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Volume 20, Number 3

Pratt's Journal of Bankruptcy Law
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Editor's Note: Decisions

*By Victoria Prussen Spears**

Important bankruptcy rulings keep coming down from the courts. Read on to see the articles in this issue that examine a host of those decisions, as well as articles on other important bankruptcy and restructuring topics.

PREFERENCES

We lead with an article titled, "Preferences for Sale? Analyzing the Fifth Circuit's *South Coast Supply Co.* Decision," by Patrick L. Hughes, Martha Wyrick and Tom Zavala of Haynes and Boone, LLP.

In this article, the authors examine a decision by the U.S. Court of Appeals for the Fifth Circuit that has opened the door for bankruptcy trustees and debtors in the Fifth Circuit to better maximize the value of intangible litigation claims by selling, pledging, or otherwise transferring preference claims (and potentially other avoidance actions) to third parties, thus conferring standing to the third parties to prosecute the claims for their own benefit.

BOY SCOUTS

Then, in "U.S. Supreme Court Allows Boy Scouts' Chapter 11 Plan to Move Forward," Christopher F. Graham and Michael Ingrassia of White and Williams

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* Victoria Prussen Spears is Senior Vice President of Meyerowitz Communications Inc. A graduate of Sarah Lawrence College and Brooklyn Law School, Ms. Spears was an attorney at a leading New York City law firm before joining Meyerowitz Communications. Ms. Spears, who is Editor of *The Banking Law Journal*, *Pratt's Journal of Bankruptcy Law*, *Pratt's Energy Law Report*, *Pratt's Government Contracting Law Report* and *Pratt's Privacy & Cybersecurity Law Report*, published by Lexis, can be reached at vpspears@meyerowitzcommunications.com.

LLP discuss the implications of a decision by the U.S. Supreme Court declining to stay the implementation of the Boy Scouts of America's confirmed Chapter 11 plan.

SYNDICATED LOANS

Ken Rothenberg, Russell Chiappetta, Jason Cygielman and Thomas Kelly of Alston & Bird LLP are the authors of the article that follows, titled, "U.S. Court of Appeals for the Second Circuit Confirms That Syndicated Loans Are Not Securities."

In this article, the authors discuss a decision by a federal appellate court affirming that syndicated terms loans are not securities.

DELAWARE LAW

The article titled, "Texas Bankruptcy Court Holds That Bankruptcy Code Overrides Delaware Limited Liability Company Act," is by Robert Klyman and Matthew Sarna of DLA Piper US.

In this piece, the authors discuss a recent decision by a Texas bankruptcy court holding that the Bankruptcy Code automatically overrides a provision of the Delaware Limited Liability Company Act and prevents a member from losing any portion of its membership interest – whether economic or managerial – merely because the member commenced a bankruptcy case.

RESTRUCTURING

The next two articles focus on restructuring matters.

First, in the article titled, "Restructuring Considerations in an Uncertain Economic Climate," Lisa M. Schweitzer and Thomas Kessler of Cleary Gottlieb Steen & Hamilton LLP explain how companies can refresh their internal planning and proactively consider the risks and opportunities that are presented when suppliers, customers and competitors encounter financial distress.

Then, in the article titled, "UK Company Restructuring Plans: What Is Next After *Adler*?," Clare Tanner, Jonathan Lawrence and Maya C. Ffrench-Adam of K & L Gates LLP examine the implications of a recent decision by the England and Wales Court of Appeal on restructurings under UK law.

RUSSIA

Polina Lyadnova, Jim Ho, Chase D. Kaniecki and Andreas Wildner of Cleary Gottlieb Steen & Hamilton LLP examine what sanctions targeting Russia and its economy mean for those invested in Russian sovereign debt in their article, titled, "Russian Sovereign Debt: What Do Investors Need to Know?"

NEGOTIATING

The final part of the three-part series, "Negotiations and The Art of Communicating," by Peter J. Winders, a shareholder and general counsel at Carlton Fields, P.A., is published here and continues the discussion of negotiating and communications – skills that every bankruptcy lawyer needs.

The first part, which was published in the January 2024 issue of *Pratt's Journal of Bankruptcy Law*, introduced the topic through engaging anecdotes, lessons and thoughts on listening and the gamesmanship of negotiations. The second part explained negotiating tactics in detail and mediation. In this conclusion, Mr. Winders examines humor in negotiations, and more.

Enjoy the issue!

Preferences for Sale? Analyzing the Fifth Circuit's *South Coast Supply Co.* Decision

By Patrick L. Hughes, Martha Wyrick and Tom Zavala [*]

In this article, the authors examine a decision by the U.S. Court of Appeals for the Fifth Circuit that has opened the door for bankruptcy trustees and debtors in the Fifth Circuit to better maximize the value of intangible litigation claims by selling, pledging, or otherwise transferring preference claims (and potentially other avoidance actions) to third parties, thus conferring standing to the third parties to prosecute the claims for their own benefit.

The U.S. Court of Appeals for the Fifth Circuit recently issued a decision that increases the marketability of estate assets often viewed as untouchable. In *In re South Coast Supply Co.* (*South Coast*),[1] the Fifth Circuit held that a bankruptcy "preference" action may be sold to a third party under Section 363 of the Bankruptcy Code even if the buyer is not an estate fiduciary and does not represent the bankruptcy estate.

A preference action is an "avoidance" claim arising under Section 547 of the Bankruptcy Code. It permits the debtor or trustee to file a lawsuit to recover prepetition transfers made by debtors to non-insiders within ninety days of the petition date, and transfers to insiders within a year of the petition date.[2] Notably, preferences and other avoidance claims have been traditionally viewed as causes of action reserved for prosecution by a bankruptcy fiduciary, like a debtor-in-possession, trustee, or other court-appointed representative with enhanced duties to the bankruptcy estate.

Following *South Coast*, preference claims, and perhaps other avoidance actions, are now more freely marketable, whether as additional collateral to secure a post-petition loan, to provide third parties with adequate protection against diminution in the value of their collateral, or for outright sale to third parties to bring cash into the estate.

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[1] In re South Coast Supply Co., 91 F.4th 376 (5th Cir. 2024).

[2] "Transfers" and "insiders" have specific meanings under the Bankruptcy Code. See 11 U.S.C. § 101(31) (insiders comprise essentially all officers, directors, and others in control of the debtor) and (54) (broadly defining transfers to include all payments and anything of value).

THE FACTS

The debtor, South Coast Supply Co. (the Debtor), issued $320,000 in checks to its former chief financial officer (CFO), resulting in prepetition transfers comprising an asserted $316,000 preference claim. The Debtor's prepetition secured lender, Briar Capital, filed a $2.5 million proof of claim secured by a first-priority blanket lien on "all of the Debtor's now owned or hereafter acquired assets, whether tangible or intangible."[3] Briar Capital believed it was oversecured, valuing the collateral at $3.9 million.

During the case, the Debtor obtained debtor-in-possession (DIP) financing from a third-party lender (the DIP Lender). DIP financing is a new loan provided to a debtor-in-possession after the case is filed. Under the order approving the DIP financing, Briar Capital retained its senior liens on property acquired by the Debtor prior to the date on which the DIP Lender advanced DIP financing, and the DIP Lender received senior liens on property acquired after that date. The Debtor also commenced a $316,000 preference lawsuit against the CFO and filed a plan of reorganization. The plan proposed to sell certain intangible assets to the DIP Lender for $700,000 cash, earmarking $200,000 to cover administrative expenses arising during the bankruptcy case and the remaining $500,000 to pay general unsecured creditors.

Briar Capital objected to the plan but ultimately withdrew its objection after agreeing with the DIP Lender to the terms of a modified plan. Under the modified plan, Briar Capital abandoned its security interest in the $700,000 proceeds from the sale of intangibles (which typically would include choses in action, but in this case did not include the preference claim against the CFO) to the DIP Lender and waived its administrative expense claim. In exchange, Briar Capital received assets valued at just over $3.4 million in the aggregate, including the $316,000 preference claim against the CFO.[4] The modified plan did not require Briar Capital to return any "surplus" value to the estate, even if it realized value exceeding its allowed $2.5 million claim from the assets.

The bankruptcy court confirmed the modified plan. The CFO later filed a Rule 12(b)(1) motion to dismiss the preference action (now owned by Briar

[3] Briar Capital Working Fund Capital, LLC v. Remmert (Briar Capital v. Remmert), No. 4:18-CV-2867 (S.D. Tex. Sept. 12, 2022), rev'd and remanded sub nom. In re South Coast Supply Co., 91 F.4th 376, 378 (5th Cir. 2024).

[4] Briar Capital received the following assets under the modified plan: (i) $896,000 in cash; (ii) $1,795,000 in inventory; (iii) $600,000 in accounts receivable, of which $400,000 was likely collectible; and (iv) the $316,000 preference claim against the CFO. Briar Capital v. Remmert, id.

Capital) for lack of subject matter jurisdiction on the basis that Briar Capital lacked standing to prosecute the preference action. The district court withdrew the reference over the preference action and issued a memorandum opinion and order granting the CFO's motion to dismiss.[5]

THE DISTRICT COURT'S RULING

The district court analyzed Briar Capital's standing to pursue the preference action under Section 1123(b)(3)(B) of the Bankruptcy Code and two Fifth Circuit opinions, *McFarland v. Leyh (In re Tex. Gen. Petroleum Corp.)* (*McFarland*)[6] and *In re Moore* (*Moore*).[7] The district court held that Briar Capital lacked standing to prosecute the preference action for two reasons.

First, Briar Capital did not qualify as a representative of the estate under the Fifth Circuit's two-pronged test from *McFarland* and, therefore, the modified plan did not satisfy the requirements of Section 1123(b)(3)(B) of the Bankruptcy Code.[8]

Second, (at the time) the Fifth Circuit had not authorized the sale of preference actions created by Section 547 of the Bankruptcy Code.[9]

Section 1123(b)(3)(B) of the Bankruptcy Code allows a plan to "provide for the . . . enforcement . . . by a representative of the estate appointed for such purpose, of any such claim or interest."[10] Under the *McFarland* test, a third party may enforce a claim owned by the estate under Section 1123(b)(3)(B) of the Bankruptcy Code only if the third party (i) was appointed, and (ii) is a representative of the estate.[11] "The primary concern [of the second prong of *McFarland*] is whether a successful recovery by the appointed representative would benefit the debtor's estate and particularly, the debtor's unsecured creditors."[12] The district court reasoned that the modified plan failed the second prong because it did not require Briar Capital to return any surplus

[5] Id.

[6] McFarland v. Leyh (In re Tex. Gen. Petroleum Corp.), 52 F.3d 1330 (5th Cir. 1995).

[7] In re Moore, 608 F.3d 253 (5th Cir. 2010).

[8] Briar Capital v. Remmert, supra n.3.

[9] Id.

[10] 11 U.S.C. § 1123(b)(3)(B).

[11] McFarland, 52 F.3d at 1335.

[12] Id.

recovery on the preference claim to the estates and, therefore, did not benefit the other creditors.[13]

Briar Capital argued that it did not need to satisfy the *McFarland* test because it purchased the preference claim by withdrawing its objection to the plan and abandoning its interest in the $700,000 cash earmarked to satisfy administrative expenses and distributions to unsecured creditors.[14] The district court disagreed, relying on "numerous" non-binding cases that prohibited the sale of avoidance claims to third parties due to the absence of guidance from the Fifth Circuit in *Moore*.[15] After the district court granted the CFO's motion to dismiss, Briar Capital appealed to the Fifth Circuit.

THE FIFTH CIRCUIT'S RULING

The Fifth Circuit phrased the issue on appeal as: "whether a preference action, a specific type of avoidance action, may be sold."[16] Reversing the district court and remanding, the Fifth Circuit held that:

(i) Preference actions are property of the estate under Sections 541(a)(1) and (7) of the Bankruptcy Code;

(ii) Property of the estate can be sold outside the ordinary course of business under Section 363(b)(1) of the Bankruptcy Code; and

(iii) Briar Capital, having purchased the preference claim, had standing to prosecute it against the CFO.[17]

The Fifth Circuit reviewed two key issues in its opinion: (i) how preference actions become property of the estate, and (ii) whether third parties must represent the estate (and act in a fiduciary capacity) to prosecute preference actions.

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[13] See Briar Capital v. Remmert, supra n.3.

[14] Id.

[15] Id. In Moore, the Fifth Circuit acknowledged that a "split of authority exists as to whether the trustee may sell causes of action that arise from his avoidance powers," but reserved ruling, instead focusing "narrowly" on the trustee's ability to sell causes of action that exist outside of bankruptcy (specifically state law fraudulent transfer claims). In re Moore, 608 F.3d at 261.

[16] South Coast, 91 F.4th at 381.

[17] Id. at 385-86.

Preference Actions Become Property of the Estate Under Section 541(a)(1) and (7) of the Bankruptcy Code

Citing Supreme Court precedent[18] and its own jurisprudence[19] to broadly construe Section 541 of the Bankruptcy Code, the Fifth Circuit ruled that the preference claim against the CFO constituted property of the Debtor's estate under Section 541(a)(1) and (7) and could, therefore, be sold to a non-fiduciary under Section 363(b)(1).[20] Section 541(a)(1) includes "all legal or equitable interests of the debtor in property as of the commencement of the case" within the meaning of property of the estate.[21] Section 541(a)(7) includes "any interest in property that the estate acquires after the commencement of the case."[22]

The Fifth Circuit based its ruling on the plain language of Section 541(a)(1) and longstanding Supreme Court precedent that held Section 541(a)(1) "is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code,"[23] including Section 547 (the preference statute). Section 541(a)(1) includes within property of the estate a debtor's property interests "as of" the commencement of a case, no matter how "conditional, future, speculative, or equitable [in] nature" the interests may be.[24] Preference actions arise with the filing of the bankruptcy petition, making them property the debtor has an interest in as of the commencement of the case,[25] and, thus, property of the estate under Section 541(a)(1) of the Bankruptcy Code. The Fifth Circuit's inclusion of preference actions within the meaning of Section 541(a)(1) fit squarely within the Supreme Court's interpretation of Section 541(a)(1) in *Whiting Pools*.[26]

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[18] Id. at 381 ("[Property of the estate] is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code." (citing U.S. v. Whiting Pools, Inc., 462 U.S. 198, 205 (1983))).

[19] South Coast, 91 F.4th at 382 (citing In re Equinox Oil Co., 300 F.3d 614, 618 (5th Cir. 2002)).

[20] South Coast, 91 F.4th at 381.

[21] 11 U.S.C. § 541(a)(1).

[22] Id. § 541(a)(7).

[23] Whiting Pools, 462 U.S. at 205.

[24] South Coast, 91 F.4th at 382 (citing In re Kemp, 52 F.3d 546, 550 (5th Cir. 1995)).

[25] South Coast, 91 F.4th at 382.

[26] Id. ("Preferences are a mechanism in the Bankruptcy Code by which additional property is made available to the estate, fitting squarely within the Whiting Pools definition.").

The Fifth Circuit also cited favorably to *Simply Essentials*,[27] in which the U.S. Court of Appeals for the Eighth Circuit concluded that "debtor[s] have an inchoate interest in [] avoidance actions *prior to* the commencement of [] bankruptcy proceedings."[28] But Section 552(a) of the Bankruptcy Code provides that property the debtor acquires post-petition is not subject to a lien resulting from a prepetition security agreement.[29] Presumably, then, an after-acquired property clause in a prepetition security agreement like Briar Capital's would not attach to (or be perfected as to) a preference action arising *with* the filing of the case, notwithstanding the Eighth Circuit's "inchoate interest" discussion. Further, the Uniform Commercial Code's requirements for perfecting a security interest may make perfection of a prepetition security interest in preferences practically impossible.

Debtors May Sell Preference Actions to Non-Fiduciaries and thus Confer Standing to Prosecute the Preference Actions to the Non-Fiduciaries

The second issue that the Fifth Circuit addressed was whether a third party must represent the estate to pursue a validly purchased preference claim. Several courts have held that the bankruptcy avoidance powers are reserved exclusively for representatives of the estate.[30] The Fifth Circuit disagreed, concluding that

[27] Id. at 382-83 ("Chapter 5 avoidance actions are property of the estate" (citing In re Simply Essentials, LLC, 78 F.4th 1006, 1011 (8th Cir. 2023))).

[28] Simply Essentials, 78 F.4th at 1009 (emphasis added). The Fifth Circuit also endorsed the Ninth Circuit's reasoning that preferences are property of the estate which can be sold to maximize the value of the estate. South Coast, 91 F.4th at 383 ("While there is some disagreement among courts about the exercise by others of the trustee's bankruptcy-specific avoiding power causes of action, the Ninth Circuit permits such actions to be sold or transferred." (citing In re Lahijani, 325 B.R. 282, 288 (9th Cir. B.A.P. 2005))). It is worth noting, however, that unlike the Fifth and Eighth Circuits, the Ninth Circuit did not expressly rule that avoidance actions are property of the estate under Section 541(a)(1). Instead, the Ninth Circuit focused on the end-goal of maximizing value. See Lahijani, 325 B.R. at 288 ("[U]nder the law of the circuit, trustee avoiding powers may be transferred for a sum certain. . . . The benefit to the estate in such circumstances is the sale price, which might or might not include a portion of future recoveries for the estate.").

[29] 11 U.S.C. § 552(a) ("[P]roperty acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.").

[30] See, e.g., In re McGuirk, 414 B.R. 878, 879 (Bankr. N.D. Ga. 2009) ("A trustee's avoidance powers, including those under sections 547, 548 and 549 of the Bankruptcy Code, are unique statutory powers intended to benefit the estate, not a single creditor."); Briar Capital v. Remmert, supra n.3 (collecting cases).

a third party need not represent the estate to prosecute a preference claim in every case.[31]

A debtor's ability to sell a preference claim to third parties and the appointment of estate representatives to prosecute avoidance actions are "exclusive and independent" issues.[32] The Bankruptcy Code requires enforcement of an estate claim by a representative of the estate only when the claim is *retained* by the estate.[33] But Section 1123(b)(3)(B) is not exclusive.[34] What if the estate no longer owns the claim? The Bankruptcy Code provides different mechanisms for a debtor to convert its assets to cash. Section 363(b)(1) of the Bankruptcy Code, for example, does not require third-party purchasers of estate claims to qualify as estate representatives in order to prosecute the claims.[35] Alternatively, a plan may provide for "the sale of all or any part of the property of the estate . . . among those having an interest in such property of the estate."[36] The Bankruptcy Code provides debtors with the flexibility to choose between prosecuting or liquidating claims owned by the estate, and debtors have several methods for realizing value on estate claims, including *but not limited to* the means set forth in Section 1123(b)(3)(B).

Following the Eighth and Ninth Circuits, the Fifth Circuit concluded that this flexibility enables the debtor to carry out its fiduciary duty to maximize estate value.

In reaching its decision in *South Coast*, the Fifth Circuit rejected the CFO's argument that its ruling would harm the general policy of equity in bankruptcy, concluding instead that allowing the sale of preference actions "will grant bankruptcy courts more flexibility in distributing assets, maximize the value of the bankruptcy estate, and in turn, allow for more equitable distribution of

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[31] South Coast, 91 F.4th at 385; see also Simply Essentials, 78 F.4th at 1009-10 (reasoning that the trustee's fiduciary duty to maximize the value of the estate may require the trustee to sell property, including an avoidance action, to a non-fiduciary).

[32] South Coast, 91 F.4th at 385.

[33] 11 U.S.C. § 1123(b)(3)(B) ("[A] plan *may* provide *for the retention* and enforcement by the debtor, the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest[.]") (emphasis added).

[34] See South Coast, 91 F.4th at 385 ("Section 1123(b)(3) states that a Chapter 11 bankruptcy plan *may* provide. . . .") (emphasis original).

[35] See 11 U.S.C. § 363(b)(1); South Coast, 91 F.4th at 385 (observing that Section 363(b)(1) of the Bankruptcy Code permits a debtor to "use, sell, or lease, other than in the ordinary course of business, property of the estate" and requires only notice and a hearing).

[36] 11 U.S.C. §§ 1123(a)(5)(D) and 1123(b)(4).

assets."[37] The Fifth Circuit highlighted the fact that Briar Capital waived its administrative expense claim and its security interest in the proceeds from the Debtor's sale of intangibles to the DIP Lender to purchase the preference claim.[38] Thus, the certainty of $700,000 in cash to the bankruptcy estate to cover administrative expenses and distributions to unsecured creditors justified selling the preference claim, which had not yet been prosecuted to judgment.[39]

CONCLUSION

Bankruptcy courts have historically balked at debtors' attempts to pledge avoidance claims as collateral to secure post-petition financing or cash-collateral usage due to uncertainty and uneasiness regarding a third party's standing to prosecute the trustee's avoidance powers. Courts have expressed similar reservations when non-fiduciaries sought to prosecute avoidance actions for their own benefit absent proof of standing. The Fifth Circuit previously reserved ruling on the issue, focusing instead on the importance of the debtor's disclosure statement describing reserved causes of action with specificity.[40] In

[37] South Coast, 91 F.4th at 384.

[38] Id. at 383.

[39] In McFarland, the Fifth Circuit explained that the "primary concern" of the estate representative requirement under Section 1123(b)(3)(B) of the Bankruptcy Code is "whether a successful recovery by the appointed representative would benefit the debtor's estate and particularly, the debtor's unsecured creditors." 52 F.3d at 1335. In South Coast, the preference sale arguably benefitted the debtor's estate more than the debtor's prosecution of the claim would have. The preference action was facially valued at $316,000, without accounting for the cost of prosecuting the claim to judgment and collecting on that judgment. Conversely, the parties' deal made possible the sale of intangibles to the DIP Lender that resulted in a sum certain of $700,000 cash to the estates, including $200,000 to fund administrative expenses and $500,000 to unsecured creditors. Thus, the sale of the preference claim advanced the principal policy underlying McFarland by guaranteeing cash exceeding the face value of the preference claim to unsecured creditors, even though the Fifth Circuit concluded that Briar Capital was not bound by Section 1123(b)(3)(B) or McFarland.

[40] See, e.g., Wooley v. Haynes & Boone, L.L.P. (In re SI Restructuring Inc.), 714 F.3d 860, 864 (5th Cir. 2013) ("For a reservation to be effective, it 'must be specific and unequivocal'—blanket reservations of 'any and all claims' are insufficient." (quoting Dynasty Oil & Gas, LLC v. Citizens Bank (In re United Operating, LLC), 540 F.3d 351, 355–56 (5th Cir. 2008))); National Benevolent Ass'n of the Christian Church (Disciples of Christ) v. Weil, Gotshal & Manges, LLP (In re National Benevolent Ass'n of the Christian Church (Disciples of Christ)), 333 Fed. Appx. 822, 827 (5th Cir. June 11, 2009) (granting defendant law firm's motion to dismiss because plan did not "specifically and unambiguously reserve the claims" stemming from alleged prepetition attorney malpractice); Dynasty Oil & Gas, 540 F.3d at 355 ("For a debtor to preserve a claim, 'the plan must expressly retain the right to pursue such actions.' The reservation must be 'specific and unequivocal.'" (quoting In re Paramount Plastics, Inc., 172 B.R.

this context, defendants in post-confirmation litigation have challenged both whether debtors properly disclosed and reserved avoidance claims and whether creditors that do not represent the estate have standing to prosecute avoidance claims. In *South Coast*, the Fifth Circuit has preempted the latter argument (at least with respect to preferences) by confirming that debtors may sell preference actions to third-party non-fiduciaries under Section 363(b)(1) of the Bankruptcy Code if the sale maximizes estate value.[41] While the Fifth Circuit limited the scope of its holding to preference actions, its reasoning may apply to other avoidance actions, including fraudulent transfers, which can include both state and federal claims under Sections 544, 548 and 550, and wrongful post-petition transfers under Section 549.

Some may find the Fifth Circuit's decision not to address certain counter-arguments incomplete. For example, the Bankruptcy Code grants certain "rights and powers" exclusively to the "trustee," including the discretion to pursue avoidance actions.[42] Further, under the Bankruptcy Act, which preceded the Bankruptcy Code, it was well-settled that the trustee could not sell or assign its avoidance powers,[43] and Congress did not materially amend the preference statute when it adopted the Bankruptcy Code and carried over the preference statute.

The Fifth Circuit did not address these concerns, ostensibly because the plain language of Section 541 of the Bankruptcy Code (at least when interpreted broadly under *Whiting Pools*) provided a sufficient foundation for the Fifth Circuit's ruling. Nonetheless, distinguishing the trustee's "rights and powers" to recover preferences from general causes of action likely amounts to a distinction without a difference because Chapter 5 avoidance powers, including preferences, are causes of action under both the text of the Bankruptcy Code and Supreme Court precedent.[44]

331, 333 (Bankr. W.D. Wash. 1994) and Harstad v. First Am. Bank, 39 F.3d 898, 902 (8th Cir. 1994))).

[41] South Coast, 91 F.4th at 384 ("The court's obligation in § 363(b) sales is to assure that optimal value is realized by the estate under the circumstances." (citing Lahijani, 325 B.R. at 288)).

[42] See 11 U.S.C. §§ 546(b)(1), (c)(1), (d), (h), 547(b), 550(a).

[43] In re Sapolin Paints, Inc., 11 B.R. 930, 937 (Bankr. E.D.N.Y. 1981) (citing 3 Collier on Bankruptcy ¶ 60.57 (14th Ed. 1979)) (collecting cases).

[44] See 11 U.S.C. § 926(a) ("If the debtor refuses to pursue a *cause of action* under section 544, 545, 547, 548, 549(a), or 550 of this title, then on request of a creditor, the court may appoint a trustee to pursue such *cause of action*.") (emphasis added); Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 53-54, (1989) (describing the "right to recover a fraudulent conveyance under 11 U.S.C. § 548(a)(2)" as a "statutory cause of action."); but see Hartford Underwriters Ins. Co. v.

Further, the fact that creditors can obtain derivative standing to pursue avoidance actions when debtors are unwilling or unable to fulfill their fiduciary duty to maximize value belies the notion that avoidance powers are reserved exclusively for the trustee under the Bankruptcy Code.[45]

Heartburn over the sale of avoidance actions ultimately seems to be caused by concern that avoidance powers will be used for one creditor's gain rather than for equitable distribution among all creditors, which is the paramount interest of bankruptcy. This has led courts to hold certain types of claims, such as personal-injury tort claims and, in most states, malpractice claims, to be non-assignable on public policy grounds. But in all bankruptcy cases, transfers of estate property interests are subject to bankruptcy court oversight and approval because the trustee must seek permission before it can pledge or sell a preference claim or any other property of the estate.[46] The notice and hearing requirements under the Bankruptcy Code ensure due process, and bankruptcy courts are well-equipped to ensure that property sales maximize value without undermining principles of equity on a case-by-case basis. If, for example, a hypothetical debtor-in-possession has the means to prosecute an avoidance action for the benefit of all its creditors but opts instead to sell the action at a discount to one creditor for its own benefit, the bankruptcy court can simply deny the related sale motion or deny confirmation of the plan, thereby preserving equity of distribution.[47]

Union Planters Bank, N.A., 530 U.S. 1, 6-7 (2000) ("Where a statute names the parties granted the right to invoke its provisions, such parties only may act.") (quoting 2A N. Singer, Sutherland on Statutory Construction § 47.23, p. 217 (5th ed. 1992)) (cleaned up).

[45] See, e.g., Louisiana World Exposition v. Fed. Ins. Co., 858 F.2d 233, 252 (5th Cir. 1988) ("If pursuing the action would maximize the value of the estate, the debtor-in-possession is obligated to do so. Where the debtor-in-possession is unable or unwilling to fulfill its obligation . . . the [Unsecured Creditors'] Committee may assert the cause of action on behalf and in the name of [the debtor] if authorized to do so by the bankruptcy court."); In re Gibson Group, Inc., 66 F.3d 1436, 1442 (6th Cir. 1995) ("We have determined that a creditor may have standing to file an avoidance action if the bankruptcy court determines that certain conditions exist and certain prerequisites are met.").

[46] For instance, a trustee may seek to transfer a debtor's property interest through a motion to approve financing, a sale motion, or a sale, pledge, or other transfer through a bankruptcy plan, as was the case in South Coast.

[47] Yet, it is not difficult to envision a contrary scenario like South Coast in which a Chapter 7 trustee lacks sufficient funds to prosecute a cognizable avoidance action but has found a buyer willing to purchase the avoidance action at a discount (for its own benefit) in exchange for cash that will flow directly to the benefit of the estate and its creditors. Under these circumstances, the trustee can either sell the avoidance action or, effectively, let it go to waste. Only one of these two options fulfills the trustee's fiduciary duty to maximize value: the trustee must sell the avoidance action. This hypothetical illustrates why the Fifth Circuit's ruling in South Coast was necessary

South Coast has opened the door for debtors to sell or pledge preference actions, and perhaps other avoidance actions, to non-fiduciary third parties in the Fifth Circuit. Time will tell the full extent of *South Coast*'s impact on bankruptcy practice in the Fifth Circuit, but the opinion indicates that trustees can sell any estate property, including Chapter 5 claims, to third-party non-fiduciaries so long as the transaction maximizes estate value. As a result, lenders, investors in third-party litigation, and others wanting to purchase and prosecute bankruptcy claims have cause to rejoice.

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to carry out the provisions of the Bankruptcy Code and constitutes sound jurisprudence for future cases.

U.S. Supreme Court Allows Boy Scouts' Chapter 11 Plan to Move Forward

By Christopher F. Graham and Michael Ingrassia*

In this article, the authors discuss the implications of a decision by the U.S. Supreme Court declining to stay the implementation of the Boy Scouts of America's confirmed Chapter 11 plan.

The U.S. Supreme Court made a significant decision by declining to stay implementation of the Boy Scouts of America's (BSA) confirmed Chapter 11 plan pending appeal, which will strip thousands of survivor claimants of their ability to assert claims outside the plan's contours.[1]

The request for the stay, brought by a group of 144 individuals who alleged that they suffered childhood sexual abuse (out of the approximately 82,000 who filed claims in the Chapter 11 case), was sought on the basis that implementation of the $2.4 billion BSA plan should be paused until the Supreme Court decides whether, and to what extent, non-consensual third-party releases are permissible under the U.S. Bankruptcy Code.

The Supreme Court is currently reviewing that very issue in connection with the Chapter 11 plan of *Purdue Pharma*.[2]

Taken in tandem with *Purdue Pharma*, the denial of the application for a stay of BSA's plan may signal that a decision from the Supreme Court on the jurisdictional limitations of the U.S. Bankruptcy Code and the bankruptcy courts is imminent.

THE COURT'S ORDER

In a terse order dated February 22, 2024, the Supreme Court, without explanation or dissent, vacated the stay order issued by Associate Justice Alito less than a week earlier. Justice Alito, notably, was highly engaged during the December 5, 2023, *Purdue Pharma* oral argument about the impact of the Supreme Court's decision on other bankruptcy cases. The issuance of civil stays by the Supreme Court is exceedingly rare.[3]

During the two hours of oral argument on the *Purdue Pharma* Chapter 11 plan, the Justices' far-ranging queries exceeded the issues on appeal. It is possible

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[1] See Lujan Claimants et al. v. Boy Scouts of America et al, Case No. 23A741 (U.S.).

[2] See In re Purdue Pharma L.P., 69 F.4th 45 (2d. Cir. 2023).

[3] See Ind. State Police Pension Trust v. Chrysler LLC, 128 S. Ct. 2275 (2009); In re Purdue.

that the Supreme Court does not anticipate that its *Purdue* decision will also govern the result in BSA. A stay would have maintained the status quo and could have avoided another Supreme Court appeal on the same issue of non-consensual third-party releases.

If nonconsensual third-party releases are not permissible, one could only wonder why the Supreme Court would permit the BSA plan to proceed prior to the issuance of the Supreme Court's decision on the issue. Does the denial of the BSA stay signal that the Supreme Court will allow such releases? Certainly spectators, bankruptcy practitioners and claimants alike are eagerly awaiting the Supreme Court's *Purdue Pharma* decision.

PURDUE PHARMA

Notably, in *Purdue Pharma*, the U.S. Bankruptcy Court for the Southern District of New York approved a Chapter 11 plan that included nonconsensual third-party releases.[4] The U.S. District Court for the Southern District of New York reversed that decision, holding that such releases were impermissible under the Bankruptcy Code.[5] Ultimately, the U.S. Court of Appeals for the Second Circuit reversed the district court decision, holding that such nonconsensual third-party releases were permissible.[6] The Supreme Court stayed implementation of the plan pending oral argument and issuance of its final decision.

The now-vacated stay of the BSA plan was issued the same day that was to be the deadline for survivor claimants to pay a nonrefundable $10,000 initial fee as a requirement of obtaining an exhaustive review of their abuse claims. According to the settlement trust's website, with the stay vacated, the trust has "resumed all operations, including processing and paying claims."

The BSA's Chapter 11 plan was approved by Delaware Bankruptcy Judge Laurie Selber Silverstein on September 8, 2022, after a three-week trial in early 2022. On March 28, 2023, the U.S. District Court for the District of Delaware affirmed the confirmation order and the effective date of the plan occurred on April 19, 2023. Although certain insurers and claimants asked the U.S. Court of Appeals for the Third Circuit to stay the Chapter 11 plan pending the Supreme Court's decision on the nonconsensual releases in the *Purdue Pharma*, on November 2, 2023, the Third Circuit denied the request without explanation.

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[4] In re Purdue Pharma, L.P., 633 B.R. 53 (Bankr. S.D.N.Y. 2021).

[5] In re Purdue Pharma, L.P., 635 B.R. 26 (S.D.N.Y. 2021).

[6] In re Purdue Pharma L.P., 69 F.4th 45 (2d. Cir. 2023).

CONCLUSION

This is a very intense time for a lot of people involved in the BSA case.

Over 82,000 survivors filed claims in the BSA Chapter 11 cases. Over 5,000 sponsoring charter organizations, hundreds of insurance carriers and thousands of professionals participated in the nearly two-year mediation process that ultimately resulted in the plan. Voting on the plan was contentious and close. BSA is one of the most expensive Chapter 11 cases in history with approved professional fees of over $274 million.

Although it is impossible to predict how the Supreme Court will rule on these thorny bankruptcy legal and policy questions, clearly the justices are fully engaged in the heavy task.

U.S. Court of Appeals for the Second Circuit Confirms That Syndicated Loans Are Not Securities

By Ken Rothenberg, Russell Chiappetta, Jason Cygielman and Thomas Kelly*

In this article, the authors discuss a decision by a federal appellate court affirming that syndicated terms loans are not securities.

In last year's biggest court case involving the $1.5 trillion syndicated loan credit market, the U.S. Court of Appeals for the Second Circuit affirmed the U.S. District Court for the Southern District of New York's decision in *Kirschner v. JP Morgan Chase Bank N.A.* holding that a syndicated term loan is not a "security" under the Securities Exchange Act of 1934 and the Securities Act of 1933.

The highly anticipated ruling upheld the historical convention and understanding of borrowers and lenders alike that syndicated loans are not securities. After the U.S. Supreme Court denied Kirschner's writ of certiorari in February 2024, the issue is settled: syndicated term loans are not securities.

THE CASE

The *Kirschner* case stemmed from a 2014 refinancing transaction where Millennium Laboratories LLC secured a syndicated term loan from various institutional investors. Millennium was the subject of a Department of Justice (DOJ) investigation during the loan syndication process and, after the loan closed, Millennium agreed to a DOJ settlement of more than $250 million, which contributed to Millennium filing for bankruptcy in 2015. Marc S. Kirschner was appointed as litigation trustee, and he brought suit against the defendants (as the arrangers for that syndicated loan) in the bankruptcy case with claims that included federal and state securities laws violations for failure to disclose the 2014 DOJ investigation.

In 2020, the district court dismissed the case on account of Kirschner failing to plausibly suggest that the Millennium loans were securities when applying the four-factor "family resemblance" test outlined by the U.S. Supreme Court in 1990 in *Reves v. Ernst & Young*.

Kirschner appealed to the Second Circuit in 2021, but the Second Circuit also utilized the *Reves* test in upholding the district court decision in a direct

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and concise opinion. Under *Reves*, there is a presumption that a note is a security, though this presumption can be rebutted if the note bears a strong "family resemblance" to notes that are not characterized as securities.

THE "FAMILY RESEMBLANCE" *REVES* TEST

There are four factors of the "family resemblance" test weighed by courts to determine whether a note was issued in an investment context (and would be considered a security) or in a consumer or commercial context (when it would not be considered a security).

Motivations That Would Prompt a Reasonable Seller and Buyer to Enter into the Transaction

A court must determine whether the motivations of the seller and buyer are investment or commercial/consumer. The Second Circuit stated that a buyer's motivation is investment if it expects a profit from its investment (specifically highlighting that profit may be through variable or fixed-rate interest), while a seller's motivation is investment if it intends to raise capital for general business enterprise use or to finance significant investments (specifically highlighting that the seller's motivation is commercial if the loan is exchanged for "the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose").

While the Second Circuit reasoned that Millennium had commercial motivation due to its intent to use the syndicated loan to pay off a then-existing credit facility, the court also noted that the lenders' motivation was investment-driven due to the scheduled interest payments under the syndicated loan. Because of the mixed motivations of the parties, the Second Circuit intimated that, at the early stage of the *Kirschner* case, the first factor leaned in favor of the Millenium loans resembling securities.

Plan of Distribution of the Instrument

The court must look to the distribution plan of the instrument to determine whether it was offered and sold to a broad segment of the public. The Second Circuit highlighted that the lead arrangers offered the Millennium loan solely to institutional investors who would receive an allocation of the loan only after submitting a legally binding offer. The Second Circuit found that the loan syndication process was not a broad, unrestricted sale to the general public.

The Second Circuit also found unpersuasive Kirschner's argument that the existence of a secondary market for the Millennium loan demonstrated an offering to the general public. In particular, the court referenced credit agreement transfer restrictions, such as minimum transfer requirements, agent and borrower consent, and restricting transfer of the loans only to current lenders or affiliates of lenders. It further noted that such assignment restrictions were similar to those in the 1992 Second Circuit case *Banco Espanol de Credito v. Security Pacific National BankKirschner*, which concluded that loan participations were not securities because of the restrictions preventing participations from being sold to the general public.

The Second Circuit held these transfer restrictions coupled with the syndication procedure for Millenium "rendered [the loans] unavailable to the general public." Therefore, the second factor weighed in favor of the Millennium loans not being securities.

Reasonable Expectations of the Investing Public

This factor requires a court to examine the public's expectations for the notes. If the public was given sufficient notice that the notes were loans and not an investment in a business, then the loans are not securities. The Second Circuit highlighted that before purchasing the Millennium loan, the lenders certified that they were sophisticated and experienced in credit matters similar to the Millennium transaction and that they independently and without reliance on any agent or lender made their own determination whether to extend its portion of the Millennium loan. That certification was substantively identical to the certification made by the *Banco Espanol* participation purchasers, which was central to determining whether those buyers would have perceived the participations as securities.

Additionally, the Second Circuit rejected Kirschner's argument that the use of the term "investors" sporadically throughout the Millennium loan documents fostered a reasonable expectation among the lenders that they were investing in securities. Consequently, the Second Circuit found that the pleaded facts did not support the argument that the lenders reasonably believed the Millennium loans were securities.

Whether Some Factors Significantly Decrease the Instrument's Risk Rendering the Application of the Securities Act Unnecessary

The final factor requires the court to evaluate whether there is another regulatory scheme that substantially reduces the risk that the sale of the instrument will cause harm to the public, rendering application of the Securities Act unnecessary. Here, the Second Circuit found that there were other sufficient risk-reducing factors weighing against the loans qualifying as securities.

More precisely, the court pointed to the fact that the loans in *Kirshner* were secured by perfected security interests in all the borrower's tangible and intangible assets, reducing the risks associated with the notes.

Furthermore, the Second Circuit stated that the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation issued specific policy guidelines addressing syndicated term loans. The Second Circuit recognized that these guidelines were meant to reduce the risk to banks and, in doing so, also sought to reduce risk to consumers and investors. Taking into account the reduction of risk by way of the security interest and the regulatory guidelines, the court found the application of the Securities Acts unnecessary. Therefore, the pleaded facts did not support the claim that the Millennium loans were securities.

KEY TAKEAWAYS

Despite the Second Circuit ruling that the first factor weighed in favor of Kirschner, the remaining three factors were held to be in favor of the defendants and, consequently, the *Kirshner* decision was affirmed by the Second Circuit. That decision has been lauded as a major win for leveraged loan market participants because it validates the long-standing approach that syndicated loans are not securities. One item of note is that although the Second Circuit requested the position of the Securities and Exchange Commission, the SEC declined to submit a brief on the *Kirshner* question.

Had the *Kirshner* decision gone the other way, requiring market participants to comply with cumbersome securities laws requirements would have caused a monumental shift in loan issuance and trading. Characterizing loans as securities would severely impact secondary trading liquidity due to the enhanced transfer restrictions necessitated by securities laws, in addition to trading potentially requiring the use of registered broker-dealers. It is not uncommon for syndicated lenders to receive nonpublic information about a borrower, though if loans were deemed securities, then lenders may run into issues with remaining "public" in order to potentially still trade in that borrower's securities.

Additionally, applying securities laws to loans would require substantially more extensive due diligence on borrowers due to heightened disclosure requirements under securities laws. For borrowers, securities registration requirements would result in considerable additional time and costs and diminish the borrowers' control over the composition of the lender group and to whom material nonpublic must be disclosed.

Kirshner also highlighted the importance in properly drafting loan documentation to avoid loans potentially being characterized as securities. When issuing a syndicated loan, market participants should consider:

- Limiting the potential lender universe to sophisticated investors;
- Including clearly defined assignment provisions and consent requirements in loan documents, such as minimum transfer requirements and a definition of an eligible assignee;
- Adding language to the issuance documents reflecting the understanding that the notes being issued are loans and not investments in a business, while making it clear that the issuance is not considered a securities offering;
- Ensuring the loans are secured by collateral whenever possible; and
- Continuing to request bank regulators to issue and update guidance aimed at protecting consumers in the syndicated loan market.

Texas Bankruptcy Court Holds That Bankruptcy Code Overrides Delaware Limited Liability Company Act

By Robert Klyman and Matthew Sarna*

In this article, the authors discuss a recent decision by a Texas bankruptcy court holding that the Bankruptcy Code automatically overrides a provision of the Delaware Limited Liability Company Act and prevents a member from losing any portion of its membership interest – whether economic or managerial – merely because the member commenced a bankruptcy case.

In *In re Envision Healthcare Corp.*,[1] Judge Christopher M. López of the U.S. Bankruptcy Court for the Southern District of Texas ruled that Section 541 of the Bankruptcy Code conflicts directly with and, therefore, trumps Section 18-304 of the Delaware Limited Liability Company (LLC) Act to prevent the termination of a member's interests in a Delaware LLC arising from such member's bankruptcy filing.

SECTION 18-304 OF THE DELAWARE LLC ACT

The Delaware LLC Act states that, unless otherwise provided in the relevant LLC agreement, the commencement of a bankruptcy case by a member of the LLC automatically divests that member of its membership interest in the LLC.

According to Section 18-304 of the LLC Act:

> A person ceases to be a member of a limited liability company upon the happening of any of the following events:
>
> (1) Unless otherwise provided in a limited liability company agreement, or with the consent of all members, a member:
>
> a. Makes an assignment for the benefit of creditors;
>
> b. *Files a voluntary petition in bankruptcy*;
>
> c. Is adjudged a bankrupt or insolvent, or has entered against the member an order for relief, in any bankruptcy or insolvency proceeding. . . .[2]

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[1] In re Envision Healthcare Corp., Case No. 23-90342 (Bankr. S.D. Tex. Dec. 12, 2023).

[2] 6 Del. C. § 18-304(1) (emphasis added).

Despite the language of Section 18-304, Delaware courts have distinguished a member's economic and managerial interests in an LLC and have limited the application of Section 18-304 to only divest a bankrupt member's managerial interests, leaving economic interests unaffected.

For example, in *Milford Power Co. v. PDC Milford Power, LLC*,[3] the Delaware Court of Chancery held that federal bankruptcy law partially preempted Section 18-304, striking a balance between the application of the Bankruptcy Code and Delaware law:

> I also conclude that the ipso facto clause[4] is preempted to the extent that it would deprive [the debtor/member] of the economic rights available to an assignee of an LLC membership interest under § 18-702(b)(2) of the Delaware LLC Act. By contrast, the ipso facto clause is enforceable insofar as it divests [the debtor/member] of its right to participate as a member in the governance of Milford Power. This conclusion rests largely on my adoption of the reasoning of the United States District Court for the District of Delaware in *In re IT Group, Inc.*[5]

The Delaware Supreme Court in *Zachman v. Real Time Cloud Services, LLC*,[6] followed *Milford Power*'s reasoning. In *Zachman*, the court held that the application of Section 18-304 did not offend federal bankruptcy law, as it acts only to decouple a member's managerial interests from its economic interests in a Delaware LLC, leaving economic interests in place.[7]

THE TEXAS DECISION

Notwithstanding this established Delaware precedent regarding Delaware law, the Texas bankruptcy court recently took a different approach.

In a case of first impression for the Texas bankruptcy court, Judge López held that the Bankruptcy Code overrides Section 18-304 of the LLC Act automati-

[3] Milford Power Co. v. PDC Milford Power, LLC, 866 A.2d 738 (Del. Ch. 2004).

[4] The reference to "ipso facto clause" refers to a contract term that permits its termination due to the bankruptcy, insolvency, or financial condition of a party. Such provisions in most contracts are rendered unenforceable in a bankruptcy case under Section 365(e)(1) of Title 11 of the U.S. Code (Bankruptcy Code).

[5] Milford Power, 866 A.2d at 740.

[6] Zachman v. Real Time Cloud Services, LLC, C.A. No. 9729-VCG (Del. Apr. 20, 2021).

[7] Id. at *3 (citing similarly reasoned decisions from the Supreme Court of Washington and the U.S. Bankruptcy Court for the Eastern District of Virginia).

cally and prevents a member from losing any portion of its membership interest – whether economic or managerial – merely because the member commenced a bankruptcy case.

Background

In *In re Envision Healthcare Corp.*, AmSurg Holdings, LLC (AmSurg) held managerial and voting interests in Folsom Endoscopy Center (FEC), a Delaware LLC. FEC's LLC agreement provided that its board of directors, of which AmSurg held two seats, could not take certain actions without AmSurg's consent, including to amend the LLC agreement itself. In May 2023, AmSurg filed for chapter 11 protection. Later that year, FEC's board voted to amend the LLC agreement without the consent of AmSurg.

AmSurg responded with a motion to enforce the automatic stay under Section 362 of the Bankruptcy Code to block that amendment to the LLC agreement. FEC contended, pursuant to Section 18-304 of the LLC Act, that AmSurg lost its membership interest in FEC automatically when AmSurg filed for bankruptcy – and therefore that FEC could proceed to amend the LLC without AmSurg's consent.

Holding

The Texas bankruptcy court ruled in favor of AmSurg, finding that the Bankruptcy Code overrides Delaware law's automatic termination of a member's LLC interests when a member files for bankruptcy. In doing so, the Texas bankruptcy court held that both a member's managerial and economic interests in a Delaware LLC constitute property of the estate under Section 541 of the Bankruptcy Code.

As such, any act to take possession or exercise control over those property interests, including FEC's vote to amend the LLC Agreement without AmSurg's post-petition consent, was blocked by the automatic stay imposed under Section 362 of the Bankruptcy Code.

Sections 541 and 362 of the Bankruptcy Code

Under Section 541 of the Bankruptcy Code, upon filing, "all legal or equitable interests of the debtor" become property of the debtor's estate.[8] Property of the debtor's estate is contemporaneously protected by the automatic stay that comes into effect upon a filing under Section 362 of the Bankruptcy

[8] 11 U.S.C. § 541(a)(1).

Code.[9] Among other things, the automatic stay acts to shield property of the debtor's estate from "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."[10]

THE TEXAS BANKRUPTCY COURT CONFLICTS WITH DELAWARE PRECEDENT

The Texas bankruptcy court's decision is at odds with *Zachman* and *Milford Power*. Reviewing these two cases, the Texas bankruptcy court explained neither Delaware court had directly confronted the scope of Section 541 of the Bankruptcy Code. To that end, the bankruptcy court found no basis in in the Bankruptcy Code to render the economic vs. managerial distinction meaningful. Rather, the bankruptcy court found Section 541 of the Bankruptcy Code and Section 18-304 of the LLC Act to be in direct conflict, with the Bankruptcy Code taking priority. As the Texas bankruptcy court explained:

> This decision clarifies that a member of a Delaware LLC who starts a bankruptcy case keeps all legal and equitable interests in the LLC that it held as of the commencement of the case. Managerial and voting rights are legal and equitable interests that AmSurg held as of the petition date, so they are included as property of its estate. . . . AmSurg was improperly stripped of rights simply because it sought relief under federal bankruptcy law. This decision restores AmSurg's rights.[11]

CONCLUSION

In reaching this decision, the Texas bankruptcy court relied on persuasive authority from bankruptcy courts in West Virginia, Oregon, and New York, each of which reached similar decisions with respect to each state's respective statutes.[12]

While the Texas bankruptcy court's ruling is not binding authority on courts in Delaware, the *Envision Healthcare* decision adds to the body of authority invalidating the impact of Section 18-304 of the LLC Act.

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[9] 11 U.S.C. § 362(a).

[10] 11 U.S.C. § 362(a)(3).

[11] In re Envision Healthcare Corp., Case No. 23-90342, at *7 (Bankr. S.D.T.X. Dec. 12, 2023) (emphasis in original).

[12] See id. (citing Sheehan v. Warner (In re Warner), 480 B.R. 641 (Bankr. N.D. W. Va. 2012), Pearce v. Woodfield (In re Woodfield), 602 B.R. 747 (Bankr. D. Or. 2019), and Weiss v. All Year Holdings Ltd. (In re All Year Holdings Ltd.), 648 B.R. 434 (S.D.N.Y. 2022)).

Restructuring Considerations in an Uncertain Economic Climate

By Lisa M. Schweitzer and Thomas Kessler*

In this article, the authors explain how companies can refresh their internal planning and proactively consider the risks and opportunities that are presented when suppliers, customers and competitors encounter financial distress.

Economic indicators remain mixed on whether there will be a recession or a soft landing over the moths. Either way, it is likely that a significant number of companies, across industries, will need to restructure their financial debt and operations. 2023 brought a significant increase in Chapter 11 filings, with a 61% percent increase compared to the same period in 2022,[1] and filings across industries, including such notable companies as Bed Bath & Beyond, Envision Healthcare, Rite Aid and WeWork. Other companies have avoided formal bankruptcy filings by undertaking liability management transactions that increase near-term liquidity through additional borrowings. However, as several high profile filings recently have shown, it is likely that many of these transactions may simply delay, rather than prevent, bankruptcy filings in the future.

The current climate presents an ideal time for all companies to refresh their internal planning and to proactively consider the risks and opportunities that are presented when suppliers, customers and competitors encounter financial distress.

EARLY PLANNING FOR POTENTIAL COUNTERPARTY DISTRESS

While free-fall bankruptcies make headline news, in most cases a company has experienced financial distress for a significant period of time before deciding to file for bankruptcy. Companies can and should monitor for early signs of distress in order to develop a comprehensive strategy to minimize the impact of the financial distress of a key supplier, customer or other industry participant on its business and operations.

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[1] Epiq Global, "Year-to-Date Commercial Chapter 11 Filings Increased 61 Percent Compared To Same Period Last Year" (October 3, 2023), available at https://www.epiqglobal.com/en-us/resource-center/news/year-to-date-commercial-chapter-11-filings-increased-61-percent-compared-to-same-period-last-year.

In particular, management should be monitoring for early signs of potential distress and planning accordingly, and boards should oversee this process, including the following types of actions:

- *Stretching of Trade Terms* – Recent financial failures have been largely driven by near-term liquidity shortages. Companies should consider whether any request to renegotiate payment terms or noticeable changes in payment patterns could be signals of potential financial stress, and whether the larger commercial relationship could be at risk in the near or medium-term.
- *Renegotiation of Material Commercial Contracts* – For many companies, their long term supply and customer contracts do not match their current business models, including as a result of external factors, such as the rising costs of materials and labor, shifting customer demand for their goods and services, regulatory developments or other changes in their business operations (such as the increasing move to remote work). Companies may be approached to renegotiate these contracts either consensually or against a backdrop threat that contract amendments are necessary to ward off a larger failure. In negotiating the amendments of contract terms, companies should account for the potential impact of a subsequent bankruptcy filing on such amendments, and whether they may be forced to make further concessions later or whether any such amendments could be challenged in a bankruptcy proceeding.
    - Companies also should review and consider the effectiveness of their own contractual default and termination rights under existing contracts with major counterparties that may be in distress. The right to enforce termination rights tied to bankruptcy filings and the financial condition of the counterparty, or that require notice and waiting periods, may not be fully enforceable in a bankruptcy scenario.
- *Readiness for an Actual Bankruptcy Filing* – If a supplier or customer files for bankruptcy, it is important to be ready to react and mobilize from the start of the case in order to be best positioned throughout the process.
    - Initial Bankruptcy Relief – Most debtors signal their restructuring strategy in their first day filings, including whether they intend to reorganize, pursue a sale or liquidate their business. They also may obtain court relief to pay select creditors that could affect other creditors. Companies should monitor the debtor's filings early on and engage of counsel to position

themselves to mitigate the impact of a filing.

- o Planning for a Sale – Bidders have the right to cherry-pick assets and contracts in a bankruptcy sale process. Contracts that are taken by a buyer also have to be "cured" or be made current. It is important for companies to be proactive in best positioning their contracts to be assigned, or to be ready to oppose such an assignment if that is their preferred strategy.
- o Assumption and Rejection of Contracts – A debtor in bankruptcy has the opportunity to reject its existing contracts and leases, which leaves the counterparty with unsecured claims for damages flowing from such rejection. This tool enables a debtor to both shed unfavorable contracts and attempt to extract consensual modifications of its agreements with others. Companies should not wait to consider the risk of the loss of their contracts in a bankruptcy and/or the concessions that may be requested, as well as the strategic leverage they may have in a case as a key supplier or customer whose contracts are essential for a successful reorganization.
- o The Official Creditors' Committee – A committee is appointed at the start of each case to advocate for the interests of unsecured creditors, which is comprised of a mix of the largest unsecured creditors willing to serve and where the fees of the committee's professionals are funded by the debtor. Companies should consider serving on the committee as a way to further advance the interests of unsecured creditors in the case, including with respect to the direction of the reorganization and the treatment of unsecured claims.

- *Avoiding Hindsight Challenges* – In bankruptcy proceedings, a debtor may seek to claw back payments made to counterparties prior to filing or to extract further value through the pursuit of claims for preference (tied to counterparties having received payments or additional security outside of the ordinary course in the months prior to the bankruptcy) and fraudulent conveyance (for transactions in the years prior to the bankruptcy filing where fair value or reasonably equivalent value was not received by the debtor company at a time it was insolvent).
  - o Extra Care – Companies should take extra care when transacting with a party potentially in financial distress to ensure that transactions – particularly extraordinary transactions such as sales or acquisitions and the settlement of claims – are conducted in

good-faith, at arms-length and for reasonably equivalent value.

SEIZE THE DAY: HOW A COUNTERPARTY'S FINANCIAL DISTRESS COULD CREATE OPPORTUNITIES

In many circumstances, a key supplier or customer's financial distress is a cause for concern and defensive planning. However, in times of economic turmoil, companies should also proactively consider opportunities that may be realized from other market participants' financial distress. In particular:

- *Acquisition Opportunities* – While a company experiencing financial distress may pursue refinancings and operational restructurings as a first line strategy, to the extent such strategies do not prove successful the company may need to initiate a sale process to avoid having to turn itself over to its lenders. Other strategic players may be best positioned to act quickly in purchasing assets due to their ability to do discrete diligence and to close a transaction quickly. Companies should proactively consider whether there are opportunities for acquisitions of other market participants, and whether they can potentially initiate the process through an unsolicited offer where there may be significant first mover advantages in a fluid situation. There are significant considerations surrounding the decision whether to engage in acquisition transactions with a distressed counterparty outside of bankruptcy, as well as the strategy for pursuing acquisitions in bankruptcy auctions, where outside counsel can help companies best position themselves to succeed in their acquisition strategy.
- *Other Opportunities* – To the extent companies are unable or uninterested in acquiring assets, other opportunities may exist including the chance to move customers from a competitor to their own business, to improve their position with common suppliers and to hire key employees who are laid off or otherwise looking to move away from a failing company. Given that these situations tend to unfold over time and are very fluid, a company may realize the most opportunities by developing a strategic plan early, monitoring the situation as it unfolds and remaining nimble and flexible in reshaping their acquisition strategy as the target's financial health may deteriorate and the situation may evolve either in or outside of a formal proceeding.

SELF-MONITORING: FINANCIALLY HEALTHY COMPANIES SHOULD REMAIN ALERT AS TO POTENTIAL RISKS TO THEIR OWN BUSINESS

Even healthy companies should do their own periodic check-ups to identify potential financial and operational risks to their business and to ensure reporting and planning accounts for potential risks including market and industry changes.

It is prudent for management, with the oversight of the board, to regularly:

- Review the company's liquidity horizon and debt maturities, including to consider the expected strategy for addressing future capital needs, potential market alternatives that may provide additional liquidity or lower cost capital (such as liability management transactions) and the potential market and corporate risks that could affect the availability or cost of future capital.
- Monitor any contingent liabilities, including unasserted claims and legacy liabilities, that may affect the company's performance or result in significant financial liabilities, and consider the availability of structuring transactions that could be implemented to manage and isolate such liabilities over time.
- Refresh disclosed risk factors to include potential risks associated with industry changes, material supplier and customer risks, the existence of legacy and contingent liabilities and potential changes in the availability and cost of capital and consumer demand, among other things, as part of the preparation of public reporting.

As companies wait to see how the financial markets and industry outlook will unfold in coming months, they can take the above proactive and defensive planning steps to best position themselves to address industry distress, both to minimize its impact on their own financial health and to realize strategic opportunities as they may arise.

UK Company Restructuring Plans: What Is Next After *Adler*?

By Clare Tanner, Jonathan Lawrence and Maya C. Ffrench-Adam*

In this article, the authors examine the implications of a recent decision by the England and Wales Court of Appeal on restructurings under UK law.

The England and Wales Court of Appeal recently handed down its first judgment relating to a restructuring plan under Part 26A of the UK Companies Act 2006: Re AGPS Bondco Plc [2024] EWCA Civ 24. Restructuring plans were a 2020 innovation in UK insolvency law. At first instance, the judge had exercised his discretion to sanction the restructuring plan and effected a cross-class cramdown (CCCD) of creditors. The appeal against the first instance decision was made by dissenting creditors and was allowed by the Court of Appeal. The lead judgment of Lord Justice Richard Snowden will inform debtors, noteholders, trustees and other participants in financial structures or restructurings when formulating or responding to Part 26A plans.

However, uncertainties remain.

BACKGROUND

In the autumn of 2022, the Adler Group (the Group), the owner of a large portfolio of residential real estate in Germany, was facing significant financial difficulties. The Group's indebtedness included a series of senior unsecured notes (the Notes) issued by Adler Group SA (the Parent Company), a Luxembourg company. The six series of the Notes had a range of maturity dates from 2024 to 2029, and each series ranked equally.

The Group proposed a controlled wind down of its business with a view to achieving better realizations than in an immediate formal insolvency process. The proposals included an injection of new money, with the new money providers receiving 22.5% of the equity in the Parent Company, the extension of the maturity dates of the 2024 Notes by a year, and the modification of the negative pledge clauses in the Notes. This modification was to facilitate an amendment of the enforcement waterfall, with the new money ranking first followed by the 2024 Notes and with the remaining series of Notes ranking junior to the 2024 Notes.

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The proposed alteration of the terms and conditions of the Notes was to be implemented by a consent solicitation process. However, there was a failure to achieve the requisite majority in relation to the 2029 Notes. The Group proposed a UK restructuring plan (the Plan). AGPS Bondco PLC (the plan company) was incorporated in England and Wales and substituted for the Parent Company as the Issuer of the Notes in order to engage the jurisdiction of the English Court (the Issuer Substitution).

At separate class meetings of the holders of each series of Notes (each, a Plan Meeting), the Plan was approved by majorities in excess of 75% of those voting at each Plan Meeting, save for the meeting of the 2029 Notes, which fell short of the required 75% majority. At the sanction hearing, the first instance court was satisfied that: (A) none of the members of the dissenting class would be any worse off if the Plan were sanctioned than in the relevant alternative (in this case, a formal insolvency process), and (B) the Plan had been approved by a class that would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative. The judge at first instance determined that conditions A and B were met and exercised his discretion to sanction the Plan. Dissenting 2029 noteholders appealed.

KEY CONSIDERATIONS ARISING FROM THE COURT OF APPEAL'S JUDGMENT

Discretion to Sanction a Plan Where CCCD Is Not Engaged

The established principles guiding a court in the exercise of its discretion to sanction a scheme of arrangement (under Part 26 of the UK Companies Act 2006) apply in relation to a restructuring plan where there is no requirement for CCCD.

The court must consider:

(i) Whether the provisions of the legislation (including questions of class composition, whether statutory majorities were obtained, and the adequacy of the explanatory statement) have been met;

(ii) Whether the class was fairly represented at the meeting and without coercion of the minority by the majority to promote interests adverse to the class;

(iii) Whether it is a fair plan that an intelligent and honest creditor could reasonably approve (the rationality test); and

(iv) Whether there is any defect that would make the plan unlawful or otherwise inoperable.

The court does not need to establish whether the scheme is the only fair scheme or the best scheme.

Discretion to Sanction a Plan Where CCCD Is Engaged

Where the court is being asked to impose a restructuring plan upon a dissenting class, the approach under Part 26 continues to apply but requires modification. The court has to be satisfied in regard to each assenting class that those who attended and voted in favour were a true reflection of the class as a whole (which might not be the case if turnout were very low) and that the majority had not voted to coerce the minority. This is of particular importance when the court is considering the class with a genuine economic interest whose affirmative vote is relied upon to satisfy condition B as stated above.

For a dissenting class, the court should not apply a rationality test based on the level of voting in assenting classes or the overall value of affirmative votes across the assenting and dissenting classes as a whole. A 'vertical' comparison (comparing the position of the dissenting creditors under the Plan with the position of the dissenting creditors in the relevant alternative) has to be carried out in order to establish that condition A (the no worse off test) is satisfied, but this does not give rise to a presumption in favor of sanction.

The court should conduct some form of "horizontal" comparison (comparing the position of the dissenting class with the position of the other classes if the restructuring goes ahead) and consider whether differences in treatment of creditors, inter se, are justified. The reference point for this analysis is the position of the creditors in the relevant alternative (for example, a formal insolvency). Where no justification is given, it will take a compelling reason to persuade the court to sanction the plan. Further, the court must inquire how the value to be preserved or generated by the restructuring plan over and above the relevant alternative is to be allocated between the different creditor groups. When considering whether the allocation of the assets is fair, the court should ask whether a different allocation would have been possible and fairer.

Pari Passu Distribution

Where the relevant alternative is a formal insolvency, in which the claims of all plan creditors would rank equally for pari passu distribution, the court will normally approve a plan replicating that pari passu distribution in relation to the benefits of the restructuring. A departure from such pari passu distribution is permissible provided that it is justified by a good reason or a proper basis. It is likely to be justifiable that creditors who provide some additional benefit to assist the restructuring in the interests of creditors as a whole are entitled to receive some priority or enhanced share of the benefits. The analysis is likely to be highly fact sensitive but, for example, creditors who provide new money to facilitate the restructuring may be entitled to receive full repayment of the new money in priority to preexisting creditors or possibly some enhanced priority (elevation) in relation to their existing claims.

There might be no justification for elevation of existing debt if, for example,

(i) The opportunity to provide new money was not available on an equal and noncoercive basis to all creditors;

(ii) If the new money was provided on more expensive terms than that available in the market; or

(iii) If the extent to which the existing debt was elevated was disproportionate to the extra benefits provided by the new money.

The Court of Appeal decided that the provisions of the Plan under which the different series of Notes would be paid sequentially on their original maturity dates (or, in the case of the 2024 Notes, one year later) involved a departure from the pari passu principle because there was no assurance that sufficient sums would be realized by the Group to pay all of the noteholders in full. The Plan carried the risk that the earlier-dated Notes would be paid in full but the Group would run out of money before being able to pay the 2029 Notes. In short "the sequential payment to creditors from a potentially inadequate common fund of money was not the same thing as a rateable distribution of that fund." There was no good reason for such sequential payments. Whilst, the enhanced priority given to the 2024 Notes involved a departure from the pari passu principle, this was not the determining factor. The continuation of credit by the 2024 noteholders justified an elevation of their claims above other creditors.

Shareholder Rights

The Court of Appeal decided that the Plan was not unfair because the shareholders of the Parent Company retained their shares (albeit diluted by the new shares issued to the providers of the new money under the restructuring) even though the 2029 noteholders continued to bear the greatest risk of nonpayment.

In his judgment, Lord Justice Snowden indicated that there is no jurisdiction under Part 26A to confiscate or expropriate shareholder (or creditor) interests for no consideration. Some element of give and take is required and paying a "modest amount" of compensation should not unduly impede the restructuring process.

Cross-Border Considerations

Without expressing a view, Lord Justice Snowden indicated that this decision did not amount to an endorsement of Issuer Substitution in future cases.

Practical Considerations

Timetable

The Court of Appeal emphasized that the court's willingness to decide cases quickly to assist companies in genuine and urgent financial difficulties should not be taken for granted or be abused. In the case of a foreseeable deadline, sufficient time for a contested Part 26A process and full compliance with the relevant practice statement must be factored in.

Disclosure and Cooperation

To prevent undue delay and expense, a plan company must make available the material underpinning valuations in a timely manner. If not, the court should exercise its power to order specific disclosure. Parties and their advisers and experts must cooperate to narrow the issues which the court has to decide at the sanction hearing.

Stay

To prevent a restructuring plan from becoming effective prior to the outcome of any appeal, it is necessary for the appellant to apply for a stay. Alternatively, the appellant can apply for a direction that the order should not be delivered to the Registrar of Companies (at which point it becomes binding on the company and all affected creditors or members) pending an appeal.

In response to the Court of Appeal's decision, the Parent Company announced that it will continue its restructuring path as planned and that the implementation of the restructuring in April 2023 was carried out in accordance with German law and remains valid. In future and particularly in cross-border situations, appellants may demand undertakings not to deliver the order to Companies House pending any appeal.

COMMENT

The *Adler* decision has provided some welcome clarity for debtors, note-holders, and other stakeholders as to the principles applicable when formulating or responding to a Part 26A plan, particularly where CCCD is likely to be engaged. Parties pursuing a consent solicitation or other consensual mechanism but anticipating, in the alternative, the use of a Part 26A plan will want to have these principles in mind, ideally at the outset.

The practical application of the principles elucidated by the Court of Appeal will be a matter for future judgments. Uncertainties remain as to matters such as the effectiveness of Issuer Substitution and the level of compensation which "out of the money" creditors or shareholders should receive on the confiscation of their shares or extinction of their debts.

In the meantime, the complexity of the issues, such as the need to consider horizontal comparisons and whether there is a fairer or better plan, and the associated evidence suggests that UK restructuring plans will give rise to increasingly heavyweight litigation. Save in the case of unexpected urgency, parties must factor in sufficient time to comply with the Part 26A process and allow the court adequate time to consider the application and give judgment.

Russian Sovereign Debt: What Do Investors Need to Know?

By Polina Lyadnova, Jim Ho, Chase D. Kaniecki and Andreas Wildner*

In this article, the authors examine what sanctions targeting Russia and its economy mean for those invested in Russian sovereign debt.

It has been a turbulent economic and political period, to say the least. Despite a great deal of hope as economies emerged from the dark days of the pandemic, Russia's decision to invade Ukraine led to disruption in the global economy, impacting supply chains and causing a rise in prices on everything from food to energy.

Western nations rushed to demonstrate their solidarity with Ukraine by rolling out an unprecedented set of sanctions targeting Russia and its economy in a bid to isolate the country from the global financial system. Russia has responded to these sanctions with its own set of countermeasures, creating a complex legal environment for foreign investors. In this article, we look at the measures taken by those on both sides, and outline what these sanctions mean for those invested in Russian sovereign debt.

BACKGROUND

In general, the Russian government sells two types of bonds to foreign investors. These include Eurobonds – those denominated in foreign currencies (usually in dollars) that form part of Russia's external debt; and local currency bonds (i.e., federal loan obligations or OFZs) – these are denominated in Russian rubles which form part of the state's internal debt. In both instances, these bonds are issued by the Ministry of Finance of the Russian Federation.

Since Russia's invasion of Ukraine, foreign ownership of sovereign Eurobonds has started to fall. In January 2022, the share of these bonds owned by foreign investors stood at 51.1%, representing circa $20 billion. By January 2023, that figure had fallen to 45%, or $16 billion, according to Russia's Central Bank. Meanwhile, foreign ownership of local currency sovereign bonds has seen an even steeper decline, falling from 19.9% (roughly RUB3.1tn) in January 2022 to 11.1% (circa RUB2.0tn) in January 2023.

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WESTERN SANCTIONS

The United States

The United States has imposed sanctions targeting Russian sovereign debt since 2019, when the country prohibited U.S. financial institutions from participating in the primary market for non-ruble denominated bonds issued by the Russian sovereign, including Russia's Central Bank (CBR), the Russian National Wealth Fund (NWF), and Russian Ministry of Finance (MinFin). At that time, the prohibition did not apply to local currency bonds or the secondary market for Russian sovereign debt.

Subsequently, in 2021, the United States prohibited American financial institutions from participating in the primary market for both ruble and non-ruble denominated bonds issued after June 14, 2021, by the CBR, the NWF and the MinFin. Again, the secondary market for Russian sovereign debt remained outside the scope of U.S. sanctions on sovereign debt, but this situation changed in 2022.

U.S. Sanctions on Russian Sovereign Debt

In late February 2022, the United States prohibited the same financial institutions from participating in the secondary market for ruble or non-ruble denominated bonds issued after March 1, 2022 by the CBR, NWF, or MinFin. In addition, it prohibited U.S. persons from engaging in any transactions involving the same institutions, including any transfer of assets to such entities and any foreign exchange transactions for or on behalf of such entities.

The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) clarified that, subject to the above-referenced secondary trading restrictions on U.S. financial institutions, the prohibition does not apply to trading in the secondary markets for debt issued by the CBR, the NWF or MinFin, provided that no such entity was a counterparty to the transaction and no other restrictions were triggered. The ban, however, applied whenever dollar interest or principal payments were made on Russian sovereign debt given that dollar payments clear through the U.S. financial system. Although OFAC temporarily authorized such payments, the general license lapsed on May 25, 2022, and has since not been renewed. Since then, U.S. persons have required a specific license to continue to receive dollar interest or principal payments on Russian sovereign debt.

As part of a further escalation in April 2022, the United States introduced a sweeping ban on "new investments," which, as OFAC clarified in June 2022, prohibits U.S. persons from purchasing both new and existing debt securities issued by an entity in Russia. The restrictions do not prohibit U.S. persons from selling or divesting debt or equity securities issued by an entity in Russia to a non-U.S. person.

The EU

The EU followed the United States in 2022 and introduced its own restrictive measures. It prohibited directly or indirectly purchasing, selling, or otherwise dealing with transferable securities, including bonds, issued after March 9, 2022, by Russia, its government, the CBR, or a legal person, entity or body acting on behalf of or at the direction of the CBR.

Furthermore, the EU introduced a prohibition on refinancing Russian sovereign debt, and banned any transactions related to the management of the reserves and assets of the CBR and the NWF (but, interestingly, not MinFin). It also made the National Settlement Depository, which provides safekeeping and depository services in respect of Russian local currency sovereign bonds and which has acted as paying agent under a number of Russian sovereign Eurobonds, subject to an asset freeze. In practice, the latter meant that there was no longer an active bridge between the NSD and international clearing systems, including Euroclear and Clearstream.

Although, in contrast to the United States, EU sanctions do not per se impose any impediments to receiving payments under Russian sovereign bonds, because of the asset freeze imposed on the NSD, any payment made by the NSD to any of the international central securities depositories (ICSDs) is subject to blocking by the latter.

Notably, the ICSDs reinforced the blow to investors by announcing the suspension of trading, clearing, and settlement of any ruble-denominated transactions, which effectively left foreign investors trapped in Russian local currency bonds.

The UK

In late February and March 2022, the UK restricted the provision of any financial services, including payment transmission services, for the purpose of foreign exchange reserve and asset management to the CBR, the NWF, and MinFin, as well as any persons owned or controlled by any of these entities or acting on their behalf or at their direction.

Similar to the United States, in April 2022 the UK Treasury temporarily authorized financial services for the purposes of the receipt and onward transfer of non-ruble-denominated interest and principal payments from the CBR, the NWF and MinFin in respect of debt issued by them before March 1, 2022. However, the authorization expired on June 30, 2022, and was not extended.

Furthermore, the UK extended existing restrictions on dealing with certain financial instruments by prohibiting any dealings with transferable securities, which includes bonds, issued on or after March 1, 2022, by the Russian government. Unlike the United States though, an outright prohibition on all new investments to Russia introduced by the UK in July 2022 did not extend to new or existing debt.

RUSSIAN RESPONSE – FROM RUSSIA WITH LOVE

The Russian state reciprocated and introduced countermeasures in response to a rollout of Western sanctions on its sovereign debt – any transactions with sovereign bonds involving Russian financial infrastructure and investors from "unfriendly jurisdictions," such as the United States, EU, and UK, now require special clearance by the Russian government.

Workarounds, such as SPVs incorporated in "friendly" jurisdictions but controlled by persons from "unfriendly" investors are also prohibited by Russian law. Furthermore, payments on sovereign bonds are now made differently. Starting in June 2022, Russia has since made interest payments on Eurobonds in rubles. Such payments are made to the NSD, which acts as paying agent and which, as mentioned, is subject to an EU asset freeze. In addition, all investors that hold sovereign Eurobonds are split into three categories, namely:

(i) Investors holding bonds entirely through Russian infrastructure (Group I);

(ii) Investors holding bonds through Russian depositories and foreign infrastructure (Group II); and

(iii) Investors "to whom it is not possible to make payments due to foreign infrastructure's failure to perform" (Group III).

While Group I investors receive payments as usual and Group II receive payments bypassing foreign infrastructure, Group III investors, or foreign investors holding through financial intermediaries in the United States, EU and UK, are required to take additional steps to receive payments from the Russian state.

After payments are made to Group I and Group II investors, the residue funds are transferred to a special "I"-type account. In order to get payments from such accounts, Group III investors will need to apply to the NSD, disclosing its holding structure up to an ultimate holder and providing title documents to Eurobonds, which could be particularly difficult given how complicated the majority of holding structures are these days. Foreign investors must also waive any potential claims to MinFin. Once such steps are completed and the NSD is satisfied with the documents, foreign investors could get payments on their personal accounts but through Russian banks. It should be noted that investors from "unfriendly" jurisdictions are eligible to have only restricted "S"-type accounts in Russia, the funds on which could not be moved out of Russia without a special clearance. Setting aside the issue of how many Russian banks are subject to Western sanctions, moving out of foreign infrastructure and getting payments on sovereign Eurobonds in Russia is not an appealing option for the majority, if not all, foreign investors.

Although a different regime applies to sovereign local currency bonds, investors from "unfriendly" jurisdictions find themselves in a similar position. Interest payments or principal repayments should be made to restricted "S"-type accounts opened with Russian credit institutions.

Furthermore, even if payments on local currency bonds were made through the normal payment routes, considering the asset freeze imposed by the EU on the NSD and the suspension of settlement of ruble-denominated payments by ICSDs, it is unlikely that funds would reach foreign investors.

CONCLUSION

Only time will tell us to what extent the Western sanctions will really affect Russia. What is clear, however, is that both the package of measures implemented by the West, and the countersanctions put forward by Russia, have created a highly complex legal landscape for foreign investors in sovereign bonds, and this is proving a significant challenge for many to navigate. With no end to the war in sight, these investors will continue to bear a significant cost as a result.

Negotiations and the Art of Communicating – Part III

By Peter J. Winders*

In this three-part series, the author discusses negotiating and communications, skills every bankruptcy lawyer needs. The first part of this column, published in the January 2024 issue of Pratt's Journal of Bankruptcy Law, *introduced the topic through engaging anecdotes, lessons and thoughts on listening and the gamesmanship of negotiations. The second part, published in the February-March 2024 issue of* Pratt's Journal of Bankruptcy Law, *explained negotiating tactics in detail and mediation. The conclusion of this column covers humor in negotiations, and more.*

HUMOR IN NEGOTIATIONS

Humor in negotiations is a tricky thing, and could probably be an article in itself. Like any aspect of life and business, an effective technique should match one's personality and talents. Some people have the discernment to use humor only when it is likely to be effective, and it can work. In court, lawyers with high opinions of their sense of humor must control themselves and remember that the only comedian permitted in the situation is the judge. In negotiations, there are times when it helps, and other times best restrained. Here are some examples when it worked. In any case it requires one to decide who the audience is, and accurately assess the likely reaction of that audience. Do not use humor just for the sake of a laugh. Just being funny is most often useless.

Governor Carlton's Million Dollar Joke

Doyle Carlton, one of the founders of my firm, definitely had the talents of a humorist. After his term as governor of Florida ended in 1933, still during the Great Depression, he was asked by the Lake Istapoga Drainage District, a quasi-governmental entity with the power to levy taxes and float tax exempt bonds, to seek a loan from the Reconstruction Finance Corporation (RFC), a federal agency designed to help with certain Depression-era crises. The drainage district was about to default on its bonds because nobody could pay their taxes during that terrible economic time. The governor negotiated a $2 million loan (about $45 million today). The entire Istapoga board took the train to Washington for the closing.

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At the closing table, with the chairman of the agency presiding, RFC staff on one side, the Istapoga board on the other, the chairman announced that a $1 million loan had been approved, but only after the district had raised the other million locally. This was not what the district needed, or what Governor Carlton had negotiated. There was a stunned silence. Then the governor said:

> Mr. Chairman. This reminds me of the farmer who wrote to Sears & Roebuck to order a gross of toilet paper. After a week, he received a letter: "When ordering from Sears & Roebuck, please give catalog page and item number." To which the farmer replied: "Dear Mr. Sears and Mr. Roebuck, if I had your catalog, I wouldn't need your damn toilet paper."
>
> Jones laughed, his minions joined in, and the result was the $2 million loan was granted.

"That Chicken Outfit You Represent"

Earlier I described the negotiation with Phosphate Company. As opposing counsel and I were signing the informal agreement to settle, he said, "I want you to give a message to that chicken outfit you represent. This may be a big deal to them but my client makes that money in about 10 minutes."

I have tried to find some negotiation game in this statement, but have concluded that there is no advantage in being a sore loser. This was just an ego thing, a mistake in my view because it diminished his stature with me, if we were ever again in a settlement discussion. On the other hand, Stephen Potter's classic 1950 book "The Theory and Practice of Gamesmanship, or How to Win at Games Without Actually Cheating" describes a gambit where the losing party attempts to make the winner believe the loser is the superior player.[1]

But then I made my own mistake of telling the client about the statement. "Chicken outfit? What? Is he trying to insult us? Screw the settlement! We will try the case!" (Crap, I thought to myself. I shouldn't have mentioned the "chicken outfit" comment – I don't want to blow the settlement, which is great from the client's prospective.)

"Yes, Lloyd," I said to the client's inside counsel, "I have been holding back on you but I'm afraid there is one condition to the closing. They insisted, and

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[1] For example, in a game of chess, in the middle of the game, the inferior player studies the board for a long time, then concedes: "You have got me! Well done! No matter what I do, within 7 more moves you will beat me. Well played!" The object is to make the winner think the loser has the ability to calculate the 3 billion possibilities 7 chess moves entails, and assumes that the winner has the talent to pick the right one.

I didn't want to lose the deal, so I agreed to it. You have to attend the closing personally, and you have to be wearing a chicken outfit. You'll have to rent a chicken suit."

Fortunately, they found that very funny, and Lloyd agreed that for $6.5 million, he would be happy to dress as a chicken. That became a running joke for the rest of the transaction. For example, he told me he had had his chicken suit cleaned and shipped to me directly from the dry cleaners, telling them to be extra careful with it, which explained the bushel of feathers that arrived with the title documents.

"Opinion of Counsel"

That same inside counsel used humor to defuse a situation that arose during a closing of a sale of a Canadian subsidiary to a Philippines company. The closing had gone all night. As with many countries that want to control any export of existing businesses, the Canadian government had to approve the sale and it had done so. Attending the closing were the Philippines' lawyer (a former chief judge of the Philippines Supreme Court) and a New York lawyer from one of the big name firms. At 5:00 in the morning the New York lawyer, who had added nothing to the process other than arrogance and pomposity, said, "We will also need an opinion of counsel."

By that, he meant a formal legal opinion from the seller's lawyer that a buyer can rely on, covering such things as the legality of the sale, the compliance with all regulations, the authority of the officers to make the deal, and the like. Lloyd said, "You really don't need one. The sale was approved by the government of Canada, which covers the only challenges that could be made to the sale. My individual opinion is valueless. I am an employee, not a big law firm. I have no malpractice insurance. I have no attachable assets. So you gain no security whatever from my formal opinion. And you are bringing this up at the last minute to delay this process for no reason. You do not need an opinion of counsel." The Philippines lawyer said that perhaps that was unnecessary. The big firm lawyer inflated himself[2] and said, "My firm always require an opinion of counsel and I strongly recommend that my client demand an opinion of counsel." Lloyd: responded, "You want an opinion of counsel? Well, here is my opinion of counsel: PPFTTT!," directing a raspberry toward the lawyer, "But

[2] Inflating oneself is a common negotiating tactic throughout nature. Pufferfish, the pancake tortoise, the sand hill crane, the hognose snakes, various toads, do it to make them look bigger, wedge themselves tighter, look more menacing, harder to swallow. Furbearing mammals and things with feathers add raising their fur or feathers for additional effect.

you may want to get a second opinion." Lloyd's audience, of course, was not the lawyer but his client, the purchaser. The purchaser agreed to ignore its lawyer's silly advice.

WINDING UP

To review some of the tactical moves and countermoves discussed above in context, I return to the story about the phosphate lease that began this article, and consider how the expert used them.

> He invited me to have lunch with him at the University Club, the most exclusive lunch setting in town [Honor or flatter the adversary. If you are of much greater stature, treat as an equal – he will be more likely to want to agree with you.] The perfect host until lunch was over, he started by explaining that his client wanted to fight this situation, and thought they would ultimately win [threat], but he had persuaded the client to settle the case for top dollar [i. Good cop, on your side; ii. Characterize the offer as high] and get on with business. He said we had done an outstanding job of lawyering on the matter so far [Flatter, characterize the offer as a win], and that while we might ultimately lose [Threat], for right now we had his client where we wanted them [Praise, characterize the offer as a win]. It was a shame really, because everyone knew that it was a mistake [Guilt, suggest we were taking unfair advantage] to omit the termination clause from the lease, and it was a shame that the field manager (who we had met at the hearing and who was in fact a nice guy) was going to lose his job over it, [Guilt, although I was not going to be the jerk that fired him, if indeed anybody would] but he had convinced the company to go all the way [Characterize the offer as all that was available and generous, and equivalent to a win] and pay a million dollars [An admittedly big round number] for the lease, and allow us to stay until they actually began operations [Anticipate objection and remove it as a counter-negotiating basis], giving us plenty of time to find new land. He figured this was an offer we couldn't refuse because it basically paid the full value of the lease and guaranteed the profit of the enterprise [Characterize the offer, show it is based in logic, to try to put the opponent in the position of justifying a different position by the same logic, guide the negotiations into what's "a fair price"]. He convinced his client to pay top dollar to avoid delay and because that was more than a fair price for the release no matter how you calculated it [Same].

You will also remember that the successful counter to this masterful use of gamesmanship was the principled position, a position that it is hard to argue with because the basic premise is not subject to debate.

Please note that the phosphate lease story is not a story suggesting that our negotiating skills were greater than those of the opponent. The opponent's need to end the negotiations with possession of the land immediately was greater than our client's need to keep it. Instead, it illustrates the importance of understanding the gamesmanship that can affect or could have affected an opponent's analysis, and some of the specific tactics that can counter them, particularly a principled position.

But I do believe there were a few negotiating mistakes. Once we had come to an agreement of the $6.5 million, Phosphate Company's lawyer accused us of extorting his client. That would have been a good move if we had actually threatened anything, but it was clumsy and simply sore losing since we did not. Instead, it had the effect of reducing his stature as a negotiator. He let his ego get in his way. And before closing, he tried to change the deal from a purchase of all the subsidiary's assets to a purchase of the stock, for which his client would want the "usual representations and warranties." I told him that was not the deal. "We are settling a lawsuit, not negotiating the sale of a business." "Well, my client always does it that way, and that's the way the deal must go." ["My client always does it that way" or "this is how it is done" is a pretty good move by a more powerful party, as the opponent is likely to fall into the trap of accepting "normal procedure" as not important as long as the deal is done, ignoring the risks.] After all, a party can win in the negotiation and lose in the documentation. I promised to ask the client about it, recommending against it. Getting back to the lawyer for the phosphate company, we said we were willing to sell the stock, with warranties, only for a higher price. "What, your client is afraid to warrant that its title and business is good?" [The suggestion that an opponent is afraid of something might be a good move in a different context, as it can often induce the opponent to make concessions in response to the dare] but I responded, "Of course they are. As mad as you and your client are about this, they would find a way to conjure a breach of warranty suit just to punish us. If you want the reps and warranties the price is $8 million." The settlement closed without them.

PLEASE CONSIDER BEING A GRACIOUS WINNER

In a professional context, doing so will enhance your reputation as a trustworthy opponent, one who does his or her job as an advocate but without personal animosity. Your opponent today is likely to be a judge next month. A modest, "We had the facts (or the law) on our side," will stand you better in the long run than a victory dance. Allowing the opponent to save face is most often the best investment.

DISCLAIMER

"Difference of opinion is what makes poor land sell and ugly people marry," has been a saying among property appraisers for generations. That is the basis of the property appraisal profession, which disregards individual opinion except as it manifests in actual sales of comparable property. Please do not get the impression that the various negotiating games and devices necessarily result in an unjustified advantage. They might. But they are part of the process in which a willing buyer, not required to buy, and a willing seller, not required to sell, achieve agreement. Everybody does not win an auction: In the view of the "losing" bidders, the article is not worth more than they were willing to pay; the winning bidder did not "overpay" because in the winning bidder's opinion the article was worth it (unless the winning bidder lost control, as warned against above). But the negotiation dance, the negotiation games, help those opinions form. Be aware of them, recognize them, and use and defend against them responsibly. I hope this helps.