL 5830214, at *4; *accord In re Petition of Valenty,* 43 A.3d 464, 466 (Pa.2012) (explaining that "an affiant must actually appear in person before the notary to swear and subscribe to the facts in the affidavit, if the affidavit is to be valid"); *In re Bokey's Estate,* 194 A.2d 194, 198 (Pa.1963) ("The essence of the notarial certificate is that the document has been executed, and that the notary knows that he is confronted by the signer, and that the signer is asserting the fact of his execution"); *Leyda v. Norelli,* 564 A.2d 244, 246 (Pa.Super.Ct.1989) ("[N]otarization certifies the fact of execution by a person who purports to be the signer").

5 Del. Lawyers' Rules of Prof'l Conduct R. 1.1 cmt. 8 (emphasis added). The citation to Rule 1.1 is not meant to suggest that this court has made any determination regarding a potential ethical violation. That question is reserved for the appropriate supervisory authorities. *See Crumplar v. Superior Court ex rel. New Castle Cnty.,* 56 A.3d 1000, 1009 (Del.2012) ("Absent conduct that prejudicially disrupts the proceeding, trial judges have no independent jurisdiction to enforce the Rules of Professional Conduct."); *In re Infotechnology, Inc.,* 582 A.2d 215, 216–17 (Del.1990) (explaining that absent conduct prejudicial to the proceeding, enforcement of Rules of Professional Conduct must be left to authorities who oversee the bar). This decision has cited Comment 8 only to illustrate the inadequacy of the most recent explanation for non-compliance provided by National's counsel.

6 *See* Steven L. Butler, *Securing Your Mobile Device,* Del. Law., Fall 2014, at 20, 21; Bruce E. Jameson, *Technology Competence for Lawyers: Not an Oxymoron,* Del. Law., Fall 2014, at 16; Kelly Phillips Erb, *You Can't Hide from Technology,* Pa. Law., May/June 2014 56, 56.

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UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

Mechel Bluestone, Inc., and Mechel Mining Oao, Plaintiffs and Counterclaim Defendants,
v.
James C. Justice Companies, Inc.; James C. Justice, II; James C. Justice, III; Jillean L. Justice; and James C. Justice II, as Trustee of the James C. Justice II Grat No. 1, and of the James C. Justice II Grat No. 2, Defendants and Counterclaimants.

C.A. No. 9218–VCL | Submitted: December 8, 2014 | Decided: December 12, 2014

Attorneys and Law Firms

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Raymond J. DiCamillo, Susan M. Hannigan, Rachel E. Horn, Richards, Layton & Finger, P.A., Wilmington, Delaware; David B. Tulchin, William H. Wagener, Sullivan & Cromwell LLP, New York, New York; Attorneys for Defendants.

MEMORANDUM OPINION

LASTER, Vice Chancellor.

***1** The defendants have moved to compel the production of documents identified on the plaintiffs' privilege log. The defendants contend that the plaintiffs' initial log was so flawed, and the plaintiffs' four subsequent efforts to provide an adequate log so feckless, that the appropriate remedy is to deem the privilege waived as to all documents listed on the log. This decision deems the privilege waived as to the items where the plaintiffs fell substantially short of the well-documented and easily identified requirements for supporting a claim of privilege.

I. FACTUAL BACKGROUND

The factual background is drawn from the pleadings and submissions made in connection with the current motion to compel. The discussion does not comprise findings of fact in the post-trial sense, but rather represents how the record appears at this preliminary stage.

A. The Merger

In 2009, plaintiffs Mechel Bluestone, Inc., and Mechel Mining OAO (jointly, "Mechel") acquired entities that owned certain coal properties and associated assets in West Virginia (the "Bluestone Properties") from defendants James C. Justice Companies, Inc., James C. Justice II, James C. Justice III, Jillean L. Justice, and James C. Justice II, as Trustee of the trusts James C. Justice II GRAT No. 1 and James C. Justice II GRAT No. 2 (collectively "Justice"). Mechel acquired the properties pursuant to an Agreement and Plan of Merger dated as of March 16, 2009 (the "Merger Agreement").

Before the acquisition, to assist in determining the purchase price, Weir International, Inc. ("Weir") prepared a report estimating the base volume of coal reserves on the Bluestone Properties. Justice believed that the report understated the amount of coal reserves and argued in favor of a greater volume. To resolve the disagreement, the parties provided in the Merger Agreement that if additional coal was discovered on the Bluestone Properties within two years (the "Contingent Reserves"), then Mechel would pay Justice additional amounts (the "Contingent Payment"). The Merger Agreement called for Weir to assess the volume of any Contingent Reserves in accordance with applicable professional standards and using the methods employed in its initial report.

By letter dated September 7, 2011, Weir identified approximately 60 million tons of Contingent Reserves on the Bluestone Properties (the "Weir Letter"). Under the Merger Agreement, this volume of Contingent Reserves would equate to a Continent Payment of approximately $165 million. Mechel disputed the determination made in the Weir Letter, contending that it failed to satisfy the relevant provisions in the Merger Agreement.

On January 2, 2014, Mechel filed this action. Count I of the complaint seeks a declaratory judgment that (i) Justice failed to satisfy its obligations under the Merger Agreement, (ii) the Weir Letter did not satisfy the Contingent Payment provisions under the Merger Agreement, and (iii) Mechel does not owe Justice any Contingent Payment. Count II asserts that Justice breached the Merger Agreement by not acting in accordance with the declarations demanded in Count I. Count III seeks a decree of specific performance compelling Justice to act in accordance with the declarations demanded in Count I. Count IV alleges that Justice committed fraud because it knew or should have known that Weir Letter provided false information about the Contingent Reserves.

***2** The parties agreed to a schedule that would bring the case to trial in May 2015. The schedule called for the parties to substantially complete their document production by August 15, 2014, to exchange privilege logs on September 12, and to take fact depositions between September 1 and December 5. Mechel advised Justice that it could not meet the August 15 deadline, and Justice agreed that Mechel could complete its production by September 12.

B. The Initial Privilege Log

On September 12, 2014, Mechel produced its initial privilege log. The 672–page document contained 6,125 entries. At the time, Mechel had produced 11,201 documents, meaning that it was withholding more than one-third of its responsive documents on grounds of privilege. Mechel did not serve a redaction log.

Mechel provided with its privilege log a list of ten organizations with thirty-nine people whom Mechel identified as attorneys or individuals otherwise involved in providing legal advice (the "Players List"). Despite the number of organizations, the Players List did not identify the clients that the organizations represented or the purposes for which they were engaged. The Players List did not distinguish attorneys from non-attorneys, except that it listed certain individuals under the names of organizations identifiable as law firms. The Players List did not identify all of the individuals on Mechel's initial privilege log, which contained approximately 830 unique names and e-mail addresses. The Players List did not even identify all of the law firms or lawyers that appeared on the log.

By letter dated September 18, 2014, Justice's counsel pointed out deficiencies in the log and asked Mechel's counsel to address them. On September 23, having not received any response, Justice moved to compel.

C. The Amended Privilege Log

After receiving the motion to compel, Mechel responded indignantly, protesting that the motion was "both premature and, at best, specious." Undercutting the sincerity of Mechel's indignation was a concession that the initial privilege log and Players List were inadequate. Mechel's counsel undertook to fix the deficiencies.

On September 26, 2014, Mechel provided Justice with an amended privilege log, an amended Players List, and a redaction log. Mechel also produced an additional 6,739 documents for a total of 32,008 pages. Because Mechel should have completed its production by September 12, the production should have consisted of entries previously identified on Mechel's privilege log. But the number of documents produced exceeded the number of documents on the initial log. Something was amiss. Yet Mechel's amended log did not cross-reference any of the produced documents by Bates number, so it was impossible to tell which documents came from where.

After reviewing Mechel's revised logs and document production, Justice concluded that there were still serious problems. By letter dated October 1, 2014, Justice identified a non-exclusive list of deficiencies, supporting each with examples:

- Mechel's privilege log continued to contain entries that lacked information about the author and recipients or did not identify the attorney whose advice was reflected in the document.

- Mechel's privilege log continued to contain entries for documents shared with third parties who were not listed on the Players List and whose role in providing legal advice was not explained.

- Many entries on the privilege log identified e-mails with attachments where it did not appear that Mechel had produced the attachments or explained why the attachments were privileged.

***3** • Mechel's newly produced redaction log did not list the Bates number for entries produced in redacted form, making it impossible to tie Mechel's production of redacted documents to the entries on its redaction log.

- Mechel produced certain documents in "redacted" form where the documents were redacted in their entirety, except for their Bates numbers. As a practical matter, Mechel was still withholding these documents in their entirety, despite purportedly producing them in "redacted" form.

Justice asked Mechel to correct the deficiencies before Justice deposed several key witnesses during the week of October 6.

D. The Second And Third Amended Privilege Logs

On October 4, 2014, Mechel produced a second amended privilege log, a first amended redaction log, and a second amended Players List. From October 4–7, Mechel produced another 1,084 documents for a total of 25,006 additional pages. Justice received the vast majority of them on the night before the scheduled depositions. Many of the documents exhibited defects like those identified in Justice's October 1 letter.

Mechel also sought to claw back a document produced on September 26, 2014. Justice had marked the document as an exhibit during the deposition of Stanislav Ploschenko, Mechel Mining OAO's former CFO. Although Justice destroyed the document, Justice found no record of it on Mechel's original privilege log, the first amended privilege log, or the second amended privilege log. Justice asked Mechel to identify the entry that corresponded to the document. Instead, Mechel produced a third amended privilege log that added an entry for the document. Mechel did not fix any of the other deficiencies.

E. The Fourth Amended Privilege Log

On October 23, 2014, Justice's counsel filed a supplemental affidavit in support of its motion to compel (the "Wagener Affidavit" or "Wagener Supp."). Using the documents that Mechel had produced, Justice had checked the accuracy of the descriptions on its Mechel's log and evaluated whether Mechel appeared to be making valid claims of privilege. For many of the documents that Mechel had produced from the privilege log, the descriptions on the log were misleading or wrong. Many documents that Mechel produced after September 12 did not correspond to entries on the logs; they were simply produced late. Other entries where Justice had challenged Mechel's privilege claims had been re-characterized as "Non–Responsive."

On October 29, 2014, in response to the Wagener Affidavit, Mechel produced a fourth amended privilege log, a third amended redaction log, and a third amended Players List. The parties completed briefing on Justice's motion to compel, and the court held a hearing on December 8. During oral argument, Mechel's counsel conceded that the original privilege log contained errors but argued that the errors did not result from any bad faith. Justice sought a waiver of privilege as to all entries on Mechel's logs.

II. LEGAL ANALYSIS

Rule 26(b)(1) frames the scope of permissible discovery:

> Parties may obtain discovery regarding any matter, not privileged, which is relevant to the subject matter involved in the pending action, whether it relates to the claim or defense of the party seeking discovery or to the claim or defense of any other party, including the existence, description, nature, custody, condition and location of any documents, electronically stored information, or tangible things and the identity and location of persons having knowledge of any discoverable matter. It is not ground for objection that the information sought will be inadmissible at the trial if the information sought appears reasonably calculated to lead to the discovery of admissible evidence.

***4** Ct. Ch. R. 26(b)(1). "[P]retrial discovery rules are to be afforded broad and liberal treatment." *Levy v. Stern,* 687 A.2d 573 (Del.1996) (TABLE). "Discovery is called that for a reason. It is not called hide the ball." *Klig v. Deloitte LLP,* 2010 WL 3489735, at *7 (Del. Ch. Sept. 7, 2010).

The burden of establishing that otherwise discoverable information is privileged rests "on the party asserting the privilege." [1]

> [A] bare allegation that information and documents are protected from discovery by ... privilege is insufficient without making more information

> available.... It is incumbent on one asserting the privilege to make a proper showing that each of the criteria [underlying the privilege] exist[s].... A proper claim of privilege requires a specific designation and description of the documents within its scope as well as precise and certain reasons for preserving their confidentiality. [2]

A party must provide "sufficient *facts* as to bring the identified and described document within the narrow confines of the privilege." *Int'l Paper,* 63 F.R.D. at 94 (emphasis in original); *accord Reese,* 1985 WL 21127, at *5 ("The documents must be precisely enough described to bring them within the rule...."). To meet its burden to establish the requirements of privilege, a party typically prepares a privilege log. The log must identify

> (a) the date of the communication, (b) the parties to the communication (including their names and corporate positions), (c) the names of the attorneys who were parties to the communication, and (d) [a description of] the subject of the communication sufficient to show why the privilege applies, as well as [the issue to which] it pertains.... With regard to this last requirement, the privilege log must show sufficient facts as to bring the identified and described document within the narrow confines of the privilege.

Unisuper Ltd. v. News Corp., C.A. No. 1699–N, slip op. at 2 (Del. Ch. Mar. 9, 2006) (internal quotations and footnotes omitted). Experienced counsel know these requirements, and any junior associate could find a case reciting them with minimal effort. [3]

***5** When a log invokes the attorney-client privilege for items that have been shared with a third party, the party asserting the privilege must explain the role played by the third party that enables the privilege to be maintained. "In most instances, a party waives the attorney-client privilege by communicating privileged information to a third party." *In re Quest Software Inc. S'holders Litig.,* 2013 WL 3356034, at *4 (Del. Ch. July 3, 2013); *accord Ryan v. Gifford,* 2008 WL 43699, at *6 (Del. Ch. Jan. 2, 2008) ("Disclosure to outsiders has never failed to waive privilege under Delaware law."). Delaware Rule of Evidence 510(a) states that

> [a] person upon whom these rules confer a privilege against disclosure waives the privilege if he or his predecessor while holder of the privilege voluntarily discloses or consents to disclosure of any significant part of the privileged or protected matter. This rule does not apply if the disclosure itself is privileged.

D.R.E. 510(a).

Under Delaware Rule of Evidence 502(b), the privilege extends to

> confidential communications made for the purpose of facilitating the rendition of professional legal services to the client (1) between the client or the client's representative and the client's lawyer or the lawyer's representative, (2) between the lawyer and the lawyer's representative, (3) by the client or the client's representative or the client's lawyer or a representative of the lawyer to a lawyer or representative of a lawyer representing another in a matter of common interest, (4) between representatives of the client or between the client and a representative of the client, or (5) among lawyers and their representatives representing the same client.

D.R.E. 502(b). A communication is "confidential" for purposes of the privilege "if not intended to be disclosed to third persons other than those to whom disclosure is made in furtherance of the rendition of professional legal services to the client or those reasonably necessary for the transmission of the communication." D.R.E. 502(a)(2). To bring a communication shared with a third party within the ambit of the rule and sustain a claim of privilege, Mechel had to explain how the third party organization or individual was a qualified representative for purposes of Rule 502(b) or

otherwise within the scope of the definition of confidentiality in Rule 502(a)(2).

If a party fails to provide an adequate description for a document, then the privilege for that document may be deemed waived. [4]

> The importance of providing an adequately descriptive and timely privilege log cannot be overlooked. Although the Delaware courts have sometimes allowed a party the opportunity to supplement an insufficient privilege log, at least where that party appears to have endeavored in good faith to provide an adequate description of the privileged information in the first instance, the failure to properly claim a privilege or immunity or failure to raise a privilege or immunity in a timely manner can, in appropriate circumstances, result in a waiver of the privilege.

Wolfe & Pittenger, § 7.04, at 7–51 to –52 (citation omitted). This is because "[a]n improperly asserted claim of privilege is no claim of privilege at all." [5]

***6** Whether to deem the privilege waived or allow the party to provide a supplemental log is a matter for case-by-case adjudication. *Emerald P'rs v. Berlin,* 1994 WL 125047, at *2 ("Discovery is subject to the exercise of this Court's sound discretion.") (citing *Dann v. Chrysler Corp.,* 166 A.2d 431, 439 (Del. Ch.1960)). If a party falls substantially short of the well-established requirements, then waiver is an appropriate consequence that helps dissuade parties from engaging in dilatory tactics. *See Willemijn Houdstermaatschaapij,* 707 F.Supp. at 1443; *Klig,* 2010 WL 3489735, at *5.

A. The Deficiencies

Mechel produced its initial privilege log on September 12, 2014. "Mechel candidly admit[ted] that there were issues with its original privilege log." Opp. at 1. This *mea culpa* is an understatement. The initial privilege log was strikingly bad.

The most glaring deficiency was 590 entries that contained no information other than the document date, the privilege asserted, and a description of the grounds for asserting the privilege. The entries lacked information identifying the parties to the communication or the attorney involved. Without this information, Justice had "no way to assess the propriety of the assertion of privilege." *Klig,* 2010 WL 3489735, at *2. Anyone who glanced at the log would realize that the entries were deficient.

Another obvious problem was Mechel's failure to provide an adequate Players List that identified the individuals who appeared on the log and their roles. The Players List listed thirty-nine of the approximately 830 unique names and e-mail addresses that appeared on Mechel's privilege log. It did not distinguish attorneys from non-attorneys, except that it listed certain individuals under the names of organizations identifiable as law firms. There were ten different organizations on the initial Players List, but Mechel did not describe by whom they were retained or what they were doing. The Players List did not explain how any of the other third parties who appeared on the log were involved in the provision of legal advice or why communicating with those third parties did not waive the privilege.

Another red flag was the massive scope of the log relative to the number of non-privileged documents that Mechel had produced. The initial privilege log was 672 pages long and contained 6,125 entries. As of September 12, 2014, Mechel had produced 11,201 documents, meaning that it had designated over one-third of the responsive documents as privileged. The underlying transaction was a business deal. Yet Mechel was claiming that one-third of the documents and communications relating to the transaction were legal in nature. One wonders how Mechel could ever get anything done if its personnel spend one-third of their time obtaining legal advice. Compounding the problem of the initial privilege log's sheer size was its incomprehensible structure. The 6,125 entries were not organized in chronological order. They did not appear to have been arranged in any particular order at all.

Unwittingly, Mechel may have revealed the reasons for the size of its log and the glaring omissions of basic information from nearly 600 entries. Entry number 227 contained an editorial note that stated: "[T]he signature was cut-off from the email and so the author is unknown. *To be safe, I assumed this was from an attorney*." Wagener Supp. Ex. A (emphasis added). Mechel obviously did not intend to produce this telling comment, which confirms what one can infer about how Mechel approached its log. Mechel inverted the law of privilege. Rather than believing that Mechel needed to justify

its privilege assertions, Mechel assumed that any document an attorney might have touched would be privileged.

***7** As a first cut when asserting privilege, a party might well set aside any document where an attorney appears as an author or recipient, or which come from an attorney's file. But that is only the starting point for privilege analysis. Once those documents have been collected, lawyers must make judgments. In the first instance, more junior lawyers typically make initial calls about which documents might be subject to a claim of privilege. Counsel disclosed that Mechel outsourced that task to contract attorneys provided by PriceWaterhouseCoopers LLC and Huron Consulting Group.

Understandably, lawyers are concerned about making a mistake and producing a privileged document, which often leads to overdesignation. Because of this risk, and because disputes about privilege are common, the senior lawyers in the case, especially the senior Delaware lawyers, must provide guidance about how the privilege assertion process should unfold. As important, senior lawyers, including senior Delaware lawyers, must ensure that the guidance provided was followed. Preparing a privilege log with integrity requires the involvement and oversight of senior lawyers who know the applicable standards, understand the roles of the individuals involved in the communications, and can make textured judgment calls on a principled basis.

The involvement of senior practitioners appears to have been entirely lacking in this case. Mechel's lead counsel was candid about his lack of involvement. He was away when the log was produced and did not look at it until after the disputes arose. There is no indication that Delaware counsel had any involvement in the preparation of the log. Mechel seems to have forwarded to Justice as its initial log whatever PriceWaterhouseCoopers and Huron gave Mechel.

Once Justice raised the obvious and extensive problems with Mechel's privilege log, Mechel had an opportunity to make things right. Despite its initial combative response, which asserted that Justice's motion to compel was “both premature and, at best, specious,” Mechel's counsel conceded that there were problems with the log and seemed willing to cooperate. But the reality of Mechel's response fell well short and actually made things worse.

Unfortunately, Mechel's amended privilege log, amended Players List, redaction log, and attendant document production did more to obfuscate than clarify. Mechel did not explain whether the documents it was producing were from the log, nor did it cross reference them to the log. Justice properly expected that, because Mechel should have completed its document production by that point, the newly produced documents would have been entries previously identified on Mechel's log. But the volume of the documents was so large that Mechel had to be co-mingling late production with entries from its log, which turned out to be the case. Mechel's new redaction log did not provide any Bates numbers for documents produced in redacted form, so it was impossible to tie the redacted documents definitively to its redaction log. Some of the documents that Mechel claimed to be producing in redacted form were actually redacted in their entirety, with only the Bates numbers showing. The “redaction” of these documents was a farce; Mechel could just as well have continued to withhold them.

Nor did Mechel fix all of the problems with its initial privilege log. Mechel's privilege log continued to contain entries that lacked information about the author and recipients or did not identify the attorney's advice that was reflected in the document. The amended log continued to contain entries for documents shared with third parties who were not listed on the Players List and whose role in providing legal advice was not explained. And many entries on the amended log were e-mails with attachments where it did not appear that Mechel had produced the attachments or explained why the attachments were privileged.

***8** When providing its second, third, and fourth amended logs, Mechel seemed to believe that its only obligation was to address the specific items that Justice raised. In essence, Mechel's counsel tried to outsource their obligation to produce an adequate log to Justice's counsel. The specific deficiencies that Justice identified illustrated broader and systemic problems which Mechel's counsel should have addressed. Justice had no way of knowing how widespread the problems were; Justice could only cite the examples it found. Given that Mechel initially produced a facially inadequate log and subsequently provided deficient amended logs, it was reasonable for Justice to believe that the problems were endemic. That is the inference the court draws.

B. The Remedy

Mechel's approach to asserting privilege fell well short of what Rule 26 and this court's precedents require. Justice urges the court to impose the type of sanction imposed in *Klig* and order Mechel to produce all of the documents listed on its log. In *Klig,* the defendants produced a privilege log where

97% of the entries employed one of five rote descriptions and "afforded [the plaintiff] no way to assess the propriety of the assertion of privilege." 2010 WL 3489735, at *2. After the plaintiff pointed out the deficiencies, the defendants refused to correct them. *Id.* at *3. The court held that the log had been prepared in bad faith and deemed the privilege waived. *Id.* at *3–4.

Mechel's conduct could support the type of order entered in *Klig*. At the same time, unlike defense counsel in *Klig,* Mechel's counsel did acknowledge that its initial log was deficient and made some efforts to correct the situation. Because the initial log was so strikingly bad, the court could hold that the offer to do what Mechel's counsel should have done in the first place came too late, particularly when the subsequent remedial measures were so flawed. Nevertheless, because Mechel's counsel made some effort, this court will not impose the blanket waiver ordered in *Klig*. But Mechel's approach to privilege does have consequences.

1. The 590 Unidentified Entries

Privilege is deemed waived as to the 590 entries on the initial privilege log for which Mechel provided almost no pertinent information. "It takes conscious effort to render a log so devoid of content." *Klig,* 2010 WL 3489735, at *5. These entries were obviously deficient, yet Mechel waited for Justice to discover and raise the lack of critical information.

2. Documents Re–Designated As Non–Responsive

Since providing its initial log, Mechel has re-designated certain documents as non-responsive. Those documents will be produced. By listing the documents initially on the log, Mechel's counsel represented that they were responsive. The re-designation of the documents as non-responsive is too convenient.

Under different circumstances, it may be appropriate to permit re-designation, as this court recently did in another case. *See AM Gen. Hldgs LLC v. Renco Grp., Inc.,* 2013 WL 1668627, at *3 (Del. Ch. Apr. 18, 2013). Notably, the litigant challenging the re-designation in *AM General* "offered no basis to suspect that [the party who re-designated the documents] is not acting with integrity in this regard." *Id.* Here, Justice has marshaled ample facts that call into question Mechel's good faith efforts to prepare its privilege logs and assert privilege claims with integrity.

3. Documents Produced With Everything Redacted

A party that redacts the entirety of a document, except for their Bates numbers, is not using the redaction tool in good faith. Redaction enables a party to produce a document that partially contains privileged matter. Redactions must be targeted to address only the privileged matter so that the non-privileged portion is produced. Mechel did not assert privilege in good faith when it claimed to produce documents in redacted form, but redacted the entire documents. Those documents will be produced.

4. The Operative Logs And Players List

***9** For the remaining entries, Mechel's privilege claims must rise or fall based on the information provided on the first amended privilege log, the first amended Players List, and the initial redaction log that Mechel served on September 26, 2014. This decision will refer to these documents, respectively, as the "Operative Privilege Log," the "Operative Redaction Log," and the "Operative Players List."

Mechel served additional supplemental logs after September 26, 2014, but allowing serial supplementation only "reinforces problematic incentives that already pervade the preparation of privilege logs." *Klig,* 2010 WL 3489735, at *6. Because of the obfuscatory manner in which Mechel provided its amended log and related production, the court could limit Mechel to its initial log. Permitting Mechel to rely on its amended log, Players List, and initial redaction log errs in favor of Mechel and the maintaining of privilege.

Based on the Operative Privilege Log, the Operative Redaction Log, and the Operative Players List, this decision can adjudicate the validity of the privilege claims for certain categories of entries. Adjudicating other issues will require the appointment of a special discovery master.

a. Entries Not On The Operative Logs

If an entry appears on a later log but not on the Operative Privilege Log or the Operative Redaction Log (jointly, the "Operative Logs"), then Mechel failed to assert a valid and timely claim of privilege for that document. Privilege is waived, and the document will be produced.

b. Documents Lacking An Individual From The Players List

If an entry on the Operative Logs fails to identify or reference an individual or organization from the Operative Players List, then Mechel failed to show how the entry involved a communication made for the purpose of facilitating the rendition of professional legal services to the client. Mechel failed to assert a valid and timely claim of privilege for that document. Privilege is waived, and the document will be produced.

c. Documents Shared With Third Parties

If an entry on the Operative Logs discloses that the document was shared with a third party, then Mechel had the burden of explaining the role played by the third parties in order to maintain the privilege. Mechel was obligated to provide "precise and certain reasons for preserving" the privilege as to these documents. *Int'l Paper,* 63 F.R.D at 94. If the role of the third party was not explained on or before September 26, 2014, the date when Mechel provided the Operative Logs, then Mechel failed to assert a valid and timely claim of privilege. Privilege is waived, and the document will be produced.

d. Work Product

There are entries on the Operative Logs for which Mechel has claimed work product protection. Court of Chancery Rule 26(b)(3) states that

> ***10** a party may obtain discovery of documents, electronically stored information, and tangible things otherwise discoverable under paragraph (b)(1) of this rule and *prepared in anticipation of litigation* or for trial by or for another party or by or for that other party's representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent) only upon a showing that the party seeking discovery has substantial need of the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means.

Del. Ch. Ct. R. 26(b)(3) (emphasis added). "The work product doctrine is intended to protect 'materials an attorney assembled and brought into being in anticipation of litigation.' " *Grimes v. DSC Commc'ns Corp.,* 724 A.2d 561, 569–70 (Del. Ch.1998) (quoting *Lee v. Engle,* 1995 WL 761222, at *4 (Del. Ch. Dec. 15, 1995)). As with the attorney-client privilege, "[t]he party asserting a claim of work product immunity has the burden of proof to establish that the protection applies for a specific document." Wolfe & Pittenger, § 7.01 at 7–2; *accord Wolhar v. Gen. Motors Corp.,* 712 A.2d 457, 459 (Del.Super.1997) (noting that the "initial burden of proving the existence of the work product privilege" lies with the asserting party).

During oral argument, the court asked Mechel's counsel when Mechel began anticipating litigation. Mechel's counsel represented that September 7, 2011, the date of the Weir Letter, was when Mechel began anticipating litigation. This date makes sense because Mechel's challenges to the Weir Letter form the basis for this case.

Because Mechel began anticipating litigation on September 7, 2011, Mechel cannot claim work product protection for documents prepared before that date. Any assertions of work product protection for earlier documents are overruled. If work product protection was the only basis for withholding any document dated before September 7, 2011, then those documents will be produced.

5. The Special Discovery Master

Justice has raised other credible challenges to Mechel's privilege assertions, including challenges about the accuracy of the descriptions on the Operative Logs, whether particular entries on the logs contain business advice as opposed to legal advice, and whether certain organizations were retained to provide legal advice. The well-supported inference of over-designation and Justice's illustrative examples of erroneous entries warrant the appointment of a special discovery master to adjudicate these challenges. Retired Superior Court Judge Charles H. Toliver, IV, has agreed to serve as special discovery master for this case (the "Special Discovery Master").

Within one week after the date of this decision, Mechel shall produce the documents called for by this decision.

Mechel shall serve contemporaneously on Justice a combined privilege log and redaction log (the "Corrected Log") that (i) lists all entries in chronological order, (ii) identifies entries that have been produced in redacted form with the word "REDACTED," and the Bates number of the produced document, and the date of production, (iii) identifies each entry produced with the word "PRODUCED," the Bates number of the produced document, and the date of production, and (iv) highlights the names of individuals on the Corrected Log who are attorneys identified on the Operative Players List in one color and those who are non-attorneys identified on the Operative Players List in a different color.

If Justice wishes to pursue further challenges to the Operative Privilege Log, then, within two weeks after the date of this decision, Justice shall submit an opening brief making those challenges to the Special Discovery Master. Justice may identify up to 10% of the entries on the Corrected Log for review by the Special Discovery Master, who shall examine the underlying documents *in camera* and determine whether the descriptions on the privilege log were accurate and whether privilege was properly asserted. If the description was not accurate, or if privilege was not otherwise properly asserted, then the document shall be produced. If the document contains business advice, then the document will be produced. If the document contains a mix of business and legal advice, and the legal advice can be redacted, then the document will be produced in redacted form. Justice may seek leave from the Special Discovery Master to challenge additional entries on the log beyond the 10%. The Special Discovery Master may, in his discretion, review as many of the entries beyond 10% as he deems appropriate.

***11** Justice may present to the Special Discovery Master any argument that a particular advisor, such as International Mining Consultants, was not engaged to assist in providing legal advice or in creating work product, or only was doing so after a certain point in time. Justice make seek leave from the Special Discovery Master to present other issues or arguments.

The Special Discovery Master will determine the briefing schedule for further submissions from the parties and for any hearing. The Special Discovery Master may provide instructions to the parties regarding the content of their submissions and the nature and scope of the hearing. Ideally, the Special Discovery Master will be able to provide his report and recommendation to the court on or before February 27, 2015. The Special Discovery Master may receive assistance from attorneys at his law firm, Morris James LLP. The Special Discovery Master and attorneys at his firm will be compensated at their customary hourly rates.

Mechel shall bear the expenses of the Special Discovery Master. Pursuant to Rule 37, Mechel shall bear the reasonable expenses, including attorneys' fees, that Justice incurred in connection with its review of Mechel's privilege logs, the efforts to meet and confer with Mechel, the motion to compel, and the proceedings before the Special Discovery Master.

Justice may re-depose any Mechel witness it has previously deposed who is an author or recipient of a document produced in response to this decision. The scope of the renewed deposition shall be limited to the newly produced documents and the subject matter they cover. Justice may re-depose each witness only once, at a time of its choosing that is convenient to the witness and Mechel's counsel. If Justice chooses to re-depose a witness before the proceedings before the Special Discovery Master are complete, Justice may not re-depose the witness if Mechel produces additional documents as a result of the Special Discovery Master process.

III. CONCLUSION

The motion to compel is granted in part. The parties shall proceed as directed in this decision.

Footnotes

1 *Moyer v. Moyer,* 602 A.2d 68, 72 (Del.1992); *accord Sokol Hldgs, Inc. v. Dorsey & Whitney, LLP,* 2009 WL 2501542, at *6 n.28 (Del. Ch. Aug. 5, 2009) (Strine, V.C.); *PharmAthen, Inc. v. SIGA Techs., Inc.,* 2009 WL 2031793, at *4 n.13 (Del. Ch. July 10, 2009); *Rembrandt Techs., L.P. v. Harris Corp.,* 2009 WL 402332, at *5 n.43 (Del.Super. Feb. 12, 2009); *SICPA Hldgs., S.A. v. Optical Coating Lab., Inc.,* 1996 WL 636161, at *7 (Del. Ch. Oct. 10, 1996); *Emerald P'rs v. Berlin,* 1994 WL 125047, at *1 (Del. Ch. Mar. 30, 1994); *Hoechst Celanese Corp. v. Nat'l Union Fire Ins. Co.,* 623 A.2d 1118, 1122 (Del.Super.1992); *In re Fuqua Indus., Inc. S'holders Litig.,* 1992 WL 296448, at *3 (Del. Ch. Oct. 8, 1992); *Deutsch v. Cogan,* 580 A.2d 100, 107 (Del. Ch.1990). *See*

*generally*Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 7.04 (2010).

2 *Int'l Paper Co. v. Fibreboard Corp.,* 63 F.R.D. 88, 93–94 (D.Del.1974); *accord Sokol Hldgs.,*2009 WL 2501542, at *8; *Deutsch,* 580 A.2d at 107; *Reese v. Klair,* 1985 WL 21127, at *5 (Del. Ch. Feb. 20, 1985).

3 *See, e.g.,Union Pac. Res. Grp., Inc. v. Pennzoil Co.,* 1997 WL 34655410, at *1 (D.Del. Aug. 12, 1997); *Cont'l Grp., Inc. v. Justice,* 536 F.Supp. 658, 664 (D.Del.1982); *Coastal Corp. v. Duncan,* 86 F.R.D. 514, 520 (D.Del.1980); *Int'l Paper,* 63 F.R.D. 93–94; *see also* Wolfe & Pittenger § 7.04, at 7–57 to –58.

4 *E.g.,Willemijn Houdstermaatschaapij BV v. Apollo Computer Inc.,* 707 F.Supp. 1429, 1443 (D.Del.1989); *Sokol Hldgs,* 2009 WL 2501542, at *8 ("Sokol has waived the right to [assert privilege] by failing to update its privilege log to provide detailed enough descriptions...."); *accord Lee v. State Farm Mut. Auto. Ins. Co.,* 249 F.R.D. 662, 683 (D.Colo.2008) ("The failure to [adequately describe any information withheld as privileged] results in a waiver of the claims of privilege."); *Aurora Loan Servs., Inc. v. Posner, Posner & Assocs., P.C.,* 499 F.Supp.2d 475, 479 (S.D.N.Y.2007) ("Failure to furnish an adequate privilege log is grounds for rejecting a claim of attorney client privilege."); *Rambus, Inc. v. Infineon Techs. AG,* 220 F.R.D. 264, 274 (E.D.Va.2004) ("The finding of inadequacy [of descriptions in Rambus' privilege log], particularly in light of Rambus' earlier discovery and litigation misconduct, conceptually is sufficient to warrant a finding that the privileges have been waived."); *Bowne of New York City v. AmBase Corp.,* 150 F.R.D. 465, 474 (S.D.N.Y.1993) ("[I]f the party invoking the privilege does not provide sufficient detail to demonstrate fulfillment of all the legal requirements for application of the privilege, his claim will be rejected."), *quoted with approval in U.S. v. Constr. Prods. Research, Inc.,* 73 F.3d 464, 473 (2d Cir.1996) (affirming order requiring disclosure of allegedly privileged documents because of an inadequate privilege log).

5 *Int'l Paper,* 63 F.R.D. at 94; *accord M & G Polymers USA, LLC v. Carestream Health, Inc.,* 2010 WL 1611042, at *51 n.262 (Del.Super. Apr. 21, 2010); *Williams Natural Gas Co. v. Amoco Prod. Co.,* 1991 WL 236919, at *2 (Del.Super. Nov. 8, 1991); *Council of Unit Owners of Sea Colony East v. Carl M. Freeman Assocs., Inc.,* 1990 WL 161169, at *2 (Del.Super. Sept. 26, 1990); *Playtex, Inc. v. Columbia Cas. Co.,* 1989 WL 5197, at *2 (Del.Super. Jan. 5, 1989); *Reese,* 1985 WL 21127, at *5.

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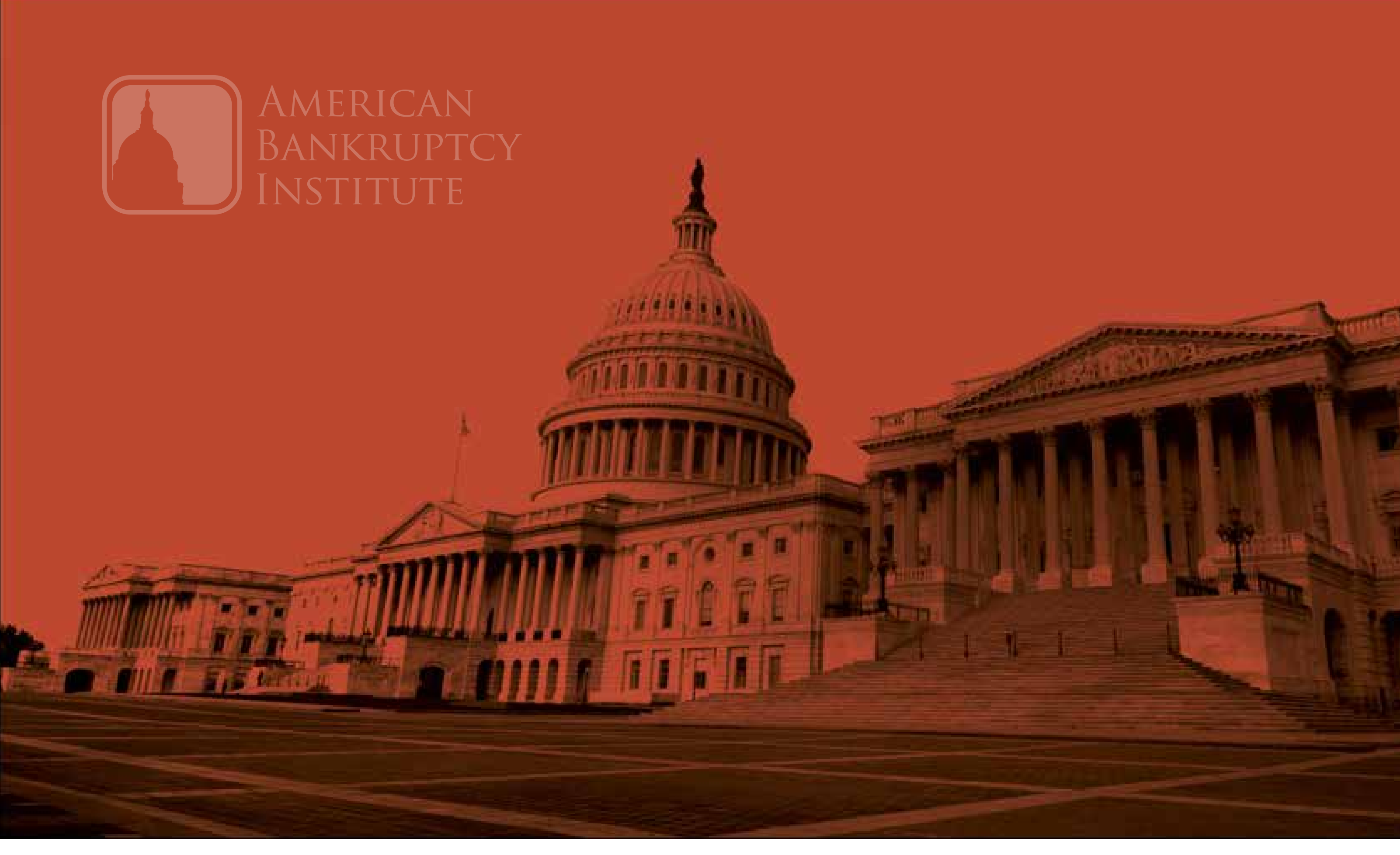

V. PROPOSED RECOMMENDATIONS: ADMINISTERING THE CASE

A. Executory Contracts and Leases

Section 365 of the Bankruptcy Code generally allows a debtor in possession to assume, assign, or reject executory contracts and unexpired leases in the chapter 11 case.[408] The debtor in possession typically makes this determination based on a variety of factors, including whether the contract or lease is above or below market, necessary to its ongoing business operations, and subject to assumption under the Bankruptcy Code. It also may consult with the unsecured creditors' committee on these issues or attempt to renegotiate the contract or lease with the nondebtor party. A debtor in possession's decision to assume, assign, or reject an executory contract or unexpired lease is subject to court approval, certain deadlines, and several other requirements detailed in section 365.[409]

1. Definition of Executory Contract

Recommended Principles:

- The Bankruptcy Code should define the term "***executory contract***" for purposes of section 365 as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other," provided that forbearance should not constitute performance. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). The contours of this definition are well developed under the case law and reflect an appropriate balance between the rights of a trustee to assume or reject contracts unilaterally under the Bankruptcy Code and the nondebtor's obligations and rights in those circumstances.

Definition of Executory Contract: Background

Section 365(a) provides that a debtor in possession,[410] "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[411] The Bankruptcy Code does not define "executory contract," and the legislative history of section 365 provides little guidance.[412] Accordingly, the court on a case-by-case basis determines whether a particular contract is executory.

Courts traditionally have used what is commonly referred to as the "Countryman" definition of executory contracts.[413] This test was developed by Professor Vern Countryman and defines an

408 11 U.S.C. § 365.
409 *See, e.g., id.* § 365(b) (requirements for assumption); *id.* § 365(c) (contracts not subject to assumption or assignment); *id.* § 365(f) (requirements for assignments).
410 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.
411 11 U.S.C. § 365(a).
412 H.R. Rep. No. 95-595, at 347 (1977) ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.").
413 *See In re* Baird, 567 F.3d 1207, 1211 (10th Cir. 2009); *In re* Columbia Gas Sys., Inc., 50 F.3d 233, 239 (3d Cir. 1995); *In re* Streets & Beard Farm P'ship, 882 F.2d 233, 235 (7th Cir. 1989); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1045 (4th Cir. 1985); *In re* Select-A-Seat Corp., 625 F.2d 290, 292 (9th Cir. 1980).

executory contract for bankruptcy purposes as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[414] Although widely used, courts have recognized limitations and potential inconsistencies in the application of the Countryman test.[415] In addition, the test may not be a good fit for certain kinds of contracts.[416]

Given the noted flaws in the Countryman test, courts have developed alternative approaches to assess executoriness. For example, some courts use the "functional approach" to evaluate a debtor in possession's request to assume or reject an executory contract. Under this approach, developed by Professor Jay Westbrook, there is no threshold standard of "executoriness" that the debtor in possession must meet to assume or reject the contract.[417] Rather, the functional approach focuses on whether assumption or rejection would create a benefit for the bankruptcy estate and its creditors. The functional approach recognizes that courts often manipulate the threshold requirement of executoriness in order to produce the desired outcome.[418] Several courts have adopted the functional approach or used it in connection with the Countryman test.[419]

Another alternative approach is commonly referred to as the "exclusionary approach." This approach is a deviation from the Countryman test and was developed by Michael Andrew.[420] The following are the primary differences between the Countryman test and the exclusionary approach: (i) the concept of executoriness is irrelevant in the rejection context;[421] and (ii) a contract is executory if each party has unperformed obligations, and if the debtor's nonperformance eliminates its right

414 Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

415 *See, e.g., In re* Gen. Dev. Corp., 84 F.3d 1364, 1374 (11th Cir. 1996); *In re* RoomStore Inc., 473 B.R. 107, 111–12 (Bankr. E.D. Va. 2012).

416 Some courts have struggled with the application of the Countryman definition in the context of the following kinds of agreements: options and rights of first refusal; restrictive covenants (covenants not to compete; restrictive covenants on land); oil and gas agreements (*e.g.*, the oil and gas leases themselves and variations thereof, like farmout agreements;, and related agreements, like surface use agreements and joint operating agreements); licenses, distributor agreements, and trademark agreements; warranties; rights of first refusal; employment contracts; and severance agreements; arbitration clauses; forum selection clauses; distributor agreements; trademark agreements; and indemnity clauses; and settlement agreements. *See, e.g.,* Water Ski Mania Estates Homeowners Ass'n v. Hayes (*In re* Hayes), 2008 Bankr. LEXIS 4668, at *31–32 (B.A.P. 9th Cir. Mar. 31, 2008) ("[A]lthough restrictive covenants contain the characteristics of both a contract and an interest in land, the primary nature of such covenants is preservation of a land interest, not future duties in contract. Although there will almost always be some incidental continuing obligations under a restrictive covenant, those duties were not the kind of obligations Congress intended to impact in enacting § 365.") (citation omitted); Frontier Energy, LLC v. Aurora Energy, Ltd. (*In re* Aurora Oil & Gas Corp.), 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010) ("The court's conclusion that the [oil and gas leases] qualify as 'leases' within the meaning of Section 365 makes it unnecessary to consider whether the [oil and gas leases] meet either the functional test or Countryman definition for executory contracts. Given the confusion in the case law, it is also improvident to opine on the question.") (citations omitted); *In re* Bergt, 241 B.R. 17, 29–31 (Bankr. D. Alaska 1999) (discussing the application of the Countryman test in recent case law to options); Bronner v. Chenoweth-Massie, P'ship (*In re* Nat'l Fin. Realty Trust), 226 B.R. 586, 589 (Bankr. W.D. Ky. 1998) ("The contingent nature of the obligations arising from an option agreement make them quite distinguishable from the typical contract. This distinction has puzzled many courts, resulting in two distinct lines of cases. The first line of cases, while recognizing the contingent nature of the obligations arising under option agreements, and while also expressly acknowledging that they are unilateral contracts until exercised, have nevertheless engaged in what could be described as analytical gymnasts to arrive at a finding that they are nonetheless executory contracts.") (citations omitted); Cohen v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 138 B.R. 687, 699 (Bankr. S.D.N.Y. 1992) ("Our readings persuade us that in each case, use of the Countryman test was neither necessary nor determinative. It was, rather, merely window dressing for results determined in the first instance by resort to another, sometimes unspecified criterion.") (analyzing case law regarding application of Countryman test to employment agreements). *See also infra* note 424.

417 Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 282–85 (1989).

418 *Id.* at 287.

419 *See, e.g.,* Route 21 Assoc. of Belleville, Inc., v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012); *In re* Majestic Capital, Ltd., 463 B.R. 289, 300 (Bankr. S.D.N.Y. 2012).

420 Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1 (1991).

421 Andrew, *Executory Contracts in Bankruptcy*, *supra* note 420, at 894.

to the other party's performance.[422] Although courts have not adopted this approach, they have considered its factors in applying other tests.[423]

Definition of Executory Contract: Recommendations and Findings

The Commission conducted an in-depth review of the literature and case law on executoriness under the Bankruptcy Code. Some of the Commissioners noted their experience with litigation concerning the executoriness issue and the attendant uncertainty and expense. The focus of the executoriness inquiry is whether each party has significant unperformed obligations under the contract.[424] The Commissioners discussed examples of contracts when this issue may be of particular concern, such as options, covenants not to compete, and oil and gas leases.[425] Although executoriness is not necessarily a bright-line determination, the Commissioners generally agreed that courts resolve this issue fairly or parties are able to negotiate a resolution.

The Commission also considered the possibility of eliminating the concept of executoriness from the Bankruptcy Code. Both the advisory committee and the 1997 NBRC endorsed this position.[426] The Commissioners debated at length the potential utility to this approach. They discussed the meaningful benefits to refocusing contract disputes on the merits of the proposed assumption or rejection rather than extensive litigation on executoriness. The Commissioners supporting this approach emphasized the value to such a clean solution: with the distraction of executoriness off the table, parties could devote more attention on their rights, obligations, and remedies under the contract. Many Commissioners found the simplicity of this approach attractive.

Further deliberations about the elimination proposal revealed, however, the potential of unintended consequences of such a dramatic shift in a fundamental bankruptcy principle. The Commissioners noted the common law origins of the executoriness requirement of section 365,[427] and they also

422 *Id.* at 893.

423 *See, e.g., In re* Family Snacks, Inc., 257 B.R. 884, 905 (B.A.P. 8th Cir. 2001).

424 The Seventh Circuit Court of Appeals explained:

> The Bankruptcy Code's legislative history states that the term "executory contract" "generally includes contracts on which performance is due to some extent on both sides.' A common definition, which this court has cited with approval, states that a contract is executory for bankruptcy purposes where "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure to complete performance would be a material breach excusing the performance of the other."

In re Crippin, 877 F.2d 594, 596 (7th Cir. 1989). *See also* Counties Contracting & Constr. Co. v. Constitution Life Ins. Co., 855 F.2d 1054, 1060 (3d Cir. 1988) ("The [Bankruptcy] Code does not define the term executory contract, however, courts have generally employed what has become known as the 'Countryman' definition of an executory contract, *i.e.*, a contract under which the obligations of both the bankrupt and the other party remain so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of the other.") (citation omitted).

425 *See, e.g.,* COR Route 5 Co., LLC v. Penn Traffic Co. (*In re* Penn Traffic Co.), 524 F.3d 373, 380 (2d Cir. 2008) ("While some courts have held that options contracts under which the optionee fully paid its price for the option to buy property before the debtor filed for bankruptcy are not executory (because no performance is due from the optionor unless the option is exercised), . . . others treat such contracts as executory.") (citing conflicting case law) (citations omitted); Powell v. Anadarko E&P Co., L.P. (*In re* Powell), 482 B.R. 873, 877–78 (Bankr. M.D. Pa. 2012) ("Some courts have assumed that an oil and gas lease is an executory contract. Other courts have considered an oil and gas lease a transfer of an interest in real property and therefore not an executory contract.") (citing conflicting case law) (citations omitted); *In re* Teligent, Inc., 268 B.R. 723, 730–31 (Bankr. S.D.N.Y. 2001) ("As a rule, Delaware law treats the covenant not to compete and the reciprocal promise to pay as material. As a result, the failure to make payment will discharge the obligation not to compete. . . . Where the covenant is given in connection with the sale of a business, it is even more likely to be deemed material. A covenant not to compete is often included in a contract to sell a business to protect the purchaser and allow him to enjoy the built-up good will.").

426 *See* NBRC Report, *supra* note 37, at 21 ("Title 11 should be amended to delete all references to 'executory' in section 365 and related provisions, and 'executoriness' should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.").

427 *See In re* Austin Dev. Co., 19 F.3d 1077, 1081 (5th Cir. 1994) ("Section 365 derives from § 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's

perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case. Thus, the elimination of the executoriness concept could simply shift, rather than reduce, the amount of litigation or uncertainty in the first instance under section 365. Moreover, many Commissioners believed that the assumption or rejection decision was largely irrelevant to contracts that have already been fully performed by at least one of the parties.

The Commissioners also discussed the functional approach to determining executoriness, but most perceived the test to be unfair toward counterparties and too heavily weighted in favor of the interests of the debtor and the estate. The Commissioners acknowledged the potential value of allowing a debtor in possession to assume or reject any contract that would provide a benefit to the estate. As with the elimination proposal, however, the Commissioners were concerned about diminishing the rights of the nondebtor counterparties under the contracts. Subjecting any contract to section 365 primarily, if not solely, for the benefit of the estate imposed a greater burden on nondebtor parties than necessary to achieve a fair result for the estate in a chapter 11 case.

On balance, the Commission voted to adopt the Countryman test and to recommend its express incorporation into the Bankruptcy Code. The Commission found that, although imperfect, the Countryman test strikes an appropriate balance between the rights of debtors in possession and nondebtor counterparties to a contract. If the parties have material unperformed obligations, it is fair and reasonable to allow a debtor to choose to assume, assign, or reject such an agreement under section 365. The Commission also determined that many of the potentially challenging issues under the Countryman test have been resolved by the courts and that this case law is a valuable resource that would guide the implementation of the codified standard.

2. General Rights of Private Parties to Executory Contracts and Unexpired Leases

Recommended Principles:

- A nondebtor party to an executory contract or unexpired lease with the debtor should be required to continue to perform under such contract or lease after the petition date, provided that the trustee needs such continued performance and pays for any products or services delivered after the petition date on a timely basis as required by the contract or lease. In paying for such products or services, however, the trustee should not be subject to any modifications or rate changes in the contract or lease triggered by the debtor's bankruptcy filing, insolvency, or prepetition default.
- Except as provided in section 365(d)(3) of the Bankruptcy Code (and the principles for that section, *see* Section V.A.6, *Real Property Leases*) and in section 365(d)(5) of the Bankruptcy Code, the trustee does not otherwise have an

leases or executory contracts or to 'reject' them if they were economically burdensome to the estate.").

obligation to perform, or to cure any defaults, under such contract or lease prior to the assumption of that contract or lease under section 365(a). The nondebtor party should be permitted to compel the trustee to perform other postpetition obligations under the contract or lease if the court determines, after notice and a hearing, that the harm to the nondebtor party resulting from the trustee's nonperformance significantly outweighs the benefit to the estate derived from such nonperformance. The court should limit the trustee's performance obligation to that which is necessary to mitigate the harm to the nondebtor party pending assumption or rejection. The nondebtor party should bear the burden of proof in any such hearing.

- The trustee should not be required to cure nonmonetary defaults that occur prior to the assumption of the executory contract or unexpired lease and that are impossible for the debtor to cure at the time of the proposed assumption under section 365(a) and (b).
- These principles governing the rights of parties to executory contracts and unexpired leases are intended to apply only to contracts and leases between private parties and should not affect the debtor's contracts or leases with any state or federal governments.

General Rights of Private Parties to Executory Contracts and Unexpired Leases: Background

In most chapter 11 cases, the debtor in possession[428] does not make its decision to assume, assign, or reject executory contracts and unexpired leases on, or even shortly after, the petition date. As such, there is a gap period between the petition date and the treatment decision under section 365. The Bankruptcy Code requires the debtor in possession to perform timely obligations arising under nonresidential real property leases, certain personal property leases,[429] and intellectual property licenses,[430] but does not otherwise address performance during the gap period.[431] In light of this silence, "most courts agree that before an executory contract is assumed or rejected under § 365(a), that contract continues to exist, enforceable by the debtor in possession, but not enforceable against the debtor in possession."[432]

428 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

429 11 U.S.C. § 365(d)(5). This provision for personal property leases applies only in chapter 11 cases. *Id.* If the case is initially filed under chapter 11 and later converted to chapter 7, section 365(d)(5) will no longer apply. 3 Collier on Bankruptcy ¶ 365.04[2][c].

430 11 U.S.C. § 365(n).

431 *Id.* § 365(d)(3). The court "may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period." *Id.*

432 *See, e.g., In re* Nat'l Steel Corp., 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (collecting cases). *See also* Howard C. Buschman III, *Benefits and Burdens: Postpetition Performance of Unassumed Executory Contracts,* 5 Bankr. Dev. J. 341, 343 (1988) (citing Douglas Bordewieck & Vern Countryman, *The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors,* 57 Am. Bankr. L.J. 239, 332 (1983)); 2 Collier on Bankruptcy ¶ 365.03, 365-28, 365-29 (15th ed. 1988); 8 Collier on Bankruptcy ¶ 3.15(6) at 204 (14th ed. 1978).

Courts generally justify this one-sided performance requirement by emphasizing the importance of the breathing spell created by the automatic stay for the debtor in possession,[433] and the severe consequences that may result from a rushed or premature decision to assume, assign, or reject an executory contract or unexpired lease.[434] They also acknowledge the burden such one-sided performance may impose on the nondebtor party, but on balance find in favor of the estate. The nondebtor party may seek to compel performance or a treatment decision by the debtor in possession under section 365, and it frequently requests an administrative claim under section 503(b)(3) for any postpetition obligations that the debtor in possession fails to perform.[435]

Once a debtor in possession decides to assume an executory contract or unexpired lease, section 365(b) requires the debtor in possession to cure or provide adequate assurance of a prompt cure of any defaults under the contract or lease. Section 365(b)(1) indicates that nonmonetary defaults that are impossible to cure under unexpired leases for nonresidential real property do not require cure, "except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph."[436] Section 365(b)(2) further provides that a debtor in possession's general cure obligations under section 365(b)(1) do not apply to "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."[437] Some courts have interpreted section 365 to preclude the assumption of executory contracts and unexpired leases (other than real property leases) if non-curable historical nonmonetary defaults exist under the contract or lease.[438]

General Rights of Private Parties to Executory Contracts and Unexpired Leases: Recommendations and Findings

The chapter 11 filing can have significant negative implications for a nondebtor party's business. Accordingly, the Commission carefully scrutinized the postpetition needs of a debtor in possession with respect to executory contracts and unexpired leases. The Commissioners discussed the importance of a reliable, steady supply of goods and services used in the debtor's business to the debtor in possession's reorganization efforts. They also acknowledged that nondebtor parties frequently threaten to stop providing goods or services unless the debtor in possession satisfies certain conditions. Although the Commissioners understood the nondebtor party's desire for more

433 *See, e.g., In re* Cont'l Energy Assocs. Ltd. P'ship, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) ("Not only does this saddle an ailing company with an additional burden which it is unlikely to overcome, it pressures the Debtor to surrender the 'breathing space' normally allowed to it to consider the assumption or rejection of the contract.").

434 11 U.S.C. § 365(g)(2). Post-assumption rejection is treated as a breach at the time of rejection (*i.e.*, postpetition). *Id.* Where a contract or lease is assumed in a chapter 11 case that is later converted to a chapter 7 and then the contract or lease is rejected in the chapter 7 case, the rejection would be treated as having occurred immediately before the date of conversion. 1 Collier Handbook for Trustees & Debtors in Possession ¶ 14.07 (2012).

435 11 U.S.C. § 503(b). The extent of the nondebtor party's administrative claim, however, may be limited by the court under the "benefit to the estate" standard of section 503(b). *See* Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 42–43 (1st Cir. 2003) ("[T]he nondebtor party will be entitled to administrative priority only to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate."); *In re* Nat'l Steel Corp., 316 B.R. 287, 301 (Bankr. N.D. Ill. 2004) ("Claims under § 503(b)(1)(A) are to be measured by the benefit received by the estate rather than the cost incurred by a claimant.").

436 11 U.S.C. § 365(b)(1).

437 *Id.* § 365(b)(2).

438 *See, e.g., In re* Carterhouse, Inc., 94 B.R. 271, 273 (Bankr. D. Conn. 1988) (holding that section 365(b)(1) "extends to nonmonetary as well as monetary breaches").

certainty and for some kind of adequate assurance, they found the general principles underlying the postpetition performance requirements to be sound.

Reflecting on the circumstances of nondebtor parties in these cases, however, the Commissioners considered various ways to mitigate the burden imposed by the general postpetition performance requirement. They did not believe that the debtor in possession should be required to provide adequate protection under section 361 of the Bankruptcy Code or to cure any historical defaults prior to assumption or rejection of the contract or lease. They also rejected full performance of the contract or lease by the debtor in possession, agreeing with courts that hold such a requirement undercuts the value of the automatic stay in the debtor in possession's reorganization efforts.

The Commissioners debated the feasibility of requiring the debtor in possession to pay for goods and services actually provided to the debtor in possession postpetition in accordance with the terms of the contract or lease. Some Commissioners commented that the debtor in possession may not have the liquidity to meet this standard on an immediate postpetition basis, while others indicated that the debtor in possession's needs in this respect could be factored into the postpetition financing budget.[439] The Commissioners stressed the need for any such payment obligation to be limited to those goods and services needed by, and provided to, the debtor in possession postpetition and that the nondebtor party should not be able to enforce more onerous payment terms from, or demand any other type of performance of, the debtor in possession pending assumption or rejection of the contract or lease.[440] The terms of the prepetition contract or lease should govern the timing and amount of the debtor in possession's postpetition payment obligations, unless the parties mutually agree to more beneficial terms for the estate.

The Commissioners also analyzed the circumstances under which nondebtor parties should be able to seek to compel full or greater postpetition performance by the debtor in possession under the contract or lease. The Commissioners generally believed that nondebtor parties should have this option, but that the standard of proof should be stringent and that the nondebtor party should bear the burden of proof, particularly in light of the Commission's recommendation to require some postpetition payment by the debtor in possession. The Commission ultimately determined that this standard was an appropriate balance and recommended the joint proposal of requiring payment solely for goods or services provided to the debtor in possession postpetition and placing a high evidentiary burden on the nondebtor party that seeks to compel further or other postpetition performance. The Commissioners also discussed the potential impact of these provisions on government contracts. In light of the different and varied interests that may be implicated by government contracts, the Commission agreed that these contracts be excluded from the recommended principles governing postpetition performance of executory contracts and unexpired leases and that such principles be limited to the rights of private parties to executory contracts and unexpired leases with a debtor.

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439 Some of the Commissioners proposed incorporating an "adequate assurance" concept similar to Section 2-609 of the Uniform Commercial Code, but others believed that this would provide too much leverage for counterparties in terms of holdup value.

440 *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–4 (June 4, 2013) (stating that retailers are failing because of the reluctance of trade creditors to extend credit on reasonable terms and the difficulty of obtaining DIP and exit financing to support reorganization), *available at* Commission website, *supra* note 55; *id.* at 5 (citing the January 2013 Senior Loan Officer Opinion Survey on Bank Practices from the Federal Reserve which indicates that DIP lending is tight and trade vendors are unwilling to extend credit except on onerous terms).

Finally, the Commissioners addressed the continued confusion in the case law concerning a debtor in possession's obligation to cure historical nonmonetary defaults in order to assume the executory contract or unexpired lease. The Commissioners acknowledged that the BAPCPA Amendments to the Bankruptcy Code clarified this issue for real property leases, but that ambiguity remained for other kinds of leases and executory contracts. The Commissioners debated whether certain kinds of historical nonmonetary defaults were so central to a contract's or lease's purpose that their nonperformance should bar assumption. On balance, the Commission determined that, with respect to all executory contracts and unexpired leases, a debtor in possession should not be required to cure nonmonetary defaults occurring prior to the assumption decision that are impossible to cure at the time of assumption under section 365(b) of the Bankruptcy Code.

3. Rejection of Executory Contracts and Unexpired Leases

Recommended Principles:

- The rejection of an executory contract or unexpired lease should continue to constitute a breach of the contract or lease as of the time immediately preceding the commencement of the case under section 365(g) of the Bankruptcy Code. The trustee's rejection of an executory contract or unexpired lease should not, however, entitle the nonbreaching, nondebtor party to a right of specific performance or to retain possession or use of any property of the debtor or the estate.
- A nonbreaching, nondebtor party should be able to retain possession or continue to use property of the debtor or the estate if expressly authorized by a section of the Bankruptcy Code (*e.g.*, section 365(n)).
- If the nondebtor party to an executory contract or unexpired lease breaches the executory contract or unexpired lease prior to the trustee's assumption or rejection decision, the trustee may treat such contract or lease as breached and exercise any rights or remedies it may have under the contract or lease or applicable nonbankruptcy law.

Rejection of Executory Contracts and Unexpired Leases: Background

A debtor in possession[441] may reject (*i.e.*, disavow) most executory contracts and unexpired leases under section 365(a) of the Bankruptcy Code. A debtor in possession's decision to reject an executory contract or unexpired lease generally relieves the debtor in possession of further performance obligations under the contract or lease. Courts, however, have differed on whether rejection terminates the contract or lease or, rather, constitutes a breach by the debtor in possession of such contract or lease.

441 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

Section 365(g) of the Bankruptcy Code specifically provides that rejection "constitutes a breach of such contract or lease." As such, section 365(g) answers the initial question concerning the effect of rejection and expressly equates rejection with a breach of the contract or lease by the debtor.[442] In some cases, that determination may end the inquiry, but in other cases, questions still remain regarding what rights the nondebtor party may pursue under the contract or lease or under applicable nonbankruptcy law because of the debtor's breach. As explained by the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,

> [w]hat § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. . . . The debtor's unfulfilled obligations are converted to damages; . . . But nothing about this process implies that any rights of the other contracting party have been vaporized.[443]

Courts and commentators agree that rejection gives the nondebtor party a right to assert monetary damages against the debtor in possession, which is deemed a prepetition claim against the estate.[444] They also generally agree that the nondebtor party cannot compel continued performance by the debtor in possession, unless otherwise specifically permitted by section 365.[445] They do not, however, agree whether the nondebtor party can enforce equitable remedies against the debtor in possession that such party otherwise would be able to assert under applicable nonbankruptcy law.[446] The court's perspective on this issue can have significant implications for the estate.

Rejection of Executory Contracts and Unexpired Leases: Recommendations and Findings

The Commission focused a substantial amount of time on the concept of rejection and whether a debtor in possession's decision to reject an executory contract or unexpired lease should trigger a breach or termination of such contract or lease. The Commissioners discussed the language of section 365 and specifically contrasted it with the chapter 5 avoiding powers of the debtor in possession. Congress did not intend section 365 to operate as an avoiding power that would allow a debtor in possession to terminate or unwind prepetition agreements or completely extinguish the rights of the nondebtor counterparty to an agreement. Such a result would be contrary to the language and structure of the Bankruptcy Code and well-settled federal policy that state law generally determines

442 *See, e.g.,* Sunbeam Prod., Inc. v. Chi. Am. Mfg, LLC, 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012). Both the National Bankruptcy Conference's Bankruptcy Code Review Project in 1993 and the NBRC in 1997 expressly considered the question of whether rejection should result in termination and provided a negative answer. A.L.I.-A.B.A., Bankruptcy Reform Circa 1993 183–87 (Nat'l Bankr. Conf. 1993); NBRC Report, *supra* note 37, § 2.4.1.

443 Sunbeam Prod., Inc. v. Chi. Am. Mfg, LLC, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012).

444 11 U.S.C. § 365(g)(1).

445 *See, e.g., In re* Walnut Assocs., 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992) ("[N]on-debtor party to the contract subject to rejection is limited in its claims for breach to the treatment accorded to a debtor's general unsecured creditors. . . . [U]nless specific performance is available to the non-debtor party under applicable state law, the debtor cannot be compelled to render its performances required under the contract. However, if state law does authorize specific performance under the rejected executory contract, it means that the non-debtor should be able to enforce the contract against the Debtor, irrespective of his rejection of it.").

446 *See, e.g.,* Abboud v. Ground Round, Inc. (*In re* Ground Round, Inc.), 335 B.R. 253 (B.A.P. 1st Cir. 2005) ("[A] party is entitled to specific performance of a rejected executory contract if such remedy is clearly available under applicable state law."); *In re* Annabel, 263 B.R. 19 (Bankr. N.D.N.Y. 2001) (same with respect to covenant not to compete). *But see, e.g., In re* Register, 95 B.R. 73, 75 (Bankr. M.D. Tenn. 1989) (refusing to enforce covenant not to compete in rejected sale agreement). *See also* Route 21 Assoc. of Belleville, Inc. v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012) (injunctive relief could be reduced to monetary claim).

property rights in bankruptcy.[447] The Commission voted to reinforce the principle that rejection of an executory contract or unexpired lease constitutes a breach, not a termination, of such contract or lease.

The Commissioners fully vetted the potential consequences of equating rejection with breach of the applicable contract or lease, using various examples to explore the nuances and variances in possible results. In analyzing these scenarios, the Commissioners worked to balance the state law rights and interests of the nondebtor party with the federal interests that are central to the reorganization efforts of a debtor in possession. These federal interests include equal treatment of all similarly situated creditors, automatic stay of actions based on prepetition transactions and relationships with the debtor, and the ability of the debtor in possession to reject burdensome contracts and leases to facilitate its reorganization.[448]

The Commission considered the rejection of different kinds of contracts and leases, and identified the competing interests of the debtor in possession and the nondebtor, and the needs of the estate, following rejection. For example, the debtor in possession, on behalf of the estate, needs (i) any property that may be held by the nondebtor party to be returned; (ii) the ability to use such property free from restraints or limitations; and (iii) relief from any performance obligations under the contract or lease. Congress was aware of these needs and carefully balanced them against the interests of the nondebtor party. In specific instances when the interests of the nondebtor party outweigh the needs of the debtor in possession, Congress specified the nondebtor party's rights upon rejection. Specifically, these exceptions arise in the context of certain real property leases, timeshares, and intellectual property licenses.[449]

The Commission agreed that, other than the exceptions already made by Congress, the nondebtor party to the rejected contract or lease should be required to immediately return the debtor's property to the debtor in possession and should not be able to enforce any equitable or injunctive relief against, or otherwise require performance by, the debtor in possession. In addition to the factors previously noted, the Commissioners pointed to section 542 in support of requiring the counterparty to return personal property to the estate upon rejection.[450] They also believed that allowing the nondebtor party to enforce equitable or injunctive relief against the debtor in possession would elevate the rights of such counterparty beyond those of other similarly situated prepetition creditors. Indeed, general unsecured creditors typically are not entitled to relief from the automatic stay or to take actions affecting the debtor in possession's postpetition business operations, despite the terms of the creditors' prepetition contracts or applicable nonbankruptcy law. Accordingly, the Commission

447 "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." Butner v. United States, 440 U.S. 48, 54 (1979).

448 *See, e.g., In re* Am. Suzuki Motor Corp., 494 B.R. 466, 477 (Bankr. C.D. Cal. 2013) ("The purpose of contract rejection under section 365 is to permit the debtor to receive the economic benefits necessary for reorganization (which includes liquidation under chapter 11) for the ultimate benefit of the estate and its creditors. State legislatively imposed buyback requirements, fair market value awards and treble-damages penalties are superimposed onto the normal contract damage remedy provisions under state common or statutory law. While Florida and many other states believe that their public policy should provide special protections for the economic interest of local car dealerships, in the area of federal bankruptcy law those remedies run counter to the federal policy of bankruptcy reorganization and are therefore preempted."); *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 344–45 (Bankr. D. Del. 1998) ("In enacting the Bankruptcy Code, Congress made a determination that an eligible debtor should have the opportunity to avail itself of a number of Code provisions which adversely alter creditors' contractual and nonbankruptcy law rights.").

449 11 U.S.C. § 365(h), (i), (n).

450 *Id.* § 542(a) ("[A]n entity . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.").

endorsed the conclusions that rejection should constitute a breach, but it should not (i) deprive the debtor in possession of the right to possess or use estate property or (ii) require specific performance by the debtor in possession or the estate.

4. Intellectual Property Licenses

Recommended Principles:

- A trustee should be able to assume an intellectual property license in accordance with section 365(a) of the Bankruptcy Code notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement.
- The trustee should be able to assign an intellectual property license to a single assignee in accordance with section 365(f) notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. If the trustee seeks to assign an intellectual property license under which the debtor is a licensee to a competitor of the nondebtor licensor or an affiliate of such competitor, the court may deny the assignment if the court determines, after notice and a hearing, that the harm to the nondebtor licensor resulting from the proposed assignment significantly outweighs the benefit to the estate derived from the assignment. The nondebtor licensor should bear the burden of proof in any such hearing.
- Foreign patents and copyrights should be included within the definition of "***intellectual property***" set forth in section 101(35A) and subject to section 365, including section 365(n). In addition, foreign trademarks should also be included in this definition, subject to the limitations and conditions imposed on domestic trademarks under the recommended principles in Section V.A.5, *Trademark Licenses*.

Intellectual Property Licenses: Background

A debtor's or the estate's assets often include intellectual property. The Bankruptcy Code defines "***intellectual property***" as a "(A) trade secret; (B) invention, process, design, or plant protected under title 35 [of the U.S. Code; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 [of the U.S. Code]; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law."[451] In the context of section 365 of the Bankruptcy Code, debtors in possession[452] commonly face issues with respect to their ability to assume, assign, or reject their intellectual property licenses.[453]

451 11 U.S.C. § 101(35A).

452 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

453 Courts generally characterize intellectual property licenses as executory contracts. *In re* Kmart Corp., 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy

A "***license***" is an agreement that generally allows an owner to monetize the value of its intellectual property. Licenses permit, often for a fee, a third party (licensee) to use the owner's (licensor's) intellectual property for a specified purpose, within a specified geographic region, for a specified time period, under specified conditions. Licenses range on a sliding scale from conferring very limited nonexclusive rights to all or essentially all rights to the intellectual property. Licenses are, in essence, a form of covenant by which the licensor agrees not to sue the licensee for using the licensor's intellectual property.

When a debtor in possession is the licensee under an intellectual property license, two potentially competing federal interests are at play: (i) the Bankruptcy Code generally allows the debtor in possession to unilaterally decide whether to assume, assign, or reject an executory contract; and (ii) the federal law on intellectual property licenses respects the right of the licensor to control its intellectual property.[454] Some courts have turned to section 365(c) of the Bankruptcy Code to address this potential conflict. Section 365(c) generally restricts the ability of a debtor in possession to assume or assign if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties."[455] Such contracts can be assumed or assigned by the debtor in possession only with the consent of the nondebtor party to the contract.

Courts applying section 365(c)(1) to the rights of a debtor in possession as a licensee under an intellectual property license are split regarding whether a debtor in possession may assume (*i.e.*, keep and perform under) the license, as opposed to assigning the license to a third party, without the consent of the nondebtor licensor. Courts that permit a debtor in possession to assume a license under these circumstances follow the "actual approach," which treats the debtor in possession as the same entity to which the third party licensor extended the license in the first instance.[456] Because the identity of the parties has not changed under this theory and the action would not be deemed an impermissible assignment under applicable nonbankruptcy law, these courts authorize the debtor in possession to assume such license under section 365(a) and (b).

Other courts, however, find the actual test in contravention of the statutory language. These courts follow the "hypothetical approach," which preclude the debtor in possession from assuming an agreement if applicable nonbankruptcy law would preclude the debtor from assigning the license to a third party, even if the debtor in possession has no intention of effecting such an assignment.[457] Some commentators have criticized the hypothetical approach as providing the nondebtor licensor

Code.'") (citations omitted).

454 *See* Unarco Indus., Inc. v. Kelley Co., Inc., 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (citations omitted) ("[L]ong standing federal rule of law with respect to the assignability of patent licenses provides that these agreements are personal to the licensee and not assignable unless expressly made so in the agreement.").

455 11 U.S.C. § 365(c)(1).

456 The First and Fifth Circuits adopted the "actual test." *In re* Mirant Corp., 440 F.3d 238 (5th Cir. 2006); Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), *abrogated by* Hardemon v. City of Boston, 1998 WL 148382 (1st Cir. Apr. 6, 1998), *superseded by* 144 F.3d 24 (1st Cir. 1998). *See also In re* Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005) (taking a slightly different approach but holding that section 365(c)(1)'s use of the word "trustee" does not include the debtor or debtor in possession when assumption is sought because assumption does not require the nondebtor party to accept performance from a new party other than the debtor or debtor in possession).

457 The Third, Fourth, Ninth, and Eleventh Circuits have adopted the "hypothetical test." *In re* Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); *In re* Catapult Entm't, Inc., 165 F.3d 747 (9th Cir. 1999); *In re* James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994); *In re* West Elec. Inc., 852 F.2d 79 (3d Cir. 1988).

with holdup power that can frustrate or completely derail the reorganization efforts of the debtor in possession.[458]

Conversely, when a debtor in possession is the licensor under an intellectual property license and decides to reject the license, section 365(n) of the Bankruptcy Code allows the nondebtor licensee to treat the license as either (i) terminated, or (ii) effective through the end of the remaining term. If the licensee elects to retain the license, it cannot compel any performance by the debtor, but it retains the ability to use certain of its rights under the license for the remaining term, for which it must continue to pay any royalties or other fees required by the terms of the license. Additionally, the nondebtor licensee may not assert any damages for nonperformance by the debtor through a setoff against any fees or payments it owes under the license. Notably, the definition of intellectual property does not include foreign intellectual property or trademarks, which often poses an issue under section 365(n). In the context of trademarks, the issue is particularly challenging when the trademarks are integrated into a license with intellectual property (as that term is currently defined under the Bankruptcy Code). The treatment of trademarks under section 365 is addressed separately in the following section.

Intellectual Property Licenses: Recommendations and Findings

Intellectual property licenses can represent valuable assets of the estate and may be necessary to the reorganization of the debtor in possession. Thus, the treatment of these licenses under section 365 of the Bankruptcy Code is often a critically important issue in the case. The Commission reviewed open issues relating to intellectual property licenses in chapter 11.

The Commissioners evaluated the statutory interpretation and practical issues raised by the debate between supporters of the hypothetical approach, on the one hand, and supporters of the actual approach, on the other hand, concerning the ability of a debtor in possession (as licensee) to assume (*i.e.*, keep and use) an intellectual property license without the consent of the nondebtor party (as licensor).[459] The Commissioners acknowledged that nondebtor licensors may have legitimate concerns about providing their intellectual property to a party other than the debtor, but those concerns should not exist when the debtor in possession proposes to assume and perform in accordance with the license. In those instances, the licensor would be receiving the benefit of its bargain. The Commissioners recognized that application of the hypothetical test results in artificial barriers to the reorganization of the debtor in possession — an outcome that directly undercuts a fundamental policy underlying the Bankruptcy Code. The Commission voted to reject the hypothetical approach and to adopt and codify the actual approach. The Commission further recommended that Congress amend the Bankruptcy Code to expressly authorize the debtor in possession to assume executory intellectual property licenses.

458 *See, e.g.,* David R. Kuney, *Intellectual Property in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 Am. Bankr. Inst. L. Rev. 593 (2001).

459 *See Written Statement of Robert L. Eisenbach III, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–6 (June 4, 2013) (discussing the tests in practical terms), *available at* Commission website, *supra* note 55; *Written Statement of Lisa Hill Fenning, Partner, Arnold & Porter LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–6 (June 4, 2013) (discussing impact of bankruptcy law on intellectual property licenses), *available at* Commission website, *supra* note 55.

The Commissioners also critically analyzed whether the result of the hypothetical test (*i.e.*, no assumption without the consent of the nondebtor licensor) was good policy in the actual assignment context. Admittedly, the ability to exclude others from using your intellectual property is a key element of intellectual property ownership. This right provides intellectual property owners some control over the use of their property and a means to monetize at least some of the value of their property. The assignment by the debtor in possession of an intellectual property license, in accordance with the terms of section 365(f) (requiring, among other things, adequate assurance of future performance and assumption of the entire agreement), arguably does not significantly decrease the value of the licensor's right to exclude users.

The Commissioners debated the advantages and disadvantages of providing debtors in possession with more flexibility to assign intellectual property licenses under the Bankruptcy Code. Some of the Commissioners believed that this flexibility was necessary to maximize the value of the estate and to facilitate certain reorganization transactions. In considering the value of the license from both the licensor's and licensee's perspectives, they observed that U.S. assignment laws are more restrictive than those in many foreign jurisdictions.[460] Moreover, many of the Commissioners did not believe that the identity of the debtor, absent unusual circumstances, was *per se* a critical factor in the licensing relationship. Rather, factors such as the licensee's ability to pay, to maintain the desired integrity and quality of the intellectual property, and to comply with all obligations imposed by the license are likely more relevant and important.

The Commissioners acknowledged that the identity of the licensee could be critical if the proposed assignee was a competitor of the licensor. In those instances, nondebtor licensors should have the ability to block a proposed assignment by the debtor licensee. The Commission supported a proposal that would permit a debtor in possession to assign an intellectual property license freely under section 365(f)(1) and (2), subject to a nondebtor licensor's right to demonstrate that the hardship imposed on it by the proposed assignment to one of its competitors would significantly outweigh the benefit to the estate.

The Commission also reviewed the exclusion of foreign patents and copyrights from the definition of intellectual property in section 101(35A) of the Bankruptcy Code. Foreign patents and copyrights are excluded from this definition because they are not covered by title 35 or title 17 of the U.S. Code. The Commissioners believed that licenses for foreign patents, copyrights and trademarks (subject to the limitations proposed for U.S. trademarks below), although generally not governed by U.S. law, should receive the same treatment in bankruptcy as U.S. licenses. Moreover, licensees under licenses of foreign intellectual property should receive the same protections as licensees under U.S. licenses pursuant to section 365(n) of the Bankruptcy Code. The Commission found no reasonable basis for treating foreign intellectual property differently.

460 *See, e.g.*, M. Reutter, *Intellectual Property Licensing Agreements and Bankruptcy*, *in* Research Handbook On Intellectual Property Licensing 281 (Jacques de Werra ed., 2013).

5. Trademark Licenses

Recommended Principles:

- "Trademarks," "service marks," and "trade names," as defined in section 1127 of title 15 of the U.S. Code, should be included in the definition of "intellectual property" under the Bankruptcy Code. Section 101(35A) of the Bankruptcy Code should be amended accordingly.
- If a debtor is a licensor under a trademark, service mark, or trade name license and the trustee elects to reject that license under section 365, section 365(n) should apply to the license, with certain modifications. The nondebtor licensee should be required to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed trademark, service mark, or trade name; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed trademark, service mark, or trade name. The trustee should maintain the right to oversee and enforce quality control for such products or services and should not be under any continuing obligation to provide products or services to the rejected licensee. In addition, the concept of "royalty payments" under section 365(n) should be expanded to include "other payments" contemplated by the trademark, service mark, or trade name license.

Trademark Licenses: Background

As noted above, trademarks are not included in the definition of "intellectual property" under section 101(35A) of the Bankruptcy Code. Congress made the conscious decision in the 1988 amendments to exclude this kind of intangible property because trademarks have slightly different characteristics as compared to other intangible property that is included in the definition of intellectual property. One key difference is that any transfer of a trademark, including a license or assignment, must include a transfer of the associated business operations (referred to as "good will" under applicable nonbankruptcy law).[461] In addition, trademark licenses raise other challenges, as explained by the legislative history of Bankruptcy Code section 365(n):

461 The relevant portion of the Lanham Act provides:

> (1) A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark. Notwithstanding the preceding sentence, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of an amendment under section 1051(c) of this title to bring the application into conformity with section 1051(a) of this title or the filing of the verified statement of use under section 1051(d) of this title, except for an assignment to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing.
>
> (2) In any assignment authorized by this section, it shall not be necessary to include the good will of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.

15 U.S.C. § 1060(a).

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor licensors. While such rejection is of concern because of the interpretation of section 365 by the *Lubrizol* court and others, such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.[462]

Several commentators have discussed the uncertainty created for nondebtor licensees of a debtor's trademarks given the exclusion of trademarks from the definition of intellectual property and section 365(n). Courts have struggled with the treatment of trademark licenses and the consequences of rejection pursuant to section 365 by a debtor licensor of a license with a nondebtor licensee.[463] Some courts have determined that the rejection of such an agreement terminates the nondebtor licensee's rights to use the relevant trademarks and any associated goodwill, and grants the nondebtor party only the right to file a claim for monetary damages against the estate.[464] Other courts have determined that the debtor in possession's[465] rejection of a license constitutes only a breach of such agreement, which is consistent with section 365(g), and that the nondebtor licensee may continue to exercise its rights under the rejected agreement consistent with applicable nonbankruptcy law.[466] In addition, some courts have determined that trademark licenses are not executory contracts and therefore cannot be rejected.[467]

Similar to other intellectual property, a trademark license may be an integral component of a nondebtor's business — particularly in the franchising context. In the event that a licensor files for bankruptcy, a bankruptcy provision that automatically strips the nondebtor licensee of all rights to use the debtor's trademarks and any associated goodwill upon the debtor in possession's rejection of the trademark license could devastate the nondebtor's business. Conversely, the ability of the debtor in possession to reorganize successfully may hinge, at least in part, on its ability to repossess

462 S. Rep. No. 100–505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3204 (citations omitted).

463 *See, e.g., In re* Old Carco LLC, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009), *aff'd sub nom.* Mauro Motors Inc. v. Old Carco LLC, 420 F. App'x 89 (2d Cir. 2011) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [, so] rejection of licenses by licensor deprives licensee of right to use trademark. . . ."); *In re* HQ Global Holdings, Inc., 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademark stops on rejection."); *In re* Centura Software Corp., 281 B.R. 660, 674–75 (Bankr. N.D. Cal. 2002) ("Because Section 365(n) plainly excludes trademarks, the court holds that [licensee] is not entitled to retain any rights in [licensed trademarks] under the rejected . . . Trademark Agreement.").

464 *See* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985) (no right to continue to use mark upon rejection). Such a claim is treated as an unsecured prepetition claim.

465 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

466 *See* Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012) (holding that *Lubrizol* was wrongly decided and that the transfer of rights embodied in trademark or other IP licenses could not be "vaporized" by rejection). "[R]ejection is not the 'functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the position they occupied before the contract was formed.' It 'merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence.'" *Id.* (citations omitted).

467 *See also In re* Exide Techs., 607 F.3d 957 (3d Cir. 2010) (trademark license not executory and not subject to rejection under facts of case). Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not — as occurred in this case — use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve. *Id.* at 967–68. *But see In re* New York City Shoes, Inc., 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (exclusive trademark licensing agreement providing for annual royalties was executory).

its trademarks and any associated goodwill and then redeploy these assets in a more productive manner consistent with its reorganization efforts.

Trademark Licenses: Recommendations and Findings

The Commission considered whether adding trademarks to the definition of intellectual property under section 101(35A) of the Bankruptcy Code was a workable solution. Several Commissioners noted that the concerns underpinning the decision by Congress in the 1988 amendments to exclude trademarks from the definition of intellectual property still persist. Generally, applicable nonbankruptcy law continues to treat trademarks differently in comparison to other intangible property. These Commissioners did not believe that the process provided in section 365(n) would necessarily work for all trademark licenses or generate the fair result — considering both the interests of the estate and the nondebtor licensee — in every case.

The Commissioners recognized, however, the uncertainty surrounding the treatment of trademark licenses in chapter 11 cases. They discussed how these licenses, to the extent they are deemed executory contracts under the Bankruptcy Code, would be treated under the recommended principles for rejection of executory contracts and leases.[468] For example, the rejection of the trademark license would constitute a breach by the debtor. It would not terminate the license or eviscerate the nondebtor licensee's rights under the license. The rejection likely would require, however, the nondebtor licensee to turn over the right to use the trademark and any associated goodwill to the estate. Moreover, the nondebtor licensee would not be able to require performance by the debtor in possession or seek equitable or injunctive relief.

The Commission considered whether section 365(n) could be modified to accommodate the unique attributes of trademark licenses and the related concerns of both the debtor licensor and the nondebtor licensee. The Commissioners discussed the advantages and disadvantages of including trademarks within the definition of intellectual property under the Bankruptcy Code. Some Commissioners believed that such inclusion was problematic because of the goodwill associated with the marks and the frequent need of trademark licensees to have access to the related products or goods, or components thereof, to utilize the marks legitimately under the license. Moreover, these Commissioners raised concerns about a debtor licensor's need to monitor quality control of the use of any marks by a licensee. Other Commissioners believed that the statute could incorporate appropriate protections and limitations to protect debtor licensors and mitigate the valid concerns regarding goodwill and ongoing compliance with the license by the licensee. The Commissioners expressed concern about the ongoing ambiguity surrounding trademarks in bankruptcy, and the related costs imposed on a debtor in possession and the estate, as well as the potential harm to the nondebtor licensee's business.

After considering the alternatives and the 2014 Innovation Act proposed in Congress,[469] the Commission determined that trademark licenses should be included in the definition of intellectual property licenses under the Bankruptcy Code. In reaching this conclusion, the Commission agreed

468 *See* Section V.A.3, *Rejection of Executory Contracts and Unexpired Leases*.
469 *See* Innovation Act of 2013, H.R. 3309, 113th Cong. § 6(d) (1st Sess. 2013), *available at* https://www.congress.gov/113/bills/hr3309/BILLS-113hr3309rfs.pdf.

that section 365(n) should be amended to address certain unique aspects of trademark licenses, including a provision that would allow a debtor in possession to monitor quality control, but otherwise not impose obligations on the debtor in possession if the license is rejected. The Commission also agreed that section 365(n) needs to expressly require a nondebtor licensee electing to retain its rights under the trademark license to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed marks; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed marks.

6. Real Property Leases

Recommended Principles:

- The trustee's time to assume or reject unexpired nonresidential real property leases under section 365(d)(4) of the Bankruptcy Code should be extended from 210 days to one year after the petition date or date of the order for relief, whichever is later, in the interest of enhancing prospects for reorganization.
- The calculation of postpetition rent under a real property lease should be calculated under the accrual method, allowing the trustee to treat rent accrued prior to the petition date as a prepetition claim and rent accrued on and after the petition date as a postpetition obligation. The trustee should be required to pay any such postpetition rent obligation on or before 30 days after the petition date or date of the order for relief, whichever is later. The trustee should pay all subsequent rent obligations accruing postpetition but prior to any rejection of the lease on a timely basis in accordance with the terms of the lease.
- A landlord's claim for unperformed obligations under section 365(d)(3) should apply only to monetary obligations. Such claim for unperformed monetary obligations should not receive superpriority treatment, but should instead constitute an administrative claim under section 503(b)(1) that is payable under section 507(a)(2).
- The meaning of the term "rent" under section 502(b)(6) should not be based on whether an obligation is labeled as "rent" under the lease. Rather, the Bankruptcy Code should define "***rent***" as any recurring monetary obligations of the debtor under the lease.
- The calculation of rejection damages for real property leases under section 502(b)(6) should be clarified as follows:

  The claim of a lessor for damages resulting from the termination of a lease of real property shall not exceed:

  (i) The greater of (A) the rent reserved for one year under the lease following the termination date and (B) the alternative rent calculation; plus
  (ii) Any unpaid rent due under the lease on the termination date.

For purposes of this section:

*The "**alternative rent calculation**" is the rent reserved for the shorter of the following two periods: (a) 15 percent of the remaining term of the lease following the termination date and (b) three years under the lease following the termination date.*

*The "**termination date**" is the earlier of the petition date and the date on which the lessor repossessed, or the lessee surrendered, the leased property.*

In calculating the rent due or reserved under the lease, such calculation should be done without acceleration.

- A landlord should be required to make reasonable efforts to mitigate damages in the event that the trustee rejects the lease under section 365, regardless of whether mitigation is required by applicable nonbankruptcy law. Any mitigation or cover received by, or security deposit held by, the landlord should reduce the landlord's prepetition claim for purposes of calculating the section 502(b)(6) claim. A landlord's obligation to mitigate damages should continue through the claims objection deadline or the date of the order allowing the claim, whichever is earlier.
- A landlord's claims for the debtor's acts and omissions resulting in damage to the real property, other than those claims relating to the rejection of the lease or for rent under the lease, should not be subject to section 502(b)(6). The landlord should be permitted to assert any such claim as a prepetition claim against the estate, subject to the trustee's or a party in interest's right to object and the general claims allowance process.

Real Property Leases: Background

Many chapter 11 debtors have one or more unexpired leases of nonresidential real property as of the petition date. These leases may be for the debtor's headquarters, stores, warehouses, or factories. They may be necessary to the debtor in possession's[470] reorganization efforts or otherwise represent valuable assets that the debtor in possession can use to maximize the value of the estate. Alternatively, they may be above-market leases or used in a part of the business being closed or downsized through the reorganization. In either scenario, a debtor in possession's ability to assume, assign, or reject unexpired leases of nonresidential real property is important to the resolution of its case.

The Bankruptcy Code includes several provisions that specifically address the rights and obligations of the debtor in possession and the nondebtor landlord under unexpired leases of nonresidential real property leases. For example, section 365(d)(3) requires the debtor in possession to timely perform obligations "arising from and after the order for relief under any unexpired lease of nonresidential real

470 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

property, until such lease is assumed or rejected."[471] In addition, section 365(d)(4) requires the debtor in possession to assume or reject any nonresidential real property lease within 120 days after the petition date, with one 90-day extension of that deadline for cause.[472] The debtor in possession generally is given until plan confirmation to assume or reject executory contracts and other kinds of leases.[473]

Commentators and practitioners have raised issues concerning several of these provisions. Many commentators have criticized the shortened deadline for the debtor in possession to assume, assign, or reject a nonresidential real property lease under section 365(d)(4) of the Bankruptcy Code.[474] Prior to the BAPCPA Amendments, a debtor in possession had an initial 60 days to review its unexpired nonresidential leases, but it could obtain one or more extensions of this deadline for cause and with court approval.[475] Some commentators and landlords believed that courts were granting debtors in possession very lengthy extensions of the section 365(d)(4) deadline on a routine basis.[476] They believed that these open-ended extensions significantly impaired the landlords' rights under the leases and nonbankruptcy law, as well as their ability to identify substitute lessees and negotiate substitute leases in a timely manner.[477]

As a result of the BAPCPA Amendments, section 365 provides a debtor in possession with 210 days following the petition date to decide whether it will assume or reject each of its nonresidential real property leases, unless the applicable landlord consents to an extension of this deadline. Some commentators suggested, immediately following the BAPCPA Amendments, that this single change to the Bankruptcy Code would discourage large retail chains from filing chapter 11 petitions.[478] Large retail chains, in particular, frequently have hundreds of unexpired nonresidential real property leases as of the petition date, and the prospect of reviewing and making prudent assumption or rejection decisions for each location within 210 days of the petition date, according to these commentators, would likely be too daunting and thus discourage filings in the first place.[479] Empirical and anecdotal evidence since 2005 suggests that this change in a debtor in possession's time to assume or assign nonresidential real property leases is at least a contributing factor to both the decline in retail filings and the results that were achieved in certain retail debtor cases since 2005.[480]

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471 11 U.S.C. § 365(d)(3).

472 *Id.* § 365(d)(4).

473 *Id.* § 365(d)(2).

474 *Id.* § 365(d)(4).

475 *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?, Hearing before the H. Subcomm. on Commercial and Administrative Law*, 111th Cong. 96 (2009) (statement of Professor Jack F. Williams, Robert M. Zinman ABI Resident Scholar (2008–09)) [hereinafter Williams Statement].

476 *See, e.g., Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) (discussion prior law), *available at* Commission website, *supra* note 55. *See generally Transcript, NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, *available at* Commission website, *supra* note 55.

477 "The deadline was originally enacted to address problems caused by extended vacancies or partial operation by a debtor of tenant space located in shopping centers which reduced customer traffic to other nondebtor tenants due to delays in debtors deciding whether to assume or reject real property leases." *In re* FPSDA I, LLC, 450 B.R. 392, 399 (Bankr. E.D.N.Y. 2011).

478 *See, e.g.,* Williams Statement, *supra* note 475, at 97 ("Professor Ken Klee suggests one other possible outcome — retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into involuntary cases.") (citations omitted).

479 *See, e.g., id.* at 96–97; *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that 210 days may not be sufficient for a debtor to make an informed decision), *available at* Commission website, *supra* note 55; *Written Statement of Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 (Nov. 15, 2012) (stating that the 210-day period to assume or reject a nonresidential lease is too short, discourages reorganization, and impairs secured creditor recoveries), *available at* Commission website, *supra* note 55.

480 *See* Kenneth Ayotte, *An Empirical Investigation of Leases and Executory Contracts*, (paper presented at 2014 symposium) (draft on file with Commission) (finding that BAPCPA is "associated with a significantly lower probability of reorganization for the most lease-intensive firms"). *See also Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (Nov. 3, 2012) (arguing that the 210-day period is insufficient, particularly for retail debtors), *available*

Courts also take different approaches to calculating the timely payments a debtor in possession is obligated to make under its nonresidential real property leases pursuant to section 365(d)(3). Some courts determine the prepetition or postpetition status of rent amounts owed by a debtor in possession using a billing approach based on the landlord's invoice date.[481] Other courts take an accrual approach and allocate the outstanding amounts between the prepetition and postpetition periods accordingly.[482] Courts also differ on the priority accorded to any unpaid postpetition amounts due under section 365(d)(3).[483]

Similarly, if a debtor in possession rejects a nonresidential real property lease, the landlord's claim for rejection damages is generally subject to the cap provided by section 502(b)(6) of the Bankruptcy Code. Section 502(b)(6) generally "limits a landlord's 'damages resulting from the termination of a lease of real property' to an amount equal to the rent the debtor-tenant would have paid for a period of one to three years, depending on the remaining term of the lease."[484] The calculation of the section 502(b)(6) cap, as well as what constitutes rent or otherwise should be included in the calculation, often produces litigation and uncertain results in chapter 11 cases.[485] Notably, courts are split regarding the application of the section 502(b)(6) cap to nontermination damages relating to the lease, which could constitute millions of dollars and significantly impact unsecured creditors' *pro rata* share of estate assets.[486]

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at Commission website, *supra* note 55; *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (testifying that the primary problem in retail reorganizations is lender control and stating that "[l]enders are sometimes willing to provide *only* enough financing to position a debtor for liquidation in the first few months of the case, and then impose restrictive covenants in post-petition financing agreements that either direct an immediate liquidation of the company, or include covenants or borrowing reserve rights that effectively allow the lender to 'pull the plug' on the retailer only a few months into the case"), *available at* Commission website, *supra* note 55; *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (explaining the tension in the timing regarding the desire of the secured creditor to liquidate the debtors' assets and the ability of the debtor to effectively conduct going-out-of-business ("***GOB***") sales at its retail locations; given the 210-day limit set by BAPCPA and given the fact that a GOB sale takes at least 120 days in most cases, the debtor has 30 to 90 days to sell its company; landlords are also unwilling to negotiate, which increases the prevalence of quick liquidations in retail cases), *available at* Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) (stating that the 210-day limit to assume or reject nonresidential leases puts retailers in a timing pinch; because GOB sales generally take at least 120 days and must take place in their retail locations, the 210-day limit to assume or reject leases puts inordinate pressure on debtors to decide within 90 to 120 days after filing to either quickly file a chapter 11 plans while complying with all their lenders' requirements, or to liquidate; also stating that the 210-day deadline to assume or reject nonresidential leases means it is nearly impossible for a middle-market retail company to do anything but conduct a GOB sale), *available at* Commission website, *supra* note 55.

481 *See* Centerpoint Props. v. Montgomery Ward Holding Corp. (*In re* Montgomery Ward Holding Corp.), 268 F.3d 205, 209–10 (3d. Cir. 2001); *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–8 (June 4, 2013) (describing how this "stub rent" problem means that landlords are, perhaps unfairly, losing money because of the timing of debtors' bankruptcy filings), *available at* Commission website, *supra* note 55.

482 *See In re* Stone Barn Manhattan LLC, 398 B.R. 359, 362–65 (Bankr. S.D.N.Y. 2008) (using the accrual method but providing historical overview and case cites of the accrual versus billing date approach).

483 *Compare In re* Oreck Corp., 506 B.R. 500 (Bankr. M.D. Tenn. 2014) (holding that debtor's obligation to pay occurred prepetition was not subject to priority treatment) *with In re* Leather Factory Inc., 475 B.R. 710 (Bankr. C.D. Cal. 2012) (holding that "stub rent" owed to landlord was a priority administrative claim).

484 11 U.S.C. § 502(b)(6); Michael St. Patrick Baxter, *The Application of § 502(b)(6) to Nontermination Lease Damages: To Cap or Not to Cap?*, 83 Am. Bankr. L. J. 111 (2009).

485 *See, e.g., In re* Heller Ehrman LLP, 2011 WL 635224 (N.D. Cal. Feb. 11, 2011) (discussing challenges in determining remaining term of lease); *In re* Titus & McConomy, LLP, 375 B.R. 165 (Bankr. W.D. Pa. 2007) (holding that, because one year's rent was greater than 15 percent of remaining term of lease following petition date, section 502(b)(6)(A) determined amount of cap was equal one year's rent).

486 Baxter, *supra* note 484, at 113–14.

Real Property Leases: Recommendations and Findings

The Commission reviewed several issues relating to nonresidential real property leases. Several Commissioners voiced strong concerns regarding the shortened deadline for a debtor in possession to assume or reject nonresidential real property leases under section 365(d)(4). The Commissioners suggested that the current deadline is preventing potential debtors from using chapter 11, at least on a voluntary and timely basis, and is making it more difficult for retail chains to reorganize their businesses.[487] The Commissioners also noted that the 210-day deadline is misleading because postpetition lenders have been requiring debtors in possession to make their decisions about nonresidential real property leases as early as 120 to 150 days after the petition date to permit these lenders to preserve their security interests in the debtors' leaseholds before the expiration of the section 365(d)(4) deadline.[488]

Other Commissioners, while acknowledging these troubling facts, emphasized the need to balance the concerns raised by landlords before the BAPCPA Amendments when courts were granting very lengthy extensions.[489] They encouraged the Commission to find a compromise that would provide more flexibility to debtors in possession to secure financing and to review their unexpired leases within a reasonable time frame without eliminating the certainty that section 365(d)(3) currently

487 *See, e.g.,* Sharon Bonelli, Isabel Hu, Gregory Fodell, *U.S. Retail Case Studies in Bankruptcy Enterprise Value and Creditor Recoveries*, Fitch Ratings, Apr. 16, 2013; *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) ("The deadline established under BAPCPA for a debtor to assume or reject unexpired leases of nonresidential property has had a substantial and unfortunate affect on retailers' ability to meet liquidity needs and obtain extended postpetition financing — the lynchpin to any successful retail reorganization."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (noting that the maximum time limit to assume or reject nonresidential real property leases should be amended, as it takes time to thoroughly assess whether a lease should be maintained for the value of reorganization efforts), *available at* Commission website, *supra* note 55; *Oral Testimony of Grant Stein: AIRA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 7, 2013) (AIRA Transcript) (noting that the court should allow more time for the assumption or rejection if it is appropriate in the circumstances), *available at* Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 8–9 (Nov. 15, 2012) ("Debtors and their secured and unsecured creditors must make decisions about whether to retain leases in a period of time that is often unrealistically short. As a result, businesses that might have been reorganized or sold as going concerns to new owners are liquidated instead. Because they know that debtors with significant leases will have difficulty reorganizing, lenders are less willing to support reorganizations with DIP financing. They do not want to begin lending money to a chapter 11 debtor only to have to choose, 7 months later, between agreeing to an unfavorable deal with a landlord that has such significant leverage and liquidating the debtor, possibly at a loss to the lender. So they simply refuse to provide DIP financing in the first place, forcing debtors to liquidate before they have had an opportunity to make operational changes, regardless of the potential for reorganization. In addition, going concern asset sales (a frequent form of 'reorganization' without a plan) become more difficult and less advantageous to creditors and owners because buyers have insufficient time to assess the value of an enterprise with important leases. Uncertainty about value always results in lower prices and therefore lower payments to creditors. Worse, such uncertainty can render going concern sales so difficult that they are not even pursued, again resulting in otherwise avoidable liquidations."), *available at* Commission website, *supra* note 55.

488 *See Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (stating that the deadline should be expanded to allow time for a debtor to secure postpetition financing and conduct a going-out-of-business sale and stating that prepetition lenders often demand provisions that result in a liquidation sale before the expiration of the 210-day period), *available at* Commission website, *supra* note 55. *But see Written Statement of David L. Pollack, Partner, Ballard Spahr LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (June 4, 2013) (stating that neither section 365(d)(4) time limits nor commercial landlords are causing retailers to fail and providing specific case examples to support assertion; also noting that retailers are failing because of other reasons, such as DIP financing conditions and reluctance of trade creditors to continue to extend credit), *available at* Commission website, *supra* note 55. *See also* Ayotte, A*n Empirical Investigation of Leases and Executory Contracts*, *supra* note 480 (finding that the seven-month limit to assume or reject a commercial lease instituted by BAPCPA (absent an extension from the landlord) "accelerated real estate lease disposition decisions"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

489 *See, e.g., Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) ("The 2005 amendments that created more certainty for shopping center owners now provide an important 'firewall' which prevents the failure of one retailer from cascading to other businesses. Under the prior law, lingering uncertainty caused neighboring stores to suffer from reduced traffic and sales while potential new tenants were reluctant to rent space in a shopping center with an uncertain future. For property owners, the contraction in credit has been even more problematic; a bankrupt tenant can cause a shopping center to default on a mortgage with no ability to cure the default. Such defaults include covenants to maintain minimum occupancy and debt service coverage."), *available at* Commission website, *supra* note 55.

provides to landlords.[490] After considering and debating different approaches that ranged from reversion to the pre-BAPCPA standard to maintenance of the *status quo*, the Commission voted to provide the debtor in possession one year from the petition date to make its assumption, assignment, or rejection decision with respect to nonresidential real property leases.

The Commission also discussed the split in the courts regarding the method — *i.e.*, the billing approach or the accrual approach — that should be used to determine whether certain rent owed under the lease should be deemed a prepetition or a postpetition obligation. The Commission reviewed case law citing both approaches to determine which approach should be adopted and codified, and focused its efforts on creating, first and foremost, a uniform standard. Ultimately, the Commission decided that the accrual method, which allocates rent between the prepetition and postpetition periods based on the date of filing, was a fair method and most closely aligned with the purpose of section 365(d)(3).

The Commission further considered the scope of a debtor in possession's obligations under section 365(d)(3). Some of the Commissioners commented on the ambiguity in the case law regarding which obligations were captured by section 365(d)(3) and how those obligations, if deferred or unpaid, should be treated. With respect to which obligations should be deemed "rent," the Commission reviewed the language of section 365(d)(3), which references section 365(b)(2), but not historical nonmonetary obligations in section 365(b)(1). The Commissioners debated whether this omission in the statute suggests that a debtor in possession should be required to perform all nonmonetary obligations on and after the petition date as provided in section 365(d)(3). Several Commissioners, however, highlighted that such a reading of section 365(d)(3) may be inconsistent with the Commission's recommended policies and approaches. Specifically, these Commissioners asserted that a debtor in possession (i) should not be required to perform under any executory contracts or unexpired leases, except to pay for postpetition goods and services (including rent), pending assumption or rejection; and (ii) should not be required to cure nonmonetary defaults that occurred prior to assumption. In light of these recommendations and the Commission's proposal for a relatively modest extension of the section 365(d)(4) deadline, the Commission decided to recommend limiting section 365(d)(3) to monetary obligations under the leases and to provide ordinary administrative priority (not superpriority) to any such unpaid or deferred obligations under section 365(d)(3).

In addition, the Commissioners evaluated the inconsistent application of section 502(b)(6) to calculate the maximum amount of a landlord's rejection damages. The Commission agreed with courts that have held that whether a given obligation is labeled as "rent" under a lease should not determine whether such obligation is subject to the section 502(b)(6) cap. The Commissioners identified obligations that have been commonly considered as "rent" (*e.g.*, monthly payments for occupying the property (including base rent, additional rent, percentage rent), common area

490 *Id.* at 2 (June 4, 2013) (stating that the time limits for debtors to assume or reject a nonresidential lease introduced by BAPCPA have "provid[ed] shopping center owners with reasonable certainty as to the disposition of leases, have prevented deterioration in shopping center properties and helped owners have access to credit to finance construction and renovation"), *available at* Commission website, *supra* note 55; *Oral Testimony of the Honorable Melanie Cyganowski (Ret.), former U.S. Chief Bankruptcy Judge, E.D.N.Y.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Nov. 15, 2012) (CFA Transcript) (stating that it would be beneficial to the court and will encourage more secured lenders to support middle-market borrowers if the BAPCPA Amendments relating to lease and plan deadlines were repealed, or at a minimum amended to provide judicial discretion to be exercised to modify the deadlines as appropriate), *available at* Commission website, *supra* note 55.

maintenance charges, taxes, and insurance) and determined that the definition of "rent" suggested by the advisory committee — "any recurring monetary obligations of the debtor under the lease" — adequately captured these obligations. The Commissioners also analyzed the varying interpretations and applications of the formula for calculating the cap on rejection damages under section 502(b)(6). The Commission agreed that many courts have confused or misapplied the formula and that, simply stated, the cap should be the rent reserved under the lease for the greater of (i) one year and (ii) the shorter of 15 percent of the remaining term and three years, plus unpaid rents. Accordingly, the Commission voted to recommend clarifying the calculation formula.

Finally, the Commission considered the treatment of nontermination damages that a landlord may assert against the estate. These claims typically arise out of the debtor's use or occupancy of the property and are not related to the debtor's rejection of the lease. Notably, section 502(b)(6) applies to, and limits, "the claim of a lessor for damages resulting from the termination of a lease of real property." Accordingly, the Commission agreed that a landlord should be able to file a prepetition claim against the estate, to the extent that the landlord can establish a legal basis and adequate factual support for such claim, for damages not resulting from the rejection of the lease. Such claim would be subject to the claims objection and allowance process under the Bankruptcy Code.

B. Use, Sale, or Lease of Property of the Estate

Section 363 of the Bankruptcy Code addresses the debtor in possession's use, sale, or lease of property during the chapter 11 case. Section 363(c) permits the debtor in possession to engage in certain of these transactions in the ordinary course of business without court approval.[491] If the debtor in possession wants to use, sell, or lease property outside the ordinary course of business, section 363(b) requires, among other things, notice and a hearing, and prior court approval.[492] Section 363(f), in turn, allows the debtor in possession to sell property free and clear of any interest in such property under certain circumstances.[493]

1. General Provisions for Non-Ordinary Course Transactions

Recommended Principles:

- Except in the context of a sale of all or substantially all of a debtor's assets (*i.e.*, a section 363x sale), the court should approve the use, sale, or lease of a debtor's assets outside the ordinary course of business only if the court finds by a preponderance of the evidence that the trustee exercised reasonable business judgment in connection with the proposed transaction. This approach often is

491 11 U.S.C. § 363(c)(1). Nevertheless, if a debtor is selling, leasing, or using assets that constitute "cash collateral," then the debtor must obtain the secured creditor's consent or court approval. *Id.* § 363(c)(2).
492 *Id.* § 363(b).
493 *Id.* § 363(f).

referred to as an "enhanced" or "intermediate" level of review that considers not only the process adopted by the board of directors (or similar governing body) to approve the transaction but also the reasonableness of the decision itself.

- Only the trustee should be able to propose the use, sale, or lease of a debtor's assets outside the ordinary course of business. Accordingly, no change to existing law is suggested on this point.
- A secured creditor's collateral should not be subject to a mandatory surcharge in favor of the estate but the court should retain the authority to make appropriate allocations of value to the estate as may be warranted under the circumstances pursuant to sections 506(c) and 552(b) of the Bankruptcy Code, as clarified by the related principles. *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.
- For the standard of review governing section 363x sales, see Section VI.B, *Approval of Section 363x Sales*.

General Provisions for Non-Ordinary Course Transactions: Background

In general, section 363(b) of the Bankruptcy Code provides that the debtor in possession,[494] "after notice and a hearing, may use, sell, or lease, outside the ordinary course of business, property of the estate."[495] The debtor in possession can use, sell, or lease a single asset, multiple assets, a division, or more. A sale of all or substantially all of the debtor's assets is addressed separately in these principles and is subject to a different standard of review and additional procedures.[496]

Under section 363(b), a debtor in possession generally must provide at least 21 days' notice of a motion to approve a proposed use, sale, or lease of property.[497] In general, any party in interest may object to the motion. At the hearing, the debtor in possession bears the burden of proof on the motion and generally must satisfy that burden by a preponderance of the evidence.[498] Courts generally evaluate section 363(b) motions under a business judgment standard. More precisely, courts often state they will approve the motion only if it represents an exercise of the debtor in possession's sound business judgment.[499] But, courts are not always clear or consistent in explaining the factors they consider under this business judgment standard.

494 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

495 *Id.* § 363(b).

496 *See* Section VI.B, *Approval of Section 363x Sales*.

497 Fed. R. Bankr. P. 2002.

498 *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983) ("[A] debtor applying under § 363(b) carries the burden of demonstrating that a use, sale or lease out of the ordinary course of business will aid the debtor's reorganization . . . ."); *In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("[T]he proponent of the sale bears the ultimate burden of persuasion . . . ."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) ("[Debtor] clearly bears the burden of demonstrating that a sale of property out of the ordinary course of business under § 363(b) of the [Bankruptcy] Code will aid [debtor's] reorganization and is supported by a good business justification.").

499 *In re* On-Site Sourcing, Inc., 412 B.R. 817, 822 (Bankr. E.D. Va. 2009) ("'A § 363(b) sale is generally viewed as quicker. Only a motion and a hearing are required, and most courts apply a 'business judgment test' to determine whether to approve the sale.'") (quoting *In re* Gulf Coast Oil Corp., 404 B.R. 407, 415 (Bankr. S.D. Tex. 2009)).

General Provisions for Non-Ordinary Course Transactions: Recommendations and Findings

The Commissioners engaged in a detailed review of the various kinds of non-ordinary course transactions pursued by debtors in possession under section 363(b). Debtors in possession have used this provision to enter into long-term equipment lease arrangements or new real property leases that require a substantial outlay of resources; to hire a service provider who is not a professional under section 327; and even to compromise and settle a cause of action.[500] The most common use of section 363(b), however, is to sell the debtor's assets. In each of these instances, the estate is potentially losing something — *i.e.*, cash in the lease, hiring, and settlement scenarios, and assets in the sale context. The Commissioners thus emphasized the important roles of process and review in the approval of these transactions.

The Commissioners examined the various standards of review applicable to similar transactions under state law. In many cases, directors' decisions are protected under state law by the business judgment rule, which presumes that "'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'"[501] Courts have articulated slightly different standards for reviewing proposed transactions under either the business judgment rule or some enhanced form of scrutiny. These variations typically depend on the kind of transaction at issue and the parties involved in the transaction.

For example, some courts undertake a very deferential review of a company's business judgment, focusing largely on the process followed by the board of directors to evaluate and approve the proposed transaction; these courts then defer to the company's articulated business justifications.[502] This type of deferential judicial review often is explained by the notion that business decisions are better made in the boardroom than the courtroom.[503] Other courts scrutinize proposed transactions more closely, reviewing not only the process implemented by the company, but also the reasonableness of the board of directors' business judgment under the circumstances of the case.[504] This latter review often is referred to as an "enhanced" or "intermediate" business judgment standard. In certain

500 *In re* Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (holding that debtor had "sound business reasons for making the sale"); *In re* Cont'l Air Lines, Inc., 780 F.2d 1223, 1226 (5th Cir. 1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 680 (Bankr. S.D.N.Y. 1989) (finding that debtor "articulated sound business reasons for, and is appropriately exercising business judgment with respect to, its decision to sell [certain assets]"); *In re* Baldwin United Corp., 43 B.R. 888, 897 (Bankr. S.D. Ohio 1984) (finding that debtors "met their burden of demonstrating that the disposition will aid their reorganization, and is supported by sound business reasons").

501 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

502 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 n.17 (Del. 1994); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

503 *See, e.g.,* Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) (holding that the Court of Chancery correctly deferred to the business decision of the board because "[t]o rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation. Such a rule would run counter to the foundation of our jurisprudence"). *See also* King v. Terwilliger, 2013 WL 708495, at *7 (S.D. Tex. Feb. 26, 2013) (finding that compensation issues are business questions "far better suited to the boardroom than the courtroom"); *In re* Curlew Valley Assocs., 14 B.R. 506, 511 (Bankr. D. Utah 1981) ("[D]isagreements over business policy are not amenable to judicial resolution. The courtroom is not a boardroom. The judge is not a business consultant. While a court may pass upon the legal effect of a business decision, (for example, whether it violates the antitrust laws), this involves a process and the application of criteria fundamentally different from those which produce the decision in the first instance. In short, the decision calls for business not legal judgment.").

504 *In re* Netsmart Techs., Inc. Stockholders Litig., 924 A.2d 171, 192 (Del. Ch. 2007). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("[C]ourt applying [the *Revlon* standard] should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.").

limited circumstances, courts apply heightened scrutiny under which the court exercises its own business judgment and determines if the decision is in the best interests of the company.[505] Finally, if the proposed transaction involves potential self-dealing, conflicts of interests, or insiders, the court may require the company to establish the entire fairness of the transaction.[506]

After much deliberation, the Commission determined that an enhanced business judgment standard was appropriate for evaluating general asset sales and other transactions under section 363(b). The court should approve the sale if it represents a reasonable process and a reasonable exercise of the debtor in possession's business judgment. Moreover, the Commission agreed that only the debtor in possession should be permitted to request the use, sale, or lease of property of the estate, which currently is the structure of section 363.

The Commissioners discussed situations in which the debtor in possession sells assets, and unsecured creditors seek recoveries from that sale, despite the fact that such assets are fully encumbered by a secured creditor's lien. The Commissioners recognized that this situation has occurred more frequently in the most recent economic cycle. Debtors have filed chapter 11 cases with substantially all of their assets fully encumbered by prepetition liens, leaving little value for the debtors' other creditors, at least at the outset of the case. The Commissioners noted that, in some cases, secured lenders will agree to set aside certain amounts for administrative or unsecured claims. The Commissioners, however, did not believe that such surcharges should be mandatory in every section 363 transaction. Rather, parties should remain free to negotiate these types of set-asides based on the facts of any given case. In addition, the Commission reviewed the recommended principles relating to sections 506(c)[507] and 552(b),[508] and found that those sections, together with the new procedures proposed for section 363x sales,[509] sufficiently addressed the underlying concerns.

505 *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (indicating that judicial business judgment may be warranted in derivative litigation involving a special litigation committee in which demand was excused under applicable state law). *See also, e.g., In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("Where an objection is made, the standard to be applied by the court in approving a disposition of assets is variously stated, but the general thrust is that the proposed sale should be in the best interests of the estate."); *In re* Am. Dev. Corp., 95 B.R. 735, 739 (Bankr. C.D. Cal. 1989) ("The proposed transaction is certainly not in the ordinary course of business and requires [the court's] approval. Debtor has the burden of proof to persuade [the court] that the proposed transaction is appropriate in light of its reorganization effort and should be approved."). Also, some courts have been less deferential with respect to break-up fees. *See, e.g., In re* Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ("This court agrees with the position taken in *S.N.A.*, *America West*, and *Hupp*. A sale pursuant to § 363 of the Bankruptcy Code is outside the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered. Therefore, 'the proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.'") (citations omitted); *In re* Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) ("[T]he Court must take into consideration what is in the best interests of the estate. As stated, the standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders, alike.'") (citing *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983)). *But see* Official Comm. of Subordinated Bondholders v. Integrated Res. (*In re* Integrated Res., Inc.), 147 B.R. 650 (S.D.N.Y. 1992), *appeal dismissed by* 3 F.3d 49 (2d Cir. 1993) (finding that the business judgment rule applied in nonbankruptcy contexts and thus relied upon that standard in the bankruptcy context as well to determine whether the proposed breakup fee at issue was appropriate).

506 Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders").

507 *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*.

508 *See* Section VI.C.4, *Section 552(b) and Equities in the Case*.

509 *See* Section VI.B, *Approval of Section 363x Sales*.

2. Finality of Orders

Recommended Principles:

- The court should not be permitted to reconsider a non-ordinary course transaction after the entry of an order approving the transaction or to reopen an auction unless the court finds extraordinary circumstances or material procedural impediments (such as the lack of adequate notice or an improperly conducted sale process) to the auction process that may have had a material effect on the sale results. For purposes of this principle, the potential that a new or continued auction would generate a higher value for the transaction alone does not constitute extraordinary circumstances.

Finality of Orders: Background

In the section 363 sale context, a debtor in possession[510] seeks to obtain the highest and best price for the assets. As explained above, a debtor in possession typically conducts an auction process to facilitate this result.[511] The auction procedures are reviewed and approved by the court and may include a marketing and diligence period and rules governing the auction itself.[512] The auction procedures also may contemplate certain bid protections for any stalking horse bidder.[513] After the auction, the debtor in possession presents the winning bid at the auction to the court for approval under the motion to approve the sale. After the court enters the sale order, parties generally have 14 days to appeal the order or it becomes final.[514] Generally, courts are not permitted to reopen an auction or sale.[515]

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510 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model.*

511 *See* Section IV.C.2, *Timing of Section 363x Sales.*

512 One court concluded that "it was necessary to have in place bidding procedures that would provide a reasonable opportunity for the APA to be tested against the market." *In re* Tex. Rangers Baseball Partners, 431 B.R. 706, 711 (Bankr. N.D. Tex. 2010). *See also In re* Innkeepers USA Trust, 448 B.R. 131, 148 (Bankr. S.D.N.Y. 2011) (explaining that bid procedures provide "the market and the Debtors the certainty and the 'rules' that they need to complete the auction process and move on to plan confirmation").

513 A leading bankruptcy treatise explains the rationale for deciding such bid protections in advance of the auction:

> Frequently, the issue of whether the court should approve buyer protections arises upon a motion to approve bidding procedures. The court is asked to approve, before the fact, procedures the propriety of which may be better determined after the "auction" of the property. For example, the reasonableness of a breakup or topping fee may be more difficult to evaluate in a vacuum before the sale. Whether a particular procedure chilled bidding may not be determinable until after the trustee offers the successful bid to the court for approval. However, the fees are to compensate the bidders for facilitating the auction, for example, by guaranteeing a floor on the bidding. If the court were not to approve the fee until after the auction, the leading bidder would not have the assurance necessary to commit to support the auction. Therefore, authorizing the fee only after the auction would defeat its purpose, and the court should address the issues upon a motion to approve the bid procedures."

3 *Collier on Bankruptcy* ¶ 363.02[7].

514 Bankruptcy Rule 6004(h) provides that "[a]n order authorizing the use, sale, or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise." Fed. R. Bankr. P. 6004(h).

515 *See* Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010). *See also In re* Gil-Bern Indus., Inc., 526 F.2d 627, 628, 629 (1st Cir. 1975) ("[I]t is an abuse of discretion for a bankruptcy court to refuse to confirm an adequate bid received in a fairly conducted sale merely because a slightly higher offer has been received after the bidding has closed."); *In re* Bigler, LP, 443 B.R. 101, 112 (Bankr. S.D. Tex. 2010) ("To reopen the bidding process to allow [a losing bidder] to make its late bid would be an abuse of this Court's discretion. Accordingly, this Court will not reopen bidding.").

Several issues can arise during the course of the sale process, including modifications to the auction procedures without notice to or approval by the court, bidders wanting to submit noncompliant bids, and even late bidders who cause the debtor in possession, the unsecured creditors' committee, or other party in interest to question whether the bid selected at the auction really is the best and highest offer for the debtor's assets. In this context, courts have granted motions to reopen an auction if it would likely result in a better offer.[516] Accordingly, courts face challenging issues and competing interests when confronted with requests to reopen the auction process or to reconsider the order approving the sale under section 363 of the Bankruptcy Code.

Finality of Orders: Recommendations and Findings

The closing of an auction and the entry of a sale order are key steps in the sale of the debtor's assets. They allow the debtor in possession to close the sale and move forward in the case and the successful bidder to take possession of the assets. The Commissioners discussed the importance of the value generated by section 363 sales to the estate, and the common desire to want to ensure that the sale process is extracting as much value as possible from the assets. The Commission reviewed examples in which this desire caused the debtor in possession, the unsecured creditors' committee, or a party in interest to second-guess the auction results or the sale order and to seek related relief from the court.

For example, in the *WestPoint Stevens*[517] chapter 11 case, the debtor in possession obtained approval of the court to conduct an auction for substantially all of the debtor's assets.[518] One of the debtor's secured creditors, Aretex LLC, along with its affiliates, emerged as the winning bidder at the auction.[519] The court approved the sale and entered a sale order permitting the consummation of the sale to Aretex for the highest and best bid.[520] But, before the sale closed, certain other lenders moved for a stay of the sale order pending appeal of certain provisions in the sale order related to lien releases, claim satisfaction, and distributions.[521] On appeal, however, the Second Circuit rejected the appeal as statutorily moot under section 363(m).[522]

The Commission also reviewed a contrary example found in the *Foamex* chapter 11 case. In that case, the debtors had selected an all-cash bid that was $5 million lower than the all-cash bid of the stalking horse because the stalking horse had conditioned its bid on the inclusion of a credit bid if the auction continued past the then-present round. The bankruptcy reopened the auction and directed the debtors in possession to accept the stalking horse bid (which included the credit bid), even though the debtors in possession had complied with the court-approved bid procedures in

516 *In re* Foamex Int'l, Inc., No. 09-10560 (KJC) (Bankr. D. Del. May 27, 2009). *See also* Lithograph Legends, LLC v. U.S. Trustee, 2009 WL 1209469, at *3 (D. Minn. Apr. 30, 2009) ("A bankruptcy court may disapprove a proposed sale recommended by a debtor-in-possession 'if it has an awareness there is another proposal in hand which, from the estate's point of view, is better or more acceptable.'") (quoting G-K Dev. Co v. Broadmoor Place Invs., L.P. (*In re* Broadmoor Place Invs., L.P.), 994 F.2d 744, 746 (10th Cir. 1993)).

517 Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

518 *Id.* at 35.

519 *Id.* at 36.

520 Contrarian Funds LLC v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 242 (2d Cir. 2010) (noting that bankruptcy court entered order confirming that "the winning bid presented 'the highest and best bid at the Auction'") (citations omitted).

521 Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30, 37 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

522 Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 247 (2d Cir. 2010).

accepting the previous bid. The court thereafter overruled the objection by the previous winning bidder to the sale.

The Commissioners acknowledged that, in some cases, reopening the auction or reconsidering the sale order may generate additional value for the estate. They also raised concerns, however, that endorsing this type of relief may prevent robust auctions in the first instance because prospective bidders need to understand the rules of the auction and to know that, if they participate according to the rules and win, they will be able to close the sale. This type of certainty and respect for the auction rules and sale order can enhance the auction itself and prevent gamesmanship by prospective bidders.

The Commissioners also noted that courts currently have the ability to reconsider their orders under Rule 60(b) of the Federal Rules of Civil Procedure, which provides that the court may relieve a party from a final order if presented with "newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial" and due to "fraud . . . misrepresentation, or other misconduct of an adverse party." The Commissioners reviewed cases in which courts have reconsidered (or refused to reconsider) sale orders.[523] They acknowledged that a motion to reconsider a section 363 sale order can be clouded by the prospect of more value for the estate. Nevertheless, the Commissioners believed that more value alone as ground for reopening an auction or setting aside a sale order was too low of a barrier, did not comply with Rule 60(b), and would introduce too much uncertainty into the sale process.

Consequently, the Commission voted to recommend codifying the standards governing requests to reopen an auction or to reconsider and set aside a sale order. Specifically, it determined that such relief should be warranted only in instances when the evidence presented at the hearing demonstrates procedural impediments in the auction or sale process or extraordinary circumstances.

3. Transactions Free and Clear of Interests

Recommended Principles:

- In general, the trustee should be able to sell a debtor's assets free and clear of all interests in a debtor's assets, including liens and encumbrances, to the extent permitted by the U.S. Constitution and the guidelines set forth in these principles. In addition, the trustee should be able to sell a debtor's assets free and clear of all claims related to a debtor's assets in the context of a sale of all or substantially all of a debtor's assets under section 363x (or a transaction involving less than substantially all of the debtor's assets if the court determines that the trustee has otherwise complied with the requirements of section 363x).
- A trustee should be able to sell assets free and clear of interests if applicable nonbankruptcy law would permit the owner of such assets to sell them free and clear of such interests. The foreclosure rights of a creditor or other third party

523 For examples of courts considering the finality issue and refusing to reopen auction, see *In re* Bigler, LP, 443 B.R. 101 (Bankr. S.D. Tex. 2010); *In re* Extended Stay Inc., No. 09-13764 (JMP) (Bankr. S.D.N.Y. June 17, 2010) [Docket No. 1102] (transcript of record); *In re* Finlay Enters., Inc., No. 09-14873 (Bankr. S.D.N.Y. Nov. 12, 2009) [Docket No. 378] (transcript of record). *But see* Corporated Assets, Inc. v. Paloian, 368 F.3d 761 (7th Cir. 2004) (auction reopened due to improper procedures).

should not be determinative in this context. Bankruptcy Code section 363(f)(1) and (5) should be amended accordingly.

- A trustee should be able to sell assets free and clear of interests without the consent of any lienholder and regardless of whether the assets generate value in excess of the aggregate value of the liens in the assets, provided that the liens attach to the proceeds of the sale or the lienholder receives another appropriate form of adequate protection of the lien. Section 363(f)(3) should be amended accordingly.
- In the context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles.
- The court should not approve a sale of a debtor's assets free and clear of the following kinds of interests: (i) easements, covenants, use restrictions, usufructs, or equitable servitudes that are deemed to "run with the land" under applicable nonbankruptcy law; (ii) environmental obligations that are deemed to "run with the land" under applicable nonbankruptcy law; (iii) successorship liability for purposes of federal labor law; and (iv) partial, competing, or disputed ownership interests, except to the extent specified in section 363(h) or (i).
- The sale of a debtor's assets free and clear of executory contracts and unexpired leases should be governed by section 365 or, for collective bargaining agreements, section 1113. Accordingly, the trustee should be permitted to sell the debtor's assets free and clear of executory contracts and unexpired leases only to the extent such contracts and leases are rejected in accordance with section 365 or section 1113, as applicable, and the trustee is permitted by section 365 to recover the property free and clear of the nondebtor counterparty's rights to use or possess such property.
- The court's approval of a sale free and clear of interests or claims under section 363(f) should continue to be considered part of the court's approval of the overall transaction under section 363(b) or (c). Accordingly, no change to existing law is suggested on this point.
- To the extent permitted by these principles for other claims, the trustee should be able to sell a debtor's assets free and clear of any monetary claims by the federal government or a state government against the debtor or the estate, provided that such monetary claims constitute "claims" under section 101(5) under current law. The trustee should not be able to sell a debtor's assets free and clear of any enforcement rights of such government to the extent that such rights are within such government's police or regulatory powers and could be enforced against the debtor or the estate under section 362(b)(4), or to the extent that the state or federal government incurs costs post-sale in the exercise of its police or regulatory powers.

Transactions Free and Clear of Interests: Background

In many chapter 11 cases, some or all of the debtor's property is encumbered or subject to the liens, interests, and claims of various stakeholders. The holders of these liens, interests, and claims may have rights under nonbankruptcy law or prepetition agreements that make the transfer of the debtor's assets difficult or less attractive to prospective lessees and purchasers. These liens, interests, and claims may include mortgages, security interests, easements, or successor liability claims.

Under section 363(f), a debtor in possession[524] may sell its assets under section 363(b) or (c) "free and clear of any interest in such property of an entity other than the estate" only if: (1) "applicable nonbankruptcy law permits sale of such property free and clear of such interest"; (2) "such entity consents"; (3) "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property"; (4) "such interest is in *bona fide* dispute"; or (5) "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[525] Section 363(f) is limited to "any interest in such property." Notably, this language is different from that used in section 1141(c), which speaks to "property dealt with by the plan [being] free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."[526]

The legislative history of section 363(f) provides little guidance on the scope of the term "interest," other than to acknowledge that a lien should be considered an interest in property.[527] Courts interpreting this section have taken two general approaches: the first construes section 363(f) narrowly and limits its application to liens, security interests, mortgages, and money judgments;[528] and the second takes a more expansive view of interests and captures claims against the debtor or estate property, including successor liability claims, discrimination claims, personal injury claims, and other "claims" within the meaning of section 101(5) of the Bankruptcy Code.[529] Some courts and commentators argue that the expansive approach is necessary to facilitate sales under section 363(f) and to achieve the underlying policy objectives of the Bankruptcy Code.[530]

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524 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

525 11 U.S.C. § 363(f).

526 *Id.* § 1141(c).

527 The legislative history provides, in relevant part:

> At a sale free and clear of other interests, any holder of any interest in the property being sold will be permitted to bid. If that holder is the high bidder, he will be permitted to offset the value of his interest against the purchase price of the property. Thus, in the most common situation, a holder of a lien on property being sold may bid at the sale, and if successful, may offset the amount owed to him that is secured by the lien on the property (but may not offset other amounts owed to him) against the purchase price, and be liable to the trustee for the balance of the sale price, if any.

H.R. Rep. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6302; S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5842.

528 *See, e.g., In re* White Motor Credit Corp., 75 B.R. 944, 948 (Bankr. N.D. 1987); *In re* New England Fish Co., 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

529 *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 283, 289 (3d Cir. 2003) ("[T]he trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property'") (citing 3 Collier on Bankruptcy ¶ 363.06[1]); *In re* WBQ P'ship, 189 B.R. 97, 105, (Bankr. E.D. Va. 1995).

530 *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 282, 290 (3d Cir. 2003) (suggesting a trend toward an expansive view of section 363(f) to include claims); Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252 (3d Cir. 2000) (holding that pursuant to section 363(f), the debtors' contractual payment rights was free and clear of a contractor's previously unexercised setoff rights, but was not free and clear of the contractor's recoupment rights because by their very nature, recoupment rights simply cannot be considered an "interest" in property extinguished by a section 363(f) free-and-clear sale"); *In re* Tougher Indus., Inc., 2013 WL 1276501, at *6 (Bankr. N.D.N.Y. Mar. 27, 2013).

Courts also take different approaches to whether a debtor in possession has satisfied one of the grounds set forth in section 363(f) to support a sale free and clear of interests in the property.[531] For example, some courts require the sale price to exceed the face value of secured claims asserted against the property to satisfy section 363(f)(3).[532] Other courts require only that the sale price exceed the economic value of the creditors' allowed secured claims under section 506.[533] Courts also disagree as to what constitutes a *bona fide* dispute for purposes of section 363(f)(4).[534] They also have taken different approaches to whether the language in section 363(f)(5) providing that the "entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest" includes a cramdown of a chapter 11 plan under section 1129(b).[535]

Transactions Free and Clear of Interests: Recommendations and Findings

The Commissioners analyzed section 363(f) of the Bankruptcy Code and the concept of sales "free and clear" of liens, interests, and claims. They reviewed the original focus of that section on "interests" in estate assets, and they discussed the expansion of that concept to claims of various kinds. The Commissioners identified different kinds of claims that courts have included within section 363(f), including litigation claims, discrimination claims, and successor liability claims. The Commission agreed that this expansive approach to section 363(f) fostered more competition for the debtors' assets and likely enhanced the value of the assets sold through the section 363(f) sale process. The Commissioners questioned whether the historical nexus between "free and clear" sales under section 363(f) and *in rem* notions of property interests still served bankruptcy policy.

To analyze this question, the Commission considered the language and purpose of section 1141(c) of the Bankruptcy Code and the inclusion of claims in the discharge injunction in connection with a chapter 11 plan. The Commissioners suggested that this difference may relate to the more significant notice and due process provided to creditors in the plan process. Although creditors holding general unsecured claims (including the kinds of litigation and other claims mentioned above) do not have any particular interest in the debtor's property, they receive notice and an opportunity to object to the treatment of their claims under the plan. In the section 363 context, such creditors may or may not receive notice of the sale motion or an opportunity to object.

531 *See generally* George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 244 (2002).

532 *See, e.g.,* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008). *See also* Criimi Mae Servs., Ltd. P'ship v. WDH Howell, LLC (*In re* WDH Howell, LLC), 298 B.R. 527, 534 (D.N.J. 2003). *See also* Robert M. Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, Bankr. L. Letter, Oct. 2008, at 7 ("Although the result in *Clear Channel* will be controversial, its specific holding on section 363(f)(3) should not be. Its reasoning is compelling on the statutory language, and it reaches a result well within the mainstream of other court decisions. To sell free and clear under section 363(f)(3), the sales price must exceed the total value of all liens regardless of whether those are totally secured or undersecured.") (citations omitted).

533 *See, e.g.,* WBQ P'ship v. Va. Dep't of Med. Assistance Servs. (*In re* WBQ P'ship), 189 B.R. 97, 105–06 (Bankr. E.D. Va. 1995); *In re* Beker Indus. Corp., 63 B.R. 474, 475–76 (Bankr. S.D.N.Y. 1986).

534 *See, e.g.,* Union Planters Bank v. Burns (*In re* Gaylord Grain LLC), 306 B.R. 624 (B.A.P. 8th Cir. 2004).

535 *See, e.g.,* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008). *See also* Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, *supra* note 532, at 8 ("Instead of the Chapter 11 cramdown, a state foreclosure proceeding would seem to be a proceeding where the second lienholder could be compelled to accept a monetary satisfaction of its lien and thus satisfy the requirements of (f)(5). Indeed, the word 'foreclosure' means exactly that — the foreclosure of junior interests. A hypothetical state foreclosure proceeding seems so obvious that one wonders why the BAP [in *Clear Channel*] did not simply take judicial notice of it to hold that (f)(5) was satisfied. Perhaps the court's concern was the lack of a solid record on how the foreclosure sale process would play out and specifically what value the property would bring at a foreclosure sale, although the bidding at the bankruptcy court would again seem to be an obvious place to look for the value of the property. The concern about the lack of a record perhaps can be seen in the BAP's references to 363 sales being used to bypass the more procedurally robust confirmation requirements of section 1129 that could protect third-party rights.") (citations omitted).

The Commissioners evaluated whether this difference in process should preclude an expansive reading of section 363(f) that would include liens, interests, and claims. With respect to single-asset sales or smaller transactions, the Commission agreed that the notice currently required by the Bankruptcy Rules was likely sufficient, as assets remained in the estate to potentially fund claims through a chapter 11 plan. In a sale of all or substantially all of a debtor's assets, however, the calculus may be different. On that point, the Commissioners noted that these principles recommend notice and due process procedures similar to what creditors are entitled to in the plan context. Accordingly, under the principles applicable to section 363x sales, creditors holding the kinds of claims subject to section 363(f) under the expansive view would receive notice and an opportunity to object to the proposed sale.

The Commissioners were also persuaded that permitting the debtor in possession to transfer clean title to a purchaser under section 363(f) held potentially significant value for the estate. To that end, the Commissioners analyzed the conflicting interpretations of certain subsections of section 363(f) and identified approaches that would foster a competitive sale process while still protecting creditors' rights against the estate. The Commission agreed that the scope of section 363(f)(1) and (5) should be clarified to focus on the property owner's rights under applicable nonbankruptcy law. The Commission also determined, however, that these ambiguities and perceived barriers to free and clear transfers in a chapter 11 case would likely be mitigated by its recommended change to section 363(f)(3). With the additional notice and process being recommended in the context of sales of all or substantially all of the debtor's assets, the Commission determined that adopting an expansive view of section 363(f) was warranted and adequately protected the interests of stakeholders.

The Commissioners further considered whether any particular liens, interests, or claims should be excluded from section 363(f) under this expansive approach. They methodically evaluated different kinds of claims and interests. They decided that the debtor in possession should be able to transfer property free and clear of all liens, interests, and claims, including without limitation: civil rights liabilities; successor liability in tort; and successor liability in contract. The Commissioners also concluded that the debtor in possession should *not* be able to transfer property free and clear of the following: easements, covenants, use restrictions, usufructs, or equitable servitudes that run with the land; environmental liabilities and related social policies that run with the land; successorship liability under federal labor laws; and partial, competing or disputed ownership interests, except to the extent specified in section 363(h) or (i). Moreover, the Commissioners recognized that a debtor in possession should not be able to sell or transfer assets under section 363(f) in a manner that violates or impedes the police or regulatory power of the federal government or a state government to the extent that such government could enforce those rights against the debtor in possession or estate property during the case, notwithstanding section 362(a) of the Bankruptcy Code. The Commission thus recommended that section 363(f) recognize the government's police and regulatory powers to the extent such powers would be enforceable under section 362(b)(4).

4. Credit Bidding

Recommended Principles:

- In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.

Credit Bidding: Background

A creditor with a perfected lien in the debtor's property has certain rights and remedies against the debtor and property within the creditor's collateral package. Among other things, the secured creditor can credit bid the amount of its allowed claim in any sale of its collateral. A secured creditor's right to credit bid exists under both state law and section 363(k) of the Bankruptcy Code. Section 363(k) provides: "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."[536]

A credit bid allows the secured creditor to purchase the property constituting its collateral if other bidders are not willing to pay sufficient value or the creditor prefers to possess the collateral in lieu of payment. The secured creditor also does not need to pay any cash for the property at the sale to the extent the allowed amount of its claim is sufficient to cover the price of its winning bid. Rather, the secured creditor can set off its secured claim against the debtor or the property against the purchase price it otherwise would be required to pay the estate.[537]

Although credit bidding is an integral part of the secured creditors' rights package, it is not without limit. Specifically, section 363(k) allows the court to limit a secured creditor's credit bid for cause.[538] Courts typically have found cause to limit a credit bid if the amount of the secured creditor's claim is disputed or unliquidated.[539] Courts also have found cause to limit a credit bid, however, based on the conduct of the secured creditor. For example, *In re Free Lance-Star Publishing Co.*, the court held that the secured creditor did not have the right to credit bid on assets that did not secure its allowed claim and found cause to limit the creditor's right to credit bid at the auction based on, among other things, the creditor's "overly zealous loan-to-own strategy," in which the creditor acquired the loan

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536 11 U.S.C. § 363(k).

537 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (providing historical overview and describing the evolution of credit bidding in bankruptcy), *available at* Commission website, *supra* note 55.

538 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.").

539 *See, e.g., In re* RML Dev., Inc., 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (valid claims objection that could not be resolved without delaying auction was cause to limit amount of credit bid).

for the sole purpose of obtaining the right to credit bid at an expedited sale of the debtor's assets and discouraged any competitive bidding.[540] Similarly, in *Fisker Automotive Holdings*, the court found cause to limit the secured creditor's ability to credit bid the entire amount of its secured claim because the amount was uncertain, and allowing the creditor to credit bid its entire claim would freeze out all competitive bidding by attractive and capable bidders.[541]

Credit Bidding: Recommendations and Findings

The Commission considered credit bidding under section 363(k) in light of recent case law developments and an arguably expanded application of the cause standard for limiting credit bids. The Commissioners discussed the fundamental role of credit bidding under state law and section 363(k).[542] They also acknowledged that all credit bidding chills an auction process to some extent. Accordingly, the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k).

The Commissioners noted that, in some cases, it may be difficult to discern any chilling effect caused by the credit bid itself from a chilling effect resulting from the conduct of the secured creditor seeking to exercise its right to credit bid. For example, the Commissioners discussed situations in which the secured creditor demands a relatively short period to market the property and conduct the sale, requires the marketing materials to highlight the secured creditor's right to credit bid, or takes other actions to discourage a competitive bidding process. The Commission agreed that such conduct could, in fact, depress the value of the property and preclude the estate from receiving any return from the sale.[543] The Commissioners, however, did not want to endorse a principle that would suggest that the chilling effect of a credit bid warrants restrictions on the right to credit bid.[544] The Commission ultimately agreed to maintain the current standard under section 363(k), with the recommendation that the chilling effect of a credit bid not be deemed sufficient cause to limit a credit bid, but that courts should attempt to mitigate any chilling effect through the auction and sale procedures approved in the case.

540 *In re* Free Lance-Star Publ'g Co. of Fredericksburg, Va., 512 B.R. 798 (Bankr. E.D. Va. 20141), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

541 *In re* Fisker Auto. Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014), *appeal denied*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

542 *See, e.g.,* Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 3 ("For secured creditors, operating on the assumption that in a free-and-clear sale of its collateral the sale price itself establishes the value of the collateral, credit bidding serves two protective functions — both as an undervaluation protection and a proceeds protection. Not only can the undersecured creditor bid in its claim to acquire the assets when it believes the otherwise prevailing sale price is too low, the undersecured creditor can also bid in its claim to acquire the assets when it believes that the proposed plan would not return to the undersecured creditor the full value of the proceeds generated by sale (*i.e.*, the value) of its collateral."); Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, Bankr. L. Letter, July 2012, at 8 ("[T]the legislative record indicates that the Code drafters also considered the credit bidding rights separately codified in § 363(k) to be an integral component of adequately protecting the secured creditor's lien rights."). "By holding that a dissenting secured creditor must be afforded credit-bidding rights under § 363(k) in any free-and-clear sale of its collateral under a plan of reorganization, RadLAX ensures that secured creditors have the same credit-bidding rights in plan sales that they have in § 363 sales." *Id.*

543 *See, e.g.,* Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 4 ("When the undersecured creditor's collateral is the entirety of the debtor's assets, therefore, credit-bidding rights in any going-concern sale of the debtor's business and assets give that senior secured creditor the leverage to always insist upon capturing all of the debtor's reorganization surplus, to the detriment of unsecured creditors and other junior classes.").

544 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) ("To the extent that the argument here is that cash bidders will be chilled because they fear that a secured creditor may outbid them, it lacks force. That would be equally true of any deep-pocketed bidder, and no auction can afford to exclude the bidders with the greatest resources on the ground that they might outbid everyone else."), *available at* Commission website, *supra* note 55.

C. Avoiding Powers

1. Preference Claims

Recommended Principles:

- The trustee's ability to pursue preference claims under section 547 of the Bankruptcy Code preserves value for the estate and tempers the "run on the debtor" that may occur immediately prior to a bankruptcy filing. The avoiding power in section 547 may, however, be subject to abuse in certain cases. The Commission analyzed a variety of potential reforms to section 547, including refining elements of, or shifting the burden of proof for, certain defenses under section 547(c). After much research and deliberation, the Commission determined that the potential abuses under section 547 are addressed most effectively through the changes in small preference actions, pleading requirements, and demand requirements described in these principles, and continued judicial oversight in accordance with the Bankruptcy Code.

- The trustee should be precluded from issuing a demand letter to, or filing a complaint against, any party for an alleged claim under section 547 unless, based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonably knowable affirmative defenses under section 547(c).

- The trustee must plead with particularity factual allegations in the complaint that establish a plausible claim for relief under section 547. In accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), legal conclusions or speculative allegations should not be sufficient to support a preference complaint.

- The dollar amount of the defense against preference claims provided in section 547(c)(9) should be increased to $25,000 in the aggregate. This dollar amount should continue to be increased based on the *Consumer Price Index for All Urban Consumers* under section 104(a).

- The small claims venue provision in 28 U.S.C. § 1409(b) should be amended to (i) clarify that the section applies to preference actions under section 547 and (ii) increase the dollar limit for debts (excluding consumer debts) against noninsiders to $50,000 in the aggregate. This dollar amount should continue to be increased based on the *Consumer Price Index for All Urban Consumers* under section 104(a).

Preference Claims: Background

The concept of preference law dates back to the 1584 English King's Bench decision, *The Case of Bankrupts* (finding postpetition transfers ineffective against a bankrupt's estate)[545] and the 1768 decision of *Alderson v Temple* (authorizing the recovery of property preferred to a particular creditor).[546] Since that time, the law has undergone numerous variations with regard to the underlying purpose of the transfer, the necessary intent of the parties, and the insolvent state of the debtor at the time of the transfer. In 1978, Congress revised the preference law to omit the requirement that the trustee[547] establish that the creditor had reasonable cause to believe the debtor was insolvent, in exchange for the reduction of the noninsider reachback period from 120 to 90 days and the addition of a 90-day presumption of insolvency.

The primary goals of preference law are (i) to equalize distribution and (ii) to maximize estate value.[548] It seeks to achieve these goals through property recapture and deterrence.[549] Under the Bankruptcy Code's original conception of preference law, the trustee could recover payments or property transferred to creditors prepetition to the extent those transfers preferred such creditors over other similarly situated creditors (typically general unsecured creditors).[550] The trustee would then distribute the recovered value to all similarly situated creditors. Even the creditors from which the trustee recovered preferences were, in many instances, entitled to receive a *pro rata* share of the recovered value.[551]

Since 1978, the application of preference law has changed. Some commentators question whether preference law continues to serve its original goals.[552] These commentators suggest that preference law is not an effective deterrent and does not necessarily equalize distributions. In fact, anecdotal evidence shows that, in many cases, the value of preference recoveries no longer is reallocated among general unsecured creditors. Rather, secured creditors are granted liens in preference claims and recoveries as part of adequate protection, cash collateral, or debtor in possession financing orders in the case.[553] Alternatively, the estate may not have sufficient resources to pay administrative and priority claims in the case, and the trustee applies preference recoveries to these claims.[554] Moreover,

545 7 Eng. Rep. 441 (K.B. 1584).

546 96 Eng. Rep. 384 (K.B. 1768).

547 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

548 John C. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 Va. L. Rev. 249, 261 (1981).

549 *Id.* at 262.

550 *See, e.g.,* G.H. Leidenheimer Baking Co., Ltd. v. Sharp *(In re* SGSM Acquisition Co., LLC), 439 F.3d 233, 238 (5th Cir. 2006) ("The theory is that when the preferential payments are returned, all creditors can share ratably in the debtors' assets, and the race to the courthouse, or the race to receive payment from a dwindling pre-bankruptcy estate, will be averted.").

551 For examples of statutory authority for such distributions, see Section 57g of the Bankruptcy Act and section 502(h) of the Bankruptcy Code.

552 *See, e.g.,* Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 Iowa L. Rev. 51 (2014).

553 Terry Brennan, *Miller: Liquidations Set to Rise*, The Deal, Dec. 2, 2003, *available at* 2003 WLNR 4666298; Kenneth N. Klee & Richard Levin, 21 Norton J. Bankr. L & Prac. 5, §§ 3.0, 3.6 (Nov. 2012); *see* Thomas D. Goldberg, *Curbing Abusive Preference Actions — Rethinking Claims on behalf of Administratively Insolvent Estates*, Am. Bankr. Inst. J., May 2004, at 14.Goldberg. *See also In re* Furr's Supermarkets, Inc., 373 B.R. 691, 697 (B.A.P. 10th Cir. 2007) (proceeds of avoidance actions split between secured lender and administrative claims); Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, 294 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (proceeds of avoidance actions used solely to pay claims of secured lenders); *In re* Payless Cashways, Inc., 290 B.R. 689, 696–97 (Bankr. W.D. Mo. 2003) (preference action recoveries solely to satisfy administrative claims).

554 Companies increasingly utilize easy to obtain prepetition financing, through mezzanine funding, leveraged lending, second lien debt, and securitization, such that potential debtors are now contemplating bankruptcy with extremely leveraged balance sheets. As a result, little, if any, unencumbered collateral is often available to offer prospective DIP lenders. *See* Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, J. Corp. Renewal, Sept/Oct. 2009, ¶¶ 11–12, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectId=11602. *See also* Goldberg, *supra* note 553, at 14.

trustees may pursue preference claims in situations in which a cost-benefit analysis indicates little value for the estate, but significant cost and burden for the targeted creditors.

Preference Claims: Recommendations and Findings

Preference law is one aspect of a chapter 11 case that affects creditors on an individual basis. Unlike other aspects of bankruptcy law that generally affect creditors' rights, preference law challenges transfers made to a particular creditor and may require that creditor to disgorge prepetition payments to the estate. The Commissioners acknowledged that from the unsecured creditor's perspective, preference law appears unfair and potentially increases the losses by that particular creditor as a result of the chapter 11 case, particularly if preference recoveries are not available to pay general unsecured claims.

The Commission reviewed the testimony from the various public hearings, which evidenced strong frustrations with preference law. Witnesses testified that some trustees pursued preference actions with little diligence and without regard to the merits of the underlying claim.[555] They suggested that, at least from an outside perspective, some trustees appear to file preference actions not necessarily to recover the alleged preference, but to extract a settlement payment.[556] The Commissioners discussed different options for addressing these concerns and enhancing the efficiency of the preference process,[557] as well as the potential abuses associated with each.[558]

Under section 547 of the Bankruptcy Code, the trustee currently bears the burden of proving the elements of a preference claim under section 547(b), and then the creditor bears the burden of proving one of the affirmative defenses contained in section 547(c). The Commission considered supplementing the elements of section 547(a) with an affirmative statement concerning diligence performed to evaluate the merits of the preference claim in light of any section 547(c) defenses available to the creditor. Alternatively, some of the Commissioners suggested a presumption in favor of the creditor that the prepetition transfer was in the ordinary course of business, which the trustee could rebut as part of its *prima facie* case.[559] Although the Commissioners found potential utility

555 *See Oral Testimony of Kathy Tomlin: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27–29 (May 21, 2013) (NACM Transcript) (noting how she spends tremendous time and resources successfully defending preference actions and arguing that trustees and debtors should have an obligation to evaluate preference claims and defenses before making a repayment demand), *available at* Commission website, *supra* note 55; *Oral Testimony of Joe McNamara: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 12 (May 21, 2013) (NACM Transcript) (providing specific example of time and costs associated with preference action in a particular case), *available at* Commission website, *supra* note 55.

556 *See Oral Testimony of Valerie Venable: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 34–37 (May 21, 2013) (NACM Transcript) ("The trustee knows [that preference defense] is going to get expensive to me to continue to defend and is counting on a monetary settlement just to get rid of them."), *available at* Commission website, *supra* note 55.

557 The Commissioners also discussed eliminating the preference statute in its entirety but that principle was rejected. The Commissioners agreed that any such elimination would only accelerate the prepetition depletion of a debtor's assets.

558 *In re* Ames Dep't Stores, Inc., 450 B.R. 24 (Bankr. S.D.N.Y. 2011), *aff'd*, 470 B.R. 280 (S.D.N.Y. 2012), *aff'd*, 506 Fed. App'x 70 (2d Cir. 2012), *cert. denied*, 134 S. Ct. 65 (2013).

559 *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 12 (Nov. 15, 2012) ("Since 1978, it has become common in cases of any size that post-confirmation liquidation trustees or post-conversion chapter 7 trustees assert claims against all creditors who received payments from the debtor within 90 days before the commencement of the case that those payments may be avoidable preferences. In some, but not all, such cases, the trustees at least perform new value analyses and claim only the net balance; in virtually no cases do the trustees assess the likelihood of an ordinary course defense. There are usually exchanges of letters and spreadsheets resulting in settlements for a fraction of the amount of the original claims. Often, the creditors settle for nuisance value just to avoid the costs of litigation. This practice imposes costs on creditors vastly disproportionate to the gain to estates, and is particularly difficult for factors who do not have direct access to the original vendors' records. Since factors are a major source of financing for small and medium sized firms, this burden should be of concern to everyone. Requiring the trustees to plead that challenged transfers were not in the ordinary course or subject to new value setoff would reduce the number and burden of weak claims without imposing undue burdens on the trustees. The same records that allow the trustees to identify the payments they question would also allow

in each option, they raised concerns regarding a trustee's ability to obtain information sufficient to make affirmative statements or rebut such a presumption as part of its *prima facie* case. Some of the Commissioners noted that, in many cases, the books and records of the debtor do not provide the information necessary to make these assessments at the outset, and that trustees typically perform due diligence and make good faith attempts to assess the merits of the potential preference action before filing the complaint against, or issuing a demand letter to, the creditor. These Commissioners acknowledged the concerns of the hearing witnesses, but believed those represented the exception rather than the rule concerning a trustee's pursuit of preference claims. The Commission reviewed the steps commonly taken by trustees in evaluating preference claims to try to develop a threshold standard that would not be unduly burdensome on trustees, but also would provide some protection to creditors in the process.

The Commission ultimately determined that codifying a standard that required the trustee to perform reasonable due diligence and to make good faith efforts to evaluate the merits of the preference claim was a reasonable compromise. It also agreed that the statute should require the trustee to plead with particularity in the complaint the facts supporting each element of the preference claim under section 547(b), in accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*,[560] which provide that legal conclusions or speculative allegations should not be sufficient to support a complaint. Finally, the Commission recommended increasing the monetary caps in section 547(c)(9) of the Bankruptcy Code and section 1409(b) of title 28 of the U.S. Code (the small claims venue provision) to $25,000 and $50,000, respectively (indexed in accordance with section 104(a) of the Bankruptcy Code). The Commission voted to recommend these three changes. The Commissioners firmly believed that these changes collectively would mitigate many of the perceived or actual abuses in the preference process.

The Commission also reviewed the potential impact of fee shifting or sanctions in the context of preference litigation. Many of the Commissioners did not support a straight "loser pays" rule, as it could penalize preference defendants in close cases when the claims were disputed and the creditor loses. The Commissioners were also concerned about requiring the estate to pay when the trustee loses on a preference claim because of the nature of preference litigation, which often is uncertain and involves trustees initially working with limited information, and the harm to other beneficiaries of the estate. The Commission determined that neither fee shifting nor sanctions were warranted or workable in the preference context.

2. Recoveries Under Section 550

Recommended Principles:

- The trustee should be permitted to name an alleged subsequent transferee as a defendant in the original complaint to avoid any transfer under Bankruptcy Code section 544, 545, 547, 548, 549, or 553(b), and to recover such property under

them to assess sufficiently for Rule 9011 purposes the ordinary course and new value issues at little additional cost to them. On the other hand, the savings to factors and other creditors that would result from weeding out weak claims before they are even asserted would be substantial."), *available at* Commission website, *supra* note 55.

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

section 550. If any alleged subsequent transferee is not named as a defendant in the original complaint, the trustee should be required to sue such transferee in a subsequent action under section 550, and such transferee should have the ability to raise any and all defenses, including those relating to the original avoidance action, in that litigation. Section 550 should be amended accordingly.

- The term "***for the benefit of the estate***" under section 550(a) should be interpreted broadly to permit recoveries for the benefit of "all creditors according to their statutory and contractual entitlements." *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004). This interpretation of section 550(a) should include all creditors, including administrative claimants and prepetition equity security holders, but should not include lenders under a postpetition financing facility. *See* Section IV.B, *Financing the Case*. It also should not expand or otherwise affect the underlying causes of action that a trustee must establish prior to seeking recoveries under section 550.
- The trustee should be able to file an action under chapter 5 of the Bankruptcy Code to avoid and recover transfers occurring outside the United States to the same extent it could file such an action with respect to domestic transfers. In reviewing any avoidance action involving transfers occurring solely outside the United States, the court should consider whether allowing such action to proceed is consistent with general principles of comity and is reasonably necessary to protect the interests of the estate, considering the expectations of the defendants, the laws of the foreign jurisdiction, and the relief available to the trustee in the foreign jurisdiction.

Recoveries Under Section 550: Background

Section 550 of the Bankruptcy Code complements the trustee's chapter 5 avoiding powers by allowing the trustee[561] to recover the property involved in, or the value of, any avoided transfers.[562] For example, a debtor in possession may avoid preferential transfers under section 547 or fraudulent transfers under section 548 or 544(b) and then seek to recover the security interest, lien, asset, or money transferred in those avoided transactions under section 550. Specifically, section 550(a) provides as follows:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —
>
> > (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

561 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

562 11 U.S.C. § 550.

(2) any immediate or mediate transferee of such initial transferee.[563]

Section 550 establishes a two-step process: the debtor in possession first files a complaint to avoid the subject transfer or transaction; and then, after the court grants the relief requested by the complaint, the debtor in possession files a separate action to recover the property (or the value of the property) involved in the avoided transfer or transaction. Although the debtor in possession may assert the avoidance action and the recovery action against the transferee in the same complaint, the language of the statute suggests that a separate action must be filed against any subsequent transferees.[564] Some courts also are uncertain whether a debtor in possession is authorized to seek to recover property from foreign subsequent transferees under section 550.[565]

In addition, courts are divided concerning the interpretation of the phrase "for the benefit of the estate" as used in section 550.[566] Some courts interpret the phrase broadly, permitting recovery as soon as there is some identifiable benefit to the estate.[567] Other courts utilize a narrower interpretation, restricting recoveries to those circumstances in which a more direct benefit to creditors (at times, specifically unsecured creditors) can be shown.[568]

The Fifth, Seventh, and Tenth Circuits, as well as certain lower courts within those Circuits, interpret section 550 broadly.[569] These courts hold that there is a benefit to the estate when *any* interested party in a bankruptcy case stands to benefit from avoidance action recoveries.[570] The term "interested party" has been interpreted not only to include secured creditors, unsecured creditors, and administrative claimants,[571] but also equity security holders.[572] In addition, the benefit to the estate does not need to be direct, but may arise indirectly by, for example, increasing the likelihood of effectuating a successful reorganization or meeting payment obligations under a plan.[573]

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563 *Id.*

564 *Id.*

565 *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 2014 U.S. Dist. LEXIS 91508 (S.D.N.Y. July 6, 2014).

566 *See e.g.*, *In re* Acequia, Inc., 34 F.3d 800, 811–12 (9th Cir. 1994).

567 *In re* C.W. Mining Co., 477 B.R. 176, 189 (B.A.P. 10th Cir. 2012), *aff'd*, 749 F.3d 895 (10th Cir. 2014) (explaining that the phrase "for the benefit of the estate," as used in section 550, should be construed broadly, rather than narrowly, to include indirect benefits). *See also* Weaver v. Aquila Energy Marketing Corp., 196 B.R. 945, 956 (S.D. Tex. 1996) (noting that section 550's "benefit" requirement is satisfied as soon as there is some identifiable benefit to the estate).

568 *See In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999) (holding that "any recovery of preferences in this case will benefit only the Successor Corporation" and that "unsecured creditors must be benefitted by recovery") (citing *In re* Resorts Int'l, Inc., 145 B.R. 412, 474–75 (Bankr. D.N.J. 1990)); Harstad v. First Am. Bank, 39 F.3d 898, 905 (8th Cir. 1994) (holding that " increas[ing] the likelihood that [debtors] will be able to pay their creditors as the Plan requires, even though it will not increase the amount paid to the creditors" is insufficient benefit to the estate to permit recovery under section 550(a)).

569 Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (holding that the term "estate," as used in section 550(a), means the set of all potentially interested parties, and not any one particular class of creditors); *In re* NETtel Corp., Inc., 364 B.R. 433, 442 (Bankr. D.C. 2006); *In re* Furrs, 294 B.R. 763, 783 (Bankr. D. N.M. 2003).

570 *See* MC Asset Recovery LLC v. Commerzbank A.G. (*In re* Mirant Corp.), 675 F.3d 530, 532–34 (5th Cir. 2012); Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004); *In re* NETtel Corp., Inc., 364 B.R. 433, 442 (Bankr. D. D.C. 2006).

571 Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (*In re* Payless Cashways, Inc.), 290 B.R. 689, 696–97 (Bankr. W.D. Mo. 2003) (holding that a chapter 11 trustee had standing to pursue preference claims even though recoveries would go solely to satisfy administrative claims).

572 *See* Kipperman v. Onex Corp., 411 B.R. 805, 876–88 (N.D. Ga. 2009) (holding that all interests, including those of all creditors and equity security holders, are comprised in the estate); *In re* Bayou Grp., LLC, 372 B.R. 661, 664 n. 2 (Bankr. S.D.N.Y. 2007) (refusing to adopt a bright-line rule that avoidance actions can never be brought in whole or in part for the benefit of equity security holders).

573 *In re* P.A. Bergner & Co., 140 F.3d 1111, 1118 (7th Cir. 1998), *cert. denied*, 525 U.S. 964 (1998) (explaining that though preference action recovery will benefit reorganized debtor and thus owners of reorganized debtor, recovery under section 550(a) is permissible because owners of reorganized debtor were the largest creditor group of old debtor, so benefit to these creditors provides a sufficient benefit to the estate to satisfy the requirements of section 550); *In re* Furrs, 294 B.R. 763, 780 (Bankr. D.N.M. 2003) (holding that "an action which will generate funds for the payment of administrative claims is a proper use of [t]rustee's avoiding and recovery powers"). *See also* Weaver v. Aquila Energy Marketing Corp., 196 B.R. 945, 956 (S.D. Tex. 1996) (holding that section 550's "benefit" requirement is satisfied as soon as there is some identifiable benefit to the estate).

Courts narrowly interpreting section 550(a) do not require an absolute direct benefit to unsecured creditors, but they generally require a more direct benefit to those creditors than do courts that employ the broader interpretation.[574] For example, the Eighth Circuit[575] and the Bankruptcy Court for the District of Delaware[576] have interpreted section 550(a) as effectively requiring that the contemplated recovery be somehow targeted, or legally tied, to the benefit of creditors (*e.g.*, pursuant to a plan in which avoidance action proceeds are distributed or in a settlement under Bankruptcy Rule 9019). In both cases, the courts found that the demonstrated benefit was insufficient to permit recovery under section 550(a).[577]

Recoveries Under Section 550: Recommendations and Findings

The Commission reviewed several issues relating to avoidance action recoveries under section 550. This section of the Bankruptcy Code is an integral component of the trustee's avoiding powers under chapter 5 of the Bankruptcy Code. It essentially represents the mechanism by which the trustee can recover any value resulting from avoidance actions for the estate. Recognizing the section's importance in the avoidance process and the need to provide a clear, efficient, and fair path to recoveries, the Commissioners discussed the actual mechanics of section 550.

Several Commissioners commented on the sometimes cumbersome process of suing on the underlying avoidance action and then bringing the recovery action under section 550 after the fact. Many of the Commissioners believed that providing subsequent transferees with at least notice of the underlying avoidance action and an opportunity to intervene would improve this system. This kind of notice would prevent duplicative litigation when no notice is provided, and a subsequent transferee disputes the existence of a valid cause of action. Others suggested requiring the trustee to name any potential subsequent transferees as defendants in the underlying avoidance action. Some of the Commissioners questioned whether such a requirement was feasible, because often the identity of any subsequent transferees is discovered in the litigation on the underlying avoidance claim and is not necessarily known to the trustee at the time of filing the complaint. Notice would not be possible in those cases.

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574 *See, e.g., In re* Acequia, Inc., 34 F.3d 800, 811 (9th Cir. 1994) (allowing recovery of fraudulent transfers even though creditors have been paid in full when recovery would aid continuing performance under plan and pay administrative creditors because "[c]ourts construe the 'benefit to the estate' requirement broadly, permitting recovery under section 550(a) even in cases where distribution to unsecured creditors is fixed by a plan of reorganization and in no way varies with recovery of avoidable transfers"); Harstad v. First Am. Bank, 39 F.3d 898, (8th Cir. 1994) ("We do not hold that a bankruptcy trustee or a debtor in possession (or a debtor or an appointed representative under powers reserved via § 1123(b)(3)) must demonstrate a direct benefit to the creditors in the form of a distribution to the creditors of the preference recovery (although that would certainly make this a much easier issue to decide). Nevertheless, we do hold that those wishing to bring preference actions must show a more definite benefit to creditors than the [debtors] have shown here."); Wellman v. Wellman, 933 F.2d 215, 218 (4th Cir. 1991), *cert. denied*, 502 U.S. 925 (1991) (holding that there is no benefit to the estate "when the result is to benefit only the debtor rather than the estate"); Adelphia Recovery Trust v. Bank of Am., N.A., 390 B.R. 80, 94 (S.D.N.Y. 2008), *aff'd*, 379 Fed. App'x 10 (2d Cir. 2010), *cert. dismissed*, 131 S. Ct. 896 (2011) ("[I]t is well settled in the Second Circuit, that avoiding powers may be exercised by a debtor in possession only for the benefit of creditors, and not for the benefit of the debtor itself.") (citations omitted) (internal quotation marks omitted); Trans World Airlines, Inc. v. Travellers Int'l AG (*In re* Trans World Airlines, Inc.), 163 B.R. 964, 972 (Bankr. D. Del. 1994) ("[T]he Code clearly contemplates the use of avoidance action recoveries in the operation of the business in a manner which only indirectly benefits creditors.").

575 Harstad v. First Am. Bank, 39 F.3d 898, 904–05 (8th Cir. 1994).

576 *In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999) ("[The] Plan does not delegate preference recoveries to the estate or list them as a source of funds designated to pay down the Note. Rather, any recovery of preferences in this case will benefit only the Successor Corporation.").

577 *See* Harstad v. First Am. Bank, 39 F.3d 898, 904–05 (8th Cir. 1994); *In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999).

Given those obstacles, the Commissioners discussed whether the federal notice standards as articulated by the U.S. Supreme Court in *Mullane v. Central Hanover Bank & Trust Co.* would suffice.[578] The *Mullane* standard basically requires notice by means "reasonably calculated, under all the circumstances, to apprise the interested parties of the pendency of the action, and afford them an opportunity to present their objections."[579] The Commission determined, however, that to the extent the trustee would be seeking to recover value from the subsequent transferees, actual notice should be required. Based on these considerations, the Commission recommended clarifying section 550 to permit the trustee to name a subsequent transferee as a defendant in the original, underlying cause of action and, if not named, to require the trustee to sue the subsequent transferee in a subsequent action, at which time the subsequent transferee should be permitted to assert defenses to the original avoidance cause of action.

The Commissioners then analyzed the extra-territorial application of the trustee's avoiding powers and recovery rights under section 550 to subsequent transferees. The Commissioners acknowledged the primary competing interests at stake: the perceived unfairness in permitting avoidance of transfers made to parties within the United States, but then precluding that remedy as to any subsequent transferees overseas; and the reasonable expectations of foreign transferees, particularly those who may not know that the transfer originated from the debtor, including the expectation that any payments they received were governed by the laws of their respective jurisdictions. The Commissioners methodically walked through examples when this issue may present itself. They considered situations were a feeder fund is the initial transferee and noted the relevance of the solvency of the feeder fund. They examined the facts of the *Madoff* and *Maxwell* cases and discussed the factual nuances of these cases.[580] The Commissioners acknowledged and appreciated the delicate balance required in these instances.

The Commissioners discussed how best to balance the competing interests with well-established principles of comity. The Commissioners generally agreed with the notion that foreign transfers should be subject to the chapter 5 avoiding powers, but only if such application was consistent with principles of comity. Accordingly, the Commission approved the recommendation that section 550 cover domestic or foreign subsequent transferees extra-territorially to the same extent as domestic subsequent transferees, but agreed that the court should consider whether allowing such action to proceed is consistent with general principles of comity and is reasonably necessary to protect the interests of the estate considering the expectations of the defendants, the laws of the foreign jurisdiction, and the relief available to the trustee in the foreign jurisdiction.

Once a trustee identifies potential avoidance and recovery actions under chapter 5 of the Bankruptcy Code, courts have differed on whether the trustee may pursue those actions if recoveries will go to stakeholders other than general unsecured creditors. The Commissioners discussed the origins of the concept that avoidance action recoveries should inure only to the benefit of general unsecured creditors and whether such a limited purpose aligned with the concept of the estate.[581] The Commissioners discussed witness testimony that supported limiting the beneficiaries of preference

578 Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950).
579 *Id.*
580 *See, e.g., In re* Maxwell Commc'n Corp., 93 F.3d 1036, 1047–48 (2d Cir. 1996); Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 2014 U.S. Dist. LEXIS 91508 (S.D.N.Y. July 6, 2014).
581 *See, e.g.,* Mellon Bank NA v. Dick Corp., 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (explaining that section 550 "speaks of benefit to the estate — which in bankruptcy parlance denotes the set of all potentially interested parties").

actions to unsecured creditors. They also considered whether administrative claimants or old equity should be permitted to benefit from recoveries under section 550. The Commissioners drew on the facts and holding in *Mirant Corp.*, in which the Fifth Circuit interpreted section 550(a) and found that "[a] bankruptcy trustee may still have standing to avoid a fraudulent transfer after the unsecured creditors are satisfied in full."[582]

The Commissioners found the reasoning of courts following a broader interpretation of section 550(a) to be sound and consistent with the general concept of the bankruptcy estate. The estate does not represent only general unsecured creditors in a case, but often represents a variety of stakeholders whose interests also may have been harmed by improper transfers and transactions subject to avoidance under chapter 5 of the Bankruptcy Code. The Commission voted to endorse a broad interpretation of the term "for benefit of the estate" in section 550(a) to mean all parties with claims against, or interests in, the estate, including administrative claimants and old equity but not including claims of postpetition secured creditors. In reaching this conclusion, however, the Commission agreed that this principle only affected a trustee's action for recoveries against transferees under section 550; it did not expand or otherwise affect a trustee's underlying cause of action under section 544, 545, 547, 548, 549, or 553(b).

D. Labor and Benefits

1. Collective Bargaining Agreements Under Section 1113

Recommended Principles:

- Disputes regarding modification and rejection of a company's collective bargaining agreements can be time-consuming, expensive, and litigious. These disputes also can be emotionally charged and disruptive at key points in the chapter 11 process. Moreover, and perhaps most importantly, they involve a resource many consider critical to a company's successful restructuring — its employees. Accordingly, the Bankruptcy Code should be amended to further the objectives of negotiation and consensual resolution underlying the collective bargaining process and section 1113.
- To that end, section 1113 should be amended to add requirements that, in addition to the provisions of section 1113(b)(1), the trustee should: (i) provide notice to the applicable labor organization(s) that modifications to the collective bargaining agreement are being proposed along with an initial proposal and description of the information to be made available for the labor organization to evaluate the proposal; and (ii) file a notice of intent to initiate proceedings under section 1113(b)

582 MC Asset Recovery LLC v. Commerzbank A.G. (*In re* Mirant Corp.), 675 F.3d 530, 534 (5th Cir. 2012).

and schedule an initial conference with the court regarding such proceedings. The foregoing is intended to promote transparency, disclosure, and communication among the parties, and to provide a reasonable time to conduct negotiations in an effort to reach a consensual agreement prior to the commencement of any litigation by the trustee to reject the collective bargaining agreement. Accordingly, section 1113 should be amended as follows:

- The trustee should file a request for an initial conference regarding the initiation of section 1113 proceedings with the court and serve the request on the authorized representative of the affected employees (the "***authorized representative***") and any other party entitled to notice of matters pending in the case under the Bankruptcy Rules. In the request, the trustee should certify that it has provided the authorized representative with a written copy of its initial proposal and the other information required by section 1113(b)(1).
- The court should set a status conference to discuss the process with the trustee and the authorized representative. This conference should be scheduled so as to allow the authorized representative sufficient time to (i) review the trustee's notice, initial proposal, and proposed information disclosures; and (ii) meet and confer with the trustee to discuss a timetable for conducting negotiations, any information-related matters, and any other particulars relevant to the conduct of negotiations, including whether the parties believe a mediator would assist in their discussions. The court should conduct the initial conference on or before 30 days after the filing of the trustee's request for an initial conference.
- At the initial conference, the trustee and the authorized representative should be prepared to: (i) discuss the timetable for conducting negotiations over the proposal; (ii) resolve any initial issues regarding the disclosure of information relevant for the evaluation of the proposal; (iii) identify any issues regarding the resources available to the parties so that they may engage in informed discussions regarding the request for modifications; (iv) discuss whether the participation of a mediator would assist the parties; and (v) discuss any other issues that may present obstacles to conducting informed, good faith negotiations regarding the trustee's request for modifications. The court may also wish to establish an expedited process for the resolution of any information-related disputes.
- If, following a reasonable period of time and consistent with the timetable established at the initial conference (which should take into consideration the nature and scope of the modification proposal), the parties have not reached an agreement regarding mutually acceptable modifications, the trustee may request a further status conference in order for the parties to report to the court regarding the status of the process and for the trustee to request a case management process for a motion to reject the collective bargaining agreement. At such status conference, the court should set a date by which the trustee and the authorized representative would submit

a case management and scheduling order. The proposed hearing schedule may incorporate a bifurcation of the trial into an initial hearing schedule for the presentation of the trustee's case and then, following an adjournment, a second hearing schedule for the authorized representative to present its case. The scheduling order may provide for the (continued) participation of a mediator to facilitate discussions between the parties if requested by the parties or otherwise warranted under the circumstances. The court should schedule the start of the trial on the motion to reject the collective bargaining agreement on or before 180 days after the filing of the trustee's request for an initial conference, unless the trustee and the authorized representative agree to extend, or the court for cause extends, this deadline. The parties should factor this trial deadline into the timetable established at the initial conference.

- o Statutory committees should be able to attend and observe any status conferences conducted under this principle, but participation, including at any hearing on rejection, should be limited to receiving and reviewing information from the trustee and the authorized representative and evaluating the trustee's business judgment regarding the decision to seek rejection under section 1113. Statutory committees would also be heard in the usual manner in connection with any settlement reached between the trustee and the authorized representative.
- o The foregoing recommendations should not be read to, and are not intended to, alter current law with respect to section 1113(e).

- The trustee's rejection of a collective bargaining agreement under section 1113 should be treated as a breach of such agreement. The authorized representative may assert a claim for monetary damages arising from the rejection of the collective bargaining agreement against the estate, on behalf of the affected employees, which claim should be a general unsecured claim, if the rejection order occurs prior to assumption of the agreement, similar to the assertion of rejection damages claims by counterparties to contracts rejected under section 365 pursuant to sections 365(g) and 502(g). Any such rejection damages claims should be determined in accordance with applicable nonbankruptcy law for breach of contract and subject to mitigation.

Collective Bargaining Agreements Under Section 1113: Background

The U.S. Supreme Court's decision in *N.L.R.B. v. Bildisco* resolved disparate rulings among the lower courts regarding the treatment of collective bargaining agreements in bankruptcy.[583] In *Bildisco*, the Supreme Court reaffirmed the characterization of a collective bargaining agreement as an executory contract subject to rejection under section 365 of the Bankruptcy Code.[584] The Supreme Court also

583 N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984), *superseded by statute*, Public Law 98-353 (section 1113 of the Bankruptcy Code), *as recognized in* N.L.R.B. v. Manley Truck Line, Inc., 779 F.2d 1327, 1331 n. 7 (7th Cir. 1985).
584 *Id.* at 522–23.

held that, in recognition of the "special nature" of a collective bargaining agreement, the debtor in possession's[585] proposed rejection of a collective bargaining agreement was subject to a "somewhat stricter standard" of review than the generally applicable business judgment standard.[586] The Court rejected a very strict standard proposed by the National Labor Relations Board, which was adopted by the Second Circuit in *REA Express*,[587] *i.e.*, that the debtor in possession should not be permitted to reject a collective bargaining agreement unless it can show that rejection is necessary to prevent the liquidation of the debtor. Instead, the Court endorsed a standard that it viewed as "somewhat higher than that of the 'business judgment rule' but a lesser one than that embodied in the *REA Express* opinion."[588] The Court also held that a debtor in possession's unilateral modification of a collective bargaining agreement prior to court approval of the rejection was not an unfair labor practice in violation of the National Labor Relations Act (the "***NLRA***").[589]

Congress enacted section 1113 of the Bankruptcy Code in direct response to the *Bildisco* decision.[590] Section 1113 establishes particularized rules regarding the treatment of collective bargaining agreements when an employer is in chapter 11.[591] Among other things, section 1113 establishes special procedures and standards that are applicable when a debtor in possession seeks to modify, or ultimately reject, a collective bargaining agreement. The statute prescribes a process of bargaining between the debtor in possession and the authorized representative of the affected employees as a prerequisite to seeking court-approved rejection. In the absence of an agreed-upon resolution regarding the debtor in possession's proposed modifications, the debtor in possession may seek court-approved rejection. In doing so, the debtor in possession must meet the rejection standards set forth in the statute in order to obtain court approval, including demonstrating compliance with the statutory bargaining requirements.[592]

585 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

586 *Id.* at 524 ("We agree with these Courts of Appeals that because of the special nature of a collective-bargaining contract, and the consequent 'law of the shop' which it creates, [citation omitted] a somewhat stricter standard should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement.").

587 Bhd. of Ry., Airline & Steamship Clerks v. REA Express, 523 F.2d 164 (2d Cir. 1975).

588 *See id.* at 525 (holding that bankruptcy court should permit rejection if "the debtor can show that the collective- bargaining agreement burdens the estate, and that, after careful scrutiny, the equities balance in favor of rejecting the collective bargaining agreement"). The standard adopted by the Supreme Court drew upon the rejection standard proposed by the Eleventh Circuit in *In re* Brada Miller Freight Sys., Inc., 702 F.2d 890 (11th Cir. 1983).

589 *Id.* at 532–33. The Supreme Court's rationale was that a collective bargaining agreement, like other executory contracts, was not enforceable by the nondebtor party upon the debtor's bankruptcy filing. The Court's ruling meant that, where an employer in chapter 11 committed an unfair labor practice by unilaterally modifying a collective bargaining agreement on filing for bankruptcy, statutory remedies under labor law would be unavailing. *See* 29 U.S.C. § 158(a)(5) (providing that it shall be an unfair labor practice for an employer "to refuse to bargain collectively" with the employees' authorized representative); *id.* § 158 (d) (establishing the parties' mutual obligation to bargain collectively, including, among other things, "that no party to [a labor contract] may terminate or modify such contract" absent compliance with the statute's requirements).

590 *See In re* AMR Corp., 477 B.R. 384, 405–06 (Bankr. S.D.N.Y. 2012) (relating enactment of section 1113 in response to *Bildisco*). *See also* Andrew B. Dawson, *Collective Bargaining Agreements in Corporate Reorganizations*," 84 Am. Bankr. L. J., 103, 104 (2010) (same).

591 Section 1113 applies to collective bargaining agreements covered by the National Labor Relations Act, 2 U.S.C. §§ 151–169 (the "***NLRA***") and to agreements covered by Title II of the Railway Labor Act, 45 U.S.C. §§ 181–188, which is applicable to the airline industry. Railroad collective bargaining agreements covered by Title I of the Railway Labor Act, 45 U.S.C.§§ 151–165, are subject to section 1167 of the Bankruptcy Code. *See* 11 U.S.C. § 1167.

592 In addition to the rejection requirements, and to counteract the Supreme Court's ruling in *Bildisco* that unilateral modification of a collective bargaining agreement prior to court-approved rejection does not constitute an unfair labor practice, Congress amended section 1113 to prohibits the trustee from unilaterally altering or terminating any provision of a collective bargaining agreement "prior to compliance with the provisions of [section 1113]." 11 U.S.C. § 1113(f). *See* Shugrue v. Air Line Pilots Ass'n, Int'l (*In re* Ionosphere Clubs, Inc.), 922 F.2d 984, 990 (2d Cir. 1990), *cert. denied*, 502 U.S. 808 (1991) (reviewing section 1113(f) and concluding that "Congress intended that collective bargaining agreement remain in effect. . . after the filing of a bankruptcy petition unless and until the debtor complies with the provisions of § 1113"). *See also In re* Cont'l Airlines, 125 F.3d 120, 137 (3d Cir. 1997), *cert. denied*, 522 U.S. 1114 (1998) (finding that the "intent behind section 1113 is to preclude debtors or trustees in bankruptcy from unilaterally terminating, altering or modifying the terms of a collective bargaining agreement without following its strict mandate").

Thus, prior to seeking rejection, a debtor in possession must make a proposal to the authorized representative of the employees that provides relevant information necessary to evaluate the proposal, and meet and confer in good faith with the authorized representative in an attempt to reach a mutually acceptable modification to the labor contract.[593] When the parties' efforts do not result in a mutually acceptable modification to the collective bargaining agreement, the debtor in possession may seek court-approved rejection. Under section 1113, the filing of the debtor in possession's motion to reject the collective bargaining agreement requires the court to hold a hearing within 14 days after the filing date, upon at least 10 days' notice to the authorized representative, although the court may extend the time for commencement of the hearing for seven days or for additional periods of time when the debtor in possession and the authorized representative agree.[594]

The statute also sets out the standards for approval of a motion to reject a collective bargaining agreement. Under section 1113(c), the court may approve the motion to reject if the court determines that: (i) the debtor in possession complied with the statutory requirements attendant to making its proposal; (ii) the authorized representative refused to accept the debtor in possession's proposal "without good cause"; and (iii) "the balance of the equities clearly favors rejection."[595] In evaluating the "balance of the equities" standard, courts have articulated certain factors to be considered.[596] Section 1113 requires that the court enter a ruling on the motion to reject within 30 days of the date of the commencement of the hearing, unless the parties consent to an extension of this period.[597] Although an early division in the interpretation of the rejection standard occurred when the Second and Third Circuits issued divergent rulings on the application of the "necessary" and "fair and equitable" standards applicable to the debtor in possession's proposal under section 1113(b)(1),[598] a study by Professor Andrew Dawson suggests that the difference in interpretation has not appeared to impact the courts' ultimate rulings — courts have generally approved the debtor in possession's motion to reject under section 1113(c).[599]

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593 *See In re* Pinnacle Airlines Corp., 483 B.R. 381, 404–05 (Bankr. S.D.N.Y. 2012) (describing general operation of section 1113). The particular requirements regarding the proposal, provision of information, and good faith negotiations are set forth in section 1113(b)(1)(A) (standards for proposal), section 1113(b)(1)(B) (requirement to provide "relevant information as is necessary to evaluate the proposal"), section 1113(b)(2) (requirement that trustee meet with authorized representative and "confer in good faith in attempting to reach mutually satisfactory modifications"). 11 U.S.C. § 1113(b).

594 *See* 11 U.S.C. § 1113(d)(1). Section 1113 requires the court to rule on a section 1113 motion to reject within 30 days of the date of the commencement of the hearing, unless the parties consent to an extension of this period. 11 U.S.C. § 1113(d)(2).

595 *Id.* § 1113(c). The debtor bears the burden of proof on the elements of a section 1113 motion to reject. *See* Truck Drivers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 88 (2d Cir. 1987).

596 *See e.g.*, Truck Drivers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 93 (2d Cir. 1987) (detailing six factors to be considered in evaluating the balance of the equities).

597 In addition to the procedures set forth in section 1113(b) through (d), section 1113 also provides for emergency "interim relief" whereby a court may authorize a debtor to make interim changes to wages, benefits, or work rules under the collective bargaining agreement "if essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate." 11 U.S.C. § 1113(e). *See* Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC, 791 F.2d 1074, 1088 (3d Cir. 1986) (explaining that, in enacting section 1113, "Congress recognized that there might be immediate problems of an emergency nature in individual cases" and therefore provided for "interim changes" if the court finds "that an interim change is 'essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate'") (citations omitted). *See also* 7 Collier on Bankruptcy ¶ 1113.02[3] (describing interim relief provision and "high standards" generally applied to requests for such relief); *In re* Salt Creek Freightways, 46 B.R. 347, 349–50 (Bankr. D. Wy. 1985) (explaining enactment of section 1113(e)).

598 *See* 11 U.S.C. § 1113(b)(1)(A). *Compare* Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC, 791 F.2d 1074, 1088–89 (3d Cir. 1986) *with* Truck Drivers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 89 (2d Cir. 1987).

599 *See, e.g.,* Dawson, *supra* note 590, at 104 (collecting data on how courts interpret the factor that the proposal be "necessary to the reorganization of the debtor" and concluding that "[b]ased on data from every large publicly traded company bankruptcy between 2001 and 2007, the present study reveals that the outcome of [section] 1113 motions was the same regardless of the legal standard applied: the court granted the debtor's motion to reject its CBA").

Collective Bargaining Agreements Under Section 1113: Recommendations and Findings

For debtors with a unionized workforce, the treatment of their labor contracts may represent one of the most important and difficult decisions in the chapter 11 case.[600] These contracts represent the company's obligations to its employees and are an integral component of the company's relationship with its employees. These contracts, however, also may impose monetary obligations on the company that it no longer can sustain in light of financial distress and its need to reorganize.[601] The Commission appreciated fully the crucial considerations and potentially dynamic elements in the collective bargaining process in a chapter 11 case. In particular, the Commissioners noted that labor relations following rejection should be taken into consideration in utilizing section 1113: even if a collective bargaining agreement is ultimately rejected through the section 1113 process, the company remains obligated to continue to bargain with the authorized representative over modifications to the agreement.[602]

Most of the testimony received by the Commission on section 1113 issues concerned the bargaining process itself and the deadlines imposed by this section.[603] Witnesses expressed concern that the statutory requirements did not, in practice, foster meaningful negotiations.[604] Rather, some witnesses suggested that many debtors in possession viewed the bargaining required under the Bankruptcy Code as a means to the litigated end they desired.[605] The Honorable Stephen Mitchell of the U.S. Bankruptcy Court for the Eastern District of Virginia (whose cases included the *US Airways*

600 *Oral Testimony of the Honorable Stephen S. Mitchell: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13–14 (Mar. 14, 2013) (ASM Transcript) ("I have to say at the outset that I thought that the decisions I had to make in terms of termination of pension plan or termination of retiree benefits or modification of a collective bargaining agreement or proving interim changes to a collective bargaining agreement were some of the toughest I've had to make as a judge . . . I could tell you in no other matters that have come before me in 16 years on the bench that I receive so much mail in chambers and they were profoundly affecting. I mean, I fully understood that for some people it means they themselves might end up having to file up for bankruptcy because necessary financial support was being taken away from them."), *available at* Commission website, *supra* note 55.

601 *Written Statement of Michael Robbins: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Mar. 14, 2013) (acknowledging that there is a need for labor representatives to make meaningful economic concessions for employers to survive), *available at* Commission website, *supra* note 55.

602 *See e.g.*, N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 534 (1984), *superseded by statute*, Public Law 98-353 (section 1113 of the Bankruptcy Code), *as recognized in* N.L.R.B. v. Manley Truck Line, Inc., 779 F.2d 1327, 1331 n. 7 (7th Cir. 1985) (noting that debtor in possession remains obligated to bargain collectively with labor organization following formal approval of rejection).

603 *Written Statement of Michael Robbins: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Mar. 14, 2013) ("[T]he expedited schedule mandated under Section 111 creates tremendous downward pressure on wages and working conditions. . . . [T]he 1113 process has become in practice a rushed 51-day countdown to destruction of their agreements."), *available at* Commission website, *supra* note 55.

604 *See Oral Statement of Bob Keach: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Mar. 14, 2013) (ASM Transcript) ("The predominance of Section 363 sales of substantially all the assets of debtors means that often the purchaser do not assume collective bargaining agreements or pension liabilities. This has particularly challenged the statutory regime for addressing such agreements and liabilities."), *available at* Commission website, *supra* note 55; *Oral Testimony of Robert Roach Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 51 (Mar. 14, 2013) (ASM Transcript) ("In normal contract negotiations there's give and take, there's talking and there's a result at the end of it. . . . When you bargain on 1113 after a period of time, and it's two weeks and a week after they file, it's either you accept what the company gives you or you don't have a collective bargaining agreement."), *available at* Commission website, *supra* note 55. "Negotiation is you come in with a position and both sides are compromised. There is no need for the corporation to compromise in the chapter 1113 proceeding." *Id.* at 58.

605 *See Oral Testimony of Debora Sutor: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 42–45 (Mar. 14, 2013) (ASM Transcript) ("Bankruptcy should only be used as a last resort. Instead . . . companies . . . are routinely placed in bankruptcy soles as a means to escape obligations and reward top executives and middle managers for simply executing a bankruptcy plan."), *available at* Commission website, *supra* note 55; *Oral Testimony of James Campbell Little: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 35 (Mar. 14, 2013) (ASM Transcript) (stating that the debtor (company) essentially had a gun to labor's head — it was a take it or leave it proposition, not a negotiation), *available at* Commission website, *supra* note 55.

bankruptcy cases) also testified that the statutory deadlines simply did not work, particularly the 14-day hearing requirement.[606]

The Commission considered whether refinements to the statutory process would better serve the goals of the statute. Section 1113(b)(2) provides: "During the period beginning on the date of the making of a proposal provided for in paragraph (1) and ending on the date of the hearing provided for in subsection (d)(1), the trustee shall meet, at reasonable times, with the authorized representative to confer in good faith in attempting to reach mutually satisfactory modifications of such agreement." Thus, with respect to the bargaining process, section 1113 does not provide any minimum period during which the parties must engage in good faith bargaining.[607] A debtor in possession could, consistent with the statute, serve a proposal and then, subject only to the requirements of proof set forth in section 1113(c), file a rejection motion quite soon thereafter. The motion would then be subject to the statutory hearing and notice schedule.

Courts and commentators have emphasized that an important goal of section 1113 is to encourage negotiated resolutions when a debtor in possession seeks modifications to its collective bargaining agreements and when litigation should be a last resort.[608] And, as one court has explained, the amount of time to be allowed for negotiations "must depend on the facts and circumstances of each case."[609]

The Commissioners discussed these perspectives and whether the requirements currently provided in section 1113(b) were sufficient to generate a meaningful dialogue between the debtor in possession and the authorized representative. The Commissioners generally agreed that the effectiveness of section 1113 was case dependent, but some suggested the process could be improved by more clearly separating the bargaining and the litigation processes. These Commissioners noted that the current process often placed the bargaining and the potential litigation on parallel tracks that had the parties trying to reach a compromise while the debtor in possession was preparing its case to support, and the authorized representative was working to identify good cause to block, the rejection of the agreement. These Commissioners also agreed with the witness testimony that bargaining under

606 *Oral Testimony of the Honorable Stephen S. Mitchell: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13–17 (Mar. 14, 2013) (ASM Transcript) ("Section 1113 and 1114 relief actually require that the judge hold a hearing within 14 days. . . . In reality there were no 14-day hearings or even 21-day hearings in the matters that came in front of me. Everybody understood that there had to be a certain amount of discovery, we [review] the underlying financials, there are opportunities to depose each side's experts and things like that."), *available at* Commission website, *supra* note 55.

607 *See, e.g., Oral Testimony of Robert Roach, Jr., ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 25 (Mar. 14, 2013) (ASM Transcript) (stating that the current good faith negotiation requirement in section 1113 "is not adequate because negotiating in good faith just means coming to the table and talking, it doesn't mean give or take. . . . [There may be] back and forth, but . . . no negotiation"), *available at* Commission website, *supra* note 55.

608 *E.g.,* N.Y. Typographical Union No. 6 v. Maxwell Newspapers, Inc. (*In re* Maxwell Newspapers, Inc.), 981 F.2d 85, 90 (2d Cir. 1992) (explaining that the statute's "entire thrust" is to "ensure that well-informed and good faith negotiations occur in the market place, not as part of the judicial process"); Dawson, *supra* note 590, at 119 (noting that the statutory "text clearly indicates that Congress preferred the outcome of negotiated settlements to labor disputes"). *See also In re* Century Brass Prods., Inc., 795 F.2d 265, 273 (2d Cir. 1986), *cert. denied*, 479 U.S. 949 (1986) (finding that section 1113 "encourages the collective bargaining process as a means of solving a debtor's financial problems insofar as they affect its union employees"); *In re* Hostess Brands, Inc., 477 B.R. 378, 382 (Bankr. S.D.N.Y. 2012) (["Section 1113's] unique purpose is . . . to provide for expedited, good faith bargaining and, ultimately, a determination by the court, if that doesn't occur."); Richard H. Gibson, *The New Law on Rejection of Collective Bargaining Agreements in Chapter 11: An Analysis of 11 U.S.C. § 1113*, 58 Am Bankr. L. J. 325, 327 (1984) (reviewing the statute and legislative history and describing principal purpose to "discourage both unilateral action by the debtor and recourse to the bankruptcy court"). "Instead, the law seeks to encourage solution of the problem through collective bargaining." *Id.*

609 Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC, 791 F.2d 1074, 1093–94 (3d Cir. 1986) (noting that the need for haste, in and of itself, is not a determining factor, citing the interim relief provision under section 1113(e) which is available to address emergency situations).

section 1113 could be shallow and perceived as a formality in the process.[610] Other Commissioners disagreed with this characterization of the process, but acknowledged the benefit to all parties of a more effective and efficient process.

The Commissioners then analyzed improving the current framework under section 1113. They recognized the delicate balance between encouraging meaningful negotiations and allowing the debtor in possession to move to litigation when necessary. To evaluate potential reforms to the section 1113 process, the Commissioners reviewed practices that have been employed in many chapter 11 cases, in which the parties opted for case management procedures in lieu of the statutory scheduling requirements, and have identified certain "best practices" from these cases. Their discussion focused on the realities of chapter 11 practice — as suggested by Professor Dawson's study, the debtor in possession usually can prevail on the motion to reject, but that result typically is not in the best interests of the debtor or its employees. Rather, a consensual resolution typically is in the best interests of both parties; it can avoid potential ill will between the parties, lost production for the debtor, and hardship for its employees.

The Commissioners proposed a more structured process for exchanging information and establishing the parameters of bargaining. The Commissioners debated whether the court should be involved in the process from the outset. The Commission determined that requiring an initial status conference with the court would encourage meaningful disclosures and discussions earlier in the process. In this context, it also considered the mandatory appointment of a mediator to help the parties reach a potential resolution more quickly. The Commissioners perceived value in the mediator's role, but expressed concerns regarding costs and a one-size-fits-all approach to a mediator. They believed that a mediator likely would be an asset in many cases, but believed it would be a more effective tool if invoked based on the facts of the particular case.[611]

Under the principles adopted by the Commission, there would be an initial conference that would follow disclosure of the proposal by the debtor in possession to the authorized representative and a notice to parties in the case of the debtor in possession's intention to seek modifications to a collective bargaining agreement by commencing a section 1113 process. The Commission determined that, at an initial conference with the court, the parties should discuss their bargaining timeline, any issues regarding disclosures made by the debtor in possession regarding its proposal, and any potential barriers to meaningful, good faith negotiations. It did not believe that the statute should establish specific deadlines for negotiations. Instead, it wanted the parties and the court to have flexibility under the general guidance that the bargaining parties have reasonable time to engage in meaningful, good-faith negotiations.

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610 *Oral Testimony of Robert Roach, Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 58 (Mar. 14, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55; *Oral Testimony of Debora Sutor: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 42–45 (Mar. 14, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55; *Oral Testimony of James Campbell Little: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 35 (Mar. 14, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55.

611 *Oral Testimony of Robert Roach, Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 60 (Mar. 14, 2013) (ASM Transcript) (stating that whether a mediator would be helpful depends on the circumstances of the case), *available at* Commission website, *supra* note 55; *Oral Testimony of James Campbell Little, Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 60 (Mar. 14, 2013) (ASM Transcript) (noting that mediators are not a panacea and that the utility of a mediator will vary by case, by mediator, etc.), *available at* Commission website, *supra* note 55.

The Commissioners also discussed an appropriate trigger for permitting a debtor in possession to proceed to litigation to reject the agreement. They compared a trigger similar to one proposed by labor-backed legislation (*i.e.*, the NLRA standard), based upon standards under nonbankruptcy labor law requiring an employer to bargain to "impasse" prior to unilateral implementation,[612] and the alternative of imposing an outside deadline based only on the passage of time. Although the Commissioners understood labor's preference for the NLRA standard, many of the Commissioners believed that the debtor in possession needed certainty as to when the case could move forward if a consensual resolution was not forthcoming. These Commissioners noted that the impasse standard could stall a debtor in possession's restructuring efforts indefinitely to the detriment of the debtor in possession and its other stakeholders (and arguably the employees as well). After considering various triggers, the Commission voted to recommend that the procedures incorporate an outside date for the start of the trial on the debtor in possession's motion to reject within 180 days of the debtor in possession's request for an initial conference. The Commissioners noted specifically that the forgoing recommended principles regarding the new case management procedures applied only when a debtor in possession pursued relief under section 1113(b), (c), or (d), and that the principles were not intended to change the current law under section 1113(e) applicable to a debtor in possession's request for interim, emergency relief.

In developing the principles for the enhanced case management process, the Commission also considered whether and to what extent other parties in interest should participate in the section 1113 proceedings.[613] For example, some of the Commissioners suggested that a statutory unsecured creditors' committee should be permitted to participate in the process. Others noted that the committee is not a party to the agreement and raised concerns about introducing third parties into the negotiation process.[614] The Commission settled on the approach used in the *Delphi* chapter 11 case, where, in ruling on a motion to limit participation in the section 1113 proceedings, the court determined that certain parties, including the statutory unsecured creditors' committee, could participate in the section 1113 process solely with respect to asserting a position regarding the debtor in possession's business judgment in seeking section 1113 relief and not with respect to whether the section 1113 factors had been met.[615] The Commission found persuasive the *Delphi* court's distinction between the role of the statutory committee in fulfilling its due diligence obligations regarding the debtor in possession's business judgment to pursue the rejection motion, as a non-ordinary course action by the debtor in possession, and the particulars of the bargaining process and related section 1113 factors, which are matters that should be left to the debtor in possession and the authorized representative both in terms of their negotiations and litigation regarding the debtor in possession's proposal and related bargaining.

612 *See The Protecting Employees and Retirees in Business Bankruptcies Act of 2013*, H.R. 100, 113th Cong. § 102 (1st sess. 2013) (proposing that a debtor may file a motion to reject a collective bargaining agreement, if, after a period of negotiations, the debtor and labor representative have not reached agreement on modifications "and further negotiations are not likely to produce mutually satisfactory modifications"). *See also N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 533 (1984) (describing "impasse" requirement under the NLRA).

613 *See* 11 U.S.C. § 1113(d)(1) (providing that, at a hearing on the motion to reject a collective bargaining agreement, "[a]ll interested parties may appear and be heard at such hearing"). The Seventh Circuit has held that section 1113(d)(2) limits the participants—the parties who are authorized to modify the agreement (and any guarantor of the agreement) — to the debtor and the applicable bargaining representative(s) of the affected employees. *In re* UAL Corp., 408 F.3d 847 (7th Cir. 2005).

614 *See, e.g., Oral Testimony of David R. Jury: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 23 (Mar. 14, 2013) (ASM Transcript) ("Collective bargaining is a relationship that in most cases long predated the filing of the petition and if the parties are successful will continue long after the bankruptcy case closes. On the other hand, creditor's committees [are transient]. It came into existence with the case, it will go out of existence with the end of the case."), *available at* Commission website, *supra* note 55.

615 *In re* Delphi Corp., Case No. 05-44481 (Bankr. S.D.N.Y. May 9, 2006) (oral decision).

The Commission also considered the consequences of the rejection of a collective bargaining agreement; specifically, does rejection give rise to a rejection damages claim, and if so, how should the claim be determined? The Commissioners discussed the current split in the case law regarding rejection damages under section 1113. One court decision, *In re Blue Diamond Coal Co.*, held that rejection damages were unavailable under section 1113 as a matter of statutory construction.[616] The *Blue Diamond* court's view was that section 1113 completely removed collective bargaining agreements from the provisions of section 365 of the Bankruptcy Code.[617] Other courts have disagreed with the *Blue Diamond* analysis of section 1113 and its relationship to section 365 and other provisions of the Bankruptcy Code, and instead have interpreted sections 1113 and 365 as working in tandem, thus permitting the assertion of rejection damages claims for the rejection of collective bargaining agreements under section 1113. As one court has explained, "[s]ection 1113 is designed to provide additional procedural requirements for rejection or modification of collective bargaining agreements, and only to that degree supersedes and supplements the provisions in § 365."[618]

The Commissioners also noted the discussion by the court in *Northwest Airlines.*[619] In this decision, the court labeled the effect of rejection as an "abrogation" of the agreement rather than a breach of the agreement, thus calling into question whether an order granting rejection could give rise to a claim for rejection damages. The Commissioners were persuaded by the reasoning and results of courts interpreting section 1113 as supplementary to section 365, as well as the practicalities of the availability of a rejection damages claim in reaching a resolution. The Commission voted to recommend that section 1113 be amended to clarify that rejection of a collective bargaining agreement constitutes a breach of the agreement as of the time of rejection, and that a claim for rejection damages may be asserted. The Commissioners also discussed how such claims would be determined. First, the Commission determined that, like damages claims asserted by nondebtor parties to contracts rejected under section 365, such claims would be general unsecured claims where rejection occurs prior to assumption of a collective bargaining agreement.[620] In addition, the Commission agreed that, generally, such claims would be based on the difference between the reductions implemented following rejection and the collective bargaining agreement terms prior to rejection, akin to a breach of contract claim under federal labor law, noting specifically that to the extent actual mitigation of damages by particular employees would apply to such claims, such mitigation would similarly apply to a rejection damages claim.[621]

616 *In re* Blue Diamond Coal Co., 147 B.R. 720 (Bankr. E.D. Tenn. 1992), *aff'd,* 160 B.R. 574 (E.D. Tenn. 1993).

617 *See* Michael St. Patrick Baxter, *Is There a Claim For Damages from the Rejection of a Collective Bargaining Agreement Under Section 1113 of the Bankruptcy Code?*, 12 Bankr. Dev. J. 703 (1996) (reviewing *Blue Diamond* decision).

618 Mass. Air Conditioning & Heating Corp. v. McCoy, 196 B.R. 659, 663 (D. Mass. 1996) (citing Norfolk and Western Railway Co. v. Am. Train Dispatchers Ass'n, 499 U.S. 117, 136 n. 2 (1991) (Stevens, J., dissenting)). *See also In re* Moline Corp., 144 B.R. 75, 78 (Bankr. N.D. Ill. 1992) (ruling that section 365 operates to fill in the gap left in section 1113 regarding rejection damages and that such omission was a legislative error); Baxter, *supra* note 617 (concluding that section 365 continues to apply except to the extent inconsistent with section 1113 and that section 365(g) applies to permit a claim for rejection damages).

619 Nw. Airlines Corp. v. Ass'n of Flight Attendants (*In re* Nw. Airlines Corp.), 483 F.3d 160 (2d Cir. 2007).

620 The allocation of a rejection damages among affected employees generally is handled in the context of the proof of claim filed by the authorized representative, but different procedures have been applied depending on the circumstances. *See In re* U.S. Truck Co., Inc., 89 B.R. 618 (E.D. Mich. 1988) (basing allocation on union's proof of claim). The Commission's recommendation on rejection damages under section 1113 does not affect these various approaches to allocation.

621 *See id.* at 625 (overruling objections to union claim for rejection damages and, where employer based need for rejection on ability to continue operation of the business, allowing union's claim to be calculated as the difference between reductions in compensatory terms and other monetary terms implemented post-rejection and terms under nonrejected collective bargaining agreement, based on analogy to claim under federal labor law for unilateral breach of collective bargaining agreement).

2. Retiree Benefits and Section 1114

Recommended Principles:

- The trustee should comply with the requirements of section 1114 of the Bankruptcy Code for all retiree benefits (as defined in section 1114(a)), even if the trustee contends that such benefits are terminable at will under the terms of the benefit plan or applicable nonbankruptcy law. The trustee's compliance with section 1114 for benefits that the trustee contends may be terminable at will should not create any new claims on behalf of retirees or otherwise affect the existence, nature, or scope of any retirees' claims upon the termination or modification of such benefits in accordance with section 1114, which claims should be determined consistent with the terms of the plan or applicable nonbankruptcy law.

Retiree Benefits and Section 1114: Background

Section 1114 requires the debtor in possession[622] to timely pay any retiree benefits and to follow a notice, disclosure, and bargaining process before seeking to modify any retiree benefits during the chapter 11 case. It also provides administrative priority for payments of retiree benefits required to be made before the effective date of a confirmed plan.[623] The protections afforded retiree benefits under section 1114 are supplemented by a corresponding plan confirmation requirement under section 1129(a)(13). Section 1114 defines the term "***retiree benefits***" as "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title."[624]

With respect to the modification of retiree benefits, the section 1114 process resembles the section 1113 process for the rejection of collective bargaining agreements, with at least one key difference.[625] Under section 1114, a committee authorized by the court to serve as an "authorized representative" of such retirees will represent retirees who are receiving benefits not covered by a collective bargaining agreement in the section 1114 process.[626]

As suggested above, the term "retiree benefits" is broad and covers such payments under any prepetition "plan, fund, or program (through the purchase of insurance or otherwise) maintained or established" by the debtor. In fact, some courts interpret this language to include payments under a prepetition retiree benefit plan even if the debtor contends that it has expressly reserved the right

622 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

623 11 U.S.C. § 1114(e).

624 11 U.S.C. § 1114(a).

625 *See In re* Farmland Indus., Inc., 294 B.R. 903, 918 (Bankr. W.D. Mo. 2003) ("A consideration of § 1113 of the [Bankruptcy] Code provides further support for the Court's understanding of § 1114.").

626 11 U.S.C. § 1114(b)(1), (2), (d). The union under the collective bargaining agreement that gave rise to the retiree benefits presumptively serves as the authorized representative for retirees receiving such benefits. 11 U.S.C. § 1114(c).

to unilaterally terminate or modify such plan at any time.[627] For example, in *Visteon*, the relevant plan documents provided that "the Company reserves the right to suspend, modify or amend the benefits provided under the Plan, or even terminate the Plan or any of the benefits provided under the Plan. . . . [T]his handbook is not a contract, nor is it a guarantee of your coverage."[628] The Third Circuit adopted a strict reading of the statute and determined that "[t]he fact that the debtor could have unilaterally stopped the payments had it not been in chapter 11 is . . . irrelevant."[629] Nevertheless, other courts have ruled that a debtor in possession is not required to comply with the section 1114 process when the debtor in possession establishes that it has the right under the prepetition program of benefits to unilaterally modify or terminate the benefits.[630]

Retiree Benefits and Section 1114: Recommendations and Findings

Bankruptcy Code sections 1114 and 1129(a)(13) evidence a strong policy preference for protecting the rights of retirees in a debtor in possession's chapter 11 case. Section 1114 was enacted in response to the *LTV Steel Company* chapter 11 case in which the debtor in possession announced its intention to discontinue health benefits for approximately 70,000 retired employees immediately upon the petition date on the basis that such benefits would be considered prepetition claims.[631] The Commissioners understood the history behind section 1114 and the special protections afforded retirees under the Bankruptcy Code. They also observed that retiree issues, when present in a chapter 11 case, can create complex and challenging issues for the debtor in possession.

The Commissioners discussed the current split in the case law regarding whether the section 1114 procedures apply to all prepetition retiree benefit plans, including those that were found to be terminable at will by the debtor outside of bankruptcy. The Commissioners acknowledged the plain meaning interpretation of section 1114 endorsed by the Third Circuit in *Visteon*. They discussed the focus of this decision on the application of section 1114 during the pendency of the chapter 11 case. As the Third Circuit explained in discussing the treatment of retiree benefits under a chapter 11 plan, "the duration of the period the debtor has obligated itself to provide such benefits plainly encompasses *any* durational obligations, including those arising outside of the bankruptcy context."[632] Accordingly, even if bound by the section 1114 process during the chapter 11 case, the reorganized

627 *See, e.g.,* IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 219–20 (3d Cir. 2010) ("Section 1114 could hardly be any clearer. It restricts a debtor's ability to modify *any* payments to *any* entity or person under *any* plan, fund, or program in existence when the debtor files for Chapter 11 bankruptcy, and it does so notwithstanding any other provision of the [B] ankruptcy [C]ode."); *In re* Farmland Indus., Inc., 294 B.R. 903, 914 (Bankr. W.D. Mo. 2003) ("In this court's view, §1114 prohibits a debtor from terminating or modifying any retiree benefits (as defined in that section) during a Chapter 11 case unless the debtor complies with the procedures and requirements of §1114, regardless of whether the debtor has a right to unilaterally terminate benefits."). *See also* IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 227 (3d Cir. 2010) (explaining legislative history indicating a desire to protect "the 'legitimate expectations' of retirees, and the necessity in a 'just society' of giving effect to those expectations wherever possible"); S. Rep. No. 100-119, at 1–2 (1987), *reprinted in* 1988 U.S.C.C.A.N. 683, 684 ("[T]o provide additional protections for the insurance benefits of retirees, their spouses and dependents, of debtors under the Bankruptcy Code").

628 IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 213 (3d Cir. 2010).

629 *Id.* at 222.

630 *See, e.g., In re* Gen. Motors Corp., No. 09-50026, Hr'g Tr. at 109:24-110:2 (Bankr. S.D.N.Y. June 25, 2009) ("Section 1114 doesn't apply to employee benefit plans that are terminable or amendable unilaterally by the plan sponsor."); *In re* Delphi Corp., 2009 WL 637259, at *19 (S.D.N.Y. Mar. 11, 2009) ("[I]f, in fact, the debtors have the unilateral right to modify a health or welfare plan . . . the debtors' pre-Bankruptcy rights [are not] abrogated by the requirements of section 1114."); *In re* N. Am. Royalties, Inc., 276 B.R. 860 (Bankr. E.D. Tenn. 2002); Retired W. Union Employees Ass'n v. New Valley Corp. (*In re* New Valley Corp.), 1993 WL 818245 (D.N.J. Jan. 28, 1993); *In re* Doskocil Cos. Inc., 130 B.R. 870 (Bankr. D. Kan. 1991).

631 *See In re* Chateaugay Corp., 64 B.R. 990, 992 (S.D.N.Y. 1986); 133 Cong. Rec. H8558 (daily ed. Oct. 13, 1987) ("[T]he triggering event for [enacting § 1114] was [the] bankruptcy of LTV Steel. . . .").

632 IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 224 (3d Cir. 2010) (citations omitted) (internal quotation marks omitted).

debtor could exercise any applicable contractual or nonbankruptcy law rights after the bankruptcy. The Commissioners also noted certain procedural advantages provided by the statute, including the designation of a statutory authorized representative for retirees to engage in the process.

The Commissioners weighed the *Visteon* approach against several competing considerations. For example, courts finding that certain retiree benefit plans fall outside the scope of section 1114 and rely heavily on the parties' prepetition nonbankruptcy rights. Some commentators have noted the practical appeal to this approach given that, even under *Visteon*, the debtor in possession presumably could pay retiree benefits during the case and then, as a reorganized debtor, terminate or modify those benefits immediately after the case, provided that the prepetition benefit plan was found to support a reservation of that right for the company as plan sponsor.

The Commissioners also factored into their deliberations the significant complexity of conducting "at will" litigation over the scope of section 1114 during bankruptcy and the time and expense consumed by such litigation. They evaluated the utility of this litigation to the chapter 11 case. The Commissioners generally found nominal value in the litigation because section 1114 is a process-based provision. Any such changes could occur only if the parties agreed to them through the section 1114 negotiation process or the court authorized the modifications proposed by the debtor in possession after the required negotiations.

Moreover, the Commissioners discussed the purpose and value of the process itself. The steps required by section 1114 provide retirees with representation and a seat at the negotiation table during the chapter 11 case. The process not only gives retirees a voice, but it also ensures that any changes proposed or made by the debtor in possession to retiree benefits are not precipitous and are understood by all affected parties. The Commissioners found value in the process for both the debtor in possession and retirees in cases in which the debtor in possession believed some change to retiree benefits was necessary — regardless of whether the debtor could implement such change unilaterally outside of bankruptcy.

In light of the various relevant factors, the Commission determined that requiring a debtor in possession to follow the section 1114 process for any proposed change to, or termination of, any retiree benefits was the better approach. In reaching this conclusion, however, the Commission also agreed that the debtor in possession's initiation of the section 1114 process where the debtor could have asserted a unilateral right to modify or terminate outside of bankruptcy should not create new claims or otherwise change the claims currently provided under the statute. Accordingly, if the parties agreed to, or the court approved, a change to, or termination of, retiree benefits through the section 1114 process, a debtor in possession asserting an "at will" or other defense limiting its obligations under the prepetition plan could assert such defense in objecting to the amount of any claims asserted by the retirees or their authorized representative arising from the termination or modification of the benefit plan through the section 1114 process. Likewise, the respective rights and remedies of the reorganized debtor and retirees under the prepetition plan (unless such obligations were altered by agreement as part of the 1114 negotiation process) would continue following the debtor's emergence from chapter 11.

E. Administrative Claims

1. Section 503(b)(9) and Reclamation

Recommended Principles:

- The protections afforded by section 503(b)(9) of the Bankruptcy Code should be limited to the value of goods received by, or at the direction of, the debtor in the ordinary course of business within 20 days before the commencement of the case. Section 503(b)(9) should be amended accordingly to permit creditors providing goods on a drop shipment basis to assert appropriate claims under this section.
- A creditor should be required to file a proof of claim and appropriate supporting documentation for any claims it may hold against the estate under section 503(b)(9) on or before the applicable bar date unless otherwise provided by an order of the court. Any such proof of claim should specifically identify the amount of the claim that the creditor asserts is subject to section 503(b)(9). A creditor's failure to file a timely proof of claim should constitute a waiver of such claim unless otherwise provided by an order of the court.
- A party's rights under section 503(b)(9) should replace any rights or remedies that the party may have under applicable nonbankruptcy law based upon reclamation or similar doctrines. Accordingly, section 546(c) should be amended accordingly.

Section 503(b)(9) and Reclamation: Background

Section 503(b)(9) of the Bankruptcy Code provides administrative claim treatment to trade creditors for "the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of business."[633] The BAPCPA Amendments added this section to the Bankruptcy Code. "The legislative history surrounding this section is scant, but presumably Congress was concerned about providing a vehicle to enhance payment to creditors who shipped goods to a debtor in the ordinary course of business on the eve of bankruptcy."[634]

Under section 503(b)(9), trade creditors selling goods (but not providing services) to the debtor during the immediate prepetition period receive an administrative priority claim for the value of those goods that remains unpaid on the petition date, regardless of whether the seller satisfies the requirements for reclamation. Prior to the BAPCPA Amendments, the entirety of a trade creditor's claims were treated as general unsecured claims, unless such creditor could establish a valid reclamation claim under Section 2-702 of the Uniform Commercial Code and section 546 of the

633 11 U.S.C. § 503(b)(9).
634 Judith Greenstone Miller & Jay L. Welford, *503(b)(9) Claimants — The New Constituent, a/k/a "The 500 Pound Gorilla," At The Table*, 5 Depaul Bus. & Com. 487 (2007).

Bankruptcy Code. To establish a reclamation claim, a creditor was required to, among other things, send its reclamation demand within 10 days after the buyer received the goods.

The BAPCPA Amendments implemented two key changes. First, they elevated certain of a trade creditor's claims to administrative priority under section 503(b)(9). Second, they extended the reclamation reachback period to 45 days and, if the 45-day period had not expired when the bankruptcy petition was filed, granted the creditor an additional 20 days from the commencement of the bankruptcy case to send its written reclamation demand. Although the second change appeared favorable to trade creditors in theory, it has turned out, in practice, to be often illusory. Section 546(c) also states that reclamation rights are expressly subject to the prior rights of a creditor with a security interest in the goods, largely reaffirming prior case law.[635]

Accordingly, as a practical matter, trade creditors seek to protect a portion of their prepetition claims under section 503(b)(9) and rarely pursue their reclamation rights under state law and section 546(c). One issue that frequently arises in this context is the process trade creditors must follow to preserve their administrative claim under section 503(b)(9). Section 503(b) states that allowance of a claim under that section is subject to notice and a hearing. This may require a creditor asserting a section 503(b)(9) claim to retain counsel and to file a motion because there is no Bankruptcy Code provision or Bankruptcy Rule permitting creditors to assert their section 503(b)(9) claims by filing a proof of claim. In certain cases, in order to simplify the process of asserting section 503(b)(9) claims and to minimize the costs of addressing those claims, debtors have moved for approval of, and courts have approved, procedures that have either authorized the modification of the official proof of claim form (the "***Official Form***") to include a specific reference to section 503(b)(9) claims or authorized the filing of a separate proof of claim to assert the section 503(b)(9) claim.

Although section 503(b)(9) has provided additional protections to trade creditors who supply goods to the debtor, certain aspects of section 503(b)(9) are ambiguous. The ambiguities include: (i) what constitutes "goods,"[636] (ii) how is the "value" of goods determined,[637] (iii) when goods have been "received,"[638] (iv) whether section 503(b)(9) claims should be disallowed or be subject to setoff when a preference or other claim is asserted against the subject creditor,[639] and (v) when should section

635 *See, e.g., In re* Furrs Supermarkets, Inc., 2012 WL 3396146, at * 3 (Bankr. D.N.M. 2012); *In re* Circuit City Stores, Inc., 441 B.R. 496, 508–10 (Bankr. E.D. Va. 2010); *In re* Advanced Marketing Servs., Inc., 360 B.R. 421, 427 (Bankr. D. Del. 2007); *In re* Dana Corp., 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007).

636 *In re* NE Opco, Inc., 2013 WL 5880660 (Bankr. D. Del. Nov. 1, 2013) (holding that electricity provided by municipal lighting plant was a service not a good, but natural gas provided by the same plant was a good); *In re* S. Mont. Elec. Generation & Transmission Coop., Inc., 2013 WL 85162 (Bankr. D. Mont. Jan. 8, 2013) (holding that electricity was a good where debtor was not an end user, but only a wholesaler of electricity); GFI Wis., Inc. v. Reedsburg Util. Comm'n, 440 B.R. 791 (W.D. Wis. 2010) (holding that electricity is a good where debtor was not an end user of electricity); *In re* Erving Indus., Inc., 432 B.R. 354 (Bankr. D. Mass. 2010) (holding that electricity is a good, not a service); *In re* Plastech Engineered Prods., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008) (natural gas is a good). *But cf. In re* Pilgrim's Pride Corp., 421 B.R. 231 (Bankr. N.D. Tex. 2009) (holding that natural gas and water are goods subject to section 503(b)(9), but where debtor is the end user of electricity, electricity is not a good but rather a service, and thus is not subject to section 503(b)(9)); *In re* Samaritan Alliance, LLC, 2008 WL 2520107 (Bankr. E.D. Ky. June 20, 2008) (holding that electricity is better characterized as a service, not a good).

637 *In re* S. Mont. Elec. Generation & Transmission Coop., Inc., 2013 WL 85162 (Bankr. D. Mont. 2013) (holding that invoice price is proper value of goods); *In re* SemCrude, L.P., 416 B.R. 399 (Bankr. D. Del. 2009) (same); *In re* Pilgrim's Pride Corp., 421 B.R. 231 (Bankr. N.D. Tex. 2009) (holding that replacement cost is the proper value of goods).

638 *In re* Momenta, Inc., 455 B.R. 353 (Bankr. D.N.H. 2011) (addressing whether drop shipped goods were received by the debtor); *In re* Circuit City Stores, Inc., 432 B.R. 225 (Bankr. E.D. Va. 2010) (addressing when consigned goods were received by the debtor); *In re* Plastech Engineered Prods., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008) (addressing whether drop shipped good were received by the debtor).

639 *In re* Ames Dep't Stores, Inc., 582 F.3d 422 (2d Cir. 2009) (holding that section 502(d) is not a ground for disallowance of an administrative priority claim); *In re* Energy Conversion Devices, Inc., 486 B.R. 872 (Bankr. E.D. Mich. 2013) (same); *In re* Plastech Engineered Prods., Inc., 394 B.R. 147 (Bankr. E.D. Mich. 2008) (same). *See also In re* Momenta, Inc., 455 B.R. 353 (Bankr. D.N.H. 2011) (holding that section 502(d) is not a ground for disallowance of a section 503(b)(9) claim); *In re* TI

503(b)(9) claims be paid (on the effective date or sometime earlier).[640] Both creditors and the estate are affected by these issues and frequently incur litigation costs to try to resolve the uncertainty.

Section 503(b)(9) and Reclamation: Recommendations and Findings

The Commission received conflicting testimony concerning the administrative priority of trade claims for certain goods under section 503(b)(9). Some witnesses testified that this additional class of administrative claims made it more difficult for debtors to reorganize because the chapter 11 plan must pay these claim in full on the effective date under section 1129(a)(9).[641] This testimony was consistent with testimony provided to Congress on the topic of the *Circuit City* bankruptcy and similar retail chapter 11 cases.[642] Other witnesses strongly disputed that trade claims were an impediment to confirmable plans of reorganization.[643]

The Commissioners weighed this testimony with anecdotal evidence concerning the types of challenges faced by chapter 11 debtors, including retail debtors, since 2005.[644] For example, debtors are more highly leveraged.[645] As a result, they have less value available to support their reorganization efforts. The economic recession that started in 2008 affected several industries and accelerated or contributed to firms' financial distress. The BAPCPA Amendments also made other changes to the Bankruptcy Code that arguably altered chapter 11 practice, at least as compared to the pre-2005 period.[646]

Acquisition, LLC, 410 B.R. 742, (Bankr. N.D. Ga. 2009) (same). *But cf. In re* MicroAge, Inc., 291 B.R. 503 (B.A.P. 9th Cir. 2002) (holding that debtor could assert preference claim as basis for temporarily disallowing section 503(b)(9) priority claims); *In re* Circuit City Stores, Inc., 426 B.R. 560 (Bankr. E.D. Va. 2010) (same).

640 *In re* Arts Dairy, LLC, 414 B.R. 219 (Bankr. N.D. Ohio 2009) (explaining that a debtor was not immediately required to pay a section 503(b)(9) claim); *In re* Global Home Prods., LLC, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006) (holding that section 503(b)(9) claim should be paid after confirmation of plan); *In re* Bookbinders' Rest., Inc., 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006) (holding that claimant was not entitled to immediate payment of section 503(b)(9) claim).

641 *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that section 503(b)(9) puts huge demands on the cash of the debtor and undermines the debtor's reorganization), *available at* Commission website, *supra* note 55; *Written Statement of Dan Dooley, CEO of MorrisAnderson: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (stating that section 503(b)(9) increases the cost of reorganization which in turn fuels trend toward bankruptcy alternatives), *available at* Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 10 (Nov. 15, 2012) ("Because holders of administrative claims are not placed in classes and do not vote on a plan, and each administrative creditor must be paid in full in cash at the time of confirmation, unless that creditor agrees otherwise, §503(b)(9) creates holdout power in all members of a particular group of creditors, contrary to the policy of bankruptcy law to reduce such power. Because of that power, and the requirement to pay all administrative expenses even in sale cases, secured creditors will reserve for such claims, reducing the resources available to distressed debtors for reorganization.") (citations omitted), *available at* Commission website, *supra* note 55.

642 *See Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44 (2009) (statements of Harvey R. Miller and Richard M. Pachulski). *But see id.* (statement of Professor Todd J. Zywicki, George Mason School of Law) [hereinafter *Zywicki Statement*]; *Lehman Brothers, Sharper Image, Bennigan's and Beyond: Is Chapter 11 Bankruptcy Working?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 110th Cong. 21 (2008) (statement of Professor Barry E. Adler, Esq., New York University School of Law) [hereinafter *Adler Statement*].

643 *See generally Transcript, NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013), *available at* Commission website, *supra* note 55.

644 *See, e.g.,* Bob Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations*, J. of Corp. Renewal (Jan. 8, 2009); *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) (stating that BAPCPA deadlines are hurting retail debtors' chances of rehabilitation), *available at* Commission website, *supra* note 55

645 *See U.S. Retail Case Studies in Bankruptcy Enterprise Values and Creditor Recoveries*, Fitch Case Studies — Retail Edition 1–2 (Apr. 16, 2013) [hereinafter Fitch Report] (observing that there is a "tendency of distressed retailers to maximize secured borrowings, subordination of significant administrative claims and dilution of recoveries from pension, general unsecured trade and operating lease rejection claims placed downward pressure on unsecured recoveries") Analyzing a sample of 20 retail cases, the Fitch Report observed that in each case at least one first lien claim was paid in full, but, alternatively, the median unsecured claim recovery was less than 10 percent, while the average was 20 percent. *Id. See also* Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, J. Corp. Renewal, Sept./Oct. 2009.

646 *See* Section III.A, *Brief History of U.S. Business Reorganization Laws*.

The Commissioners acknowledged that trade creditors are aware of, and rely on, their rights under section 503(b)(9) in making prepetition credit and shipment decisions. Some of the Commissioners raised concerns about the increasing number of administrative and priority claims categories.[647] Each additional administrative or priority claim category undercuts the Bankruptcy Code's policy of fair and *pro rata* distributions among similarly situated creditors. The Commission agreed that administrative and priority status should be a limited exception and that general unsecured status should be the rule. Several Commissioners did not believe, however, that eliminating the section 503(b)(9) category would provide significant benefits to the estate, but they did believe that it may make operating the debtor's prepetition business more challenging or expensive to the extent that trade creditors refuse to ship goods or will do so only on modified credit or all-cash terms. On balance, the Commission voted to retain the section 503(b)(9) administrative claims priority, provided that this provision represent the only priority treatment made available to such creditors. The Commission also agreed to recommend the elimination of all reclamation rights in bankruptcy under section 546(c), as well as any doctrine of necessity arguments related to these claims.[648]

In making this determination, the Commissioners discussed whether a valid basis existed for excluding drop shipment transactions, when the trade creditor supplies goods on the debtor's behalf to another party, from section 503(b)(9). The Commissioners acknowledged the statutory support for the exclusion given that the debtor does not "receive" the goods in this instance and given that section 503(b)(9) was intended to benefit creditors with reclamation rights.[649] Nevertheless, they discussed the substance of drop shipment transactions and their use to increase efficiencies in the transactions, which may still be provided for the benefit of the debtor's business. Accordingly, the Commission determined that, if the debtor directed the creditor to ship the goods directly to a third party in lieu of the debtor making that shipment, then applying section 503(b)(9) serves the same policy goal of encouraging trade creditors to supply goods on credit and should apply to the drop shipment transaction.

The Commissioners also discussed the inclusion of services in section 503(b)(9). Again, the Commissioners recognized the difficulty in drawing a bright line to limit the scope of the exception to that necessary to achieve the desired policy goals. They distinguished service providers from suppliers of goods based on their respective state law rights and the use of section 503(b)(9) as a substitution for creditors' state law reclamation rights. They also believed that a debtor in possession would have adequate ability to justify and request authority to pay service providers critical to the business and reorganization efforts through the Commission's proposed codification of the doctrine of necessity, as explained above.[650]

The Commissioners did note the confusion and uncertainty regarding the process for creditors to assert and preserve section 503(b)(9) claims. Some of the Commissioners suggested that, just as with any other administrative claim request, the creditor should be required to file a motion and justify the request. Other Commissioners believed that such a requirement would add unnecessary

647 *See, e.g.,* Howard Delivery Serv. Inc. v. Zurich Am. Insur. Co., 547 U.S. 651, 655 (2006) (explaining that exceptions to general equality principle should be "clearly authorized by Congress" and strictly construed).

648 *See* Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

649 *See, e.g.,* Ningbo Chenglu Paper Prods. Mrf. Co., Ltd v. Momenta, Inc. (*In re* Momenta, Inc.), 2012 WL 3765171, at *4 (D.N.H. Aug. 29, 2012).

650 *See* Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

cost to the process and would not be particularly efficient for either the debtor in possession or the estate in many cases. After discussing various alternatives, the Commission agreed that these principles should recommend a modification to section 503(b)(9), the Bankruptcy Rules, and the Official Form to require creditors asserting section 503(b)(9) claims to file a proof of claim for such claims on or before the general bar date or a specific section 503(b)(9) bar date established by the court.

2. Administrative Claims Committee

Recommended Principles:

- Neither the court nor the U.S. Trustee should be authorized to constitute an official committee of administrative claimants. Accordingly, a new provision should be added to section 1102 to clarify this point.

Administrative Claims Committee: Background

Section 1102 of the Bankruptcy Code currently mandates the appointment of a committee of creditors holding unsecured claims and allows the court to order the appointment of other committees of creditors or equity security holders "if necessary to assure adequate representation" of such creditors or equity security holders. In all instances, the members of the committee are vetted and appointed by the U.S. Trustee. As discussed in Section IV.A.4, *Statutory Committees*, committees generally provide a voice for unsecured creditors in the case, protect the rights and interests of unsecured creditors, and serve as a statutory watchdog or check on the debtor in possession.

Traditionally, unsecured creditors were viewed as one of the more vulnerable classes of stakeholders in a chapter 11 case. Many debtors had liquidity or other resources to pay their secured creditors and administrative and priority claimholders, but often did not generate sufficient value to pay unsecured creditors in full, or even a meaningful distribution, in the case. Moreover, the Bankruptcy Code requires a debtor to pay the allowed claims of secured creditors and holders of administrative claims in order to confirm a chapter 11 plan. Accordingly, secured creditors and the holders of administrative claims typically have sufficient protection in a chapter 11 case.

In recent years, the more vulnerable (or perceived vulnerable) classes of stakeholders in a chapter 11 case have moved up in a debtor's capital structure. The debtor often does not generate sufficient value to pay its administrative claimants. As "administratively insolvent" cases have become more common, some practitioners have questioned whether administrative claimants need representation through the committee structure. Most courts have rejected requests for the appointment of administrative claims committees. The one notable exception is *In re LTV Steel.*

Administrative Claims Committee: Recommendations and Findings

Committees serve oversight and representative functions that generally are lacking in the chapter 11 case. The latter is particularly important in the context of unsecured creditors and, in some cases,

equity security holders whose distributions in the chapter 11 case are determined largely by the value of the estate, or value generated for the benefit of the estate during the case. The Bankruptcy Code does not require a minimum distribution to general unsecured creditors or equity security holders. Rather, plan confirmation standards require only that these parties receive at least as much as they would receive in a chapter 7 liquidation and that, to the extent they are impaired, no junior class receive a distribution.

The Commissioners did not perceive the same risks for administrative claimholders. Although the value generated in a case may prove inadequate and administrative claims may not be satisfied in full, the Bankruptcy Code incorporates protections for these claimholders at least in the confirmation context. In addition, the Commissioners noted that the recommended principles on section 363x sales propose extending similar protection to administrative claimholders in the context of sales of all or substantially all of a debtor's assets. Accordingly, the Commission determined that the additional time and expense often associated with statutory committees were not necessary or warranted with respect to administrative claims.

3. WARN Act Claims

Recommended Principles:

- When a plant closing, mass layoff, or other triggering event under the Worker Adjustment and Retraining Notification Act (the "***WARN Act***") occurs on or after the filing of the bankruptcy petition, claims for (or on behalf of) employees for damages under the WARN Act should be treated as administrative claims under section 503(b) of the Bankruptcy Code for the number of postpetition days comprising the violation, provided that the claims are otherwise entitled to protection under the WARN Act.

WARN Act Claims: Background

The Worker Adjustment and Retraining Notification Act (the "***WARN Act***")[651] requires covered employers to provide affected employees with at least 60 days' advance notice prior to effecting a plant closing or covered mass layoff. The WARN Act is intended to "provide[] protections to workers, their families and communities by requiring employers to provide notification 60 calendar days in advance of plant closings and mass layoffs. Advance notice provides workers and their families some transition time to adjust to the prospective loss of employment, to seek and obtain alternative jobs and, if necessary, to enter skill training or retraining that will allow these workers to successfully

651 29 U.S.C. §§ 2101–2109.

compete in the job market."[652] When the required notice is not given, employers may be liable for back pay and benefits for the period of the violation, up to a maximum of 60 days.[653]

There are statutory exceptions that, if established by the employer, would permit a notification period of fewer than 60 days. Under the "faltering company" exception, a company may provide fewer than 60 days' notice of a plant closing if, during the 60 days prior to shutdown, the company was "actively seeking capital or business, which, if obtained, would have enabled the employer to avoid or postpone the shutdown and the employer reasonably and in good faith believed that giving the notice required would have precluded the employer from obtaining the needed capital or business."[654] In addition, when a mass layoff or plant closing is caused by business circumstances that were "not reasonably foreseeable as of the time the notice would have been required," the notification period may be reduced.[655] Similarly, a natural disaster may reduce the notice period.[656] An employer relying one of the statutory bases for a reduction in the notice period must still provide "as much notice as is practicable."[657] Other defenses to WARN Act liability may apply as well.[658]

Employees aggrieved by a violation of the notice requirement, or their representatives,[659] may assert claims for back pay for "each day of the violation," and for benefits under an employee benefit plan.[660] Liability is calculated for the period of the violation, up to a maximum of 60 days. Certain reductions may apply, for example, for any wages paid by the employer for the period of the violation.[661]

Liability for WARN Act damages when the requisite notice was not given has been analogized to liability for severance pay in lieu of notice, when courts have viewed such pay to be earned in full upon the triggering event. Thus, courts have held that WARN Act damages give rise to a right to payment upon the occurrence of the event triggering the violation (*i.e.*, the employment termination or mass layoff). Accordingly, the timing of the triggering event generally has determined the payment classification of the claim for bankruptcy purposes. When employment loss occurred prepetition, due to a plant closing or mass layoff that is covered by the WARN Act, the WARN Act damages claim generally has been held to arise in full prepetition, even if the termination occurred close in time to a bankruptcy filing such that a portion of the 60-day period covered by the notice requirement

652 20 C.F.R. § 639.1(a). *See In re* FF Acquisition Corp., 438 B.R. 886, 891 (Bankr. N.D. Miss. Oct. 26, 2010), *aff'd and appeal dismissed sub nom.* Angles v. Flexible Flyer Liquidating Trust, 471 B.R. 182 (N.D. Miss. 2012), *aff'd sub nom. In re* Flexible Flyer Liquidating Trust, 511 Fed. App'x 369 (5th Cir. 2013). *See also* Hotel Employees & Rest. Employees Int'l Union Local 54 v. Elsinore Shore Assocs., 173 F.3d 175, 182 (3d Cir. 1999) (noting adoption of WARN Act "in response to the extensive worker dislocation that occurred in the 1970s and 1980s").

653 *In re* FF Acquisition Corp., 438 B.R. 886, 891 (Bankr. N.D. Miss. Oct. 26, 2010), *aff'd and appeal dismissed sub nom.* Angles v. Flexible Flyer Liquidating Trust, 471 B.R. 182 (N.D. Miss. 2012), *aff'd sub nom. In re* Flexible Flyer Liquidating Trust, 511 Fed. App'x 369 (5th Cir. 2013). *See also* 29 U.S.C. § 104(a)(1)(A)–(B).

654 29 U.S.C. § 2102(b)(1). *See* 20 C.F.R. § 639.9(a) (setting forth qualifying requirements for "faltering business" exception).

655 29 U.S.C. § 2102(b)(2). *See* 20 C.F.R. § 639.9(b)(2) (setting forth indicators where business circumstance may not be reasonably foreseeable).

656 *See* 29 U.S.C. § 2102(b)(2)(B); 20 C.F.R. § 639.9(c).

657 29 U.S.C. § 2102(b)(3).

658 *E.g.*, *id.* § 2104(a)(4) (providing that, in an action to recover damages, where an employer proves "reasonable grounds for believing that the act or omission was not a violation" of the statute, court may reduce the amount of the liability). *See also id.* § 2103 (listing exemptions where plant closing or mass layoff constitutes a strike or lockout, or closing relates to a temporary facility).

659 *See* United Food & Commercial Workers Local 751 v. Brown Grp., Inc., 517 U.S. 544 (1996) (holding that union representing affected employees has standing under WARN Act to sue for damages on their behalf).

660 *See* 29 U.S.C. § 2104(a)(1)(A)–(B).

661 *See id.* § 2104(a)(1), (2).

included time following the petition date.[662] When applicable, prepetition WARN Act claims have been held to be subject to the wage priority.[663]

When the event triggering WARN Act liability occurs postpetition, courts have held that employees terminated postpetition have claims that accrue in full postpetition.[664] Thus, these cases hold that WARN Act claims based on a postpetition termination are entitled to administrative priority.[665]

One case held differently, although in the context of deciding whether a WARN Act claim should proceed as an adversary proceeding or through the claims adjudication process. In *In re Circuit City*, the plaintiff was terminated postpetition, but the date on which notice should have been given, had his employer complied with the WARN Act, was eight days prior to the petition date.[666] The debtor argued that the claim arose on the date that notice was due, not on the date of termination. The court's rationale was that, as of the date the company gave notice of the store closing, which occurred prior to the bankruptcy, the employees had a "contingent" claim against the debtor, in the event the debtor's notice was inadequate under the WARN Act.[667] Thus, the court concluded that (at least for purposes of determining the mechanism for pursing the claim) the claim arose on the date notice was due. The court thus concluded that the claim should proceed through the claims adjudication process and dismissed the plaintiff's adversary proceeding.

WARN Act Claims: Recommendations and Findings

In considering cases involving postpetition closures or other triggering events under the WARN Act, the Commission agreed that the event giving rise to WARN Act damages is the loss of employment due to the WARN Act triggering event, and not the date the notice should have been given. In order

662 *See, e.g., In re* Powermate Holding Corp., 394 B.R. 765, 772–73 (Bankr. D. Del. 2008); Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc. (*In re* Kitty Hawk, Inc.), 255 B.R. 428, 438 (Bankr. N.D. Tex. 2000) (Bankr. N.D. Tex. 2000). *See also In re* First Magnus Fin. Corp., 403 B.R. 659, 665–66 (D. Ariz. 2009) (holding that WARN Act rights of workers discharged without requisite notice accrue in their entirety upon termination and damages are vested prepetition); *In re* Continentalafa Dispensing Co., 403 B.R. 653, 658 (Bankr. E.D. Mo. 2009) ("Here, Plaintiff was terminated before Debtors filed their petitions and therefore, Plaintiff performed no work after the petitions were filed. Thus, Plaintiff has a prepetition claim.").

663 *E.g., In re* Powermate Holding Corp., 394 B.R. 765, 772–73 (Bankr. D. Del. 2008); Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc. (*In re* Kitty Hawk, Inc.), 255 B.R. 428, 438 (Bankr. N.D. Tex. 2000). Courts generally have held that WARN Act damages are considered "wages." *E.g., In re* Powermate Holding Corp., 394 B.R. 765, 771 (Bankr. D. Del. 2008); *In re* Hanlin Grp., Inc., 176 B.R. 329, 333 (Bankr. D.N.J. 1995); *In re* Riker Indus., Inc., 151 B.R. 823 (Bankr. N.D. Ohio 1993); *In re* Cargo, Inc., 138 B.R. 923, 927 (Bankr. N.D. Iowa 1992).

664 Courts have considered whether to apportion WARN Act damages between prepetition and postpetition periods under section 503(b)(1)(a)(A)(ii), a section added to the Bankruptcy Code pursuant to BAPCPA. However, although courts have consistently declined to apply revised section 503(b) where a WARN Act event occurs prepetition, they have not agreed on an interpretation of this provision that would encompass WARN Act damages. *Compare In re* First Magnus Fin. Corp., 390 B.R. 667, 679 (Bankr. D. Ariz. 2008) (interpreting section 503(b)(1)(a)(A)(i) and (ii) such that both subparts must apply for subpart (ii) to apply at all, so that statute is inapplicable where no services are rendered postpetition) *with In re* Continentalafa Dispensing Co., 403 B.R. 653, 658 (Bankr. E.D. Mo. 2009) (holding that BACPA was not meant to "slant" the law to cover prepetition terminations); *In re* Powermate Holding Corp., 394 B.R. 765, 777 (Bankr. D. Del. 2008) (holding that statutory use of "and" meant that subparts (i) and (ii) were independent examples of administrative claims, but BAPCPA was not meant to "drastically change the outcome of prepetition employment terminations"). *But see In re* Phila. Newspapers, LLC, 433 B.R. 164, 174–75 (Bankr. E.D. Pa. 2010) (disagreeing with *Powermate*'s conclusion that statute must be applied based on the timing of accrual or vesting of right to payment, but holding that statute is inapplicable to back pay award based upon contractual violation). The Commission did not address whether an employment loss resulting from a prepetition WARN Act triggering event could nonetheless fall within BAPCPA.

665 *E.g., In re* Beverage Enters., Inc., 225 B.R. 111, 115–16 (Bankr. E.D. Pa. 1998) (holding that WARN Act claims of workers who were terminated approximately four months after chapter 11 petition was filed were deemed "severance" benefits that was earned immediately upon termination, that it was indisputable that termination occurred postpetition, and that WARN Act claims were therefore entitled to administrative priority); *In re* Hanlin Grp., Inc., 176 B.R. 329, 334 (Bankr. D.N.J. 1995) ("Back pay under WARN [Act] is deemed to be earned at the date of termination. Because the date of termination occurred postpetition, any back pay due for a WARN [Act] violation will be deemed as earned postpetition, and therefore in the nature of wages for services rendered after the commencement of the case entitled to administrative priority status.").

666 *In re* Circuit City Stores, Inc., 2010 WL 120014 (Bankr. E.D. Va. Jan. 7, 2010).

667 *Id.* at *4.

to violate the WARN Act, an employer must effect a mass layoff or plant closing that takes place without providing the requisite WARN Act notice. Until such an event occurs, there has been no violation of the WARN Act. Thus, aggrieved employees should have a postpetition administrative claim for WARN Act damages for the number of postpetition days comprising the violation. The principle would apply assuming the claim for WARN Act damages is otherwise determined to be a valid claim under the WARN Act. The Commission did not address the substance of any potential defenses that may be applicable under the WARN Act, and instead proposed its recommendation strictly on the basis that the appropriate forum has otherwise determined that damages were owed.

The Commission considered whether a bright-line rule that postpetition WARN Act violations give rise to administrative claims might create an incentive for companies with plants or operations that are of doubtful viability to close such plants or operations prepetition rather than trying to turn them around postpetition and risk an administrative priority WARN Act claim if the turnaround effort fails. However, strategic decisions based solely on the economics of a potential WARN Act claim seem unlikely, particularly because most courts already determine payment priority status based on the timing of the triggering WARN Act event, and the Commission's clarifying recommendation would not represent a significant change in current law.

4. Severance Benefits

Recommended Principles:

- An employee's claim for postpetition severance benefits should be eligible for treatment as an administrative claim under section 503(b)(1)(A)(i) of the Bankruptcy Code.
- If an employee is terminated postpetition and entitled to severance benefits that are calculated based on length of service, the employee's claim against the estate for severance benefits should be bifurcated between the prepetition and postpetition periods, such that the employee is permitted to assert (i) a prepetition claim for severance benefits based on prepetition service and (ii) a postpetition administrative claim for severance benefits based on postpetition service. Such an employee also should be permitted to assert a priority claim for any qualifying portion of the prepetition severance benefits claim under section 507.

Severance Benefits: Background

Severance benefits generally are described as payments due to an employee as a result of the termination of employment or some other significant adjustment to or change in the employee's employment circumstances.[668] In a chapter 11 case, a debtor may reduce its workforce because, for example, it is downsizing, restructuring its business operations, or liquidating. Employees impacted

668 5 Collier on Bankruptcy ¶ 507.06[5](b) (16th ed. 2012).

by these decisions may be covered by prepetition severance plans. These plans may be based on (i) a fixed payment at termination in lieu of notice, or (ii) the terminated employee's length of service.[669]

The treatment of employees' severance benefits in the chapter 11 case is important to both the debtor and its employees. The primary issue in this respect is whether the severance benefits are treated as prepetition unsecured claims or postpetition administrative claims. Section 503(b) of the Bankruptcy Code grants administrative priority to the "actual, necessary costs and expenses of preserving the estate."[670] These claims generally include costs associated with operating the debtor's business and administering the estate during the chapter 11 case. Section 503(b)(1)(A)(i) specifically identifies "wages, salaries, and commissions for services rendered after the commencement of the case" as administrative claims.[671] These claims are entitled to payment priority (*i.e.*, paid before prepetition unsecured claims are paid) and generally must be paid in full under the chapter 11 plan. Accordingly, the characterization of severance benefits can have significant consequences for the debtor and the terminated employees.

Although not specifically referenced in the statute, courts analyze the treatment of severance benefits under section 503(b)(1)(A)(i).[672] In general, courts tend to treat severance benefits as prepetition or postpetition claims based on the type of severance plan at issue: if it is a lump sum payment plan in lieu of notice, courts treat the benefits as postpetition claims;[673] if it is a plan based on length of service, courts generally allocate the benefits between prepetition and postpetition claims according to when the severance benefits were earned.[674] Notably, the Second Circuit has rejected the allocation of severance benefits — even under plans based on length of service — finding that the purpose of severance benefits is to compensate the employees for termination, which is the event that should determine the treatment of claims in bankruptcy.[675] Courts in the Second Circuit thus treat all true severance benefits triggered by a postpetition termination as postpetition administrative claims. Moreover, in the context of section 507(a)(4) priority claims, the Fourth Circuit has determined that severance compensation was "earned" upon the employees' termination.[676]

669 *See, e.g.,* Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (*In re* Health Maint. Found.), 680 F.2d 619, 621 (9th Cir. 1982); Richard F. Broude, Reorganizations Under Chapter 11 of the Bankruptcy Code 6-12.3 (Law Journal Press, 2005).

670 11 U.S.C. § 503(b).

671 *Id.* § 503(b)(1)(A)(i).

672 *Id.* Before a debtor can provide or pay any insider of the debtor administrative priority severance pay, the debtor must satisfy the requirements of section 503(c)(2). *Id.* § 503(c). The Commission did not address the payment of severance or other compensation to insiders under section 503(c).

673 5 Collier on Bankruptcy ¶¶ 503.06[7](d), 507.06[5](b) (16th ed. 2012).

674 *See, e.g.,* Preferred Carrier Svcs. Va., Inc. v. Phones For All, Inc.(*In re* Phones For All, Inc.), 288 F.3d 730 (5th Cir. 2002); Bachman v. Commercial Fin. Svcs., Inc. (*In re* Commercial Fin. Svcs., Inc.), 246 F.3d 1291, 1294 (10th Cir. 2001); *In re* Roth Am., Inc., 975 F.2d 949 (3d Cir. 1992); Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (*In re* Health Maint. Found.), 680 F.2d 619, 621 (9th Cir. 1982); Cramer v. Mammoth Mart, Inc. (*In re* Mammoth Mart, Inc.), 536 F.2d 950 (1st Cir. 1976); *In re* Public Ledger, Inc., 161 F.2d 762 (3d Cir. 1947); Rawson Food Svcs., Inc. v. Creditors' Comm. (*In re* Rawson Food Svcs., Inc.), 67 B.R. 351 (Bankr. M.D. Fla. 1986).

675 Rodman v. Rinier (*In re* W.T. Grant Co.), 620 F.2d 319 (2d Cir. 1980), *superseded by statute* (Bankruptcy Code) *as recognized in In re* Hooker Investments, Inc, 145 B.R. 138 (Bankr. S.D. New York. 1992); Straus-Duparquet, Inc. v. Local Union No. 3, Int'l Bhd. of Elec. Workers, AFL-CIO (*In re* Straus-Duparquet, Inc.), 386 F.2d 649, 651 (2d Cir. 1967), *superseded by statute* (Bankruptcy Code) *as recognized in In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 687, 711 (Bankr. S.D.N.Y. 1992) *See also* Supplee v. Bethlehem Steel Corp. (*In re* Bethlehem Steel Corp.), 479 F.3d 167, 175 (2d Cir. 2007) ("The key inquiry is whether the payment is a new benefit earned at termination or instead an acceleration of benefits [which the employee accrued over time].").

676 Matson v. Alarcon, 651 F.3d 404, 409 (4th Cir. 2011). The Fourth Circuit specifically highlighted the difference in language between section 503(b)(1)(A)(i) and section 507(a)(4), noting that the former — dealing with characterization of employee payments as administrative claims — expressly tied such claims to "services rendered after the commencement of the case." *Id.* Accordingly, the Fourth Circuit's decision may have limited application in the analysis of severance benefits arising from a postpetition termination.

Severance Benefits: Recommendations and Findings

The Commission considered two issues with respect to severance benefits in chapter 11: first, whether section 503(b)(1)(A)(i) should be amended to specifically reference severance benefits, in addition to "wages, salaries, and commissions for services rendered after the commencement of the case"; and second, whether the Bankruptcy Code should be amended to address the treatment of severance benefits relating to a postpetition termination or other triggering event. The Commission agreed that "severance benefits" should be added to section 503(b)(1)(A)(i) and largely viewed this change as a technical amendment. The Commissioners engaged in a more in-depth analysis of the treatment of severance benefits as prepetition or postpetition claims.

The Commissioners discussed the underlying nature of severance benefits. Some of the Commissioners viewed severance benefits in all circumstances as compensation for the termination itself, not wages or compensation for services previously rendered. These Commissioners emphasized that severance benefits are intended to mitigate at least some of the hardship imposed upon employees by the termination of employment and the resulting loss of wages and benefits. They also observed that, even if a severance plan uses length of service to calculate the amount of the severance benefit, that reference is solely a calculation tool and does not necessarily speak to the nature or purpose of the benefit. Finally, these Commissioners highlighted the additional burden on more senior employees imposed by an allocation rule. These employees may have the majority of their severance benefits calculated based on a long prepetition tenure with the debtor, arguably penalizing them for their loyalty and service to the debtor.

Other Commissioners strongly believed that severance benefits calculated based on length of service should be deemed earned when such services were provided. This approach requires an allocation of the severance benefits between the prepetition and postpetition periods. These Commissioners observed that many claims are bifurcated in this manner under the Bankruptcy Code, and they did not find justification for varying it in the employment context. They also emphasized that administrative claims must be grounded in value provided to the estate — whether to preserve or enhance the estate — and focused on the general purpose and language of section 503(b) of the Bankruptcy Code.

In vetting these issues, the Commission considered the U.S. Supreme Court's decision in *United States v. Quality Stores.*[677] In *Quality Stores*, the Supreme Court held that severance payments were wages for purposes of FICA, and provided guidance on how to characterize these types of payments. Specifically, the Supreme Court explained:

> [S]everance payments often vary, as they did here, according to the function and seniority of the particular employee who is terminated. For example, under both termination plans, Quality Stores employees were given severance payments based on job grade and management level. And under the second termination plan, nonofficer employees who had served at least two years with their company received more in severance pay than nonofficer employees who had not — a standard example of a company policy to reward employees for a greater length of good service and loyalty.

677 United States v. Quality Stores, Inc., 134 S. Ct. 1395 (2014).

> In this respect severance payments are like many other benefits employers offer to employees above and beyond salary payments. Like health and retirement benefits, stock options, or merit-based bonuses, a competitive severance payment package can help attract talented employees. Here, the terminations leading to the severance payments were triggered by the employer's involuntary bankruptcy proceeding, a prospect against which employees may wish to protect themselves in an economy that is always subject to changing conditions.[678]

Some of the Commissioners asserted that the Supreme Court's holding in *Quality Stores* suggested that the characterization of severance benefits as payment either due upon termination or for services previously provided by an employee should be left to the courts to resolve on a case-by-case basis. The advisory committee recommended this approach as well. Other Commissioners did not necessarily disagree with this assessment, but argued that the Bankruptcy Code should still clarify the treatment of severance benefits if the court determines they are earned based upon length of service under the applicable severance plan. The Commission recommended that the Bankruptcy Code codify an allocation rule for severance benefits triggered postpetition and calculated based on length of service. For additional views on the recommended principles for severance benefits, see ***Appendix G***.

F. General Valuation Standards

Recommended Principles:

- The court should continue to determine valuation issues based on the evidence presented by the parties. The Bankruptcy Code should not dictate the valuation methodology to be used by the court in resolving these issues. Accordingly, no change to existing law is suggested on this point.
- The court should be permitted to use a court-appointed expert and to rely on the hearing testimony of a court-appointed expert in addition to any expert offered by the parties to assist in determining valuation issues. Section 105 of the Bankruptcy Code and Rule 706 of the Federal Rules of Evidence permit the court to appoint valuation experts. Accordingly, no change to existing law is suggested on this point.

General Valuation Standards: Background

Valuation issues arise at various points in a chapter 11 case. Parties may need a valuation of the debtor's assets early in the case to resolve, for example, a secured creditor's request for adequate protection under section 361 or to assess a proposed sale of some or all of a debtor's assets under section 363. They may need to revisit valuation issues later in the case in connection with creditors'

678 *Id.* at 1499.

requests for relief from the automatic stay or confirmation of a chapter 11 plan. Indeed, the value of a debtor's assets impacts adequate protection requests, postpetition financing terms and collateral, the amount of secured creditors' allowed secured claims against the estate, distributions available to creditors in the case, the feasibility of a plan, and the application of the absolute priority rule in the plan cramdown context.[679] Nevertheless, the Bankruptcy Code does not address valuation issues directly in the chapter 11 context or mandate a particular methodology for valuing a debtor's assets.

Accordingly, courts generally determine the value of a debtor's assets, and resolve any related valuation disputes, based on the evidence presented by the parties at the hearing on the matter. This method, commonly referred to as "judicial valuation," introduces some uncertainty into the process, but it also allows courts to consider various valuation methodologies and to tailor the valuation to the facts and circumstances at hand. Parties may value the debtor's assets based on, among other factors, a balance sheet analysis, a discounted cash flow analysis, or market comparables.[680] Parties typically introduce this evidence through expert testimony at the hearing, and courts weigh and consider this testimony and the other evidence in reaching their valuations. Empirical studies suggest that courts thoughtfully consider valuation disputes and do not simply resolve such matters by splitting the difference.[681]

In addition to relying on the parties' experts, courts also may appoint an expert to testify on valuation issues. Rule 706 of the Federal Rules of Evidence provides that "the court may appoint any expert that the parties agree on and any of its own choosing." In addition, the court may establish the expert's duties and compensation in the order of appointment. Court-appointed experts generally are subject to discovery and cross-examination. Moreover, some courts have invoked section 105 of the Bankruptcy Code and Rule 706 of the Federal Rules of Evidence to appoint "experts with teeth," in that the court-appointed expert served both as a valuation expert for the court and a mediator between the parties on the valuation issues.[682]

General Valuation Standards: Recommendations and Findings

In general, valuation is more art than science. Regardless of the valuation methodology, the results depend on a variety of factors, including timing, market conditions, assumptions, and appraisers.[683] As one court explained:

679 Section 506(a)(1) provides that a secured creditor's claim is secured to the extent of the value of its collateral and that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a)(1). In addition, section 506(a)(2) provides more specific guidance in the case of an individual under chapter 7 or 13. *Id.* § 506(a)(2) (mandating valuation based on the replacement value of the property as of the petition date in individual chapter 7 and 13 cases).

680 *See* Bernard Trujillo, *Patterns in a Complex System: An Empirical Study of Valuation in Business Bankruptcy Cases*, 53 UCLA L. Rev. 356 (2005). In addition, parties may present testimony of a potential purchaser or prospective user of the property at issue; the contract method or rates agreed to by the parties, or general observations about market or industry trends for such property. *Id.* at 383–85.

681 *Compare id.* at 370 (study of 180 observations drawn from 145 published opinions reported in the Westlaw computer database decided from 1979 through 1998, finding "complete success for the debtor or for the creditor — about equally . . . [C]ourts very rarely split the difference between the debtor's and the creditor's numbers") *with* Keith Sharfman, *Judicial Valuation Behavior: Some Evidence from Bankruptcy*, 32 Fla. St. U. L. Rev. 387, 396 (2005) (study of 24 valuation disputes, finding "(1) bankruptcy judges on average allocated 65.2% of the value in controversy to debtors and only 34.8% to secured creditors; and (2) bankruptcy judges were more than three times as likely to allocate most of the value in controversy to debtors as they were to secured creditors"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

682 *See, e.g., In re* Calpine Corp., 377 B.R. 808 (Bankr. S.D.N.Y. 2007).

683 *See, e.g.,* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1941–42 (2006) ("A business, however, cannot be valued with such precision. There are different methods of valuing a business, but in the end all are merely estimates of the present value of the business's future earning capacity.").

> [T]he valuation of an enterprise . . . is an exercise in educated guesswork. At worst it is not much more than crystal ball gazing. There are too many variables, too many moving pieces in the calculation of value . . . for the court to have great confidence that the result of the process will prove accurate in the future. Moreover, the court is constrained by the need to defer to experts and, in proper circumstances, to Debtors' management.[684]

The Commissioners discussed the uncertainty surrounding valuation generally and considered whether judicial valuation significantly enhanced this uncertainty. Such inherent uncertainty is recognized in the legislative history of the Bankruptcy Code, which explains that, "[a]s Peter Coogan has aptly noted, such a valuation [of the enterprise in connection with applying the absolute priority rule] is usually 'a guess compounded by an estimate.'"[685] The Commission reviewed valuation methodologies used as part of, or independent from, judicial valuation to value a debtor's assets or business as a going concern. These methodologies include discounted cash flow, market comparables, and securities based valuations, among others. The Commissioners explored how different components of these valuation methodologies are subject to varying interpretation or application, which can cause fluctuation in asset or business valuations.[686] For example, an empirical study of companies emerging from chapter 11 prior to 1994 finds "that estimates of value are generally unbiased, but the estimated values are not very precise — the sample ratio of estimated value to market value varies from below 20 percent to more than 250 percent."[687] The authors of this study suggest that the variance in valuations may result from the administrative bankruptcy process or from strategic distortion. "The strategic distortion explanation for the imprecision of the cash flow forecasts implies that the valuation errors are systematically related to proxies for the competing financial interests and relative bargaining strengths of the parties."[688]

The Commissioners also examined the impact of valuation uncertainty on chapter 11 cases. Many of the Commissioners commented that although valuation litigation can be time-consuming and expensive,[689] judicial valuation and any related uncertainty can encourage negotiated resolutions.[690] A negotiated resolution of valuation uncertainty aligns with the consensual nature of the chapter 11 process. Although disputes arise and not every chapter 11 is consensual, commentators typically describe "the goal of a Chapter 11 restructuring [as achieving] a consensual plan of reorganization."[691] Chapter 11's preference for consensual resolutions evolved at least in part from business reorganization's Chapter XI roots. A consensual plan between the debtor and its unsecured creditors was the hallmark of the Chapter XI process under the Bankruptcy Act.[692]

The Commissioners found continued utility in the judicial valuation approach, including the flexibility it gives the parties in selecting the best valuation methodology. Judicial valuation allows the court and parties to consider market valuations, book and adjusted book valuations, and other

684 *In re* Mirant Corp., 334 B.R. 800, 848 (Bankr. N.D. Tex. 2005).
685 1977 House Judiciary Committee Report on Public Law 95-598, at 222.
686 *See* Baird & Bernstein, *supra* note 683, at 1943 ("Differences of 10% are almost inevitable, and often the differences are far larger.").
687 Stuart C. Gilson et al, *Valuation of Bankrupt Firms*, 13 Rev. Fin. Studies 43–74 (2000) ("This study explores the relation between the market value of 63 publicly traded firms emerging from Chapter 11 and the values implied by the cash flow forecasts in their reorganization plans.").
688 *Id.*
689 *In re* Mirant Corp., 334 B.R. 800, 809, 824 (Bankr. N.D. Tex. 2005) (conducting 27-day valuation trial with separate valuation experts for key parties testifying to values ranging from $7.2 billion to $13.6 billion).
690 *See* Baird & Bernstein, *supra* note 683, at 1963 ("These dynamics regularly lead to negotiated reorganization plans with basic features consistent with the idea that valuation uncertainty plays a key role in dictating the contours of such plans.").
691 Miller & Waisman, *Is Chapter 11 Bankrupt?*, *supra* note 26, at 144–45.
692 For discussion of Chapter XI of the Bankruptcy Act, see Section III.A, *Brief History of U.S. Business Reorganization Laws*.

factors that may be relevant to particular debtor and its reorganization efforts. The Commissioners were also mindful, however, of witness testimony suggesting that judges may need assistance with complex or contested valuations. For example, the Honorable James Peck of the U.S. Bankruptcy Court for the Southern District of New York testified as follows:

> An inexperienced judge navigating unfamiliar territory introduces an extra element of risk and uncertainty into what necessarily is an unpredictable process in which the skills and personality of the advocate and witness may be the most important variables. An experienced judge is likely to be more facile in deciding these questions but reliability and predictability remain a problem because the experienced judge will be applying his or her own valuation judgments without being able to confer with someone deeply grounded in the subject. Such a valuation professional would be more skilled than most judges in being able to verify or question the assumptions and adjustments that so often dictate the conclusions reached. Valuation is an art more than a science, and it would be helpful for the Court to have access to a seasoned art critic in deciding whether a particular challenged valuation is genuine or a fake.[693]

The Commission reviewed witness testimony and related anecdotal evidence on valuation. The Commission agreed that courts should be permitted and encouraged to appoint valuation experts in cases in which such an expert can provide assistance to the court. The Commissioners debated whether an appointed expert should be permitted to consult with, and to advise the court, but not necessarily be called to testify in the case. After debating the benefits to the court and the due process and procedural concerns for the parties, the Commission agreed that, if the court intends to rely on the court-appointed valuation expert, such expert must testify in the case and be subject to cross-examination. The Commissioners also observed that estate neutrals under the recommended principles could now perform the expanded role, including that of mediator, served by court appointed valuation experts in the past. Finally, the Commissioners evaluated the language of Rule 706 of the Federal Rules of Evidence and found it sufficient as written for the contemplated role of court-appointed valuation experts.

G. Standard for Reviewing Settlements and Compromises

Recommended Principles:

- The principles and standards of Bankruptcy Rule 9019 should be codified to foster uniform application of a court's authority to approve a settlement or compromise of controversies in a chapter 11 case. Accordingly, the court, after notice and a hearing, should approve a trustee's proposed settlement or compromise of a controversy only if the court finds, based on the evidence presented, that the proposed settlement or compromise is reasonable and in the best interests of the estate.

693 *Written Statement of Honorable James M. Peck, VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Feb. 21, 2013), *available at* Commission website, *supra* note 55.

Standard for Reviewing Settlements and Compromises: Background

In general, "compromises are favored in bankruptcy."[694] Negotiated resolutions of disputes can create efficiencies in the process and cost savings for the parties. Bankruptcy Rule 9019, like its predecessor Rule 919 under the Bankruptcy Act, provides a process for parties to request court approval of settlements and compromises. Specifically, Bankruptcy Rule 9109 states, in relevant part: "On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement."[695] Notably, neither the Bankruptcy Rules nor the Bankruptcy Code provide a standard or criteria for the court to use in assessing proposed settlements and compromises.

Given general bankruptcy policy and the lack of guidance in the Bankruptcy Rules and the Bankruptcy Code, courts tend to invoke a "presumption in favor of settlements," and approve a proposed settlement or compromise unless it "'fall[s] below the lowest point in the range of reasonableness.'"[696] Various courts have developed factors to assist in this determination, but not all courts use the same factors or apply the factors in a uniform manner.[697] This variation can cause uncertainty for the parties filing motions under Bankruptcy Rule 9019 and inconsistent rulings on proposed settlements and compromises. In addition, courts take different approaches to reviewing settlements and compromises incorporated into plans of reorganization.[698] This latter issue is discussed below.[699]

Standard for Reviewing Settlements and Compromises: Recommendations and Findings

A trustee[700] may seek to settle any number of disputes in the chapter 11 case, including claims resolution matters, avoidance claims, and prepetition litigation. Because any such settlement necessarily impacts the estate — either because the estate will fund at least a portion of the settlement or the estate's claims against third parties are being compromised — the court and parties in interest

694 Myers v. Martin (*In re* Martin), 91 F.3d 389, 393 (3d Cir. 1996), quoting 9 Collier on Bankruptcy ¶ 9019.03[1] (15th ed. 1993).
695 Fed. R. Bankr. P. 9019(a).
696 *In re* Tower Auto., Inc., 342 B.R. 158, 164 (Bankr. S.D.N.Y. 2006), *aff'd*, 241 F.R.D. 162 (S.D.N.Y. 2006). *See also* Hicks, Muse & Co., Inc. v. Brandt (*In re* Healthco Int'l, Inc.), 136 F.3d 45, 50 n.5 (1st Cir. 1998) (holding that court may accord deference to the position of the trustee or debtor in possession); *In re* WorldCom, Inc., 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006) ("While the bankruptcy court may consider the objections lodged by parties in interest, such objections are not controlling . . . the bankruptcy court must still make informed and independent judgment."); *In re* Hibbard Brown & Co., Inc., 217 B.R. 41, 46 (Bankr. S.D.N.Y. 1998) (holding that court may exercise its discretion under Bankruptcy Rule 9019 "in light of the general public policy favoring settlements").
697 Courts consider a variety of factors, including:

> (1) the balance between the litigation's possibility of success and the settlement's future benefits; (2) the likelihood of complex and protracted litigation, with its attendant expense, inconvenience and delay, including the difficulty in collecting on the judgment; (3) the paramount interests of the creditors, including each affected class's relative benefits and the degree to which creditors either do not object to or affirmatively support the proposed settlement; (4) whether other parties in interest support the settlement; (5) the competency and experience of counsel supporting, and the experience and knowledge of the bankruptcy court judge reviewing, the settlement; (6) the nature and breadth of releases to be obtained by officers and directors; and (7) the extent to which the settlement is the product of arm's length bargaining.

In re Iridium Operating LLC, 478 F.3d 452, 462 (2d Cir. 2007) (internal citations omitted). Although several of these factors were developed by courts in the plan settlement context, they also apply outside the plan context in certain instances.
698 A related but different issue arises when the proposed settlement "has the effect of dictating the terms of a prospective chapter 11 plan." *In re* Capmark Fin. Grp. Inc., 438 B.R. 471, 513 (Bankr. D. Del. 2010). In those instances, courts may deny approval of the settlement because it constitutes an impermissible *sub rosa* plan. *See generally*, Craig A. Sloane, *The* Sub Rosa *Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37 (1999).
699 *See* Section VI.F.4, *Settlements and Compromises in Plan*.
700 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

should have an opportunity to review the terms of the proposed settlement. The settlement or compromise also should be subject to court approval.

The Commissioners discussed the soundness of the notice and hearing process required by Bankruptcy Rule 9019, but acknowledged the discretion given the trustee in presenting the settlement, and the court in approving or denying the settlement. Beyond requiring notice and a hearing, Bankruptcy Rule 9019 establishes no parameters for the content or timing of settlements. It also does not set forth a standard or criteria for the assessment of settlements. The Commission agreed that codifying the settlement approval process, including an appropriate standard of review, would further facilitate the bankruptcy policy of encouraging consensual resolution of disputed matters.

The Commission reviewed the courts' various approaches to assessing proposed settlements and compromises under Bankruptcy Rule 9019. This review identified a wide range of approaches, from "the lowest point of reasonableness" to the "fair and equitable" standard used to evaluate compromises and plans under the Bankruptcy Act. The Commissioners generally agreed that the lowest point of reasonableness standard did not sufficiently scrutinize the terms of the proposed settlement and its impact on the estate. Several Commissioners suggested using the fair and equitable standard as applied by the U.S. Supreme Court in *TMT Trailer Ferry*.[701] Other Commissioners expressed concern regarding the ambiguity surrounding "fair and equitable" and its common association with approval of a chapter 11 plan in the cramdown context.[702] The Commissioners generally agreed that something less than fair and equitable, but still meaningful, should govern the approval of settlements and compromises.

After discussing different approaches, the Commission agreed to use a hybrid standard that requires the settlement or compromise to be "reasonable and in the best interests of the estate." It favored this standard because it would adequately protect the estate and allow the court to weigh the evidence presented on the particular settlement or compromise. Although the Commission believed that the proposed "reasonable and in the best interests of the estate standard" is better suited than a "fair and equitable" standard for the review and approval of settlements and compromises, it also believed that courts should still engage in a totality of the circumstances analysis that considers factors such as those articulated by courts under the fair and equitable approach.[703]

701 Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968).

702 The fair and equitable standard is used in the cramdown context under section 1129 of the Bankruptcy Code. The Bankruptcy Code also incorporates elements necessary to make a plan fair and equitable to any particular class of creditors or equity securities holders that reject the plan.

703 *See, e.g.,* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968) ("[T]he judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.").

H. The *In Pari Delicto* Doctrine

Recommended Principles:

- The *in pari delicto* defense should be inapplicable to claims for relief that a trustee appointed under section 1104 in the chapter 11 case asserts against third parties under section 541 of the Bankruptcy Code. The absence of the *in pari delicto* defense should not otherwise affect the trustee's burden to establish the claims for relief under applicable law.
- The Commission was unable to reach a consensus on eliminating the *in pari delicto* defense with respect to claims for relief that other estate fiduciaries or parties authorized to act on behalf of the estate (*e.g.*, litigation trustees, postconfirmation entities, unsecured creditors' committees, debtors in possession) might assert against third parties under the Bankruptcy Code.

The In Pari Delicto *Doctrine: Background*

The Latin phrase *in pari delicto* means "in equal fault,"[704] and the in *pari delicto* doctrine generally bars the pursuit of a cause of action by a plaintiff who allegedly acted in concert with the defendants, or was otherwise involved, in the wrongful conduct underlying the plaintiff's complaint. The *in pari delicto* doctrine is "grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[705] The *in pari delicto* issue arises in a variety of instances in chapter 11 cases, but perhaps most commonly in cases precipitated by a prepetition Ponzi scheme.[706]

In many cases, the underlying cause of action is grounded in prepetition conduct and belongs to the estate under section 541 of the Bankruptcy Code. The target defendant might be an accountant, auditor, attorney, bank, broker, insider, or others. The state law claim might be aiding and abetting fraud, breach of fiduciary duty, negligence, malpractice, aiding and abetting breach of fiduciary duty, negligent misrepresentation, negligent supervision, or conspiracy. Among the defendant's affirmative defenses is *in pari delicto.* Under present law, because the debtor's wrongdoing would bar any recovery by the debtor, the trustee is likewise entitled to no relief. Every circuit except the Ninth Circuit has ruled on the issue and has held that, under section 541, the *in pari delicto* doctrine bars a trustee's claims when the doctrine would bar the claims if brought by the debtor.[707]

704 *See, e.g.,* Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985).

705 Mosier v. Callister, Nebeker & McCullough PC, 546 F.3d 1271, 1275 (10th Cir. 2008).

706 In the context of reviewing fraudulent transfer law under section 548 of the Bankruptcy Code, the Commission considered codifying the "Ponzi scheme presumption," which would basically create a rebuttable presumption that transfers made in furtherance of a Ponzi scheme are fraudulent transfers subject to avoidance. *See, e.g., In re* Manhattan Inv. Fund Ltd., 397 B.R. 1, 11–13 (S.D.N.Y. 2007). The term "Ponzi scheme" is not well defined under the case law. *Id.* After much deliberation, the Commission decided that this issue was best left to further development under the case law.

707 *See, e.g.,* Peterson v. McGladrey & Pullen, LLP (*In re* Lancelot Investors Fund, L.P.), 676 F.3d 594 (7th Cir. 2012); Gray v. Evercore Restructuring L.L.C., 544 F.3d 320, 324–25 (5th Cir. 2008); Mosier v. Callister, Nebeker & McCullough, 546 F.3d 1271, 1276 (10th Cir. 2008); Baena v. KPMG LLP, 453 F.3d 1, 6 (1st Cir. 2006); Nisselson v. Lernout, 469 F.3d 143, 153 (1st Cir. 2006), *cert. denied*, 550 U.S. 918 (2007); Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1149–56 (11th Cir.

Courts have recognized certain exceptions to the application of the *in pari delicto* doctrine. For example, the "adverse interest" exception provides that if the officers and directors of the debtor who participated in the fraudulent transactions were acting in their own interests and to the detriment of the debtor, then the adverse interest exception defeats the *in pari delicto* doctrine.[708] Another exception, known as the "innocent decision maker" exception, may apply if not all of the "shareholders or decision makers are involved in the fraud" — *i.e.*, there was at least one innocent insider to whom the defendant could have reported their findings.[709] Some courts have found the innocent decision maker exception inapplicable, however, when an innocent member of management "could and would have prevented the fraud had they been aware of it."[710]

In addition, the *in pari delicto* doctrine applies only to a trustee's claims under section 541. Accordingly, courts have determined that the doctrine should not apply to, for example, the trustee's "strong arm" claims under section 544;[711] preference claims under section 547;[712] and fraudulent transfer claims under section 548.[713]

Despite the various exceptions, the *in pari delicto* doctrine may preclude the trustee from pursuing causes of action that benefit the estate and the beneficiaries of the estate who are innocent victims as to the underlying cause of action. Several commentators thus have questioned the relevance and fairness of applying the *in pari delicto* doctrine in bankruptcy cases. These commentators note, among other things, that state and federal law receivers generally are not subject to the *in pari delicto* defense.[714] The question persists whether trustees in bankruptcy should have the same ability to pursue actions against third parties to the same extent as a state law receiver (or a receiver under the Federal Depository Insurance Act or the federal securities laws), or whether trustees should be treated differently, given the bankruptcy maxim that a trustee stands in the shoes of the debtor and is subject to the same defenses as the debtor.[715]

2006), *cert. denied*, 549 U.S. 811 (2006); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 836–37 (8th Cir. 2005); Logan v. JKV Real Estate Servs. (*In re* Bogdan), 414 F.3d 507, 514–15 (4th Cir. 2005), *cert. denied*, 546 U.S. 1093 (2006) (noting exception where claims have been assigned to trustee); Official Comm. of Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand, LLP, 322 F.3d 147, 158 (2d Cir. 2003); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 354–60 (3d Cir. 2001); Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 380 (6th Cir. 1997), *cert. denied*, 525 U.S. 812 (1998); Sender v. Buchanan (*In re* Hedged-Invs. Assocs., Inc.), 84 F.3d 1281, 1284–86 (10th Cir. 1996); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094–95 (2d Cir. 1995); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118–20 (2d Cir. 1991). *But see* USACM Liquidating Trust v. Deloitte & Touche, 754 F.3d 645, 649 (9th Cir. 2014), *aff'g* 764 F. Supp. 2d 1210, 1229 (D. Nev. 2011). Notably, the Second Circuit appears to treat the issue not as a defense like the other circuits, but as an issue of standing. *See* Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Grp., Inc.), 336 F.3d 94, 100 (2d Cir. 2003); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094–95 (2d Cir. 1995); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991).

708 Bankruptcy Servs., Inc. v. Ernst & Young (*In re* CBI Holding Co., Inc.), 529 F.3d 432 (2d Cir. 2008). Importantly, there are variations on the adverse interest exception. For example, some courts narrowly interpret the exception to apply when the guilty manager has "totally abandoned" the interest of the principal corporation, while other courts engage in an analysis of the respective benefits received by the corporate entity and the wrongdoer insider, Thabault v. Chait, 541 F.3d 512, 527 (3d Cir. 2008); Baena v. KPMG, LLP, 453 F.3d 1, 8 (1st Cir. 2006); Breeden v. Kirkpatrick & Lockhard LLP (*In re* Bennett Funding Grp.), 336 F.3d 94, 100 (2d Cir. 2003). Other courts have found that the adverse interest exception should be determined by the agent's subjective motives, rather than by a strict rule of whether the debtor received any benefit as a result of the agent's activities, Bankruptcy Servs. Inc. v. Ernst & Young (*In re* CBI Holding Co., Inc.), 529 F.3d 432, 451 (2d Cir. 2008).

709 Smith v. Andersen L.L.P., 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704, 710 (S.D.N.Y. 2001), *aff'd*, *In re* Bennett Funding Group, Inc., 336 F.3d 94 (2d Cir. 2003); SIPC v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999), *aff'd in part*, 222 F.3d 63 (2d Cir. 2000).

710 *See, e.g.*, *In re* CBI Holding Co., Inc., 311 B.R. 350, 372 (S.D.N.Y. 2004), *aff'd in part, rev'd in part*, 529 F.3d 432 (2d Cir. 2008).

711 Kaliner v. MDC Sys. Corp., LLC, 2011 U.S. Dist. LEXIS 5377, at *15 (E.D. Pa. Jan. 20, 2011).

712 *See, e.g.*, *In re* CBI Holding, Inc., 311 B.R. 350, 372 (S.D.N.Y. 2004), *aff'd in part, rev'd in part*, 529 F.3d 432 (2d Cir. 2008).

713 McNamara v. PFS (*In re* Pers. & Bus. Ins. Agency), 334 F.3d 239, 245–47 (3d Cir. 2003).

714 *See* FDIC v. O'Melveny & Myers, 61 F.3d 17, 18–19 (9th Cir. 1995); Scholes v. Lehmann, 56 F.3d 750, 754–55 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995); Goldberg v. Chong, 2007 U.S. Dist. LEXIS 49980, *28–29 (S.D. Fla. July 11, 2007).

715 Some courts follow the bankruptcy analogy and conclude that because the receiver simply steps into the shoes of the receivership entity in pursuing the entity's claims, and because the *in pari delicto* doctrine would bar the entity's claim, it bars the receiver's claim. *See, e.g.,* Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 792 (6th Cir. 2009); Knauer v. Jonathon Roberts Fin. Grp., Inc.,

The In Pari Delicto *Doctrine: Recommendations and Findings*

The *in pari delicto* doctrine's application to certain of a trustee's or other estate representative's claims against third parties in a bankruptcy case is subject to much debate in the literature. The conclusion that parties cannot assert the *in pari delicto* defense against claims that are available only to the trustee in a bankruptcy case — such as preference claims and fraudulent conveyance claims — is well supported. A debtor has no rights in, or ability to pursue, such claims, and the trustee does not stand in the shoes of the debtor for purposes of those actions. Prepetition claims of the debtor that become property of the estate under section 541 of the Bankruptcy Code may, however, require a different analysis. The Commission considered current trends in the case law on the *in pari delicto* doctrine, the underlying justifications for the doctrine, and whether a trustee or estate representative *should* be subject to the *in pari delicto* defense in bankruptcy, irrespective of the genesis of the claims.

The Commission reviewed the primary purposes of the *in pari delicto* doctrine, most commonly articulated as follows: that "courts should not lend their good offices to mediating disputes among wrongdoers" and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[716] The Commissioners generally agreed that the doctrine served these basic goals when applied outside of bankruptcy: a company that participated in a wrong should not be able to benefit from that wrong. For some of the Commissioners, however, the intervention of a bankruptcy case changed the calculus dramatically.

In bankruptcy, a party not involved with the alleged prepetition wrongdoing may bring the action for the benefit of the estate (*e.g.*, innocent creditors of the debtor). That party typically is the trustee, unsecured creditors' committee, litigation trustee, or other estate representative. The trustee, unsecured creditors' committee, litigation trustee, or other estate representative did not participate in the wrong and is not seeking recoveries that would benefit any of the wrongdoers. Indeed, to the extent that the debtor's prepetition shareholders, officers, or directors who may have been involved with the alleged wrongdoing are creditors of the estate, those claimants can be barred from receiving any recoveries from the litigation.

Several of the Commissioners found the case for not allowing third parties to assert the *in pari delicto* defense against the trustee or other estate representative very compelling. These Commissioners

348 F.3d 230, 236 (7th Cir. 2003); *In re* Wiand, 2007 WL 963165, at *6–7 (M.D. Fla. Mar. 27, 2007). Other courts conclude that because the receiver's role is to protect innocent investors, and because these investors were not complicit in the fraud, the *in pari delicto* doctrine does not bar the receiver's claim. *See, e.g.,* Jones v. Wells Fargo Bank, N.A., 666 F.3d 955, 966 (5th Cir. 2012) ("A receiver is 'the representative and protector of the interests of all persons, including creditors, shareholders and others, in the property of the receivership.' . . . The receiver has a duty to pursue a corporation's claims.' . . . Although a receiver generally 'has no greater powers than the corporation had as of the date of the receivership,' it is well established that 'when the receiver acts to protect innocent creditors . . . he can maintain and defend actions done in fraud of creditors even though the corporation would not be permitted to do so.' . . . The receiver thus acts on behalf of the corporation as a whole, an entity separate from its individual bad actors.") (citations omitted); FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) ("A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects. This places the receiver in stark contrast to the normal successor in interest who voluntarily purchases a bank or its assets and can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses. In such cases, the bank receives less consideration for its assets because of its inequitable conduct, thus bearing the cost of its own wrong."); Javitch v. Transamerica Occidental Life Ins. Co., 408 F. Supp. 2d 531, 538 (N.D. Ohio 2006) ("An equity receiver's duties are fashioned and may be modified by the appointing court. Because this Court has expressly given the Receiver's broad authority to pursue claims on behalf of Liberte and the investors, the Receiver is not precluded from these actions under the doctrine of *in pari delicto*."); Isp.com LLC v. Theising, 805 N.E.2d 767, 773 (Ind. 2004) ("The receiver is in some respects a new entity, untainted by the corporation's wrongdoing. He is not necessarily barred by *in pari delicto*.").

716 Official Comm. of Unsecured Creditors of PSA Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006), *cert. denied*, 549 U.S. 811 (2006).

emphasized the distinction between the prepetition debtor company and a trustee or litigation trust for purposes of the defense. They posited that the justifications for the *in pari delicto* doctrine, as articulated above, simply did not apply in the trustee context. In fact, they noted that innocent creditors actually were being penalized because, outside of bankruptcy: (i) state law receivers and receivers appointed by the Securities and Exchange Commission or the Federal Depository Insurance Company could pursue claims previously belonging to the alleged company wrongdoer and not be subject to the defense;[717] and (ii) individual creditors harmed by the wrong could sue the third parties without being subject to the defense.[718] The Commissioners supporting elimination of the *in pari delicto* defense in bankruptcy viewed its enforcement as penalizing the debtor's innocent creditors, who likely were already suffering losses as a result of the bankruptcy itself.

The Commissioners parsed through the likely practical implications of eliminating the *in pari delicto* defense in bankruptcy. The Commissioners acknowledged that including the debtor in possession in the concept of an "estate representative" not subject to the *in pari delicto* defense may raise closer policy issues. Although the debtor in possession has a legal status different from the prepetition debtor under the Bankruptcy Code, the Commissioners acknowledged that the debtor in possession could still employ some of the individuals who allegedly participated on behalf of the debtor in the wrongdoing. They also presented a closer conceptual question on the policy issues. Some of the Commissioners supported including the debtor in possession among the estate representatives that should not be subject to the *in pari delicto* defense.[719] Some of the Commissioners believed it was more important to eliminate the defense, at least as to bankruptcy trustees, and then also as to unsecured creditors' committees, litigation trustees, and similar estate representatives that were not affiliated with the prepetition debtor.

Other Commissioners voiced concern that any change to the current law essentially would create a new cause of action for the estate not otherwise available under state law. These Commissioners focused on the fact that the debtor (or an entity acting on behalf of the debtor) generally could not pursue such claims under nonbankruptcy law, unless a receiver was appointed.[720] They believed that eliminating the *in pari delicto* defense in bankruptcy directly conflicted with the long-standing principle that bankruptcy does not enhance a debtor's rights in property.[721] From that principle flow the equally important concepts that the estate's interest in property is limited to that held by the debtor prepetition, and that the trustee steps into the debtor's shoes with respect to those property interests and is subject to any defenses otherwise applicable against the debtor.[722] These Commissioners could

717 O'Melveny & Myers v. FDIC, 512 U.S. 79 (1994) (remanding on grounds that state law should determine if defense applies). On remand, the Ninth Circuit held that the defense did not apply to receiver even under California law. FDIC v. O'Melveny & Myers, 61 F.3d 17 (9th Cir. 1995). *See also* Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995) ("Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.").

718 FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) ("While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law. Moreover, when a party is denied a defense under such circumstances, the opposing party enjoys a windfall. This is justifiable as against the wrongdoer himself, not against the wrongdoer's innocent creditors.").

719 These Commissioners noted that, in most cases, management of the old debtor has been replaced or a Chief Restructuring Officer has been appointed.

720 These Commissioners noted that the receiver context was different than the collective action process of bankruptcy and believed that the different treatment was justified on that basis.

721 *See, e.g.,* S. Rep. No. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787; H.R. Rep. No. 95-595, at 367–68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 (explaining that section 541 cannot "expand the debtor's rights against others more than they exist at the commencement of the case").

722 *See, e.g.,* McNamara v. PFS (*In re* Personal & Bus. Ins. Agency), 334 F.3d 239, 245 (3d Cir. 2003) ("[I]n actions brought by the trustee as successor to the debtor's interest under section 541, the 'trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor. [Conversely,] the trustee is, of course, subject to the same defenses as could have

not reconcile these principles with the elimination of the *in pari delicto* defense. They also pointed to the inherent unfairness of allowing the principal wrongdoer, or someone standing in the shoes of the wrongdoer, to prosecute a claim against a party who may have been negligent when the wrongdoer's conduct was intentional (*i.e.*, the defendant is liable to the plaintiff because it negligently failed to detect the plaintiff's intentionally concealed fraud).

These Commissioners objected not only to eliminating the defense as to a debtor in possession but also as to the trustee and any other estate representative. They argued that it would be bad policy to allow an estate representative to pursue professionals and institutions on claims that may lack merit and for which one of the alleged wrongdoers — the debtor — is not subject to collection actions. They suggested that such a proposal would encourage "shakedowns" and unfounded settlements because defendants would be forced to settle (regardless of merit) to avoid the risk of potentially significant liability. They likewise noted that eliminating the defense could skew incentives and create unintended challenges for professionals in the distressed industry.

The Commissioners supporting the elimination of the *in pari delicto* defense in bankruptcy focused on the parties represented by the trustee in bankruptcy — *e.g.*, typically general unsecured creditors. They repeatedly emphasized that these creditors are innocent in the process and generally harmed by the types of wrongful conduct alleged in lawsuits in which third parties may assert the *in pari delicto* defense. They suggested that eliminating just the *in pari delicto* defense and preserving a defendant's other defenses would strike the appropriate balance between the bankruptcy policy of allowing an estate representative to pursue claims to maximize the value of the estate for the benefit of creditors and allowing parties to appropriately defend themselves in unfounded litigation. From this perspective, allowing defendants to assert the *in pari delicto* defense against the bankruptcy trustee would place the trustee (and creditors) at a significant disadvantage and provide defendants with a shield that they would not be able to use under state or federal receivership law.

The Commission explored several alternatives for bridging the disparate views of the Commissioners on this issue. Some of the Commissioners suggested a compromise of a federal comparative default rule for these actions, wherein the *in pari delicto* defense would not be available, but defendants could assert that the debtor or its management was primarily at fault. Others suggested modifications to this proposal that would allow defendants to assert that they should not be liable because they were not primarily at fault (*i.e.*, the debtor or another defendant was primarily at fault). The Commissioners expressed concern that this approach would only result in finger-pointing and not serve the purpose of compensating the estate and creditors for prepetition wrongs against their interests.

The Commission then attempted to identify areas of agreement to build consensus on this issue. First, the Commissioners discussed allowing individual creditors to pursue claims that they in fact hold under applicable nonbankruptcy law against third parties allegedly acting in concert with the prepetition debtor free of the *in pari delicto* defense (which would not be applicable in any event) in the bankruptcy case. The Commissioners were generally comfortable with this approach,

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been asserted by the defendant had the action been instituted by the debtor.'") (quoting Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001)); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093 (2d Cir. 1995) ("[T]he trustee stands in the shoes of the debtors, and can only maintain those actions that the debtors could have brought prior to the bankruptcy proceedings.").

provided that any recoveries were available only to those creditors holding the claims. Second, the Commissioners discussed allowing a creditor or creditors to pursue such claims in the bankruptcy case on behalf of all creditors when a generalized harm existed. The Commission was fairly evenly split on this component, with some arguing that, in substance, it was no different than allowing an estate representative to bring the claim free of the *in pari delicto* defense.

After extensive deliberation, the Commission recommended the elimination of the *in pari delicto* defense solely with respect to any trustee appointed in the chapter 11 case. The Commission determined that this modification would provide the trustee with rights similar to those possessed by receivers in other contexts, and it would not expose defendants to claims brought by a party controlled or influenced by alleged wrongdoers (*e.g.*, directors, officers, or employees of the debtor). The Commission viewed this as an extension of the potential liability of defendants outside of bankruptcy, where creditors (or a receiver on behalf of creditors) could assert claims not subject to the *in pari delicto* defense, and not as a significant expansion of the trustee's powers against the defendants in bankruptcy. The Commission did not reach a position with respect to the availability of the *in pari delicto* defense in actions brought by other estate representatives, the debtor in possession, or unsecured creditors' committees. Accordingly, the Commission is not making a proposal on the *in pari delicto* defense in actions brought by those entities in the chapter 11 case.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF DELAWARE

	. Chapter 11
IN RE:	.
	. Case No. 15-10197 (BLS)
RADIOSHACK CORPORATION, et al,	.
	. Courtroom No. 1
	. 824 Market Street
Debtors.	. Wilmington, Delaware 19801
	.
	. Wednesday, February 25, 2015.

. . . .

TRANSCRIPT OF HEARING
BEFORE THE HONORABLE BRENDAN L. SHANNON
CHIEF UNITED STATES BANKRUPTCY JUDGE

APPEARANCES:

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1 (Proceedings commence at 9:39 a.m.)
2 (Call to order of the Court.)
3 THE COURT: Please be seated. Good morning. Mr.
4 Gordon, good morning.
5 MR. GORDON: Good morning, Your Honor.
6 THE COURT: We seem to be fairly close to standing
7 room, but I don't think we need to overflow. If we do, I would
8 ask that somebody just advise me, and I will be happy to set it
9 up, but I think we've got enough seating for parties.
10 Mr. Gordon, it's good to see you. Welcome back.
11 MR. GORDON: Thank you very much, Your Honor.
12 What I thought it would make sense to do is to reset a
13 bit. I'd like to kind of, sort of go from where we've been, to
14 a certain extent, and then where we are at the moment with
15 respect to both motions. And as Your Honor pointed out at one
16 of the hearings earlier, these motions really are tied
17 together, I think. The motion for the approval -- final
18 approval of DIP financing and the bid procedures; they do have
19 links to each other.
20 But just to reset, if I could, Your Honor. When we
21 filed this case, you know, we advised that we had really
22 parallel goals in mind:
23 One was to take our under-performing stores, close
24 them as quickly as possible, and start the liquidation process.
25 And all of this is against the backdrop of we have so many

1 stores, we have a very significant rent obligation, as Your
2 Honor knows.
3 THE COURT: I'm aware.
4 MR. GORDON: And you were very gracious in having
5 hearings very promptly. We got relief right away, that's
6 putting it mildly, I understand.
7 (Laughter.)
8 MR. GORDON: But you provided us some temporary relief
9 right away, to get that process started, and we were able to
10 save the first weekend in February that -- after we filed, and
11 that process is well underway.
12 And then, at the same time, of course, we wanted to
13 pursue a 363 sale process, and we talked about that a bit at
14 the first-day hearing. And as Your Honor knows, the effort
15 there is to, ultimately and hopefully, have a going concern
16 sale of a substantial portion of the assets of the business,
17 with the higher hope and the expectation that that will
18 generate more value than a full chain liquidation of
19 RadioShack.
20 And as I advised Your Honor, we felt fortunate, in a
21 way, even though this is obviously a very, very difficult
22 Chapter 11 case, to literally, on the eve of the filing, have
23 reached, you know, three critical agreements:
24 One being the -- an agreement for debtor-in-possession
25 financing with our ABL lenders, which, as I know you know from

1 the papers, we believe provides the liquidity we have to have
2 to get through this 363 sale process.
3 Also on the eve of the filing, we finalized and signed
4 a stalking horse purchase agreement with Standard General. And
5 at that time, it was for between 1,500 and 2,400 stores, and it
6 was at a price that we believed and still believe is in excess
7 of a liquidation price for those stores.
8 And then we also, literally, again, on the eve of the
9 filing, finalized and signed a detailed termsheet with Sprint,
10 which again, we thought was a real benefit to the estate
11 because, as we advised Your Honor, mobility has been a real
12 problem for the -- for this business for quite a while. And we
13 felt that the, and continue to feel that this new commercial
14 arrangement with Sprint, with a new store-within-a-store
15 concept, actually sort of right -- or put that business on the
16 right track, and made it much more favorable, and we hope will
17 generate competitive bidding.
18 So, as I indicated, the -- you know, the store process
19 -- store closing process is well underway. We then had to
20 burden Your Honor with another issue, which was an attempt to
21 sell leases related to the store closings --
22 THE COURT: You know, can I ask you?
23 MR. GORDON: Sure.
24 THE COURT: I realize that that's coming up on Friday.
25 MR. GORDON: Correct.

1 THE COURT: And I recall from our hearing last Friday,
2 where we set out the mechanics of that process -- and I know
3 that there were some issues that had been articulated by a
4 number of the landlords, and that Mr. Howley had said
5 repeatedly that the debtor was prepared to coordinate and
6 cooperate. And I offered the prospect of a Monday
7 teleconference, if need be, if there were issues.
8 I'm certainly happy to see that there wasn't that
9 request. And I'm aware that the auction is today.
10 MR. GORDON: Correct.
11 THE COURT: So I'm wondering what Mr. Howley is doing
12 here.
13 MR. GORDON: The auction is this afternoon, Your
14 Honor.
15 THE COURT: This has "Mr. Howley's Problem" written
16 all over it.
17 (Laughter.)
18 MR. GORDON: Well, actually, I don't think there's a
19 problem. The auction is this afternoon --
20 THE COURT: I'm aware.
21 MR. GORDON: -- and Mr. Howley is obviously here, and
22 he'll answer whatever questions he needs to answer.
23 But I think one reason Mr. Howley was here was, in the
24 event landlords were here this morning, potentially, with
25 issues --

1 THE COURT: Uh-huh.
2 MR. GORDON: -- related to that process; he wanted to
3 be here for purposes of that. And I think he feels like we
4 don't have any issues to discuss in connection with that.
5 THE COURT: I believe that there were reports that
6 were supposed to have been filed on Saturday. My understanding
7 is they've been filed, but I haven't studied them. I wouldn't
8 mind -- and again, I'm not trying to open the door to a big
9 discussion about what's coming up on Friday. But I wouldn't
10 mind a heads-up about where we stand right now. Mr. Howley,
11 would you mind?
12 MR. HOWLEY: Good morning, Your Honor.
13 THE COURT: Good morning.
14 MR. HOWLEY: Tom Howley with Jones Day on behalf of
15 the debtors.
16 Judge, you know, when we embarked upon the process,
17 there was a big fear of the unknown as to how many bids would
18 come in, how the process would unfold, as we were trying to
19 monetize the Tranche 1 and 2 categories of leases.
20 I'm pleased to report that, now that the process has
21 unfolded, it's ended up being a very manageable number of
22 leases subject to bid. And ordinarily, the debtors would want
23 to be overwhelmed with bids, but here, we kind of had a
24 suspicion that, at the end of the day, there would be a certain
25 level of bids, and that's really what has transpired here, now

1 that the bid deadline has passed.

2 We did file a report on Saturday that basically

3 indicated that there were approximately 205 leases that were

4 subject to a bid, and I can break that down real quickly for

5 Your Honor, if you'd like.

6 THE COURT: Sure.

7 MR. HOWLEY: Of the 205 leases, approximately, let's

8 say 35 are subject to landlord lease termination agreement type

9 bids.

10 Then you have literally a handful of one-off bids, and

11 some of those have already fallen by the wayside. But maybe,

12 on Friday, we'll have a couple of one-off --

13 THE COURT: Okay.

14 MR. HOWLEY: -- transactions. And then it really --

15 what's left is a very significant development from the estate

16 perspective, and that is this bid by Spring Communications for

17 designation rights. And when I say "designation rights," it's

18 really a hybrid structure. It's not a designation rights where

19 the bidder is attempting to, from a monetary perspective, you

20 know --

21 THE COURT: These are the keepers.

22 MR. HOWLEY: -- have economicals -- these are keepers.

23 THE COURT: These are keepers.

24 MR. HOWLEY: It's really structured in a way that

25 addresses what the landlords wanted, which is more time to work

1 out adequate assurance and cure costs down the road. And the
2 intent by the buyer is to work -- use the next 60 days -- and
3 we can get into this in more detail on Friday, but to cover the
4 occupancy costs, the rent, and work out assignment and
5 assumption scenarios. And so we'll have that as kind of the
6 main issue.
7 And there's little to no overlap between the lease
8 termination bids --
9 THE COURT: And the DR.
10 MR. HOWLEY: -- and this bid. So that issue never
11 really developed, like we thought it might.
12 THE COURT: Okay. I think that's really all that I
13 need to know at this point. I am aware that there are many,
14 many submissions, objections, limited objections that have been
15 filed by landlords. I don't believe that I need to hear
16 anything further on that.
17 I understand -- I've accepted it for purposes of a --
18 really, a status report. I'd certainly be happy to hear from
19 Mr. Pollack.
20 (Laughter.)
21 THE COURT: Come on up. If they start lining up
22 behind you, I will blame you.
23 (Laughter.)
24 MR. POLLACK: You'll blame me, anyway.
25 THE COURT: I probably will.

1 MR. POLLACK: Thank you, Your Honor. David Pollack
2 for the landlords noted of record.
3 Your Honor, unfortunately, there are some issues.
4 THE COURT: Okay.
5 MR. POLLACK: I don't know that we can address them
6 today. But some things have come up during the process that
7 will affect this afternoon. The primary -- and first, I have
8 to say that Mr. Howley, Mr. Jerovich (phonetic), a whole bunch
9 of people have been on the phone with us. We had a
10 conversation on Saturday afternoon, we had conversations with
11 the prime bidder on Monday morning. And so we have been
12 talking and trying to get information.
13 The problem, however, is that we're now at 10 minutes
14 to 10 on Wednesday, with a one o'clock auction. The prime bid
15 is a DRA, and that has not, as far as we know, been finalized.
16 We haven't seen it. We've talked around it. But there's
17 nothing that's been filed, and we're supposed to go into an
18 auction this afternoon at one o'clock, and possibly bid against
19 or have filed by noon today objections to something that isn't
20 even of record. We know the bid is out there, everybody has
21 been talking about it, counsel has been talking to us. That's
22 issue number one.
23 Issue number two, which doesn't affect any of my
24 clients directly, but does affect some of the people -- I'm
25 sorry, it does affect one of them, and some of the people for

1 whom we're local counsel -- is that there were discussions over
2 the weekend about how the bidding would proceed; in other
3 words: Could you bid on an individual lease? Because, again,
4 we haven't seen the agreement, we don't know if it's got --
5 you've got to take them all, or take nothing, if it's got
6 breakouts.
7 THE COURT: A breakout.
8 MR. POLLACK: We know from the cover letter that we've
9 seen that it was X dollars per lease, which leads people to
10 believe that they are -- can be bid on individually. We're
11 told this morning, and second, third-hand, that the bidding
12 will be -- if the bids by everybody else does not top the bid
13 by Spring Communications, then there will not be individual
14 bidding.
15 We have some issues with that, I don't know if we can
16 get to that today or not, especially with the one o'clock
17 hearing [sic]. But those are the two main points that we see
18 are a problem for this afternoon.
19 The last little note is that, even though it's Spring
20 Communications, we've been told that, with regard to a couple
21 of our leases, Spring Communications is a wholly owned
22 subsidiary, we're told, of GameStop Corp. And we're told that
23 some locations might be GameStop, not Spring Communications.
24 So, forgetting all of the individual issues with regard to the
25 leases about exclusives and this and that and whatever --

1 THE COURT: I'm sorry. Did you say Sprint
2 Communications is --
3 MR. POLLACK: Spring.
4 UNIDENTIFIED: Spring.
5 THE COURT: Spring.
6 MR. POLLACK: Yeah, I know, I had the same problem.
7 THE COURT: Okay.
8 MR. POLLACK: G, not T.
9 THE COURT: Okay.
10 MR. POLLACK: Spring Communications is a wholly owned
11 subsidiary of GameStop Corp.
12 THE COURT: I catch the issue. I spend a lot of time
13 in GameStop; my son is 12.
14 (Laughter.)
15 MR. POLLACK: Anyway, those were our issues. I don't
16 want to belabor them, but there are issues for this afternoon.
17 THE COURT: Okay. And I appreciate getting the heads-
18 up. I understand that those issues are there. I think,
19 consistent with Mr. Howley's comments and your comments from
20 Friday, I believe all parties rights are fully reserved with
21 respect to, you know, every aspect of this process.
22 Again, I commend all of the parties, particularly,
23 frankly, the landlords, who I think have been as agile as
24 anybody could have asked in a difficult situation.
25 So I don't believe, unless there is something

1 pressing, that I need further context or guidance. It is
2 helpful to me at least to anticipate what's coming on Friday.
3 And if these issues are out there, then, again, I'm sure he's
4 heard you previously, but I'm sure the debtors and Spring
5 Communications and other parties are aware now that these are
6 issues that are of consequence to the landlords, and that I
7 will consider on Friday. All right?
8 MR. POLLACK: Thank you, Your Honor.
9 THE COURT: Thank you. Okay.
10 Mr. Gordon.
11 MR. GORDON: Thank you, Your Honor. So then, with
12 respect to the 363 process, we obviously advised the Court we
13 were attempting to move on a fast track. We asked for a bid
14 procedures hearing within 14 days; you gave us one within 15
15 days. And the lenders all agreed with that, and that was fine.
16 And that was set for Friday.
17 And then the committee was appointed, and the
18 committee asked for additional time, and we agreed to move --
19 we, together, agreed to move that until Monday.
20 And then, as I understand it, at the hearing on
21 Friday, Your Honor offered the possibility of actually having
22 that hearing Wednesday. And I think the initial, knee-jerk
23 reaction was, no, we probably ought to go forward on Monday.
24 And I think everybody, during the course of the day on Friday,
25 began to think about that, and think, well, we really are

1 moving quickly here, we probably could benefit from some
2 additional time to get together. And there was also some fact-
3 finding that the committee wanted to do. So we, ultimately,
4 all agreed that it made more sense to proceed today. And we
5 certainly appreciate Your Honor being flexible on that.
6 THE COURT: I'm happy to oblige.
7 MR. GORDON: And so we -- from our perspective, we put
8 that time to good use. So we all went to New York on Monday --
9 of course, most people were in New York. I had to fly there,
10 but no one was interested in Dallas for some reason, but ...
11 went to New York on Monday, had meetings Monday afternoon. All
12 the lenders were there; of course, committee counsel was there.
13 And I think we made some progress that day. We didn't resolve
14 everything.
15 And then, yesterday, the time was used for the
16 committee to take depositions. They took depositions of our
17 two witnesses, Mr. Adrianopoli, the acting CFO of the company,
18 and Mr. Kurtz, the investment banker for the company. And then
19 we took the investment banker for the committee, Mr. Pitts of
20 Houlihan Lokey.
21 But then there's been movement since then. And since
22 -- and literally, this thing is moving so fast, it's kind of
23 hard, really, to keep up. But the parties are continuing to
24 talk, the parties are continuing to consider positions, trying
25 to get to a consensus on issues.

1 So there have been a number of changes that have been
2 made, literally overnight, to the bid procedures order. There
3 have been a number of substantial changes made to the stalking
4 horse purchase agreement. Because I think Your Honor knows,
5 from reading the objections, there were specific issues raised
6 with regard to the agreement itself.
7 THE COURT: Sure.
8 MR. GORDON: And there's been, even overnight -- and I
9 just learned about some of these this morning -- some changes
10 made to the proposed final form of DIP order that are in the
11 form of concessions related to points made by the creditors'
12 committee.
13 So what I would like to do -- well, I can do a couple
14 of things. One is I can kind of describe some of these changes
15 here. But it may be better just to take a break, if we could,
16 so that -- maybe for 30 minutes. Because I'd like to be sure
17 that all the parties are aware of all the movement that's
18 literally occurred overnight. Because I do feel that these
19 changes are all for the positive. I'm not convinced,
20 necessarily, we can get entirely there, but I think we can
21 narrow the scope of the issues for Your Honor and make this
22 hearing more efficient.
23 THE COURT: Well, let me make a couple of
24 observations.
25 MR. GORDON: Sure.

1 THE COURT: I'm fine to give you a break. I'd
2 actually like to hear briefly from the committee, not really,
3 necessarily, by way of opening; there will be opportunity for
4 that, if need be, or however we proceed. But clearly, there
5 were -- I'm aware that this process has moved quickly since
6 I've scheduled it.
7 MR. GORDON: Right.
8 THE COURT: In addition, I'm aware that the
9 transaction was reported to me, and the DIP, frankly, were both
10 reported to me to have been inked, you know, hours before the
11 filing. The transaction is not -- the sale transaction is not
12 a simple one --
13 MR. GORDON: Right.
14 THE COURT: -- by any stretch. And so there were
15 concerns that I've read in the objections, and I've seen all of
16 the objections. And I, frankly, really appreciate getting the
17 objections on the time line, as well as the replies, which are
18 helpful.
19 Experience teaches that a lot of these issues are
20 subject to -- are the sort of thing I would expect to be
21 resolved or susceptible to negotiation and agreement. And
22 obviously, there are issues that are -- that will remain.
23 So, when I look at a hearing like this, with
24 objections, I think you go up to (bbb). I've read the landlord
25 objections, and I understand them. Many of them are joinders,

1 and they raise consistent themes. The -- there is a panoply of
2 issues raised as to the DIP and the sale by the committee, by
3 first -- by Wilmington Trust, and as well as by the SEP
4 lenders, that are deal points and structural, as well.
5 So I think it is probably wise to get everybody on to
6 the same page. One of the main things that I always ask at the
7 beginning of a hearing is: What is the bid and the ask? Where
8 are we on the issues that you are going to ask me to rule upon?
9 And so I don't have any problem with that, and I think that
10 that probably does make good sense.
11 But I would like to take just a moment and hear from
12 the committee. And again, I'm not going to invite to hear from
13 anybody that wishes to be heard, but I, at least, wouldn't mind
14 some context before we take that break --
15 MR. GORDON: Right.
16 THE COURT: -- of, you know, 30 or 45 minutes.
17 MR. GORDON: My only request would be, Your Honor -- I
18 think -- and obviously, that's certainly fine with Mr.
19 Kirpalani making some comments. But maybe if I could, maybe I
20 should preview what some of the changes are --
21 THE COURT: That would be fine.
22 MR. GORDON: -- so that Mr. Kirpalani -- because I
23 don't know, actually, at this point what Mr. Kirpalani knows or
24 doesn't know. And so it might help to -- it might help him if
25 I can go through some of these points.

1 THE COURT: That would be fine.
2 MR. GORDON: And this isn't in any particular order of
3 importance because I'm literally just sort of scratching these
4 down as I'm trying to recall all the changes. But there was an
5 objection made by the U.S. Trustee about a consumer ombudsman.
6 We've agreed to that.
7 THE COURT: Okay.
8 MR. GORDON: I think another change that I think
9 everybody is basically agreeable to -- maybe we've got to fine-
10 tune it a little bit -- is the time line. You know, there were
11 a lot objections raised about the process isn't long enough.
12 And I think we did make progress on Monday in the sense, I
13 think everybody recognized the -- recognizes the importance of
14 trying to close the transaction in March to avoid April rent.
15 And so we now have a new proposal for a time line, and
16 we understand this end date is available for Your Honor. But
17 we would move the sale hearing date from what we had proposed,
18 March 12th, to March 26th. That would put the auction -- we
19 are proposing an auction date of March 23rd, which I believe is
20 a Monday. Bid deadline of March 17.
21 And then the other thing I want to point out is there
22 was a concern raised about a condition in the agreement about
23 when the store count, subject to purchase, had to be finalized,
24 and whether that was coming too late in the process. Now where
25 we are is we have an agreement that that store count would be

1 finalized -- and I may get the date off by one day -- it's
2 either March 6th or March 7th; I think it's the 6th. So that
3 would be finalized. So that's one thing I wanted to let
4 everyone know.
5 We have, I think, a consensus on a new time line.
6 Again, maybe there's some fine-tuning we have to do with the
7 bid deadline by a day or so, but I think we're kind of in the
8 ball park on that.
9 The term lenders raised a number of issues about their
10 credit bid rights and when they had to credit bid and the like.
11 And changes have been made to the bid procedures, for example,
12 to make clear that they don't have to exercise their credit bid
13 rights until the auction. If there's not going to be an
14 auction, and they want to credit bid, you know, if there's one
15 bid on the table that they don't like, they've got to credit
16 bid, I think within one business day of the bid deadline or --
17 I may not have the timing right. But in between the --
18 THE COURT: This is from --
19 MR. GORDON: -- bid deadline and the auction.
20 THE COURT: -- SEP lenders?
21 MR. GORDON: Yeah, yeah. SEP -- I call them "term
22 lenders." SEP lenders. I should call them that because I know
23 that's what they call themselves.
24 We had a request that they wanted the bid procedures
25 to be clear that we allocated the purchase price -- anybody

1 bidding on the two sets of collateral, the ABL collateral on
2 the one hand, and the SEP collateral on the other, had to
3 allocate the purchase price. We're fine with that.
4 We've agreed to clarifications to the parties'
5 consultation rights. And SEP's counsel this morning just added
6 some further references to consultation rights in the bidding
7 procedures. But the idea is the committee, the lenders all
8 have consultation rights at various parts of the process, with
9 respect to the auction.
10 And then there were some other things I wanted to
11 point out. Your Honor may recall there were concerns raised
12 about intellectual property. The Sprint deal seems to require
13 the buyer to have the RadioShack name and the like.
14 THE COURT: The co-branding concept.
15 MR. GORDON: The co-branding.
16 And where we are now is that Standard General has now
17 changed their purchase agreement and indicated a willingness to
18 bid at least $20 million for the intellectual property rights.
19 And they would do that separately. In other words, they've
20 agreed not to bundle it with the other -- they have agreed not
21 to condition their purchase of the rest of the business on
22 acquiring the intellectual property rights. And there will be
23 no breakup fee associated with that separate transaction.
24 They've also agreed to bid separately on the company's
25 Asian sourcing operations that your court may --

1 THE COURT: Uh-huh.

2 MR. GORDON: -- or that the Court may recall.

3 They further agreed, overnight, to assume the AT&T
4 contract, and to remit residual amounts owed under that
5 contract to the company going forward. And what that is, is
6 when customers come in -- Your Honor knows what that is.

7 THE COURT: I think I understand.

8 MR. GORDON: Yeah.

9 THE COURT: But you can explain it for the record.

10 MR. GORDON: Well, that's when customers come in, if
11 they purchase a phone in RadioShack, as they have a contract
12 going forward, we get a piece of the --

13 THE COURT: A piece.

14 MR. GORDON: -- payments under that contract, on a go-
15 forward basis.

16 THE COURT: And they would come -- so they are not
17 actually acquiring that payment stream. That payment stream
18 would remain with the seller.

19 MR. GORDON: Yeah, they would remit those payments
20 back.

21 THE COURT: I got it.

22 MR. GORDON: So that's a change that's been made.

23 Further, Your Honor, I'm sure you're aware of the
24 various objections that were made by the committee and others
25 to the conditionality of the stalking horse agreement.

1 One of those conditions was the Sprint condition; that
2 it was subject to reaching terms on a final agreement with
3 Sprint. And I'm pleased to report that happened yesterday.
4 The final agreement was signed with Sprint, it was filed with
5 the Court last night, so that's a breaking development.
6 The financing conditions, another condition that's
7 been the focus of the objection, that still remains open at
8 this point. We know Standard General is working on it, we've
9 seen a draft of a financing commitment letter, but that's still
10 a work in process.
11 The other issue I mentioned before was the store
12 count. We've made the change, in terms of the time line. But
13 the other change in the APA is the range of the stores that
14 they can buy has now been narrowed. Before, my memory is the
15 range was between 1,500 and 2,400 stores. It's now been
16 narrowed to between 1,700 and 2,050 stores. So that, at least,
17 obviously doesn't eliminate that conditionality, but it narrows
18 --
19 THE COURT: Uh-huh.
20 MR. GORDON: -- the scope of the conditionality.
21 Another issue, I think it's pretty significant, Your
22 Honor, is with respect to the breakup fees and the expense
23 reimbursement. Your Honor, I'm sure, is aware that there were
24 a number of objections asserted to those provisions.
25 THE COURT: Right.

1 MR. GORDON: And I have to be honest, standing here, I
2 don't have the complete details on this; that's one of the
3 reasons I want to take a break. But my understanding is, is
4 that Standard General has agreed, for today, to put off the
5 issue of whether they're entitled to -- would be entitled to a
6 breakup fee or expense reimbursement, subject to one exception
7 I'll get to in a moment -- in a moment. And they're doing that
8 because those are only payable if they --
9 THE COURT: If they get topped.
10 MR. GORDON: -- if they ultimately get a financing
11 commitment that's reasonably acceptable the company. And since
12 they don't have it at the moment, it's kind of a hypothetical
13 conversation to have with the Court, or a hypothetical
14 litigation to have over this issue. And so, at our request,
15 they've agreed to push that off. Where I don't have total
16 clarity is whether they've pushed it to a definitive date, or
17 it's until they have the commitment letter, so I'll have to get
18 clarity on that over the break.
19 But the one piece that remains is they do want Your
20 Honor to consider expense reimbursement related to the work
21 they did in connection with the Sprint contract because they
22 were heavily involved in the negotiation of the Sprint
23 contract. They feel, and I agree, that that is a material
24 benefit to the estate, and at least at this point, Your Honor
25 should consider the propriety of expense reimbursement just

1 relating to the work that they performed in connection with the
2 negotiation and finalization of the Sprint deal.
3 THE COURT: Is there a number associated with that
4 piece, or is that still in discussion?
5 MR. GORDON: I don't have it.
6 THE COURT: Okay.
7 MR. GORDON: But I'll address that at the break.
8 THE COURT: We'll allow that to play out.
9 MR. GORDON: Okay.
10 THE COURT: Okay. I understand the question.
11 MR. GORDON: Obviously, a fair question. I'll just
12 make a note.
13 And I think Your Honor recalls, that is -- the Sprint
14 agreement is an agreement that's available to other prospective
15 bidders, provided they're acceptable --
16 THE COURT: To Sprint.
17 MR. GORDON: -- to Sprint.
18 Also, I just -- the other piece I learned this morning
19 was that the lenders, overnight, as I indicated, made some
20 changes to the form of final order with respect to the debtor-
21 in-possession financing. And I know that one of the changes --
22 and I'm sure I'm missing some. I think there were -- I was
23 told three this morning. I can probably only remember two.
24 One was there was concern about the extent of the
25 challenge period. And I think the lenders have agreed that, if

1 the committee files a motion for standing to bring claims
2 within the proposed sixty-day period, that would be viewed as
3 extending the period. And again, the lenders can correct me if
4 I'm wrong, and we'll clarify all the details over the break.
5 There was also a concern raised by the committee about
6 the cross-collateralization effect of the roll-up. And my
7 understanding is the current draft basically limits that effect
8 to diminution in collateral value.
9 THE COURT: Basically, the 507(b) component,
10 functionally.
11 MR. GORDON: Yeah.
12 THE COURT: Right?
13 MR. GORDON: So the diminution in collateral value.
14 And again, Your Honor, I think there's one other thing
15 that I'm overlooking at the moment. But nonetheless, I think,
16 overall, there's been a lot of material changes that have been
17 made to try to bring the parties closer together. And the
18 debtors are extremely grateful for the efforts by these parties
19 to try to move this case ahead because, as we said, this is a
20 difficult case.
21 We've got to sort of find a way, collectively, to get
22 through these issues, or we're just not going to get to the
23 finish line on this. And our feeling is we have to do
24 everything we can to get this case to the auction, to the sale,
25 so that we don't have hypothetical issues anymore, we don't --

1 we don't even know who the parties are going to be anymore
2 because pay-downs are being made and the like. We know exactly
3 where we stand, and we can see where we need to go. And I
4 think parties are endeavoring, in a very, you know,
5 collaborative way, to try to get us to the point where we can
6 move this process forward and see where we come out at the end.
7 So I just wanted to give Your Honor a flavor for some
8 of the material changes that have -- again, I know I've missed
9 some, maybe I've misstated them slightly, to some degree. But
10 that's, I think, the gist of what's been happening.
11 THE COURT: I understand. This has actually been
12 helpful, and I appreciate the report.
13 MR. GORDON: Thank you.
14 THE COURT: Mr. Kirpalani, good to see you. Welcome.
15 MR. KIRPALANI: Thank you, Your Honor. For the
16 record, Susheel Kirpalani from Quinn Emanuel on behalf of the
17 creditors' committee.
18 Judge, I think you probably could tell, just from the
19 look on my face, that I've drank from many fire hoses in my
20 life, but usually they have one spout, and this one is more
21 like a giant sprinkler system, and it's been pretty exhausting.
22 And I think, not just for me and my team and our co-counsel,
23 but I think for the committee members, too.
24 I did just want to take a second to orient the Court
25 on who is the committee because, as you know, I've had

1 different cases in front of Your Honor, and sometimes it's a
2 bunch of bondholders, and they want certain things, and other
3 times, it's other folks.
4 This committee has one bundled representative: The
5 indenture trustee. We've had no contact at all from any actual
6 bondholders. I think people are still observing and reading
7 and trying to learn from the work that we're doing. There's a
8 severed employee on the committee. Various trade creditors and
9 landlords make up the balance.
10 So we did agree to the adjournment on Friday, around
11 three or four o'clock. It was a difficult process because we
12 were trying to condition the agreement to adjourn that we would
13 get the new APA by Sunday, at a certain time. And that
14 required negotiation, for some reason. So we did -- you know,
15 put all that to the side because I don't want to waste the
16 Court's time.
17 We did have a meeting on Monday with all of the other
18 parties' counsel and advisors, as Mr. Gordon reported. We
19 spent over five hours together. And my take-away, honestly,
20 was less optimistic than Mr. Gordon's. I didn't really think
21 we resolved anything. But it looks like, perhaps, after the
22 meeting, other folks went back to the drawing board without us,
23 and said, we ought to concede a few things, which I applaud.
24 On the other hand, there are some very fundamental
25 things. It's almost like -- it's almost like the effort was to

1 throw numerous objectionable, offensive things at the unsecured
2 creditors, and then take away ones that were easy gives, and
3 hopefully it looks like there's been some reasonableness.
4 And the first time I'm hearing of some of these
5 concessions was when Your Honor just heard of them. But I have
6 to say that there is -- you know, there's a couple of elephants
7 in the room. And you know, one of them is the complete
8 disconnect between the DIP orders sixty-day period, which we
9 would ask to be extended.
10 But you should -- Your Honor should know -- and I
11 don't mind since it's my own settlement offer, I can tell you,
12 I said on Monday, we would live with the 60 days; we will just
13 not sleep, but we will live with the 60 days, provided we get
14 the discovery under Rule 2004, within 14 days, so that gives
15 us, you know, a couple of weeks to analyze what we got. And
16 we'll work as hard as we can. And I said, don't bother me with
17 budget issues, I have no idea what it's going to cost. We're
18 just going to work -- the time period is the budget. And that
19 was I was proposing.
20 And I think, while I appreciate the concession that,
21 if the committee were to file a motion for standing, that that
22 would toll the sixty-day deadline. I think there used to be a
23 local rule about that, that it happened automatically. But I
24 appreciate it as a concession.
25 On the other hand, without knowing that we're going to

1 have information that we've asked for -- and I realize, I think
2 it was eleven or twelve o'clock last night, that I think the
3 debtors were opposing our Rule 2004. To be honest, I didn't
4 spend time reading it. I don't know what's being said about
5 it.
6 But we will do everything we can not to -- the one
7 benefit of Monday's meeting is I think we understand the
8 importance of getting a sale done in the month of March. The
9 reason why that's important raises other red flags, but we
10 understand we are where we are right now, and the red flags can
11 be dealt with later. The short answer is, there's no
12 inventory; there's not enough inventory to go beyond that. I'm
13 not sure how we got here, but that's what we intend to find
14 out.
15 The big disconnect, the big disconnect, one of the
16 elephants in the room, is: How can Standard General be the
17 acquirer before the 60 days is up, and also credit bid, not
18 just for its own purported collateral, but for things that are
19 not its collateral, and demand the release as part of all of
20 that, by March -- he said the deadline --
21 THE COURT: It's the 26th.
22 MR. KIRPALANI: The 17th is the deadline? Oh, twenty
23 -- okay. The sale hearing is the 26th. So, by March 26th.
24 I'm a quick study, but that's record time. And I just don't
25 know the answer.

1 You know, the answer that was employed in Fisker,
2 which I'm intimately familiar with -- I think Your Honor will
3 remember, you handled one hearing in Fisker, and the attorney -
4 -
5 THE COURT: I did. It was my chance to get my name in
6 the paper.
7 MR. KIRPALANI: Yeah.
8 (Laughter.)
9 MR. KIRPALANI: I've been known to like to do that,
10 too, but ...
11 (Laughter.)
12 MR. KIRPALANI: But ...
13 THE COURT: I don't have a marketing department, so
14 ...
15 (Laughter.)
16 (Participants confer.)
17 MR. KIRPALANI: But no, in all seriousness, Your
18 Honor, I think the Court will remember Tobias Keller, who I
19 know Your Honor knows --
20 THE COURT: Sure.
21 MR. KIRPALANI: -- from many years of hearing from
22 him. He was counsel for the secured lender, initially, in
23 Fisker, and we did come in, after Judge Gross ruled that the
24 credit bid could not be permitted, and we attempted to appeal
25 it. And ultimately, it was an interlocutory appeal in the

1 District Court; Judge Sleet wanted to have none of it, but that
2 was fine.
3 Our client still said, fine, we'll bid, and they bid
4 cash. And I think everyone -- certainly, everyone in Delaware,
5 and certainly everyone in the bankruptcy bar should know what a
6 success that case was, as a result of the competitive cash
7 bidding, which my client, the secured lender, who believed it
8 had a lien on everything, participated in. And I do think that
9 that's the right answer. You know that's our position from our
10 papers.
11 But the problem is, the huge disconnect is that is
12 DOA, in terms of the discussions we've had. There is no
13 appetite at all to do anything other than the credit bid. And
14 here's the part, here's the rub that makes it worse. Okay?
15 Which we only learned during Mr. Kurtz's deposition yesterday.
16 Standard General itself -- and Your Honor will hear
17 the evidence because it's -- I think it's undisputed -- doesn't
18 have that much of the prepetition loan facility. They were a
19 small piece of it; what I think Mr. Kurtz would describe as the
20 "LC backstop piece," and not really the loan piece.
21 THE COURT: Uh-huh.
22 MR. KIRPALANI: The other hedge -- a bunch of other
23 hedge funds were the -- became the loan piece for whatever
24 reasons. And those hedge funds are also not part of the sale,
25 but there are discussions, right now, going on between Standard

1 General and these hedge funds to acquire their prepetition loan
2 pieces, which, if Your Honor approves a DIP, become DIP pieces,
3 and then use those pieces to do the credit bid.
4 So, in other words, it's not just the one entity that
5 needs a release by March 26th; it would wind up being -- which,
6 again, we just learned yesterday --
7 THE COURT: All the players --
8 MR. KIRPALANI: -- all of them.
9 THE COURT: -- in the syndicate.
10 MR. KIRPALANI: Yeah. It's like -- it's like run the
11 laundry machine in the first 20 days of the case, you know, and
12 give everybody clean shirts, like that's what it is.
13 So it's been extremely difficult to keep up. I would
14 say that Jones Day has been extremely cooperative with us.
15 They've got a lot of mouths to feed, in terms of information-
16 seekers. And we do appreciate that they have been trying, but
17 there's only so many hours in the day, and the exigencies of
18 the case are not the unsecured creditors' doing.
19 We're trying to accommodate what the needs of the
20 secured lenders are, to have their collateral liquidated as
21 soon as possible. But by the same token, we feel we're being
22 gouged by this DIP, where we believe it's unnecessary. And you
23 know, Your Honor knows I've tried in the past, and I would try
24 again to show that, here, in fact, perhaps more than -- not
25 "perhaps" -- more than in any case I've ever seen in 21 years,

1 there is adequate protection, based on what is the proposed
2 use.
3 This is not a case being run for everyone's benefit
4 right now, and -- nor is the collateral being used in a way
5 other than to try to monetize the assets as fast as humanly
6 possible for everyone's benefit, I appreciate that. But do we
7 need to pay two percent more than the default rate of the
8 prepetition DIP that was just entered into four months ago --
9 prepetition facility?
10 THE COURT: Facility.
11 MR. KIRPALANI: I mean, really? Do we need to pay one
12 and a quarter percent of $285 million to get a twenty-million-
13 dollar bonding, that we don't even need? We need, so that
14 professionals like me can have a fully funded carveout on day
15 one? I'll take my chances, you know, there will be enough
16 money generated in a case for people to get paid. We should
17 stop worrying about those things. That's not the priority of
18 Chapter 11.
19 You know, the priority here is to treat the creditors
20 fairly. And I'm not worried, and I don't think everybody else
21 should be worried, either. We should move forward with the
22 sale process on the time line -- frankly, the time line that
23 Mr. Gordon just reported, reacting without having the benefit
24 of talking to our investment banker, sounds pretty close.
25 So, you know, I think you even offer that there may be

1 a day or two on the bid deadline. I think we'd like to talk
2 about that in the little break.
3 In terms of the breakup fee, again, you know, this is
4 like sleeves off someone's vest. Okay, we agree to put off the
5 breakup fee until we give you a firm bid. Okay, thanks, that's
6 terrific. But on the other hand, we would like to get an
7 expense reimbursement now. Reacting on the fly? Sounds to me
8 we should put all of those things off, until there is an actual
9 transaction under O'Brien. It could be retrospective, and say,
10 did it confer a benefit; maybe it did.
11 Mr. Kurtz testified yesterday, and I'm sure he'd say
12 the same thing to you today, that the Sprint Alliance
13 agreement, it could very well be an extremely valuable asset of
14 the estate. But the market will tell us. So sounds like that
15 would be a good record on which to decide whether more expense
16 reimbursements should go to the same players that just got
17 expense reimbursements and fees four months ago. So I'm
18 reacting on the fly, but that's how I think we should be
19 narrowing issues.
20 And then, you know, on the DIP, on the disconnect, the
21 credit bid, what I call a "back-door release," and you know,
22 Mr. Galardi told me I used a pejorative term. I didn't mean it
23 in a pejorative way. It's just not in the front door. It
24 doesn't say, you know, I want a release in order to buy the
25 company. You've got to scour through it and read 9.7 of the

1 APA, and you see, ah-hah, anything the buyer uses to credit bid
2 must no longer be subject to challenge. And then we got to
3 wait until depositions to find out, oh, the buyer might be
4 using all sorts of things that it buys from people in trading
5 market. It's dizzying. But I think that's a big elephant in
6 the room that we need to deal with, the credit bid, Your Honor.
7 THE COURT: Okay.
8 MR. KIRPALANI: And I think that's my reaction off the
9 top.
10 THE COURT: Okay.
11 MR. KIRPALANI: Thank you.
12 THE COURT: All right. Mr. Burke.
13 MR. BURKE: Good morning, Your Honor. I'll be brief.
14 Michael Burke, Sidley Austin, for AT&T Corp.
15 Your Honor, just because I heard Mr. Gordon say this,
16 or recite this during some of the progress that has been made
17 about -- with respect to the assumption of the AT&T contract.
18 Very briefly, we filed a limited objection to the sale
19 procedures motion.
20 THE COURT: I saw it.
21 MR. BURKE: The point is this is the first AT&T is
22 hearing of this purported assumption. You may note, in our
23 limited objection, although this issue isn't ripe before Your
24 Honor because I think the list of executory contracts was
25 supposed to be on March 6th, we did footnote that we didn't

1 believe that the contract was assumable without our consent.
2 So I just didn't want to leave --
3 THE COURT: Okay.
4 MR. BURKE: -- the impression with Your Honor or any
5 of the parties that we had agreed to assumption or anything
6 along those lines.
7 THE COURT: I understand.
8 MR. BURKE: Thank you.
9 THE COURT: Okay. All right. Here's what we'll do.
10 I think that the debtors' request for a short break right now
11 of -- we'll go to eleven o'clock. It is now 10 -- according to
12 the Court, it's about 10:22, so that will give you some time.
13 I would like to reconvene at 11. If there are
14 productive discussions going on, I'll probably be happy to give
15 you more time. But I know that we've got a lot of people
16 participating on the phone, and a lot of people that aren't
17 necessarily going to be part of the dialogue that the debtor is
18 having. So, as a courtesy to them, I want as measure of
19 confidence that we will reconvene at 11, at a minimum, for a
20 further status report, or to move forward with the hearing.
21 I appreciate getting the guidance from the parties.
22 There are, obviously, a number of significant moving parts. It
23 is, as I said earlier, helpful to me to get that context
24 because, again, a number of these issues I expected would be
25 the subject of ongoing dialogue. Sometimes it's a chicken-and-

1 egg thing about whether or not certain matters will be
2 resolved, unless other matters are resolved.
3 And I've said before, one of the luxuries I have is
4 able and experienced professionals that have done this before,
5 so I'm relying on you.
6 (Laughter.)
7 THE COURT: Now I'm shaming you.
8 (Laughter.)
9 THE COURT: So what I'd like to do is take that break,
10 have that opportunity. If there's any particular issue with
11 respect to scheduling or other issues that might be conducive
12 to that dialogue, we can confer with respect to that. But I
13 would look to reconvene at eleven o'clock. We will stand in
14 recess. Thank you.
15 (Recess taken at 10:22 a.m.)
16 (Proceedings resume at 11:30 a.m.)
17 (Call to order of the Court.)
18 THE COURT: Please be seated.
19 Mr. Gordon, I certainly was not intending to rush the
20 parties. I want the dialogue to occur. It seems like there is
21 a lot to talk about. But I also expressed some concern about
22 just making sure that either the parties in the courtroom or on
23 the phone had some sense of where we stand. But I'm really at
24 your pleasure today.
25 MR. GORDON: We really appreciate your flexibility,

1 Your Honor.

2 The conversations were productive. We're very, very
3 close on a couple of issues, and like one issue away from
4 resolving a number of objections. But we are one issue away.

5 THE COURT: Sure.

6 MR. GORDON: And then, you know, I think there's more
7 issues maybe with respect to the committee, but I think we've
8 made progress with the committee, as well. But I'm mindful of
9 the fact there are many people and people on the phone. So I
10 think the debtors' view at this point is we should go ahead and
11 proceed with the hearing. We're going to continue to sort of
12 work --

13 THE COURT: Okay.

14 MR. GORDON: -- behind the scenes, if we can, to see
15 if we can't move this ahead. But it might be helpful to the
16 process to move this ahead, if that's okay with Your Honor.

17 THE COURT: That's fine with me. And part of the
18 reason is that I'm good today until between 4:30 and 5. And if
19 we don't conclude, we're back on Friday with the lease issues,
20 depending on availability. The first item on is, obviously,
21 the lease issues. But just to be aware of timing and
22 scheduling.

23 But I'm aware that there's, obviously, a record that
24 the debtor is going to look to make. And you know, many of
25 these issues are not necessarily evidentiary in nature.

1 They're deal points, and they need to be presented or
2 negotiated. So shall we proceed?
3 MR. GORDON: Yes, Your Honor. And in that respect, I
4 think we have an understanding with counsel for the committee -
5 - and obviously, feel free to disagree -- that we'll forego
6 opening statements --
7 THE COURT: Okay.
8 MR. GORDON: -- you had some preliminary comments from
9 both of us before -- and go right to the record. And I advised
10 counsel a few minutes ago, our feeling is, from the perspective
11 of both the DIP motion and the bidding procedures motion, we've
12 laid -- we've presented our record, in terms of the
13 declarations on file --
14 THE COURT: Mr. Kurtz's declaration and Mr.
15 Adrianopoli's declaration.
16 MR. GORDON: Correct, Your Honor. And so we stand on
17 those. Our witnesses are here. And so we, obviously, tender
18 them for cross-examination by the other side, if that works,
19 subject to our right, obviously, to do any redirect that we
20 think is appropriate.
21 But we do agree with Your Honor, we do feel like the
22 issues, largely, are not evidentiary ones --
23 THE COURT: Right.
24 MR. GORDON: -- and they are more deal points. But I
25 know the committee has a desire to make a record, and

1 obviously, that's completely their right to do that --

2 THE COURT: Sure.

3 MR. GORDON: -- and we're prepared to proceed.

4 THE COURT: That sounds fine. Mr. Kirpalani, does

5 that game plan sound all right to you?

6 MR. KIRPALANI: Yes.

7 THE COURT: Okay.

8 MR. KIRPALANI: Yes, Your Honor.

9 THE COURT: Then I think you would be moving into

10 evidence the two declarations, obviously, subject to cross-

11 examination --

12 MR. GORDON: Yes.

13 THE COURT: -- not only by the committee, but by any

14 party that wishes to cross.

15 MR. GORDON: Yes.

16 THE COURT: I would ask --

17 MR. GORDON: And that's in support of both motions, by

18 the way --

19 THE COURT: Right.

20 MR. GORDON: -- to be clear. And the thought was,

21 when we put the witnesses up, they would be cross-examined and

22 redirected, potentially, in connection with both motions at

23 once.

24 THE COURT: Okay. I'd ask if anyone objects to

25 admission of the two declarations in support of the debtors'

1 case-in-chief, subject, of course, to the opportunity to cross-
2 examine. Any objections?
3 (No verbal response.)
4 THE COURT: Very well. Both are admitted.
5 MR. GORDON: Thank you, Your Honor.
6 (Kurtz Declaration received in evidence.)
7 (Adrianopoli Declaration received in evidence.)
8 THE COURT: Counsel?
9 MS. SELDEN: Shannon Selden of Debevoise & Plimpton
10 for Standard General.
11 And I thought, if Your Honor wouldn't mind, and the
12 parties wouldn't mind, it might be helpful if I clarified a
13 couple of things in response to Mr. Kirpalani's remarks.
14 THE COURT: Sure. And in the same context as Mr.
15 Gordon's and Mr. Kirpalani's comments, that's probably going to
16 be helpful, and we'll move forward.
17 MS. SELDEN: I think so. I think there are a couple
18 of points that Mr. Kirpalani made that I could maybe help to
19 clarify.
20 First, I think everyone knows that Standard General is
21 here for RadioShack as a clear stalking horse bidder. We put a
22 tremendous amount of effort into negotiate the APA and the
23 Sprint deal. Those are expressly subject to higher and better
24 bids, and we welcome the market test that the auction would
25 provide. The Sprint agreement is available to any party that

1 chooses to bid, and is acceptable to Sprint.
2 I think there are a couple of things in Mr.
3 Kirpalani's remarks that I want to clarify specifically:
4 One is that Standard General is not seeking a release.
5 Section 9.7 of the APA seeks exactly what it says it seeks,
6 which is confirmation that we hold valid and enforceable debt,
7 and that it won't be subject to challenge after the deal is
8 closed.
9 I'm sure that Mr. Kirpalani has thought of many
10 affirmative claims that are unrelated to the validity of the
11 debt, and I'm sure, if I haven't heard of them already, we'll
12 hear from them -- from him soon. We're not asking for a
13 release of those claims. All we're asking is for the credit
14 bid.
15 THE COURT: Let me ask you, though. In the event that
16 I'm not prepared to reduce the time afforded under our local
17 rules for the committee to investigate and challenge the
18 validity of the liens, he referred to it as the "disconnect" or
19 the "elephant in the room." How does the sale close without me
20 blessing those liens or, essentially vitiating their
21 investigation right?
22 MS. SELDEN: I think there are two aspects of that,
23 Your Honor. First, the schedule is driven by the debtors. The
24 schedule is not Standard General's, and we're prepared to go
25 forward on the schedule that works for the debtors.

1 Second, the credit bid is a fundamental part of
2 Standard General's deal. Standard General has a lot of skin in
3 the game. Mr. Kirpalani suggested some significant --
4 THE COURT: Well, I don't disagree with -- I don't
5 disagree with that.
6 MS. SELDEN: Sure.
7 THE COURT: My question is -- I've dealt with this in
8 different situations, I know my colleagues have, and every case
9 is different. But we've had situations where sales had to
10 occur. I think our practice, among my colleagues and I, has
11 been fairly consistent. You can probably find an order I've
12 signed for almost any proposition.
13 (Laughter.)
14 THE COURT: But it may be that I've reduced it. I
15 don't believe that I've ever reduced it over a committee's
16 objection. And so the predicate for the exercise of a credit
17 bid is a presumption that there is, in fact, a valid lien.
18 And if the lien is still subject to challenge, then,
19 theoretically, a sale could move -- an auction could proceed, a
20 sale could close. But it -- there would need to be some side
21 of backside arrangement that would either be that the purchaser
22 understands they're obliged to deliver cash, in the event that
23 the liens are unwound, or that there's some other mechanic.
24 You know, the committee and Wilmington Trust also touches on
25 this issue.

1 We don't necessarily need to answer that question
2 today -- or we actually do need to answer that question today
3 in one form or another. But the question I have is: Is the
4 purchaser expecting that, if I set up a time line -- and there
5 seems to be consensus on a time line. You know, I said there -
6 - most of this isn't evidentiary, there is not a material
7 debate, there's nobody in here that's saying this ought to just
8 be a stand-up reorg, not a sale; so there doesn't seem to be
9 any issue there, so there's going to be a sale, and it's going
10 to happen at the end of March. How does that closing occur in
11 a way that, nevertheless, protects the rights that the Court
12 regards as significant, which are the investigation rights?
13 MS. SELDEN: Your Honor, the proposal is for the
14 investigation, and we're prepared to go forward as quickly as
15 Mr. Kirpalani would like with respect to the validity of the
16 credit before the sale closes. That is a closing condition;
17 that is what Section 9.7 is. I'm ready and able to deliver it
18 to him via email as soon as he asks for it --
19 THE COURT: Okay.
20 MS. SELDEN: -- and I've invited him to make that out.
21 THE COURT: All right. I understand. Okay. Well, I
22 think we need -- that remains an issue. And I understand that
23 it is the subject of dialogue. But I don't want anyone to
24 proceed under an assumption that, if, indeed, the committee is
25 conducting its investigation and has not concluded, and is

1 still within the time line, which I think is 14 April, I
2 struggle -- I don't struggle. I mean, there are a number of
3 ways to deal with it, but we need to deal with it and, frankly,
4 account for it. And there are proposals that are out there. I
5 can think of some, but your people are smarter than I am. But
6 it does seem to me that that is an issue.
7 And I would say that, simply stating that either
8 there's nothing out there, or that we've made everything
9 available to the committee, and they just haven't acted, is not
10 dispositive of the question because, again, our -- I think our
11 rules are pretty clear. And we try -- well, I will not reduce
12 the time because every sale case would present precisely that
13 posture, we got to reduce the time.
14 I am not -- I have not argued with Mr. Gordon for a
15 moment, or frankly, Standard General or anybody, about the time
16 lines. I have jammed landlords, in this context, to an extent
17 that I feel very uncomfortable about, and they've been very
18 accommodating. So the time line is what it is.
19 There are a number of open issues. But to me, Mr.
20 Kirpalani focused on that -- and some other issues, but focused
21 on that. But I want to be clear that we need -- we need a fix
22 for that issue, and I'm not certain what it is, but that
23 remains out there. I don't see that being a question of
24 evidence or testimony because, you know, wanting it is not part
25 of an evidentiary record. So I think the issue has been laid

1 out. And again, it's my expectation there's a dialogue going
2 on regarding it. But I believe it's helpful, at least, to the
3 extent I can share some of the issues that I see and the
4 concerns that I have.
5 MS. SELDEN: Thank you, Your Honor. We understand and
6 appreciate those concerns, and are prepared to engage in that
7 dialogue about the time line. It might be helpful for me to
8 further clarify in response --
9 THE COURT: Sure.
10 MS. SELDEN: -- both to those remarks and Mr.
11 Kirpalani's, that the credit bid is a fundamental part of
12 Standard General's deal for real business reasons.
13 Our client isn't insignificant here. On day one, we
14 back-stopped by $120 million. We're the last out piece. And
15 because we're in the last out, as others are paid down, our
16 percentage, overall, increases. Given the size of our
17 investment and the skin that we have in this game, we have an
18 obligation to our own LPs to make sure that our existing
19 investment is good money --
20 THE COURT: Uh-huh.
21 MS. SELDEN: -- before this deal closes. And so we do
22 view it as a fundamental piece of our -- of our bid. And the
23 only way to protect that last out is to credit bid the whole
24 facility --
25 THE COURT: I understand.

1 MS. SELDEN: -- as we're proposing to do.
2 THE COURT: Okay.
3 MS. SELDEN: Thank you very much, Your Honor.
4 THE COURT: All right. Thank you very much.
5 MR. HARRIS: Your Honor, may I just one point on the
6 question you raised to Standard General's counsel?
7 THE COURT: Sure, Mr. Harris.
8 MR. HARRIS: Thank you. Adam Harris from Schulte,
9 Roth & Zabel on behalf of Cerberus, one of the SEP lenders.
10 Your Honor, the one point I don't think should ever
11 get lost in the conversation here is what is likely and
12 hopefully will occur in the context of the auction. During the
13 break, we had an opportunity to speak with the debtors and
14 confirm this, and I don't think anybody is operating under
15 misconceptions.
16 The closing condition in the Standard General deal is
17 what it is. However, in the context of any given auction with
18 competing -- hopefully sufficient competing bids, that
19 condition is potentially going to create a basis to discount
20 the value associated with it, to the extent it presents closing
21 risk.
22 And we have made it very clear that that is an issue
23 for us, it's obviously an issue for the committee, should be an
24 issue for the debtors, that would be taken into account in the
25 context of those discussions, as they move along, and where

1 people will have to make informed decisions, maybe better
2 informed than we are today, frankly, as to what value it is, if
3 any, that the estate may be giving up by allowing Standard
4 General to go ahead and credit bid in the context of an auction
5 on the time table that we've laid out here.
6 We don't know that today. I can assure you it is
7 going to be the subject of great discussion on a go-forward
8 basis. Whether their denominated the stalking horse today, or
9 whether they just show up at the auction with the same bid and
10 the same closing condition, I take their counsel at her word,
11 I've heard this numerous times over the course of the last
12 week, that condition is not going away, no matter what. So, if
13 Standard General is going to make a bid here, and we think
14 that, you know, we should encourage them to do so, that
15 condition is not going away.
16 But the time to deal with the issue of the credit bid
17 is going to be in the context of the auction, where it may
18 become completely irrelevant, if they get outbid and they don't
19 want to move up at all, in terms of a value proposition, in
20 which case, we never have to deal with this issue; or we'll
21 deal with it then, if it turns out that they are, at least on a
22 facial bid, the highest and best bid. But we have to figure
23 out what discount, if any, to attribute to that, in light of
24 what the estate may be giving up, if we go forward in that
25 manner; or we can get them to do what Your Honor suggested,

1 which is provide some kind of potential back stop.

2 So I didn't want the Court or any of the parties here

3 to lose sight of the fact that that is an issue which is going

4 to be four square in front of all of the parties who are going

5 to be at the auction, and who are going to be involved in the

6 evaluation of the bids overall.

7 THE COURT: Okay. I understand.

8 MR. HARRIS: Thank you.

9 THE COURT: Thank you.

10 Mr. Gordon, do you tender your witness?

11 MR. GORDON: Yes, Your Honor. I guess I'd like to

12 kind of -- well, we have the two witnesses. You tell me who

13 you want first.

14 (Participants confer.)

15 MR. GORDON: We'll tender David Kurtz, who is with

16 Lazard Freres.

17 THE COURT: Let me ask you a question. Mr. Kurtz is

18 certainly welcome to come on up. Will the testimony adduced go

19 to the bid process and the DIP?

20 UNIDENTIFIED: Yes.

21 MR. GORDON: Yes.

22 THE COURT: I think we're dealing with them

23 collectively.

24 MR. GORDON: Yes.

25 THE COURT: Mr. Kurtz, good to see you, sir.

1 MR. GORDON: And as you may recall, his declaration
2 went --
3 THE COURT: I recall.
4 MR. GORDON: -- went to both.
5 THE COURT: All right. Let's swear the witness,
6 please.
7 DAVID KURTZ, WITNESS FOR THE DEBTORS, SWORN
8 THE CLERK: Can you state and spell your name for the
9 record?
10 THE WITNESS: David Kurtz.
11 THE COURT: Spell your last name, please.
12 THE WITNESS: K-u-r-t-z.
13 THE COURT: Welcome.
14 MR. GORDON: Your Honor, I'd like to introduce my
15 partner Mr. Bob Gaffey who is a litigator. He knows what he's
16 doing in a courtroom much better than I do.
17 THE COURT: Yeah, but this is a Bankruptcy Court.
18 MR. GAFFEY: No pressure, Your Honor. Thank you.
19 THE COURT: Okay. Mr. Kirpalani?
20 MR. KIRPALANI: Thank you, Your Honor.
21 Could I ask, Ms. Good, can you deliver to the Court
22 our exhibit binder and also to the witness?
23 THE COURT: Oh, I have a binder. I have one. Thanks.
24 MR. KIRPALANI: Okay.
25 THE COURT: Okay.

1 MR. KIRPALANI: Thanks.
2 (Pause in proceedings)
3 **CROSS-EXAMINATION**
4 **BY MR. KIRPALANI:**
5 Q Good morning, Mr. Kurtz.
6 A Good morning.
7 Q You are the vice chair of Lazard Freres, correct?
8 A I am one of the vice chairman at Lazard Freres.
9 Q And you're the vice chair in charge of restructuring?
10 A Correct.
11 Q Lazard was first retained by the board of directors in
12 connection with RadioShack, correct?
13 A Yes.
14 Q Okay. And that was on September 5th?
15 A Yes.
16 Q Of 2014?
17 A Correct.
18 Q You didn't do any work related to RadioShack before then.
19 Is that right?
20 A That is correct.
21 Q And I believe to the best of your recollection, you were
22 contacted first by Jones Day to come work potentially on this
23 matter?
24 A I was first advised by Jones Day that I may be hearing from
25 RadioShack with respect to a potential opportunity to advise

1 the board of directors.
2 Q And just for the record, you're a former partner at Jones
3 Day, correct?
4 A David Heiman.
5 Q Right.
6 A Yes.
7 Q And it was Mr. Heiman that contacted you with the --
8 A Sorry. I am a former partner of Jones Day. Correct.
9 Q Yes. And it was Mr. Heiman, a current partner at Jones
10 Day, who had reached you to you and said it may be that an
11 opportunity comes your way?
12 A Correct.
13 Q Okay. The company at the time had its own financial
14 advisor, correct?
15 A Yes.
16 Q And that was Peter J. Solomon?
17 A Yes.
18 Q And I believe you've told me before that you were retained
19 in September of 2014 because you understood the board had a
20 lack of confidence in the advice they were getting from Peter
21 J. Solomon. Is that right?
22 A I think it's fair to say that the board wanted a second
23 opinion from someone experienced in restructuring matters.
24 Q And you were aware, were you not, that Peter J. Solomon had
25 previously marketed the company in April of 2014, right?

1 A I am now aware of that. I'm not sure I was aware of that
2 when I was first hired. But I am now aware of that.
3 Q And your understanding now is that at that time they
4 contacted maybe six or so buyers?
5 A Correct.
6 Q And when you came aboard, you didn't review that process
7 that they ran in detail to determine whether it was a good
8 process?
9 A We did not.
10 Q So in early October, the board was presented with a
11 potential recapitalization and investment transaction that
12 would be sponsored by Standard General. Is that right?
13 A Yes.
14 Q Okay. And you attended the board meeting telephonically,
15 correct?
16 A Correct.
17 Q In fact, the meeting was telephonic, right?
18 A Yes. As I said in my deposition, certain of the board
19 members may have been onsite at the company headquarters in
20 Fort Worth, but I participated by phone and as well as others.
21 Q Okay. And this is the board meeting -- just so it's clear
22 for the Court, this is the board meeting where the board is
23 considering whether to enter into the October 3rd transaction
24 with Standard General and its co-investors, correct?
25 A Yes.

1 Q Okay. The board was given just two options during that
2 meeting, right?
3 A That -- I think it's fair to say that the board had two
4 options in front of it at that meeting.
5 Q Okay. And one option was to liquidate the company
6 immediately with GE funding an orderly liquidation process. Is
7 that right?
8 A Yes.
9 Q Okay. And the other option was enter into the Standard
10 General transaction?
11 A Correct.
12 Q Okay. The board at that time was never presented with a
13 transaction that the company could enter into with AT&T, right?
14 A That is correct.
15 Q And the board was never presented with a transaction that
16 the company could enter into with the unsecured bondholders,
17 correct?
18 A Correct.
19 Q And Lazard was not on the front line of whatever
20 negotiations may have been going on with those parties, right?
21 A We were definitely not on the front line. We were -- I
22 think maybe the best way to describe it as peripherally
23 involved in the negotiations. We did attend I think one
24 meeting in person and talked to certain of the people who were
25 involved offline. But, you know, we were not running that

1 process. You know, Peter J. Solomon was the financial advisor
2 to the company at that point in time, and they were in the
3 lead.
4 Q Okay. And the Standard General transaction, you understood
5 at that time and today, had two material conditions that would
6 be required to convert Standard General's money -- loaned money
7 into equity. Is that right?
8 A It is. Yes.
9 Q And can you tell the Court what those two conditions were
10 in your own words?
11 A Sure. One condition is what we described as the liquidity
12 condition. The liquidity condition required that the company
13 have on January 15th, 2015 not less than $100 million of
14 liquidity available to it.
15 The second condition was what we call the mobility
16 condition. The mobility condition obligated the company to
17 enter into a new contract with Sprint on terms that were not
18 less favorable to the company than the old contract by December
19 31st. On December 31st, the Sprint contract that was currently
20 in place between Sprint and RadioShack expired and it was a
21 condition that a new contract with Sprint on terms no less
22 favorable than the existing contract was completed by the end
23 of the year.
24 Q Thank you.
25 And do you remember who made the presentation to the board

1 over the phone for your consideration?
2 A As I recall, the presentation was largely made by Durc
3 Savini who is a managing director at Peter J. Solomon,
4 supported by Holly Etlin who I believe at that time was the
5 chief financial officer of the company.
6 Q And what about the CEO, Joseph Magnacca?
7 A Magnacca?
8 Q Magnacca.
9 A He also participated as well. And there was questioning by
10 board members. I don't mean to imply that no one else spoke.
11 But there was a book that was prepared for the board in
12 connection with that meeting that had been prepared by Peter J.
13 Solomon, and the essence of the discussion at the board was to
14 go page-by-page through that book. And because it was Peter J.
15 Solomon's book, that discussion was led by Durc.
16 Q Okay. And I think you recall it as being a pretty thick
17 deck, right?
18 A Yes.
19 Q Okay. And Lazard didn't perform any due diligence on the
20 assumptions in that deck, right?
21 A No. We made an effort between the time we were hired and
22 that board meeting to understand enough about the company so
23 that we were conversant with the issues and the financial
24 circumstances of the company. But we did not perform
25 independent due diligence on any of the work produce that was

1 presented to the board at that meeting.
2 Q Okay. And to the best of your recollection, that board
3 meeting lasted about two hours?
4 A Correct.
5 Q I think you told me that it started in the evening. Is
6 that right?
7 A It did. Uh-huh.
8 Q And you can't remember today how far in advance the board
9 might have gotten that thick deck before the --
10 A I don't know.
11 Q And do you have any understanding when the transaction that
12 became the October 3rd recapitalization and investment
13 agreement began to be negotiated?
14 A I cannot -- well, all I can tell you, Mr. Kirpalani, is
15 that it was -- it was in process before we were brought into
16 the situation in September.
17 Q All right. But was the understanding when you came in that
18 Standard General had been doing considerable due diligence on
19 the company at that time?
20 A Yes.
21 Q And that Standard General had been spending a significant
22 amount of time at the company with management developing their
23 own point of view with respect to RadioShack. Is that right?
24 A I believe that occurred. Yes.
25 Q And during the due diligence period I believe you told me

1 that in your view, Standard General had free access to members
2 of senior management of the company, right?
3 A Yes. To my knowledge.
4 Q And that included the CEO, Joseph Magnacca?
5 A Yes.
6 Q And the former CFO John Feray?
7 A Correct.
8 Q And that Standard General was not using any outside
9 financial advisors as a go-between between management and
10 themselves?
11 A Not to my knowledge.
12 Q SO they had direct contact with senior management?
13 A Yes.
14 Q Mr. Kurtz, were you aware that Peter J. Solomon received a
15 five-and-a-half-million-dollar fee for the company's agreement
16 just to enter into the Standard General transaction in October?
17 A Well, I am now aware of that.
18 Q At the time were you aware of it?
19 A "The time" being what time?
20 Q Oh, October 2nd I believe is when the board considered the
21 transaction.
22 A No.
23 Q Peter J. Solomon was soon after terminated by the company,
24 correct?
25 A That happened either in late November or very early

1 December.

2 Q Okay. And we'll come back to that period because obviously

3 we want to talk about your larger role for the company.

4 And what about Ms. Etlin, Holly Etlin at AlixPartners?

5 What was her job again at the company?

6 A Holly Etlin had been the chief financial officer of the

7 company prior to the hiring of John Feray which -- and I'm just

8 not sure when that occurred. It was prior to my involvement at

9 RadioShack. Upon John Feray being hired as chief financial

10 officer of the company, the Alix team continued to provide

11 advice to the company and Holly Etlin was a member of that

12 team.

13 Upon John Feray's departure from RadioShack, Holly Etlin

14 resumed the position of chief financial officer.

15 Q And was she also let go by the company?

16 A She and the Alix team were terminated in December.

17 Q Okay. And was she terminated after it became clear that

18 the liquidity condition was not going to be satisfied?

19 A I think that probably the best way to answer that question

20 is that it was highly likely that the liquidity condition would

21 not be satisfied before she was terminated.

22 Q Okay. Let's actually talk about that. So after the

23 October board meeting, you hadn't heard from RadioShack for a

24 while?

25 A No. As I said yesterday, I went into hibernation for about

1 a month or so.

2 Q Right. Just like the Interstellar movie, right? You look

3 great, by the way.

4 The -- so then in November I believe you said you got a

5 phone call again from RadioShack?

6 A Correct.

7 Q Okay. And what was the message?

8 A The message was, you know, we may want to reactivate you,

9 we may decide to terminate Peter J. Solomon and ask you to

10 assume the role -- I mean "you" being Lazard, of course --

11 assume the role as -- of financial advisor to the company.

12 Q And you did in fact accept that invitation and assume the

13 role of financial advisor to the company, right?

14 A Yeah. The actual decision was not made until I'm going to

15 say 10 days to two weeks after I first heard that it might

16 happen. But we did step into the role when it was offered to

17 us.

18 Q Okay. And that was in December of 2014?

19 A That was in either very late November or very early

20 December of 2014.

21 Q Okay. And by the time you had come back from the

22 hibernation, had anyone new come to the company in terms of

23 outside advisors?

24 A Yes.

25 Q Who was that?

1 A MAEVA.

2 Q What is MAEVA?

3 A MAEVA is an advisory firm that is I believe founded by an

4 individual by the name of Harry Wilson.

5 Q Okay. And do you know how MAEVA was brought to the

6 company?

7 A My understanding is that MAEVA was introduced to the

8 company by Standard General.

9 Q Okay. Can you take a look at the exhibit binder in front

10 of you? And let's just take a look at Exhibit 2 for a second.

11 Do you have it, Mr. Kurtz?

12 A Exhibit 2. Yes.

13 Q Yes. And is it -- just to make sure you have the right

14 binder in front of you, is it the recapitalization and

15 investment agreements?

16 A Yes.

17 Q Okay. And this is the transaction that we've been talking

18 about, right?

19 A Right.

20 Q The document itself was not the subject of detailed review

21 by the board, right? That's -- just to be clear.

22 A I think the board had the document.

23 Q Okay.

24 A I don't know -- I mean, individual board members may have

25 read it carefully.

1 Q Okay. Are you aware that there were various exhibits to
2 the recapitalization and investment agreement?
3 A Yes.
4 Q Okay. And if you just -- if I can find it. Can you just
5 turn the page to -- I guess on the .pdf document, Mr. Kurtz, on
6 the top right it would say Page 6 of 65.
7 A (Witness reviews exhibit)
8 THE COURT: Did you say 6 of 65?
9 MR. KIRPALANI: 6 of 65, Your Honor, on the top part.
10 Yeah.
11 THE COURT: I'm there.
12 THE WITNESS: And you're in the table of contents,
13 right?
14 BY MR. KIRPALANI:
15 Q Yes. That's where it will be. Uh-huh.
16 A Yes. I have it.
17 Q So there's a list of exhibits there. Do you see that?
18 A Yes.
19 Q And you see it says Exhibit C, interim operating budget?
20 A Yes.
21 Q And do you see it says Exhibit G, business plan?
22 A Yes.
23 Q Okay. Do you recall reviewing those items at the board
24 level?
25 A I recall that there was a discussion about those two items

1 at the board meeting.
2 Q Okay. And am I right if I say that part and parcel of the
3 recapitalization agreement was that the company was going to
4 operate pursuant to an interim operating budget and business
5 plan attached to the recapitalization agreement?
6 A You are correct. Yes.
7 Q Can you take a look at another document in this binder?
8 This would be -- sorry -- Document 6, please.
9 A I have it.
10 Q Okay. And on this document it's recorded, RadioShack
11 Corporation and schedule of fees and costs, debt restructuring
12 10/3/14. Do you see that?
13 A I do.
14 Q Okay. And I think you've told me before, but just so the
15 record is clear, you didn't have specificity of each of the
16 various fees in mind when the board approved the transaction,
17 but you were aware of the aggregate number. Is that fair?
18 A At the time of the board meeting I may have had
19 specificity. But what, you know, stuck in my mind and I have a
20 recollection of today was the aggregate number with respect to
21 the amount of fees paid in connection with the transaction.
22 Q And in the middle of this page is the total fees, including
23 the expenses, almost $40 million, right?
24 A Yes.
25 Q And to your knowledge, there's nothing -- the numbers on

1 this page, you don't see anything that's wrong about these
2 numbers, right?
3 A Well, as I mentioned yesterday, I was not aware of -- and I
4 knew there were fees being paid. I don't have a -- I don't
5 think I ever knew, you know, what King & Spalding was getting
6 paid versus Blank Rome versus Debevoise other than fees would
7 be paid. In fact, those numbers probably came in later. Well,
8 maybe not if this is dated on the 3rd. But the number -- the
9 actual amounts paid to the lenders which -- this is the 31,775.
10 I do recall that number.
11 Q Right. And so the letter of credit facility, that $120
12 million-dollar facility, that was the facility that counsel for
13 Standard Gen was just talking about. Do you see that?
14 A I do.
15 Q And that one, it earned a five-and-a-half-percent fee,
16 right?
17 A Yes.
18 Q Okay. And the Peter J. Solomon investment banker that led
19 the process that led to this agreement, they got the five and a
20 half million that's listed there, right?
21 A They did.
22 Q But you didn't know that at the time?
23 A Not at that time.
24 Q Okay. Mr. Kurtz, at some point, did you come to understand
25 after you came back from what we'll call the hibernation that

1 one of the main reasons the company missed its liquidity
2 condition is that it was unable to buy sufficient inventory to
3 stock the shelves for the holiday season?
4 A I am aware of that. Yes.
5 Q Mr. Kurtz, you don't know, do you, when Standard Gen became
6 a significant shareholder?
7 A No.
8 Q And you don't know whether the SEC Form 13 document that it
9 filed signified that it had an interest in acquiring the
10 company, do you?
11 A No. I've never seen that document.
12 Q Okay. Standard General didn't put the October money in all
13 by itself, did it?
14 A It did not.
15 Q It essentially provided the LC backstop of the facility we
16 were just talking about, right?
17 A Right. In the amount of $120 million.
18 Q Okay. And the other first lien lenders who are here, I
19 think they're still involved in the case, they were a group of
20 hedge funds, right?
21 A Yes.
22 Q Okay. And that would include Blue Crest, right?
23 A Right.
24 Q And Saba?
25 A Yes.

1 Q Right? And Taconic?
2 A Yes.
3 Q Right?
4 And to your knowledge, are those funds that have done
5 business with MAEVA before?
6 A Yesterday, you showed me a disclosure document that was
7 part of the MAEVA application for employment in this case which
8 indicates that there was a relationship with at least certain
9 individuals at MAEVA and those firms.
10 Q Right.
11 A But I don't think I was aware of that before you showed me
12 the exhibit in my deposition yesterday.
13 Q If you take a look at Exhibit 4 in the binder?
14 A Yes.
15 Q This is the declaration of Michael Cole [sic] that's filed
16 by RadioShack in the bankruptcy cases that I showed you, isn't
17 it?
18 A Yes.
19 Q Okay. And I believe the part you were -- I drew your
20 attention to is in the "disinterestedness" section. It's on
21 Page 7 of this declaration. And if you look at Paragraph
22 15(a), do you see that?
23 A Yes.
24 Q Is that the basis of your understanding of that MAEVA has
25 done business with Blue Crest, Saba and Taconic before?

1 A Yes.
2 Q And the same thing with letter ©, there's a reference there
3 -- I'm not asking you to attest to it because you don't know
4 firsthand, but that's the basis of your understanding, right,
5 that Taconic and MAEVA have also done separate business
6 together?
7 A Yes. Exactly.
8 Q Okay. To the best of your knowledge, was Standard General
9 involved in the creation of the interim operating plan that the
10 company was to follow after October?
11 A Well, they were certainly knowledgeable about it and
12 engaged with the people who were creating it. You know, was it
13 correct to say that they were involved in the creation? I
14 don't know the answer to that.
15 Q Fair enough.
16 And just going back, so it was by November of 2014 that the
17 company had already begun missing its plan, right?
18 A I think I learned in December that the company had failed
19 to achieve the -- the forecast for the month of November in
20 November.
21 Q Right. And when you returned to advise the company in
22 December, the company was not being actively marketed to third
23 parties, right?
24 A Right.
25 Q You did at some point, though, Mr. Kurtz -- I almost called

1 you Mr. Lazard, sorry. You did at some point -- wouldn't be
2 the worst thing in the world.
3 You did at some point begin doing a full-on marketing
4 process for the company, correct?
5 A Correct.
6 Q And that was by January 20th, according to your
7 declaration.
8 A Yes. We launched a full-blown marketing process for the
9 company in January.
10 Q Right. And when you were marketing the company, you
11 reached out to I think at least 75 people?
12 A Seventy-five potential buyers.
13 Q Okay. Thank you.
14 I'm going to shift gears now to the post-petition period.
15 I appreciate all the background. I thought it would be
16 important for the Court to understand a little bit that -- what
17 we're learning.
18 But I want to talk a little bit about the quality of the
19 stalking horse bid. Okay?
20 A Sure.
21 Q That's -- before I continue, that's the subject matter.
22 A Okay.
23 Q Under the proposed APA with Standard General, there's great
24 variability in the number of stores. Isn't there?
25 A There's less variability today than there was yesterday.

1 Q It is all relative.

2 A Yes.

3 Q I agree with that. I agree with that.

4 You can't tell -- the Court can't tell how many employees

5 Standard General is actually going to keep going forward today,

6 right?

7 A No. I mean, it will depend on the number of stores.

8 Q And when you say that, it is -- that's because it's your

9 understanding that Standard General would take with them

10 employees at the store level for whatever stores it takes. Is

11 that right?

12 A Yes. That is my understanding.

13 Q Okay. But you do also understand they have no legal

14 obligation to actually do that under their APA, right?

15 A I believe that's correct, although it has been confirmed to

16 me subsequent to my deposition today, but before today's

17 hearing, that their intention is to take the store level

18 employees, unless there's a good reason not to take an

19 individual.

20 Q But isn't --

21 A And potentially certain management employees as well.

22 Q It is important to you as the financial advisor to the

23 company conducting a sale process to try to lock down the

24 number of stores, right?

25 A Sure.

1 Q You don't know, Mr. Kurtz, how Standard General is
2 financing its acquisition for RadioShack, do you?
3 A Not yet.
4 Q And you don't know if Standard General's go-forward capital
5 structure is feasible?
6 A I'm not sure -- when you use the term "feasible," I'm not
7 sure what you mean.
8 Q I probably mean the word that you know the term to -- term.
9 So in other words, what I'm asking is, what level of certainty
10 do you have that Standard General's capital structure would
11 enable it to not have to file Chapter 11 at some point in the
12 near future?
13 A I mean, we would need to understand exactly how the capital
14 structure works before we could make that determination.
15 Q And that information has not been made available to you
16 yet?
17 A Well, we do know that the new company will be capitalized
18 with $75 million of equity. We don't know how the debt
19 component will work yet because we have not yet seen a
20 commitment.
21 Q Right. And you don't know whether whatever the capital
22 structure is will be sufficient to actually operate the number
23 of stores that Standard General indicates it wants?
24 A No. I mean, we'd have to look at the business plan in the
25 context of the capital structure that needs to be created in

1 order to make that determination.
2 Q And Standard General has not given you a copy of its
3 business plan yet, right?
4 A I have not seen Standard General's business plan as of yet.
5 Q Okay. Let's talk a little more about Standard General's
6 offer. Standard General is essentially acquiring the inventory
7 and the store footprint and the Sprint Alliance agreement. Is
8 that the way you look at it?
9 A I wouldn't say it exactly that way.
10 Q Okay.
11 A I would say Standard General is acquiring the inventory, is
12 acquiring the fixtures in the stores that it will be
13 purchasing, which, you know, as Mr. Gordon indicated earlier,
14 that range has been narrowed to I think 1,750 -- or maybe 1,700
15 to 2,050, so the range has shrunk. That's true.
16 They will also proceed with the Sprint relationship that is
17 embodied in the documents that were filed with the Court last
18 night. I'm not sure it would be correct to say that the
19 company is transferring the Sprint agreement, or selling the
20 Sprint agreement to Standard General because the Sprint
21 agreement only exists if there is a buyer for the assets.
22 There is no independent value to the company. There's no way
23 for the company to utilize that contract or to monetize that
24 contract outside of the context of a sale of the business to a
25 going-concern buyer that is acceptable to Sprint.

1 And so I think I'd quarrel a little bit with you with
2 respect to your statement that Standard General is acquiring
3 the Sprint contract from the company. Standard General will,
4 if it is the successful buyer, go forward with the relationship
5 with Sprint that is set forth in those agreements which, of
6 course, is available to other potential buyers if those buyers
7 are acceptable to Sprint. But I think it would be incorrect to
8 say that Standard General is acquiring that contract from
9 RadioShack.
10 Q I think I understand your position on that.
11 But you would agree with me that the Sprint contract which
12 was just filed is a very valuable agreement to any buyer?
13 A We believe it is. Yes.
14 Q Okay. And it is your hope, I believe you told me, that the
15 Sprint agreement will stimulate competitive bidding for assets
16 of the company that might not otherwise result in a sale?
17 A Correct.
18 Q And Lazard has not been leading the discussions with
19 Sprint, right?
20 A We have not.
21 Q Okay. That's through MAEVA, right?
22 A MAEVA working on conjunction with the company management.
23 Q And the company management in particular would be the CEO?
24 A The CEO and, as I mentioned yesterday at my deposition,
25 there is an individual who runs the mobility business for

1 RadioShack whose name I couldn't recall yesterday and I still
2 can't recall his name today. I think that individual was also
3 very involved in the negotiations with Sprint for the company.
4 Q Okay. And Standard General was to credit bid for the
5 inventory, right?
6 A Yes.
7 Q Okay. And what about the FF&E? What are they doing with
8 that?
9 A Well, I think the way to think about it, Mr. Kirpalani, is
10 that Standard General has made an offer to buy assets
11 consisting of inventory and fixtures. And for those assets,
12 they intend to credit bid their debt, potentially credit bid
13 the debt of the remaining members of the syndicate if they
14 happen to be the financing source for the company that is the
15 acquirer of the assets, and then they will pay cash for the
16 difference. That's the consideration that they will be paying
17 for the business. I don't know that you can -- I'm not exactly
18 sure what your --
19 Q I --
20 A That's the -- so they're credit bidding plus paying cash
21 for inventory plus fixtures.
22 Q And the amount that they will pay in cash for each store is
23 $3,000.
24 A Well, for the fixtures in the store. Yes.
25 Q Okay. For the fixtures in the store.

1 A Right. Inventory would be, you know, additional dollars.
2 Q That is what I was getting at. That's perfectly fine.
3 Are they allocating any portion of their consideration
4 towards the leases?
5 A They are not allocating. There is no allocation. So as I
6 indicated, and this really gets to the point that I was trying
7 to make, they're paying a price for a package of assets that
8 includes the leases of the stores that they're purchasing, the
9 fixtures within those stores, and the inventory in those
10 stores. There is no allocation set forth in the asset purchase
11 agreement with respect to those individual categories of
12 assets.
13 Q The leases are unencumbered assets of the company but for
14 the DIP, right?
15 A Correct.
16 Q And Lazard has not attempted to value these leases as a
17 standalone asset, right?
18 A We have not.
19 Q And although valuable to a buyer, Standard General is not
20 allocating any portion of its purchase price for the privilege
21 of the Sprint agreement.
22 A No.
23 Q Right?
24 A No. I mean, we may decide as the seller to allocate. We
25 may need to allocate. But there's no allocation set forth in

1 the asset purchase agreement.
2 Q Right. And I would hope that there's value there to
3 allocate, but that's what we're working on.
4 A Exactly.
5 Q Right.
6 What about causes of action of the estate? Is Standard
7 General acquiring any causes of action of the estate?
8 A My understanding is the -- they answer is a limited yes.
9 Only with respect to causes of action that relate to ongoing
10 business relationships. And so, for example, if there is a
11 claim against a vendor, that claim would transfer to Standard
12 General as the acquirer. If there is a preference claim --
13 well, maybe preference is a bad example. If there is another
14 form of claim against a third party that does not relate to the
15 ongoing business, that claim would not transfer to Standard
16 General.
17 Q Okay. But the company has not tried to determine whether
18 there are valid preference claims that would go away as a
19 result of the acquisition, right?
20 A I don't recall an independent determination being made as
21 to the quantum of value that, you know, one would ascribe to
22 the claims that they are acquiring.
23 Q Okay. That answers a couple of different questions.
24 And do you know whether Standard General is willing to buy
25 the assets and let the estate keep any causes of action that it

1 may have against Standard General?
2 A Well, my understanding is informed by what I heard from
3 counsel for Standard General this morning. And other than
4 repeating what I heard her say, I don't know anything more than
5 that.
6 Q Okay. What we didn't hear, though, from the podium a few
7 minutes ago was that it is in fact currently being discussed
8 that Standard General may acquire or use other pre-petition
9 lenders' secured claims as part of its credit bid, right?
10 A So let me comment on that, at least based on my
11 understanding, of course. I don't believe it's correct to say
12 that -- I am not aware of any plan by Standard General to
13 acquire those claims for purposes of bidding them in.
14 Q Okay.
15 A What I do understand is that the holders of those claims
16 may in fact become lenders to the new company. And so that
17 debt will be rolled over into the new company, if you will,
18 through a credit bid of that debt. So it's not as though
19 Standard General is going out-of-pocket to acquire those
20 claims. It may be that those claims are those -- that debt
21 will become the debt financing for the new company that will
22 act as the acquirer.
23 THE COURT: Mr. Kurtz, let me ask you a question
24 because this was the subject of Mr. Kirpalani's comments at the
25 outset and now we're drilling down on it. And I realize that

1 this is evolving or moving.

2 But as you just described it, I think I'm not certain

3 who the buyer is.

4 MR. KIRPALANI: I had a question about that in a

5 minute.

6 THE WITNESS: The buyer of what? The --

7 THE COURT: Well, look. If I had liens and I show up

8 and say, I want to buy your business, and your business has

9 obviously a secured debt to me. We'll leave the issue of

10 legitimacy or validity out. All right? It's got secured debt

11 to me plus all these guys over here. And we can assign any

12 number. I'm owed $100; these guys collectively are owed 500.

13 And I assume you'll make a credit bid. My presumption would be

14 that I'm making a hundred-dollar credit bid. That is the lien

15 that I have. And I am the purchaser. And then it -- I'm not

16 trying to trip up on a --

17 THE WITNESS: No, no. I see how I've confused you.

18 THE COURT: -- on a complicated -- but if I'm going to

19 start bidding theirs, because we're chatting and we're

20 collaborative and we're already in for a dime, we'll be in for

21 a dollar, that may be fine. But the purchaser at the table is

22 not me, but it is this collection. And I'm not certain of the

23 significance of that. But the dynamic I'm not certain I'm

24 following and so I think I want to understand the dynamic and

25 its significance.

1 THE WITNESS: I think I can clarify because I may
2 have, you know, unintentionally muddied the waters on this.
3 So I think the mechanic here would be a -- an
4 acquisition of those claims by NewCo. The way those new claims
5 will be paid for will be to issue a debt instrument to those
6 entities and so, therefore, they become the financing source of
7 the new company. And then the acquiring company will credit
8 bid the entire amount of that debt.
9 So when you said it's being acquired, I was thinking
10 is it being acquired by Standard General. It's really being --
11 those claims would be acquired by --
12 THE COURT: General Wireless.
13 THE WITNESS: Exactly. By the buyer via a new
14 relationship that would enable the buyer to pay for the claims
15 acquired through a debt instrument.
16 BY MR. KIRPALANI:
17 Q Okay. That helps.
18 If, in fact, General Wireless or whatever acquisition
19 vehicle they decide to use does exactly that, would the
20 estate's claims against those lenders have to be released as
21 part of the acquisition?
22 A That sounds like a legal question and I'm not comfortable
23 answering.
24 Q Okay. We'll work with the documents. It's unfair to ask
25 you that question.

1 I'm going to talk about the breakup fee.
2 A Yes.
3 Q Although I think it's still a bit moving whether the
4 debtors are actually asking for a breakup fee to be approved
5 today or at some point in the future, I think that might have
6 been changing during the course of the hearing.
7 A No. The debtors are not asking that the breakup fee be
8 approved today.
9 Q Okay. Let's just talk about the size, then, since I have
10 you.
11 A Okay.
12 Q The -- it's $6 million, right?
13 A Correct.
14 Q Okay. And in considering the size of the breakup fee, you
15 did not consider the fact that Standard General and the same
16 co-investor/lenders had been paid $32 million plus expense
17 reimbursements four months ago in assessing the reasonableness
18 of $6 million today?
19 A That is correct. When we considered the breakup fee, it
20 was in the context of, as I said in my deposition, a general
21 understanding that, you know, within Courts of Bankruptcy,
22 three percent is the maximum breakup fee that can be accorded a
23 potential buyer. I think Standard General's counsel had the
24 same point of view with respect to that. And so the $6 million
25 is in essence three percent of a 200-million-dollar purchase

1 price.
2 Q And you're including in the purchase price the credit bid
3 right, correct?
4 A Yes.
5 Q Okay. You do agree, do you not, that the fees that were
6 paid in October were very expensive for the company?
7 A No doubt.
8 Q And is it your understanding that Standard General is
9 seeking to credit bid the same exposure that it put into the
10 company in October?
11 A Well, the origin of the debt that it would be credit
12 bidding dates back to the October 3rd transaction. So the
13 answer is yes.
14 Q And that exposure that was deposited back in October by
15 Standard General, that's the exposure that Standard General was
16 obligated to convert into stock if the liquidity condition and
17 mobility condition had been met, right?
18 A Exactly.
19 Q Let's talk one more second about the buyer. And which
20 Standard General affiliate, to your knowledge, is the buyer?
21 A General Wireless. Is that the name? Did I get that right?
22 Q Let the record reflect the witness is pointing to the
23 judge.
24 A I'm not very good with names.
25 (Laughter)

1 THE WITNESS: I guess I'm not supposed to -- yeah.
2 You get to ask me the questions. I don't get to ask you the
3 questions. Understood. Fair enough.
4 THE COURT: No. That's why I get the big bucks.
5 (Laughter)
6 BY MR. KIRPALANI:
7 Q I'm sorry. I didn't mean to --
8 A No. You're right. You're right.
9 Q -- I'm serious. I'm sorry.
10 If I represent to you that it is a newly formed acquisition
11 vehicle of Standard General, would that comport with your
12 understanding?
13 A Yes. That's the way I think about it.
14 Q Okay. What assets does that buyer have?
15 A Today I'm not aware of any buyer -- excuse me, any assets
16 that that entity has other than it is a beneficiary of a 75-
17 million-dollar equity commitment from Standard General.
18 Q Okay. And so it's got some contingent right to receive
19 equity from its affiliate?
20 A Correct.
21 Q And if I understood your testimony correctly, that buyer
22 may be the assignee of purportedly secured claims against the
23 estate?
24 A Yes.
25 Q And I believe you told me yesterday that -- I think it's

1 undisputed -- those claims have not yet been allowed?
2 A Correct.
3 Q Okay. And do you know if Standard General will guarantee
4 the performance of its affiliate's acquisition agreement?
5 A I have no knowledge that it's prepared to do that, or not
6 prepared to do that. I have never asked them that question.
7 Others probably have on the RadioShack team. But I personally
8 don't know the answer to that.
9 Q Well, they're here and they can -- they can tell us. So --
10 let's talk about the DIP, and then I think we're just about
11 done.
12 A Okay.
13 Q DIP financing fees. How much is the fee for the DIP
14 proposed by the debtors?
15 A 1.25 percent of $285 million, which equates to $3.6
16 million.
17 Q Okay. And how much money is actually being incrementally
18 loaned to the debtors?
19 A Thirty-five million dollars. Well, including a 15-million-
20 dollar letter of credit facility. So it's $20 million of
21 actual loans, and a 15-million-dollar LC facility, for a total
22 of $35 million of new credit.
23 Q And the letter of credit facility that Standard General had
24 backstopped up to $120 million back in October, right?
25 Remember that?

1 A Yes.
2 Q What's the current level of exposure that Standard General
3 has on that facility?
4 A As I told you yesterday, my understanding is that assuming
5 a hypothetical closing date of March 28th, that exposure will
6 have been reduced to 54 or $55 million. That's based on
7 current forecasts.
8 Q Okay. And, Mr. Kurtz, as advisor to the debtor, you did in
9 fact ask the ABL lenders to simply permit the debtors to use
10 cash collateral instead of a roll-up DIP financing facility,
11 right?
12 A Yes. We at Lazard -- I didn't personally do it. But we at
13 Lazard did make that request more than once.
14 Q And to the best of your understanding, then, their answer
15 was that they would rather be paid the fee than not?
16 A Yeah. That they would not consent to the use of cash
17 collateral.
18 Q Unless they got the fee plus other things in the DIP order?
19 A Well, they -- I don't know if they said they will consent
20 to cash collateral with the fee. They said they will not do a
21 cash collateral only deal. They are prepared to go forward
22 with the DIP which carries the point and a quarter fee.
23 Q Right. But in addition to the fee, the DIP also carries a
24 higher interest rate than the pre-petition facility, right?
25 A It does, by 200 basis points.

1 Q It's 200 basis points higher than the default rate, right?
2 A I believe that's correct.
3 Q Are you aware, Mr. Kurtz, of any financial projection by
4 the company that shows the ABL lenders would receive anything
5 other than payment in full, even in a liquidation?
6 A All of the forecasts that I have seen, which are premised
7 upon the Standard General deal, show that the ABL lenders would
8 be paid in full.
9 Q But even in the liquidation scenario where there is no
10 sale, they would be paid in full, right?
11 A Yes. We -- we have run a hypothetical liquidation
12 scenario. And in that -- or FTI has and I have seen it. That
13 forecast also indicates that the ABL lenders will be paid in
14 full.
15 Q Okay.
16 MR. KIRPALANI: I have nothing further for you. Thank
17 you.
18 THE COURT: Okay. Does anyone else wish to cross the
19 witness before we tender for redirect? Mr. Schepacarter.
20 **CROSS-EXAMINATION**
21 **BY MR. SCHEPACARTER:**
22 Q Good afternoon, Mr. Kurtz.
23 A Good afternoon.
24 Q Just a couple questions on the breakup fee. I just want to
25 cover a couple of points. I think some of it was covered on

1 your cross-examination, but I want to cover a couple other
2 things.
3 The breakup fee that's sought to be paid in this -- in this
4 agreement on this stalking horse bid is $6 million, correct?
5 A Correct.
6 Q Okay. And you had indicated that generally three percent
7 is sort of the benchmark that's followed so that a bid of about
8 -- or a purchase price of about $200 million would correlate to
9 a six-million-dollar breakup fee?
10 A Right. I think what I said is that three percent is the
11 upper end of the allowable range. And how we got to the 6
12 million is three percent of 200 million. Exactly.
13 Q Okay. And I kind of want to focus in on the 200 million.
14 A Sure.
15 Q Under the APA, the purchase price is equal to -- and it's
16 made up of a number of different items that you have to sort of
17 net out and calculate --
18 A Right.
19 Q -- one of which is cash in the amount of a cash
20 consideration. Okay.
21 A Well, cash in the cash registers.
22 Q Okay. And --
23 A I'm sorry. Maybe I didn't -- I think I just gave you a
24 wrong answer. Would you please re-ask your question?
25 Q I know you gave me a wrong answer.

1 Okay. And the cash consideration under the APA, and I'll
2 just --
3 A Right.
4 Q -- I'll just state it for you. It's $3,000 multiplied the
5 number -- multiplied by the number of stores, correct?
6 A Well, the amount to be paid for the fixtures is $3,000 per
7 store.
8 Q Right. Okay. Right.
9 And then it says plus the amount, if any, by which the
10 amount of the estimated credit bid consideration exceeds the
11 amount of debt under the credit facilities held by the buyer at
12 the closing.
13 A Right.
14 Q And what's that number made up of?
15 A Well, so that's what we've been talking about in my
16 examination by Mr. Kirpalani. So my understanding is, as I
17 said, that using a March 28th hypothetical closing date, the
18 amount of debt owed to Standard General will be 54 or $55
19 million pursuant to the LC backstop.
20 If Standard General acquires the right to bid in the claims
21 -- or, again, not Standard General, the NewCo -- let's call it
22 NewCo.
23 Q Uh-huh.
24 A If NewCo acquires the right to bid in the claims of the
25 other ABL lenders, that will take that 55-million-dollar number

1 up to approximately $130 million. If the purchase price is
2 $200 million, then it will require Standard General to pay --
3 or NewCo to pay an additional $70 million of cash.
4 Q Seventy million you said?
5 A Right. To build up to the -- to a 200-million-dollar
6 purchase price.
7 Q Okay. So the cash would --
8 A Again, and as you said, these are rough numbers because we
9 -- we won't know what the actual numbers -- the number will be
10 until we have the actual store closing count and we know the
11 amount of inventory that's actually, you know, in the stores as
12 of the closing date.
13 Q Okay. But we don't know that number now because under the
14 APA, the purchase price is equal to the cash and the cash
15 consideration, which you just explained.
16 A Right.
17 Q Right? Then there's a credit against an amount of debt
18 under the credit facilities held by the buyer.
19 A Right.
20 Q Which -- do you have any idea what that number might be?
21 A Well, I think that's the -- that would be either the 55-
22 million-dollar number if it's Standard General alone, or the
23 130-million-dollar number if they -- if NewCo acquires the
24 right to -- the rights to the debt held by the -- I mean,
25 assuming the DIP is allowed by the DIP lenders.

1 Q Right. By the other ABL lenders, correct?
2 A Yes. Correct.
3 Q Okay. But there hasn't been any purchase by NewCo of that
4 or negotiation of those other amounts, correct?
5 A I'm sorry. By "other amounts" you mean?
6 Q When I say "the other amounts," I'm talking about -- you
7 said there's a range of about 54 million, right --
8 A To 130.
9 Q -- it could go up to 130.
10 A Yeah. So my --
11 Q But what's -- I mean, just to get you back on track.
12 What's the amount of that -- that number now? Is it 54 million
13 or is it 130, or is it somewhere in between?
14 A Sure. So let me clarify. And the numbers that I'm going
15 to use are forecasts as of a hypothetical March 28th closing
16 date.
17 Q Okay. Well, I'm asking you what's the number today?
18 A I don't know the number today.
19 Q Is it 54?
20 A I said I don't know. It could be higher than 54. I don't
21 know.
22 Q Is it anything less than 54?
23 A No. It couldn't be less than 54.
24 Q Okay. So it's at least 54?
25 A It's at least 54.

1 Q Okay. All right. And then it could be -- it could be
2 greater, but you don't know what the delta is between the 54
3 and sort of -- and the 130, where it sort of falls into that
4 range today?
5 A I -- sorry. I'm confused by your question. I apologize.
6 Because I do believe I know these numbers, but I'm not
7 following your question in a way that allows me to give you the
8 answer you're looking for.
9 Q All right. Let me see if I can back up and maybe clarify a
10 little bit.
11 The bottom-line number is the 54, correct?
12 A So again, 54 -- may I --
13 Q Yeah. Go ahead.
14 A -- just one more time to make sure I understand what I'm
15 saying to you.
16 Based upon a forecast that I have seen prepared by FTI as
17 of a hypothetical March 28th closing date, the amount owed to
18 Standard General with respect to outstanding letters of credit
19 would be either 54 or $55 million. That's how I got to that
20 number.
21 Q Right. Okay.
22 THE COURT: Let me ask a question now.
23 MR. SCHEPACARTER: Yeah. Go ahead.
24 THE COURT: Because I think I followed this, and then
25 I didn't. But let's assume for a moment that none of the other

1 facility participants decides to climb into a credit bid. At
2 that point, then, and we'll pick this -- let's round it to 50,
3 make the math easier. At that point, then, the effective
4 credit bid for Standard General or General Wireless would be
5 $50 million, the bid is 200, of which only 50 would be
6 susceptible to credit bid treatment, and they'd have to come up
7 with 150 million in cash plus three grand per store which
8 covers FF&E?
9 THE WITNESS: No. The two -- you were right except
10 for the last statement.
11 THE COURT: Okay.
12 THE WITNESS: So the $200 million includes the $3,000
13 --
14 THE COURT: Includes the three grand per store. Okay.
15 THE WITNESS: For the FF&E. So to go back to the way
16 you were laying it out, you have it exactly right. If there is
17 no acquisition of the claims by NewCo, then the credit bid
18 would be for --
19 THE COURT: A partial burn amount. Fifty --
20 THE WITNESS: -- right, $54 million of a 200-million-
21 dollar purchase price and the remainder would be paid in cash.
22 THE COURT: Okay. I understand.
23 BY MR. SCHEPACARTER:
24 Q The 200-million-dollar purchase price, is that reflected in
25 any document anywhere?

1 A No. The 200-million-dollar -- well, it is reflected in a
2 analysis done by FTI of the value of the -- of the sale
3 contemplated by the asset purchase agreement.
4 Q Okay. All right. And that's --
5 THE COURT: Hang on, Mr. Schepacarter. Before we move
6 on, and you may not be, Mr. Kurtz, the appropriate witness. So
7 if this is not your issue, then feel free to defer to counsel.
8 But somebody's got to explain this to me.
9 There has been an issue that was raised in several of
10 the objections and responded to, but I'm not certain that I
11 followed it with respect to a description of the credit bid
12 that relates to the LCS as being a contingent liability and how
13 is it that someone takes a liability like that and bids that
14 sort of credit bid.
15 I saw that. I'm not -- I will confess I'm not
16 sufficiently familiar with the mechanics of the investment or
17 the capital structure to precisely understand it. I heard the
18 committee objection and if you can shed light on it, you're
19 welcome to. And if not, then it's incumbent on the debtor or
20 Standard General at some point to explain that to me. We
21 haven't really touched on that in the discussions we've had
22 earlier today, but since we're talking about the LC, this might
23 be an appropriate time.
24 THE WITNESS: I think I can shed some light on that.
25 And it really goes to where does the 54-million-dollar number

1 come from.
2 THE COURT: Right.
3 THE WITNESS: The 54-million-dollar number is an
4 estimate developed by FTI of the actual exposure under the LCS
5 that are backstopped by Standard General. That amount is not
6 viewed as a contingent amount. So what FTI has done is look at
7 each one of the LCS and made an independent determination as to
8 the likely draw on the LCS that are outstanding under that
9 facility.
10 And so if it's done right, the 54-million-dollar
11 number should not be viewed as contingent. It should be viewed
12 as actual exposure because the purpose of the analysis was to
13 determine the actual exposure. We are and have been from the
14 beginning very focused on ensuring that we don't give Standard
15 General the ability to credit bid contingent exposure which
16 doesn't materialize. And so we wanted to make sure that
17 they're only getting credit for the amount of actual exposure
18 with respect to those LCS. The analysis that has been prepared
19 is how we derive our way into the 54-million-dollar number.
20 THE COURT: Okay. I understand. Thank you. Sorry
21 for the interruption.
22 MR. SCHEPACARTER: That's fine, Your Honor.
23 BY MR. SCHEPACARTER:
24 Q Just going back to the 200-million-dollar-number, you had
25 indicated that that was part of an analysis that was developed

1 by FTI?
2 A Yes. So what FTI has done is assume a certain store
3 number, because that's all we can do at this point. We don't
4 have the actual store number. Taken the inventory price that's
5 reflected in the APA which is 85 percent of eligible inventory.
6 And eligible inventory, by the way, is inventory that -- an
7 inventory amount that is net of consignment inventory and
8 obsolete inventory. So they -- first they work their way down
9 to that number. They apply an 85-percent factor to that
10 number. Then they add to that the amount -- the $3,000 per
11 store for the fixtures, and that's what gets you to this, you
12 know, 200-million-dollar-number.
13 Now, the actual number could be more or it could be less.
14 If they -- the analysis that I saw that gets you to about 200
15 is for, you know, roughly 2,000 stores. So if they take more
16 than 2,000 stores it could be higher. If they take less than
17 2,000 stores of course it would be lower which is why we can't
18 know the exact number. But it is not difficult to calculate
19 the price that would be paid by Standard General if you make an
20 assumption with respect to the number of stores that they're
21 taking.
22 Q Okay. And does the 200 million also include the assumption
23 of liabilities under the APA? Because there's a number of
24 liabilities that are to be assumed as well.
25 A You're referring to the leases, for example, and --

1 Q Well, any assumed liability. There's a number of them.
2 A Right. So that --
3 Q It says including cure costs associated with assigned
4 agreements. So --
5 A So the cure costs are the responsibility of the buyer.
6 Q Right. Okay. But that 200 million is part of that number,
7 whatever that is?
8 A Actually, that number does not include the cure cost
9 amount. So if one were to include cure costs which would be a
10 reasonable thing to do, it would be a higher amount.
11 Q Okay. Can you repeat that answer just one more time to
12 make sure I get it?
13 A This 200-million-dollar-number that we're using for
14 purposes of this conversation and was the basis of how we
15 derived the six-million-dollar breakup fee does not to my
16 knowledge include the cure costs that will be absorbed by the
17 buyer.
18 Q Okay. Does not include.
19 A Right.
20 Q Okay. Why is that?
21 A I just don't know what that number is as I sit here.
22 Q Okay.
23 A Or say that the -- I mean, one could say that the actual
24 amount of the breakup fee is less than three percent because we
25 could have and should have used the cure amount to boost that

1 number to a -- you know, something higher than 200 million and
2 then given them three percent of that. That's not what we did.
3 We roughly assumed that the value of the purchase price for
4 purposes of the six-million-dollar breakup fee was $200 million
5 and we gave them three percent of that.
6 Q Okay. I think argument and maybe some testimony has been
7 that some of these contingencies, we'll call them for lack of a
8 better term, have been sort of getting closer to solidifying
9 the purchase price here.
10 As we sit here today, where -- where are we with respect to
11 the purchase price? Are you at the 200-million-dollar-number?
12 A Well, again, it depends on the number of stores that are
13 taken. And so the -- the contingencies associated with the
14 deal -- well, one very large one fell away last night. So we
15 now have the Spring deal done. So that is no longer a
16 contingency. And that was a -- as you've heard in the
17 discussion today, that was a very important development.
18 Another important contingency which remains unresolved is
19 the financing source for the debt component of the purchase
20 price. But there is no contingency around the -- the price
21 that will be paid with respect to fixtures. It's 3,000 per
22 store. There is no contingency around the price that will be
23 paid for inventory. It's 85 percent of eligible inventory. We
24 don't know the amount -- the number of stores. But I wouldn't
25 -- I mean, I wouldn't call that a contingency. I'd call that a

1 -- you know, an unknown fact at the moment. But, you know,
2 whether or not the deal happens is not dependent upon the
3 ultimate determination as to the number of stores that will be
4 taken by the buyer.
5 Q Okay. If NewCo doesn't acquire any more of the debt, so it
6 stays at about 54, is the 200-million-dollar-number still a
7 reachable number?
8 A Yeah. So as we indicated a few moments ago, if the only
9 creditable amount for bid purposes is $54 million, then the
10 remainder, getting you up to the 200-million-dollar purchase
11 price would have to be paid in cash.
12 Q Okay. Okay. And the other variable being the number of
13 stores. That includes not just the $3,000 per store, but the
14 amount of inventory. So the 85-percent number based on the
15 number of stores can change as well, correct?
16 A Well, the -- 85 won't change.
17 Q No, that's what I said. The 85 doesn't change --
18 A So right. It will be 85 percent. The amount of inventory
19 that we're applying --
20 Q But 85 times something.
21 A -- that will be dependent upon the number of stores that
22 are actually taken.
23 Q Right. Okay.
24 MR. SCHEPACARTER: Your Honor, I don't have any
25 further questions. Thank you.

1 THE COURT: Very good. Mr. Somerstein?
2 MR. SOMERSTEIN: I just have one question, Your Honor.
3 THE COURT: Sure.
4 MR. SOMERSTEIN: Nothing, Your Honor. Sorry.
5 MR. MIKELS: Your Honor?
6 THE COURT: A moment.
7 Mr. Kurtz --
8 MR. MIKELS: Sorry.
9 THE COURT: No, that's fine. I'll give you an
10 opportunity in a moment.
11 Mr. Kurtz, I have a question. And you touched on it
12 yourself, that the debtor is not looking today for approval of
13 a breakup fee. And I understood from Mr. Gordon what that
14 context was. I understand that there may be a request for an
15 expense reimbursement related to a component which is the
16 Sprint transaction. We'll deal with that at the appropriate
17 time.
18 And again, I'm not trying to attribute too much
19 significance to this uncertainty about contingency with the LCS
20 and what the amounts are. But --
21 THE WITNESS: Right.
22 THE COURT: -- I'm just trying to get my head around
23 it.
24 It seems, though, that at least in the context of
25 bidding procedures, I'm not certain that that -- that seems to

1 me to be an auction issue about the value that the debtor would
2 attribute to a secured claim or a credit bid. If I were being
3 asked to allow credit bidding within the exercise of the
4 auction and the debtors' decision about -- debtors' with
5 consultation decision about the value of various competing
6 bids, I'm not certain whether that's a question that I need to
7 answer today. And I know it's sort of an odd question to put
8 to you. But this is a complicated transaction and I would
9 appreciate your thoughts on that question.
10 THE WITNESS: Sure. So I -- if I understood your
11 question correctly, I think I completely agree with you. The
12 amount of the credit bid as it relates to the LCS -- I mean,
13 direct dollars, that's easy. But as it relates to the LCS, I
14 mean, we -- I assume at the final hearing, assuming, you know,
15 that the Standard General NewCo affiliate is the successful
16 buyer, we will have to establish through evidence how and why
17 it is that we gave them credit for the amount that we gave them
18 credit for which kind of takes us back to the 54, 55. But
19 we'll have to show Your Honor how we got to the 55 or 54 at
20 that point in time.
21 THE COURT: Okay. I understand.
22 THE WITNESS: I completely agree with that.
23 THE COURT: All right. And, again, I'm not trying to
24 attribute too much significance to that discrete issue. But it
25 does seem there. It's not --

1 THE WITNESS: Yes.
2 THE COURT: So I appreciate your comments on it. And
3 I will, of course, deal with that issue as raised by the
4 committee at the appropriate time.
5 Does anyone else wish to cross-examine Mr. Kurtz?
6 Redirect? Oh.
7 MR. MIKELS: I just have a few questions.
8 THE COURT: And identify -- and please identify
9 yourself.
10 MR. MIKELS: Yes. I'm Richard Mikels of Mintz Levin.
11 And I represent the Ad Hoc Committee of Dealers and
12 Franchisees.
13 THE COURT: Okay. Couple things. First, I will give
14 you a little bit of opportunity. It is pretty consistently my
15 practice that I do not permit counsel to examine witnesses on
16 the phone. So I'll give you a little bit of leeway, and I will
17 depart from that practice. But it's not going to last very
18 long.
19 You may proceed.
20 MR. MIKELS: Thank you, Your Honor. Before I begin, I
21 just want to -- I just received my engagement letter this
22 morning. So as a result, I've not yet found local counsel.
23 THE COURT: That's fine. I'm happy to hear -- I'm
24 happy to hear from you. You may proceed.
25 MR. MIKELS: All right.

1 **CROSS-EXAMINATION**

2 **BY MR. MIKELS:**

3 Q I'd just like to ask Mr. Kurtz -- good afternoon, Mr.

4 Kurtz.

5 A Good afternoon.

6 Q I just wanted to ask a few questions about the sale that I

7 think if notice is going out of a sale, you know, people want

8 to be able to understand what's happening. And, therefore, I

9 have a few questions about what is being sold because the court

10 record that's available doesn't have some schedules and so

11 forth.

12 So my first question is, are the dealer and franchise

13 agreements being assumed and assigned as part of this deal?

14 A Not to my knowledge, unless that was incorporated in last

15 night's draft which I have not yet seen.

16 Q Okay. If that's the case, is the RadioShack name being

17 sold?

18 A Let me make an important point here before I answer the

19 question because I think it will aid in the answer. There's a

20 difference between what assets will be offered for sale and

21 what assets will be sold. Our intention is to offer all assets

22 for sale. Whether or not we decide to go forward and sell

23 assets at the sale will be a determination that will be made at

24 that point in time.

25 And so it would be our intention to sell the franchise

1 agreements -- or to offer for sale the franchise agreements.
2 Whether or not they are sold at the sale is something that
3 remains to be seen.
4 Q But are you involved in the -- is Lazard involved in the
5 marketing of these agreements?
6 A Yes. We're involved in the marketing of all assets.
7 Q Okay. So everything becomes clear, obviously, when they're
8 marketed. But in the meanwhile, is the RadioShack name that's
9 sold, are provisions being made to protect the use of that name
10 by the franchisees and dealers?
11 A We are well aware of the existence of the franchisees and
12 the dealers. And we will be careful to ensure that, you know,
13 all appropriate legal rights are respected and all laws are
14 observed.
15 Q Okay. Could you explain whether or not the buyer is going
16 to be taking on the consumer loyalty programs?
17 A I don't know the answer to that.
18 Q Okay. Let me ask a more specific question, then.
19 The company has how many gift cards outstanding?
20 A I don't know. I am not the right witness. There is
21 another witness here who can answer those questions. But I
22 don't know the answer to that.
23 Q Okay. Have you considered the impact on the value of the
24 dealer agreements if -- because you're trying to market that --
25 if the gift card -- gift cards are not honored by the buyer?

1 A Have we considered that? Yes.
2 Q Okay. Has anyone notified the holders of gift cards of the
3 potential sale and the impact on them of the gift cards not
4 being honored?
5 A I don't know the answer to that question. But, again,
6 there are other people in the courtroom here on behalf of
7 RadioShack that do know the answer to that.
8 Q Okay. What is your plan for continuing to provide the
9 dealers with inventory? I mean, RadioShack won't have very
10 much and the buyer -- it's unclear what the situation is with
11 the buyer. So is there a plan to provide inventory to the
12 dealers?
13 A Well, one thing I can assure you is that RadioShack itself
14 will not be supplying inventory to the dealers certainly after
15 the -- the end of March. Whether the -- the buyer of the
16 RadioShack business will be in a position to provide that
17 inventory, I don't know the answer to that question. I think
18 that's something that has yet to be determined.
19 Q Okay. And so have you as the investment banker looking to
20 find a buyer for the dealer division, have you analyzed the
21 impact of the value of the dealer position if nobody's selling
22 the inventory?
23 A Yes.
24 Q And what you have discovered?
25 A That if there is no ability to make a profit on the -- on

1 inventory sales, the value of the dealer network would be
2 substantially diminished.
3 Q Would you anticipate that someone purchasing the dealer
4 network would also be interested then in supplying the
5 inventory?
6 A Potentially.
7 Q All right.
8 MR. MIKELS: Your Honor, I'll stop at this point and
9 reserve my rights for later for the hearing on the sale.
10 THE COURT: Very good. Thank you. All right.
11 Counsel?
12 MR. MIKELS: Thank you, Your Honor.
13 THE COURT: Redirect?
14 MR. GAFFEY: Thank you, Your Honor. For the record,
15 Robert Gaffey from Jones Day. I'll be very brief.
16 THE COURT: Okay. Sure.
17 **REDIRECT EXAMINATION**
18 **BY MR. GAFFEY:**
19 Q Mr. Kurtz, in response to a question from Mr. Kirpalani,
20 you said that MAEVA and RadioShack management were involved in
21 the negotiation of the Sprint transaction. Do you recall that?
22 A Yes.
23 Q To your understanding, was Standard General involved in the
24 negotiations with Sprint?
25 A Yes.

1 Q Did they play a small role? Large role? Can you describe
2 -- can you characterize what role they played?
3 A My understanding is they played a large role.
4 Q Mr. Kirpalani asked you a few questions about the retention
5 of employees post-transaction, whether employees would continue
6 to work in the RadioShack stores. Do you recall that?
7 A Yes.
8 Q And asked you whether you understood or had a view as to
9 whether the buyer would have a legal obligation to take -- to
10 take the employees. I want to ask you a question about that.
11 As a practical matter, and in your work and in your
12 discussions, have you come to a view about whether they would
13 need to keep the employees on if they operated the stores post-
14 transaction?
15 A Yes. As a practical matter, my view is that they would
16 need to keep the store-level employees. And as I indicated, I
17 have been told by Standard General that they intend to keep the
18 store-level employees.
19 Q And do you have -- in your declaration on -- which is your
20 direct testimony, you referred to the saving of some jobs. Do
21 you have a sense of how many jobs we're talking about here at
22 the store level?
23 A Well, again, of course -- here again, it depends on the
24 number of stores --
25 Q Sure.

1 A -- that they actually take. But it's somewhere in the
2 neighborhood of 5,000 employees whose jobs could be saved if
3 this transaction is -- ultimately completes itself.
4 Q Now, a number of questions -- I won't belabor the point,
5 sir -- went to the breakup fee.
6 A Right.
7 Q And the three percent on the $200 million that you have
8 talked about, was that negotiated?
9 A Yes.
10 Q Did you try and get a lower one?
11 A Yes.
12 Q And there was also, sir, in your questions from Mr.
13 Kirpalani some discussion of whether Standard General would
14 agree to a cash collateral deal.
15 Do you know if the debtor has consent from its lenders to
16 pursue a cash collateral structure?
17 A The company does not have consent from its lenders to use
18 cash collateral.
19 Q Has it asked for it?
20 A Yes.
21 MR. GAFFEY: Okay. Nothing further, Your Honor.
22 THE COURT: Mr. Kirpalani, any questions?
23 MR. KIRPALANI: No, Your Honor.
24 THE COURT: All right. Mr. Kurtz, thank you, sir.
25 You may step down.

1 THE WITNESS: Thank you, Your Honor.
2 (Witness excused.)
3 THE COURT: Okay. Here's what we'll do. We'll break
4 now --
5 (Participants confer.)
6 THE COURT: We'll break now for lunch until 1:45.
7 Given the number of folks, I think that's a little bit tight,
8 but still gives us a prospect of resuming. And you can
9 obviously leave all of your stuff here. And we will reconvene
10 in 45 minutes. We'll stand in recess.
11 (Luncheon taken at 1:00 p.m.)
12 **AFTERNOON SESSION**
13 (Proceedings resume at 1:50 p.m.)
14 (Call to order of the Court.)
15 THE COURT: All right. We had just concluded with Mr.
16 Kurtz.
17 MR. GORDON: Yes, Your Honor. And I think it's time
18 for Mr. Adrianopoli.
19 THE COURT: Okay.
20 (Participants confer.)
21 THE COURT: Good to see you, sir. Welcome. We'll
22 swear the witness. Please remain standing.
23 CARLIN ADRIANOPOLI, WITNESS FOR THE DEBTORS, SWORN.
24 THE CLERK: Please state and spell your name for the
25 record.

1 THE WITNESS: Carlin Adrianopoli, A as in apple, D as
2 in David, r-i-a-n as in Nancy, o-p as in Paul, o-l-i.
3 THE COURT: Mr. Tecce.
4 MR. TECCE: Good afternoon, Judge Shannon. For the
5 record, James Tecce, T-e-c-c-e, of Quinn Emanuel, on behalf of
6 the official committee.
7 **CROSS-EXAMINATION**
8 **BY MR. TECCE:**
9 Q Good afternoon, Mr. Adrianopoli.
10 A Good afternoon, Mr. Tecce.
11 Q Mr. Adrianopoli, you are a senior managing director at FTI,
12 correct?
13 A Yes, I am.
14 Q And that's a position that you've had since 2002, correct?
15 A 2010.
16 Q I've been with FTI since 2002.
17 A Thank you.
18 Q You also are currently the interim chief financial officer
19 for RadioShack Corporation, correct?
20 A Yes, that's correct.
21 Q And that is a position that you've held since approximately
22 December 15th. Is that correct?
23 A That's correct.
24 Q And your duties as the interim chief financial officer
25 include working on cash flows, correct?

1 A Yes, that's correct.

2 Q And it would also include preparing budgets and forecasts.

3 Is that fair to say?

4 A That's correct.

5 Q You should have a binder in front of you, sir, that, if you

6 could, I would ask you to turn to Tab 2.

7 A (Witness reviews exhibits.)

8 I'm there.

9 THE COURT: It's the DIP order?

10 THE WITNESS: Yes, sir.

11 MR. TECCE: Yes, Judge. Yes.

12 BY MR. TECCE:

13 Q Do you recognize that, sir, as the interim DIP order?

14 A I do.

15 Q And I'm going to ask you now to turn to the last page of

16 that very thick document, which, I believe, should be -- say

17 "190-1" at the top. And do you recognize that document, sir?

18 A I do.

19 Q And that document was prepared by you or persons at your

20 direction?

21 A Yes, it was.

22 Q So can we just call that the "DIP budget" for simplicity's

23 sake here?

24 A Yes, we can.

25 Q And sir, in looking at the DIP budget, about a little more

1 than halfway down the page, if you're looking at the left-hand
2 side of the DIP budget, there's a box called "net cash flow
3 from operations." Do you see that box?
4 A Yes, I do.
5 Q And is it fair to say that that is cash generated during
6 this period from sales and the collection of receivables and
7 inventory?
8 A Yes, it is.
9 Q Is there anything else that that would include?
10 A (Witness reviews exhibit.)
11 From a receipt standpoint, no. The large part is that.
12 Q And right -- immediately below that line, there is an entry
13 called "starting estimated book" -- well, "starting EST
14 period."
15 A Yes.
16 Q "Book available cash." Do you see that?
17 A Yes, I do.
18 Q And there's a number there of $48,159,000. Do you see
19 that?
20 A Yes, I do.
21 Q And is it fair to say that that is the current available
22 cash for operating purposes that's on the balance sheet as of
23 that date, February 7th?
24 A At -- for the beginning of the weekend at February 7th,
25 yes, that is correct.

1 Q And two lines below that, sir, you see an entry entitled
2 "add DIP draw." Do you see that?
3 A Yes, I do.
4 Q And if you move over to the right there, there is a ten-
5 million-dollar number under the February 14th, I believe,
6 column. Is that correct?
7 A Yes, it is.
8 Q And is that one of the available draws under the DIP
9 facility?
10 A Yes, it would be.
11 Q Okay. And with respect to that draw, that ten-million-
12 dollar figure, is it fair to say, sir, that the company did not
13 change its operations, receipts, or disbursements because of
14 that additional $10 million?
15 A Yes, that's correct.
16 Q And is it fair to say that that $10 million was not used
17 directly for any working capital purpose?
18 A So we talked about this a little bit yesterday. The 10
19 million draw never occurred. What we were able to do was, in
20 our borrowing base calculation, we were allowed to increase our
21 incremental borrowing capacity by up to that 10 million. So it
22 allowed us to repay the lenders less back.
23 Q All right. But I am asking, sir, whether or not that
24 dollar amount was, in point of fact, paid directly to somebody.
25 Did a vendor or a supplier receive a direct payment with the

1 additional money under the DIP, sir?
2 A No. That -- those proceeds were with the remaining
3 additional proceeds, but we did not change our receipts or
4 disbursements because of that.
5 Q Going down on our budget, sir, the -- there's a column
6 there called "Less DIP Pay-Down." Do you see that?
7 A Yes, I do.
8 Q And that is a line item that represents the repayment of
9 monies to the lenders. Is that correct?
10 A Yes, it is.
11 Q And that number totals, through the 28th of March,
12 $146,299, correct?
13 A Yes, that's correct.
14 Q And is it fair to say that that is the largest single use
15 of cash on this budget?
16 A We talked about this yesterday. It is the largest single
17 line item on the repayment of the debt facility as the
18 collateral winds down. That's correct.
19 Q And if the company was not making those payments, would
20 that $86 million that we talked about in the net cash flow from
21 operations, would that be sufficient to fund the operations of
22 the company through the 28th of March?
23 A Yes. If we were not required to live within our borrowing
24 base, and were allowed to just use cash flow generated from a
25 liquidation of that collateral, that 86 million would, in fact,

1 be enough.

2 Q And if, for whatever reason, sir, you were not required to

3 pay the lenders back, then is it fair to say that there would

4 be no need for the additional $20 million of liquidity?

5 A Yes, that's correct.

6 Q Sticking with our budget, if you go down a little further -

7 - well, actually, I'm still in the DIP pay-down line. I'm

8 sorry about that.

9 A No problem.

10 Q There are three numbers there, Mr. Adrianopoli, on February

11 7th, February 14th, and February 21st, in the "Less DIP Pay-

12 Down" column, and I believe they total $38 million. Do you see

13 those three numbers? Approximately $38 million.

14 A Yes, I do.

15 Q And these would be pay-downs, presumably, through the

16 period of 2/21. Is that correct?

17 A Yes, that's correct.

18 Q Do you know whether, in point of fact, these monies have

19 been paid to the lenders?

20 A These particular payments were not, but we did make $28

21 million in pay-downs over the last few weeks; 11 million and 17

22 million, as a result of the borrowing base calculations that

23 required the negative availability to be cured.

24 Q Moving off the budget, sir. Mr. Adrianopoli, you're

25 familiar with the proposed asset purchase agreement. Is that

1 correct?

2 A Yes. I'm generally familiar with it.

3 Q Okay. You're generally familiar with it. And you're

4 familiar with who the stalking horse bidder is. Is that

5 correct?

6 A Yes, that's correct.

7 Q And as of today, you don't know whether or not the stalking

8 horse bidder has its financing in place, do you?

9 A No, I do not believe it does.

10 Q And have you had an opportunity to review the asset

11 purchase agreement?

12 A Not --

13 Q So I'll -- let me --

14 A The one from --

15 Q -- be more specific.

16 A -- just an hour ago?

17 Q Any one of them.

18 A The new ones?

19 Q The first one, the one from over the weekend, or the one

20 from an hour ago.

21 A Yeah. Yes.

22 Q Have you reviewed any of those?

23 A Yes, I have.

24 Q Okay.

25 (Laughter.)

1 Q It's a start.
2 A I wasn't trying to be cute.
3 Q No, I know you're not trying to be cute; I'm not trying to
4 be cute, either.
5 So have you -- or have you reviewed Section 9.7 of that
6 agreement?
7 A Would you refresh my --
8 Q Well, I'll --
9 A -- recollection?
10 Q Let me help you out here, a little bit.
11 (Participants confer.)
12 Q Mr. Adrianopoli, if you'd turn to Tab 4 in your binder --
13 A Yes.
14 Q -- you'll find what I refer to colloquially as the "second
15 asset purchase agreement," which I believe is the one that was
16 circulated over the weekend.
17 A (Witness reviews exhibits.)
18 Q Take your time, don't let me rush you.
19 A Oh, no problem.
20 (Witness reviews exhibits.)
21 Yes, I'm here. Credit bid?
22 Q And if you see section -- can I ask you to turn to Page 44
23 of that agreement?
24 A Yes, I'm here.
25 Q And sir, I'm actually holding the third -- what would be

1 the third agreement, which was the one circulated in court
2 today. And I would represent to you, and I'm happy to hand you
3 a copy of it, but that there are no changes in Section 9.7.
4 A That's fine.
5 Q Fair?
6 A Yes, fair.
7 Q And are you familiar with this provision?
8 A I am generally familiar with it, yes.
9 Q And do you understand that this provision is a condition to
10 closing?
11 A Yes, I do.
12 Q And is it fair to say that, as far as you know, the company
13 did not perform an analysis of potential claims against the
14 stalking horse before it agreed to this section of the asset
15 purchase agreement?
16 A That's correct. At the time, this credit bid is the --
17 this particular piece of the LC facility is the same facility
18 from October 14, which then is a subset of the same facility
19 from December 13th.
20 Q And is it fair to say, as far as you know, no one else --
21 this been done [sic], to ascribe a value of any release that
22 may be given to a stalking horse purchaser?
23 A No, nothing has been done by me, and I don't believe
24 anything has been done by others.
25 Q Do you have an understanding of what the stalking horse

1 purchaser's business plan is, post-closing business plan?
2 A I do not.
3 Q Has you or anyone at the company, to your knowledge, been
4 provided of -- with a copy of that business plan?
5 A We have not. We have created our own business plan, as
6 discussed, incorporating the agreements, but we have not seen
7 their business plan.
8 Q Mr. Adrianopoli -- and I have been using your name
9 infrequently. It's not -- I just don't want to butcher it.
10 A No problem.
11 Q But can I ask you to turn to Tab 5 in your binder?
12 A Of course. Okay.
13 Q Do you recognize the document, sir?
14 A I do.
15 Q And are you familiar with the document?
16 A I am.
17 Q Was that document prepared by you or persons at your
18 direction?
19 A Yes, it was.
20 MR. TECCE: Your Honor, I'd move that document -- I'd
21 move to admit that document into evidence.
22 UNIDENTIFIED: No objection.
23 THE COURT: Is this a public document?
24 UNIDENTIFIED: I'm sorry, Your Honor. I didn't hear.
25 THE COURT: Is this a public document?

1 (Participants confer.)
2 THE COURT: Well, I'll admit it. But you need to get
3 back to me because, by admitting it, it doesn't wind up on the
4 docket, but I would feel badly if people were unhappy about
5 that.
6 UNIDENTIFIED: May I just confer for one second, Your
7 Honor?
8 THE COURT: Yeah. We can answer that question later,
9 I just ...
10 (Participants confer.)
11 (Exhibit Number 5 Received into Evidence)
12 THE COURT: Mr. Tecce, you can proceed. The document
13 is admitted, and we'll figure out how to treat it.
14 MR. TECCE: Your Honor, I don't have any further
15 questions.
16 Sir, thank you very much for your time.
17 THE WITNESS: Thank you, Mr. Tecce.
18 MR. TECCE: Thank you.
19 THE COURT: Okay.,
20 THE WITNESS: Thank you, Your Honor.
21 THE COURT: Sure.
22 (Participants confer.)
23 THE COURT: Does anyone else wish to cross-examine Mr.
24 Adrianopoli. Any redirect?
25 MR. MIKELS: Your Honor, maybe I could get just a few

1 minutes if (indiscernible) the witness (indiscernible) some of
2 my questions (indiscernible) Richard Mikels.
3 THE COURT: All right. Could you identify yourself
4 for the record, please?
5 MR. MIKELS: Yes. Richard Mikels for the Ad Hoc
6 Committee of Dealers and Franchise Store Owners.
7 THE COURT: All right. Briefly, again, sir. You may
8 proceed.
9 MR. MIKELS: I will be as brief as the last time.
10 **CROSS-EXAMINATION**
11 **MR. MIKELS:**
12 Q Okay. So are you aware of a notice that went out to the
13 dealers last night, changing terms as of today, credit terms?
14 A Yes, I am aware of that; not aware of the delivery of the
15 letter, but I am aware of the discussion surrounding that.
16 Q Okay. So and isn't it a fact that they cut off credit from
17 the dealers?
18 A So yes, sir, it is. But I think, just to clarify, what the
19 general concern is, and what -- while I appreciate that the
20 terms may seem erroneous, but in reality, what we're trying to
21 do is protect the estate from sending goods on credit, only to
22 have those dealers not pay us back.
23 And so what we wanted to do -- and we've offered some
24 discounts to the dealers in an effort to incentivize you to,
25 not only purchase goods from the estate going forward, at

1 hopefully better costs than we're currently getting from the
2 stalking horse bidder or others, but then also to enforce or
3 award those dealers who stay current with their terms. Because
4 what I want to ensure is, at the conclusion of the auction,
5 that I'm not stuck with a significant amount of receivables
6 balance left to be collected.
7 Q Okay. But it does call for prepayment now, right?
8 A Yes, sir. That's correct.
9 Q And in turn, it provides great, deep discounts. Is that
10 correct?
11 A I'd like to classify it as discounts to incentives you to
12 purchase the goods.
13 Q Okay. And so, in your experience -- you're from FTI, so
14 I'm sure this is not your first retail rodeo, correct?
15 A No, sir, it is not.
16 Q Okay. So is this in the ordinary course of RadioShack's
17 business, to make this abrupt change, and to give steep
18 discounts, and suddenly ask people that had had credit given to
19 them, for the last 30 years in some cases, to suddenly pay in
20 advance?
21 A Sure. So I guess I'd -- I'd look at it this way. Given
22 the situation, the very fast auction process, what we were
23 doing before is we were not shipping to the dealers. So given
24 an incentive, which then still rewards the estate in excess of
25 what we're going to get, or are likely to get at the auction, I

1 think we're still doing trades with our dealers, and that's in
2 the ordinary course.
3 The way we've structured our cash payments shouldn't mean
4 anything to you, as long as you were intending on paying us,
5 which I'm sure you were. But this just merely facilitates or
6 ensures that that gets done.
7 Q Okay. So people prepay. Hypothetically, a dealer prepays,
8 and March 28th comes, and the -- and there's no money left over
9 from the sale, which was a credit bid. How are -- so isn't --
10 how do these people get their goods? Because the last witness
11 testified they weren't going to get any goods after March 28th.
12 I mean --
13 A Excellent question.
14 Q -- what happens? How are these people going to assured
15 receiving their goods?
16 A Oh, excellent question. So what we're currently doing --
17 when I say "prepay," I mean, literally, we're talking about
18 cash on disbursement out of the Fort Worth DC. And what we're
19 intending to do -- and I've seen goods there myself -- is we've
20 got goods ready to ship as soon as we have receipt of money.
21 If your concerned, or there is a concern that, a day or two
22 before the auction, a franchisee might get caught up, it's a
23 very fair concern and something that we can adjust right prior
24 to the auction, to stop taking goods in advance.
25 Q And what is the plan to continue to supply goods and

1 inventory after the sale?
2 A So I believe Mr. Kurtz had alluded to that a little bit,
3 but I think, in all realities, the RadioShack brand is going to
4 be owned by somebody. Someone is going to like to have your
5 outlets, in order to distribute goods at an agreed-upon price.
6 I know we have a number of Asian suppliers who are probably
7 anxious to do that.
8 I think the reality is the debtors, in their current
9 position, cannot obligate anyone else how they're going to
10 handle those contracts or agreements. But I would expect that
11 there are going to be people who are going to want to ship
12 RadioShack products into the future, that your franchisees can
13 take advantage of.
14 Q Okay. But if that's the case, then the buyer -- has the
15 buyer paid anything for the rights -- for the franchise
16 agreements, or are they just going to be able to supply and not
17 pay the estate anything?
18 A Well, one would expect either your franchisee agreements or
19 a future franchisee agreement is going to be implicit in the
20 price that someone is going to pay for the trademark, that
21 would be our hope. And to the extent that that franchise --
22 franchisee agreement is beneficial to the estate and to the
23 bid, one would hope that that increases it.
24 If a new agreement or new, you know, profitability targets
25 on goods shipped going forward is going to be changed, the

1 debtors' expectation and hope is that we would see that
2 reflected in the higher bid for the IP.
3 Q Yeah. But that's not the case at the moment, right?
4 A So --
5 Q There is no bid for the IP at the moment --
6 A As --
7 Q -- (indiscernible) --
8 A So, prior to, I think, 12:30 last night, that is correct.
9 I do believe that we were able to ascertain a revised bid from
10 the -- a revised bid on the IP as a stand-alone bid for
11 approximately $20 million.
12 Q Okay. Just one other quick question --
13 A Sure.
14 Q -- or group of questions.
15 A Of course, sir.
16 Q The gift cards.
17 A Yes, sir.
18 Q How many gift cards are outstanding, not in -- you know, in
19 (indiscernible).
20 A Of course, sir. Approximately -- let's just say 20 million
21 of total liability. But in -- what we've seen, I believe, in
22 the current practice is approximately, I think, three to 4
23 million in distribution per month. And on average, it's been
24 turning relatively frequently on that thirty-day churn.
25 Q Okay. I thought I saw something in the papers of -- that

1 said 44 million. Is that not right?
2 A The 44 million -- that's a very good question. The 44
3 million is the history of life of RadioShack. So, as you can
4 imagine, over many, many years, that number has accumulated.
5 But our current estimates are -- the book value piece is
6 approximately 20 million, sir.
7 Q Okay. And after the sale, how will they be treated?
8 A We are hoping -- since -- to your point, per my earlier
9 comments, the approximate thirty-day churn on these gift cards
10 -- if you recall, we have stopped issuing gift cards at the
11 beginning of this process. Our hope and expectation is that
12 the vast majority of any cards in circulation are going to be
13 fully utilized by the time of the auction.
14 Q And have the gift card owners been notified?
15 A Sir, after your call, I was trying to reach out to -- I was
16 trying to understand the exact notice -- notice procedure to
17 all the gift card holders. But where we had an address, or
18 where we had someone we could notice, I believe has been
19 noticed. And I'm going to be researching that to make sure and
20 to understand. And obviously, we did our notices via the
21 first-days, and this has been a very public bankruptcy, for a
22 variety of levels and a variety of reasons. But our hope is
23 that everyone who has those gift cards now, you know, has been
24 diligent in returning to RadioShack.
25 Q So, without (indiscernible) legal obligations are, if

1 there's 10 million or 15 million of gift cards left upon the
2 sale, and maybe that month, what is your plan, to just have
3 them file claims? Because it could affect the business of the
4 franchisees, as well.
5 Q That's a -- it's a very fair point, sir.
6 Q Because either they're going to have to honor the gift
7 cards, or they're going to have to take the good will hit by
8 not honoring them, correct?
9 A I believe that the -- we talk about the fact that the
10 letter of -- or the cards expire at the conclusion of the
11 auction. But it's a -- it's a fair point, in terms of the
12 claims and how to file the proper claims procedure. I believe
13 we have that on our website, in addition to our phone line,
14 through our claims agent if there's any questions on that, but
15 that would be --
16 Q But it's a fair point -- it's a fair point, as well, in
17 determining the value of the dealer division, correct?
18 A It's hard for me to step into the shoes of the dealer who
19 is -- who's left with a --
20 Q (Indiscernible)
21 A I apologize, but ...
22 Q Well, I wasn't asking you to value the dealer. I mean,
23 you're out looking for buyers for a -- is this going to have an
24 impact on them, on the price you're likely to receive?
25 A One would hope that the estate would be able to be net

1 neutral on its purchase price, if not have the purchase price
2 enhanced, versus assuming a liability that is an estimation,
3 that would likely be a reduced -- a reduction to the purchase
4 price.
5 Q Okay. And that's been calculated into your thinking -- has
6 that been calculated into your thinking, with respect to the
7 purchase price of the stalking horse bid?
8 A Yes. The stalking horse has not accepted the obligations
9 beyond the auction, as it currently stands.
10 Q Well, but my question is: In assessing the stalking horse
11 bid, have you taken into consideration that there will be a
12 decrease in the value of other assets, assuming that they don't
13 decide to buy what -- take an assignment of the dealership
14 agreements?
15 A If your -- if your question is around not being able to
16 monetize or get a value from the dealer franchise agreements
17 themselves, I think, as I had mentioned before, our hope is
18 that the IP that we now have set a floor on of $20 million will
19 help to achieve value for the estate.
20 Q This is my last question, and I just want to explain what I
21 just asked.
22 A No problem, sir.
23 MR. MIKELS: I apologize, Your Honor. It's taken a
24 little bit longer than the last time.
25 BY MR. MIKELS:

1 Q What I'm trying to find out is, in assessing the value of
2 the bid that is on the table, the stalking horse bid, have you
3 taken into consideration what you've described as a possible
4 decrease in the value of the dealer franchises to RadioShack
5 and its bankruptcy estate?
6 A Not -- not to correct you, sir, but I didn't actually say
7 that there -- I didn't acknowledge that there was a decrease in
8 the value to the franchisees. I think what I had attempted to
9 say was that whether or not a stalking horse accepts or rejects
10 your leases -- or your agreements, what the estate is hoping to
11 do would be maximize value.
12 And they're going to have flexibility, obviously. If they
13 feel as though those agreements are valuable, we will try and
14 monetize those three at the auction process. If nobody bids on
15 those and we, in fact, get more value because people might want
16 to work with your constituents directly to arrive at a new
17 agreement, one would hope that that's going to be reflected in
18 the value of the trademarks and IP.
19 Q All right. And quickly, when we will know that? In other
20 words, if someone's contract is going to be assumed or rejected
21 -- well, let's say assumed, how long before the actual auction
22 will they know that?
23 A Sir, if you -- I can get you that answer. I don't know off
24 the top of my head, from looking at the agreement last night,
25 but I will -- I will get that. I can get that to you.

1 Q All right. Thank you very much.
2 MR. MIKELS: Thank you, Your Honor.
3 A Thank you, sir.
4 THE COURT: Certainly. Very well.
5 Any redirect.
6 **REDIRECT EXAMINATION**
7 **BY MR. GAFFEY:**
8 Q Carlin.
9 A Yes.
10 Q Would you turn back to Tab 2 of the book that Mr. Tecce
11 gave you, to the last page, just to that budget document that
12 he asked you about.
13 A (Witness reviews exhibits.)
14 Yes.
15 Q And Mr. Tecce directed your attention to the number at the
16 eight-week total column of $86,350,000 as net cash flow from
17 operations.
18 A Yes.
19 Q And asked you whether that sum would be sufficient to fund
20 operations through that date, through March 28th?
21 A Yes.
22 Q Is the company free to spend that cash?
23 A No, it is not.
24 Q Why not?
25 A We have to live within the confines of the borrowing base.

1 Q Say that again, please. I couldn't hear you.
2 A We have to live within the confines of the borrowing base.
3 Q And is it also subject to liens?
4 A Yes, it is.
5 Q And do you have the consent of those lenders to spend that
6 cash, if subject to liens?
7 A Yes, within the parameters of the DIP budget, we do.
8 Q Okay. And have you asked for that consent; has the company
9 asked for that consent?
10 A Yes. Yes, we have.
11 Q What was the response?
12 A As it relates to the DIP, DIP budget, they have consented
13 to us to use this cash.
14 Q Have the lenders who have liens on that cash consented to
15 the use of that as cash collateral?
16 A I'm sorry. Could you repeat -- cash collateral in what --
17 Q I think I may be confusing things here a little bit.
18 When I say is it "free cash," is it subject to liens from
19 prepetition lenders?
20 A Yes, it is.
21 Q Do you have the consent of the prepetition lenders to spend
22 it, despite those liens?
23 A Under the confines of the budget, we have both the ABL
24 lenders, as well as the term loan lenders' consent.
25 Q And the budget, which includes the DIP facility.

1 A Yes, that's correct.
2 Q Absent the DIP facility, would you have their consent?
3 A No, we would not.
4 MR. GAFFEY: Thank you.
5 THE COURT: Okay. Any recross?
6 MR. TECCE: None, Your Honor. Thank you very much.
7 THE COURT: Thank you, Mr. Tecce.
8 Mr. Adrianopoli, thank you, sir. You may step down.
9 THE WITNESS: Thank you, sir.
10 (Witness excused.)
11 THE COURT: To Mr. Pitts?
12 MR. TECCE: Yes.
13 THE COURT: Debtors' witness?
14 MR. TECCE: Yeah. I -- Your Honor, we call Derek
15 Pitts.
16 THE COURT: Well, they call him because I've already
17 admitted -- right? Actually, do I have Mr. Pitts' -- a
18 declaration for Mr. Pitts?
19 MR. TECCE: There's no declaration for Mr. Pitts, Your
20 Honor. We are proceeding by direct examination.
21 MR. GORDON: We presented our case. I think now they
22 want to present their case, Your Honor.
23 THE COURT: Okay. Please remain standing.
24 Please swear the witness.
25 DEREK PITTS, WITNESS FOR THE COMMITTEE, SWORN

1 THE CLERK: Please state and spell your name for the
2 record.
3 THE WITNESS: Derek, D-e-r-e-k, last name Pitts, P-i-
4 t-t-s.
5 THE CLERK: Thank you.
6 THE COURT: Welcome.
7 **DIRECT EXAMINATION**
8 **BY MR. TECCE:**
9 Q Good afternoon, Mr. Pitts.
10 A Good afternoon.
11 Q Mr. Pitts, by whom are you employed?
12 A Houlihan Lokey Howard & Zukin.
13 Q What is your current job title with Houlihan?
14 A I'm a managing director.
15 Q Can I ask you -- you should have a binder in front of you
16 that has your name on it. Can I ask you to turn to Tab 1 of
17 that binder, please?
18 A I'm there.
19 Q And what is that document, sir?
20 A That is my CV created for this testimony.
21 MR. TECCE: Your Honor, I'd like to move that document
22 into evidence.
23 MR. GAFFEY: No objection, Your Honor.
24 THE COURT: Very well. It's admitted.
25 (Pitts *Curriculum Vitae* received in evidence.)

1 BY MR. TECCE:

2 Q Mr. Pitts, how would you describe your responsibilities as

3 a managing director?

4 A Generally, I'm responsible for client acquisition,

5 developing projects, managing relationships with clients that

6 we have, as well as the deals that we are processing, managing.

7 Essentially all aspects of the day-to-day activities as well as

8 the -- a staff that I utilize in discharging those activities.

9 Q And how many Chapter 11 cases have you worked on over the

10 course of your career, sir?

11 A Chapter 11?

12 Q Yes, sir.

13 A Probably around 22, 23 out of the forty-plus deals I've

14 worked on.

15 Q And in those Chapter 11 cases, how many of them were

16 debtor-side representations?

17 A A little over half.

18 Q And what were the others?

19 A A combination of creditor representation, and then a couple

20 equity representation in bankruptcy.

21 Q Is there any particular industry that you cover?

22 A I've done deals across a wide range of industries. Part of

23 my focus, however, at the firm is -- is on retail engagements.

24 Q And of the Chapter 11 cases that you've been involved in,

25 how many of them involved debtor-in-possession financing?

1 A Substantially all of them. I wouldn't know the exact
2 number. It's most of them.
3 Q And of those cases, did any of them involve Section 363
4 sales?
5 A Yes.
6 Q How many?
7 A About 12, 13.
8 THE COURT: Are you going to qualify him or -- I mean,
9 he's the managing director at Houlihan. We can move on.
10 MR. TECCE: Okay, Your Honor. I --
11 THE WITNESS: Thank you, Your Honor.
12 MR. TECCE: -- thank you very much. I move to qualify
13 -- just want to make sure -- I have to cover my bases.
14 THE COURT: No. I'm not really here to give you an
15 "attaboy," but it's getting late.
16 MR. TECCE: Okay.
17 (Laughter.)
18 THE WITNESS: I appreciate it in any event. Thank
19 you.
20 MR. TECCE: So I won't need a Third Circuit case --
21 okay. Fair enough.
22 Yeah. I move to qualify Mr. Pitts as an expert in DIP
23 financing and Section 363 sales processes.
24 THE COURT: Okay.
25 MR. GAFFEY: Okay.

1 MR. TECCE: Thank you. Okay.
2 BY MR. TECCE:
3 Q Houlihan is the proposed financial advisor for the
4 creditors' committee. Is that correct?
5 A That is correct.
6 Q When did Houlihan begin work on the RadioShack engagement
7 for the creditors' committee?
8 A Friday 13 when the committee was formed.
9 Q Prior to Houlihan's retention -- proposed retention by the
10 Official Committee, did Houlihan perform work for other
11 creditors with respect to RadioShack?
12 A We did.
13 Q And could you describe that for me, please?
14 A We represented an ad hoc group of unsecured noteholders who
15 held unsecured notes in RadioShack hired by an ad hoc group
16 through counsel to have conversations with the company about
17 the restructuring transaction.
18 Q And over what period of time did -- was that work
19 performed, sir?
20 A That was August and September of last year.
21 Q Of 2014, correct?
22 A Yes.
23 Q And are you part of the team, the Houlihan team that's
24 responsible for the Creditor Committee engagement in
25 RadioShack?

1 A I am.
2 Q How would you describe your primary day-to-day
3 responsibilities with respect to that engagement?
4 A To the current one?
5 Q Yes. The proposed retention by the Official Committee.
6 A Clearly, Official Committee is a fiduciary in this case as
7 it has -- it has a number of things it needs to do in the
8 discharge of those duties. And as financial advisor to the
9 Committee, we provide a wide range of -- of work product in
10 support of that, from diligence to negotiation, analyses,
11 anything you could imagine that would -- that would aid the
12 Committee's determination of the things they would like to
13 accomplish in these cases.
14 Q And are you familiar with the debtors' proposed financing
15 facility, debtor-in-possession financing facility?
16 A I am.
17 Q And did you perform work in connection with your
18 responsibilities to the creditors' committee with respect to
19 that application?
20 A I did.
21 Q And do you have an understanding of the relief the debtors
22 are requesting with respect to the proposed facility?
23 A I do.
24 Q Do you have an understanding of the particular economic
25 terms of the proposed financing?

1 A I do generally, yes.
2 Q Mr. Pitts, are you familiar with the term "roll-up"?
3 A I am, as used in this context.
4 Q What is your understanding of that term?
5 A It is generally referred to the type of a DIP facility
6 where you roll up pre-petition secured claims into the post-
7 petition DIP facility generally referred to as the roll-up.
8 Q Do you think that term could be used to describe the
9 proposed financing?
10 A Yes. Absolutely.
11 Q Mr. Pitts, can I ask you to turn to Tab 3 in your binder?
12 A I'm there.
13 Q Do you recognize the document?
14 A I do.
15 Q What is it?
16 A This is a -- this is the analysis that we put together that
17 summarizes a few key terms of the RadioShack proposed DIP with
18 certain -- DIPs of certain other cases?
19 Q Who prepared this document?
20 A This was prepared by my team at my direction.
21 Q Is it the type of document that Houlihan creates in the
22 ordinary course of its business?
23 A It is.
24 Q Was the document prepared in accordance with Houlihan's
25 engagement for the creditors' committee?

1 A It was.
2 MR. GAFFEY: Objection, Your Honor. I don't think
3 that it qualifies as a business record. I mean, the two
4 questions were asked and the answer is yes. But it's not the
5 ordinary course of Houlihan Lokey's business. The ordinary
6 course of their business is their business records or the
7 business of Houlihan Lokey, not analysis of someone else's
8 business. So I object to it on -- if its being offered as a
9 business record.
10 I'd also object because we haven't seen it before.
11 But it's not a business record, either.
12 MR. TECCE: For the record, Your Honor, this document
13 was attached as an exhibit to our objection to the DIP
14 financing. But I'll propose to use it solely as a
15 demonstrative and will not seek to admit it into evidence.
16 MR. GAFFEY: As a demonstrative, I have no objection,
17 Your Honor.
18 THE COURT: Very well.
19 MR. TECCE: Thank you.
20 BY MR. TECCE:
21 Q Can you walk the Court through the document, Mr. Pitts?
22 A Yeah. What it -- what it has there is on the left it's got
23 some -- just some selected key elements. And then it's got the
24 RadioShack provisions that -- in accordance with those
25 elements, and then a series of other names that are selected

1 from -- from a large database with an effort to be as
2 comparable as possible for the key terms that you want to
3 analyze. Generally, these were selected largely based on
4 common size and to the extent we could stay within industry, we
5 tried. But relative to size, these are the most comparable.
6 And probably one of the key elements for the purpose of
7 this analysis was to demonstrate -- and a key element we look
8 at it is -- demonstrates the roll-up percentage here in this
9 particular case relative to the entire facility, how much of
10 it's roll-up, and we show that comparable across the other
11 names on this page.
12 Q And you mentioned a percent -- in the far lefthand column
13 there's a shaded -- a shaded column, and there's a number
14 there, 87.7 percent. Can you tell me what that represents?
15 A That represents the amount of the roll-up, the 250 over the
16 amount of the -- the size of the DIP facility which is 285.
17 That number, if you -- given -- to make it more comparable with
18 some of the numbers on this page, if you were to readjust this
19 demonstrative, we would have excluded the LC facility. And I
20 think if you did that, that 87 percent would be around 92
21 percent.
22 Q So if the LC facility is taken out, then the percentage of
23 new money to the percentage of pre-petition debt is
24 approximately 92 percent?
25 A Correct.

1 Q Do you have an understanding as to what the fees -- the
2 proposed fees are in connection with the DIP financing?
3 A I do.
4 Q What is your understanding?
5 A It's 1.25 percent of the entire facility size, 285 million.
6 Q So that fraction, that 1.25 percent, is applied to the
7 total outstanding loan, sir?
8 A The total amount represented in the DIP facility of which a
9 substantial portion of that is, is the roll-up, yes.
10 Q And it's not limited to the incremental liquidity?
11 A It is not limited to just the incremental liquidity
12 provided to the debtor, which is -- which is frequently what
13 you would see.
14 Q And do you have an understanding as to what that
15 incremental liquidity is?
16 A Twenty million dollars plus an LC facility.
17 Q Do you think the fees are appropriate for this transaction?
18 A No.
19 Q Why is that?
20 A I don't believe it's appropriate -- in the first instance,
21 I don't believe a DIP is needed in these cases as a bottom
22 line. And then relative to the fee that's allocated, I don't
23 think it's appropriate to do on the entire amount. I don't
24 think it should include the roll-up feature.
25 Q Mr. Pitts, could I ask you to turn to Tab 2 in your binder?

1 A I'm there.
2 Q Do you recognize that document?
3 A Yes. I believe this is the DIP budget.
4 Q In connection with Houlihan's review of the proposed
5 financing, did you undertake an analysis of this budget, you or
6 persons at your direction?
7 A Yes, we did.
8 Q And are there entries on this budget to which you or your
9 team paid particular attention?
10 A Well, of course we analyzed the whole document when -- in
11 this particular situation. We -- we tended to focus on, for
12 example, the beginning cash, the amount of cash that these --
13 these cases were entered with, the cash flow from operations
14 row, we examined the pay-down row, examined the draws, we took
15 the borrowing base elements, a number of those.
16 Q You mentioned the beginning cash. Is that the 48-million-
17 dollar figure there, sir?
18 A Under, "Starting estimated book available cash," yes, in
19 the week of 2/7. That's correct. Forty-eight million one five
20 nine.
21 Q And you mentioned that cash flow from operations. Is that
22 the eighty-six-million-three-hundred-and-fifty-dollar figure
23 that appears approximately two-thirds down the page?
24 A Yes, in the far right-hand column.
25 Q And you also mentioned the pay-down. Can you tell me what

1 you were talking about?
2 A That's the -- it's titled, "Less DIP pay-down." And then
3 in the right-hand column it's a hundred and forty-six million
4 two nine nine.
5 Q Do you have an understanding of how the $20 million of
6 additional liquidity is to be used after looking at this
7 budget?
8 A I do.
9 Q What is that understanding?
10 A It's essentially to pay down amounts that were rolled into
11 the pre-petition -- into the post-petition loan.
12 Q And why is that your view?
13 A Well, the estates since the petition date are generating
14 cash over the eight-week period. There is no need to borrow
15 additional funds because there's no purpose for that additional
16 liquidity in operating the estates post-petition. And when you
17 do the calculation and look at the amounts available to the
18 debtor to make the DIP pay-downs, that amount is clearly
19 utilized to make pay-downs of the pre-petition rolled up
20 amount.
21 Q Mr. Pitts, can I ask you to turn to Tab 9 in your binder?
22 A I'm there.
23 Q And you should have before you the first-day declaration in
24 the case. Do you see that? Of Mr. Adrianopoli?
25 A Yes. I see that. I have that.

1 Q Can I ask you to turn to Paragraph 50, please?
2 A Fifty?
3 Q Yes. Five zero. It starts on the bottom of Page 16.
4 A I see that.
5 Q And do you see where Mr. Adrianopoli avers that:
6 "The debtors have an immediate and critical need to
7 obtain financing and use cash collateral for, among
8 other things, working capital purposes to pay expenses
9 incurred in these Chapter 11 cases in connection with
10 the proposed budget approved by the lenders."
11 Do you see that?
12 A I do see that.
13 Q Do you see where it continues:
14 "Without immediate access to the financing and use of
15 cash collateral, the debtors would be unable to meet
16 payroll and otherwise operate their businesses and the
17 debtors' ability to preserve and maximize the value of
18 their estates and operations would be irreparably
19 harmed"?
20 Do you see that?
21 A I do see that.
22 Q Mr. Pitts, do you agree that there is an immediate need for
23 cash?
24 A Not from a DIP facility.
25 Q And can you identify on that interim budget where the $20

1 million of additional liquidity is being used directly for
2 working capital purposes?
3 A No, I cannot.
4 Q Can you tell me on that budget where the incremental
5 liquidity is being used directly for payroll payments?
6 A No, I cannot.
7 Q Do you have an understanding of the item entitled, "DIP
8 pay-down" on that budget?
9 A I do.
10 Q What is that?
11 A That is the -- that is an amount that is required to pay
12 down the DIP facility as a function of the declining borrowing
13 base because the company is monetizing its inventory and
14 generating cash but not reinvesting in inventory. And so the
15 borrowing base drives based on its formula a required reduction
16 in the pay-down feature that exists simply because the DIP
17 roll-up is proposed as part of this facility.
18 Q And that number aggregates through the 28th of March to
19 $146,299,000. Is that correct?
20 A That's correct.
21 Q Is there any single larger use of cash other than that DIP
22 pay-down on this budget?
23 A There is not.
24 Q Mr. Pitts, can I ask you to turn to Tab 4 in your binder?
25 A Okay. I'm there.

1 Q Can you tell us what that document is?
2 A This -- this is an adjusted version of the company's DIP
3 budget where very simply we wanted to back out the impact of
4 not having the DIP in place. And so what that did is that
5 removes the required element of the pay-down, eliminates the
6 borrowing base requirement.
7 We also made in accordance with that conforming adjustments
8 such as reversing out fees that would have been paid as a part
9 of that.
10 Q So you took out the DIP draws and the fees, and you made
11 conforming adjustments to the borrowing base, correct?
12 A That's correct.
13 Q And other than those two changes, did you make any other
14 changes to the forecast which we were just looking at, the DIP
15 forecast?
16 A We did not.
17 Q Did you or your team change any of the top-line projections
18 from the debtors' forecast?
19 A We did not.
20 Q As a financial advisor in Chapter 11 cases, Mr. Pitts, what
21 level of confidence do you have that that budget can be
22 achieved, the one that you created?
23 A Well, this particular budget is the company's creation
24 relative to the operating cash as we made certain
25 modifications. But I have a reasonably high level of

1 confidence given that the nature of the cash flow that's
2 generated here is simply from the monetization of the assets
3 that exist, largely the inventory and the receivables.
4 Q Does your analysis assume that adequate protection payments
5 are made?
6 A In this budget they're accrued because we did not eliminate
7 them when we took out the DIP budget. We're not making any
8 statements that they should be paid. That's for a Court to
9 decide. But they're accrued in here just to be conservative.
10 Q I don't mean to make you jump around here, but I'm going to
11 ask you to go back to Tab 2 in your binder which I believe was
12 the -- is the DIP budget.
13 A I have it.
14 Q And returning, Mr. Pitts, to the series of entries below
15 "net cash flow from operations," --
16 A Right.
17 Q -- you see the DIP pay-down row across there beginning
18 twenty-three nine oh one six one two zero? Do you see that
19 row, sir?
20 A I do.
21 Q And do you have an understanding of what those payments
22 are, just those first three?
23 A My understanding is those either are or are close to the
24 payments -- pay-downs that have actually been made so far in
25 these cases.

1 Q And the Houlihan Lokey slide that we were just looking at,
2 does it assume that those payments were made?
3 A No. That last slide we were looking at is sort of the full
4 recast of the budget fully eliminating the impact of the DIP so
5 we could have a clean look at the cases without any impact from
6 the DIP facility.
7 Q And in -- is your understanding -- do you have an
8 understanding as to whether all or some portion of those
9 payments have actually been made?
10 A I believe they have been made.
11 Q And so in that slide that we were looking at, you didn't
12 assume that they had been made. Is that correct?
13 A That is correct.
14 Q Can I ask you to turn to Tab 5 in your binder? And what is
15 that document at Tab 5?
16 A This is another version of the adjusted budget that we were
17 just looking at. And the only modification made here was to
18 reinstate those three pay-downs that we were just discussing,
19 the pay-downs that occurred in the week of 2/7, 2/14 and 2/21.
20 Q And does the treatment of those payments, does the
21 inclusion of those payments change your conclusion as to
22 whether or not the budget is sustainable?
23 A It -- it does not change my conclusion. We believe even
24 though those payments have already been made, and if the DIP is
25 not approved at this point forward, it does not change our

1 inclusion that -- conclusion that a DIP is still not needed.
2 Q And you still have confidence in the budget which your firm
3 prepared based on the debtors' budget, and that that budget can
4 be achieved?
5 A Same level of confidence.
6 Q Mr. Pitts, have you formed a view with respect to whether
7 the debtors should proceed with the proposed financing?
8 A I do not believe they should proceed with the proposed DIP
9 financing.
10 Q Do you think the debtors have any alternative to proceeding
11 with the proposed financing?
12 A They could seek the use of cash collateral.
13 Q And explain to me what you mean by that? Explain to the
14 Court, rather.
15 A The estates are generating substantial amounts of cash
16 post-petition through the monetization of assets. There's not
17 an operating need, a liquidity need or any operating need for
18 the additional liquidity, albeit small provided in the DIP
19 facility. There's not a need for it. It's just used to pay
20 down pre-petition debt. And so if you do not have the DIP
21 facility, the estates stand alone on their own in being able to
22 fund these cases.
23 Q To your mind, Mr. Pitts, what is the difference between
24 using cash collateral and obtaining a DIP facility in this
25 particular case? What would the difference be?

1 A From an operational and risk perspective?
2 Q Start there.
3 A I don't think there is any difference.
4 Q Are there any other differences to your mind between going
5 forward with the proposed DIP financing and using -- simply
6 using cash collateral?
7 A Again, subject -- if this is one of the documents that
8 hasn't been moving around the last 24 hours, you have fees debt
9 you would not incur if you were using just cash collateral
10 because you're not paying the DIP facility fees. And there are
11 other elements, for example the DIP facility would encumber
12 currently unencumbered assets, for example, and you would not
13 have that issue in cash collateral. I think the cash -- the
14 use of cash collateral would be more favorable than this DIP
15 facility.
16 Q And are you --
17 THE COURT: Hang on a second. And I know that this
18 will be the subject of cross-examination. But I'll at least
19 start that inquiry.
20 The use of cash collateral is predicated upon adequate
21 protection of the creditor whose cash you're using.
22 THE WITNESS: Correct.
23 THE COURT: And that's not unusual.
24 THE WITNESS: Right.
25 THE COURT: Sometimes we offer replacement liens or

1 other formats. And use of cash collateral with an operating
2 business is not unusual at all --
3 THE WITNESS: Right.
4 THE COURT: -- because cash comes in, it's used to pay
5 employees, but also to purchase new inventory which generates
6 more sales which generates more cash, and we all move forward.
7 I don't know if you've seen the submissions, but I'm
8 sure you've heard the issue. But I think it's been heavily
9 briefed by the parties that given the fact that the debtor is
10 liquidating assets and liquidating the collateral, the cash
11 that results from that is the collateral of the secured
12 creditors and that unless you're giving them something else --
13 giving them a lien in that collateral is not protecting their
14 position because the debtor will use that money to operate, pay
15 rent, pay employees, pay whoever. And so that's the crux of
16 this.
17 I understand -- I mean, I can read the budget. I
18 understand. And I share the Committee's concerns with respect
19 to the expense associated with this transaction. But when we
20 encounter a debtor that is afforded an opportunity in an
21 analysis like this to say, you can use cash collateral and not
22 have to incur the costs of the money that you're going to
23 borrow --
24 THE WITNESS: Right.
25 THE COURT: -- first you generally have to demonstrate

1 that you can adequately protect the affected creditor. And
2 then there's a second consideration that is a tactical or
3 strategic issue which is if -- in the absence of consent do you
4 want to go to war at the outset of your creditors -- at the
5 outset of your bankruptcy proceeding with your largest and most
6 powerful creditor constituency.
7 Leaving that second question aside of whether you want
8 to pick that fight, the issue of adequate protection is
9 something I'd appreciate your thoughts on.
10 THE WITNESS: Let me -- let me address that. And I
11 may address -- try and address the second point as well.
12 THE COURT: Sure.
13 THE WITNESS: With respect to the modifications we
14 made and how we look at this budget, if we did not move forward
15 with the DIP financing and we only had the cash collateral, we
16 are not suggesting that the cash flow that gets generated would
17 be used for other purposes. The expenses that are in this
18 budget, the investments being made to monetize the collateral
19 on behalf of the lenders, right, they've agreed to and
20 approved, and that's what's reflected in this budget.
21 The cash flows that are generated in excess of that
22 from the monetization of their collateral, we are suggesting it
23 can go nowhere. It can go in a segregated account. We are not
24 suggesting that the lenders be forced to or be asked to or
25 consent to spend any more than what they've agreed to in the

1 monetization of that. We just don't think it's appropriate,
2 one, to pay a fee for liquidity we don't need, and, two, that
3 it's not critical at this point in time given a lot of other
4 elements in the case and the things that you've heard that that
5 cash be paid to the pre-petition lenders just because they
6 rolled up just about all of their pre-petition loan into post-
7 petition.
8 So we're not saying that we want people to incur
9 greater costs. We actually are saying they should incur less
10 cost because you don't need to pay the fee. And the cash
11 should be -- and the cash should be -- should be set aside.
12 We're not suggesting it needs to be paid -- it needs to be paid
13 more.
14 Relative to the litigation point, it's certainly not
15 uncommon to have litigation in the beginning of a bankruptcy
16 case and I would certainly think the litigation even over this
17 DIP as we sit here could have been just as valid as the
18 litigation over the non-consensual use of cash collateral. And
19 I think people even looking at this see people objecting to the
20 DIP and I don't think they're saying, oh, if they don't get the
21 DIP there's no financing. I think people are saying they
22 either get the DIP or they get to use cash collateral. But
23 it's not clear to me that people are concerned about these
24 cases falling apart. And we're liquidating the assets as fast
25 as they can. And so I don't think you could really incur more

1 harm than the fact that you're liquidating as fast as you can
2 already.
3 And so that's why I think -- I don't want you to
4 construe that we're saying something else has to be done with
5 the money. We're saying just put it aside.
6 THE COURT: Okay. Obviously, I think other people are
7 going to want to talk with you about that, too.
8 THE WITNESS: That's why I'm sitting here.
9 THE COURT: Mr. Tecce, sorry for the interruption.
10 MR. TECCE: No. Thank you, Judge.
11 BY MR. TECCE:
12 Q Mr. Pitts, Judge Shannon asked you -- you referenced some
13 of the pleadings that have been filed in connection with the
14 DIP motion. Have you reviewed the pleadings that have been
15 filed in connection with the DIP motion?
16 A Yes, I have.
17 Q And have you reviewed some of the pleadings submitted by
18 the debtors in connection with the DIP financing motion?
19 A Yes.
20 Q And do you have an understanding of the sum and substance
21 of the arguments that the debtors have made on this issue of
22 adequate protection?
23 A I do.
24 Q What is that understanding?
25 A I think there are largely two points that the debtor has

1 made I think specific in a reply in some of the papers I think
2 that we have filed that they had felt that they would not have
3 been able to make a showing of adequate protection. And they
4 specifically focus on two elements of what could be construed
5 as adequate protection, didn't address others. But the two
6 they focused on were being able to demonstrate an equity
7 cushion in the value of the collateral that supports this debt
8 as well as a belief that they could not show that the estates
9 were at least cash-flow break even on a cash operating basis.
10 Q And let's start with the allegation that there's an
11 inability to show an equity cushion. Do you agree with that
12 assertion?
13 A I do not.
14 Q And why is that?
15 A I believe there is a significant equity cushion in the
16 value of this collateral.
17 Q Could I ask you to look at Tab 8 in your binder, Mr. Pitts?
18 A I'm there.
19 Q And this is a document which is now admitted into evidence
20 in this case. Do you recognized the document?
21 A I do recognize it.
22 Q And it's called, "Hypothetical recovery analysis."
23 Correct?
24 A That's correct.
25 Q And does this document inform your view with respect to the

1 allegations concerning equity cushion?
2 A It does. And I want to be clear, this document was not
3 prepared by Houlihan Lokey.
4 Q Thank you.
5 A This is a company prepared document
6 Q And explain to the Court, if you could, how this document
7 informs your view on the equity cushion.
8 A This document is essentially trying to accomplish what its
9 titled, "Hypothetical recovery analysis," respectively, the
10 waterfall. And it's organized in a manner which shows the
11 monetization of assets and then the -- and the payment or the -
12 - or the accrual of claims that would go against the
13 monetization of those assets. And there's a lot of numbers on
14 the page. But, basically, the top part goes to an analysis
15 either under a liquidation or the 363 sale scenario we've been
16 discussing this morning, generates at a presumed level of --
17 you know, the gross proceeds you would get, deducts certain
18 expenses. And then if you -- if you look not so much at the
19 bottom of the first page, but if you look at the top of the
20 second page which has the same number, there's a -- there's a
21 row that says, "ABL proceeds available for Cerberus/Salus
22 repayment."
23 And at least on this budget, it reflects that after you
24 have repaid or satisfied the ABL claims, including the cost of
25 satisfying those ABL claims, it shows that there is at least

1 111 to $125 million of excess value over and above their claims
2 that would then inure to the benefit of junior creditors.
3 Q And to your mind, is that the source of the equity cushion?
4 A It is a meaningful equity cushion relative to the size of
5 this claim.
6 Q Mr. Pitts, you also mentioned cash flow break even as one
7 of the -- the inability to demonstrate cash flow break even as
8 an issue with respect to adequate protection. Can you expand
9 on that, please?
10 A And that's one of the things that the debtor has indicated
11 they --
12 Q Correct.
13 A -- didn't think they'd be able to show. But when you look
14 at the budget -- I don't recall what exhibit it was -- if you
15 look at the budget, it was the cash flow from operations which
16 in the company's DIP budget reflected $86 million on I think
17 virtually just about every week in that budget as cash flow
18 positive. And so they are generating positive cash flow while
19 monetizing assets.
20 Q And how about the amount of cash on hand as of February 7?
21 Does that play a role in your cash flow analysis?
22 A It -- it does.
23 Q What's your understanding of that number?
24 A According to the budget up here, they would have entered
25 the case with somewhere around 40, $48 million in cash.

1 Q Switching gears, Mr. Pitts, are you familiar with the
2 debtors' application to sell their assets and establish bidding
3 procedures?
4 A I'm aware of the request.
5 Q You're aware of the request.
6 A Several of the requests.
7 Q And have you reviewed in the -- have you reviewed the asset
8 purchase agreement? I believe there are now three. Have you
9 reviewed the asset purchase agreement that was filed with the
10 motion?
11 A I did.
12 Q And did you review the one that came around over the
13 weekend?
14 A I did.
15 Q And have you been in court here today where changes to that
16 asset purchase agreement were announced?
17 A I have. But I have not reviewed that document.
18 Q Are you familiar with the term "equity bid," Mr. Pitts?
19 A I am.
20 Q Can you tell me what that means to you, that word -- that
21 phrase, "equity bid"?
22 A I think in the context we're -- in the context we're using
23 here, there are essentially a couple of ways you can sell the
24 assets in a Chapter 11 case. One is you can simply liquidate
25 them. And a common way to liquidate them is you would hire a

1 national round liquidator to give you a guaranteed payment to
2 purchase the ability to liquidate inventory in their view for
3 profit. And they give you a guaranteed payment in return for
4 that and take it off your hands. And that's what's commonly
5 referred to as an "equity bid."
6 And that can be compared to what's usually referred to as a
7 "going-concern bid," where someone gives you a value for the
8 assets they want to purchase. It's not necessarily allocated
9 as a function of different assets. And it presumes certain
10 levels of working capital that you would need to be able to
11 support that enterprise value. And you take that business and
12 -- and you'd own it and you go off.
13 In this particular situation, the asset purchase agreement
14 under the stalking horse is -- resembles more of an equity bid
15 that you would get from a liquidator as opposed to a going-
16 concern bid.
17 Q Do you have an understanding, Mr. Pitts, of the value that
18 the debtors are ascribing to the stalking horse bid?
19 A Not really.
20 Q Is that an important data point?
21 A If you're utilizing -- well, it's important in a couple of
22 ways. One is you want to know what the value of the contract
23 is relative to other alternatives.
24 And two is -- I mean, the whole purpose of utilizing a
25 stalking horse contract is to send a very clear signal, very

1 clear message to the marketplace and potential bidders of what
2 kind of transaction it is that they can either step into or be
3 -- and the value of having a stalking horse agreement is -- its
4 sole purpose is to have a very healthy auction that you hope to
5 substantially increase value.
6 And not being able to even broadly communicate even within
7 a range what the value is to potential bidders, you know, I
8 just find that meaningfully lacking.
9 Q Do you have an understanding as to whether the company has
10 communicated and ascribed a value of the stalking horse bid to
11 potential bidders?
12 A No. I don't believe so.
13 Q You don't believe you have an understanding? Or you don't
14 believe that's been communicated?
15 A I believe I have an understanding. I don't believe it has
16 been communicated.
17 Q Do you have an understanding generally of what the
18 composition of the stalking horse bid is?
19 A Between, for example, credit bid and cash?
20 Q That's correct.
21 A I do not have a clear understanding of that.
22 Q And why is that?
23 A I don't think it's been clearly communicated and it's
24 virtually impossible to tell from the papers.
25 Q And why is it important to -- well, let me ask the

1 question.
2 Is it important to know what the different -- what the two
3 forms of consideration are in --
4 A From a prospective bidder perspective it is. Yes.
5 Q And why is that?
6 A In the first instance, you want to know the value of the
7 assets that you're supposed to be trying to buy.
8 The second instance -- everybody has their views about
9 credit bidding, right? And credit bidding certainly does have
10 a -- have a chilling effect on the way certain bidders would
11 look at it. It doesn't mean nobody would come to the party.
12 But I think it certainly impacts how people would view it.
13 For people that want to view it and want to perhaps even
14 embrace it to figure out still how to bid for the assets and
15 come to the party, it's important that they have an idea of
16 what relationship that currency has to the overall value, is it
17 all of it, is it more of it, is it a fraction of it, because to
18 them, they view -- they view -- credit bidding mechanics, they
19 view these auction dynamics. There's a lot of elements they
20 examine and analyze as they assess their probability of
21 winning, which then informs their desire whether to engage even
22 in the process or not.
23 And I think the lack of clarity around the valuation, the
24 lack of clarity around the credit bidding currency, what it is,
25 how big could it be, I think can provide significant pause for

1 bidders who you already want to get them over that hurdle to
2 make the investment of time, effort and energy for potentially
3 no return. And it's hard enough to do as it is. And that kind
4 of dynamic I think just creates -- it's just lack of
5 transparency creates a hurdle for bidders.
6 Q Mr. Pitts, do you have an understanding as to the total
7 number of stores that is the subject of the stalking horse bid?
8 A I have an understanding within a very broad range.
9 Q And what is that understanding?
10 A The first contract had about 1,500 to 2,400. The second
11 contract, to my understanding, had a floor of either 1,700 or
12 2,050, which I think was time-based. And I think both
13 contracts have been publicly filed so people are looking at
14 both and probably still don't have a clear indication of what
15 the answer is. And my understanding is that the third
16 contract, I think if I recall correctly what was said today, I
17 think may still be the 1,700 to 2,050 threshold.
18 Q Is there an issue if the number of stores is not clearly
19 defined?
20 A It's another one of those lack of clarity/lack of
21 transparency elements that's just another hurdle for a bidder
22 to get their arms around to determine whether or not they think
23 they can put together a competitive bid.
24 Q Mr. Pitts, you're -- are you familiar with breakup fees?
25 A I am.

1 Q And do you have an understanding of what breakup fees are -
2 - what the purpose is that they serve?
3 A I do.
4 Q What is it?
5 A A breakup fee is -- it's the most basic element in
6 inducement for a buyer to serve as a stalking horse, to go
7 through the time, effort, energy of committing to purchase your
8 assets. And for that, there are certain protections that
9 you're afforded. A break fee [sic] is typically one of those
10 protections.
11 Q Do you have an understanding as you sit here today as to
12 what -- whether Standard General is going to receive a breakup
13 fee?
14 A Whether they're going to receive one?
15 Q Yes, sir.
16 A I think it's proposed that they receive one.
17 Q And to your mind, is the fee justified for the stalking
18 horse bidder?
19 A No. I don't think -- I don't believe --
20 Q Why is that?
21 A A number of reasons. Again, the whole purpose of
22 compensating a stalking horse is they provide benefit to the
23 estates of allowing you to have an auction that is just clear
24 as day, transparent, that people know what they're shooting at.
25 If you have a muddled auction, a series of asset purchase

1 agreements being filed, important agreements such as the Sprint
2 deal are being done very recently with a very limited amount of
3 time to analyze the bid, transition services agreements which -
4 - which is among financing commitments which aren't done.
5 There's a whole number -- number of things. Plus the ongoing
6 business plan. I mean, they call it a "going-concern bid," but
7 we know the company's effectively going to come close to
8 depleting its inventory by the end of March. And they have
9 been making no new purchases of inventory since they started
10 these cases. And so if you're going to buy this as a going
11 concern, where is the inventory you're going to use to
12 replenish the stores? It just adds a lot of doubt and
13 uncertainty as to what exactly you're supposed to be shooting
14 at.
15 And the credit bidding mechanism as well, and the way the
16 fees work, and we've heard a lot of testimony today, but, you
17 know, the dollars that were invested as part of the credit
18 agreement back in October, got a fee. These exact same
19 dollars, are proposed to get a fee in the DIP roll-up if it
20 happens, and the exact same dollars is now proposed to get a
21 breakup fee if they're outbid. It's just a lot of value going
22 to this. And I think when you look at the package of what we
23 have here today, it's questionable as to whether it's actually
24 providing the estate the benefit we're looking for.
25 Q You're referring to the October transaction. Is that

1 correct?
2 A That is correct.
3 Q And you're referring to a fee paid to Standard General in
4 connection with that?
5 A Correct.
6 Q You mentioned credit bidding. Can you explain to the Court
7 -- well, let me ask the question this way.
8 Do you have a view as to what -- can you explain to the
9 Court what you think the effect of credit bidding is on this
10 particular asset sale?
11 A It targets (indiscernible) without knowing its magnitude
12 relative to the valuation of the assets, like I indicated
13 before. It's a feature that's there. I mean, I don't think
14 people -- I mean, there's enough confusion just in this room,
15 and this room is filled with professionals who have actually
16 been working on the documents and we can't all seem to agree on
17 what the number is. And bidders, I think, looking at all the
18 documents, look at -- they're just going to have a hard time
19 understanding what it means in the context of this transaction.
20 Q How would you -- how would you address the issue, Mr.
21 Pitts?
22 A If I understand the question, I think I'd say -- I'd say
23 two things. One is I'd love to have a lot of -- a lot of
24 transparency in the transaction that's crystal clear. You want
25 to be able to have a bidder on the phone and in ten minutes

1 explain to them exactly what it is and exactly what they need
2 to do when. And you can't do that.
3 And, two, eliminate the credit bid. Just make it a cash
4 bidding process. Depending on where the relationship with the
5 credit bid is to the total value, that may mean a little, mean
6 a lot, sorry to say. But just create an even playing field and
7 just require that cash bidding be required for all bidders.
8 Q Can I ask you to go back to Tab 9 in your binder, Mr.
9 Pitts, which is Mr. Adrianopoli's first day declaration?
10 A I'm there.
11 Q And in Paragraph 58 he states that --
12 A Sorry. 58?
13 Q Right. On Page 20. It says:
14 "The proposed sale process is the combination of
15 nearly a year-long process. Since early 2014, debtors
16 have been exploring possible sale or other transaction
17 with a variety of financial or strategic buyers."
18 Do you see that?
19 A I do.
20 Q Given the amount of time these assets have been shopped, do
21 you think that the bidding procedures that are proposed are
22 going to lead to a robust auction in these cases?
23 A You mean, given as much as the assets have been shopped --
24 I read the words on the page and I understand that any company
25 would say, you've always had the opportunity to come acquire

1 assets. And in many cases, that could be true.
2 In this particular situation over the last year, this
3 company has been in nothing but flux. They've been trying to
4 close stores, haven't been able to, constant public fights with
5 its lenders, burning cash flow. Not exactly the most
6 attractive environment for parties to come. And probably a
7 difficult transaction. That's not to say that people didn't
8 have an interest in doing something. But it's not clear to me
9 that there were a lot of detailed conversations about how to do
10 that.
11 And then when you look at this particular process, I mean,
12 people have talked about -- I don't think I disagree with the -
13 - people talk about the Sprint deal as adding a lot of value.
14 Right? That if you had that along with an acquisition of the
15 assets to try and make it a going-concern effort that that
16 could make a real difference to people. The Sprint deal was
17 like filed yesterday. Right? And so it -- from -- if that was
18 a month ago or two months ago with the package it gives the
19 people with the right time line a process to understand it and
20 allow the estates to be able to mine that value out of bidders
21 for whatever it's worth.
22 And so there -- plus the bankruptcy process, sometimes
23 people are attracted to a bankruptcy auction despite its intent
24 to get as much value out of you as possible. But one of the
25 benefits of it is it crystalizes a process. I know there's a

1 start, I know there's an end, I know if I dedicate resources,
2 call lenders, harass investors to give me capital to do all
3 these things to gen up the machine, to buy an asset, I know
4 that there's going to be a process where I either win or lose.
5 Outside of that, where the company has a lot of
6 optionality, it's not choiced, they're not really up for sale,
7 but come look at our assets, it's hard for people to have a
8 serious -- make a serious effort because there's an opportunity
9 cost of doing so.
10 So I think the bankruptcy process can crystalize that. And
11 I think the Sprint deal can crystalize that. I think with the
12 right stalking horse agreement that was clear, that can
13 crystalize that. And then I think all these things are coming
14 together with -- it's just questionable. There's not enough
15 time I think to really maximize the value of all that effort.
16 MR. TECCE: Thank you, Mr. Pitts.
17 Judge, I don't have any further questions for the
18 witness at this time.
19 THE COURT: Very well.
20 Cross?
21 MR. GAFFEY: Thank you, Your Honor.
22 **CROSS-EXAMINATION**
23 **BY MR. GAFFEY:**
24 Q Good afternoon, Mr. Pitts.
25 A Good afternoon.

1 Q Could you take a look at Tab 9 of the book that Mr. Tecce
2 gave you? It's --
3 A My binder?
4 Q Yes, sir. It's Mr. Andrianopoli's declaration.
5 A (Witness reviews exhibits.)
6 I'm there.
7 Q Did you -- Mr. Tecce's pointed you to couple of paragraphs
8 in it. Have you read it before today?
9 A I have read this before today.
10 Q Okay. And have you read Paragraph 31 which describes a
11 2013 term loan?
12 A Okay, I've read it.
13 Q Had you read it before today is my question.
14 A I read the entire document so I -- I believe the answer's
15 yes.
16 Q Okay. So you are aware, and you have been aware, that the
17 2013 term loan is -- and I'm reading from the affidavit:
18 "-- secured on a second priority basis by current
19 assets and a first priority lien on fixed assets,
20 intellectual property, equity interests of certain
21 direct and indirect subsidiaries."
22 Correct?
23 A I am aware.
24 Q Say that again please?
25 A I am aware. Yes.

1 Q Okay. And would you turn now, sir, back to the -- let me
2 get the right tab number here. Tab 8. That's the hypothetical
3 recovery analysis you've testified about a bit today?
4 A Correct.
5 Q And in answer to Mr. Tecce when you opined that there is a
6 sufficient equity cushion and pointed, did you not, to the top
7 line of the second page on proceeds available for the ABL
8 proceeds of a hundred and eleven and $125 million in the two
9 respective columns, correct?
10 A Correct.
11 Q If you read further down on that page, sir, you'll see at
12 the bottom term loan exposure? Do you see that?
13 A I do.
14 Q And the term loan exposure is for Cerberus and Salus,
15 correct?
16 A That's correct.
17 Q You understand Salus is sometimes referred to as "SCP"?
18 A I do.
19 Q That's how it was referred to at your deposition yesterday,
20 right?
21 A Understood. Yes, I agree.
22 Q Took me a day to figure out; I was wondering what "SEP"
23 was.
24 A I understood where you were. Yes, that's right.
25 Q Right.

1 And the term loan exposure that's referred to there is
2 secured. Is it not?
3 A It is.
4 Q Secured debt?
5 A As we just discussed, it is.
6 Q That's the second lien that we've been talking about?
7 A Correct.
8 Q And as you read across you see that on that hypothetical
9 recovery analysis under either a liquidation scenario or a sale
10 scenario, a hundred percent is used up for -- that last item of
11 -- to pay off secured debt, correct?
12 A Sorry, can you repeat that question?
13 Q I'm reading across, a hundred point seven, hundred percent,
14 hundred point seven, hundred percent. Do you see --
15 A Oh, yeah. I see that, yes.
16 Q All right. So you would agree, would you not -- and sorry,
17 just below that you'll see proceeds available for unsecured
18 creditors and there's nothing there.
19 A Correct.
20 Q Does that suggest to you a lack of equity, sir?
21 A I don't understand your question.
22 Q Well, when you tell Mr. Tecce that there's a sufficient
23 equity cushion --
24 A Yeah.
25 Q -- to protect secured lenders --

1 A Yeah.
2 Q -- you're not taking into account the second lien, are you?
3 A I was referring to the ABL collateral.
4 Q You're not taking into account the term loan, correct?
5 A Correct.
6 Q And you agree with me that the term loan is also secured
7 debt, correct?
8 A Correct, my equity cushion commentary respect to this
9 analysis was limited to the ABL claims.
10 Q It's above the second lien?
11 A Which is above the second lien.
12 Q Under the scenario that you've laid out for us today, sir,
13 you would agree, would you not, that the second lien remains
14 impaired, correct?
15 A Correct.
16 Q So there's no -- so in order to make -- and those second
17 lien lenders would have to also consent to the use of cash
18 collateral or the estate would have to litigate with them,
19 correct?
20 THE COURT: All right. Hang on. That's the second
21 time I've heard a phone go off. I'm going to ask that you
22 close them. Our rules are very clear. And if one goes off
23 again, somebody is going to have to do the walk of shame and
24 come up here and you won't get your phone back --
25 MR. GAFFEY: Okay.

1 THE COURT: -- for a very long time. I find it
2 disruptive. I understand that when we take breaks people turn
3 their phones back on, but it is important to do so please
4 silence your phones.
5 My apologies for the interruption.
6 MR. GAFFEY: Your Honor, before you apologize to me,
7 can I just make sure --
8 THE COURT: Was it your phone?
9 MR. GAFFEY: -- it's not me? Yeah.
10 (Laughter.)
11 THE COURT: You know, you would be shocked at the
12 number of times that happens.
13 MR. GAFFEY: Mr. Tecce and I have experience with that
14 in another trial, Your Honor.
15 MR. TECCE: We do.
16 MR. GAFFEY: And I'll said it again, it was him last
17 time.
18 THE COURT: He's probably --
19 (Laughter.)
20 THE COURT: If he's smart, he's dialing you now.
21 (Laughter.)
22 THE COURT: You may proceed.
23 BY MR. GAFFEY:
24 Q You would agree, would you not, Mr. Pitts, that this --
25 even under the scenario that you posit today, the second lien

1 remains impaired? Yes?
2 A Remains impaired, yes.
3 Q Okay. And with the second lien lenders remaining impaired
4 under the scenario that you lay out today, it would still be
5 necessary, would it not, to obtain their consent to use of cash
6 collateral if adequate protection could not be shown, correct?
7 A It would be, yes.
8 Q And the adequate protection that you have demonstrated is
9 above that line; it's only as to the first lien debt, correct?
10 A Let me be clear. Right, the adequate protection we've
11 talked about relates to the equity cushion --
12 Q Yes.
13 A -- and the property supporting the ABL claims and the cash
14 flows related to each week that the estates are operating.
15 Those were two elements of adequate protection that the debtors
16 highlighted in their reply. There are other forms of adequate
17 protection. They can be provided in -- equally, in cash
18 payments or replacement liens, which we have not addressed.
19 Q We may be missing each other here, sir, and it may be
20 explained by the fact that I'm not a bankruptcy lawyer so
21 you're going to have to forgive me.
22 A Okay.
23 Q As I understand it, sir, we -- or you agree, do you not,
24 that in order to make use of cash collateral, the debtor has to
25 show either an equity -- either consent on the one hand,

1 correct?

2 A The debtor would have to get consent -- the use of cash

3 collateral would have to be via court order. Whether it's

4 consensual or whether it's not consensual --

5 Q Okay.

6 A -- you would not be able to use cash collateral without a

7 court order.

8 Q And if we don't get consensual use of cash collateral, we

9 have to have litigated use of cash collateral, correct?

10 A Much like litigating this DIP facility. That is correct.

11 Q What His Honor referred to as going to war with the major

12 lenders of the debtor? Yes?

13 A I did hear that reference.

14 Q You agree with that?

15 A I agree there would be litigation. There's almost always

16 litigation.

17 Q And that consent or court ordered use of cash collateral

18 over the objection of the lender -- I'm sorry, court ordered

19 use of the collateral over the objection of the lender requires

20 a showing of an equity cushion or adequate protection, correct?

21 A It requires a showing of adequate protection. I think an

22 equity cushion could be an element of that or one thing you

23 would look at, but I -- Mr. Gaffey, I would not agree with your

24 characterization that that needs to be a component of adequate

25 protection.

1 Q You would agree with me, sir, that the opinion you've given
2 today doesn't anticipate an equity cushion or adequate
3 protection for the second lien; they remain impaired, correct?
4 A I've made no comments relative to the adequate protection
5 that would need to go --
6 Q I'm asking you to make one. They remain impaired, don't
7 they?
8 A They remain impaired. They do, correct.
9 Q And you have no indication, sir, that the second level debt
10 has consented to the use of cash as -- cash collateral. Isn't
11 that right?
12 A I only know the debtors have said they have asked and I'm
13 assuming the second liens may have been a part of that ask and
14 thus far my understanding is the answer's been no.
15 Q And you've heard the debtor say they've been refused as
16 well, correct?
17 A Yeah. That's correct.
18 Q You have no reason to disbelieve that, right?
19 A I do not.
20 Q All right. So your analysis covers first lien, doesn't
21 cover second lien, fair?
22 A Related to the equity cushion and cash flows? That's
23 correct.
24 Q Now, I'd like to talk a little bit, sir, about your time at
25 Houlihan Lokey in August to September of 2014 when on behalf of

1 an ad hoc committee of bondholders you took a look at the
2 company.
3 A Right. Okay.
4 Q That did not result in a proposal from your committee of ad
5 hoc bondholders, did it? You described it as conversations in
6 your direct testimony. Is that more accurate?
7 A Conversations and -- it's not clear to me how free I am to
8 talk about it in a public forum. A lot of the things that
9 happened under -- under NDA, I don't know if I'm limited or
10 not.
11 Q Well, I'll step as carefully as I can, sir, and we'll deal
12 with it when we get there. It's a yes or no question. Did it
13 come to -- it didn't arrive at an agreement, did it?
14 A There was no agreement.
15 Q Okay. And there was no proposal made, was there? No firm
16 proposal.
17 A It's couple of subjective words you're throwing in there.
18 Q Well, the term you used on your direct testimony, sir, was
19 there were some conversations. You said there were some
20 meetings, some conversations you met some management --
21 A And documents.
22 Q And some documents.
23 A Right.
24 Q Another subjective characterization, sir, perhaps but it
25 didn't go anywhere, did it? There was no deal?

1 A No, the debtors terminated discussions.
2 Q Wasn't a sufficiently attractive proposition for your
3 committee or ad hoc -- your ad hoc committee of bondholders to
4 come to a transaction in the fall of 2014?
5 A I would disagree with that characterization.
6 Q But no deal ever was made.
7 A No deal was ever made.
8 Q And can I just back up to (indiscernible) about the second
9 lien lenders we were talking about a moment ago? You don't
10 have an alternative to offer in -- to get them adequate
11 protection or an equity cushion, do you? You haven't come to
12 us today saying this is what you should do to give them
13 adequate protection or an equity cushion --
14 A No, I have not come to you and asked that. That's right.
15 Q You've just got a generalized view that it ought to be
16 possible. You know how to do it with the first but not with
17 the second. Is that right?
18 A I didn't happen to have conversations with the second over
19 the topic.
20 Q In order to try and obtain their consent?
21 A Even to see where they are.
22 Q Let's assume they don't, sir. In the event that they don't
23 consent, you don't come to court today with a proposal as to
24 what to do with regard to providing adequate protection or an
25 equity cushion for that second level debt, do you?

1 A No.
2 Q Okay. Now, you testified on direct, sir, that in your view
3 the budget prepared by the company is achievable without DIP
4 financing. Is that fair?
5 A That's fair, yeah.
6 Q And you've not got direct knowledge of what it takes to run
7 the company? You're not in conversations about the day-to-day
8 needs or management of the company, are you, sir?
9 A Well as part of our diligence we have a fair amount of
10 conversations with the advisors and sometimes even management
11 -- representatives of management about the day-to-day affairs
12 and operations of the business, their ability to get cash
13 flows, are they on or off plan, what's going on in the
14 marketplace, so we -- I'm not running the company, but we're
15 well informed.
16 Q But you have sufficient transparency about its operations
17 to opine that you think the budget is achievable if it's
18 amended as you suggest?
19 A I missed the beginning part of your question. Can you --
20 Q You have sufficient transparency into the operations of the
21 company to opine that it can achieve the budget as you
22 suggest --
23 A I've --
24 Q -- with the changes that you suggest?
25 A Yeah, I feel that we've done enough diligence where I'm

1 comfortable with that conclusion.

2 Q You have enough data to make -- to give that opinion but

3 not enough data to understand the transactions, sir -- you've

4 had enough transparency in this process to learn that?

5 A Which transaction are you referring to?

6 Q The ones brought us here today, the proposed transaction.

7 A The APA?

8 Q Yes.

9 A I don't understand your question.

10 Q Okay. Would you turn to Tab 3 of your book please, sir?

11 That's the DIP facility roll-up overview that you prepared.

12 A (Witness reviews exhibits)

13 Yes. I'm there.

14 Q And again forgive me if I'm a little slow on this, but what

15 you've done in essence here, sir, is take some other similar

16 transactions and compare the size, composition, roll-up, term,

17 et cetera one to the other. Is that right?

18 A Generally correct, yes.

19 Q How many -- the comparatives running from Associated

20 Wholesaler through Orchard Supplies Hardware Store, reading

21 from left to right across that column, how many comparatives

22 did you have to choose from?

23 A I'll explain the process. The database is around 240, 250

24 DIP facilities I think probably going back maybe like five

25 years or something --

1 Q Okay.
2 A -- like that and you -- and you -- you do a scan or a
3 search -- you try to stay more recent, last 12, 18 months.
4 Q And of the --
5 A I think the -- the --
6 Q I'm sorry, I didn't mean to interrupt.
7 A I was going to say the primary screening element was size
8 in this particular circumstance.
9 Q So -- but I guess my question is how many comparables were
10 there for you to choose from?
11 A Again we -- we have pretty large database we scan from and
12 based on size, these are what was selected. I don't believe
13 there were many others. There -- I think we spent some time
14 focusing on four or five other ones that we might have thought
15 would be comparable but did not make this list.
16 Q So there are at least 10 comparables and you chose five of
17 them?
18 A I -- I -- I would say -- I would say that there are five
19 comparables and they're reflected on -- on this sheet.
20 Q We're not able to tell from the demonstrative chart you've
21 put in which comparables you rejected, are we, sir? We only
22 know what you to compare?
23 A That's correct.
24 Q We -- you have no way to tell us now, do you, if you
25 rejected five or 10 or 15 comparable candidates that may have

1 had less onerous roll-up provisions or less onerous terms?
2 A I would not be able to sit here and tell you specifically.
3 Q All we have is the one page you put together with some
4 sources, and you're telling us that you chose your comparables
5 from a Holihan Lokey database?
6 A It's not a Houlihan Lokey database but it's a database of
7 DIP transactions but yes.
8 Q So on the record as we have it now, sir, I'm not able, am
9 I, to compare what you chose to put in your chart against what
10 you chose to leave out?
11 A That's correct.
12 Q And neither is the Court?
13 A That's correct.
14 Q I had an understanding, sir, and correct me if I'm wrong,
15 that you have some degree of dissatisfaction with the marketing
16 of this company. Is that correct?
17 A The -- yeah, the marketing of the assets as proposed under
18 the current DIP procedures.
19 Q And in your prior engagement on behalf of the ad hoc
20 bondholders committee, did you ever make a plan or proposal
21 with regard to how about marketing the assets of the company?
22 Did it get that far?
23 A That was not a part of that mandate.
24 Q Okay. So you -- the answer's no, you did not?
25 A We did not.

1 Q And you don't have a proposal now as to how it should have
2 been marketed otherwise, do you?
3 A I don't have a proposal -- I have thoughts but I don't have
4 a proposal.
5 Q You have a view that how it's been marketed is not
6 satisfactory but you don't have a proposal to alternative as to
7 how it should have been. Is that correct?
8 A Well I -- I -- certainly a number of elements I'd like to
9 be different. Timing is certainly an issue. The way the --
10 the assets have been made available. Baskets or lots I think
11 I'd have some -- some issues with. I think the lack of clarity
12 that's been prevalent in this case over the stalking horse I
13 think has limited -- added a lot of friction to people's
14 ability to jump right to it and be able to provide it. Those
15 are just some thoughts.
16 Q And much of that is a function of the time. Is that
17 correct?
18 A That's correct.
19 Q And you would agree, would you not, sir, that this is not a
20 company that could sustain a long marketing and negotiating
21 process in order to achieve a useful bankruptcy. Isn't that
22 correct? We need to hurry here. Is -- do you agree with that?
23 A Sustain is one element, but I think to maximize recoveries,
24 you know, you don't want to waste assets in activities or time
25 that you don't think going to generate value. I would agree

1 with that.
2 Q Do you think the inventory and the assets of the company
3 will be more valuable if this process is elongated?
4 A I don't think the inventory gets more valuable the longer
5 it would sit there.
6 Q In attempting to -- how much -- how big was your team on
7 the Fall 2014 engagement for the ad hoc bondholders committee?
8 A The number of people?
9 Q Yeah, more or less.
10 A It was -- it was around five.
11 Q Okay. And of those five people, the management level
12 people were the same team that are working on the assignment
13 from the creditors committee now. Yes?
14 A The top three people relative to seniority are the same.
15 Q Okay. And although you -- one of the challenges here is
16 compressed time, sir. Now you and your team have made
17 absolutely no use of any of the information you learned during
18 that prior engagement. Is that correct?
19 A It's not relevant to this assignment.
20 Q So the answer's no, you have not?
21 A The answer's no, I have not.
22 Q And the reason you haven't is your view that what you
23 learned about the company several months ago was irrelevant to
24 what's going on today?
25 A That is correct.

1 MR. GAFFEY: Your Honor, may I just confer for one
2 moment with Mr Gordon?
3 THE COURT: Sure.
4 MR. GAFFEY: Thank you.
5 (Participants confer.)
6 MR. GAFFEY: I have nothing further, Your Honor.
7 Thank you, Mr. Pitts.
8 THE WITNESS: You're welcome.
9 THE COURT: Okay. Does anyone else wish to cross-
10 examine, Mr. Pitts?
11 Mr. Harris?
12 MR. HARRIS: Thank you, Your Honor.
13 **CROSS-EXAMINATION**
14 **BY MR. HARRIS:**
15 Q Mr. Pitts, I'm going to not -- I'll try not to cover any
16 ground that has already been covered by the debtors here but on
17 a slightly different subject, on behalf of the unsecured
18 creditors committee, I assume it's your position that the
19 company should do everything it can do to maximize the value of
20 the leaseholds interests?
21 A Yeah. It should maximize all value to the extent that it
22 can. Leasehold interest for sure.
23 Q And you think the debtor's actions in getting an expedited
24 auction going for the 1,700 -- at least for the 1,700 stores
25 that are already being closed is a good thing, don't you?

1 A I agree it was a good thing.
2 Q And holding this auction this afternoon and potentially
3 generating bids for that is a -- is also a good thing for both
4 the -- for all the creditors of the estate?
5 A It is a good thing, yes.
6 Q And the unsecured creditors are taking the position that
7 the value of those leaseholds is an unencumbered asset. Is
8 that correct?
9 A Believe that's correct.
10 Q And under the proposed DIP order, those leaseholds would be
11 granted as replacement liens to the extent of diminution the
12 value of our collateral. Isn't that right?
13 A Granted -- I believe the DIP facility encumbers any
14 unencumbered assets.
15 Q Including leaseholds?
16 A Including leaseholds.
17 Q And is it your understanding that that encumbrance is to
18 the extent of diminution resulting from, among other things,
19 (indiscernible)
20 A I thought it was just an encumbrance, but ...
21 Q But it takes estate -- it takes money to basically do the
22 kinds of things the debtors are doing right now in terms of
23 monetizing those leases, doesn't it?
24 A It is -- you can't monetize the assets without incurring
25 expense. That's correct.

1 Q So there's legal expense for instance?
2 A There's a lot of expense, yeah, for instance.
3 Q And there's broker expenses.
4 A Sure.
5 Q Okay. And there are other expenses that inure to the
6 benefit of the unsecured creditors that are being incurred by
7 the estate as well. Isn't that right?
8 A I'm sorry, repeat the question, Mr. Harris.
9 Q There are other expenses that are being incurred by the
10 estate for the benefit of unsecured creditors as well. Isn't
11 that correct?
12 A Generally I don't think I disagree with that.
13 Q Okay.
14 MR. HARRIS: I have nothing else, Your Honor.
15 THE COURT: Okay. Any redirect?
16 MR. SCHIABLE: Yes.
17 THE COURT: Oh, I'm sorry.
18 MR. SCHIABLE: More cross.
19 Good afternoon, Your Honor. Damian Schiable of Davis
20 Polk on behalf of the first-out lenders --
21 THE COURT: Welcome.
22 MR. SCHIABLE: -- ABL lenders. Thank you, Your Honor.
23 My *pro hac* has been filed. I believe the order has not yet
24 been --
25 THE COURT: That's just fine. I'll sign it.

1 MR. SCHIABLE: Thank you, Your Honor.

2 **CROSS-EXAMINATION**

3 **BY MR. SCHIABLE:**

4 Q Just a couple of questions, Mr. Pitts.

5 First, you testified that in something like half of the

6 deals -- bankruptcy deals you've worked on you've been on the

7 debtor side. Is that correct?

8 A That's correct.

9 Q And have you ever advised one of your debtor clients to

10 undertake a cash collateral fight with their prepetition

11 secured lenders?

12 A As -- as best as I recall thinking back over 15 years of

13 experience, we have -- have definitely recommended. I don't

14 know if we've ever actually engaged in one on the company side.

15 Q Do you have a memory -- you say you have no specific memory

16 of ever having actually engaged in a cash collateral fight on

17 the debtor side when you're representing a debtor?

18 A No, not me personally.

19 Q And do you know that in your 15 years of experience to be a

20 common occurrence? Cash collateral fights against --

21 A I know it has happened, I don't know -- like I don't have a

22 basis to know how common it is, but I know it has happened.

23 Q But if you can't remember one within 15 years, do you think

24 that's generally pretty infrequent?

25 A Yeah, it's infrequent.

1 Q And do you have any idea why debtors might want to avoid
2 such a fight? Why it may be so infrequent?
3 A I do.
4 Q Why is that?
5 A In the way that this case is different than probably just
6 about a lot of the others we've seen is usually even when
7 you're trying to accomplish a plan or trying to accomplish a
8 sale of assets, how you're going to finance the case is
9 obviously of critical importance largely because most of the
10 time the effort is to continue to operate the business as a
11 going concern, to do a plan or to sell on a going concern basis
12 and that requires liquidity to finance new inventory, new
13 working capital, run the business.
14 In liquidating cases, that can be different. I don't think
15 it's uncommon to find in liquidating cases where you would just
16 be using cash collateral because you're generating liquidity
17 immediately because you're not making an effort to operate and
18 run the business, you don't have investments you have to make.
19 In this particular example, they filed with a substantial
20 cash balance, they stopped making any purchases of inventory,
21 and so it's basically just a liquidation -- a monetization of
22 all the assets in one form or another of which they're
23 generating cash every day. And so in that particular
24 circumstance, I don't think there's a need for the DIP and this
25 is a case -- and granted it may be infrequent, but when you

1 look at the facts and circumstances of this case, I think that
2 the effort to seek non-consensual use of cash collateral would
3 be warranted in this case.
4 Q Can we agree that it costs something to do that?
5 A Sure.
6 Q Can we agree that there's litigation involved?
7 A Like fighting over DIP? Sure.
8 Q Can we agree that it takes time?
9 A Sure.
10 Q And can we agree that there's risk?
11 A Yes.
12 Q Okay. Are you aware of any other parties, sir -- you've
13 had two major roles with respect to RadioShack in the past
14 year. Are you aware given that extensive experience with
15 RadioShack of any other parties standing by to offer a DIP to
16 the debtors on either the terms that are being offered today or
17 on better terms?
18 A No.
19 Q And so you testified before about your ad hoc assignment in
20 2014. When you were working with the ad hoc members, I think
21 you testified yesterday during your deposition that you had
22 provided illustrative terms for second lien term loan financing
23 to the debtors -- to the company at the time. Is that correct?
24 A I can't say that we provided illustrative terms. I know
25 that there was a --

1 Q Did you put together a document that says:
2 "Set forth on the following page are illustrative
3 terms for second lien term loan financing."
4 A I would really like to see the document you're trying to
5 show me. I recall this document from my deposition yesterday.
6 MR. SCHIABLE: Your Honor, I apologize, I only have
7 one copy.
8 THE COURT: That's okay.
9 BY MR. SCHIABLE:
10 Q So can we agree that it says at the top, "Overview of
11 Potential Financing" and it says:
12 "Set forth on the following page are illustrative
13 terms for a second lien term loan investment that
14 would be contemplated" --
15 And I'm leaving out the rest because I don't want to get
16 into too much detail. Do you want to see it again?
17 A I do.
18 (Witness reviews document.)
19 Q Maybe you could just -- or you could just say that you
20 submitted illustrative --
21 A Do you want me to read the rest of the sentence or?
22 Q -- you submitted illustrative terms --
23 A In connection with --
24 MR. KIRPALANI: Your Honor, are we having a
25 conversation?

1 THE COURT: Yeah. Yeah.
2 MR. SCHIABLE: Sorry. I'm just --
3 MR. KIRPALANI: Because I want to be part of it.
4 THE COURT: Yeah.
5 (Laughter.)
6 BY MR. SCHIABLE:
7 Q I -- where I'm trying to go is yesterday at your deposition
8 this was used as an exhibit and I guess the question is: Is
9 this a -- something put together by you or your team that was
10 presented to the company in 2014 for a potential financing?
11 A It was put together by our team; it was not given to
12 anybody.
13 Q Okay. And I'll show it to you to refresh your recollection
14 but can you tell me what the interest rate was that was
15 proposed and can you tell me what the total fees were that were
16 proposed?
17 MR. TECCE: Objection, Your Honor, to the relevance of
18 this document, especially given the time frame.
19 MR. SCHIABLE: All I would say is that Mr. Pitts has
20 testified that the DIP terms are --
21 THE COURT: Onerous.
22 MR. SCHIABLE: -- out of line and onerous and this
23 document which his team prepared has higher interest rate and
24 higher fees.
25 THE WITNESS: Okay, if I -- if I might suggest that at

1 the time we were contemplating that kind of structure, that was
2 for a term loan to finance an exit from bankruptcy that would
3 have been junior to the DIP, or an exit facility it would have
4 had that was a junior piece of capital that was proposed to be
5 funded as part of an emergence from Chapter 11.
6 THE COURT: Okay, let's move on.
7 MR. SCHIABLE: Okay.
8 THE COURT: I follow the point.
9 BY MR. SCHIABLE:
10 Q And last thing, Mr. Pitts, could I ask you, you testified
11 about the cash, the $10 million that's been used and how it was
12 not used to pay customers and make payments directly. Is that
13 right?
14 A Are you referring to the $10 draw in the company's budget?
15 Q Yes, sir. Yes, sir. But is cash fungible? In other
16 words, if cash is saved in one place, can it be used in another
17 place?
18 A Sure.
19 Q Okay. Thank you, sir.
20 THE COURT: Okay. Any other cross?
21 (No verbal response.)
22 THE COURT: Very well.
23 Mr. Tecce, redirect.
24 MR. TECCE: Very briefly.
25 THE COURT: Sure.

1 **REDIRECT EXAMINATION**

2 **BY MR. TECCE:**

3 Q Mr. Pitts, when did your representation of the ad hoc

4 committee end?

5 A It was around October 1st or October 2nd of 2014.

6 Q And how do you know it was around October 1st or October

7 2nd, Mr. Pitts?

8 A That's about the time we were told that the company was

9 discontinuing negotiations with us and were going to engage in

10 what became the October financing led by Standard General.

11 Q So the work you did for the ad hoc group was done before

12 the October transaction. Is that correct?

13 A That's correct.

14 Q And Mr. Gaffey or -- I'm sorry. The debtor's counsel asked

15 you whether you've used any information that you had gathered

16 during your representation of the ad hoc committee and you said

17 it wasn't relevant, right?

18 A Correct.

19 Q Can you explain why it's not relevant?

20 A The -- the -- the nature of the engagement and the type of

21 transaction we were talking about trying to do at that time

22 became null and void when the company entered into the Standard

23 General financing transaction.

24 Q You were asked -- you've been asked about how many roll-up

25 transactions you've seen over the course of your career. How

1 many roll-up transactions have you seen over the course of your
2 career where the amount rolled up is 10 times the amount of the
3 incremental liquidity?
4 A I don't think I've ever seen that.
5 Q You were asked about this document, the DIP facility
6 roll-up, by debtor's counsel which -- and I apologize.
7 UNIDENTIFIED: Demonstrative.
8 Q Demonstrative that was used.
9 A I'm sorry. Can you show it to me again?
10 Q Sure.
11 A I can't see what you're looking at.
12 Q It's the DIP facility roll-up overview.
13 A Okay.
14 Q You were asked about this document. It lists the
15 comparative DIPs?
16 A I don't remember what tab it is but yeah.
17 Q And that document was actually filed on the 20th of
18 February along with the creditors committee's objection to the
19 DIP motion, correct?
20 A Correct.
21 Q And yesterday you were deposed in connection with this
22 matter. Is that correct?
23 A That's correct.
24 Q And you were -- were you asked questions about this
25 document?

1 A I was.
2 Q And were you asked if you would provide all the companies
3 that were kicked out?
4 A I was -- I was not asked that.
5 Q If you were asked that, would you have done it?
6 A Yes.
7 Q The -- you were asked about the Salus term loan and we were
8 on -- the questions came about on Tab 9 of your binder, the
9 Andrianopoli first day declaration Paragraph 31.
10 A Which paragraph?
11 Q 31.
12 A 31, yeah.
13 Q -- on Page 9. And you were asked about --
14 A Okay, yes.
15 Q Mr. Pitts, do you have an understanding as to what the
16 collateral is that secures the SEP loan or the Salus loan?
17 A Basically non-current assets, fixed -- IP and FF&E.
18 Q And they have a first lien on those assets. Isn't that
19 correct?
20 A A first lien on those assets. That's correct.
21 Q And could the fact -- if the debtors were to partner with
22 those lenders to market those assets on a timetable that were
23 acceptable to those lenders, would that be a form to your mind
24 of adequate protection?
25 A It could be.

1 Q And that includes intellectual property, correct?
2 A It does.
3 Q And so if there were an agreement between the debtors and
4 the second lien or the SEP lenders rather about an acceptable
5 timetable to market that IP, would that to your mind be a form
6 of adequate protection?
7 A It could be a form if it was agreed to.
8 Q Earlier in our discussion today we looked at a document
9 that Houlihan had prepared was a budget based on the debtor's
10 budget, correct?
11 A I --
12 Q That did not include the DIP draws, correct?
13 A Correct.
14 Q And did that budget provide for adequate protection
15 payments?
16 A Well again that -- that budget did include the accrual of
17 adequate protection payments to be conservative to see if it
18 would influence our conclusion and those interest payments that
19 are on there -- the adequate protection I'm talking about I
20 think was generally interest payments to be agreed to be paid
21 and included the SEP lenders. We left it in. Again, we're not
22 making a statement as to whether that they're entitled to it,
23 but it was in there just to be conservative to incorporate in
24 the cash flows to see if it modified our conclusion.
25 Q So your budget, if it were to include those interest

1 payments, you still had confidence that that budget could be
2 achieved. Is that right?
3 A That is right.
4 Q And do replacement liens provide a form of adequate
5 protection?
6 A They're a form of adequate protection, yes.
7 Q Do you think, Mr. Pitts, if we provided or if the debtor --
8 if there was an agreement to provide the SEP lenders with an
9 adequate protection package that consisted of interest of
10 replacement liens and agreements to market the intellectual
11 property on a time line that worked for them, do you think that
12 that would adequately protect those lenders?
13 A I think it could, yes.
14 MR. TECCE: No questions for the witness, Your Honor.
15 Thank you.
16 THE COURT: All right. Any recross?
17 MR. GAFFEY: No, Your Honor. Thank you.
18 THE COURT: Thank you, Mr. Pitts. You may step down.
19 THE WITNESS: Thank you.
20 (Witness excused.)
21 THE COURT: Mr. Kirpalani, does the committee have any
22 other witnesses?
23 MR. KIRPALANI: No, Your Honor, just some closing
24 remarks whenever the Court --
25 THE COURT: What I'd like to do is we'll take a break

1 and then I'd like closing remarks because I think I need them
2 from the parties. The testimony -- you can have a seat.
3 MR. KIRPALANI: Yeah.
4 THE COURT: The testimony was certainly helpful and
5 illuminated some of the open issues. This is, frankly, a
6 rapidly evolving and complicated transaction and that is part
7 of the challenge that we face. But before we go to argument, I
8 would at least share some observations with you that would
9 hopefully tell you the kind of questions that I have and where
10 I could benefit perhaps from argument and guidance from the
11 parties on at least a number of discrete issues that weren't
12 necessarily part of the testimony itself; these are business
13 issues.
14 First, there is a consensus that we're -- we need and
15 have a process to get to a sale hearing on the 26th of March
16 and I'm on board with that. And it seems to me the mechanics
17 of that process are largely agreed to in terms of time line, et
18 cetera, but to the extent that there are issues, they're day
19 here, day there issues and I expect that those issues are
20 solvable.
21 These are not in any particular order, but they are
22 points that have been raised either in the briefs or in
23 argument and in the testimony today and so I've just raised my
24 own comments and to the extent I'm not clear, it's because I
25 may not be able to read my own writing.

1 But as I said, I've read all of the briefs and I've
2 read and looked carefully at Section 9.7 of the agreement, and
3 I understand that it is a closing condition of the GW bid that
4 the secured claims that underlie the credit bid not be subject
5 to challenge. I understand the wisdom of that. That makes
6 fine sense to me as a business proposition, but I note that the
7 current challenge deadline for the committee is April 14 and I
8 do not expect to reduce that deadline or close that deadline
9 absent committee consent.
10 There may be ways to address this issue, but I don't
11 want anyone to proceed under the impression that at a sale
12 hearing in March I will simply turn and bless liens or
13 foreclose the committee from pursuing a challenge or
14 investigation. There's an opportunity to investigate. I
15 understand and appreciate that counsel observe that the lender
16 is prepared to make all sorts of discovery available. I expect
17 that that will occur, but that time line is the time line.
18 I note -- I think this was in the opening comments --
19 the breakup fee is not going to be before me today. I
20 understand that. I'm not really clear why I should parse out
21 an expense reimbursement that relates to the Sprint transaction
22 alone, so my inclination would be to deal with the breakup fee
23 and expense reimbursement when they're before me. But
24 obviously if there's a particular reason why that doesn't make
25 sense, I will hear from the parties.

1 I would observe that the lack of clarity on the GW
2 bid, the General Wireless bid, and the amount of the credit bid
3 at this stage is problematic, but it is evolving rapidly and
4 I'm satisfied that, frankly, everybody is doing their best to
5 pull together a complicated transaction under difficult
6 circumstances. And I think as Mr. Harris noted, many of these
7 issues will likely remain issues for the auction as parties
8 evaluate what the bid is and what a competing or superior bid
9 is.
10 But I shared -- I think I shared at the outset that
11 when I look at these for purposes of bid procedures, one of the
12 things that I do is I remove my robe and put on my lawyer hat
13 and think if I were contacted -- if I were practicing and
14 contacted by someone who said I'm interested in this, how do I
15 bid, or what's the bid, what do I need to top? That's the
16 thought process, and I do believe that there's been a
17 substantial amount of improvement in the clarity and
18 transparency of the process, but it is still a moving target
19 and that's a challenge.
20 I'm satisfied that the debtors and the professionals
21 are working as best they can to close those uncertainties, but
22 this is complicated. And so I understand that.
23 The credit bid we've had, again, some back and forth
24 and there was substantial time spent in the briefing about the
25 credit bid as it relates to Standard and the contingency of

1 letter-of-credit-related liabilities. I think Mr. Kurtz's
2 comments clarified that for me. I'm not going to address that
3 any further today, but obviously the issue of what a secured
4 creditor is bidding that -- that currency is important not
5 simply for the debtor to know, but frankly, for competing
6 bidders to know. And I think Mr. Pitts didn't say anything to
7 the contrary in that case. People need to know what kind of
8 currency people have at an auction table.
9 But I don't really see this case as being analogous to
10 the Fisker or Free Lance-Star cases and to the extent that the
11 committee is asking that I completely preclude credit bidding,
12 I would be unlikely to go along with that at least as I
13 understand the issues before me, but I would hear from the
14 committee on those points.
15 As to the DIP facility, again, I observe that this is
16 expensive. I don't think that's inconsistent with Mr. Kurtz's
17 comments, and in many respects it's not very favorable to the
18 estate on a variety of grounds.
19 The committee contends that non-consensual cash
20 collateral usage should satisfy the debtor's needs, but I've
21 listened carefully to Mr. Pitts and I'll take certainly
22 argument on it, but I'm not really clear on how those multiple
23 levels of secured parties in this case are actually susceptible
24 to being adequately protected in a context where the collateral
25 is being liquidated rather than recycled through an operating

1 business. So subject to a different answer on that question,
2 it does appear to me that this debtor, frankly, likely does
3 need DIP financing in one form or another.
4 And my notes will -- on this will be a little bit
5 jumbled because the arguments cover a number of issues, but I'm
6 troubled by the massive costs that are associated with this
7 financing that otherwise offers, frankly, little in terms of
8 additional available cash flow to the estate. And I have seen
9 many roll-ups, and I have -- I've approved many, but I don't
10 believe I've approved one, for example, that has an increase in
11 the -- of two percent in the interest rate. I realize it's a
12 relatively limited anticipated period of time, but I'm not sure
13 how I would find that that roll-up to operate to increase a
14 prepetition default rate above that would be either fair or
15 appropriate.
16 And again, the roll-up, as I said, as currently
17 configured is troubling. As I said, I've dealt with and
18 approved many roll-ups and I've rejected them at times. To me
19 the fact that a lender insists on it is not a legitimate basis
20 or predicate for approving relief and protection that this
21 Court has consistently said should be strictly construed and,
22 frankly, not encouraged.
23 In this roll-up, the roll-up actually increases, as I
24 said, the interest rate over the prepetition rate and it
25 triggers a very large facility fee based upon the amounts that

1 are rolled up. So we're pushing up $250 million from
2 prepetition into post-petition and then charging 1.25 percent.
3 I understand lender fees. I understand that 1.25
4 percent doesn't shock my conscience. It's expensive, but 1.25
5 percent on $250 million sure sounds like money for nothing from
6 the Court's point of view, but I would look for guidance from
7 the parties on how that is warranted or provides a
8 corresponding or discernible benefit for the estate sufficient
9 to justify me granting those protections.
10 And again, when I've approved roll-ups in a contested
11 context in other cases, and you pointed out Trico, which was a
12 bit of a brawl, but there have been other cases, I've at least
13 been able to identify for my own purposes benefits that I see
14 to the estate that would warrant the protections or treatments
15 beyond simply obtaining lender support or the lack of violent
16 lender opposition and you don't need -- I raised the point.
17 Mr. Pitts touched on it as well. You don't need to convince me
18 that consensus with a senior secured lender is of value, but I
19 believe that this Court and the committee and stakeholders have
20 a responsibility to ensure that that value is obtained; that
21 benefit of consensus or peace is purchased for a reasonable
22 price and to me this is expensive.
23 And again, I'm not certain that I've seen much
24 justification here for this roll-up which is a complete roll-
25 up, again, which is not unheard of, but it is not typical, and

1 I don't see much justification other than it is a lender
2 condition.
3 I also think -- I would observe that I think the
4 lenders have a substantial burden in this case to convince me
5 that a lien on avoidance actions is necessary or appropriate in
6 this case. I typically will not grant such a lien in the face
7 of committee opposition. We can have a long discussion about
8 the philosophical predicate for avoidance actions and the
9 relationship between unsecured creditors and avoidance actions
10 and rights that arise after the petition date.
11 I also don't dispute that these are rights that a
12 debtor, frankly, could pledge and I have in the past approved
13 and authorized it. But our local rules and our practice
14 demonstrate that this kind of provision is not favored and I'll
15 hear from the lender on this point, but the -- again, really
16 wanting something is not a legal predicate for me ordering it.
17 And again, as I -- as an aside on the lien on
18 avoidance actions, I see this as a different issue from a
19 concern that often arises in sales and may be arising here,
20 which is an issue about whether a buyer wants to ensure that
21 their customers and vendors aren't going to get sued. I don't
22 -- on that you're pushing an open door. I don't have any issue
23 with that. There -- that's a deal issue, but I think that's
24 different from a lender that obtains liens on avoidance
25 actions.

1 If a buyer wants to make sure that folks don't want to
2 get -- that their continuing business partners don't get sued
3 by a liquidating trust, that makes fine sense to me. I've seen
4 it many times, but I'm not certain precisely -- there are a
5 bunch of ways to memorialize that or to negotiate that piece,
6 but I don't see that as being consistent with the issue of
7 granting liens on avoidance actions purely in the context of a
8 DIP financing.
9 So those are at least some of the issues that I've
10 identified. Again, the briefing laid out many of these issues
11 and so these are questions that I came out. We did not take
12 openings so some of these I would have probably touched on, on
13 the openings. Some of these were touched on by the testimony
14 which was helpful, but I will need guidance from the parties.
15 I'd also observe that I have about an hour, and as I
16 said, we also have Friday morning if we don't conclude right
17 now. But we have a number of moving parts. I thought that it
18 would be helpful to at least share with you at the conclusion
19 some of my observations and I would suggest that we break and
20 we'll reconvene in say 15 minutes?
21 Counsel, do you wish to be heard?
22 MR. SWAN: I do. Appreciate. Don't mean to
23 interrupt. I just want to --
24 THE COURT: But you will.
25 MR. SWAN: -- clarify one point. This is David Swan

1 for Sprint. I didn't want to let the day go by without saying
2 hello.
3 THE COURT: Hello.
4 MR. SWAN: Hello. Just want to speak to one point
5 specifically and that's to the expense reimbursement. Sprint
6 is not seeking a breakup fee, but the deal was for Sprint to
7 receive an expense reimbursement. It was built into the
8 motion, into the proposed order, and we don't want that to be
9 dragged down or moved as a result of today's breakup for
10 Standard General being removed or --
11 THE COURT: Well as I said, I'm happy to take argument
12 on it and I will after we conclude. You know, this is the
13 first that I've heard of it was from Mr. Gordon's comments
14 today so I have not necessarily seen anything on it. Expense
15 reimbursements, I don't think you knew what the number was. I
16 don't really want to know before now. But -- so I know that
17 that issue's out there and if there's a reason that it's okay
18 or makes sense for me to deal with that, and maybe that this is
19 part of Sprint's deal, we can talk about that.
20 MR. SWAN: Okay.
21 THE COURT: But at least at this stage, you know, I
22 wanted to at least share with you what my observations are so
23 you have the benefit of that and then we can reconvene in a few
24 minutes. Say 10 minutes?
25 UNIDENTIFIED: Yes.

1 THE COURT: And we'll reconvene. Stand in recess.
2 MR. SWAN: Thank you.
3 THE COURT: Thank you.
4 (Recess taken at 3:52 p.m.)
5 (Proceedings resume at 4:13 p.m.)
6 (Call to order of the Court.)
7 THE COURT: Please be seated.
8 Mr. Gordon.
9 MR. GORDON: Thank you, Your Honor. And I very much
10 appreciate what you did at the conclusion of the hearing,
11 helping to focus the parties on your thoughts. I always think
12 that's enormously helpful, to try to streamline things. So I
13 can definitely cut my remarks down, and I want to really focus
14 on the issues that Your Honor raised.
15 And if it's okay with Your Honor, I'm not going to
16 take them up in exactly the order that you've presented them.
17 I --
18 THE COURT: That's fine.
19 MR. GORDON: I really wanted to deal with the DIP
20 first because this is the one matter, for me, that I can't even
21 really -- I have to say, I don't even really understand the
22 committee's primary viewpoint on this.
23 The idea that this company could pursue cash
24 collateral in the face of a clear view by the lenders that
25 they're unwilling to consent, so that we would have come into

1 this case trying to run a sale process, without knowing if we
2 had the necessary financing unless we succeeded in a litigation
3 battle with all our lenders; and in a context where, in my
4 view, we would have absolutely not basis to establish adequate
5 protection because, as the committee's own documents show,
6 there's no equity cushion beyond the collateral here.
7 And there seems to be some confusion on that, and I
8 want to be sure that Your Honor is clear because both sets of
9 lenders have liens in the current receivables, both sets. And
10 so, in order to establish an equity cushion, you have to show
11 that the value exceeds -- the value of the collateral exceeds
12 their debt. And you can't stop just at the ABL debt because
13 the SEP lenders have a lien in the same cash; it's the same
14 issue. So, for me, to even suggest that you could even
15 credibly argue adequate protection, I just don't understand at
16 all; I don't see it.
17 THE COURT: Okay. Well, I think I expressed that I
18 have some reservations about that. The issue that I have is
19 with respect to, you know, at least the present issue. And
20 I'll hear more on --
21 MR. GORDON: Sure.
22 THE COURT: -- on various pieces, and I'll hear from
23 the committee. But you know, I look at it, I think in the same
24 points that you do.
25 MR. GORDON: Yeah.

1 THE COURT: First, I followed -- I paid careful
2 attention to the colloquy regarding adequate protection. And I
3 understand -- I think I understand the argument. I'm not sure
4 I'm buying -- I'm not really buying it.
5 In addition, even if that were a close call, I think
6 you're underselling the problems you would have had. And I
7 know you're acutely aware of them. But this case was all about
8 selling their collateral.
9 MR. GORDON: Right.
10 THE COURT: And frankly, you know, if you walked in on
11 an adverse position, the opposition or the heartburn of the
12 landlords would have been the least of your problems. And so,
13 to me, it's inconceivable that you would have been able to move
14 forward. But I understand the point.
15 And again, you know, financing always looks expensive,
16 it always is, and I get it. But you know, I've shared with you
17 some concerns that I have with respect to the financing
18 structure in this case, and I'm not -- I think I'd like, you
19 know, your thoughts with respect to that, having dealt with
20 the, all right, we're in financing, we're -- the debtor needs
21 some form of financing. The answer has to be more than: These
22 are the terms that were presented to us. That's just -- that's
23 a fact of life. The U.S. Trustee and I deal with this question
24 all the time.
25 MR. GORDON: Right. And I get that. And if I could,

1 just for a second -- and I would say on this -- just on this
2 litigation point, to add to what Your Honor is saying, we would
3 have been picking that fight with lenders who are saying, we're
4 prepared to give you financing. And I think it would have been
5 difficult --
6 THE COURT: Yeah.
7 MR. GORDON: -- to even come into this Court --
8 THE COURT: It would have.
9 MR. GORDON: -- and say, we want to litigate --
10 THE COURT: Right.
11 MR. GORDON: -- this issue with lenders who are
12 willing to provide us this on a consensual basis, in a context
13 where we're on the precipice of a full-scale liquidation here -
14 -
15 THE COURT: Yeah.
16 MR. GORDON: -- and we are trying to salvage value
17 here that's not going to be available if we go into a full-
18 chain liquidation. So, against that backdrop, I don't see how
19 we could have done that. Not to -- and then, of course, the
20 other prong is: Can we show that we're maintaining the value
21 of the collateral. We, obviously, can't do that when we're
22 liquidating half the chain. So, anyway, that I didn't get.
23 Your Honor, obviously, raises -- you raised a number
24 of points about the other terms of this facility; the economics
25 of the facility, the roll-up. All of those were heavily

1 negotiated with these lenders.

2 You know, I think -- I basically have to defer to the

3 lenders. I know there's some willingness to move. We've had a

4 lot of conversations with the lenders. And you know, I

5 appreciate the fact from the debtors' perspective that you've

6 made the comments you have. And I'm hoping that we're going to

7 get to -- there's going to be some movement on those points; on

8 the roll-up, on the fee, on the interest rate and the like,

9 where we can get this loan in shape, where Your Honor feels

10 comfortable approving it.

11 But as the debtors' counsel, I sit here saying --

12 thinking to myself, we're on the verge of liquidating, we had

13 to have financing to run a process; at the same time,

14 convincing these lenders this process would benefit them

15 because we think there's more value.

16 THE COURT: Yeah. I don't think -- I'll cut to the

17 chase.

18 MR. GORDON: Sure.

19 THE COURT: I don't think I need a lot more from you -

20 -

21 MR. GORDON: Okay.

22 THE COURT: -- on the financing. I understand that

23 this issue --

24 MR. GORDON: Okay.

25 (Laughter.)

1 MR. GORDON: Well, I just sat there listening to all
2 this, and I --
3 THE COURT: I have been there.
4 MR. GORDON: Right. Okay. I appreciate that.
5 Let's talk about the bid procedures then for a minute
6 --
7 THE COURT: Okay.
8 MR. GORDON: -- if I could, Your Honor. And I
9 appreciate, again, Your Honor's comments with respect to these
10 -- I mean, we are working really hard. And I credit Standard
11 General.
12 THE COURT: Uh-huh.
13 MR. GORDON: You know, Standard General is sort of in
14 the cross-hairs here, and that is what it is. And I think they
15 knew this coming in; that this was going to come in. But
16 they've been working very hard to try to make changes, to move
17 this along. And they know and we know that this isn't as clean
18 as we'd like it to be, it's not as clear as we'd like it to be.
19 But we've made some really significant strides in that regard.
20 THE COURT: Well, I think -- I tried to be -- and
21 again, I'm shooting from the hip in my comments and sharing my
22 observations, and I hope that it is helpful. But I would
23 observe, you know, when I referred to the other cases that had
24 significant issues with credit bidding and conduct allegations,
25 et cetera, I think I was pretty assiduous in saying, I don't

1 necessarily see this as this situation. I have dealt with
2 cases where I've had, to be blunt, an overbearing purchaser,
3 you know, driving an unfair process. And I hear the committee
4 on their oppositions. But I guess what I'd say is I've seen
5 those cases, and I'm not satisfied that this is that case. I -
6 -
7 MR. GORDON: Yeah.
8 THE COURT: I think that the idea here is trying to
9 salvage as much value. Part of the question, really, the
10 committee is raising is: For whom is that value being
11 salvaged?
12 MR. GORDON: Right.
13 THE COURT: And so, you know, I don't think that
14 there's a -- but I want to be clear because that's an overlay
15 in the committee objections that I'll hear from them on. But
16 at least, at this point, you know, I don't see this as that.
17 This is a difficult situation, and a difficult case.
18 And we don't talk about it very much in this case.
19 And I know you're aware of it, and I'm very sure Mr.
20 Adrianopoli is. But there are thousands of jobs that relate to
21 this. And in many ways, the easiest path forward for some
22 folks would be, we're just going to hire Hilco, and we'll be
23 done --
24 MR. GORDON: Right.
25 THE COURT: -- we'll be done by the 1st of April --

1 MR. GORDON: Right.
2 THE COURT: -- and we'll take what we get, we'll take
3 our lumps, and we'll move on.
4 MR. GORDON: Right.
5 THE COURT: And I have said many, many times that,
6 while I care deeply about the returns that sophisticated
7 investors obtain on their investments, I really, actually
8 don't.
9 (Laughter.)
10 THE COURT: When compared with the interests of, you
11 know, a guy that's a store manager in Omaha.
12 MR. GORDON: Yeah.
13 THE COURT: I -- you know, you have my attention.
14 MR. GORDON: Yeah.
15 THE COURT: So that is why I think we've accommodated,
16 I think that's been the driving spirit behind your team, and I
17 follow that.
18 So, you know, and again, the evolving transaction, it
19 is what it is.
20 MR. GORDON: Right.
21 THE COURT: And if I had a sense that this was being
22 kept deliberately uncertain, in order to frustrate competitive
23 bidding, I would react to that. But I -- I'm not getting that
24 sense. And again, we'll allow the record to develop over time,
25 but the matter will move forward.

1 MR. GORDON: Right. And I want Your Honor to know, in
2 that regard, I mean, the debtors' professionals -- and I know
3 this -- we are committed to pushing that deal as fast as we can
4 push it and get it clarified as fast as it can be clarified.
5 And you know, I know Mr. Pitts had a number of
6 criticisms about the process, and you know, we accept those.
7 THE COURT: Uh-huh.
8 MR. GORDON: I mean, you can say, yes, objectively,
9 there are things we'd like to be better. But this is what
10 we've got, I mean, this is what we've got to move forward with.
11 And we think, from the standpoint of all the
12 creditors, we need to push this process on to get to the point
13 where we can get through an auction, get to a sale hearing.
14 And then everybody, at that point, knows exactly what we have.
15 We have a Standard General deal, and they still have conditions
16 to it. Hopefully, we'll have other deals, as well.
17 And we're all in a position -- we've agreed to provide
18 consulting rights to everybody, in terms of identifying the
19 winning bidders and that sort of thing. And I think everybody
20 in this room, as fiduciaries, needs -- well, I think they all
21 feel the same, but we need to get to the point. And we all
22 know, as Your Honor acknowledged, that we need to get there by
23 the end of March.
24 So that leads me to what's really -- what I see as the
25 stumbling block at this point. And I've heard what Your Honor

1 said a couple of times about the timing, and I did want to
2 address that, at the risk of, I guess, Your Honor rejecting
3 what I'm going to ask for, but I'd like to address it, if I
4 could, anyway. And that's this whole issue of the credit bid.
5 That is -- you know, it is a -- Your Honor is now
6 clear. It is a condition to this deal. This is the deal that
7 we have.
8 THE COURT: Uh-huh.
9 MR. GORDON: That condition is still going to --
10 unless Standard General pulls it out -- and there's been no
11 indication they have any interest in that -- that condition is
12 still going to be in the deal when we get to the sale hearing.
13 And my feeling is -- and I know what the local rule
14 says, and I know Your Honor has the ability to modify it --
15 THE COURT: Uh-huh.
16 MR. GORDON: -- in the interest of justice -- that, if
17 we can just focus on that issue only -- and when I say "that
18 issue," I'm talking about the credit bid, the validity of the
19 liens, the enforceability of the claims -- leave all other --
20 you know, there's other waivers in there about any other
21 claims; as Ms. Selden was saying, leave all that aside. From
22 my perspective, you could extend the challenge period even
23 further. I think the lenders will probably say, fine, if 60
24 days isn't enough, move it further for any other types of
25 claims that are out there.

1 But let's focus on this one issue. And I would like
2 to request that Your Honor set the hearing on that. And this
3 would be like an estimation of allowability of the claim. Any
4 363(k) argument that the credit bid is no good, set that for no
5 later --
6 THE COURT: I'm not going to do it.
7 MR. GORDON: Okay.
8 THE COURT: And I hear you.
9 MR. GORDON: Yeah.
10 THE COURT: But I would ask you -- without busting
11 your chops, I would ask you, tell me -- this is a pass-over, I
12 know -- but tell me what is different about -- why is this case
13 different from all other cases.
14 MR. GORDON: Well --
15 THE COURT: Okay? Hang on.
16 MR. GORDON: Sure.
17 THE COURT: Yeah. This is like Lake Woebegone; all my
18 debtors are above-average.
19 (Laughter.)
20 THE COURT: Look, the problem is this: Every sale
21 presents this issue. I have, I think, tried to be consistent,
22 and I believe that my colleagues are, as well. If there is a
23 purpose to this exercise, to the opportunity for the
24 investigation, that opportunity must be afforded. Every case
25 present legitimate grounds to reduce that time. Every case

1 presents a context in which there is value to be obtained, and
2 the risk of value being lost.
3 I know, because, frankly, I conferred with all of my
4 colleagues on this in the last 48 hours. Different people have
5 dealt with it different ways. But I believe that the consensus
6 is that you've done -- we've done situations where you look at
7 a lender and say, you need to be good for cash, we need to
8 understand that, you can bid your credit bid, but you need to
9 be able to -- you need to be able to deal with it if they get
10 unwound. And that needs to be a realistic protection.
11 But I am not prepared -- because I do think that,
12 while I think you've got great grounds, I think it would do
13 violence to the practice in this jurisdiction. We have no
14 shortage of sale cases, we have no shortage of sale cases that
15 present, frankly, much more complex or troublesome secured
16 lending arrangements than are at least present here. You know,
17 I'm not saying -- I'm not making any comment about the merits
18 of --
19 MR. GORDON: Understood.
20 THE COURT: -- claims, et cetera. But if Mr.
21 Kirpalani were to spend, you know, a solid weekend drafting a
22 complaint, there's no legitimate basis to say that I would --
23 especially if the complaint is predicated upon equitable
24 subordination and recharacterization.
25 If he had a complaint that said, your UCC-1's are bad,

1 maybe we'd dispose of that on summary judgment in the same way
2 that the Court in Free Lance-Star disposed of those issues
3 before an auction. And again, I regard -- I carefully -- I've
4 read that case now several times.
5 MR. GORDON: Yeah.
6 THE COURT: But I am not prepared to do that. And I
7 don't know where that leaves you. It may be -- I think, as Mr.
8 Harris said, it may be an issue for an auction. It's a
9 decision that Standard General is going to have to make, or
10 General Wireless. It is, as I said in my comments, a
11 completely rational, completely predictable concern, and a deal
12 point that they would and should negotiate for. But the timing
13 of the sale is what it is.
14 MR. GORDON: Yeah.
15 THE COURT: And the timing of their challenge rights
16 are what they are.
17 MR. GORDON: I'm going to make a couple of comments --
18 THE COURT: Yeah.
19 MR. GORDON: -- again, at the risk of -- and I
20 apologize, at the risk of testing your patience, I guess, but
21 just to give as little bit of my perspective on this, for
22 whatever it's worth, and it may be worth nothing.
23 But number one, the one thing that strikes me about
24 this situation is that the -- in terms of equitable
25 subordination, for example. The debt we're talking about

1 equitably subordinating is a financing transaction that was
2 done in December of 2013, when --
3 THE COURT: With GE.
4 MR. GORDON: Yeah, when Standard General wasn't
5 around. So this is --
6 THE COURT: Hang on.
7 MR. KIRPALANI: Mr. Gordon, I'm very sorry, and I
8 don't think I've ever done this before, but I do believe --
9 MR. GORDON: There's a first time for everything.
10 MR. KIRPALANI: I do believe Mr. Gordon himself is a
11 witness to some of the events, that he is now acting as an
12 advocate.
13 THE COURT: Well, aren't we getting dramatic? Okay.
14 (Laughter.)
15 THE COURT: All right. Here's the thing. I don't
16 know how much more clear I can be.
17 MR. GORDON: Yeah.
18 THE COURT: I'm not going to do it. The committee has
19 an opportunity, it's afforded under our local rules. I know it
20 -- and it's not simply being a stickler for our local rules.
21 If that said 45 days, if it said 75 days, the point is that we
22 have a -- we have a process here. It's not simply the rule.
23 And every single case would afford a legitimate predicate for
24 doing precisely what you're asking, and I'm not going to head
25 down that path.

1 MR. GORDON: Okay. Okay. Well, I hear you, Your
2 Honor.
3 Otherwise, with respect to the bid procedures, I'm not
4 sure there's much more that I can do. I think you -- the other
5 issues have been largely addressed. I think, in our
6 discussions with various parties, a lot of the -- a lot of the
7 issues, we've agreed to make a number of changes to the bidding
8 procedures order. And so, at least from the debtors'
9 perspective, I'm not aware of any other significant issues --
10 THE COURT: Okay.
11 MR. GORDON: -- that need to be addressed.
12 THE COURT: All right. Thank you.
13 Mr. Kirpalani.
14 MR. KIRPALANI: Yeah. I'll try to be brief, Your
15 Honor, because I think I've been hearing you loud and clear,
16 and greatly appreciate how carefully you read all the briefs
17 and came in with prepared questions.
18 With respect to the bid procedures -- we'll start with
19 the easy one -- I told you the big elephant in the room this
20 morning. And I think that's really our issue. I believe you
21 heard Mr. Pitts even testify on cross-examination the committee
22 is not opposing the time table. This does make sense, this is
23 business sense --
24 THE COURT: Uh-huh.
25 MR. KIRPALANI: -- and good business sense. And even

1 if we didn't feel that way, we certainly understand the Court
2 has a lot of experience selling assets, or authorizing the sale
3 of assets, and you can see it for yourself.
4 The sixty-day deadline under -- so let me just finish
5 on the bid procedures. During the break, there was an outreach
6 by Sprint about their expense reimbursement. All I can is we
7 don't have the committee here and committee authority on the
8 issue. I believe they requested an expense reimbursement. We
9 asked them, well, how much is it. And they have come back and
10 said, we want as much as Standard Gen [sic] was being allotted,
11 so up to $2 million. I just don't have any ability to react to
12 it, but I think we could probably work something out.
13 If -- Sprint was not the big issue on the expense
14 reimbursement, is what I'm trying to say, Your Honor.
15 THE COURT: Sure.
16 MR. KIRPALANI: Because they did need incentives to
17 come in, unlike -- our position, our litigation position, is,
18 of course, that Standard Gen didn't need those incentives.
19 In terms of the bid deadline, I think I would leave it
20 to the investment bankers to agree whether it's the 17th or the
21 18th. What do I know?
22 The General Wireless bid, what claims are going to be
23 credit bid, how that's going to work. I do actually agree with
24 Mr. Harris, counsel for Cerberus, that -- it's very hard for
25 the Court to be put in a position to try to figure it out. I

1 think, as things get clearer, Standard General has already
2 shown a great interest in this company since the summer of
3 2014, when a sale -- when there is an auction, at that auction,
4 there's going to be a lot of people having to understand the
5 transparency.
6 I do think it would help competitive bidders if the
7 could see, okay, this shell co has got the following secured
8 debt in there, and it plans to credit bid those. So now we all
9 know what it is. I may not like it, but at least we know what
10 it is. And that's something that I think people who are trying
11 to achieve clarity can achieve. And we're still going to have
12 my problem, which is the elephant in the room problem. But at
13 least that would be a lot of progress.
14 The -- I just want to make a brief comment about
15 Fisker, very brief. The parties in Fisker actually stipulated
16 --
17 THE COURT: I recall.
18 MR. KIRPALANI: Okay. So it really was about
19 encumbered and unencumbered mooshed together, and that a
20 secured lender should be willing -- I remember what Judge Gross
21 said because I was standing there, and it didn't feel good. He
22 said, put the money in, and you can get it right back out.
23 And all I'll say is that we have told Standard Gen's
24 counsel, if my deadline to fish or cut bait on the validity of
25 these claims -- and I think Your Honor knows I wouldn't be

1 bringing claims just for the sake of bringing them; they've got
2 to be real. But if our deadline to do that is April 14th, and
3 we get the cooperation, they're basically putting in cash for
4 two weeks. And if it turns out that the claims are good -- the
5 claims are bad, then I guess they get their cash back.
6 They're basically rolling the same cash, Judge, that
7 they've had since October in this LC back stop synthetic
8 facility, whatever it is. I'm going to figure it out, but I
9 haven't done it yet. But whatever that is, it used to be a
10 hundred and twenty. Today, you heard Mr. Kurtz say he's not
11 sure, you heard him say, by March 28th, he think it will be
12 down to 55 million. All we're talking about is whatever
13 they're planning to use as a credit bid, let it still sit
14 there. And they've got to make a cash purchase.
15 It gets more complicated with the Blue Crest, the
16 Taconic, the Saba, the DW Investment; the other secured claims
17 that they want to contribute. We're looking at those claims,
18 as well, but it makes it more complicated than it otherwise
19 appears on the papers. And I think Your Honor has heard me on
20 that.
21 On the DIP. This afternoon, I saw comments ...
22 (Participants confer.)
23 MR. KIRPALANI: Yeah. I saw comments to the DIP order
24 that went a very long way to resolving a lot of concerns that
25 we had. And I think the primary concern that we had -- and to

1 tell you why I keep saying it's not a primary concern, I don't
2 even know if that made any changes to the, quote,
3 "investigation budget," because I just don't care what it says
4 about that. That's never been our focus or our concern. Our
5 concern was cross-collateralization of prepetition versus this
6 roll-up.
7 If the new liens are being granted just as adequate
8 protection, even if the pay-downs had to occur subject to
9 disgorgement, because we're using their collateral --
10 THE COURT: Uh-huh.
11 MR. KIRPALANI: -- and converting it to cash, and they
12 should have it. And I understand that's what Cerberus is
13 asking for and insisting that we agree to, as -- because it
14 helps them to have their senior debt paid down because there's
15 a negative arbitrage on the interest rate. I get that. If
16 that were all going to happen, then we're really -- and the
17 interest rate comes down to the prepetition default rate on the
18 first lien facility, then we really are down to the fee. And
19 $3.6 million for $20 million of incremental borrowing just --
20 it's just -- it doesn't pass muster, at least not for this
21 committee.
22 And I have asked. There have been settlement
23 discussions all day long. I've been asking, I'm updated, I
24 know the committee cannot consent to this fee. We can't
25 withdraw our objection on that. It feels very similar to a lot

1 of fees that were just paid to the very, very same lender
2 group, who got those fees in connection with very little
3 incremental liquidity, even in October. So we're doing it all
4 over again. But the only difference is, this time, we've got
5 you; and at that time, we had nobody. So that's all I can say,
6 is -- with respect to that, Your Honor.
7 But other than that, we hear you on the very, very
8 difficult to give adequate protection, especially for the
9 Cerberus and Salus.
10 But the one thing that I don't want to be lost on the
11 Court is the irony of all of this -- Mr. Schaible comes up here
12 and talks about fees and cross-examines my witness, I get all
13 of that. But do you know what the irony is? How much of the
14 fee do you think is going to that impaired Salus and Cerberus?
15 Zero. Okay? So the one that's getting the fee is the one that
16 is adequately protected. So talk about irony. I'll just leave
17 it at that. Those are our views. We don't think that it
18 should be approved if the lenders are going to stand on their
19 fee.
20 You know, I would think -- I would think the committee
21 would consent to a fee that I believe is reasonable, a million
22 dollars. That's a lot of money for, essentially, just
23 incrementally increasing $20 million of a facility. There's
24 really no other difference. They're getting paid down in real
25 time. They're getting post-petition interest at the default

1 rate. But I don't know if that's acceptable. Thank you, Your
2 Honor.
3 THE COURT: Okay.
4 (Participants confer.)
5 THE COURT: Mr. Schaible.
6 MR. SCHAIBLE: Your Honor, Damian Schaible of Davis
7 Polk on behalf of the first-out lenders.
8 I guess the good news is my finely thought out,
9 multiple-page speech can go out the window, which is at least
10 good for you. I had some jokes in there.
11 THE COURT: All right.
12 MR. SCHAIBLE: You'll just have to pretend I made
13 them.
14 (Laughter.)
15 MR. SCHAIBLE: One -- a couple of things before we get
16 to the elephant in the room. First, I do want to just -- a lot
17 keeps being said, and I understand Mr. Kirpalani is not
18 necessarily intending to malign people. But you know, he just
19 got to the podium a moment ago and said, you know, Standard
20 General's claims, those will be easy to look at, but let me
21 list to you the seven first-out lenders, those are going to be
22 real issues. That -- I mean, I take a little bit of exception
23 to that.
24 I mean, for the record, for reorg research, I do want
25 it to be known and clear that there has not been a hint of a

1 whiff of impropriety. And in fact, the seven lenders that I
2 represent, that are the first-out ABL lenders, were secondary
3 market purchasers --
4 THE COURT: The issue --
5 MR. SCHAIBLE: -- of the October debt.
6 THE COURT: Right. Well, I want to touch on that for
7 a second because I don't disagree with that. All right? And I
8 think I've been as clear as I can with no record in front of
9 me. And I mean, I've had cases that come in with all kinds of
10 hair all over them. This is a difficult case, but this doesn't
11 -- this case, at least thus far, does not resonate with the
12 kind of concerns that you're responding to.
13 What I heard more from the committee was a -- sort of
14 an additional point on the lack of clarity into the General
15 Wireless bid, which, again, I've said is something that I'm not
16 blaming them for. But the amount of the credit bid -- again,
17 in a typical case, you know precisely what the credit bid is.
18 Often, there's difficulty and there's a bogey about what the
19 cash figure is or an inventory number or an allocation figure,
20 et cetera, we've all seen that.
21 But this one -- and I, frankly, got a lot of clarity
22 from Mr. Kurtz in the -- in his testimony because, as I said, I
23 look at these, and I think about them, in terms of how I would
24 advise a client. And I will tell you -- and I mean no offense
25 to the debtor -- I read this motion about four times, and then

1 I read his summary of it about three times. I still didn't
2 understand the transaction. I think I understand it now.
3 (Laughter.)
4 THE COURT: But I -- but it is a moving target, in
5 some ways. And that's -- we are where we are.
6 I heard Mr. Kirpalani's comments about the other
7 parties, in part, to be an investigation issue. But I think
8 part of his question was: Tell us what you're bidding. And
9 right now, Mr. Kurtz said, I can speak with confidence that
10 there's a fifty-four-million-dollar credit bid. That is not
11 what the motion says.
12 MR. SCHAIBLE: Right, right. Sure.
13 THE COURT: And if I'm bringing a client in -- Mr.
14 Pitts said it, and I don't think it's a controversial
15 proposition -- I would like to know what I'm -- who I'm bidding
16 against and how much money is on the table.
17 And so leave aside the question of an investigation.
18 We'll come back to that elephant. But is there a mechanic by
19 which -- and this really isn't your issue or your client. But
20 I think Mr. Kirpalani's comments about listing all those folks
21 was to say, I need to know if they've been acquired.
22 MR. SCHAIBLE: Right. Right, right. And I'll tell
23 you, Your Honor, it would -- I would do a disservice to the --
24 because it's so technical, and I'm not sure that it's, frankly,
25 to anyone in the room. They're a very complicated set of

1 documents that I think everyone has that deal with, as you
2 said, the transaction and the October transactions. And I
3 don't, fully, myself understand, sitting here, having been
4 hired just a few days ago, frankly, how they work, such that
5 Standard General may end up, essentially, credit bidding in
6 part some participation from some of the rest of the group.
7 But we hear Your Honor.
8 And the only thing I would say is I have no reason to
9 believe that there's anything untoward about it.
10 THE COURT: Yeah, I don't --
11 MR. SCHAIBLE: It's claims trading --
12 THE COURT: I don't much care.
13 MR. SCHAIBLE: -- and participation.
14 THE COURT: And I don't much care. I just --
15 MR. SCHAIBLE: Right. Heard. Right.
16 THE COURT: I think -- but I think --
17 MR. SCHAIBLE: But we hear --
18 THE COURT: -- you know --
19 MR. SCHAIBLE: We hear --
20 THE COURT: -- people need to know.
21 MR. SCHAIBLE: -- Your Honor, you know, we've taken
22 note, and we will talk with Standard General, and there needs
23 to be more clarity around that, and that's very easy to do.
24 I do think that, in fairness, Mr. Kirpalani was
25 talking about the investigation.

1 THE COURT: That was part of it, too. I agree.
2 MR. SCHAIBLE: And I do think that there -- I do -- I
3 would like us all to be clear on the record that there has not
4 yet been any basis for thinking that there was anything
5 untoward.
6 And I would like to just tell Your Honor -- and again,
7 you'll hear more about it on the 2004 and otherwise. But these
8 were secondary market purchasers.
9 THE COURT: Right.
10 MR. SCHAIBLE: These are not the people doing the
11 October deal; these were people who bought the deal after it
12 was done. So it is important to kind of delineate.
13 So now, on to Your Honor's points. You know, again, I
14 hear you. I'm -- I hear you. We need to fix the interest
15 rate.
16 THE COURT: What is this, therapy?
17 MR. SCHAIBLE: We need to fix the --
18 (Laughter.)
19 MR. SCHAIBLE: Tell me about your hopes and dreams,
20 Your Honor.
21 (Laughter.)
22 THE COURT: It's about my parents.
23 (Laughter.)
24 MR. SCHAIBLE: Me, too.
25 We need to come back. I have seven clients, and I

1 need to talk to them. I hear that the interest rate needs to
2 go down.
3 THE COURT: Uh-huh.
4 MR. SCHAIBLE: I hear that the fees need to go down.
5 THE COURT: Uh-huh.
6 MR. SCHAIBLE: And I hear, and I'm sure that I can
7 represent that the lien on the proceeds of avoidance actions
8 needs to go away. Heard, and we'll do it.
9 I have every assurance that I will be able to -- I
10 don't want to say things like that. I will be strongly
11 recommending to our clients that they accept the interest rate,
12 the prepetition default rate interest rate, so lower it by 200
13 basis points, consider it be done. And the lien on avoidance
14 actions, totally understood. Proceeds on avoidance actions,
15 totally understood.
16 The fee, I feel like we're in a -- you know, in a
17 strange situation here, where it's sort of "Let's Make a Deal."
18 The committee -- you know, I can argue to you why this is an
19 appropriate fee in these circumstances.
20 THE COURT: And I --
21 MR. SCHAIBLE: I hear --
22 THE COURT: And I can hear that, and I'm sure that --
23 MR. SCHAIBLE: Right.
24 THE COURT: -- that you could either present a
25 witness, or Mr. Kurtz has also testified that he understands.

1 MR. SCHAIBLE: Right.
2 THE COURT: I'm not necessarily complaining that 1.25
3 percent as a fee is a crazy number. The difficulty with --
4 that I have is the -- a complete roll-up --
5 MR. SCHAIBLE: Uh-huh.
6 THE COURT: -- for, you know -- again, I don't want to
7 sound like a broken record. But the -- that fee, it's a lot of
8 money in the context of this case.
9 MR. SCHAIBLE: Uh-huh.
10 THE COURT: And I -- it's not that I -- you are sort
11 of in a "Let's Make a Deal" kind of way. I've said before,
12 I've approved fees. I don't have a problem with the 1.25
13 percent. It does seem to me that, presented with this, that a
14 roll-up that contemplates this much additional fee burden on an
15 estate is beyond what I would feel comfortable approving.
16 MR. SCHAIBLE: Understood.
17 THE COURT: I said to Mr. Gordon, you know, this is
18 bankruptcy, DIPs are expensive, people that lend in want
19 compensation and are entitled to protection. Right? I find
20 all of that. All I'm telling you is that this is more than I'm
21 comfortable with.
22 MR. SCHAIBLE: I hear that.
23 THE COURT: And it seems to me that a dialogue ought
24 to be able to resolve that.
25 MR. SCHAIBLE: I hear that. I hear that.

1 THE COURT: Okay.
2 MR. SCHAIBLE: As Your Honor knows, this is a
3 situation where the debtors looked for another loan.
4 THE COURT: Oh, I know.
5 MR. SCHAIBLE: I mean, this is not a -- this is not a
6 great loan for folks to be making, and they are making a loan
7 that they don't love making. And there is a portion -- there
8 is something to that. But we hear the fee needs to be lower
9 than 3.6 million, and I will do my best.
10 THE COURT: Let me ask you, because we're pressing up
11 against time. I am aware from my comments that either the
12 committee would need to confer with its members, or the --
13 counsel would need to confer with clients. And it is my
14 intention that that process occur.
15 And frankly, you are reading me exactly; that, you
16 know, I tried to be as clear about the concerns that I have,
17 and I think that you can convey them with clarity to your
18 clients. And either the matters will be resolved, or I can, I
19 think, readily dispose of them.
20 I would like to hear from anybody -- people have sat
21 patiently, and I don't have a great deal of time right now.
22 But I think I'd like to hear from parties, and then try to
23 figure out how we try to move forward.
24 Mr. Harris, very briefly. And then I'll hear -- Mr.
25 Pollack, don't go far, he won't be long.

1 MR. HARRIS: Thank you, Your Honor. I appreciate Mr.
2 Schaible giving away the collateral from the guy whose
3 testimony said he was completely over-collateralized.
4 From the perspective of those of us who are not, Your
5 Honor, given the markup of the -- well, while the committee's
6 objection took issue with the idea of granting liens on
7 avoidance actions, the markup to the proposed order that they
8 actually attached actually granted those liens, but only to the
9 extent of actual diminution in the value of the collateral
10 during the course of the case. The DIP order that actually has
11 been presented to Your Honor actually tracks that exact
12 language. So the lien on avoidance actions --
13 THE COURT: If limited to the 507(b) structure --
14 MR. HARRIS: Correct, Your Honor.
15 THE COURT: -- is certainly less troublesome.
16 MR. HARRIS: Yeah. So I didn't want Mr. Schaible's
17 giving it away -- he's certainly free to give it away with
18 respect to the ABL guys.
19 (Laughter.)
20 MR. HARRIS: But I had to stand up to say
21 (indiscernible).
22 THE COURT: Yeah.
23 MR. HARRIS: And just on the other issues, Your Honor,
24 quickly. We had put in an objection on the bid procedures and
25 the stalking horse bid. Just very quickly on that. I think

1 we've resolved the issues on our -- on the bid procedures, the
2 way they are playing out. We -- there was a number of things
3 we listed in there in Paragraph 19. I appreciate Mr. Gordon's
4 diligence in working with us to work through those, and I think
5 we've basically resolved those.
6 On the stalking horse piece, Your Honor, I just want
7 to make one thing clear, which is: With all the changes that
8 have been proposed; we've deferred the breakup fee, we're
9 deferring the expense reimbursements, we're deferring all of
10 that, what we're basically down to at this point --
11 THE COURT: Scheduling.
12 MR. HARRIS: -- is a locked-in deal that's got some
13 hair on it. But it gives us a floor bid that the parties can
14 go forward on and deal with in the context of an auction. It
15 does give people something to shoot at.
16 I agree on the credit bid portion. The debtors should
17 be telling people that, if we hit our budget, and the pay-downs
18 on the first lien are what they are, this is what's going to be
19 left to credit bid by the time we get to March 28th. And that
20 should be pretty easily calculable, based upon the budget. And
21 it is something they should clarify.
22 With that, I will pass the podium to the next
23 gentleman.
24 THE COURT: Mr. Pollack.
25 MR. POLLACK: Thank you, Your Honor. David Pollack

1 for landlords of -- noted of record.
2 I don't know if anybody else heard you, Your Honor,
3 but I did hear your shout-out to Hilco. And I'm sure Mr.
4 Fredericks appreciates it. And when you get letters from Great
5 American and SV Capital and the others, I'll be happy to answer
6 them for you.
7 THE COURT: All right.
8 MR. POLLACK: Your Honor, with the change in the dates
9 that Mr. Gordon announced this morning, that settles a lot of
10 the landlord issues. I think, of the thirty-some objections
11 you got to the bid procedures, probably 25 or so were from
12 landlords.
13 There are still some issues, but we tentatively have
14 some new dates for cure objections of March 12th, and for
15 objections to the sale and adequate assurance, of March 19th,
16 which means that we can actually submit them after the bids
17 have come in, and we know who the bidders are.
18 There are still issues of receipt of adequate
19 assurance. We've made that known to Mr. Galardi and to Mr.
20 Foley. And moving forward on this, we, again, urge them --
21 we're not asking for something in the order -- to make sure
22 that we get that information as early as possible. And the
23 same goes to the issue of cures, getting not just the numbers,
24 but if the want to resolve the number issues, getting us the
25 breakdowns that they want from us is very helpful.

1 Your Honor, if I might take one more minute.
2 THE COURT: Sure.
3 MR. POLLACK: I know that Friday seems to be in the
4 offing for lots of different things, as well as for the sale
5 hearing. And I just -- I hesitate to bring this up because Mr.
6 Howley is not here. But I understand that, as of four o'clock,
7 my colleagues who are the auction were still going over the
8 DRA.
9 THE COURT: Uh-huh.
10 MR. POLLACK: That there are significant changes from
11 what we had heard earlier.
12 And I'm told, this morning, when I thought I said that
13 we had not seen the final DRA, I'm told that I said we had not
14 seen a DRA. And some of us did, in fact, see a DRA over the
15 weekend. So I just wanted to clarify that for Your Honor.
16 THE COURT: I understand.
17 MR. POLLACK: But there are issues that are still
18 going on. And I'm not sure where we're going to be on Friday
19 morning. I just wanted to give Your Honor a heads-up about
20 that.
21 THE COURT: Okay.
22 MR. POLLACK: Thank you.
23 THE COURT: Mr. Burke.
24 MR. BURKE: Good afternoon, Your Honor. Michael
25 Burke, Sidley Austin, for AT&T. I'm conscious of the time

1 issue, so I'll try to be brief, Your Honor.
2 Very briefly, our objection is a little bit off the
3 beaten path of what's been discussed today, but I think it has
4 a bit of a heightened alert, based upon the debtors'
5 representations this morning that, as a deal point, Standard
6 General or General Wireless would be assuming the AT&T
7 agreement. We've referenced we don't think it's assumable
8 without our consent.
9 But I just recently was handed a copy of the new APA,
10 and I just want to be certain -- because I'm reviewing it along
11 with the order, at the same time -- that it is contemplated by
12 the debtors that we will get a fair and full opportunity to
13 file an objection. And I think the new deadline is March 13th.
14 So I'm not incorrect, am I right? Am I?
15 MR. GORDON: You are correct.
16 MR. BURKE: Okay. Thanks.
17 Also, I think that the order might have to be modified
18 because, as I read it, objections are limited to cure and
19 adequate assurance of future performance, if the bidder is not
20 -- if the stalking horse purchaser is not the successful bidder
21 under the order, you're only allowed two grounds to object to.
22 So the order would need to be modified a bit, which I presume
23 won't be a problem. We suggested proposed language in the
24 objection.
25 Last item, Your Honor -- and this is -- we discussed

1 this a little bit last time. But it was in the objection about
2 the confidential nature of the AT&T agreement --
3 THE COURT: Uh-huh.
4 MR. BURKE: -- as well as the customer information.
5 Now I presume that, since Standard General is assuming
6 it, that they have been given full access to it. One of the
7 objections was, clearly, that there contains highly sensitive
8 commercial information, trade secrets in this agreement.
9 Again, I presume Standard General has been able to review it,
10 which we would not have -- we would have liked to have been
11 consulted in that regard. But I imagine other bidders now,
12 since it's a part of the APA, would like to see it.
13 We have a lot of issues with that. I don't know if
14 Sprint has seen it already. But we provided some language in
15 the limited objection. I know Mr. Gordon is on a lot of other
16 issues. But quite literally, Your Honor, we can't just allow
17 that contract to be viewed by anyone that just happens to sign
18 a confidentiality agreement. The issue is going to have to be
19 dealt with. We understand the timing of the sale. But AT&T
20 just does not consent to highly commercial -- commercially
21 sensitive information being shared with anyone that signs a
22 confidentiality agreement.
23 THE COURT: I understand.
24 MR. BURKE: Thank you, Your Honor.
25 THE COURT: Thank you.

1 Ms. Kelbon.
2 MS. KELBON: Good afternoon. Regina Stango Kelbon on
3 behalf of Verizon Wireless. I'll try to be very brief because
4 I see we're coming upon the deadline. Your Honor, not to --
5 THE COURT: The deadline was 10 minutes ago.
6 MS. KELBON: Okay. Your Honor, we filed an objection,
7 and I'm sure Your Honor has read it.
8 THE COURT: Yes, I have.
9 MS. KELBON: But we really are focused on the
10 confidential information. And we need protections in the bid
11 procedures order that our contract, our compensation data, and
12 the consumer information, which we -- is all defined as
13 confidential information, not be shared with others --
14 THE COURT: Uh-huh.
15 MS. KELBON: -- without safeguards put in place. We
16 have proposed language to the debtor; the debtor has rejected
17 that language, but said they want to work with us. But we
18 don't want the order entered unless we're protected on that.
19 And so we want all data excluded from the data room until that
20 is resolved or we can get back before Your Honor for a further
21 resolution of that issue. So they are the main issues that we
22 raised.
23 We will be back before you, Your Honor, I think
24 sooner, rather than later, because we do note that we have
25 significant rights: Set-off rights, recoupment rights, and

1 other contract rights. And the sale order proposes to
2 obliterate all of those rights, which we don't believe is
3 appropriate. And we will be back to Your Honor to protect us
4 on those issues, as well.
5 THE COURT: Very good.
6 MS. KELBON: We'll save that for a later day.
7 THE COURT: Thank you.
8 MR. HAZELTINE: Your Honor, William Hazeltine on
9 behalf of certain landlords. Just to follow up on Mr.
10 Pollack's point with respect to adequate assurance.
11 I wasn't precisely sure what day the bid deadline was;
12 I think it was the 16th or the 17th.
13 THE COURT: 17 or 18, I believe.
14 MR. HAZELTINE: 17 or 18? We would prefer 17. And we
15 -- you know, I assume that it -- that they're going to be
16 providing the known landlords with the adequate assurance
17 information, like, you know, hopefully shortly after the bids
18 are received; certainly, the next day, to give us as much time
19 as possible. You know, I understand that the process is moving
20 very fast, and there are many other issues. But certainly, the
21 adequate assurance information is important to us.
22 THE COURT: Okay.
23 MR. HAZELTINE: Thank you, Your Honor.
24 THE COURT: Thank you.
25 Mr. Somerstein? Oh.

1 MR. SOMERSTEIN: And Your Honor, I know you said five
2 o'clock. For the record, Mark Somerstein, Ropes & Gray, for
3 Wilmington Trust, as Trustee.
4 Your Honor, so to try to keep to the deadline, all I'm
5 going to say is I noticed before that maybe you were nodding
6 your head when there was a discussion about the avoidance
7 actions being subject to 507(b). I think the reason for the
8 local rule is that the Chapter 5's give at least some baseline
9 recovery to unsecured creditors.
10 So all I'm going to say in my 30 seconds is that, when
11 you consider this issue, I think, in this case, where you see
12 from the documentation that, at this point, there is zero
13 recovery promised, this is a case where Your Honor should
14 eliminate all avoidance action from secured creditor
15 recoveries. Thank you, Your Honor.
16 THE COURT: I understand.
17 Counsel?
18 MR. GOODING: Good afternoon, Your Honor. Douglas
19 Gooding for the SEP lenders. I'm going to limit my comments
20 just to the issue of the Sprint expense reimbursement.
21 There's no evidence, at this point, that the Sprint
22 agreement has any value to the estate. It was just filed. We
23 have no idea, obviously, how things are going to play out at
24 the auction. If, for example, the highest and best bid at the
25 auction is by the liquidators, the Sprint agreement will have

1 no value to the estate.

2 As a result, the SEP lenders agree with Your Honor's

3 earlier observations that the expense reimbursement issue

4 should be deferred, along with the breakup fee, and be

5 considered at the same time, at a later date.

6 THE COURT: Okay.

7 MR. GOODING: Thank you.

8 THE COURT: Thank you.

9 Yes, sir.

10 MR. SWAN: (Indiscernible) hopefully allowed some

11 overtime as a result of those comments.

12 Sprint has been very engaged in this case. And no one

13 is fighting with us until this little point, but that sort of

14 makes us unique, I think, to this case. We've been engaged

15 with landlords on the potential store within the stores,

16 engaged with General Wireless. Our Alliance deal was filed

17 yesterday. We had the potential to be engaged with competing

18 bidders.

19 The expense reimbursement, Your Honor, we're not,

20 again, seeking a breakup. But the deal was for Sprint to

21 receive an expense reimbursement if the deal is broken, and

22 that was the agreement, that was the deal. It was in the

23 termsheet, it was in the bid procedures motion. No one

24 objected to it. So it's --

25 THE COURT: Was the amount in the motion? What's the

1 amount?

2 MR. SWAN: The amount -- it's an expense

3 reimbursement, so it's --

4 THE COURT: Usually, we try to attach something to it.

5 MR. SWAN: What we can do is we can talk to the

6 committee about capping it, but --

7 THE COURT: Well, let me make -- let me make this

8 observation. First, I don't regard it as remarkable, I don't

9 regard it as particularly controversial. I'm generally aware

10 of where Sprint has been in this dynamic, and it seems to me

11 that it is important to the process, at least thus far. So I

12 don't regard this as something that is controversial.

13 I'm not satisfied that there is enough before me today

14 that I could confidently say that an expense reimbursement in

15 an amount that hasn't been identified for an agreement that was

16 filed last night is appropriate. I don't think that it will be

17 controversial.

18 There are other, more material issues that have been

19 raised with respect to other folks. And you're right, you're

20 getting kind of dragged into it, but not really.

21 MR. SWAN: Well, it is separately identified in --

22 THE COURT: I am aware of that.

23 MR. SWAN: Yeah, okay.

24 THE COURT: Okay? But I'm not comfortable approving

25 that at this stage. I may deal with it on a different time

1 line than the other guys because I think that you are different
2 than the concerns that have been raised with respect to
3 Standard General. Those issues have been -- General Wireless.
4 Those issues have been about, one, the calculation of
5 that, mostly the breakup fee. And second, with respect to
6 General Wireless, you've seen the submissions. The issues are
7 whether or not it's necessary, et cetera, et cetera. I don't
8 know that you are sort of within the ambit of those concerns,
9 so ...
10 But I don't think I'm in a position today to simply
11 bless it, especially where there is no amount. If there's
12 consensus and consent with stakeholders about treatment for
13 Sprint, I'd probably be on board with it, without any
14 heartbeat. If there's opposition, it would probably have to be
15 pretty substantial opposition because I don't think that
16 there's any dispute that you've been actively engaged in the
17 process.
18 MR. SWAN: Yeah, and it took us a little bit by
19 surprise today. Again, it was in the termsheet --
20 THE COURT: Yeah.
21 MR. SWAN: -- it was in the motion --
22 THE COURT: All right.
23 MR. SWAN: -- it was --
24 THE COURT: Okay.
25 MR. SWAN: So ...

1 THE COURT: Okay. All right. I've heard enough.
2 MR. SWAN: Thank you.
3 THE COURT: All right. Here's what we're going to do.
4 I am prepared to approve bidding procedures.
5 The breakup fee, as it relates to General Wireless and
6 Sprint, are not before me today, and will be presented to me at
7 an appropriate time. So I make no comment with respect to the
8 breakup fee and the expense reimbursement, either for Sprint or
9 for General Wireless.
10 I will schedule a sale hearing to occur on the 26th of
11 March. I will look to the parties to confer with respect to an
12 appropriate time line. The time line that was generally
13 described on the record to me was appropriate.
14 With respect to the concerns raised by Verizon and
15 AT&T, I would ask that they confer with the debtor. I believe
16 that there are legitimate confidentiality concerns that have
17 been assiduously or acidulously protected by those folks at
18 hearing after hearing. And it seems to me, again, that this is
19 not the first time that we've dealt with these kind of issues.
20 And so I will be solicitous of their concern.
21 And again, it's my hope and expectation that,
22 particularly when the financial advisors get together with
23 folks from Verizon and AT&T, that they can implement
24 appropriate protections, mechanics for purposes of a data room
25 or otherwise, to resolve their concerns.

1 With respect to the other issues raised by AT&T about
2 assumability of the agreement, et cetera, they're not
3 necessarily before me today, and so those rights are reserved.
4 I'm going to do something I have not done previously,
5 I believe. Generally, when I set bid procedures, my goal is to
6 allow as much certainty, and then to leave it to the auction.
7 So, sometimes, I get requests to say, will you allocate or will
8 you identify. Normally, I will not do that; I leave that to
9 the financial advisors, to earn their pay.
10 In this instance, though, I will at least propose
11 that, if there -- if the calculus of the credit bid remains in
12 flux -- I'm not going to necessarily say "in dispute" -- and
13 that we need a determination of what that amount is, that we
14 could have a further hearing, perhaps at the time of the bid
15 procedures or otherwise. I think we need to fill that in. And
16 again, I'm not saying that there's gamesmanship or anything
17 else going on, but I don't believe that I can fix that number.
18 But I will observe that the request that credit
19 bidding be precluded, and that cash bidding only move forward
20 will be -- is denied. And I will authorize credit bidding,
21 consistent with established practice in this jurisdiction.
22 I have addressed the issue with respect to the closing
23 condition, and that the Court will not reduce the investigation
24 fee -- the investigation time period. But that's a closing
25 condition, and that's an issue that Standard General and

1 General Wireless can consider as they approach the auction, and
2 that the debtor can evaluate as they go through a sale process.
3 And I assume that there will be a dialogue with the committee
4 and with others.
5 With respect to the other concerns about the
6 sufficiency of the process, et cetera, again, it's my
7 expectation that, while we're on an expedited time line, we
8 have now better than a month to get to a sale hearing. And so
9 my concerns with respect to sufficiency of notice and
10 transparency of process, I expect will be cured.
11 I would note, and you probably don't need me to tell
12 you this, but I would note that, if issues remain with respect
13 to transparency, I would ask that you get me on the phone, or
14 that we schedule a prompt hearing. This is a difficult
15 transaction and a difficult case, and I'm sympathetic to the
16 position of all parties. But I don't want to get to a sale
17 hearing and have somebody say, I have been trying for three
18 weeks to get an answer to this question.
19 With respect to the issues raised by Mr. Pollack, some
20 of those relate to issues that are going to be coming up on
21 Friday. The -- Mr. Hazeltine requested that adequate assurance
22 information and related information that would be relevant or
23 important to a landlord be promptly disseminated, and I expect
24 that that will occur.
25 I'm not sure that there are other open issues with

1 respect to the bid procedures. But what I would look to do is
2 ask the parties to memorialize that. If we still have open
3 issues, we can talk about it, either telephonically or
4 otherwise, on Friday morning. I do have the other guys here.
5 But it seems to me most of the other issues should fall into
6 line, consistent with my comments and comments between the
7 parties.
8 As I said previously, it seems to me that this case is
9 appropriate for DIP financing, and that the debtor has carried
10 its burden with respect to the request for financing. I've
11 expressed my concerns with respect to the costs. And Mr.
12 Schaible, I think, you know, clearly grasped that I'm not going
13 to give a number.
14 But to me, when I look at the roll-up, the scope of
15 the roll-up, a full roll-up for relatively nominal additional
16 liquidity is not typical. And in this case, where we're
17 looking at a zero distribution, at least at a projection at
18 this stage, for unsecured creditors, the layering on of those
19 additional fees has been pointed out by the committee, and I
20 find not warranted.
21 A debtor and a lender have a burden to carry with
22 respect to a request for a roll-up. I don't dispute that the
23 debtor has negotiated in good faith and at length, and that
24 alternative financing is not available. So, in that respect, I
25 do find that the debtor has carried its burden for financing.

1 But I believe that the parties, with the comments from the
2 Court today and otherwise, should be in a position to promptly
3 resolve those issues.
4 I make no comment about the avoidance actions issue.
5 That seems to be in live negotiation, and I'll leave that to
6 the parties.
7 But at this point, I am prepared to leave it at that.
8 But I would be prepared to approve and authorize financing on
9 terms that are either consensually achieved between the
10 parties; or, if there are discrete issues that remain, I think
11 I have a handle on them, and if we need to, again, we can talk
12 about them on Friday morning.
13 Mr. Gordon, where does that leave us, besides 10
14 minutes late?
15 MR. GORDON: No, Your Honor, I think, from the
16 debtors' perspective, we're in good shape. I think you
17 basically set the table for us to negotiate the remaining
18 issues. I feel confident that we can do that.
19 The only issue I was raising with my colleagues here
20 was I want to be sure we don't have a lapse in financing before
21 we can get this final order fully negotiated. And I'm
22 confident we will. But I don't have at my fingertips whether
23 there's any kind of sunset on the interim order or not.
24 (Participants confer.)
25 MR. GORDON: Well, we have to change the milestones,

1 but also ...

2 (Participants confer.)

3 MR. TALMADGE: Your Honor, Scott Talmadge from Kaye

4 Scholer, representing the agent on the facility.

5 THE COURT: Can you get to the podium?

6 MR. TALMADGE: Yes, sir.

7 MR. GORDON: Yeah, if we can just get consent to --

8 MR. TALMADGE: It's consented. It's already been --

9 the milestones have already been adjourned through tomorrow,

10 and we'll deal with it in another amendment to documents.

11 THE COURT: Okay.

12 (Participants confer.)

13 MR. TALMADGE: So I think that should cover the -- any

14 lapse in the financing.

15 THE COURT: Okay. The one concern -- and I'm not

16 trying to -- I promise, I'm not trying to drag this out

17 tonight. But I am not available, I am in DC for a two-day

18 seminar that I got out of half of because of you folks.

19 (Laughter.)

20 THE COURT: So I just want to make sure that you will

21 not be able to get an order signed -- well, I can sign certain

22 things remotely, but it -- I don't want a lapse in payroll or

23 anything else. So I need to be sure that people can deal with

24 that; and, if not, I will get you a duty judge. Because we're

25 talking things like stipulations and simple orders.

1 MR. TALMADGE: It can be dealt with, Your Honor.
2 THE COURT: All right. I appreciate that. All right.
3 MR. GORDON: With that clarification, I think we're
4 good.
5 THE COURT: Ms. Meltzer.
6 MS. MELTZER: Sorry, Your Honor. I know you're short
7 for time. I just need to address one administrative issue with
8 you.
9 As Your Honor may be aware, there was a motion filed
10 and a motion to shorten filed by a movant seeking stay relief.
11 THE COURT: Yes.
12 MS. MELTZER: We reached out to counsel to discuss
13 that matter, and I was asked to put on the record that the
14 parties have agreed that that matter will be heard on the 12th,
15 and that objections will be due on the 10th, by 10 a.m. And we
16 just wanted to make Your Honor aware.
17 THE COURT: Very good. That sounds fine.
18 MS. MELTZER: Thank you, Your Honor.
19 THE COURT: All right. I appreciate everyone's
20 patience today. We will stand in recess.
21 COUNSEL: Thank you, Your Honor. Thank you, Your
22 Honor.
23 (Proceedings concluded at 5:10 p.m.)
24 ******

1 CERTIFICATION

2 We certify that the foregoing is a correct transcript

3 from the electronic sound recording of the proceedings in the

4 above-entitled matter prepared to the best of our knowledge and

5 ability.

6

7

8

9 /s/ Coleen Rand February 26, 2015

10 Coleen Rand

11 Cathryn Lynch Renzoni

12 Tracy Gegenheimer

13 Certified Transcriptionists

14 For Reliable

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
RICHMOND DIVISION

In re: THE FREE LANCE-STAR PUBLISHING CO.
OF FREDERICKSBURG, VA, *et al.*,

Debtors.

Case No. 14-30315-KRH
Chapter 11
(Jointly Administered)

MEMORANDUM OPINION

On January 23, 2014 (the "Petition Date"), The Free Lance-Star Publishing Company of Fredericksburg, VA ("The Free Lance-Star") and William Douglas Properties, LLC ("William Douglas" and, together with The Free Lance-Star, the "Debtors") filed voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code. 11 U.S.C. §101 *et. seq.* (the "Bankruptcy Code"). The Debtors' bankruptcy cases are being jointly administered pursuant to the Court's Order of January 30, 2014. The Debtors are continuing to operate their business as Debtors-in-Possession ("DIP") under §§ 1107 and 1108 of the Bankruptcy Code.

The Debtors filed on the Petition Date a Motion to Sell Business Assets and a Motion to Sell Tower Assets[1] (collectively, the "Sale Motions") seeking approval of bidding procedures for an auction of substantially all of the Debtors' assets. On March 10, 2014, the Court entered orders approving the bidding procedures set out in each of the Sale Motions, including the right

[1] The Debtors own and operate four radio stations in addition to its printing and newspaper businesses. The Tower Assets are employed in broadcasting activities associated with the Debtors' operation of its radio business. The Tower Assets include the Tower Parcels and the improvements thereon; certain equipment located on the Tower Parcels; all permits issued to the Debtors relating to the ownership or operation of the foregoing assets; all contracts related to the Tower Assets that are designated to be assumed; any counterclaims, setoffs, or defenses that the Debtors may have with respect to any assumed liabilities designated by the purchaser of the Tower Assets; all of the Debtors' insurance policies insuring the Tower Real Property or the other Tower Purchased Assets, to the extent assignable; all of the Debtors' indemnification rights under or with respect to the Assumed Liabilities or other Tower Purchased Assets; and certain documents relating to the Tower Assets or to the Assumed Liabilities. The Sale Motions included a procedure for a separate sale of the Debtors' Tower Assets, as the Debtors assert that no entity has a lien on or security interest in the Tower Assets.

of DSP Acquisition, LLC ("DSP") to credit bid its claim against the Debtors' assets on which it had valid liens or security interests, as either (i) agreed to by the Debtors, DSP, and the Official Committee of Unsecured Creditors (the "Committee") or (ii) as determined by the Court at a hearing to be held on March 24, 2014.

Also on March 10, 2014, DSP filed a Complaint (the "Complaint") initiating Adversary Proceeding No. 14-03038 (the "Adversary Proceeding"). The Complaint seeks a declaration that DSP has valid and perfected liens on substantially all of the Debtors' assets including the Tower Assets. DSP has also filed a motion seeking summary judgment pursuant to Rule 56(c) of the Federal Rules of Civil Procedure, as incorporated by Rule 7056 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") on all counts set forth in its Complaint (the "Plaintiff's Motion for Summary Judgment"). DSP filed the Declaration of Allyson Brunetti in support of the Complaint and Plaintiff's Motion for Summary Judgment.[2] The Debtors, who are the named defendants in the Complaint, filed their own motion for summary judgment against DSP (the "Defendants' Motion for Summary Judgment" and together with Plaintiff's Motion for Summary Judgment, the "Cross Motions for Summary Judgment").

On March 24, 25, and 31, 2014, the Court conducted an evidentiary hearing (the "Hearing") (i) to determine DSP's right to credit bid its claim against the Debtors' assets in connection with the Sale Motions and (ii) to determine the validity, extent and priority of the liens asserted by DSP in connection with the Cross Motions for Summary Judgment. At the conclusion of the Hearing, the Court ruled that DSP did not have valid, properly perfected liens on the Tower Parcels or the improvements thereon, the other Tower Assets, the FCC licenses, the

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[2] An affidavit or declaration used to support or oppose a motion must be made on personal knowledge, set out facts that would be admissible in evidence, and show that the affiant or declarant is competent to testify on the matters stated. Fed. R. Civ. P. 56(c)(4).

rolling stock, insurance policies, and/or bank accounts. The Court also ruled that 11 U.S.C. § 552 prevented DSP from asserting a lien on any proceeds that may be derived from the disposition of any of the forgoing assets on which it did not have a valid lien as of the Petition Date. Accordingly, the Court denied Plaintiff's Motion for Summary Judgment and granted partial summary judgment in favor of the Debtors on Defendants' Motion for Summary Judgment.[3] The Court ruled that DSP could not credit bid a claim against assets on which it lacked a valid lien or security interest. The Court found that DSP had engaged in inequitable conduct that, under the circumstances, required the Court to limit DSP's credit bid right in order to foster a robust auction. This Memorandum Opinion sets forth the Court's findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.[4]

The Court has subject-matter jurisdiction over the Sale Motions and the Adversary Proceeding pursuant to 28 U.S.C. §§ 157 and 1334 and the general order of reference from the United States District Court for the Eastern District of Virginia dated August 15, 1984. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A), (C), (K), (N) and (O). Venue is appropriate pursuant to 28 U.S.C. § 1409.

Section 363(b)(1) of the Bankruptcy Code provides that a trustee, "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). DSP argues that, as the holder of a secured claim, the Bankruptcy Code gives it the right to credit bid its claim at such a sale. *See* 11 U.S.C § 363(k). The Debtors submit that "cause" exists in this case to limit the credit bid amount. *See id.* DSP, as the entity

[3] *See* Order and Memorandum Opinion of even date in Adversary Proceeding.

[4] Findings of fact shall be construed as conclusions of law and conclusions of law shall be construed as findings of fact when appropriate. See Fed. R. Bankr. P. 7052.

asserting an interest in property of the estate, has the burden of proof on the issue of the validity, priority, or extent of its liens. 11 U.S.C. § 363(p)(2). Because it is the filing of the objection that creates a contested matter under Rule 9014 of the Bankruptcy Rules, the Debtors, as the objecting parties, are treated as the movants and have the burden of proving cause under § 363(k) of the Bankruptcy Code. *See In re DeSoto*, 33 C.B.C.2d 902, 905, 181 B.R. 704, 706 (Bankr. D. Conn. 1995).

As a general rule, a "preponderance of the evidence" standard is appropriate in all bankruptcy proceedings. *Grogan v. Garner,* 498 U.S. 279, 286, 111 S.Ct. 654, 112 L.Ed.2d. 755 (1991); *see, e.g., In re Santaella,* 298 B.R. 793, 799 (Bankr. S.D. Fla. 2002); *see also In re Galanis*, 334 B.R. 685 (Bankr. D. Utah 2005). "Preponderance of the evidence" is the weight accorded to the aggregate evidence on either side. It is synonymous with the term "greater weight of the credible evidence." 30 Am. Jur. 2d Evidence § 1164, at 339 (1967). The Court will apply the "preponderance of the evidence" standard to the issues at bar.

Facts

The Free Lance-Star is a family-owned publishing, newspaper, radio, and communications company located in Fredericksburg, Virginia (the "Company"). William Douglas is a related entity that owns a portion of the land on which The Free Lance-Star operates its business. The Free Lance-Star owns the Tower Assets, which include three parcels of real estate (the "Tower Parcels"). The Tower Assets are the primary focus of the Sale Motions and the Cross Motions for Summary Judgment. The Tower Assets are used predominately in The Free Lance-Star's radio broadcasting operations. The first of the Tower Parcels is located at 122 Mountain Avenue in Stafford County, Virginia. The second of the Tower Parcels is located at 6701 Rumsey Lane in Spotsylvania County, Virginia. The third of the Tower Parcels is located

at 22601 Penola Road in Caroline County, Virginia. Between 1988 and 1998, The Free Lance-Star improved the Stafford County Tower Parcel by constructing a guy wired mast on the property. Towers were already erected on the Spotsylvania County and Caroline County Tower Parcels when the Debtors purchased those properties (collectively, the masts erected on the Tower Parcels, the "Towers").

In 2006, the Debtors developed a plan to expand their commercial printing business. To undertake this expansion, the Debtors borrowed funds from Branch Banking and Trust ("BB&T") in the approximate amount of $50.8 million (the "Loan"). To secure this Loan the Debtors granted liens on, and security interests in, certain of the Debtors' real and personal property. The Debtors did not agree to grant any liens on or security interests in the Tower Assets, nor did BB&T record deeds of trust covering the Tower Parcels. BB&T did not obtain or record any assignment of leases or rents concerning the Tower Parcels. The Credit Agreement makes no reference to granting liens on the Tower Assets, nor does the Security Agreement specifically reference the Tower Assets. It appears that during the time that BB&T held the Loan, BB&T did not record any financing statements perfecting a security interest in any of the Tower Assets.

With the Loan, the Debtors built a state-of-the-art printing facility that began operation in 2009. Construction of the facility coincided with the severe recession that began in December 2007 and ended in June 2009. In early 2009 the Company fell out of compliance with certain of the Loan covenants contained in its Loan agreement with BB&T. In December of 2011, the Company signed a forbearance agreement with BB&T. The Company continued to make timely payments to BB&T even as its revenue declined. Prevailing economic conditions prevented the Company from restructuring its business and becoming compliant with its Loan covenants. The

Company was unsuccessful in its attempts to obtain replacement refinancing. Finally, in late June of 2013, BB&T sold its Loan to Sandton Capital Partners ("Sandton").[5]

On July 3, 2013, Sandton informed the Debtors that it wanted the Company to file a Chapter 11 bankruptcy case and sell substantially all of the Debtors' assets pursuant to 11 U.S.C. § 363. Sandton indicated that it intended to be the entity that purchased the Debtors' assets at the bankruptcy sale. Sandton advised that it would continue to operate the business and that it intended to keep the Debtors' management in place. Thereafter, the Debtors agreed to work on implementing a plan that would involve the Debtors filing a Chapter 11 bankruptcy case and selling all of their assets to DSP pursuant to 11 U.S.C. § 363, so long as it was done in the best interests of the estate, and was within the fiduciary duties of the Debtors' officers and directors.

On or about July 25, 2013, the Debtors received, on behalf of DSP, a request that the Debtors execute three deeds of trust to encumber the Tower Parcels.[6] On or about August 8, 2013, counsel for DSP provided a "Restructuring Timetable" that contained an expectation for the timely recordation of the executed deeds of trust and the commencement of the bankruptcy case in September of 2013. Over the next several days, email correspondence concerning the "Restructuring Timetable" was exchanged between counsel for the Debtors and DSP. Communication between the parties stopped abruptly in mid-August. Unbeknownst to the Debtors, during the several weeks of ensuing silence, DSP unilaterally filed UCC Fixture Financing Statements in Caroline County, Stafford County, and Spotsylvania County. DSP was

[5] Counsel for DSP suggested at the Hearing that DSP is an affiliated entity operated by Sandton Capital Partners and that DSP is now the holder of the Draw Commercial Note dated September 11, 2007, made by the Debtors payable to the order of BB&T in the original principal amount of $45,842,400.00.

[6] These Deeds of Trust sought to expand the scope of the initial Security Agreement entered into between BB&T and the Debtors by granting consensual liens on the Debtors' Tower Parcels and the improvement thereon.

the first entity since the Loan's inception to attempt to perfect a security interest in the Debtors' Tower Assets.[7]

On September 24, 2013, DSP resumed negotiations by providing the Debtors with a revised Forbearance Agreement that did not require that the Debtors execute the deeds of trust. The revised Forbearance Agreement included instead a provision for a blanket release of all claims held by the Debtors against DSP. The Debtors' attempts to limit the blanket release provision to apply only to all known claims were soundly rejected by DSP. DSP explained that the new Forbearance Agreement did not include the additional mortgages and liens on the Tower Assets as DSP expected to pick up that collateral in a DIP post-petition financing order.

Ninety days after DSP had recorded its UCC Fixture Filings, DSP renewed its pressure on the Company for a speedy bankruptcy filing. The Debtors requested a meeting with DSP and its counsel at which a coordinated, global, planned approach for a bankruptcy case could be developed. On December 3, 2013, the Debtors held a phone conference with representatives of DSP. During this meeting, DSP indicated, among other things, that there was no reason to market the Debtors' assets. DSP insisted that the timeframe for conducting a bankruptcy sale of its business, with a credit bid, should be no more than six weeks from petition date to closing. DSP strongly objected to the Debtors' engagement of Protiviti as the Debtors' financial consultant. When Protiviti insisted upon distributing marketing materials in connection with the bankruptcy sales process, DSP required that the marketing materials contain on the front page, in bold font, a statement that DSP had a right to a $39 million credit bid.

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[7] The financing statements purported to perfect a security interest in, among other things, "all machinery, equipment, fixtures, and other property of every kind and nature whatsoever owned by the Debtor . . . located upon the [Tower Parcels]."

The Debtors continued to express a willingness, consistent with their fiduciary responsibilities, to work with their secured lender in order to develop a fair process to market the Company's assets in a manner designed to maximize value for the benefit of the estate as a whole. When Protiviti developed cash flow projections for the Company, which cash flow projections indicated that the Company could survive in bankruptcy without a post-petition DIP loan facility, the relationship between the Debtors and the secured lender turned sour. Counsel for DSP challenged Protiviti's projections as too optimistic. DSP insisted that the Company had to have a new post-petition loan facility made by DSP. Otherwise, DSP would not be able to get the liens it coveted on the Tower Assets. The Debtors refused the new loan and all negotiations between the Debtors and DSP ceased at that point.

On January 11, 2014, DSP contacted counsel for the Debtors and informed them that DSP no longer supported a bankruptcy filing under the terms proposed by the Debtors. DSP advised that it would be suspending all work in connection with the bankruptcy filing. The next week, DSP recorded additional financing statements in various jurisdictions without giving any notice to the Debtors. The Debtors commenced the bankruptcy case without the support of their secured lender.

Following the Petition Date, DSP objected to the Debtors' use of cash collateral. At a contested hearing conducted on January 24, 2014, DSP asked the Court to give DSP new liens on the Tower Assets as additional adequate protection to supplement the post-petition replacement liens and adequate protection payments offered by the Debtors. DSP did not disclose to the Court or the Debtors that it had already recorded financing statements against the Tower Assets in August of 2013 and again in January of 2014. The Court denied DSP's request for the supplemental liens, finding that DSP's interest in cash collateral was adequately protected.

DSP failed to provide any witness at the Hearing to refute the Debtors' allegations that DSP's conduct was inequitable. DSP provided no evidence concerning its acquisition of the BB&T loan. In fact, there is no evidence that DSP is the holder of the Draw Commercial Note dated September 11, 2007, made by the Debtors payable to the order of BB&T in the original principal amount of $45,842,400 (the "Note"). The Court invited DSP to supplement the record with this information and with information about the amount paid for the Loan, but DSP made the calculated decision not to do so. The only witness DSP did provide at the Hearing was found to be not credible. The declaration filed by DSP in support of its Complaint was found to be both false and misleading.[8]

Analysis

A secured creditor should be entitled to credit bid the full amount of its claim at any sale of its collateral outside the ordinary course of the debtor's business. *In re SubMicron Sys. Corp.*, 432 F.3d 448, 459-60 (3d Cir. 2006) (collecting cases and holding that the district court did not err in allowing secured creditors to credit bid the full face value of their claims when the plan administrator sought to limit the secured creditors' credit bids to the economic value of their claims). *See also Suncruz Casinos*, 298 B.R. 833, 838-39 (S.D. Fla. 2003) (stating that a secured creditor may credit bid the full amount of its claim, including any deficiency claim). The right to credit bid is codified in § 363(k) of the Bankruptcy Code which provides:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise, the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

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[8] *See* Order and Memorandum Opinion on Emergency Motion for Reconsideration entered in Adversary Proceeding No. 14-03038.

11 U.S.C. § 363(k).

The right to credit bid under § 363(k) of the Bankruptcy Code is an important safeguard that insures against the undervaluation of the secured claim at an asset sale.[9] Credit bidding "allows the secured creditor to bid for its collateral using the debt it is owed to offset the purchase price[,]" which "ensures that, if the bidding at the sale is less than the amount of the claim the collateral secures, the secured creditor can, if it chooses, bid up the price to as high as the amount of its claim." *Quality Props. Asset Mgmt. Co. v. Trump Va. Acquisitions, LLC,* No. 3:11–CV–00053, 2012 WL 3542527, at *7 n.13 (W.D.V.A. Aug. 16, 2012); *RadLax Gateway Hotel, LLC v. Amalgamated Bank,* 132 S.Ct. 2065, 2070 n.2 (2012) ("The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price [ ]" by enabling the secured "creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan.").

Credit bidding, however, is not an absolute right. *See In re Antaeus Tech. Servs., Inc.*, 345 B.R. 556, 565 (Bankr. W.D. Va. 2005). The Bankruptcy Court in Delaware recently admonished that while "[i]t is beyond peradventure that a secured creditor is entitled to credit bid its allowed claim . . . [t]he law is equally clear, as § 363(k) provides, that the Court may 'for cause order otherwise.'" 11 U.S.C. §363(k). *See, e.g., In re Fisker Auto. Holdings, Inc.*, Case No. 13-13087-KG, 2014 Bankr. LEXIS 230. at *15-17 (Bankr. D. Del. Jan. 17, 2014)*; see also In re Philadelphia Newspapers, LLC,* 599 F.3d 298, 315-316 (3d Cir. 2010). Generally, "a court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."

[9] Section 506(a) of the Bankruptcy Code limits a creditor's allowed secured claim to the value of the collateral.

Philadelphia Newspapers, 599 F.3d, at 316, n. 14. *See also In re Aloha Airlines Inc.,* No. 08-00337, 2009 Bankr. LEXIS 4588, 2009 WL 1371950, at *8 (Bankr. D. Hawaii May 14, 2009); *Greenblatt v. Steinberg,* 339 B.R. 458, 463 (N.D. Ill. 2006); *In re Theroux,* 169 B.R. 498, 499 n. 3 (Bankr. D.R.I. 1994) ("[T]here is no absolute entitlement to credit bid.").

The court in *In re Antaeus Tech. Servs., Inc.* denied the right of a secured creditor to credit bid in order to facilitate a fully competitive auction. *In re Antaeus,* 345 B.R. at 565. The court in *In re Fisker* found "cause" existed under § 363(k) of the Bankruptcy Code where the secured lender had chilled the bidding process by inequitably pushing the debtor into bankruptcy so that it could short-circuit the bankruptcy process. *In re Fisker* at *15-17.

The Debtors in the case at bar urge the Court to find cause exists to limit DSP's credit bid rights. The Debtors advance three reasons for doing so. First, DSP does not have a lien on all of the Company's assets. The Debtors argue that it is axiomatic that a creditor cannot credit bid the economic value of its claim against assets in which it holds no security interest. Second, the Debtors maintain that DSP has engaged in inequitable conduct that has damped interest in the auction and depressed the potential sales price the Debtors' otherwise might have realized from the sale of the the business. Finally, limiting the amount of the credit bid in this case will restore enthusiasm for the sale and foster a robust bidding process. Maximizing the value debtors might be able to realize from the sale of their assets is an important policy advanced by the Bankruptcy Code.

The Court has addressed separately the validity and extent of DSP's liens. The Court has held that DSP does not have a valid perfected security interest in all of the assets upon which it asserts it does. DSP does not have valid, properly perfected liens on, or security interests in, the Debtors' Tower Assets, the Debtors' motor vehicles, the Debtors' FCC licenses, the Debtors'

insurance policies, or the Debtors' bank account deposits. DSP's lien on general intangibles does not give it a lien on the proceeds the Debtors will generate from the bankruptcy sale. The Court has denied Plaintiff's Motion for Summary Judgment and has granted partial judgment on Defendants' Motion for Summary Judgment.[10] DSP does not have a right to assert a credit bid on assets that do not secure DSP's allowed claim.

From the moment it bought the loan from BB&T, DSP pressed the Debtor "to walk hand in hand" with it through an expedited bankruptcy sales process. It was a classic loan-to-own scenario. DSP made no secret of the fact that it acquired the Loan in order to purchase the Company. It planned from the beginning to effect a quick sale under § 363 of the Bankruptcy Code at which it would be the successful bidder for all the Debtors' assets utilizing a credit bid.

The bump in the road occurred in July of 2013, when DSP learned that it did not have a lien on the Debtors' Tower Assets. DSP made the unilateral decision to expand the scope of its security interest when DSP's overt requests for the Debtors to grant such liens on the Tower Assets failed. DSP's protestations to the contrary notwithstanding, DSP knew it did not have a valid lien on the Tower Assets when it filed the Financing Statements. The Court is troubled by DSP's recordation of the UCC Fixture Financing Statements in Stafford County, Spotsylvania County, and Caroline County in August of 2013 and again in January of 2014. The Court is disappointed that DSP neglected to disclose the Fixture Filings at the January 24, 2014, contested cash collateral hearing during which DSP requested the Court to grant it liens on those very assets.[11] DSP pressured the Debtors to shorten the Debtors' marketing period for the sale of its

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[10] *See* Order and Memorandum Opinion of even date in Adversary Proceeding No. 14-03038.

[11] The Court is quite concerned by the false declaration DSP filed in support of Plaintiff's Motion for Summary Judgment in the Adversary Proceeding.

business and to put language in the marketing materials conspicuously advertising DSP's credit bid rights. The Court is equally troubled by DSP's efforts to frustrate the competitive bidding process.

The Court finds that DSP did engage in inequitable conduct. The credit bid mechanism that normally works to protect secured lenders against the undervaluation of collateral sold at a bankruptcy sale[12] does not always function properly when a party has bought the secured debt in a loan-to-own strategy in order to acquire the target company. In such a situation, the secured party may attempt to depress rather than to enhance market value. Credit bidding can be employed to chill bidding prior to or during an auction, or to keep prospective bidders from participating in the sales process. DSP's motivation to own the Debtors' business rather than to have the Loan repaid has interfered with the sales process. DSP has tried to depress the sales price of the Debtors' assets, not to maximize the value of those assets. A depressed value would benefit only DSP, and it would do so at the expense of the estate's other creditors. The deployment of DSP's loan-to-own strategy has depressed enthusiasm for the bankruptcy sale in the marketplace.

The only testimony provided at the Hearing regarding the proposed bidding procedures and auction process was from the Debtors' expert witness, Suzanne Roski ("Roski") from the firm of Protiviti, Inc ("Protiviti").[13] Roski presented evidence at the Hearing that many interested parties have executed nondisclosure agreements. Many of those same parties have visited the data room, which is populated with confidential financial information concerning the

[12] *See In re Philadelphia Newspapers, LLC,* 599 F.3d 298, 315-316 (3rd Cir. 2010).

[13] Protiviti is serving as Debtors' financial advisors in this bankruptcy case pursuant to order of this Court. Counsel for DSP acknowledged during the course of the Hearing that Protiviti is among the best firms in the restructuring world.

Debtors' business, in order to conduct preliminary inquiry in connection with the sale. To date, however, only one party has made a site visit. Numerous parties are awaiting resolution of the credit bid issue before launching advanced due diligence. There is genuine confusion among potentially interested parties over on what assets DSP has a lien and on how the auction process may unfold.

Potential bidders are now less likely to participate in the sale process. Roski testified that under the unique circumstances of this case, limiting DSP's credit bid would help restore a competitive bidding environment and engender enthusiasm for the sale. DSP chose not to present any evidence to refute or otherwise contradict this testimony. The Court can only conclude from the uncontroverted evidence presented that it is necessary to limit DSP from bidding the full amount of its claim against all of the Debtors' assets in order to foster a fair and robust sale.

At the Court's request, Roski testified as to the best procedure for fashioning a competitive auction sale and credit bid price. The Court had concerns about the sensitive nature of this testimony and about the potential for disclosure of confidential business information that might compromise the competitive nature of the auction. Accordingly, the Court ordered the courtroom to be closed to the public for this portion of Roski's testimony. The Court also ordered the transcript of the closed proceeding to be placed under seal.

The methodology Roski employed eliminated the unencumbered assets of the Debtors from the potential credit bid and applied a market analysis to develop an appropriate cap for a credit bid that would foster a competitive auction process. Roski cautioned that the methodology was not intended to present a valuation of the Company or any of its specific assets. The Court is satisfied that Roski's approach was appropriate and that her conclusions were based upon

credible analysis. Given the Court's finding that cause exists under the facts and circumstances presented in this case to limit the amount of DSP's credit bid, Roski's recommendations properly address the Court's concern for fostering a competitive sale while maintaining a fair credit bid amount. DSP failed to provide the Court with any alternative method for limiting the credit bid, and it declined the Courts invitation to provide evidence of the amount it paid for the Loan.

Conclusion

The confluence of (i) DSP's less than fully-secured lien status; (ii) DSP's overly zealous loan-to-own strategy; and (iii) the negative impact DSP's misconduct has had on the auction process has created the perfect storm, requiring curtailment of DSP's credit bid rights. First, the Debtors' business operation necessarily includes unencumbered assets upon which DSP has no lien. The credit bid amount must be configured to prevent DSP from credit bidding its claim against assets such as the FCC licenses that are not within the scope of its collateral pool. Second, DSP's loan-to-own strategy has depressed enthusiasm for the sale in the marketplace. Potential bidders now perceive the sale of the business to DSP as a *fait accompli*. Those parties are not inclined to participate in an auction process. Third, limiting DSP's credit bid will attract renewed interest in the bidding process and will serve to increase the value realized for the assets.

Although DSP has engaged in inequitable conduct, the Court will not extinguish DSP's right to credit bid entirely. But sufficient cause exists for the Court to limit that credit bid amount in order to foster a robust and competitive bidding environment. Accordingly, the Court will sustain the Debtors' objection. DSP's right to credit bid under § 363(k) of the Bankruptcy Code will be limited to $1,200,000 for assets related to the Debtors' radio business on which

DSP has a valid, properly perfected lien and $12,700,000 for assets related to the Debtors' newspaper and printing business on which DSP has a valid, properly perfected lien.[14]

A separate order shall issue.

ENTERED: April 14, 2014

/s/ Kevin R. Huennekens
UNITED STATES BANKRUPTCY JUDGE

ENTERED ON DOCKET
April 14, 2014

[14] For purposes of this decision, the Court has presumed that DSP is the holder of the Note. In order to take advantage of any credit bid, DSP must first provide proof that the Debtors and the Committee agree is sufficient, or if there is a disagreement as to the sufficiency of the proof, proof the Court concludes is sufficient, that it is indeed the lender who holds the Note that gives rise to a credit bid pursuant to 11 U.S.C. § 363(k).

499 F.3d 300
United States Court of Appeals,
Third Circuit.

IN RE: FLEMING COMPANIES, INC., et al., Debtors,
AWG Acquisition LLC; Associated Wholesale Grocers, Inc., Appellants.

No. 05–2365. | Argued: Dec. 12, 2006. | Filed Aug. 22, 2007.

Synopsis
Background: Chapter 11 trustee moved for assumption and assignment of executory supply agreements. The United States Bankruptcy Court for the District of Delaware, 2004 WL 385517, Sue L. Robinson, J., denied motion. Trustee appealed. The United States District Court for the District of Delaware, Sue L. Robinson, Chief Judge, affirmed. Trustee again appealed.

[Holding:] The Court of Appeals, Chagares, Circuit Judge, held that assignment was not permitted, where material and significant term of agreement could not be performed by prospective assignee.

Affirmed.

West Headnotes (11)

[1] **Bankruptcy**
Conclusions of Law; De Novo Review
Bankruptcy
Clear Error
The Court of Appeals reviews the bankruptcy court's findings of fact for clear error, and exercises plenary review over its conclusions of law. 28 U.S.C.A. § 158(a).

1 Cases that cite this headnote

[2] **Bankruptcy**
Scope of Review in General
Because the district court sits as an appellate court in bankruptcy cases, the review by the court of appeals of its decision is plenary. 28 U.S.C.A. § 158(a).

Cases that cite this headnote

[3] **Bankruptcy**
Assumption, Rejection, or Assignment
Provision of Bankruptcy Code allowing trustee to assume or reject any executory contract of debtor permits the trustee to maximize the value of the debtor's bankruptcy estate by assuming executory contracts that benefit the estate and rejecting those that do not. 11 U.S.C.A. § 365(a).

3 Cases that cite this headnote

[4] **Bankruptcy**
Grounds for and Objections to Assumption, Rejection, or Assignment
In determining whether to allow assignment of a debtor's executory contract, the bankruptcy court must be sensitive to the rights of the non-debtor contracting party and the policy requiring that the non-debtor receive the full benefit of his or her bargain. 11 U.S.C.A. § 365(k).

1 Cases that cite this headnote

[5] **Bankruptcy**
Assumption, Rejection, or Assignment
The bankruptcy court can excise or refuse enforcement of terms of an executory contract in order to permit assignment. 11 U.S.C.A. § 365(f)(2)(B), (k).

1 Cases that cite this headnote

[6] **Bankruptcy**
Grounds for and Objections to Assumption, Rejection, or Assignment
In determining whether a term of debtor's executory contract is material and significant, for purpose of motion for assignment of the contract, the focus is placed on the importance of the term within the overall bargained-for exchange; that is, whether the term is integral

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to the bargain struck between the parties, and whether performance of that term gives the non-debtor party the full benefit of his bargain. 11 U.S.C.A. § 365(a), (f)(2)(B), (k).

2 Cases that cite this headnote

[7] **Bankruptcy**
Curing Defaults; Adequate Assurance

What constitutes "adequate assurance of future performance" of an executory contract must be determined by consideration of the facts of the proposed assumption and assignment of the contract. 11 U.S.C.A. § 365(k).

6 Cases that cite this headnote

[8] **Bankruptcy**
Curing Defaults; Adequate Assurance

Provision in executory supply agreement, stating that Chapter 11 debtor would supply wholesale groceries to non-debtor grocery retailer "from its Tulsa Facility" was "material and significant term" of the executory contract, and thus, debtor's rejection of the Tulsa Facility lease at the request of debtor's prospective assignee precluded adequate assurance of future performance by prospective assignee, as required for assignment of the contract; the non-debtor retailer not only bargained for timely delivery and agreed-upon prices, it also bargained for the benefits of expedience of a trained staff, and a proven electronic system of record-keeping, which were only available "from the Tulsa Facility." 11 U.S.C.A. § 365(a, f, k).

3 Cases that cite this headnote

[9] **Bankruptcy**
"Ipso Facto" Clauses

Provisions in executory contracts which are so restrictive that they constitute de facto anti-assignment provisions are rendered unenforceable by bankruptcy provision permitting liberal assignment of executory contracts. 11 U.S.C.A. § 365(f)(1).

Cases that cite this headnote

[10] **Bankruptcy**
Partial Assumption; Burdens and Benefits

If a debtor accepts an executory contract he accepts it cum onere, subject to both the benefits and burdens thereunder. 11 U.S.C.A. § 365(f).

3 Cases that cite this headnote

[11] **Bankruptcy**
Effect of Acceptance or Rejection

An assignment of a debtor's executory contract is intended to change only who performs an obligation, not the obligation to be performed. 11 U.S.C.A. § 365(f)(1).

Cases that cite this headnote

Attorneys and Law Firms

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Before: FISHER, CHAGARES, Circuit Judges, and BUCKWALTER, [*] Senior District Judge.

OPINION OF THE COURT

CHAGARES, Circuit Judge.

This appeal arises out of a bankruptcy involving grocery wholesalers and retailers in the Oklahoma marketplace. The Bankruptcy Court denied a motion for assumption and assignment of an executory contract in favor of Albertson's, Inc. (Albertson's), the nondebtor contracting party. The Bankruptcy Court determined that the proposed assignee, appellants AWG Acquisition LLC and Associated Wholesale Grocers, Inc., (collectively, AWG), could not

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provide adequate assurance of future performance of the contract because an essential term of the contract could not be fulfilled. The District Court affirmed.

We are called upon to decide the narrow question of whether a term relating to the use of a specific facility is material and economically significant to a contract and, if it is, whether AWG's undisputed inability to fulfill the term prevented the assumption and assignment of that contract under ***302** § 365(f) of the Bankruptcy Code, 11 U.S.C. § 365. We will affirm.

I.

The debtor, Fleming Companies, Inc. (Fleming), is a wholesale supplier of grocery products to supermarkets. Albertson's, a supermarket chain, operates more than 2,300 retail grocery stores in the United States. In most cases, Albertson's stores are supplied by warehouse distribution centers that Albertson's owns and operates. In Oklahoma, for example, Albertson's constructed a large distribution facility (the "Tulsa Facility") to supply its stores throughout the Midwest, including those in Oklahoma. After operating at only 60% capacity, however, Albertson's decided to sell the Tulsa Facility. In 2002, Fleming purchased the Tulsa Facility as part of an integrated transaction for approximately $78 million in cash. In return, Fleming received the warehouse, the inventory in the warehouse, and Albertson's agreement to a long-term supply arrangement for its Oklahoma and Nebraska stores.

The supply arrangement was embodied in two independent written contracts executed on June 28, 2002: the Lincoln Facility Standby Agreement (Lincoln FSA) and the Tulsa Facility Standby Agreement (Tulsa FSA). The FSAs set forth the terms and conditions under which Albertson's agreed to purchase groceries and supermarket products from Fleming for its twenty-eight Oklahoma and eleven Nebraska grocery stores. Although the two agreements were nearly identical, Section 1 differed in one important respect pertinent to this appeal. Section 1 of the Lincoln FSA stated:

Section 1: Fleming's Commitment to Supply

> Throughout the Term (as defined below) of this Agreement, Fleming will maintain capital, employees, inventory, equipment, and facilities sufficient to supply food, grocery, meat, perishables and other related products, supplies and merchandise ("Products") as provided in the Special Fleming FlexPro/FlexStar Marketing Plan described below to Albertson's in quantities sufficient to allow Albertson's to purchase the Estimated Purchase Level described in Section 3 of this Agreement.

Appendix (App.) 806. In contrast, Section 1 of the Tulsa FSA read:

Section 1: Fleming's Commitment to Supply

> Throughout the Term (as defined below) of this Agreement, Fleming will maintain capital, employees, inventory, equipment, and facilities sufficient to supply food, grocery, meat, perishables and other related products, supplies and merchandise ("Products") as provided in the Special Fleming FlexPro/FlexStar Marketing Plan described below to Albertson's in quantities sufficient to allow Albertson's to purchase the Estimated Purchase Level described in Section 3 of this Agreement *from the Tulsa Facility.*

App. 836 (emphasis added.)

According to Albertson's, the Tulsa Facility was a key element in the bargain between Albertson's and Fleming. The Tulsa FSA emphasized the importance of a supply of products "from the Tulsa Facility" because the Tulsa Facility contained not only many of its former employees but also the infrastructure created by Albertson's. This allowed Albertson's to continue using its electronic ordering systems and ordering codes for the products supplied under the Tulsa Agreement. The electronic ordering system in place at the Tulsa Facility permitted Albertson's to gather data which it then used to make ***303** marketing and pricing decisions. At the time of the agreement, Albertson's envisioned, and the contract reflects, a seamless supply of products to Albertson's stores. In other words, the parties contracted to limit the economic damage of any disruption in service, recognizing the critical importance of consistency in the competitive grocery industry.

Fleming and Albertson's operated under the FSAs for less than one year before Fleming filed for bankruptcy on April 1, 2003. Throughout that time, Fleming was unable to meet the required service levels. The Tulsa FSA obligated Fleming to maintain a service level of 96% on each category of product, or otherwise be in material breach of the agreement. There were eight categories of products: (1) warehouse grocery; (2) dairy; (3) frozen food products; (4) produce; (5) meat; (6) bakery; (7) deli; and (8) grocery, dairy and frozen warehouse

supplies. Within these broad categories, Fleming supplied more than 2,500 private label products to Albertson's stores. On Albertson's part, the Tulsa FSA required Albertson's to pay Fleming a fixed weekly payment of $210,113 to help Fleming defray the costs of running the Tulsa Facility.

By August 2003, Albertson's stopped ordering grocery products from Fleming and stopped paying the weekly charge. Albertson's switched its source of supply for the Oklahoma market from the Tulsa Facility to its own warehouse in Fort Worth, Texas.

On August 15, 2003, the Bankruptcy Court entered an Order approving the sale of Fleming's assets to C & S Wholesale Grocers, Inc. and C & S Acquisition LLC (collectively, C & S). The Order authorized C & S to designate third-party purchasers for certain assets, included among them the right to acquire Fleming's executory contracts with Albertson's. C & S designated AWG. AWG is a cooperative of independent grocery wholesalers operating in the Midwest from distribution centers in Kansas City, Missouri; Oklahoma City, Oklahoma; Springfield, Missouri; and Ft. Scott, Kansas. In addition, AWG operates retail supermarkets in Tulsa and Oklahoma City through a wholly-owned subsidiary called Homeland Stores, Inc. (Homeland). In some places, Homeland markets are located directly across the street from Albertson's stores. Homeland carries similar products.

On August 23, 2003, Fleming closed the Tulsa Facility and the Lincoln Facility. At about the same time, Fleming rejected its lease for the Tulsa Facility at the direction of AWG. The Bankruptcy Court approved the rejection on September 17, 2003.

On September 3, 2003, Fleming filed a motion to assume and assign the Lincoln FSA and the Tulsa FSA to AWG pursuant to 11 U.S.C. § 365. AWG proposed to supply Albertson's Oklahoma stores from AWG's Oklahoma City distribution center and to supply Albertson's Nebraska stores from AWG's Kansas City warehouse. Albertson's opposed the motion for a variety of reasons, among them that AWG's electronic ordering, billing and inventory systems were not compatible with Albertson's and switching to AWG's system would have been costly and inefficient for Albertson's. According to Albertson's, AWG's deliberate decision *not* to acquire the Tulsa Facility created a real and cognizable economic detriment that contravened the essence of the contract embodied in the term "supply ... from the Tulsa Facility."

The Bankruptcy Court conducted a hearing on the motion for assumption and ***304** assignment.[1] At the hearing, AWG's representatives testified that it was capable of fully performing both the Tulsa FSA and the Lincoln FSA: Albertson's would be able to purchase its products from AWG at the same price and on the same terms that Albertson's expected to receive from Fleming, pursuant to the FSAs, including freight charges.

The Bankruptcy Court granted Fleming's assumption motion as to the Lincoln FSA, but denied the motion as to the Tulsa FSA. The decision regarding the Lincoln FSA is not the subject of this appeal. As for the Tulsa FSA, the Bankruptcy Court held that "fulfillment from the Tulsa Facility is an essential element of the agreement." App. 9. On motion for reconsideration, the Bankruptcy Court reiterated "that shipment from the Tulsa Facility was a material term of the Tulsa Agreement and that adequate assurance of performance of that term had not been proven." App. 18. Fleming and AWG appealed.

The District Court affirmed the decision to deny Fleming's motion for assumption and assignment of the Tulsa FSA. The District Court found no error in the Bankruptcy Court's conclusion that "use of the Tulsa Facility was an essential provision of the Tulsa FSA." App. 47. The District Court also upheld the Bankruptcy Court's determination that "AWG, which had directed the debtors to reject the Tulsa Facility lease, could not fulfill the express requirements of the Tulsa FSA." *Id.* Thus, the District Court concluded that permitting "AWG to supply Albertson's through its own channels of supply would impermissibly modify the terms of the Tulsa FSA." App. 47–48.

This appeal followed.

II.

The Bankruptcy Court exercised jurisdiction over the underlying motion for assumption and assignment of the Tulsa FSA pursuant to 28 U.S.C. § 157(a). The District Court had subject matter jurisdiction over the appeal of the bankruptcy order under 28 U.S.C. § 158(a). We have jurisdiction pursuant to 28 U.S.C. § 158(d).

[1] **[2]** We review the Bankruptcy Court's findings of fact for clear error, and we exercise plenary review over its

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conclusions of law. *Cinicola v. Scharffenberger,* 248 F.3d 110, 115 n. 1 (3d Cir.2001). "Because the district court sits as an appellate court in bankruptcy cases, our review of its decision is plenary." *Id.* (citing *In re Lan Assocs. XI, L.P.,* 192 F.3d 109, 114 (3d Cir.1999)).

III.

A.

[3] **[4]** Section 365 of the Bankruptcy Code generally permits the trustee to assume or reject any executory contract of the debtor. 11 U.S.C. § 365(a). This allows " 'the trustee to maximize the value of the debtor's estate by assuming executory contracts ... that benefit the estate and rejecting those that do not.' " *Cinicola,* 248 F.3d at 119 (quoting *L.R.S.C. Co. v. Rickel Home Ctrs. (In re Rickel Home Ctrs., Inc.),* 209 F.3d 291, 298 (3d Cir.2000)). Upon assuming an executory contract, the trustee is likewise authorized to ***305** assign the executory contract. Section 365 provides in pertinent part:

> (f)(1) Except as provided in subsections (b) and (c) of this section, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.
>
> (2) The trustee may assign an executory contract or unexpired lease of the debtor only if—
>
> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
>
> (B) *adequate assurance of future performance by the assignee* of such contract or lease is provided, whether or not there has been a default in such contract or lease.

11 U.S.C. § 365(f) (emphasis added). The statutory requirement of "adequate assurance of future performance by the assignee" affords "needed protection to the non-debtor party because the assignment relieves the trustee and the bankruptcy estate from liability for breaches arising after the assignment." *Cinicola,* 248 F.3d at 120; 11 U.S.C. § 365(k). While the bankruptcy court has discretion to excise or waive a bargained-for element of a contract, "Congress has suggested that the modification of a contracting party's rights is not to be taken lightly. Rather, a bankruptcy court ... must be sensitive to the rights of the non-debtor contracting party ... and the policy requiring that the non-debtor receive the full benefit of his or her bargain." *In re Joshua Slocum Ltd.,* 922 F.2d 1081, 1091 (3d Cir.1990).

The text of § 365(f)(2)(B) employs the phrase "adequate assurance of future performance" of the contract, but that phrase is not defined in the Bankruptcy Code. As we noted in *Cinicola,* however, the Bankruptcy Code adopted the phrase "adequate assurance of future performance" from Uniform Commercial Code § 2–609(1), which provides that "when reasonable grounds for insecurity arise with respect to the performance of either party, the other may in writing demand adequate assurance of future performance ...." *Cinicola,* 248 F.3d at 120 n. 10 (quoting UCC § 2–609(1)).

[5] It is clear that adequate assurances need not be given for every term of an executory contract. Because the bankruptcy court can excise or refuse enforcement of terms of a contract in order to permit assignment, we must determine what standard applies to evaluate whether excising "supply ... from the Tulsa Facility" would deny Albertson's the full benefit of its bargain. In *Joshua Slocum,* we applied a "material and economically significant" standard to determine whether the Bankruptcy Court had the authority to excise an "average sales" clause in a lease agreement, and then assign the lease to the designated third-party assignee. We concluded there that the clause was "a material and economically significant clause in the leasehold at issue." 922 F.2d at 1092. We found that the Bankruptcy Court did not have authority to excise the relevant provision because the "particular clause [was] of financial import to the landlord in insuring occupancy by high volume sales, viable businesses, thus increasing the rent received under the percentage rent clause." *Id.* As a result, we held that the Bankruptcy Court erred in assigning the lease without the "average sales" clause.

The "material and economically significant" standard we employed in *Joshua Slocum* was derived from a review of case law interpreting § 365 of the Bankruptcy Code which focused on balancing twin concerns: ***306** preventing substantial economic detriment to the nondebtor contracting party and permitting the bankruptcy estate's realization of the intrinsic value of its assets. *See id.* (citing *In re Mr. Grocer, Inc.,* 77 B.R. 349, 354 (Bankr.D.N.H.1987)); *see also In re Carlisle Homes, Inc.,* 103 B.R. 524, 538 (Bankr.D.N.J.1988) (recognizing § 365's attempt "to strike a balance between two sometimes competing interests, the right of the contracting nondebtor to get the performance it bargained for and the

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right of the debtor's creditors to get the benefit of the debtor's bargain. Nowhere is the tension between these interests, and the difficulty in striking the balance, more apparent than in trying to determine whether there is the requisite adequate assurance of future performance.") (quotation marks and alterations omitted).

Neither AWG nor Albertson's disputes the essence of the "material and economically significant" standard or its applicability in this context. Under AWG's understanding of *Joshua Slocum,* however, an assignee must only give adequate assurance of future performance of the "economically material" terms of the contract. AWG argues that shipment "from the Tulsa Facility" is not such a term given that AWG can supply groceries to Albertson's at the same price and on the same payment terms as had Fleming. According to AWG, the Tulsa Facility is merely a warehouse with nothing unique about it. Albertson's bargained to buy $1.155 billion of groceries and supermarket products (of a type and quality) for a certain price (including freight) to be timely delivered to Albertson's Oklahoma stores. As long as Albertson's receives groceries on those bargained-for terms, AWG contends, it does not matter from where those groceries are supplied. Finally, AWG argues that Albertson's failed to provide any evidence that it would suffer economic harm if supplied from AWG's Oklahoma City facility. Therefore, AWG argues that "supply ... from the Tulsa Facility" is not an economically material term, and AWG's performance from its Oklahoma City facility should not preclude assignment of the Tulsa FSA to AWG.

[6] We disagree. AWG misconstrues the *Joshua Slocum* standard. The resolution of this dispute does not depend on whether a term is "economically material." Rather, the focus is rightly placed on the importance of the term within the overall bargained-for exchange; that is, whether the term is integral to the bargain struck between the parties (its materiality) and whether performance of that term gives a party the full benefit of his bargain (its economic significance). *See* *Joshua Slocum,* 922 F.2d at 1092 (concluding that "average sales" provision of lease which permits either landlord or tenant to terminate the lease after either three or six years if annual sales are below a certain level is "material in the sense that it goes to the very essence of the contract, i.e., the bargained for exchange"); *In re E–Z Convenience Stores, Inc.,* 289 B.R. 45, 51–52 (Bankr.M.D.N.C.2003) (holding that right of first refusal is a material and bargained-for element of the lease which is economically significant to nondebtor party to lease); *In re New Breed Realty Enter. Inc.,* 278 B.R. 314, 324–25 (Bankr.E.D.N.Y.2002) (holding breached "time is of the essence" clause is material aspect of agreement based upon agreement's unequivocal statement and state law); *In re Southern Biotech, Inc.,* 37 B.R. 311, 317 (Bankr.M.D.Fla.1983) (barring assumption of contract by trustee, involving sale of plasma from blood collected by inmates, where contract required that collection be conducted in accordance with "good and sound medical practice" and trustee could not provide such adequate assurance).

***307** A "time is of the essence" clause is similar to "supply ... from the Tulsa Facility" in the sense that it is not inherently material or obviously economic, but such a term can be integral to a contract, and certainly, delay can cause economic detriment. *See* *New Breed,* 278 B.R. at 322–25 (noting that a party's failure to perform by the date specified is a material breach of an agreement where both parties agreed to include "time is of the essence" provision in the contract). Likewise, "supply ... from the Tulsa Facility" does not have manifest material and economic significance. However, because the Tulsa FSA arose from Fleming's acquisition of the Tulsa Facility, it is clear that the parties considered supply from that facility to be "material" in the sense that the express condition was an integral part of the agreement. Moreover, not utilizing the Tulsa Facility would burden Albertson's in an "economically significant" way—that is, Albertson's would not reap the benefit of its bargain. Not only did Albertson's expect timely delivery of foodstuffs at agreed-upon prices no matter where product was purchased or shipped, but it also bargained for the benefits of expedience, of a trained staff, a consistent supply of products, and a proven electronic system of record-keeping which furthered Albertson's marketing and pricing plans, all of which were only available "from the Tulsa Facility."

[7] Our analysis does not end here. We must also consider the rights of AWG and Fleming's creditors to get the benefit of the bargain Fleming struck with Albertson's. *See* *Joshua Slocum,* 922 F.2d at 1092. " 'Adequate assurance of future performance' are not words of art; the legislative history of the [Bankruptcy] Code shows that they were intended to be given a practical, pragmatic construction.... What constitutes 'adequate assurance of future performance' must be determined by consideration of the facts of the proposed assumption." *Cinicola,* 248 F.3d at 120 n. 10 (quotation marks and alterations omitted). Here, the record reflects and our review confirms that AWG could not provide the same benefits to Albertson's as were available from Fleming, due

to the fact that Fleming rejected the Tulsa Facility lease at AWG's behest. AWG has not pointed to any evidence on appeal that would lead to an opposite conclusion. On balance, considering the right of Albertson's to expect their foodstuffs to be "suppl[ied] ... from the Tulsa Facility" and the rights of AWG and Fleming's creditors to get the benefit of a supply contract, we conclude that the scale tips in favor of Albertson's.

[8] Accordingly, we hold that "supply ... from the Tulsa Facility" is both a material and an economically significant term of the contract, and AWG, by its own actions, cannot give adequate assurance of performance.

B.

[9] AWG further argues that designating "from the Tulsa Facility" as a material term effectively transforms the term into a *de facto* anti-assignment provision. The Bankruptcy Code expressly permits assignment of executory contracts even when contracts prohibit such assignment. 11 U.S.C. § 365(f)(1). Section 365(f)(1) is not limited to explicit anti-assignment provisions. Provisions which are so restrictive that they constitute *de facto* anti-assignment provisions are also rendered unenforceable. *See In re Rickel Home Ctrs.,* 240 B.R. 826, 831–32 (D.Del.1999) (citing *Joshua Slocum,* 922 F.2d at 1090). Neither Albertson's nor Fleming could operate the Tulsa Facility profitably. According to AWG, reading the Tulsa FSA to require a buyer to acquire the Tulsa Facility ***308** limits the scope of potential buyers in that sale to either an existing wholesaler in the region who does not have its own distribution center or to a new entrant into the marketplace seeking to acquire both the Tulsa FSA and the distribution center. C & S, the high bidder on Fleming's assets, was unwilling to commit to taking the Tulsa Facility, in part because both Albertson's and Fleming were unable to operate the facility successfully. Therefore, AWG contends that to require shipment from the Tulsa Facility is to burden an assignee with a heavy economic obligation, thus constituting a *de facto* anti-assignment provision.

[10] Section 365(f) requires a debtor to assume a contract subject to the benefits and burdens thereunder. *In re ANC Rental Corp.,* 277 B.R. 226, 238 (Bankr.D.Del.2002). "The [debtor] ... may not blow hot and cold. If he accepts the contract he accepts it *cum onere.* If he receives the benefits he must adopt the burdens. He cannot accept one and reject the other." *In re Italian Cook Oil Corp.,* 190 F.2d 994, 997 (3d Cir.1951). The *cum onere* rule "prevents the [bankruptcy] estate from avoiding obligations that are an integral part of an assumed agreement." *United Air Lines, Inc v. U.S. Bank Trust Nat'l Ass'n (In re UAL Corp.),* 346 B.R. 456, 468 n. 11 (Bankr.N.D.Ill.2006).

[11] Applying this precept to our determination above that "supply ... from the Tulsa Facility" is a material term of the contract, we reject AWG's argument that the term operates as a *de facto* anti-assignment provision. We recognize that a fine line exists between reading a contractual term as a burdensome obligation or as a *de facto* restriction on assignment. However, we draw the line where a party refuses to accept part of the contract's obligations, and as a result it cannot perform a material bargained-for term of the contract. Here, AWG rejected the Tulsa Facility lease, and now complains that it is impossible to comply with an integral term of the contract. This term could have been performed by some party. It is not now an anti-assignment provision simply because AWG made the decision not to take on a necessary burden. As we have previously expressed, "[a]n assignment is intended to change only who performs an obligation, not the obligation to be performed." *Medtronic AVE., Inc. v. Advanced Cardiovascular Sys., Inc.,* 247 F.3d 44, 60 (3d Cir.2001) (quotation marks omitted).

IV.

We conclude that "supply ... from the Tulsa Facility" is a material and economically significant term which AWG cannot perform because it has rejected the lease for the Tulsa Facility. The inability to perform this aspect of the agreement precludes the assignment of the Tulsa FSA to AWG. Accordingly, we will affirm the District Court's judgment.

Parallel Citations

48 Bankr.Ct.Dec. 188, Bankr. L. Rep. P 80,996

Footnotes

* The Honorable Ronald L. Buckwalter, United States District Judge for the Eastern District of Pennsylvania, sitting by designation.

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1 Albertson's filed a cure claim against Fleming as a result of Fleming's purported material breaches of the Tulsa and Lincoln FSAs. However, at a hearing before the Bankruptcy Court on December 4, 2003, Albertson's voluntarily withdrew the cure claim with prejudice and agreed to proceed solely on the issue of whether, as a matter of law, the Tulsa and Lincoln FSAs could be assumed and assigned.

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bill forward despite the President's plan. Senator ENZI's unwavering commitment in this area is unparalleled. I hope that the administration understands that our decision to make this the first major piece of education legislation that we take up this Congress is reflective of our unwavering commitment to career and technical education. We will not let this program fall by the wayside. Perkins will not be eliminated.

We often hear the pledge that we will leave no child behind. May I suggest that we also make every effort to ensure that we leave no career and technical education student behind? Passage of these important provisions today will go a long way toward ensuring that career and vocational education students are not left behind in the classroom, that they are being held to high academic standards, that their teachers are provided with the training they need to keep up to date with the latest industry needs, and that high schools, industry and higher education work seamlessly together to provide our workforce with the skills that they need to maintain America's economic dominance in the 21st century.

Career and vocational programs are an essential part of keeping students in school and helping our Nation train its workforce. I am confident that this bill will go a long way in helping another generation of Americans succeed, and, in doing so, strengthen our economy.

Mr. KENNEDY. Mr. President, I will be glad to yield back my time.

Mr. ENZI. I yield back my time.

Mr. KENNEDY. I ask for the yeas and nays.

The PRESIDING OFFICER. Is there a sufficient second?

There appears to be a sufficient second.

The yeas and nays were ordered.

The PRESIDING OFFICER. Under the previous order, the committee substitute is adopted and the bill will be read a third time.

The committee amendment, in the nature of a substitute, was agreed to.

The bill was ordered to be engrossed for a third reading and was read the third time.

Mr. ENZI. I suggest the absence of a quorum.

The PRESIDING OFFICER. The clerk will call the roll.

The legislative clerk proceeded to call the roll.

Mr. ENZI. Mr. President, I ask unanimous consent that the order for the quorum call be rescinded.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. ENZI. Mr. President, I ask unanimous consent that the next series of votes begin at 4:30 p.m. today.

The PRESIDING OFFICER. Without objection, it is so ordered.

Mr. ENZI. For the information of my colleagues, the next vote, which will begin at 4:30 p.m., will be on passage of the Perkins vocational education bill which was just debated, to be followed by a series of rollcall votes on the remaining amendments to the bankruptcy bill, to be followed by final passage. That means there could be up to seven rollcall votes in this next series of consecutive rollcall votes. Once again, we urge Members to stay close to the Chamber during these votes to avoid missing any.

I yield the floor and suggest the absence of a quorum.

The PRESIDING OFFICER. The clerk will call the roll.

The assistant legislative clerk proceeded to call the roll.

Mr. HATCH. Mr. President, I ask unanimous consent that the order for the quorum call be rescinded.

The PRESIDING OFFICER. Without objection, it is so ordered.

BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005—Continued

Mr. HATCH. Mr. President, I rise today to speak in favor of S. 256, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and to thank all of the people who made this bill possible. This bankruptcy bill has been a long time coming. We all know how bankruptcy claims have skyrocketed since the last major bankruptcy reform bill in 1978. We all know about the abuses of the system.

Well, that is about to change for the better. This bill is about fairness and accountability. We have made some important changes in this legislation. This bill contains a debtor's bill of rights with new protections that prevent bad actors from preying upon the uninformed.

The bill also includes new consumer protections under the Truth in Lending Act, such as new required disclosures regarding minimum monthly payments and introductory rates for credit cards. It protects consumers from unscrupulous creditors, with new penalties on creditors who refuse to negotiate reasonable payment schedules outside of bankruptcy.

S. 256 provides for protection of educational savings accounts, and it gives equal protection for retirement savings in bankruptcy. It helps women and children by providing a comprehensive set of protections for child and domestic support throughout the bankruptcy process.

This legislation dramatically revises the reaffirmation agreement provisions of the Code. It imposes critical disclosure requirements that will put a stop to abusive practices. It makes the provisions relating to farmers in chapter 12 permanent and broadens its provisions. It cleans up the law governing complex exchanges and thereby reduces systemic risk in our marketplace. It acts to stop abuse.

When this bill hit the floor on Monday, February 28, I mentioned that we were in the last leg of a legislative marathon. The finish line is finally in sight. I am pleased to have been a part of this process and I am even more pleased we are able to pass this important legislation, and I anticipate that it will pass shortly. This bill has been a long time in development. I am proud of what we have been able to accomplish. Today it seems it is finally going to cross the finish line, and it is well worth it.

This bill may not lead to a severe reduction in the number of bankruptcies. I believe, though, that it will reduce the number of fraudulent and abusive filings and help educate consumers to keep their financial houses in order. This is always an important goal. No responsible society can long countenance the open flouting and abuse of its laws.

This bill, with its means test, will discourage such abusive filings by restricting access to chapter 7 liquidation by those with relatively high incomes. We should all stand behind a law that requires people with the ability to repay their debts to actually repay those debts.

Most of our debate on this bill has focused around the means test. There is no doubt that this will discourage some bankruptcy filings, but I also hope our credit counseling provisions will work to persuade even some low-income debtors that there is another way out.

Right now, too many are only hearing one part of the story: Declare bankruptcy. Liquidate your debts. Some attorneys pushing this line, however, leave out the part about the years of ruined credit that result, the inability to get a car loan or a house loan. My hope is our modest credit counseling provisions will persuade some people to stay out of bankruptcy and meet their obligations, do what is right, and keep their credit alive.

While a great majority of Senators support this bill, I know not all of my colleagues are pleased. Last night my friend from Massachusetts, Senator KENNEDY, again voiced his strong opposition to this legislation. This was probably clear from my response. I vehemently disagree with his opinions about this bill, but I hope he understands that we are trying our best.

Could we have done better? I have no doubt about that, not for a second, but I also know this bill has benefitted from some of Senator KENNEDY's suggestions over the years. We have not ignored him, and I hope he understands we appreciate his participation.

I also understand some of my colleagues feel that they may not have been treated fairly in this process. My desire throughout this process, and the desire of my colleagues who supported this bill, was always to act as an honest broker who took the suggestions of the other side with appropriate seriousness. I understand the frustration from some on the other side at the inability to get amendments agreed to or considered on the floor, but I hope they in turn can understand that we have tried our best on this side to balance all of the competing interests in this body

while also trying to get this very important bill done.

In particular, I think we could have done a better job of working through the technical amendments offered by Senator FEINGOLD. Truth be told, I do not think all of these amendments were merely technical amendments. Be that it as it may, Senator FEINGOLD had a right to submit his amendments at the committee and then on the floor. Perhaps the consideration of the Feingold amendments would have been more complete if we had all focused on these proposals earlier in this debate. I fully respect the right of the distinguished Senator from Wisconsin to offer his amendments, even if we know he is opposing the underlying bill, which he always has. Getting all the parties on board is an uphill climb.

I was given the assignment by Chairman SPECTER to try to get this bill reported by the last recess. We accomplished that goal. In that process, I know Senator FEINGOLD feels he did not get a fair hearing in the committee. I hope the final outcome today persuades him otherwise.

For my part, I instructed my staff to meet with the staff of the distinguished Senator from Wisconsin after the markup. Our staffs met on a number of subsequent occasions. We were able to work out several agreements. Frankly, I was sympathetic to several features of other of his amendments. As we all recognize, proposing an amendment is much easier than getting an agreement on an amendment. I want him to know that we tried.

In discussions with the sponsor of the bill, Senator GRASSLEY, the chairman of the Judiciary Committee, Senator SPECTER, our leadership, Senator SESSIONS, who has played a significant role on this bill and others, we had to make a number of determinations over what amendments to support and what to exclude from the bill. These were not easy decisions, and sometimes they had to be made in conjunction with leaders in the House of Representatives, which is not unusual. We do try to work with them, if we can. In this case, I think we have been working with them.

We could not accept all of Senator FEINGOLD's amendments. I think he probably knows that, too. Our staffs made the effort to work through both the substance and the politics of the issues, and these consultations have borne some fruit. That is important to state, because I do not want my colleague to feel badly or feel he has not been treated fairly. I wish we could have found still more common ground, but after consulting with and facilitating consultations between Senator FEINGOLD's staff and my staff and other Senate staff, we at least made some progress.

I thank and congratulate Senator GRASSLEY, the prime sponsor of this bill over the last 8 years. He has worked extraordinarily hard on this bill. It has been a long time in coming. My hat, as usual, is off to him. Senator SESSIONS is another Senator whose hard work made this possible. We all appreciate his work in the committee and on the floor during the last few weeks.

I would also thank the majority leader, Senator FRIST, and the majority whip, Senator MCCONNELL, and the chairman of the Judiciary Committee for their efforts on behalf of this legislation. Chairman SPECTER has been here working hard for the people of Pennsylvania only days after his cancer treatments, and that is not easy to do, and certainly not easy since he has a continuation of those treatments. He is a heroic figure, in my eyes, for the way he has handled himself in this very difficult time.

I must also thank Chairman SHELBY, and Senator SARBANES of the Banking Committee. We all know how vital the Banking Committee was to this process. We could not have gotten this done without their help.

I believe that several Senators from across the aisle deserve recognition as well. I want to once again thank the Minority Leader, Senator REID, and the Minority Whip, Senator DURBIN, for helping to move this bill through the Senate.

Senators BIDEN and CARPER have worked tirelessly for years on this legislation, and they have taken some tough votes to get it done. Senator NELSON from Nebraska has also shown great resolve and deserves recognition for his efforts, particularly with respect to the provisions affecting farmers. Senator JOHNSON has also been committed to this legislation and I thank him.

No thank you list would be complete without the Senator from Vermont. My dear friend Senator LEAHY and I have not always agreed on every aspect of this legislation, but we have worked hard to make it better. Senator LEAHY developed two important amendments that were accepted. Similarly, Senator FEINGOLD—who has been an ardent opponent of this legislation—has nevertheless dedicated himself to improving it. I have enjoyed working with him, and several other Democratic members of the Judiciary Committee over the years—including Senators FEINSTEIN, KOHL, KENNEDY, SCHUMER and DURBIN—to get this bill done.

I would also like to take a moment to thank all of the staff who worked so hard to make this happen. I know that several of them—on both sides of the aisle—have not seen their significant others in weeks. We owe them a great debt of gratitude. If my colleagues would permit me, I would like to name a few of them.

I think the record should reflect that Rene Augustine, a former counsel now at home with her new-born child, and Makan Delrahim and Manus Cooney, both former Judiciary Committee Chief Counsels, worked for years on this legislation and it would not have been possible but for their efforts. Similarly, John McMickle, a former staffer of Senator GRASSLEY who worked on this bill while he was in the Senate, has taken an enormous amount of time away from his young children to help on this project.

For staff who still work here, I think that Senator GRASSLEY'S chief counsel, Rita Lari-Jochum, should be singled out for her hard work and dedication to this bill. She has helped manage this process over the last several weeks, and she has done a fantastic job. Similarly, Mike O'Neill, Judiciary Committee Chief Counsel, and Harold Kim, Chief Civil Counsel, have done an outstanding job—as have the whole Judiciary team. There are several new counsels in that office that were thrown into the crucible in their starting weeks. First with class action, and now with bankruptcy. The record should reflect the professionalism and excellence with which Ivy Johnson, Tim Strachan, Ryan Triplette, Hannibal Kemmerer, and Nathan Morris have conducted themselves. They are a fantastic group.

In Senator SESSIONS office, no one could overlook his chief counsel, William Smith, or his deputy chief counsel Cindy Hayden. Amy Blakenship and Wendy Fleming also with Senator SESSIONS, did a great job as well. They all did wonderful job.

In the Majority Leader and Majority Whip's office, Eric Ueland, Sharon Soderstrom, and Allen Hicks led the team. John Abegg in Senator MCCONNELL'S office, proud father of a baby girl born on the day this bill hit the floor, nevertheless managed to get the job done. Kyle Simmons, Brian Lewis, and Malloy McDaniel all worked vigorously to plan and manage the strategy and votes on amendments. Stephen Duffield and his team at the R.P.C. has also provided timely and accurate information on the bill on a daily, and when needed, hourly, basis.

As my colleagues all know, the Banking Committee played an important role in this process. Senator SHELBY is fortunate to have people like Kathy Casey, Doug Nappi and Mark Oesterle working for him.

I would also like to thank the House Judiciary Committee staff—they have been an invaluable resource and we would not have been able to get this done without them. As always, Phil Kiko provided a steady hand steering important legislation. Susan Jensen is a treasure trove of information and she has devoted herself to this endeavor. Stephanie Moore and Perry Applebaum of Representative CONYER's office, I am sure will help the legislation move through the House.

The hardworking people in the legislative counsel's office have also undertaken a Herculean effort and flourished in the process. I believe that 125 amendments were filed on this bill, and that does not include the 50 or so that we had in Committee. That is a lot of drafting of complex legislation and we all owe Bill Jensen, Matt McGhie and Amy Gaynor our thanks for their contributions during this long trip. I

would add Bob Schiff of Senator FEINGOLD'S staff, who worked to make this a better bill. It is a pleasure to work with him and he is someone we respect. I wish we could have done more for him and his great boss. We have done the best we can.

Finally, on my own staff, Bruce Artim, Kevin O'Scannlain, Perry Barber and Brendan Dunn all worked very hard on this legislation.

My personal executive assistant, Ruth Montoya, has put up with an awful lot over these last few weeks, and I appreciate her as well as my chief of staff Trish Knight, and Susan Cobb and the many others who literally have worked so hard to help me over these last several weeks—frankly, over the last many years. I know there are many others I have not been able to recognize, and they should all know what a wonderful job I believe they have done. I believe we have an important achievement with this bill, and I think it is only a matter of time until we get this bill passed on the floor, which will be a good end.

Mr. President, the bankruptcy legislation cures some abuses in the Bankruptcy Code regarding executory contracts and unexpired leases.

One provision, Section 404(a) of the bill, amends Section 365(d)(4) of the Bankruptcy Code. Presently, Section 365(d)(4) provides a retail debtor 60 days to decide whether to assume or reject its lease. A bankruptcy judge may extend this deadline for cause—and therein is the problem. Some experts believe that too many bankruptcy judges have allowed this exception essentially to eliminate any notion of a reasonable and firm deadline on a retail debtor's decision to assume or reject a lease. Some bankruptcy judges have been extending this deadline for months and years, often to the date of confirmation of a plan.

This situation can be troublesome. For example, a shopping center operator is a compelled creditor. It has little if any choice but to continue to provide space and services to the debtor in bankruptcy. Yet, the current Code permits a retail debtor as long as years to decide what it will do with its leases. Coupled with the increased use of bankruptcy by retail chains, the Bankruptcy Code is seen by some to be tipped unfairly against the shopping center operator.

Some stores curtail their operations or go dark, and still the lessor cannot regain control of its space.

This legislation, like the conference report in the last two Congresses, acts to curb this abuse. It imposes a firm deadline on a retail debtor's decision to assume or reject a lease. It permits a bankruptcy trustee to assume or reject a lease on a date which is the earlier of the date of confirmation of a plan or the date which is 120 days after the date of the order for relief. A further extension of time may be granted, within the 120 day period, for an additional 90 days, for cause, upon motion of the trustee or lessor. Any subsequent extension can only be granted by the judge upon the prior written consent of the lessor: either by the lessor's motion for an extension, or by a motion of the trustee, provided that the trustee has the prior written approval of the lessor. This is important. We are limiting the bankruptcy judges' discretion to grant extensions of the time for the retail debtor to decide whether to assume or reject a lease after a maximum possible period of 210 days from the date of entry of the order of relief. Beyond that maximum period, there is no authority in the judge to grant further time unless the lessor has agreed in writing to the extension.

Retail debtors filing for bankruptcy will undoubtedly factor into their plans this new deadline. Most retail chains undertake a careful review of their financial condition and business outlook before they file for bankruptcy. They will already have an understanding of which leases are ones they wish to assume and which ones they wish to dispose of. The legislation gives them an additional 120 days to decide on what to do with their leases, once they file for bankruptcy. Beyond that 120 day time period, an additional 90 days can be granted for cause. A further extension may be negotiated by the retail debtor and the lessor if circumstances warrant, and any such extension can be granted by a judge only with prior written consent of the lessor. Further, a lessor's prior written approval of one such extension does not constitute approval for any further extensions—each such extension beyond the 210-day period requires the lessor's prior written approval.

The bill in Section 404(b) also amends Section 365(f)(1) of the Bankruptcy Code to make sure that all of the provisions of Section 365(b) of the code are adhered to and that 365(f) of the code does not override Section 365(b).

This addresses another problem under the Bankruptcy Code. The bill helps clarify that an owner should be able to retain control over the mix of retail uses in a shopping center. When an owner enters into a use clause with a retail tenant forbidding assignments of the lease for a use different than that specified in the lease, that clause should be honored. Congress has so intended already, but bankruptcy judges have sometimes ignored the law.

Congress made clear, in Section 365(b)(1) and 365(f)(2)(B), that the trustee may assume or assign an executory contract or unexpired lease of the debtor, only if the trustee gives adequate assurance of future performance under the contract or lease.

In Section 365(b)(3), Congress provided that for purposes of the Bankruptcy Code:

adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—

(A) of the source of rent and other consideration due under such lease, and in the case of an assignment, that the financial condition and operating performance of the proposed assignee and its guarantors, if any, shall be similar to the financial condition and operating performance of the debtor and its guarantors, if any, as of the time the debtor became the lessee under the lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease is subject to all provisions thereof, including (but not limited to) provisions such as a radius, location, use, or exclusivity provision, and will not breach any such provision contained in any other lease, financing agreement, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt any tenant mix or balance in such shopping center.

Congress added these provisions to the Code in recognition that a shopping center should be allowed to protect its own integrity as an ongoing business enterprise, notwithstanding the bankruptcy of some of its retail tenants. A shopping center operator, for example, must be given broad leeway to determine the mix of retail tenants it leases to. Congress decided that use or similar restrictions in a retail lease, which the retailer cannot evade under nonbankruptcy law, should not be evaded in bankruptcy.

It is my understanding that some bankruptcy judges have not followed this Congressional mandate. Under another provision of the Code, Section 365(f), a number of bankruptcy judges have misconstrued the Code and allowed the assignment of a lease even though terms of the lease are not being followed. This appears to ignore Section 365(b)(3).

For example, if a shopping center's lease with an educational retailer requires that the premises shall be used solely for the purpose of conducting the retail sale of educational items, as the lease in the *In re Simon Property Group. LP* v. *Learningsmith, Inc.* (D. Mass. 2000) case provided, then the lessor has a right to insist on adherence to this use clause, even if the retailer files for bankruptcy. The clause is fully enforceable if the retailer is not in a bankruptcy proceeding, and the retailer or the bankruptcy trustee or judge should not be able to evade it in bankruptcy. Otherwise, the shopping centers operator could lose control over the nature of its business.

In the Learningsmith case, the judge allowed the assignment of the lease to a candle retailer because it offered more money than an educational store to buy the lease, in contravention of Section 365(b)(3) of the Code. As a result, the lessor lost control over the nature of its very business, operating a particular mix of retail stores. If other retailers file for bankruptcy in that shopping center, the same result can occur.

In the past, courts have disagreed about whether Section 365(f) overrides the provisions of Section 365(b)(3). For example, in the case of *In re Rickles Home Ctrs., Inc.*, 240 B.R. (D.Del. 1999), appeal dismissed, 209 F.3d 291 (3d Cir.), cert. denied, 531 U.S. 873 (2000), the

judge disregarded the use clause and allowed a lease sale to go through to a non-conforming user. However, in *In re Trak Auto Corp.*, 367 F.3d 237 (4th Cir. 2004), an appellate court held that a use clause must be strictly enforced under Section 365(b)(3) on sale of the lease, notwithstanding Section 365(f). This legislation provides the necessary clarity by amending Section 365(f)(1) to help make clear it operates subject to all provisions of Section 365(b).

I note that Section 365(d)(4) of the Bankruptcy Code applies to cases under any chapter of Title 11. Language to that effect in the current Code's Section 365(d)(4) is deleted because it is repetitive of Sections 103(a) and 901 of the Code, which already make clear that provisions like Section 365(d)(4) apply to all cases under Title 11.

This bill creates new legal protections for a large class of retirement savings in bankruptcy. This measure has widespread support from a long list of groups, ranging from the American Association of Retired Persons, to the Small Business Council of America and the National Council on Teacher Retirement.

Let me take this opportunity to point out that the assets of some pension plans already are protected from bankruptcy proceedings. The United States Supreme Court has ruled in Patterson v. Shumate, reported at 504 U.S. 753 (1992), that assets of pension plans which have, and are required by law to have, anti-alienation provisions, are excluded from bankruptcy estates.

Let me be absolutely clear that this provision is not intended in any way to diminish the protections offered under existing law and under the United States Supreme Court's decision in Patterson v. Shumate, but rather, is intended to provide protection to other retirement plans and accounts not currently protected.

Mr. President, this has been a battle, there is no question about it, like all hotly contested issues are. But I think virtually everybody has contributed, and we have had some tough times on the floor. We have had even some bad feelings from time to time. But we have been at this for 8 solid, difficult years. It is unfortunate we could not work out more amendments, also, but we couldn't and still have this bill pass, hopefully for the last time. We worked in good faith to try to do that.

For those who feel they have not been treated as fairly as I would certainly have wanted to treat them or I feel I have treated them and others as well have treated them, we feel bad about that and hope they will forgive us for not being able to make some of the changes that perhaps we would have made had this been the first year of this bill and we didn't have the difficulty of meeting the suggestions of our friends over in the other body.

We think they have done a terrific job. The people in the House of Representatives are tremendous leaders, from Chairman SENSENBRENNER right on through the whole Judiciary Committee and, of course, the leadership over in the House as well and others who are not on the Judiciary Committee but are concerned about this very important bill. They work closely with us. It is difficult for them and it is difficult for us, but that is the way these two bodies ought to work together, and this bill is a perfect illustration of what can happen if good people can get together, compromise on some of these issues that can be compromised, and yet stand firmly so we can pass legislation like this that will benefit the whole country.

In my final remarks, let me recognize the efforts of Ed Pagano and Bruce Cohen of Senator LEAHY's office and Jim Flug and Jeff Teitz of Senator KENNEDY's office for all the hard work they have done over the years on this issue as well. It is a pleasure to work with staff on the Judiciary Committee. They are bright. They are articulate. They are brilliant, as a matter of fact. That is what you want in Judiciary Committee staffers. I wish those on the minority side would not be nearly as tough as they are, but I respect them for being that way.

With that, I suggest the absence of a quorum.

The PRESIDING OFFICER. The clerk will call the roll.

The assistant legislative clerk proceeded to call the roll.

Mr. HATCH. Mr. President, I ask unanimous consent that the order for the quorum call be dispensed with.

The PRESIDING OFFICER. Without objection, it is so ordered.

CARL D. PERKINS CAREER AND TECHNICAL EDUCATION IMPROVEMENT ACT OF 2005—Continued

The PRESIDING OFFICER. Under the previous order, the question is, Shall the bill pass? The yeas and nays have been ordered, and the clerk will call the roll.

The assistant legislative clerk called the roll.

Mr. DURBIN. I announce that the Senator from New York (Mrs. CLINTON) is necessarily absent.

The PRESIDING OFFICER. (Mr. VITTER). Are there any other Senators in the Chamber desiring to vote?

The result was announced—yeas 99, nays 0, as follows:

[Rollcall Vote No. 43 Leg.]

YEAS—99

Akaka	Burns	Corzine
Alexander	Burr	Craig
Allard	Byrd	Crapo
Allen	Cantwell	Dayton
Baucus	Carper	DeMint
Bayh	Chafee	DeWine
Bennett	Chambliss	Dodd
Biden	Coburn	Dole
Bingaman	Cochran	Domenici
Bond	Coleman	Dorgan
Boxer	Collins	Durbin
Brownback	Conrad	Ensign
Bunning	Cornyn	Enzi
Feingold	Lautenberg	Rockefeller
Feinstein	Leahy	Salazar
Frist	Levin	Santorum
Graham	Lieberman	Sarbanes
Grassley	Lincoln	Schumer
Gregg	Lott	Sessions
Hagel	Lugar	Shelby
Harkin	Martinez	Smith
Hatch	McCain	Snowe
Hutchison	McConnell	Specter
Inhofe	Mikulski	Stabenow
Inouye	Murkowski	Stevens
Isakson	Murray	Sununu
Jeffords	Nelson (FL)	Talent
Johnson	Nelson (NE)	Thomas
Kennedy	Obama	Thune
Kerry	Pryor	Vitter
Kohl	Reed	Voinovich
Kyl	Reid	Warner
Landrieu	Roberts	Wyden

NOT VOTING—1

Clinton

The bill (S. 250), as amended, was passed.

BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005—Continued

AMENDMENT NO. 90

The PRESIDING OFFICER. There will now be 2 minutes of debate, equally divided, on the Feingold amendment No. 90.

Mr. FRIST. Mr. President, for the information of my colleagues, in consultation with the Democratic leader, we would like to have all of the remaining votes be 10-minute votes. We are going to be enforcing it strictly, so we have a reason to keep moving along. We ask that everybody, once we start voting shortly, stay in the Chamber and continue to vote. We will have 10-minute votes for the remainder of the evening.

The PRESIDING OFFICER. The Senator from Wisconsin is recognized.

Mr. FEINGOLD. Mr. President, if we have a brief quorum call, I believe we may be able to eliminate the need for some of the votes.

Mr. FRIST. Mr. President, I suggest the absence of a quorum.

The PRESIDING OFFICER. The clerk will call the roll.

The legislative clerk proceeded to call the roll.

Mr. FEINGOLD. Mr. President, I ask unanimous consent the order for the quorum call be rescinded.

The PRESIDING OFFICER. Without objection, it is so ordered.

The Senator is recognized.

Mr. FEINGOLD. Mr. President, I appreciate the fact that we have had some opportunity to make a few modest modifications at the end of this process. Obviously, I hoped for more, but I do thank the Senator from Utah, Mr. HATCH, the Senator from Alabama, Mr. SESSIONS, the Senator from Iowa, Mr. GRASSLEY, and the Senator from Pennsylvania, Senator SPECTER, who are working on a number of changes and accepting a couple of amendments so we can move this process through. The result will be that the next five votes on my amendments will not be necessary, if this agreement is made. So I hope that causes the unanimous consent agreement to go through.