

# CRaB Alert

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## IS TRIANGULAR SET-OFF ENFORCEABLE UNDER U.S. LAWS?

The U.S. Bankruptcy Court for the District of Delaware recently issued a decision addressing triangular set-off provisions, which potentially has very far-reaching implications for the enforceability of contractual set-off rights under U.S. law.

It is not uncommon to find in trading agreements triangular set-off provisions, also commonly referred to as “cross-affiliates” set-off clauses. Such provisions are intended to allow a nondefaulting party to apply against the amount owed as a result of an agreement termination, any amounts owing between the nondefaulting party and affiliates of the defaulting party. Such clauses generally do not appear as standard in industry-wide contracts (e.g., the ISDA Master Agreement), but commonly are added by mutual agreement of the parties, most often in contracts that are governed by U.S. laws.

On January 9, 2009, the federal bankruptcy court in Delaware, presiding over the jointly administered chapter 11 bankruptcy cases of *In re SemCrude L.P., et al.*, 399 B.R. 388 (Bankr. D. Del. Jan. 9, 2009), held that triangular set-offs are impermissible under section 553 of the U.S. Bankruptcy Code (11 U.S.C. 101 et seq.) (“Bankruptcy Code”) regardless of express contractual provisions permitting such set-offs. See *In re Semcrude, L.P., et al.*; 2009 Bankr. Lexis 21, Case No. 08-11525 (BLS). The court held that (a) triangular set-off provisions cannot satisfy the “mutuality” requirement of the Bankruptcy Code;

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For related story, see “Fourth Circuit Rules on Safe Harbor Protections for Commodity Forward Contracts,” p. 4.



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### Hot News

## THIRD CIRCUIT CLARIFIES DEGREE OF CONTROL NECESSARY TO BE AN INSIDER

A recent opinion from the U.S. Court of Appeals for the Third Circuit confirms that “actual control” over a debtor is not necessary to qualify as a nonstatutory “insider” for the purpose of extending the period for preference recovery under Section 547 of the Bankruptcy Code. See *Schubert v. Lucent Technologies, Inc.* (*In re Winstar Communications, Inc.*), 554 F.3d 382 (3rd Cir. 2009).

In *Schubert*, the chapter 7 trustee sought to recover more than \$188 million from Lucent Technologies, Inc. that was transferred prior to the 90-day statutory

period applicable to non-insiders under the Bankruptcy Code. The transfer did take place within the one-year statutory period applicable to insiders of the debtor. See 11 U.S.C. § 547(b)(4)(B).

In support of her claims, the trustee asserted that Lucent was a nonstatutory insider of the debtor as a result of its pre-petition “strategic partnership” with the debtor, pursuant to which Lucent agreed to help finance and construct the debtor’s global broadband telecommunications network.

In response, Lucent argued the strategic partnership was an arm’s-length transaction, and because Lucent did not exercise “actual control” over the debtor, it could not qualify as an insider under the Bankruptcy Code.

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## DELAWARE COURT ALLOWS CORPORATE WASTE CLAIM BASED ON EXECUTIVE COMPENSATION

The Delaware Court of Chancery recently held that large executive compensation packages paid by corporations that lose money may not survive corporate waste analysis. See *In Re Citigroup Inc. Shareholder Derivative Litigation*, Civil Action No. 3338-CC (Del. Ch. Feb. 24, 2009).

The decision, issued in a consolidated stockholders’ derivative action brought against current and former directors and officers of Citigroup,<sup>1</sup> did provide some solace for corporate executives amid the current economic downturn. The court refused to hold directors and officers personally liable for breach of fiduciary duty based on taking business risks that resulted in substantial losses for the corporation.

### Waste Claims

The *Citigroup* plaintiffs’ claims centered on the directors’ alleged breaches of the fiduciary duty of care and waste of corporate assets.<sup>2</sup> Specifically, plaintiffs alleged that Citigroup’s directors breached their duty of care by failing to adequately oversee, manage and disclose the company’s exposure to massive losses the company ultimately suffered in the subprime mortgage market.<sup>3</sup>

The plaintiffs’ corporate-waste claims sought to recoup from the directors a \$68 million severance and benefit package paid to Citigroup’s former CEO upon his retirement; \$2.7 billion spent to acquire subprime loans; funds paid through a share repurchase program at allegedly inflated prices; and investments in failing special investment vehicles.<sup>4</sup>

It is a “cardinal precept” of Delaware law that directors, rather than shareholders, manage the corporation.<sup>5</sup> Therefore, under Court of Chancery Rule 23.1, stockholder plaintiffs alleging derivative claims must either: (1) plead that they made a pre-suit demand on the corporation’s board to take remedial action and that the board wrongfully refused to bring suit on behalf of the corporation; or (2) plead facts showing that such a demand on the board would have been futile.<sup>6</sup>

Since the plaintiffs in *Citigroup* did not make a pre-suit demand on the company’s board, the defendants moved to dismiss the complaint on the grounds that the plaintiffs failed to meet the more stringent pleading requirements under Rule 23.1, and plead with particularity facts showing demand futility.<sup>7</sup>

### Excessive Compensation Claim

The plaintiffs’ waste claims based on the former CEO’s multimillion-dollar retirement package survived the defendants’ motion to dismiss.

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## Third Circuit Clarifies Degree of Control Necessary to Be an Insider—continued from page 2

### Third Circuit Appeal

Affirming the bankruptcy court's decision in favor of the trustee, the Third Circuit determined that the arrangement between Lucent and the debtor was not an arm's-length transaction. In support of this holding, the Third Circuit affirmed the bankruptcy court's findings that Lucent:

- (a) Controlled many of the debtor's decisions relating to the build-out of the debtor's telecommunications network;
- (b) Forced the debtor to purchase Lucent's goods well before equipment was needed and, in many instances, even though the equipment was not needed at all; and
- (c) Treated the debtor as a captive buyer for Lucent's goods.

*Winstar*, 554 F.3d at 397.

The Third Circuit affirmed the bankruptcy court's finding that "what began as a 'strategic partnership' to benefit both parties quickly degenerated into a relationship in which the much larger company, Lucent, bullied and threatened the smaller Winstar into taking actions that were designed to benefit the larger at the expense of the smaller." 554 F.3d at 392-93, quoting 348 B.R. 234,

closeness to suggest that any transactions were not conducted at arm's length." *Id.*

The characteristics of the relationship between the debtor and Lucent were indicative of a transaction that was not at arm's length, the Third Circuit concluded.

The court further differentiated the relationship between Lucent and the debtor from relationships in which a creditor simply exerts financial pressure over a debtor. The Third Circuit noted that "it is well established that the exercise of financial control incident to the creditor-debtor relationship does not make the creditor an insider." In the instant case, however, the facts were not limited to Lucent compelling payment of debts or other financial concessions related to its agreements with the debtor.

Instead, the Third Circuit found, among other things, that Lucent had the ability to coerce Winstar to make unnecessary purchases and used Winstar as a mere instrumentality to inflate Lucent's own revenues. As such, Lucent exercised sufficient control to qualify as a nonstatutory insider, and the Third Circuit



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The Third Circuit affirmed the bankruptcy court's finding that 'what began as a "strategic partnership" to benefit both parties quickly degenerated into a relationship in which the much larger company, Lucent, bullied and threatened the smaller Winstar into taking actions that were designed to benefit the larger at the expense of the smaller.'

251 (Bankr. D. Del. 2005). Consequently, the Third Circuit determined that the relationship was not an arm's-length transaction.

Further, the Third Circuit rejected Lucent's assertion that it could not be a nonstatutory insider under Section 101 of the Bankruptcy Code because it did not exercise actual control over the debtor's operations in the same way that a director or officer might. In considering this point, the Third Circuit reviewed the definition of "insider" under the Bankruptcy Code.

The court noted that Section 101(31) of the Bankruptcy Code defines the term "insider" and enunciates several categories of insiders, known as "statutory insiders" because they are expressly included in the language of the statute. See 11 U.S.C. § 101(31).

Still, it is well-settled that Section 101(31) also includes certain parties not expressly defined by the language of the statute, known as nonstatutory insiders.

### Nonstatutory Insiders

In *Winstar*, the Third Circuit held that actual control (or its close equivalent) is necessary to qualify as a statutory insider under Section 101(31). *Winstar*, 554 F.3d at 396. In contrast, a demonstration of actual control is not necessary to qualify as a nonstatutory insider. A party can qualify as a non-statutory insider if "there is a close relationship between debtor and creditor and [there is] anything other than

affirmed the Bankruptcy Court's ruling that the longer statutory period applicable under Section 547(b)(4)(B) applied.

Further, given Lucent's treatment of Winstar, which the Bankruptcy Court determined was "egregious," the Trustee also prevailed on her breach of contract and equitable subordination claims against Lucent.

This case illustrates that companies entering into a strategic partnership should make sure the partnership is negotiated at arm's length. The failure to do so could subject an otherwise unaffiliated party to a substantially longer statutory period for preference liability, as well as other longer statutory terms applicable to insiders under the Bankruptcy Code.

## FOURTH CIRCUIT RULES ON SAFE HARBOR PROTECTIONS FOR COMMODITY FORWARD CONTRACTS



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The U.S. Court of Appeals for the Fourth Circuit recently issued a decision that has the potential to have a major impact on how contracts that provide for physical delivery of commodities are treated under U.S. bankruptcy law.

The decision in *Hutson v. E.I. Dupont De Nemours & Co., et al. (In re National Gas Distributors LLC)*, 556 F.3d 247 (4th Cir. 2009) is a positive development for parties entering into so-called physically settled transactions (i.e., those that provide for the physical delivery of commodities) with an entity that subsequently becomes subject

to a U.S. bankruptcy procedure. In essence, the decision allows for contractual close-out netting and other key safeguards for the non-debtor counterparty.

### 'Safe Harbor'

In a case of first impression, the Fourth Circuit determined that a physically settled "commodity forward agreement" may qualify as a "swap agreement" under the Bankruptcy Code, thereby falling within its so-called "safe harbor" provisions. The court determined that its holding applies regardless of whether these over-the-counter ("OTC") transactions are:

- (a) Settled by physical delivery of a commodity (rather than cash),
- (b) Assignable, or
- (c) Traded on a financial market or exchange

In the underlying bankruptcy case, the trustee was seeking to set aside certain gas-forward contracts, not because they were fraudulent per se, but because the debtor had sold counterparties gas for less than the market value at the time of the transaction, and at a time when the debtor presumably was insolvent (thereby deemed to be "constructive fraudulent conveyances" under bankruptcy law).

The "safe harbor" provisions provide special rights to non-debtor counterparties of certain financial contracts, such as swap agreements and forward agreements. Such rights include, among other things, the exemption from certain provisions of the Bankruptcy Code's automatic stay, including the right upon a bankruptcy filing to terminate, liquidate and accelerate a swap agreement; apply master netting agreements and contractual set-off rights; and to foreclose on pledged collateral.

In addition, the safe harbors protect, or exempt, nondebtor counterparties from the debtor's or its trustee's avoidance powers—i.e., the right to bring preferences and fraudulent conveyance claims against creditors and other third parties.

### Commodity Forward Contracts

While the safe harbor provisions generally apply to "swap agreements" as broadly defined by the Bankruptcy Code, there has been considerable dispute among U.S.

bankruptcy courts as to whether physically settled commodity forward contracts constitute swap agreements and thus fall within the safe harbors, or whether they simply should be treated as physical supply contracts between sellers and end-users, devoid of such protections.

The Fourth Circuit's decision provides significant clarification and some direction to parties to such contracts.

In December 2006, during the *In re Natural Gas LLC* bankruptcy case pending before the U.S. Bankruptcy Court for the Eastern District of North Carolina, Richard M. Hutson, the court-appointed trustee for the debtor, filed actions to avoid—or reverse—the debtor gas distributor's contracts with numerous customers.

The trustee sought to recover from more than \$4 million on the grounds that the contracts (and any related transfers of gas for cash) were entered into at below-market prices at a time when the debtor was insolvent and, as such, were constructively fraudulent conveyances and transfers of value prior to the commencement of the bankruptcy case.

The contracts at issue were entered into by the debtor and the customers prior to commencement of the debtor's bankruptcy proceeding, and enabled the customers to hedge against adverse changes in the price of natural gas by requiring the debtor to sell and deliver gas, and the customers to receive and purchase gas at a fixed price over the respective terms of the contracts.

The customers filed motions to dismiss the trustee's complaint or for summary judgment on the basis that the contracts were "commodity forward agreements," a type of "swap agreement" exempt from the avoidance powers otherwise afforded to the debtor under the Bankruptcy Code. In support, they cited the express statutory definitions of the subject agreements and legislative history of the Bankruptcy Code. Further, the customers asserted that the contracts were in fact hedging contracts that were part of a larger risk management program through which they regularly used forwards and other derivatives.

### Bankruptcy Court's Decision

The bankruptcy court issued orders May 24, 2006 (the "Initial Orders") that denied the customers' motions and concluded that the contracts were not "commodity forward agreements." Instead, the court determined the contracts were, as a matter of law, "agreements by a single end-user to purchase a commodity," rather than swap agreements exempt from the avoidance powers otherwise afforded to the debtor under the Bankruptcy Code.

Analyzing the legislative history and statutory construction of the Bankruptcy Code's definition of swap agreements, the court determined that any such agreement must be "regularly the subject of trading in financial markets" and must be settled by financial exchanges of differences in commodity prices.



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## Feature

### AS BANK INSOLVENCIES LOOM, LENDING GROUPS SHOULD ACT NOW TO PROTECT THEMSELVES



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With the economy in tatters and an ever-increasing number of questionably solvent banks, the prospect of a bank failure in your syndicate increases.

Because we are facing the first bank crisis since Congress added the automatic stay to the Federal Deposit Insurance Act (“FDIA”) in October 2006, lenders have little guidance as to how to address the potential impact of a Federal Deposit Insurance Corporation (“FDIC”) receivership of one or more members of its lending group. In particular, lenders are unsure of how an FDIC receivership would affect the rights and remedies of nondefaulting lenders under loan documents.

Given this uncertainty, the time for lenders to act is now.

Lenders should take a close look at their loan documents to ensure that the defaulting lender provisions addressing loan fundings, payments, voting and the like, are applicable to insolvent lenders. In addition, lending syndicates should consider various options for pre-insolvency termination of a troubled lender to avoid the impact of the FDIA automatic stay.



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Once an automatic stay goes into effect, nondefaulting lenders will be unable to amend the documents in instances in which such an amendment would affect the contractual rights of an insolvent lender, or the insolvent lender’s vote is required to pass the amendment.

#### FDIA Automatic Stay

Congress added the automatic stay to the FDIA for the first time in 2006. Specifically, Section 11(e)(13)(C)(i) now provides:

[N]o person may exercise any right or power to terminate, accelerate, or declare a default under any contract to which [a depository institution in conservatorship or receivership] is a party, or to obtain possession of or exercise control over any property of the institution or affect any contractual rights of the institution, without the consent of the conservator or receiver, as appropriate, during the 45-day period beginning on the date of the appointment of the conservator, or during the 90-day period beginning on the date of the appointment of the receiver, as applicable.

#### Funding Mechanics

A lending syndicate may make meaningful revisions to its loan documents affecting an insolvent lender’s relationship with the administrative agent (the “Agent”) and the non-defaulting lenders in the context of funding loans and applying payments.

Most loan documents already provide that if a lender fails to fund its share of a requested advance, such lender is considered a “Defaulting Lender.” However, to provide certainty as to which lenders are required to fund in the event of a lender takeover by the FDIC, the definition of a “Defaulting Lender” should be expanded to include lender insolvency and instances in which a lender is placed under FDIC receivership or conservatorship.

Special attention should be paid to loans that provide for swingline advances and letters of credit. Since swingline loans and letters of credit are funded by the swingline lender and the letter-of-credit issuer (the “Issuer”) on behalf of the lenders, and later reimbursed by the lenders, both the swingline lender and the Issuer will want to limit their funding exposure to the Defaulting Lender.

The loan agreement should state that the swingline lender is not obligated to fund the Defaulting Lender’s portion of any swingline loan. Furthermore, nondefaulting lenders should be required to reimburse the swingline lender based on the nondefaulting lender’s share of the requested amount, rather than the funded amount (which already has been reduced by the Defaulting Lender’s share), so the swingline lender is reimbursed in full.

The Issuer should not be required to issue the Defaulting Lender’s portion of any requested letter of credit unless the borrower posts cash collateral for the Defaulting Lender’s portion. If there is a drawing under the letter of credit, the Agent can apply the cash collateral to the Defaulting Lender’s share and seek reimbursement from the nondefaulting lenders, based on their share of the issued letter of credit.

#### Payment Mechanics

Lenders should check the definitions that govern the allocation of interest and principal payments to the lenders so that a Defaulting Lender isn’t entitled to receive interest and principal relating to advances it did not make. A lender’s share of a requested advance should be calculated based on the percentage a lender’s commitment bears to the aggregate commitment of all lenders (frequently called, the “Pro Rata Share”).

On the other hand, a lender’s share of the principal and interest payments received from the borrower should be calculated based on the percentage such lender’s loans bears to the aggregate loans funded by all lenders (the “Percent Outstandings”).

The loan document should provide that interest payments received by Agent will be apportioned to each lender based on its Percent Outstandings and not its Pro Rata Share. The loan document should further provide that principal payments received by the Agent will not be paid to a Defaulting Lender until the nondefaulting lenders have been reimbursed for advances such that the Percent Outstandings of all lenders, including the Defaulting Lender, is equal to their Pro Rata Share.

## BONA FIDE PURCHASERS PROTECTED FROM TRUSTEE ACTION

The U.S. Court of Appeals for the Ninth Circuit has held that a bankruptcy trustee could not avoid an unauthorized sale of real estate to a bona fide purchaser—although the proceeds of the sale did belong to the estate.

The court ruled that an unauthorized postpetition transfer of real property in California could be avoided only if the buyer had actual knowledge of a bankruptcy filing, or if the trustee recorded the transfer of title to the property from the debtor to the estate in the land records of the applicable county, *In re Tippett*, 542 F.3d 684 (9th Cir. 2008).

After filing a joint chapter 7 petition, Craig and Christine Tippett retained a realtor and sold their home without the chapter 7 trustee's knowledge. The home was sold to a bona fide purchaser under California law, unaware of the Tippetts' pending bankruptcy case. The trustee filed an adversary action to avoid the unauthorized postpetition transfer.



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The bankruptcy court ruled in the trustee's favor. The Bankruptcy Appellate Panel for the Ninth Circuit, however, reversed and entered judgment in favor of the purchaser and its mortgagee. The Ninth Circuit Court of Appeals affirmed the panel decision and upheld the postpetition transfer.

### Bona Fide Purchaser

In *In re Tippett*, the Trustee filed an adversary action to recover the sale proceeds, avoid the liens of the purchaser's mortgage lenders, and to quiet title.

In affirming the Ninth Circuit BAP, the Court of Appeals examined three issues: the effectiveness of the deed to the buyer, federal preemption of state law, and application of the automatic stay.

The court rejected the trustee's argument that because all property of the debtor becomes property of the estate by operation of law when the bankruptcy case is filed, the debtor lacked the power to convey property by deed to the buyer.

California's bona fide purchaser statute is meant to address just such a situation, the court reasoned. The state statute protects parties such as the buyer, whose title to real estate is defective because of some unrecorded conveyance. Because the bankruptcy filing was not recorded in the real estate records of the appropriate county, the court held that the transfer of title from the debtors to the trustee that happens by operation of law when a bankruptcy case is filed was not effective against the buyer.

### Federal Preemption

The court next examined whether federal bankruptcy laws preempted application of California's bona fide purchase statute. The court held that while federal bankruptcy laws clearly preempt state laws with respect to bankruptcy, federal bankruptcy laws nonetheless frequently coexist with other state laws, and often

expressly incorporate state laws regulating the rights and obligations of debtors and creditors.

Whether California's bona fide purchase statute was preempted depended on whether it was inconsistent with the "essential goals and purposes of federal bankruptcy law."

The court found that the essential goals and purposes of federal bankruptcy law in a chapter 7 case include: (1) giving the individual debtor a fresh start through a discharge of most pre-petition debt; and (2) equitably distributing a debtor's assets among competing competitors.

The court determined that the first goal was unaffected by the state statute. The court then determined that because the proceeds of a sale protected by California's statute are brought into the estate, the equitable distribution among creditors of estate assets is not adversely impacted if the state statute is enforced.

Moreover, the Bankruptcy Code contains provisions similar to California's bona fide purchase statute. For example, Section 549(a) of the Bankruptcy Code protects bona fide purchasers from avoidance of unauthorized postpetition transfers, much like California's statute protects bona fide purchasers from unrecorded transfers. Therefore, California's bona fide purchaser's statute is not inconsistent with federal bankruptcy law and is not preempted.

### Other Issues

The court dispensed with the trustee's final argument stating that transfers initiated by the debtor do not constitute violations of the automatic stay imposed by Section 362(a) of the Bankruptcy Code. As such, a postpetition transfer initiated by the debtor will not be void *ab initio*.

The court highlights the distinction between Section 362(a) transfers that are void because they protect the debtor, from actions taken by creditors and Section 549(a) transfers that are voidable to protect creditors from actions taken by the debtor. Under Section 549(a)—and California law—an unauthorized transfer to a bona fide purchaser is unavoidable.

Accordingly, while the proceeds of the sale certainly must be turned over to the estate, the sale itself was valid and unavoidable.

## Delaware Court Allows Corporate Waste Claim Based on Executive Compensation—continued from page 2



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For their waste claims to survive dismissal, under Rule 23.1 the plaintiffs had to plead facts establishing a reasonable doubt that the approval of the challenged transactions was a valid exercise of business judgment.<sup>8</sup>

The court found that plaintiffs had complied with Rule 23.1. In so doing, the court noted that directors of Delaware corporations generally have “the authority and broad discretion to make executive compensation decisions.”<sup>9</sup> The court cautioned, however, “the discretion of directors in setting executive compensation is not unlimited.”<sup>10</sup> Instead, Delaware case law makes clear that “there is an outer limit” to a board’s discretion to set executive compensation that is reached when “executive compensation is so disproportionately large as to be unconscionable and constitute waste.”<sup>11</sup>

Ultimately, the court concluded that plaintiffs’ allegations that the multimillion-dollar retirement package was paid to a retiring CEO who was “allegedly responsible, in part, for billions of dollars of losses at Citigroup”<sup>12</sup> raised a reasonable question as to whether it was “so one sided” that it met the test for corporate waste.<sup>13</sup>

### ‘Duty to Monitor’

The rest of the plaintiffs’ fiduciary duty and waste claims were dismissed under Rule 23.1.

In particular, the court held that “[u]ltimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be personally liable if the company experiences losses.”<sup>14</sup>

The plaintiffs’ main fiduciary-duty claim was based on a subset of the duty of care—the “duty to monitor” first enunciated in the *Caremark* case.<sup>15</sup> The Delaware “duty to monitor” standard first was enunciated by the Court of Chancery in the 1996 opinion *In re Caremark Int’l Inc. Derivative Litig.* Claims based on an alleged breach of the so-called “duty of oversight” are “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.”<sup>16</sup>

Although Delaware courts recognize that fiduciaries of Delaware corporations have certain responsibilities to implement and monitor a system of oversight, *Caremark* limits liability for failing to do so to only those rare situations in which a “sustained or systematic failure of the board to exercise oversight” exists, as in situations of an “utter failure to attempt to assure a reasonable information and reporting system exists” or of consciously failing to monitor such a system after it is implemented.<sup>17</sup>

Even if such a situation exists, Delaware courts further have limited liability for failure to monitor to situations where directors and officers failed to implement proper systems in bad faith—i.e., the defendants knew they were not discharging their fiduciary obligations or they demonstrated a conscious disregard for such obligations.<sup>18</sup>

### Subprime Mortgage Losses

Applying these standards, the *Citigroup* court dismissed the plaintiffs’ “duty to monitor” claims on three grounds.

First, the court found that plaintiffs’ allegations were insufficient to show likelihood that plaintiffs could rebut the presumption of the business judgment rule.<sup>19</sup> The court observed that plaintiffs’ allegations could be characterized simply as attempting to hold the directors liable for “business decisions that, in hindsight, turned out poorly for the Company.”<sup>20</sup>

Second, the court addressed the merits of plaintiffs’ “duty to monitor” claims. The plaintiffs asserted that the Citigroup board failed to adequately consider alleged “red flags” from 2006 - 2008 relating to the decline in the subprime mortgage market.<sup>21</sup> The court, however, found that pleading the mere existence of such “red flags” and Citigroup’s losses from the subprime crisis was insufficient to prove a knowing or conscious disregard by the board for its fiduciary obligations.

Plaintiffs therefore failed to plead with particularity a substantial likelihood of personal liability sufficient to excuse demand.<sup>22</sup>

Third, and most notably, the court refused to extend the “duty to monitor” standard of *Caremark* and its progeny to the directors’ alleged failure to properly



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Delaware case law makes clear that “there is an outer limit” to a board’s discretion to set executive compensation that is reached when “executive compensation is so disproportionately large as to be unconscionable and constitute waste.”

monitor and oversee business risks.<sup>23</sup> Instead, the court held that “the mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct and, without more, is not a basis for personal director liability.”<sup>24</sup>

The court further distinguished the case before it from its recent decision in *American Int’l Group, Inc. Consol. Derivative Litig.* (“*AIG*”).<sup>25</sup> In *AIG*, the plaintiffs’ derivative complaint alleged financial fraud involving managers at the highest levels of the corporation and, based on allegations that certain *AIG* insiders not only knew of the alleged fraud, but also were involved in much of the wrongdoing, survived a motion to dismiss.<sup>26</sup>

## KNOWLEDGE OF BANKRUPTCY DOES NOT BAR STATE ACTION WHERE CREDITOR IS NOT GIVEN FORMAL NOTICE

A known creditor, which was aware of a debtor's pending bankruptcy but did not receive legally required notice of the debtor's chapter 11 case, was not barred from bringing a state action following bankruptcy discharge.

The U.S. Court of Appeals for the First Circuit held that actual knowledge of the pending chapter 11 case did not satisfy due process requirements; therefore, the known creditor's subsequent claim was not barred by the debtor's discharge injunction. *Arch Wireless, Inc. v. Nationwide Paging, Inc. (In re Arch Wireless, Inc.)*, 534 F.3d 76 (1st Cir. 2008).



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The debtor, Arch Wireless, Inc. ("Arch Wireless"), supplied pagers and paging network airtime to Nationwide Paging, Inc. ("Nationwide"). Prior to the petition date, Nationwide corresponded with Arch Wireless regarding certain billing and defective product issues. Arch Wireless filed its voluntary petition for chapter 11 relief Dec. 6, 2001 in the U.S. Bankruptcy Court for the District of Massachusetts. Arch Wireless did not include Nationwide as a creditor on its bankruptcy schedules, and Nationwide did not file an appearance in the bankruptcy case.

Accordingly, Nationwide did not receive any notices from Arch Wireless or the bankruptcy court regarding the bankruptcy proceedings. On May 15, 2002, the bankruptcy court confirmed Arch Wireless's chapter 11 reorganization plan and entered a confirmation order that included a discharge injunction precluding the assertion of any claims that arose prior to the confirmation date.

### 'Known Creditor'

Following confirmation of the debtor's reorganization plan, Arch Wireless began terminating Nationwide's service for nonpayment. Thereafter, Nationwide commenced a state court action under the Massachusetts unfair business practices statute alleging harm for Arch's overbilling and defective pagers. Almost two years later, Arch Wireless sent Nationwide a copy of the bankruptcy court's confirmation order and demanded that Nationwide withdraw its state court claims against it.

The First Circuit affirmed the bankruptcy court's determination that Nationwide was a "known creditor" that did not receive adequate notice sufficient to comport with the requirements of due process; thus, the discharge injunction contained in the confirmation order did not preclude Nationwide from asserting its pre-confirmation claims.

The court determined that Nationwide was a known creditor because of the pre-bankruptcy correspondence regarding payment and defective product issues. The First Circuit found that Nationwide's claim could have been reasonably ascertained from a review of the debtor's own records—namely, the pre-petition correspondence that asserted "an entitlement to affirmative compensation."

Accordingly, Nationwide was a "known creditor," and pursuant to the Federal Rules of Bankruptcy Procedure, entitled to notice of the claims bar date, a copy of the reorganization plan, notice of the confirmation hearing and a copy of the confirmation order.

### Due Process Requirements

To satisfy due process requirements in the context of a chapter 11 discharge injunction, debtors must ensure that "required information" [is] 'reasonably conveyed' to the creditor against whom the debtor wishes to enforce the discharge injunction." Unlike a chapter 7, chapter 13 or a case against an individual debtor, in a chapter 11 case, neither publication notice nor a general awareness of the pending reorganization is sufficient to satisfy these due process notice requirements. In a chapter 11 case, something more is required before a known creditor's claims will be barred forever.

In the case at hand, although Nationwide's president generally was aware of Arch Wireless's chapter 11 bankruptcy filing, the creditor did not have actual knowledge of the claims bar date or information regarding the debtor's reorganization plan. Therefore, the First Circuit determined that the discharge injunction did not apply to Nationwide because such application would violate due process.

Creditors of chapter 11 debtors should be mindful that those that do not receive actual written notice of a debtor's claims bar date and information regarding the reorganization plan may not be bound by a discharge injunction. To avoid application of the discharge injunction to a creditor's claim, however, a creditor first must prove it was a "known creditor" of the debtor and, as a result, was entitled to receive written notice of such events sufficient to comply with constitutional due process requirements.

## FIFTH CIRCUIT UPHOLDS BAD FAITH SANCTIONS

Troubled economic times predictably result in an escalation in bankruptcy filings. As the economy began to worsen last year, the U.S. Court of Appeals for the Fifth Circuit issued a reminder that courts can—and will—penalize parties that tax an already busy bankruptcy court system with bad faith filings.

In an en banc decision, the Fifth Circuit held that a bankruptcy court did not abuse its discretion by imposing \$90,000 in monetary sanctions following the bad faith filing of two bankruptcy petitions. *In re Yorkshire LLC (Knight v. Luedtke, et al.)*, No. 07-20644 (5th Cir. Aug. 8, 2008).



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Under the facts of this case, a business disagreement culminated in the filing of a state court action. Subsequent to this filing, the president/manager of two companies and his counsel filed voluntary petitions for bankruptcy relief on behalf of a limited partnership and its sole general partner, a limited liability company. The filings were made shortly before a scheduled change of venue hearing in the state court action and a business meeting at which the removal of the president/manager from any position of authority would be discussed.

The bankruptcy court found that the appellants prepared the bankruptcy petitions in secret and without consulting any other person with authority to act on behalf of the companies. The bankruptcy court further found that counsel conducted little, if any, due diligence about whether bankruptcy was appropriate under the circumstances and who was vested with the authority to make such decisions on behalf of the debtor companies. All parties stipulated that, at all times, the debtor companies were solvent.

### Bad Faith Elements

When imposing sanctions on the appellants, the bankruptcy court relied on the court's "inherent authority to regulate the practice of litigants and lawyers appearing before it," as well as Bankruptcy Rule 9011(c).

On appeal, the Fifth Circuit noted that appellants did not act in the best interest of the companies, concealed their actions from the debtor companies and their creditors, and filed "to inflict injury . . . with a bad motive and with no meaningful thought being given to the purposes of chapter 11 bankruptcy." In upholding the bankruptcy court's decision, the Fifth Circuit further determined that the appellants' arguments all lacked merit and none went to the foundation of the bankruptcy court's order, the bad faith nature of the filing.

Affirming the bankruptcy court's imposition of sanctions, the Fifth Circuit remarked upon the bankruptcy court's careful consideration of evidence. The bankruptcy court specifically found that the appellants acted in bad faith by using the bankruptcy filing as a means to inflict injury on others after becoming frustrated by the exhaustion of available state court remedies. The Fifth Circuit determined that the bankruptcy court was well within the purview of its powers to impose sanctions following this specific finding of bad faith.

The Fifth Circuit further held that the amount of sanctions should be limited to an amount sufficient to deter similar conduct. To calculate the amount of sanctions, the bankruptcy court used as a starting point the amount of attorneys' fees incurred by the debtor companies, as well as the appellants' annual income and net worth. The Fifth Circuit concluded the sanctions imposed were appropriate.

The bad faith use of the chapter 11 process for a personal vendetta is regarded seriously by the courts and may lead to the imposition of large monetary sanctions that go well beyond attorneys' fees incurred by the debtors.

### Update

## 11TH CIRCUIT: LEASE TERMINATION FEES CAN QUALIFY AS PREFERENTIAL PAYMENTS



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The U.S. Court of Appeals for the Eleventh Circuit has affirmed a lower court ruling that lease termination fees can be considered preferential transfers under the Bankruptcy Code, subject to avoidance. The court's holding reinforces concerns over whether landlords can structure lease terminations in a manner that protects them from preference recovery.

Last year, a federal district court in Georgia held that payments pursuant to a "lease termination agreement" constituted payments on account of antecedent debt, giving rise to potential

preference claims under Section 547 of the Bankruptcy Code. See *Midwest*

*Holding # 7, LLC v. Anderson*, 387 B.R. 892 (N.D. Ga. 2008), as reported by Derek J. Baker, "Termination Fees," *CRaB Alert*, November 2008, p. 12.

Following the district court's decision, the landlord appealed to the Eleventh Circuit, which adopted the reasoning of the lower court. See *Midwest Holding #7, LLC v. Anderson (In re Tanner Family, LLC)*, 556 F.3d 1194 (11th Cir. 2009). The Eleventh Circuit confirmed that payments made pursuant to a lease termination agreement are payments made as a result of the previously existing (and to be terminated) lease agreement.

Because the obligations to pay rent under that lease preceded the payment made pursuant to the termination agreement, the payments could be fairly construed as "on account of" the previously existing lease obligation. Therefore, the payments could constitute payments "on account of antecedent debt" and could qualify as potential preferential transfer under Section 547 of the Bankruptcy Code.

The Eleventh Circuit's conclusion reinforces concerns we raised in our discussion of the district court's decision in *Midwest Holding*—that landlords may have difficulties structuring lease-termination clauses that successfully protect them from preference recovery actions.

## Is Triangular Set-off Enforceable Under U.S. Laws?—continued from page 2

and (b) there is no contract exception to the express and limited set-off language of the Bankruptcy Code.

The court denied the motion of Chevron Products Company (“Chevron”) to apply express contractual rights of set-off against three affiliated debtors in connection with three separate agreements for the sale and purchase of crude oil, regular unleaded gasoline, and/or butane, isobutane and propane, respectively.

Chevron moved for reconsideration Jan. 20, arguing that the three contracts are forwards and swap agreements, fall within the Bankruptcy Code’s “safe harbor” provisions for financial contracts, and as such, should fall into an exception to the court’s narrow interpretation of the Bankruptcy Code’s set-off provisions.

### Contract Provisions

Chevron’s purchases under the three contracts were governed by three sets of terms and conditions that were cross-referenced in each of the contracts with the three subject debtors, SemCrude LP, SemFuel LP, and SemStream LP. Each contract provided that:

in the event either party fails to make a timely payment ... or ... a timely delivery of product or crude oil ... the other party may offset any deliveries or payments under this or any other agreement between the parties and their affiliates.

When the *SemCrude* bankruptcy case commenced, Chevron owed payment to SemCrude, but was owed substantially more from the other two debtors, both affiliates of SemCrude. Because the commencement of the cases under Chapter 11 of the Bankruptcy Code resulted in an automatic stay enjoining ordinary contract parties from acting against the debtors, including enforcing set-off rights, Chevron sought leave of the court to undertake the contractual triangular set-off among the affiliated debtors.

### Bankruptcy Court’s Opinion

The court took a strict approach to interpreting the set-off provisions of the Bankruptcy Code, and found that express contractual set-off provisions like those in the Chevron contracts (which allow a single creditor to set off obligations with several different—but affiliated—debtor entities) were unenforceable in bankruptcy as a matter of law. The court noted that the Bankruptcy Code preserves for a creditor’s benefit set-off rights it may have under nonbankruptcy law, but imposes additional conditions that must be met to effect set-off against a debtor in bankruptcy. These additional conditions include that the obligations must be “mutual” pre-petition debts, and thus must be due to and from the same persons or entities in the same capacities.

The court acknowledged that U.S. common law appears to establish a contractual exception to the mutuality requirement when contracts expressly provide for cross-affiliate set-off and netting. The court, however, dismissed this argument as at best merely theoretical in nature, finding support neither in the plain reading of the controlling Bankruptcy Code section, nor in the reported cases (none of which in fact allowed contractual triangular set-off). In short, the court held that an agreement to set off funds as among multiple affiliates cannot satisfy the Bankruptcy Code’s mutuality requirement because such agreement does

not create the required indebtedness from one party to another, and thus is unenforceable in a bankruptcy case.

### Motion for Reconsideration

Chevron countered with a motion to reconsider the opinion, arguing that the subject contracts are “forward contracts” and “swap agreements” that fall under the so-called “safe harbor provisions” of the Bankruptcy Code, and that as a result, exceptions to the general rules for set-off should apply and lead to a contrary outcome. The “safe harbors” are a set of statutory provisions under the Bankruptcy Code that apply to qualified financial contracts and financial participants, excepting them from certain restrictions of the automatic stay, and allowing special rights for non-debtor counterparties to swap agreements, forward agreements and other financial contracts. Such rights include, among other things, the right upon a bankruptcy filing to terminate, liquidate and accelerate their swap agreements; apply master netting agreements and contractual set-off rights; and to foreclose on pledged collateral.

Importantly, the safe harbor provisions that permit termination, netting and set-off as applied to pre-petition commodities or forward contracts and swap agreements state that such contractual rights “shall not be stayed, avoided or otherwise limited by operation of any provision of this title or by any order of a court ... in any proceeding under this title.”

By seeking to recast the three pre-petition supply contracts as forwards and swap agreements, and itself as a forward contract merchant and swap participant, Chevron argues that its right as a non-debtor counterparty to such contracts to terminate, net and apply set-off to the three contracts is expressly excepted from the automatic stay, and that complete deference to the contractual set-off provision is required by the court for forwards and swap agreements.

Although the legal classification of such physically settled forward oil and gas contracts (i.e. those forward contracts for the sale and purchase of a commodity, providing for the physical delivery of commodities themselves rather than a cash settlement reflecting the market pricing of the underlying commodities) is an issue disputed in the U.S. bankruptcy courts, Chevron may find support from the timely Feb. 11, 2009 decision of the U.S. Court of Appeals for the Fourth Circuit, in *Hutson v E.I. Dupont De Nemours & Co., et al. (In re National Gas Distributors LLC, )* No. 07-2105 (Hutson). In *Hutson*, the Fourth Circuit reversed the ruling of the North Carolina Bankruptcy Court that found physically settled commodity contracts, as matter of law, were mere supply contracts not subject to safe harbor protections.

Instead, the Fourth Circuit determined that a physically settled “commodity forward agreement” may qualify as a “swap agreement” under the U.S. Bankruptcy Code, and fall within the so-called “safe harbor” provisions of the Bankruptcy Code, regardless of whether these over-the-counter transactions are (a) settled by physical delivery of a commodity (rather than cash), (b) assignable, or (c) traded on a financial market or exchange.

In reaching its decision, the Fourth Circuit first rejected the bankruptcy court’s assumption that a “swap agreement,” which is defined to include a “commodity

## Is Triangular Set-off Enforceable Under U.S. Laws?—continued from page 10

forward agreement,” must be “regularly the subject of trading in financial markets.” The Fourth Circuit based its rejection on the twin principles that:

- (1) Every “forward contract” is a “forward agreement,” since the term “agreement” is broader than and encompasses the term “contract.”
- (2) The legislative history, case law, and market practices relating to forward contracts permit such contracts to be directly negotiated and do not require that such contracts be traded in a financial market to be part of an overall hedging program.

Second, on the basis of legislative history, case law, and common definitions of a forward agreement, the Fourth Circuit rejected the bankruptcy court’s assumption that a “commodity forward agreement” must be cash-settled.

The Fourth Circuit’s decision is binding on courts within its circuit, and likely to materially influence other courts considering similar issues. Whether its influence will be felt in Delaware and to Chevron’s benefit remains to be seen. Chevron’s motion for reconsideration was scheduled at press time to be argued March 12.

### Weighing the Risks

The *SemCrude* opinion, issued by a trial-level court, is not controlling law outside of Delaware and remains subject to reconsideration and appeal. That said, the opinions of the federal bankruptcy court in Delaware—one of the busiest and most prolific U.S. bankruptcy courts—are instructive and often relied upon by state courts nationwide. Further, while the issue of the applicability of the safe harbor provisions to physically settled forward contracts is unlikely to be resolved in connection with *SemCrude*, it continues to percolate among the U.S. bankruptcy courts, and has been squarely addressed by the Fourth Circuit Court of Appeals.

The *CRAB Alert* will continue to monitor these issues and report on further developments.

In the interim, parties should be aware that a substantial risk exists that triangular set-off provisions will be held to be ineffective in U.S. bankruptcy cases.

Care therefore should be taken when drafting contractual provisions that the requirements of mutuality and pre-existence of the obligations to be set-off are satisfied. That may be addressed, for instance, by having all the parties concerned execute a multilateral netting agreement that expressly provides for both. The *SemCrude* opinion as it stands, however, does not address whether any such enhanced contractual set-off ultimately could be relied upon in a U.S. insolvency.

The most prudent approach—especially in contracts providing for a physical delivery—therefore is not to rely on set-off across affiliates as a way to reduce exposure to a counterparty’s insolvency. Alternatively, parties should seek independent credit evaluations of each counterparty on an individualized basis, and consider contracting for collateral and obtaining guarantees.

**Case update:** On March 20, the bankruptcy court entered a decision denying the motion to reconsider based on Chevron’s failure to raise the safe harbor provisions in its initial moving papers. The court found that Chevron failed

to satisfy the standard for reconsideration under Bankruptcy Rule 59(e)(i.e., reconsideration of a decision based on (a) an intervening change in controlling law; (b) new or previously unavailable evidence, or (c) to correct a manifest error on the part of the court). See Memorandum Order Denying Chevron Products Company’s Motion for Reconsideration of This Court’s Opinion dated January 9, 2009 Regarding Contractual Netting (Bankr. D. Del. March 20, 2009).

The court did not address the substantive issue of set-off under the safe harbor provisions, noting that Chevron did not raise the safe harbor issue as an alternative ground for relief when it moved to lift the stay to apply cross-affiliate set-off, and instead merely cited to Section 553 of the Bankruptcy Code. Raising the safe harbor grounds in the motion for reconsideration was procedurally too late to be recognized. Chevron has filed a notice of appeal and we will follow for developments.

*Editor’s note: Andrea’s bankruptcy practice includes all aspects of chapter 11 cases, as well as out-of-court workouts involving private and publicly held companies. In addition, she represents hedge funds, banks and other financial institutions in connection with investing or trading strategies, structured debt, and derivative transactions based on ISDA documentation, with a focus on credit default swaps and valuation disputes. Andrea also advises commodities traders in commodities contract disputes, cross-border issues, counterparty insolvency, and derivatives disputes under ISDA and similar documentation.*

## LENDER MAY BE LIABLE FOR ALLOWING DISBURSEMENTS IN EXCESS OF LOAN BUDGET

A federal district court has held in a construction lending dispute that claims that a bank breached its contract by allowing loan disbursements in excess of the loan budget, and by failing to perform inspections before disbursement, could proceed to trial.

The scope of the court's holding in *LaSalle Bank Nat'l Assoc. v. Paramount Properties*, 588 F.Supp.2d 840 (N.D. Ill. 2008) is limited—i.e., the court ruled the case could go to trial but made no underlying determination of liability. Nonetheless, the decision provides some cautionary warning for lenders.



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In *LaSalle Bank*, the court considered a motion to dismiss various counterclaims asserted by a borrower and guarantor to a simple collection action commenced by the bank. The facts are not unlike routine construction lending arrangements; however, the court's holdings raise questions about the role of the lender in such arrangements.

LaSalle made a loan to Paramount for the acquisition and development of approximately 250 lots (to be developed in two phases) in Missouri. The borrower entered into an

agreement with a contractor to perform the improvements on the property. The terms of the loan were consistent with a relatively routine construction lending scenario. The arrangement permitted the bank to honor requests for loan advances signed by the contractor (not the borrower), and provided that the bank could inspect the project and otherwise verify any matters set forth in a request for advance prior to honoring an advance.

The borrower alleged that, despite those provisions in the underlying loan documents, the bank never performed any inspections, and made advances that exceeded the original budget attached to the loan documents. Defaults occurred as a result of the borrower's failure to make payments, and the bank instituted a collection action against the borrower and guarantor. The defendants counterclaimed, alleging breach of contract and other claims for negligence and negligent misrepresentations. The bank moved to dismiss the defendants' counterclaims.

### Negligence in Loan Servicing

The court held that the defendants' claims resulted from the bank's alleged failure to administer the loan in accordance with the terms of the loan documents. Concluding that Illinois law applied, the court further noted that Illinois law prohibits negligence claims based on the failure to perform contractual obligations absent some other, particularized duty, which did not arise under the contract.

Although the defendants pointed to a "general duty" by lenders to supervise loan disbursements, the court stated that various cases decided by courts in California, Florida and Massachusetts expressly rejected such a duty. Therefore, the court dismissed the defendants' negligence claims. The court further dismissed claims asserted for negligent misrepresentation, noting that any claims

related to an oral promise are barred by the integration clause in the applicable loan documents.

### Breach of Contract Claim

The court then turned to the defendants' counterclaim asserted for breach of contract. In its counterclaims, the defendants asserted that the bank breached obligations under the loan documents by failing to make inspections of construction progress, and by allowing disbursements to be honored without the prior written approval of the borrower. The bank sought dismissal, arguing that the terms of the note do not "require" any preconditions to advances; rather, the note simply "authorized" the bank to require compliance prior to funding.

The court noted that the terms of the loan documents are written as a mandatory precondition (i.e., using the word "shall"); therefore, the bank's assertion was inconsistent with the terms of the documents. Further, the documents did not have a provision that permitted the bank to unilaterally waive conditions prior to advances. As a result, the court held that the defendants could assert that the bank breached its contract with the borrower by allowing loan disbursements in excess of the loan budget, and by failing to perform an inspection before each disbursement.

Because the bank could not establish that the defendants' claims were barred by the express terms of the documents, the court permitted the case to proceed to discovery.

While the language of the court's decision is somewhat troubling for lenders, the scope of the court's holding is limited. The court's decision is only at the "sufficiency" phase of the litigation and merely allows the case to proceed to trial. There is no determination of liability and assessment of damages against the bank.

The decision in *LaSalle Bank*, however, does raise areas of concern for lenders. As a result, lenders should ensure that their loan documents: (i) provide the lender sufficient flexibility to determine when strict compliance with conditions is required; (ii) allow the lender to waive conditions when in its best interests; and (iii) otherwise limit any "obligations" a lender could be deemed to incur as a result of entering into a construction loan agreement.

## JUNIOR LIEN HOLDER BANKRUPTCY STAYS FORECLOSURE BY SENIOR LIEN HOLDER

A bankruptcy filing by a property owner may not be the only action that prevents foreclosure of a security interest in that property held by a secured creditor. In a growing list of cases, courts also have held the bankruptcy of a junior secured creditor with a lien on the property invokes the automatic stay against such action.

In one such case, a federal bankruptcy court in Texas held that the bankruptcy filing by an entity that held a second secured lien on property of a nonbankrupt borrower automatically stayed a foreclosure action by the senior secured lender with a lien on the same property. See *In re Three Strokes L.P.*, 379 B.R. 804 (Bankr. N.D. Tex. 2008).



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In *Three Strokes*, certain Arizona real property was owned by Citadelle at Arrowhead Ranch, LLC. Citadelle was owned by two other entities, Arrowhead Point, Inc. and Bean Premier, LLC. Long before the dispute at issue, Citadelle borrowed approximately \$28 million from an entity that had transferred the loan to Consec by the time of the bankruptcy case. The loan was secured by a first lien on the Arizona real property, assignment of rents and other personal property relating to a 100,000 sq. ft. mixed-use retail and office facility, and 10 acres of additional real property. The loan also was

guaranteed by an individual, Albert Paul Stevens.

Consec appears to have been an outsider to a series of incestuous relationships between the debtor, Three Strokes, Citadelle, the actual owner of the 100,000 sq. ft., 10 -cre real estate at issue; Citadelle's owners, Arrowhead Pointe, Inc. and Bean Premier, LLC; and Mr. Stevens. The court noted that all of the shares of Arrowhead Pointe were owned by the debtor, Three Strokes, and that the shares were subject to a pledge to Bean Premier. Stevens was a "principal" of Citadelle and signed a voluntary petition of debtor Three Strokes as president of the general partner of the debtor.

### First Security Interest

Consec had, however, a first-secured security interest that was in default, and a written "Intercreditor Subordination Agreement" with Three Strokes, fully and completely subordinating Three Strokes' security interest in the property to Consec's security interest in the property. There was conflicting appraisal evidence as to whether the value of the property was enough to fully secure Consec's lien, and whether there was some possible additional value that might be available to Three Strokes as second lien holder.

On a motion for relief from stay, and alternatively for a determination that the stay simply did not apply, the bankruptcy court held that the stay was applicable. The court further ruled that a decision as to whether the stay ought to be lifted would be made based on the usual factors: cause and lack of adequate protection for Consec's lien.

Thus, the *Three Strokes* court joins a lengthening list of bankruptcy courts that have held that a bankruptcy filing by the holder of a junior lien on property of a nonbankrupt owner automatically triggers the protection of the bankruptcy stay, precluding enforcement of liens against that property by a senior secured lender. These courts have held this to be the case even though the owner of the property and the obligor to the senior secured lender are not in bankruptcy.

In so holding, the bankruptcy court provided the clearest statement yet of the logic behind this decision: the property on which both senior and junior lien holders have liens is not the property of the bankruptcy estate. The second lien interest of Three Strokes, however, is property of the Three Strokes bankruptcy estate. The foreclosure proceedings by Consec would have the effect of extinguishing Three Strokes' second lien interest, and would give Consec control over property of the Three Strokes estate.

### Purpose of the Stay

Consec argued that Section 362(a) of the Bankruptcy Code is designed to stop creditor collection actions. The court, however, noted that Section 362 actually designates "all entities" as targets of the stay. The stay's general purpose—to prevent disbursement of the bankruptcy estate and allow a breathing spell for a debtor-in-possession to collect itself—applies equally in instances in which an asset is a lien as it does when it is the dirt itself.

The court's decision is in line with earlier decisions such as *Florida Inst. of Tech. v. Carpenter (In re West Tech Corp.)*, 460 F.2d 1139, 1142 (5th Cir. 1972) (a chapter X case); *In re Chestnut*, 433 F.3d 298, 303 (5th Cir. 2005); *Fidelity Mortgage Investors v. Camelia Builders, Inc.*, 550 F.2d 47 (2nd Cir. 1976) (a chapter XI case); *In re Capital Mortgage and Loan Inc.*, 35 B.R. 967 (Bankr. E.D. Cal. 1983); and *Cardinal Indus., Inc. v. Buckeye Fed. Sav. and Loan Ass'n (In re Cardinal Indus. Inc.)*, 105 B.R. 834 (Bankr. S.D. Ohio. 1989).

In enforcing the automatic stay, the court declined to follow contrary case authority. These include *Farmers Bank v. March (In re March)*, 140 B.R. 387 (E.D. Va. 1982), which was affirmed by the U.S. Court of Appeals for the Fourth Circuit at 988 F.2d 498, but the affirmation was on procedural grounds and not the substantive issue of the automatic stay. Other cases in this line of authority include *In re Le Peck Constr. Corp.*, 14 B.R. 195 (Bankr. E.D.N.Y. 1981) and *In re Holiday Lodge, Inc.*, 300 F.2d 516 (7th Cir. 1962).

The bankruptcy court ultimately determined that a trial was needed on the factual issues concerning whether there was cause for relief from the automatic stay. The legal result reached by the *Three Strokes* court, however, adds additional weight to the proposition that a junior lienholder seeking bankruptcy protection can preclude the enforcement of a senior lien, even though the owner of the encumbered property has not sought (and may not even be eligible for) bankruptcy relief.

## ARE ATTORNEY'S FEES RECOVERABLE IN STATE ACTIONS FOR WORK DONE IN BANKRUPTCY COURT?

Under the “American Rule” concerning the recovery of attorney’s fees in pursuing breach of contract litigation, the prevailing party is awarded fees if the contract or an applicable statute provides for such recovery. Some states also allow a judgment creditor to recover fees incurred in enforcing the judgment, if the judgment was based on a contract or statute that authorized fees in the original litigation. See, *e.g.*, California Code of Civil Procedure § 685.040.



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But to be recoverable, do these fees have to be incurred in the usual kinds of enforcement process, such as execution, examination of a judgment debtor or writ practice? A recent California case extends recovery to fees and costs incurred in a bankruptcy case.

A California Court of Appeal held that California state law permitted recovery of attorney’s fees and costs post-judgment incurred by the judgment creditor in a bankruptcy case filed by the defendant and judgment debtor after suffering the judgment. *Chinese Yellow Pages Co.*

*v. Chinese Overseas Mktg. Serv. Corp.*, 170 Cal.App.4th 868 (2009).

### Lawsuits & Bankruptcy

The facts are complex but boil down to this: In Case 1, Chinese Yellow Pages (CYP) sued Chinese Overseas Marketing Service Corporation (COMSC) for false advertising and unfair competition, and the case was settled for a substantial sum and certain “good conduct” promises. The settlement agreement also included a provision for awarding attorney’s fees to the prevailing party in any action later brought to enforce or interpret the settlement agreement. A judgment based on the settlement agreement and including a permanent injunction was entered by the court in Case 1.

After several years, CYP filed Case 2 in state court against COMSC, alleging a violation of the “good conduct” terms of the settlement agreement. Case 2 was tried, and CYP won a judgment against COMSC for \$4.25 million in compensatory damages, plus \$750,000 in punitive damages.

COMSC filed a chapter 11 bankruptcy petition. The bankruptcy case also was hotly contested by CYP. While the bankruptcy litigation proceeded, CYP filed in state trial court pursuant to Case 2 a supplemental cost memorandum seeking approximately \$500,000 in additional attorney’s fees and costs for work performed in the bankruptcy case, citing California Code of Civil Procedure § 685.040.

The judgment debtor and the appointed bankruptcy trustee in the Chapter 11 case opposed the motion on the grounds that a decision as to the entitlement and amount of any such fees or costs should be made by the bankruptcy court rather than the state trial court. While that motion was pending, the bankruptcy court entered a formal order dismissing the Chapter 11 case, so no decision on the motion was made by the bankruptcy court. In addition, the bankruptcy court,

relying on its dismissal of the chapter 11 case, declined the state trial court’s request to advise it as to whether an attorney’s fees award would be proper.

The state trial court then heard and denied the attorney’s fees motions on the grounds that it lacked authority to award attorney’s fees for work done in the bankruptcy case.

### Literal Reading

On appeal, the California Court of Appeal ruled that neither the bankruptcy code nor the pendency of the bankruptcy case precluded the state trial court from ruling on the merits of the creditor’s motion under California Code of Civil Procedure § 685.040. The Court of Appeal determined that the trial court was not precluded from awarding attorney’s fees and costs incurred to enforce the multimillion-dollar judgment in Case 2, even though those expenses were for work in the bankruptcy case.

The court applied a literal reading to section 685.040 (“Attorneys incurred in enforcing a judgment are [recoverable] . . . if the underlying judgment includes an award of attorney’s fees to the judgment creditor . . .”). It also relied on an earlier decision by a different California Court of Appeal, *Circle Star Center Assoc., L.P. vs. Liberate Tech.*, 147 Cal. App. 4th 1203 (2007), in which a plaintiff leased space to a defendant that filed a bankruptcy petition. The plaintiff was able to secure dismissal of the defendant’s bankruptcy case by motion in the bankruptcy court, and subsequently sought an award in state court under the attorney’s fees clause in the lease.

The *Circle Star* court approved this procedure and affirmed the judgment. Based on this analysis, the *Chinese Yellow Pages* court reversed the trial court’s refusal to enter a judgment for attorney’s fees and costs.

### Unexpected Consequences

It is difficult to argue with the logic of these decisions, but the consequences for some litigants in bankruptcy court may be unexpected. For example, can a party engaged in state court specific performance litigation over a contract with an attorney’s fees clause obtain an award of attorney’s fees for its costs in successfully obtaining relief from stay by motion in the bankruptcy court?

Suppose a party successfully contests the confirmation of a chapter 11 plan of reorganization that would have treated its creditor’s claim based on a state court judgment (with an attorney’s fee award) as a nonpriority unsecured claim, thereby gaining priority unsecured status instead? Can this party then return to state court to obtain a supplemental award of attorney’s fees for winning the battle over the confirmation of the plan—which also will be treated as priority?

Look at another example: A debtor makes a payment on a partly secured obligation established by a state court judgment in an action involving the interpretation of a security agreement with an attorney’s fees clause. What if the debtor then sues on behalf of the bankruptcy estate, to recover this payment as a pre-bankruptcy preferential transfer? If the creditor/recipient of the transfer successfully defends the preference recovery action by litigating to establishing that the value of the collateral well exceeds the amount transferred, can the creditor then approach the state court to obtain a supplemental award, also to be paid as secured from the estate’s property?

As these examples demonstrate, the holding in *Chinese Yellow Pages* has the potential to shift significantly the burden of bankruptcy court litigation costs.

## Fourth Circuit Rules on Safe Harbor Protections for Commodity Forward Contracts—continued from page 4

By comparison, the contracts at issue were directly negotiated between the debtor and the respective customers, and contemplated physical delivery of the commodity (gas) to the purchasers.

The customers filed motions to amend the Initial Orders to allow for the development of certain factual findings in support of the position that the contracts indeed qualified as commodity forward agreements and, by extension, swap agreements. They were joined with an amicus brief by the International Swaps and Derivatives Association.

The bankruptcy court, however, denied the motions to amend on June 20, 2007, reiterating that, as a matter of law, the contracts were not commodity forward agreements or swap agreements. The court held again that the contracts were “simple supply contracts” for the future delivery of a commodity, and thus concluded that no factual findings were mandated.

The customers sought and obtained leave to appeal directly to the Fourth Circuit (which is infrequently granted), citing as a case of first impression the legal issues involved in interpreting physically settled commodity forward contracts under the Bankruptcy Code.

### Fourth Circuit’s Holding

Upon appeal, the Fourth Circuit reversed the bankruptcy court on virtually all grounds, finding that “commodity forward contracts” are both “commodity forward agreements” and “swap agreements” under the Bankruptcy Code. The appeals court further held that the bankruptcy court orders rested upon two patently false assumptions.

First, the Fourth Circuit rejected the bankruptcy court’s assumption that a “swap agreement,” which is defined to include a “commodity forward agreement,” must be “regularly the subject of trading in financial markets.” The court based its rejection on the twin principles that:

- (1) Every “forward contract” is a “forward agreement,” since the term “agreement” is broader than and encompasses the term “contract.”
- (2) The legislative history, case law, and market practices relating to forward contracts permit such contracts to be directly negotiated and do not require that such contracts be traded in a financial market to be part of an overall hedging program.

Significantly, the Fourth Circuit pointed out that the contracts, although privately negotiated and quite possibly not assignable, were part of an overall hedging program for each of the customers, which also involved other transactions that were traded in financial markets.

On the basis of legislative history, case law, and common definitions of a forward agreement, the Fourth Circuit rejected the bankruptcy court’s assumption that a “commodity forward agreement” must be cash-settled. Citing to decisions of federal courts ranging from Texas to Delaware, as well as the 2005 and 2006 Congressional amendments to the Bankruptcy Code, the Fourth Circuit noted that just as forward contracts may be physically settled, so too may forward agreements.

While the Fourth Circuit did not instruct the bankruptcy court to find that the individual subject contracts were “commodity forward agreements” or “swap agreements,” it did remand the case for further proceedings consistent with the appellate decision.

### Still to Come

Accordingly, we now await an outcome on remand to the bankruptcy court. The customers in the case will attempt to demonstrate factually and legally that their contracts did qualify as swap agreements and/or commodity forward agreements. If successful, the customers’ pre-bankruptcy settlements (including pre-bankruptcy deliveries of gas) under the contracts at issue in this case will be exempt from the trustee’s avoidance powers.

Regardless of the outcome in the underlying case, the Fourth Circuit decision brings commodity forward contracts squarely within the scope and protections of the Bankruptcy Code safe harbor provisions. This is the case whether or not they are physically or cash-settled. The decision is binding on courts within the Fourth Circuit and likely to materially influence other courts considering similar issues.

Practitioners and participants in the OTC derivatives markets are advised to carefully review the Fourth Circuit’s reasoning, as it provides a roadmap for key acknowledgments to be exchanged by counterparties to contracts for hedging transactions linked to a physical commodity.

Specifically, counterparties should consider including acknowledgements to the effect that:

- (1) The parties intend their contract to be considered a “swap agreement” or a “commodity forward agreement,” as defined in the Bankruptcy Code;
- (2) Whether the contract is cash-settled or settled via physical delivery of the commodity, the value of the contract is based upon changes in the value of a commodity, rather than changes in the value of costs attributable to other factors such as the packaging, marketing, transportation and servicing of the commodity; and
- (3) The contract and related transaction are tied to the broader financial market, since the counterparties entered into the transactions to hedge against risk and may enter into other related derivative transactions with other financial intermediaries to manage the risks and obligations under the contract.

## As Bank Insolvencies Loom, Lending Groups Should Act Now to Protect Themselves—continued from page 5

### Lender Action During Stay

The automatic stay restricts the nondefaulting lenders from taking action to “affect any contractual rights of” the Insolvent Lender. Although there is scant precedent as to how the FDIC will exercise this new power, we know from other bank receiverships that the FDIC has taken a broad view of its power under the FDIA.<sup>32</sup>

The FDIC likely would consider prohibitions on voting by an Insolvent Lender to be in contravention of the automatic stay. Similarly, the agency likely would view provisions that provide a threshold for lender consent during the automatic stay that does not include the Insolvent Lender as an unallowable restriction that prevents the Insolvent Lender from enforcing its contractual rights during the automatic stay period.

So how can nondefaulting lenders continue business as usual under the loan documents without violating the automatic stay? One approach would be to make changes to the documents that otherwise would not require the consent of the Insolvent Lender. Amendments that only require the consent of requisite lenders, as opposed to all lenders, should be valid so long as they have enough support without the Insolvent Lender’s vote.

Another approach is to move away from taking action against the Insolvent Lender based upon the insolvency or the lender’s resultant inability to fund, to the extent applicable, and instead focus on events prior to the take-over by the FDIC. These could include a ratings downgrade, placement on the FDIC’s watch list, or stock price volatility, all of which indicate the lender is headed for trouble.

This approach represents a significant shift in the treatment of troubled lenders. Yet obtaining a prior agreement from a lender to transfer or suspend its voting rights based upon the occurrence of certain “bad” events would create a plausible argument that actions taken by the other lenders pursuant to loan document provisions, and prior to insolvency, do not violate the automatic stay.

### Agent Receivership

The lending syndicate also should focus on preserving the ability to take action if the FDIC becomes receiver of the Agent. Without such precautions, the operation of the automatic stay would render the loan documents unworkable in such an event.

Similar to the discussion concerning voting rights, the most obvious solution to the dilemma of an insolvent Agent is to act before the Agent is declared insolvent. The syndicate should identify early warning signs of an impending insolvency as triggers for removing the rights the lenders seek to preserve during the automatic stay. The loan documents could provide for termination of the Agent upon events similar to those set forth above for the voting rights .

Upon termination, the Agent automatically would assign its rights and duties to a successor Agent to be selected by the nondefaulting lenders. Collateral such as bank accounts held in the name of the Agent would be moved prior to the receivership. A power of attorney in favor of the lender group could permit any one of the nondefaulting lenders to act as successor Agent and move the accounts.

### Going Forward

It is difficult to predict the impact the new FDIA automatic stay will have on lending syndicates. There are exceptions to the automatic stay, one of which is that the provision does not allow the FDIC as conservator or receiver to fail to comply with otherwise enforceable contractual provisions. The legislation, nonetheless, could be interpreted to prohibit lenders from taking certain actions to implement contractual provisions.

It appears likely that funding obligations in revolving facilities will be impacted in ways that may be detrimental to credit facility co-lenders and Agents. The potential impact can be mitigated, however, by proactively reviewing and amending loan documents. Lenders and Agents should review provisions addressing the definition of a defaulting lender, funding mechanics, payment mechanics and voting to ensure as much flexibility as possible should one of the lenders become an Insolvent Lender.

## Delaware Court Allows Corporate Waste Claim Based on Executive Compensation—continued from page 7

In contrast, Chancellor William B. Chandler III noted that “there are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company’s business risk.”<sup>27</sup>

### Disposition of Corporate Waste Claims

Under Delaware law, a plaintiff asserting a claim for corporate waste must show that fiduciaries “authorized an exchange that is so one-sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”<sup>28</sup> Generally, establishing a waste claim is difficult for any plaintiff because the plaintiff must overcome the “general presumption of good faith by showing that the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.”<sup>29</sup>

The *Citigroup* court dismissed the plaintiffs’ waste claims arising from subprime asset purchases and investments in special investment vehicles because the plaintiffs failed to allege that such transactions resulted from bad faith conduct by the defendants.<sup>30</sup> The court also dismissed the waste claims regarding the stock repurchase program, finding that all repurchases were at market price, i.e., “the price at which presumably ordinary and rational businesspeople were trading the stock.”<sup>31</sup>

The *Citigroup* opinion represents an interesting milestone in the current economic downturn. The decision makes clear that disaffected shareholders may have difficulty convincing the Delaware Court of Chancery to extend established doctrines of fiduciary duty in the face of economic crises and mounting losses, but nonetheless signals that extra care must be taken with respect to executive compensation packages coinciding with decreasing corporate success.

## Counsel's Corner

## NEWS FROM REED SMITH



Peter S. Clark II  
Partner  
Philadelphia

### Reed Smith Ranks Among Top Bankruptcy Firms

Reed Smith had the fourth-highest number of active bankruptcy cases in the fourth quarter of 2008, according to *The Deal's* Global Bankruptcy League Tables.

"We're pleased to be among the busiest firms in the country handling bankruptcy matters," said **Peter S. Clark, II**, firmwide Practice Group Leader of Reed Smith's Commercial Restructuring & Bankruptcy Practice. "This high level of activity is indicative of Reed Smith's longstanding reputation for helping its clients weather financial adversity and economic turbulence of all types."

**Kurt F. Gwynne**, a Wilmington-based partner in Reed Smith's Financial Industry Group, earned the 18th spot on the Bankruptcy League Tables' "Top Bankruptcy Lawyers" most recent list, with 60 active assignments at the end of 2008.

"This is a very busy time for bankruptcy lawyers particularly in Delaware," said Mr. Gwynne. "I do not expect that to change in the foreseeable future."

Reed Smith's Commercial Restructuring & Bankruptcy Practice Group has built a global reputation for achieving results in complex

financial restructurings, workouts, bankruptcies, insolvencies and other matters involving financially distressed transactions.

Firm clients include financial institutions, creditor committees, indenture trustees, insolvency practitioners, private equity and hedge funds, investment management groups, bond holders, venture capital funds, asset custodians, insurance companies, lessors, trade creditors, and debtors.

Although the breadth of Reed Smith's experience spans every industry, the firm is particularly active in industries such as asbestos, energy, food, health care and pharmaceuticals, insurance and finance, real estate, retail, steel, subprime lending, transportation and automotive, telecom and technology, and manufacturing. Reed Smith is one of the 15 largest law firms in the world.

### Reed Smith Partner Named Outstanding Restructuring Lawyer

Reed Smith New York partner **J. Andrew Rahl, Jr.** has been named an Outstanding Restructuring Lawyer for 2008 by legal and business publisher Beard Group.

Andy, a partner in Reed Smith's Commercial Restructuring & Bankruptcy Group, has long been active in the representation of financial institutions and other clients in bankruptcy and restructuring matters.

In naming him among 2008's top 12 attorneys in the restructuring field, the December 2008 Beard Group *Special Report* cited Andy's work in "representing one of the largest AIG CDS counterparties in the federal bailout, counsel in the monoline insurance restructurings, and his cutting-edge work on the bankruptcy/FDIC derivatives safe harbor, along with actions as counsel to the Official Finova Equity Committee before the Third Circuit."

"We're delighted, but not surprised that Andy was selected for this signal honor," said Peter S. Clark, II, firmwide Practice Group Leader of Reed Smith's Commercial Restructuring & Bankruptcy Practice. "He has amassed an enviable record in restructuring representations and has earned a national reputation for his contributions to this field. We congratulate him for this well-deserved inclusion on the list of 2008's most outstanding attorneys."

In June, **James C. McCarroll**, a New York City-based partner in the firm's Commercial Restructuring & Bankruptcy Group, was selected by Beard Group as one of the nation's top 12 restructuring attorneys younger than 40.

### In the News ...

Reed Smith Pittsburgh partner **Robert P. Simons** was quoted in the January 14 issue of *The Deal Pipeline*, in an article titled, "Survival mode," detailing retailer bankruptcies.

"Unlike past economic downturns that were confined to specific industry sectors, the present downturn and resulting economic contraction will not spare any industry, from high tech to real estate," Bob, a bankruptcy and corporate restructuring attorney, told the *Pipeline*.

He added that a cross-industry bailout is not the answer. "Larry Flynt is asking for a bailout of *Hustler* magazine to protect the libidos of our citizens, so I suppose there is no limit to those who will ask. But it is up to our leadership to start saying no ...."



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New York



James C. McCarroll  
Partner  
New York



Robert P. Simons  
Partner  
Pittsburgh

## Counsel's Corner—continued from page 17



Andrea J. Pincus  
Partner  
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## Speakers Bureau

Reed Smith partners **J. Andrew Rahl** and **Andrea J. Pincus** spoke at the March 18 Beard Group Audio Conference on the topic, “Financial Meltdowns—What You Should Know About Counterparty Risk and Valuation When Financial Institutions Fail.” Andy and Andrea, both New York partners in the firm’s Commercial Restructuring & Bankruptcy Group, were joined by Phil Weeber of the financial advisory firm Chatham Financial, and provided real-world legal and practical advice to parties facing major exposure to failed (or failing) financial institutions.

Pittsburgh partner **Robert P. Simons** moderated a panel at the 2009 Association for Corporate Growth Conference Feb. 18 titled, “Managing Distressed Situations.”

Reed Smith’s Commercial Restructuring & Bankruptcy Group comprises more than 60 bankruptcy lawyers in 16 of our 23 offices in the United States, Europe, the Middle East and Asia. The firm’s offices in New York and Wilmington place our attorneys at the doorstep of two of the most active bankruptcy courts in the United States.

## ENDNOTES

1 *In re Citigroup Inc. S’holder Derivative Litig.* at 1–3, 10.

2 *Id.* at 1.

3 *Id.* at 4–9.

4 *Id.* at 1, 2, 9, 55.

5 *In re Citigroup Inc. Shareholder Derivative Litigation* at 17–18 (citing *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984)).

6 Del. Ch. Ct. Rule 23.1(a)(2008), *In re Citigroup Inc. S’holder Derivative Litig.* at 18 (citing *Stone v. Ritter*, 911 A.2d 362, 366-367 (Del. 2006)).

7 *Id.* at 2, 18–19, *In re Citigroup Inc. S’holder Derivative Litig.* at 19 (Citing *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). Del. Ch. Ct. Rule 23.1(a).).

8 *In re Citigroup Inc. S’holder Derivative Litig.* at 54, 55.

9 *Id.*

10 *Id.*

11 *Id.* at 54, 55 (citing *Brehm*, 746 A.2d at note 56).

12 *Id.* at 55.

13 *Id.* at 55–56.

14 *Id.* at 58.

15 *Id.* at 21–49, *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

16 *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d at 967.

17 *Id.* at 970–971, *In re Citigroup Inc. S’holder Derivative Litig.* at 23, 29 (citing *Stone*, 911 A.2d at 370).

18 *In re Citigroup Inc. S’holder Derivative Litig.* at 23, 24.

19 *Id.* at 26, 29, 30, 39, 43.

20 *Id.*

21 *Id.* at 7–9, 34–35.

22 *Id.* at 34, 35.

23 *Id.* at 24, 25, 40, 41.

24 *Id.* at 38, 39.

25 *Id.* at 39, 40.

26 *American Int’l Group, Inc. Consol. Derivative Litig.*, 2009 WL 366613 at 23, 24 (Del. Ch. 2009).

27 *In re Citigroup Inc. S’holder Derivative Litig.* at 40.

28 *Id.* at 51 (citing *Brehm*, 746 A.2d at 263).

29 *Id.* at 51-53 (citing *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001)).

30 *Id.* at note 96.

31 *Id.* at 50-54.

32 In the receivership of NextBank, N.A. the FDIC took the position that an automatic event, default, acceleration or early amortization based solely on insolvency or its appointment as receiver was not enforceable against it. The court upheld the FDIC’s position.

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