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COURT STRICTLY INTERPRETS WHAT CONSTITUTES THE IMPAIRMENT OF ASSIGNED CLAIM UNDER A CLAIM ASSIGNMENT AGREEMENT

The District Court for the Southern District of New York recently held that a bankruptcy court order preserving the debtors' objection under Section 502(d) of the Bankruptcy Code to an assigned claim was not an "impairment" of the claim under the terms of a claim assignment agreement. In *Longacre Master Fund Ltd. v. ATS Automation Tooling Systems, Inc.*, ATS Automation Tolling Systems ("ATS") assigned its general unsecured claim (the "Claim") against Delphi Automotive Services, LLC (the "Debtor," and together with its affiliated debtors, the "Debtors"), to Longacre Master Fund Ltd. ("Longacre") pursuant to a claim assignment agreement. The claim assignment agreement provided, among other things, that if all or any part of the Claim is "offset, objected to, disallowed, subordinated, in whole or in part for any reason whatsoever, pursuant to an order of the Bankruptcy Court (collectively, an "Impairment")," ATS would repay Longacre the purchase price of the portion of the Claim subject to Impairment, plus interest from the date of the assignment. The claim assignment agreement also provided that in the event a "possible Impairment is raised against the Claim in the Case and actually received by [Longacre] (a "Possible Impairment")," Longacre had the right, after 180 days had passed without a full resolution of the Possible Impairment, to make the same request for repayment of the purchase price plus interest (subject to Longacre's return to ATS of the purchase price (plus interest from the date ATS repaid Longacre to the date Longacre refunds ATS) if the Possible Impairment never actually became an Impairment). *Continued on page 2.*

Articles also included in this report:

From page 1. After the Claim was assigned, the Debtors filed an Objection, objecting, among other things, to certain preference-related claims (the "Claims Objection"), in which they sought to preserve their objection to the Claim under Section 502(d) of the Bankruptcy Code pending the conclusion of a preference action brought by the Debtors against ATS. Section 502(d) provides for the disallowance of a claim against a debtor of a transferee of a preferential transfer. The Bankruptcy Court granted the Claims Objection, ordering that the Debtors' objection to the Claim under Section 502(d) of the Bankruptcy Code was "deemed preserved" pending the conclusion of the preference action (the "Order").

Following the filing of the Claims Objection and the entry of the Order, Longacre asserted a Possible Impairment of its Claim under the claim assignment agreement and sought the return from ATS of its purchase price plus interest from the date of the claim assignment agreement. When ATS did not comply, Longacre brought suit against ATS. Subsequently, the parties agreed to dismiss the Debtors' preference action against ATS and the Claims Objection was withdrawn, but, because ATS had not remitted the interest still owing to Longacre as a result of the alleged Possible Impairment, Longacre continued the proceeding against ATS to recover interest through the date of the withdrawal of the Claims Objection. In response to motions for summary judgment filed by each party the Court handed down its decision.

The Court granted ATS's motion for summary judgment and dismissed the action, ruling that ATS did not owe Longacre any interest under the claim assignment agreement because neither the filing of the Claims Objection nor the entry of the Order was a Possible Impairment. The Court examined the impairment language in the claim assignment agreement, which required that a Claim be "objected to," and interpreted such provision narrowly. Because the Claims Objection sought to, and the Order did, merely preserve the Debtors' Section 502(d) objection in the event of a successful preference action, the Court concluded that there had never been an actual Section 502(d) objection raised, filed, or formally commenced against the Claim. The Court noted that there could be no objection in the future because, as a result of the dismissal of the preference action, there was no vehicle through which an objection to the Claim could be raised.

The Court also held that because the Claim assignment was actually a sale and not a pure assignment of a claim under New York law, even if the Debtors had actually objected under Section 502(d) and not just preserved the objection, such objection would not have constituted an Impairment. Relying on a fellow Southern District of New York judge's controversial ruling in *Enron Corp. v. Springfield Assocs., LLC* that Section 502(d) objections are personal liabilities of the entity that had received the alleged preferential transfer, are not attributes of the claim itself, and are not transferred to a transferee unless there had been a pure assignment of the claim (i.e., that the assignor holds no remaining rights in the claim) the Court ruled that Longacre could not have any exposure to a Section 502(d) objection even if the preference action had been successful against ATS. The Court found that the assignment of the Claim was a sale because the claim assignment agreement limited Longacre's rights in the Claim to less than those that ATS had held. Under the claim assignment agreement, ATS assigned all of its rights in documents evidencing the Claim, "but such documents are assigned solely to the extent necessary to support or enforce the Claim," and further, Longacre did not accept the risk

that the Claim might be subject to an objection.

As a result of the Court's decision, which Longacre has appealed to the Second Circuit Court of Appeals, claim purchasers should pay careful attention to the potential risks of payment delay and make sure that claim assignment agreements are crafted to include language that covers situations where the claim has not been literally objected to but where the debtor seeks, or has been granted, the right to preserve an objection. Broad impairment language such as was included in the *Longacre* claim assignment agreement may not afford a claim purchaser the level of protection it is looking for when allowance or payment of its purchased claim is delayed by a debtor.

IN RE ZAIS: TRANCHE WARFARE

The United States Bankruptcy Court for the District of New Jersey recently found that Zais Investment Grade Limited VII ("ZING VII"), a Cayman Islands issuer of collateralized debt obligations ("CDOs"), could be properly subject to an involuntary Chapter 11 bankruptcy case in the United States brought by senior noteholders.

An event of default occurred under ZING VII's indenture on March 11, 2009, triggering a provision in the indenture requiring the ZING VII indenture trustee to hold ZING VII's securities intact. On April 1, 2011, certain senior noteholders—who had acquired their notes after ZING VII went into default—filed an involuntary Chapter 11 bankruptcy petition against ZING VII. After ZING VII did not contest the petition, the court entered an order for relief on April 16, 2011. The plan of reorganization filed by the petitioners calls for the assets held as collateral for ZING VII's obligations to its noteholders to be transferred to an entity controlled by certain senior noteholders and liquidated, with the proceeds to be distributed among the senior noteholders *pro rata*. Certain junior noteholders, who stood to recover nothing under the petitioners' plan, moved to dismiss the case, arguing (a) that ZING VII, as a Cayman Islands entity, is ineligible to be a debtor under the U.S. Bankruptcy Code; (b) that the petitioners, as holders of non-recourse notes, are not unsecured creditors and are therefore not qualified to petition the court; (c) that the ZING VII creditors would be better served by abiding by the liquidation provisions of the indenture; and (d) that the petitioners filed the case in bad faith. On August 26, 2011, the court issued an opinion denying the junior noteholders' motion for dismissal.

With respect to whether ZING VII was an eligible debtor under Section 109(a) of the Bankruptcy Code, the court noted that the entities primarily responsible for carrying out business on ZING VII's behalf—the indenture trustee, which was responsible for collecting proceeds from the ZING VII collateral and distributing money to the noteholders, and the collateral manager, which was tasked with the management of ZING VII's collateral—performed their services in the United States, thereby fulfilling the requirement that ZING VII have a "place of business" in the United States. The court also held that ZING VII had property in the United States, on the grounds that the ZING VII collateral, which was nominally the property of ZING VII, was held in the United States by the trustee.

The court also rejected the junior noteholders' argument that the senior noteholders were not qualified to petition the court because they were not unsecured creditors. The court, however, did not address on its merits the junior noteholders'

contention that because the notes were non-recourse (and noteholder claims could therefore never be greater than the value of the ZING VII collateral), the petitioners were secured, rather than unsecured, creditors. Instead, the court held that only the alleged debtor—ZING VII—could challenge the qualifications of the petitioning creditors. In this case, where ZING VII failed to contest the petition and the order for relief was entered by default, the court held that the junior noteholders had no grounds to question the petitioners' qualifications.

The court further held that the junior noteholders failed to prove that the interests of the debtor and the creditors would be best served by dismissal of the case, noting that it was "not realistic" to suggest another forum to grant relief. The court found that, even if true, the junior noteholders' argument that the petitioners were seeking bankruptcy jurisdiction in order to circumvent the express liquidation provisions of the indenture did not constitute grounds for dismissal prior to a confirmation hearing.

The court also refused to dismiss the case based on what the junior noteholders argued was the bad faith filing of the case by the petitioners in an effort to gain an unfair economic advantage and avoid the express terms of the indenture. The court held that "the Bankruptcy Code specifically permits the rejection of an executory contract indicating that there are circumstances justifying overriding a burdensome contract." The court further stated that the Bankruptcy Code "specifically provides that a plan may impair secured or unsecured claims or interests," noting that while the indenture does not permit junior noteholders to file an involuntary bankruptcy petition against ZING VII, it contains no such prohibition against the senior noteholders.

The decision has been appealed to the District Court of New Jersey. If ultimately upheld, the decision could have significant implications for CDO and collateralized loan obligation ("CLO") investors, as it could potentially embolden senior noteholders in other transactions to avoid the terms of their indentures in an effort to seek higher returns as quickly as possible by petitioning the bankruptcy court, potentially to the detriment of junior noteholders. The decision could also create uncertainty for contracting parties with respect to whether the negotiated terms of their agreement will ultimately hold. Going forward, drafters of CDO and CLO documentation should take care to ensure that the provisions governing collateral liquidation are clear and unambiguous.

TO BID OR NOT TO BID…

On June 28, 2011, the United States Court of Appeals for the Seventh Circuit rendered a decision in the jointly administered appeals of *River Road Hotel Partners, LLC* and *RadLAX Gateway Hotel, LLC*. The Seventh Circuit held that Section 1129(b)(2)(A) of the Bankruptcy Code does not allow the confirmation of Chapter 11 reorganization plans directing the sale of assets free and clear of liens without first providing secured creditors the opportunity to credit bid at the asset sale. According to the Seventh Circuit, if property secured by a lien is sold under a plan, the "fair and equitable" standard under Section 1129(b)(2)(A) could only be satisfied by allowing secured creditors to credit bid under Section 1129(b)(2)(A)(ii). As discussed in detail in the Spring 2011 Distressed Debt Report article entitled "The War Over Credit Bidding in Chapter 11 Continues…" in essence, credit bidding enables a secured creditor to compete for the purchase of a debtor's assets in which such

creditor holds a lien without having to present a cash bid at the time of sale. It allows a secured creditor to bid part or all of its claim against the bankruptcy debtor as currency for the assets of the debtor.

Under Section 1129(b)(2), a plan of reorganization that impairs creditors' interests without their consent cannot be confirmed unless such plan provides for the "fair and equitable" treatment of creditors with respect to each class of impaired claims. Fair and equitable treatment of secured claims under Section 1129(b)(2)(A) provides three alternative treatments including credit bidding under subsection (ii) and the receipt of the indubitable equivalent of the claim under subsection (iii). Historically, most plans that provided for the sale if assets gave secured creditors the opportunity to credit bid during the bankruptcy sale of encumbered assets.

The Seventh Circuit's ruling in *RadLAX*, while in keeping with the traditional interpretation of Section 1129(b)(2)(A), is directly at odds with decisions from the Court of Appeals for both the Third and Fifth Circuits regarding the interpretation of Section 1129(b)(2)(A) with respect to a secured creditor's ability to credit bid. In the rulings rendered in *In re Philadelphia Newspapers* and *In re Pacific Lumber*, the Fifth and the Third Circuits, respectively, approved bidding procedures under Section 1129(b)(2)(A)(iii)'s indubitable equivalent standard. The Courts reasoned that so long as the asset sales in question produce the "indubitable equivalent" of the secured creditor's claims, then the plans may be confirmed without providing for credit bidding. Ultimately, both Circuits found that bidding procedures promulgated under Section 1129(b)(2)(A)(iii) that do not allow credit bidding satisfy Section 1129(b)(2)(A)'s "fair and equitable" requirements notwithstanding Section 1129(b)(2)(A)(ii).

As a result of the split in the circuits, the *RadLAX* debtors submitted a petition to the United States Supreme Court on August 5, 2011, requesting that it hear the case. The question on appeal is "whether a debtor may pursue a chapter 11 plan that proposes to sell assets free of liens without allowing the secured creditor to credit bid, but instead providing it with the indubitable equivalent of its claim under Section 1129(b)(2)(A)(iii) of the Bankruptcy Code." In other words, the fundamental issue is whether a plan of reorganization proposing the sale of collateral free of liens can be confirmed under 1129(b)(2)(A)(iii) without allowing for credit bidding.

Without direction from the Supreme Court, uncertainty with respect to a core element of Chapter 11 reorganizations will remain, and secured creditors in different forums may receive disparate treatment with respect to their claims.

SEC Proposes Rule Prohibiting Conflicts of Interest in Certain Securitizations

On September 19, 2011, the Securities and Exchange Commission (the "SEC") proposed a new rule to prohibit conflicts of interest between parties creating, distributing or managing certain securitizations, and the related investors in such securitizations. Rule 127B, issued pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, would prohibit an underwriter, placement agent, initial purchaser or sponsor of an asset-backed security from engaging in a transaction that would result in a material conflict of interest with respect to any

investor in such asset-backed security for a period of one year following the initial closing date of the securitization.

In commenting on proposed Rule 127B, the SEC presented five criteria, all of which would have to be present for the rule to apply:

Covered Persons: The rule will apply to underwriters, placement agents, initial purchasers, sponsors, and any of their subsidiaries or affiliates. The commentary noted that the SEC would be using a broader interpretation of "sponsor" than Regulation AB, and, of particular note, collateral managers will be covered by the proposed rule.

Covered Products: The definition of asset-backed security for the proposed rule is being taken from the Securities Exchange Act of 1934 and not from the narrower definition under Regulation AB, resulting in a broader range of securitizations, including not only traditional asset-backed securities, but also synthetic asset-backed securities, collateralized debt obligations and collateralized loan obligations.

Covered Timeframe: The prohibition period under the proposed rule will end one year after the first closing of the sale of the asset-backed security. While no commencement date for the covered period is currently specified the SEC indicated in its commentary that for now, transactions entered into prior to the closing of the securitization (such as transactions effected during a warehouse period) would be covered.

Covered Conflicts: The conflicts covered under the rule must be between a covered person and an investor in the related securitization, and in each of their respective capacities under the securitization. Thus, conflicts solely between covered persons, or solely between investors, would not be covered. Furthermore, the conflict must arise out of the related securitization and must also arise as a result of engaging in a transaction. Examples of covered conflicts provided by the SEC were short sales, purchasing CDS protection on the offered securities or the underlying assets, or selecting underlying assets for the securitization. On the other hand, providing investment research was cited as not constituting a transaction under the rule.

Material Conflict of Interest: In order for a conflict to qualify as a "material" conflict of interest, a two-pronged test must be satisfied. First, either (a) a relevant party must benefit directly or indirectly from actual, anticipated or potential adverse performance of the related asset pool, losses on the asset-backed securities or a decline in market value of the asset-backed securities *or* (b) a party who controls the structure of the securitization or the selection of assets in the pool must benefit directly or indirectly from future fee income, promise of future business, or other remuneration, as a result of allowing a third party to structure the securitization or select assets in a way that would allow such third party to benefit from a short position. Secondly, there must be "substantial likelihood" that a "reasonable" investor would consider the conflict important in making an investment decision.

The SEC has set a comment deadline of December 19, 2011 for proposed Rule 127B, and a final rule is not expected to be issued until 2012.

LSTA INCORPORATES BISO PROVISIONS INTO DISTRESSED DEBT TRADING

In September, the LSTA incorporated Buy-In/Sell-Out ("BISO") provisions to its revised Standard Terms and Conditions for Distressed Trade Confirmations. The BISO provisions for distressed debt trades seek address settlement delays caused by nonperforming counterparties by enabling performing parties to compel performance or ultimately terminate the trade and effect a cover transaction. Participants in distressed debt trades should be aware of several potential considerations in connection with the exercise of the BISO provisions, including meeting BISO delivery requirements, monitoring upstream allocations, and invoking BISO at the proper time. For more information about the new BISO provisions, please see the client alert prepared by Seward & Kissel LLP, available at:
http://www.sewkis.com/pubs/xprPubDetail.aspx?xpST=PubDetail&pub=358

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If you have any questions or comments about this Newsletter, please feel free to contact any of the attorneys in our Distressed Debt Group via telephone at (212) 574-1200 or e-mail by typing in the attorney's last name followed by @sewkis.com.

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