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Bankruptcy Law Update

This memorandum briefly summarizes some recent noteworthy bankruptcy decisions.

I. In re Iridium Operating LLC

In *Motorola, Inc.* v. *Official Committee of Unsecured Creditors and JPMorgan Chase Bank, N.A. (In re Iridium Operating LLC, et. al.)*, No. 05-2236 (2d Cir. Mar. 5, 2007), the Second Circuit Court of Appeals ruled for the first time that the single most important factor for a court to consider in determining whether to approve a pre-plan settlement under Bankruptcy Rule 9019 is whether the distributions provided for under the settlement accord with bankruptcy's "absolute priority" rule.

In *In re Iridium*, the Official Creditors' Committee and JPMorgan Chase were litigating the validity of Chase's pre-petition liens on the Debtors' property. Simultaneously, the Committee was contemplating litigation against Motorola, the Debtors' former parent company. Rather than pursue simultaneously two litigations with limited funding, the Committee decided to settle with Chase. The settlement with Chase provided, in part, that Chase would fund $37.5 million into a litigation vehicle that would pursue claims against Motorola, the proceeds of which, if any, would be split between Chase (37.5%) and the Debtors' estate (62.5%). Significantly, the settlement also provided that any money remaining in the fund at the conclusion of the litigation with Motorola would be distributed directly to unsecured creditors. Motorola's objection to the settlement was directed primarily to this latter provision, which it argued violated the "absolute priority" rule because unsecured creditors would be paid prior to administrative priority creditors, of which Motorola asserted it was one.

Typically, courts have evaluated settlements pursuant to Bankruptcy Rule 9019 by applying a number of factors that speak to the fairness of the settlement, such as: the likelihood of success in the litigation; the attendant expense of the litigation; and the inconvenience and delay, including the difficulty in collecting the judgment. The Second Circuit now has overlayed an additional factor – whether the settlement is consistent with bankruptcy's "absolute priority" rule – and identified it as the most important factor for a court to consider. In refusing to approve the settlement and remanding the matter to the bankruptcy court, the Second Circuit stopped short of holding that any settlement that includes a distribution scheme that is inconsistent with the "absolute priority" rule is *per se* prohibited; however, the Second Circuit observed that in most cases such non-compliance will be dispositive.

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II. In re Calpine Corporation

In *In re Calpine Corporation, et. al.*, No. 05-60200 (Bankr. S.D.N.Y. Mar. 5, 2007), Judge Lifland held that, even though the secured loans the Debtors sought to repay were in a so-called "no-call" period, the secured loans could be repaid and the secured lenders would be entitled to a pre-petition general unsecured claim for damages resulting from the Debtors' breach of the so-called "no-call" provision.

In that case, the Debtors sought to refinance their existing debtor-in-possession financing and to repay certain pre-petition secured debt of their largest operating subsidiary. The secured lenders objected to the refinancing motion on the grounds that the agreements governing the secured debt contained "no-call" provisions prohibiting the Debtors from repaying the debt or, in the alternative, the lenders were entitled to seek a prepayment premium or "make whole" damages for the Debtors' breach of the "no-call" provision.

First, the Court found that "no-call" provisions are generally unenforceable in chapter 11 cases, so the Debtors could repay the secured debt early. The Court next observed that none of the governing loan documents provide for a prepayment premium for repayment during the "no-call" period, even in the circumstance where, as here, the debt had been accelerated as a result of the Debtors' chapter 11 filings. As a result, the Court held that under section 506(b) of the Bankruptcy Code, the secured lenders may not claim as part of their secured claim any prepayment premium or "make whole" damages. Nevertheless, the Court found that the lenders are entitled to an unsecured claim for damages based on the Debtors' repayment, which the Court determined would be equal to the prepayment premiums contained in the loan documents.

The correctness of the decision has already been the subject of much debate and, though an appeal has yet to be filed, it is unlikely, absent a settlement, that Judge Lifland's will be the last word on the matter.

III. In re Northwest Airlines Corporation

In *In re Northwest Airlines Corporation, et. al.*, No. 05-17930 (Bankr. S.D.N.Y. Feb. 26, 2007), Judge Gropper required the various hedge funds that comprise an ad hoc committee of shareholders to disclose, pursuant to Bankruptcy Rule 2019, the amount of shares each committee member holds, the prices each paid and the dates the shares were purchased.

Bankruptcy Rule 2019 requires ad hoc or unofficial committees and their counsel to disclose, among other things, "the amounts of claims or interests owned by the members of the committee, the times when acquired, the amounts paid therefor, and any sales or other disposition thereof." In practice, this information is never provided given the sensitivity most investors have to disclosing such proprietary information. In an apparent effort to quiet this litigious committee, the Debtors moved to require the ad hoc committee to supplement its Rule 2019 statement to provide this information. Significantly, the Court granted the Debtors' motion and ordered the committee to file an amended Rule 2019 statement, reasoning that Bankruptcy Rule 2019 plainly requires such disclosure and there is no basis for failing to apply it as written.

In response to this ruling, the ad hoc committee moved for an order that would permit the portion of the amended statement that discloses the specifics of the purchases and sales of Debtors' securities by committee members to be filed under seal, available only to the Court and the U.S. Trustee. In a subsequent decision, captioned *In re Northwest Airlines Corporation, et. al.*, No. 05-17930 (Bankr. S.D.N.Y. Mar. 9, 2007), Judge Gropper denied the committee's sealing motion. The Court reasoned that Bankruptcy Rule 2019 is a disclosure rule that contemplates public dissemination of the required information. The potential protection recognized by the Second Circuit available for information that is "confidential" and "commercial in nature" does not apply to "trading strategies." Any individual interest in keeping confidential prices at which committee members bought and sold the Debtors' securities is overridden by the interests that Bankruptcy Rule 2019 seeks to protect – other shareholders of the Debtor have a right to know "where their champions are coming from."

This decision, if allowed to stand, is sure to have a potentially chilling effect on collective actions by hedge funds in bankruptcy cases. Certain ad hoc committee members are seeking reconsideration of Judge Gropper's decision to compel disclosure and will in all likelihood appeal if its request for reconsideration is denied.

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