BUSINESS LAW NEWS

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IN THIS ISSUE

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MR. SHINBROT IS A BANKRUPTCY ATTORNEY BASED IN BEVERLY HILLS, CA. IN ADDITION TO REPRESENTING BUYERS AND SELLERS OF BANKRUPTCY ASSETS, HIS PRACTICE INCLUDES BANKRUPTCY LITIGATION AND TRIAL MATTERS, CORPORATE RESTRUCTURING AND PERSONAL BANKRUPTCY MATTERS.

THE BANKRUPTCY AUCTION BLOCK: A PRIMER FOR ACQUIRING ASSETS

JEFFREY S. SHINBROT

The word *bankruptcy* is usually associated with the termination of a business and the liquidation of its assets. For the savvy investor, however, bankruptcy proceedings present an opportunity for the strategic acquisition of a company or its assets. Fundamentally, there are two methods of buying a bankrupt company or its assets: a purchase transaction may be consummated through a Chapter 11 plan of reorganization or assets may be purchased outside of a plan pursuant to section 363 of the Bankruptcy Code.[1] Although Chapter 11 plans are a useful vehicle for purchase transactions, the confirmation process can be complex, uncertain, and may take years to complete. The advantages of purchasing a company's assets pursuant to section 363[2] are the speed at which such a transaction may be completed, potential buyer protections in the acquisition process and, perhaps most importantly, a bankruptcy court order that shields the buyer against certain claims. The following is a primer for purchasing assets pursuant to section 363.

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The commencement of a bankruptcy case creates an estate that, with limited

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BAD FAITH FILINGS AND SOLVENT TENANT BANKRUPTCIES

PHILLIP K. WANG

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In an economic downturn, the commercial real estate market is often depressed, lease defaults are common, and owners and managers find themselves spending more time chasing existing tenants for rent and less time on new leasing matters. The last thing an owner or manager wants to deal with during these times is a tenant in bankruptcy. On the other hand, tenants deciding whether to ride out the difficult cycle or to close shop have been choosing the latter, not because tenants are necessarily insolvent, but rather to maximize the return to their equity holders at the expense of creditor-landlords by filing bankruptcy with the specific purpose of capping the landlords' damages. And, the leading venue for developing law in this area—Delaware—has been allowing tenants to do just that. However, the tide may finally be turning in the landlords' favor.

In a recent case entitled *In re Integrated Telecom Express, Inc.*[1], a financially healthy company that was going out of business was not permitted to file for bankruptcy solely to take advantage of a provision of the Bankruptcy Code which sharply limits the amount a landlord may recover for termination of a long-term lease.[2] The *Integrated Telecom* case is significant because it finally provides a limit to the latest string of decisions allowing debtor-tenants to file bankruptcy to cap a landlord's lease termination damages.

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Executive Committee: Message from the Chair

Suzanne S. Graeser*

I am now past the halfway point of my position as Chair of the Section and am pleased to report on the Section's accomplishments over the past several months.

Programs: The Section's first teleseminar on opinions issues was well-attended and very successful. By the time this edition is published, the Insolvency Committee will have held a teleseminar on the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the first major change to the bankruptcy laws in 21 years. We expect that the Section and our standing committees will begin to more frequently utilize this method of delivering quality programs in a manner that is both cost- and time-efficient to our members.

Publications: The Section's collection of quality publications on opinions has now been expanded to include the 2005 Report on "California Legal Opinions in Business Transactions" prepared by the Corporations Committee. An exposure draft of this report is available at http://www.calbar.org/corporations-draft and will be finalized soon. In addition, a copy of the 2004 Annual Legislative Review of California laws will be distributed to our members in the next few weeks and is available on the web at www.calbar.ca.gov/buslaw.

Legislation: The Section has an active agenda in the California legislature that it is pursuing. Among the legislation introduced are several pieces sponsored by the Section, including the Revised Uniform Limited Partnership Act (AB 339), and bills that would dispense with tax clearance certificates for California interspecies mergers (AB 241) and permitting unanimous written consent of directors to board actions to be taken without participate of interested directors (SB 119). The Corporations Committee has also recently provided testimony before the ABA's Task Force on Attorney-Client Privilege, continuing its participation in the dialogue regarding the scope of the privilege in the corporate context.

Electronic Communications: In the recent months, the Health Law Committee's "e–News"

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Message from the Editors

Catherine E. Bauer and James P. Menton, Co-Editors

This issue of the BLN focuses on bankruptcy law. This is fortuitous: On April 20, 2005, the President signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. This new law will make the most significant changes in consumer and business bankruptcy practice in more than 25 years.

The changes to bankruptcy law will take effect on October 17, 2005. We hope that the articles in this issue will inform and fascinate you to such a degree that, if you weren't already overcome with interest in our bankruptcy system, you will want to read the revised Bankruptcy Code from cover to cover! ■

Don't Take For Granted The Drafting Of A "Simple" Assignment Provision, Especially in a Non-Exclusive Intellectual Property License, You May End Up In A Bankruptcy Court

By Robbin L. Itkin and Katherine C. Piper

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How often in the midst of negotiating an agreement have you taken for granted that your affluent client would never be the subject of a bankruptcy proceeding? Did you happen to represent Executive Life Insurance Company, Enron, United Airlines, or the myriad of other corporate giants before they shockingly commenced bankruptcy cases? As this article will address, even the simplest assignment clause in a contract can drastically affect the ability of a debtor to restructure a business through an unforeseen bankruptcy.

The Basics: How Does Bankruptcy Affect A Contract?

Title 11 of the United States Code (the "Bankruptcy Code") gives debtors many protections to achieve the goal of providing debtors with a "fresh start." One of the most significant protections is the ability of a debtor to assume,[1] reject, or assume and assign[2] an "executory contract" pursuant to section 365. An executory contract—a term unique to bankruptcy law—is almost universally accepted as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[3]

It is important for the non-bankruptcy lawyer to know that certain provisions in an executory contract are not enforceable in bankruptcy. Clauses that trigger the automatic termination of a contract upon the filing of a bankruptcy, for example, are not enforceable when a debtor files for bankruptcy. (See 11 U.S.C. § 365(e) (providing that an executory contract may not be "terminated or modified" solely because the debtor files for bankruptcy).) For example, despite the routinely included provision that a contract terminates, or a payment obligation accelerates, upon the filing of a bankruptcy by a contracting party, such a provision is deemed an *ipso facto* clause that is not enforceable in bankruptcy as contrary to public policy and the "fresh start" goals of the Bankruptcy Code. Moreover, the standard anti-assignment provision in a contract is generally also unenforceable once the debtor files for bankruptcy. (See 11 U.S.C. § 365(f)(1) (providing that a debtor may assign a contract in bankruptcy regardless of whether the contract contains an anti-assignment provision).)[4] On the other hand, a client that becomes a debtor in bankruptcy may not be able to retain a desired contract if the contract is of a type that requires, under applicable state law, the consent of the non-debtor counter-party to that contract for assignment. It is this latter precarious situation that is the subject of this article.

If the vagaries of what standard contract provisions are or are not enforceable in a bankruptcy were not confusing enough for the non-bankruptcy lawyer, a recent Fourth Circuit Court of Appeals decision, *RCI Tech. v. Sunterra Corp. (In re Sunterra Corp.)* (4th Cir. 2004) 361 F.3d 257, has further confused bankruptcy and non-bankruptcy practitioners alike by concluding that even where a pre-petition intellectual property license expressly provides for the assignability of the license, such license may not be able to be assigned, or even assumed by the debtor in bankruptcy, if the counter-party refuses to consent to such assumption or assignment in the bankruptcy case. The inability to retain or transfer the license to another party through a sale of the business can severely hamper a client's ability to reorganize in a bankruptcy case, to maximize the value of the assets for a sale of the business, or to continue operations depending upon the critical nature of the license to a client's ongoing business.

Based on *Sunterra*, An Express Consent to Assignment in a License Agreement May Not Be Enforceable in a Bankruptcy to Allow the Debtor in Bankruptcy to Retain the License

Section 365(c) of the Bankruptcy Code provides that a debtor in possession or a trustee "may not *assume or assign* any executory contract . . . [if] applicable law excuses a party, other than the debtor, to such contract. . . from accepting performance from or rendering performance to an entity other than the debtor," and such counter-party does not consent to the "*assumption or assignment*." (11 U.S.C. § 365(c)(l).) In interpreting section 365(c)(l), the majority of circuits, including the Ninth Circuit, have found that the use of the word "or"

between "assumption" and "assignment" in that section means that a debtor cannot assume a contract if non-bankruptcy law prohibits that debtor from *assigning* the contract without the consent of the counter-party. This test—the "hypothetical test"[5]—holds that subsection (c)(l) prohibits assumption by a debtor when applicable non-bankruptcy law prohibits assignment—even though the debtor has no intention of assigning the contract.

In *Sunterra,* the Fourth Circuit joined the Ninth, Third, and Eleventh Circuits in adopting the "hypothetical test" and denying a debtor in possession's motion to *assume* an executory contract under section 365(c) of the Bankruptcy Code, despite an express assignability provision in the contract that allowed the assignment of the contract to the debtor's successors-in-interest. In *Sunterra*, the debtor was a licensee of software. The applicable non-bankruptcy law—federal copyright law—prohibits the assignment of such a license without the consent of the licensor. However, the software agreement contained the following consent provision (the "Transfer Provision"):

> The provisions of this section shall not preclude the transfer of this license to a successor in interest of substantially all of [Sunterra's] assets if the assignee agrees in writing to be bound by this license. (*Sunterra, supra,* 361 F.3d at p. 271 n. 15 (brackets in original).)

In *Sunterra*, the counter-party argued that the Transfer Provision only applied to *assignments* and Sunterra was trying to *assume* the Agreement—thus, the Transfer Provision was inapplicable. The court agreed and held that because the Transfer Provision only applied to *assignments* and Sunterra was trying to *assume* the Agreement, the debtor could not rely on the Transfer Provision to assume the Agreement. Therefore, the Fourth Circuit relied on the "hypothetical test" and held that Sunterra was unable to assume the Agreement over the objection of the counter-party because copyright law (the applicable non-bankruptcy law) barred assignment to a hypothetical third party, even though the pre-petition Agreement contained consent to assignment and Sunterra was not going to assign the Agreement.[6]

How Can Counsel Protect Their Clients From The Sunterra Problem Before A Bankruptcy Filing?

Sunterra begs the question: if a debtor is unable to assume an agreement when the debtor could not *hypothetically* assign the agreement, why is the debtor prohibited from assuming the agreement when the agreement contains consent to assignment so that the debtor in reality could assign the agreement? What can counsel do to protect their clients from this bizarre result?

The most practical solution is to negotiate better assumption and assignment provisions from the beginning—particularly when intellectual property rights have become so crucial to the operation of many businesses. The negotiation of a succinct and precise assumption and assignment clause can prevent debtors from facing the *Sunterra* problem. Adding the concept of assumption to the standard assignment provision certainly eliminates one reason given for the denial of the assumption of the Agreement in *Sunterra*. If the counter-party to the agreement is willing to consent to assignment, is assumption too much to ask? The logic for such a negotiation is compelling—if the parties are already dealing with each other, why should they object to the ability of one party to assume an agreement in which it already has rights and under which it is performing?

The negotiation of a succinct and precise assumption and assignment clause can prevent debtors from facing the Sunterra problem.

An additional concept that may be added to the standard assignment provision is the concept of a bankruptcy. The "standard" assignment clause could include that the contracting party can assume or assign whether inside or outside of bankruptcy[7]—the more precise the language the less a court or other party can attempt to change its meaning. However, many parties fear using the term "bankruptcy" as it will lead to suspicions about the financial stability of their business. If that concern exists, merely adding to the contract the concept of assumption by the contracting party (to the extent it is ever deemed a distinct entity from its current form) and/or assignment to the contracting party's affiliated entities and successors in interest certainly would help. Obviously, the other party to the contract may not want to give up future rights so easily (or be perceived to do so), or it may want the leverage of prohibiting any future assignment subject to receiving acceptable consideration.[8] Thus, these will be difficult negotiations, but negotiating precise language *before* a bankruptcy is almost certain to help avoid ambiguity later. A myriad of judicial doctrines and Bankruptcy Code provisions will apply once a bankruptcy is actually filed.[9] How these provisions and doctrines may be utilized to favor the client will depend on the language in a pre-bankruptcy contract, thus making pre-bankruptcy negotiations critical.

Conclusion

The *Sunterra* decision appears to turn the hypothetical test on its head. Until the Supreme Court addresses section 365(c), counsel should be very aware of *Sunterra's* effects on their clients.

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Calculation Of Holdover Rent In A Claim For Commercial Lease Rejection Damages

Christopher V. Hawkins

Christopher V. Hawkins
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Introduction

Debtors, commercial landlords, and practitioners face a myriad of issues involving commercial leases as a bankruptcy case unfolds. Some of the most common issues include the assumption or rejection of a lease under Bankruptcy Code section 365,[1] the calculation of damages for rejection of a lease under section 502(b)(6); and the application of a security deposit to various landlord claims. For the most part, these issues are well developed under both statute and case law. One lesser known issue is the following: On what basis will a court calculate a claim for unpaid rent owed by a debtor to a lessor of nonresidential real property when the lease has been rejected post-petition, but the debtor "holdsover" and remains in possession of the premises after the date of rejection? Fortunately for debtors and practitioners—although not for landlords—the law on this issue, though not particularly well known or developed, is fairly straight forward.

Discussion

Bankruptcy Code section 365(d)(3) was enacted to provide significant protection to commercial landlords. It provides:

> The trustee shall timely perform all the obligations of the debtor, except those specified in section 365(b)(2), arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title.

Thus, between the entry of the order for relief and the date on which a lease is rejected, whether by motion or by operation of law, section 365(d)(3) provides that a commercial landlord is entitled to, among other things, payment of the full rental amount set forth in the lease. [2]

Given the chaos that often exists in a debtor's business at and shortly after a bankruptcy filing, it is no surprise that many debtors often find themselves still occupying a leased premises after the relevant lease has been rejected. This factual situation lies outside the scope of section 365(d)(3). As discussed in detail below, after a lease is rejected, whether by motion or by operation of law under section 365(d)(4), section 365(d)(3) no longer controls the issue. Instead, section 503(b)(1)(A) controls. Section 503(b) provides:

> After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including…(1)(A) the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case….

In the context of the issue discussed herein, the language "actual and necessary costs and expenses" begs the question: What are the actual and necessary costs and expenses of the debtor's continued occupancy of the leased premises? The terms "actual" and "necessary" are construed narrowly to keep fees and administrative costs at a minimum and to maximize and protect the estate's assets for the benefit of creditors. [3]

Does the Contract Rate Still Control?

The first issue faced by practitioners in this situation is the following: Does the contract rate set forth in the lease still control after rejection and during the holdover period? While the contract rate is not necessarily irrelevant to the analysis, it does not control the situation.

In *In re National Refractories & Minerals Corp.*, [4] the lessor alleged that the debtor remained in possession of the premises not only after the filing of the petition, but also after the lease was rejected by motion and court approval. The lessor filed an administrative claim for the post-petition rent due, seeking the contract rate for both the pre- and post-rejection periods. The court performed its analysis of the issue before it by discussing the case of *In re Trak Auto Corp.*, [5] a case with similar facts, by writing as follows:

> In *Trak Auto*, the debtor did not vacate the premises by the rejection date. When the debtor did move out, it owed rent for both the pre-rejection and post-rejection period (sic), the latter as a holdover tenant. The lessor sought an administrative claim for both types of rent at the rate specified in the lease. (277 B.R. at p. 664.) The Trak Auto court concluded that, while the lessor was entitled to an administrative claim for the pre-rejection rent at the rate specified in the lease, based on title 11 of the United

States Code section 365(d)(3), its claim for holdover rent had to qualify as an administrative claim under section 503(b)(1). Thus, the lessor was only entitled to rent for the latter period to the extent the use of the leased premises directly benefited the estate. (*Trak Auto, supra,* 277 B.R. at pp. 666-67.)

> [This court] agrees with the analysis set forth in *Trak Auto* and finds it applicable to [the landlord's] claim for the Holdover Rent. [6]

The court did not conduct further analysis of the "direct benefit to the estate" issue, and did not discuss the evidence required to make such a showing, because it ruled that the debtor had not actually occupied the leased premises during the time period in question, and thus, the lessor's claim failed.

What Is the Applicable Rental Rate During the Holdover Period?

The next issue practitioners should look to is the following: At what rate will the court compel the debtor to pay rent during the holdover period?

From a practical perspective, in a rising market, a prudent debtor will assume a lease if the debtor still requires the space, or will assume and assign the lease if it does not require the space, as the lease will likely provide a lower rental rate than is otherwise available in the market place, and thus add value to the debtor's estate.

In *Chandel Enterprises, Inc.*, [7] the debtor filed for bankruptcy, and while the case was pending, attempted to negotiate a sale of its business. Over the next five months, well beyond the automatic lease rejection date provided by section 365(d)(4), the debtor made numerous rent payments to the lessor, initially on its own volition, and then ultimately by order of the bankruptcy court. [8] Finally, the lessor filed a motion to have the lease deemed rejected retroactively, which the bankruptcy court granted. The question then arose: What becomes of the lease payments made after the deemed rejection date of the lease, when the debtor was effectively a holdover tenant? The court wrote:

> During the 60-day period and any authorized extensions of time, timely payments under the lease are required by section 365(d)(3). (*In re Tandem Group, Inc.* (Bankr. C.D.Cal. 1986) 60 B.R. 125.) However, once the lease is deemed rejected, the lease rate no longer controls; instead, the debtor is only required to pay the reasonable rental value of the premises. (*Tandem Group, supra*, 60 B.R. 125 (emphasis added).)[9]

The court ultimately ruled that because the lessor was not entitled to immediate payment of rent during the holdover period, and merely entitled to a claim for such rent, the debtor was entitled to recover from the lessor all rent payments made during the holdover period. It conducted no further analysis of what precisely constituted a "reasonable rental value."

As stated above, while the contract rate does not control the outcome of this issue, it may be quite relevant.

In re Gillis [10] presented the typical situation involving a debtor holding over on leased premises beyond the lease's rejection. In analyzing the case, the court wrote:

> Pursuant to section 365(d)(3), [lessor] is automatically entitled to all amounts due and owing under the lease agreement for the 60 day period following the filing [of the petition]. (Cites omitted.)
>
> During the holdover term beyond the 60-day period set forth in section 365(d)(4), [lessor] is entitled to recover the fair rental value of the leased property. Although courts have differed with respect to whether the administrative expense claim is to be based on the full rental value or the debtor's actual use, this split in authority is inapposite in the present case, since the debtor enjoyed the actual use and possession of the leased premises during the relevant time period.
>
> The lease agreement will establish the amounts owed by the debtor, absent convincing evidence to the contrary. (Cites omitted.) This court has found as a matter of fact that the rent and other charges set forth in the lease are reasonable. [11]

Thus, while the court held that the lessor was entitled to a "fair rental value," it then looked to the contract rate and determined that, on the evidence before it, such contract rate represented a fair rental value. Many circuits apply a rebuttable presumption that the contract rate establishes a reasonable rental rate or fair market value. [12]

From a practical perspective, in a rising market, a prudent debtor will assume a lease if the debtor still requires the space, or will assume and assign the lease if it does not require the space, as the lease will likely provide a lower rental rate than is otherwise available in the market place, and thus add value to the debtor's estate. In a falling market, a landlord will strive mightily to have the contract rate control, as the fair market value measure will provide a smaller

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Insights on a Mega-case: An Interview with Judge Montali on the PG&E Case

Interview Conducted by Catherine Bauer

Judge Montali

Background

In the wake of California's energy crisis, Pacific Gas and Electric Company, a California Corporation, filed chapter 11 bankruptcy on April 6, 2001 in the Northern District of California, San Francisco Division. The case was assigned to Judge Dennis Montali, then an eight-year veteran of the bankruptcy bench.

The case attracted substantial media attention. Ratepayers, regulators, investors, creditors, taxpayers, politicians, and PG&E employees all followed the proceedings in Judge Montali's courtroom, trying to determine the effect the proceedings would have on them.

The effective date of PG&E's plan of reorganization was April 14, 2004. As of press time, the case remains open.

Question: Was PG&E your first mega-case?

That's an interesting question. What is the definition of a mega-case? I suppose by most people's definition, this was a mega-case since there was an enormous amount of debt, a great number of parties and counsel, and substantial media attention. Yes, by most definitions, this was my first mega-case.

Question: What was the first action you took when you found out that the PG&E case had been assigned to you?

I picked my law clerk up off the floor. Actually, we knew it was likely to happen because of the media. But, we didn't know which judge would be assigned to the case. Judge Carlson and I are the two judges in the San Francisco Division. When my law clerk came in with word that the case had been filed, I had my courtroom deputy call the Clerk's Office to find out who had been assigned the case. She told me I had. The case was filed at 9:00 a.m., and the first hearing took place at 9:45 a.m. The debtor's counsel requested that I hold a hearing later in the day to deal with preliminary administrative matters. Then I called my wife and told her to get ready for who knows what!

During the first hours, we had to decide where we'd have hearings. This was such an unusual case, and our court is on the 22nd floor of a private building. You have to switch elevators and pass through security on the 19th floor. We were concerned about accessability and having enough room. We thought about borrowing a larger District Court or Ninth Circuit courtroom. In the end, we consulted with the principal counsel, and decided not to move.

Question: What special procedures did you set up in order to deal with the case?

The case was filed when the court was experiencing layoffs. Since a provision of Title 28 allows the court to direct the debtor to provide support to the court, we arranged for it to pay for an employee to work exclusively on PG&E matters under the direction of the Court Clerk. The debtor engaged an employment agency to provide that person, and it just so happened that one of our own staff members, who had recently been laid off, was available, so we were able to utilize someone who was already familiar with our court procedures. Thus, while she worked under the Clerk, her compensation was paid for by PG&E.

At the time, we weren't requiring electronic filing. So, the PG&E employee who was working at the court would copy the daily filings and send them, along with the docket, to PG&E. PG&E would scan the majority of the filings (a few types of documents were exempt), and post them on PG&E-maintained bankruptcy Web site. When lawyers or the public went to the court's Web site, there was a link taking them to the PG&E-maintained Web site. We had a disclaimer that the Web site was not maintained by the court.

Question: Were there any special challenges due to PG&E being a utility?

I had to learn a whole new parlance. Energy lawyers speak in a different code. I needed to learn about a huge industry. Early on, I had a glossary of energy law terms prepared. I had to learn about things like energy swap agreements, tariffs, stranded costs, the filed rate doctrine, California's experiment with energy deregulation, etc.

And, there was a very complex interplay among the various players, as well as jurisdictional issues. I had to understand the different roles played by federal and state regulatory agencies. The Public Utilities Commission, for example, was both a litigant in the case, and a supervisor of the debtor.

Question: How did you deal with the media?

I didn't deal with the media directly. Before the case was filed, Judge Carlson and I met with the Clerk of the Court and our staffs and decided to have one person designated as the media and public interface person. We choose a staff attorney with extensive bankruptcy experience. I found that this approach worked well.

It was strange having photographers follow me out of the building. It was unusual to go out for a walk with my dog and see my photo on the front page of the Chronicle.

Early on we realized that the media would need a media room. Media like a place to do their thing. Before the case was even filed, Judge Carlson and I agreed that the hallway outside the courtroom of the non-PG&E judge would be the ad hoc media area.

As the case progressed, we made sure things got on the court's Web site. We put links to calendars, case management orders, and recent decisions on the home page. We made a point of putting things out there so that people would have access. And, when we promised decisions would be made by a certain time, we made them by that time.

Question: Do you have any tips for lawyers involved in mega-cases?

My tips are the same as in other cases. Read and follow the judge's procedures, including copying and electronic filing requirements.

Question: In retrospect, what were your greatest challenges during the case?

Coping with the huge volume of paper and people.

Shifting gears and learning new areas of law. At one point, I had a three-day trial on the anti-trust doctrine of essential facilities. I had to learn about section 2 of the Sherman Act. I had to learn how electrical systems work and the related buzz words and terminology.

There were the state sovereign immunity issues, and whether a regulatory agency can consent to be bound by a federal court. The ultimate resolution of the case includes an agreement between the debtor and the Public Utilities Commission that bankruptcy court jurisdiction will continue for some period of years.

Question: Did the case affect how you managed your other cases?

I'm on the BAP, so I have an extra law clerk and both of them worked on the case. The other Northern District bankruptcy judges offered to help me out and did take a few matters. They also loaned me their law clerks for specific tasks. I didn't want to adjust my case assignment, and for the most part, I didn't have to make changes. In the early days of the case I was given a slightly lighter assignment of BAP cases.

My law clerks and I met everyday to go over what needed to be done. There was a lot of work. This was before e-filing, so we kept our own internal log on the case.

Question: Was there anything you found surprising about the case?

The media attention. It was strange having photographers follow me out of the building. It was unusual to go out for a walk with my dog and see my photo on the front page of the Chronicle.

Question: Did dealing with the case present different challenges than other recent mega-cases?

This was such an unusual case as compared to, say, United Airlines. We didn't have insolvency issues. There weren't any critical vendors demanding payment, just millions of ratepayers. There weren't the usual tensions between equity representatives and creditor groups. There weren't any labor union problems.

On the other hand, there were some very unusual sovereign immunity and jurisdictional issues that probably don't appear in most other mega-cases.

Question: If you were assigned another mega-case, would you do anything differently?

I'd explore using video and other ways to cut down on expenses. I'd look into using video facilities at federal courts in other cities where counsel could convene and participate in our hearings.

Question: Are you glad you got the case?

It's a shame the company had to file, but since it did, I welcomed the opportunity to serve and was enriched by the experience. ■

Business Law Section: Calendar of Important Dates

- ❑ Jun. 30 — Deadline Issue No. 3, 2005 of Business Law News
- ❑ Sep. 30 — Deadline Issue No. 4, 2005 of Business Law News

Please visit www.calbar.ca.gov for upcoming Executive Committee Meetings and other section events and programs.

The Aftermath And Jurisdictional Quagmire Following California's Energy Crisis

Marc S. Cohen and Corrine J. Rebhun

Marc S. Cohen

Mr. Cohen serves as Chair of Kaye Scholer's Business Reorganization Group in Los Angeles. His involvement in the aftermath of California's energy crisis began in March of 2001, upon being retained as committee counsel for the Official Committee of Participant Creditors appointed in the Chapter 11 bankruptcy proceeding of the California Power Exchange.

Corrine J. Rebhun

Ms. Rebhun is a Corporate Restructuring Associate in the Los Angeles office of Kaye Scholer LLP. She was the primary associate responsible for the representation of the CalPX Participants Committee and continues to represent the Reorganized CalPX.

California's Energy Market Before Deregulation[1]

California's electricity market consists of three vertical components—generation, transmission and distribution. Before deregulation, all three components were owned by single Investor Owned Utilities ("IOU's"), such as Southern California Edison ("SCE"), Pacific Gas & Electric Company ("PG&E"), and San Diego Gas & Electric Company ("SDG&E").

The IOU's purchase power at wholesale rates controlled by the Federal Energy Regulatory Commission ("FERC"). Under section 201 of the Federal Power Act ("FPA"), title16 of the United States Code section 824, et seq., FERC has exclusive jurisdiction to regulate the wholesale sales of electric power and the interstate transmission of electricity. (See 16 U.S.C. § 824(a).) FERC's exclusive jurisdiction includes setting rates for any interstate transmission or sale. (See *Miss. Power & Light Co. v. Miss.* (1988) 487 U.S. 354, 371.) This statutory authority necessarily includes requiring all wholesale electric power sellers and interstate transmission providers to file schedules and tariffs with FERC showing all rates for interstate sales and transmissions, including the classifications, practices, and regulations affecting such rates. (16 U.S.C. §§ 824d, 824e.) Such rates must be "just and reasonable." By exercising its authority over filed tariffs and schedules to ensure that rates are just and reasonable, FERC fulfills its statutory duty to regulate wholesale electricity sales and interstate transmissions.

Before deregulation, wholesale rates generally equaled cost plus a FERC-approved expected rate of return. Sellers were only allowed to charge the wholesale rates on file with FERC and were not permitted to contract for another price. FERC, however, only controls wholesale rates, not retail rates which are within each state's jurisdiction. In California, the California Public Utilities Commission ("CPUC") controls retail rates.

The Market After Deregulation

On September 23, 1996, California signed into law deregulation legislation, Assembly Bill No. 1890 (1995-1996 Reg. Sess) ("Deregulation Legislation"), which required the IOU's to divest ownership of their generating assets. The transmission facilities owned by the IOU's were then transferred to an independent state-chartered body, the California Independent System Operator ("CalISO"), which acted as the grid operator.[2] The Deregulation Legislation also created an energy marketplace, the California Power Exchange Corporation ("CalPX"). The IOU's were required to conduct virtually all trades through CalPX's markets. Both CalISO and CalPX (established in March 1998 after obtaining FERC approval) are subject to FERC's jurisdiction and operate pursuant to FERC-approved tariffs which specify, among other things, the means of determining allowable market rates, collateral requirements for participating in the markets, and terms for settling market transactions. (See *Pac. Gas & Elec. Co.* (1996) 77 FERC ¶61,204; *Cal. Power Exchange Corp.* (2003) 103 FERC ¶61,001.)

CalISO, charged with managing and operating California's transmission grid and balancing electrical supply and demand, operated the real-time market by adjusting marginal incremental power requirements necessary to operate the grid. When demand exceeded supply, CalISO was "required to procure power on the spot market to maintain the stability of the grid." (*Snohomish, supra,* 384 F.3d at p. 759.)

CalPX, a nonprofit public benefit corporation, provided a centralized auction market for electricity trading. Its markets consisted of two primary markets, the Core Market and the CTS Market. Two sub-markets, the Day-Ahead Market and the Day-of Market, comprised the Core Market. The CTS Market, opened in the summer of 2000, was a block-forward auction market for longer-term contracts. Buyers and sellers in CalPX's markets were not matched. Instead, sellers sold into, and buyers purchased from, a blind pool. Market clearing prices were determined by CalPX's computer system using participant bidding and other data, through a calculation methodology approved by FERC. More than 70 entities, including utilities and power generators, traded energy through CalPX's markets ("Participants").

FERC continued to control wholesale prices. FERC required each Participant in California's competitive market to file a market-based umbrella tariff, preauthorizing each Participant to engage in sales with market-based prices. Approval was conditioned on the Participant demonstrating that it lacked market power or that it had adequately mitigated market power. FERC also required each Participant to file quarterly reports. Furthermore, both CalISO and CalPX filed tariffs that were reviewed and approved by FERC and to which each Participant signed onto *vis-a-vis* a market participation agreement.

Retail prices under the Deregulation Legislation included a mandatory rate freeze until the earlier of (a) the date an IOU recovers transition costs, and (b) March 31, 2002. The CPUC retained jurisdiction over retail rates and the conditions of service for the IOU's within California.

Deregulation Unravels

California's wholesale electricity prices increased dramatically in 2000 and 2001, apparently due in part to market manipulation. By May 2000, the frozen retail rates were insufficient to cover the IOU's' wholesale electricity procurement and service costs. Furthermore, the CPUC refused to allow the IOU's to charge retail rates equal to the inflated wholesale rates. Thus, the IOU's were unable to recoup the difference between frozen retail rates and their dramatically increased wholesale procurement costs.

The inability to recoup costs triggered massive IOU defaults in CalPX's markets. On January 16, 2001, SCE filed an 8-K with the Securities and Exchange Commission (the "SEC") stating SCE's suspension of the $214 million payment due to CalPX on January 18, 2001. SCE subsequently failed to pay its January 18TH invoice. On February 1, 2001, PG&E also filed an 8-K with the SEC stating its inability to pay over $1 billion that it owed to CalPX.

The IOU defaults created a severe cash shortage leaving CalPX unable to clear its markets. CalPX's Tariff provided several default remedies and mechanisms intended to ensure that CalPX could clear its markets, but the defaults were of a magnitude well beyond those contemplated when the default remedies were created. (*Pac. Gas & Elec. Co. v. Cal. Power Exchange Corp.* (2001) 95 FERC ¶¶61,020, 61,045.) These remedies included, among other things, (1) allocating and charging-back defaults to Participants; (2) using collateral posted by Participants to offset defaults; (3) collecting CalPX's pool performance bonds; and (4) liquidating the IOU's' block-forward contracts (the BFM Contracts"). CalPX, however, was intentionally prohibited as seen below, from taking any remedial measure in a timely fashion.

CalPX began charging-back defaults to the Participants because the CalPX Tariff allowed CalPX to either invoice each Participant for defaults in the market or use collateral (e.g. surety bonds, letters of credit, and cash) posted by Participants to cover the defaults. When CalPX attempted to chargeback the IOU defaults, certain Participants filed complaints at FERC ("Chargeback Proceedings"). On March 5, 2001, other Participants sought injunctive relief in the District Court for the Central District of California to enjoin CalPX from further invoicing the Participants for the IOU defaults or from using the Participants' collateral to clear its markets. Judge Moreno granted the injunction, prohibiting CalPX from issuing further chargeback invoices and enjoining CalPX from using any of the Participants' collateral.

California's wholesale electricity prices increased dramatically in 2000 and 2001, apparently due in part to market manipulation. By May 2000, the frozen retail rates were insufficient to cover the IOU's' wholesale electricity procurement and service costs.

Meanwhile, PG&E and SCE filed lawsuits in the Superior Courts of California in San Francisco and Los Angeles, respectively, seeking to enjoin CalPX from liquidating the BFM Contracts. PG&E and SCE successfully obtained temporary restraining orders prohibiting CalPX from liquidating the BFM Contracts. Making matters worse, on February 2 and 5, 2001, one day before PG&E's and SCE's TROs were to expire, Governor Davis in Executive Orders D-20-01 and D-21-01 commandeered the BFM Contracts. (*Duke v. Davis*, *supra.* 267 F.3d at p. 1047.)

Prevented from clearing its markets through the FERC approved default remedies, on January 31, 2001, CalPX suspended its markets. On March 9, 2001, CalPX filed for protection under Chapter 11 of the Bankruptcy Code in the Bankruptcy Court for the Central District of California.

Several bankruptcies followed on the heels of CalPX's filing: (1) PG&E in the Northern District of California on April 6, 2001; (2) Enron in the Southern District of New York on December 2, 2001; (3) National Energy & Gas Transmission, Inc. (f/k/a PG&E National Energy Group, Inc.) in the District of Maryland on July 8, 2003; (4) Mirant Corp. in the Northern District of Texas on July 14, 2003; and (5) NorthWestern Corporation in the District of Delaware on September 14, 2003.

Litigation Arising from the Collapse of California's Energy Market

CalPX is currently involved in the PG&E, Mirant, and Enron

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Don't Be An Impediment To A Mediated Settlement

Gerald F. Phillips and Susan Keenberg

Gerald F. Phillips

Mr. Phillips is an adjunct professor at the Straus Institute at Pepperdine University School of Law. He is "Of Counsel" to the law firm of Phillips, Lerner & Lauzon, (Phillips in the name of the firm is his daughter Stacy D. Phillips). He is a founding member of the College of Commercial Arbitrators.

Susan Keenberg

Ms. Keenberg is a mediator and business transactions attorney. Before limiting her full-time endeavors to mediation and counseling clients on business transactions, employment law and human resource issues, Susan was general counsel at 1-800-Dentist® and also enjoyed a career as a business manager in the entertainment industry.

Keenberg: Gerry, the State Bar Business Law Section ADR Committee, on which we both serve, has asked us to prepare a program for the broad spectrum of attorneys who represent clients in mediations. These include business transactions specialists, in-house counsel, and litigators. Our presentation will be titled, "Don't Be an Impediment to a Mediated Settlement." What do you think is the most important advice we can offer all of these attorneys?

Phillips: Mediations can be instigated in any one of three ways. The parties may agree that a dispute should be mediated without having had any prior agreement to do so. In that case, they will enter into an agreement and give it to a provider or just retain a mediator privately. The parties may do that at any time, even after a suit has been brought or even after the parties have submitted the dispute to a provider for arbitration. In a second scenario, there is a dispute resolution provision in a contract that calls for the parties to mediate. This is not too common now, but requiring the parties to a contract to mediate in good faith before commencing litigation is becoming more common as time goes by. Finally, where litigation has been filed, the court may order the parties to meditation before the suit goes to trial. But regardless of how the mediation comes about, attorneys must recognize that there are very important differences between representing parties in mediation and in court. I hope that those who represent parties in mediation will do more than just not impede the mediation, but will work proactively with the mediator to effectuate a resolution of the controversy. Abraham Lincoln wrote, "Discourage litigation. Persuade your neighbor to compromise whenever you can . . . . As a peacemaker the lawyer has a superior opportunity of being a good man."

It is counsel's job to educate clients that mediation avoids the detrimental aspects of adversarial litigation, where attorneys all too often employ Rambo tactics. Mediation replaces litigation with a more conciliatory process of negotiation and settlement. To paraphrase Robert Frost, two roads cross in the wilderness, mediation and litigation, where counsel may select the higher road—mediation, the less traveled—which will make all the difference.

Selecting The Mediator

Keenberg: Gerry, in court, cases are assigned to judges at random and the parties have no say in who is assigned. In mediation the parties and their counsel select the mediator. How important is this distinction?

Phillips: Perhaps the most important advice we can give attorneys about this would be: Select the mediator carefully. Ask others for the names of mediators whom they recommend. Interview mediators and decide if that person has the expertise that your case demands and the personality and demeanor that will mesh well with your client.

Keenberg: I agree. Attorneys must recognize that a mediator whose expertise is perfect for one dispute may be totally inadequate for a dispute involving other issues or another industry. Even in the case of many court-mandated mediations, the attorneys have the option of selecting a mediator from the panel rather than allowing the ADR clerk to select a mediator at random. Whenever possible, they should elect this important option. Let's talk a bit about preparing the client for mediation.

Preparing The Client For Mediation

Philips: I think it is very important that the attorney works with the client to develop a positive frame of mind in the client, so that the client believes that the mediation will produce a win-win result.

Keenberg: Yes, and if they can't sign on to the "win-win" philosophy, perhaps they can adopt what Pete Rose says about that. He doesn't believe in "win-win," but he says, "Me first; you, too!" I think that's closer to the attitude most people can be encouraged to bring

to a mediation, so during my pre-mediation conference calls with attorneys, I always ask them to talk with their clients about preparing for the mediation by thinking of themselves as entering into an "atmosphere of conciliation." Such an atmosphere is vastly different from the combative environment in which litigation is conducted and in which the parties frequently have worked themselves into such deeply entrenched positions that settlement seems almost out of the question.

Phillips: Attorneys must also enter into the "atmosphere of conciliation" with a strong conviction that the case will settle. Some great trial attorneys don't recognize that their behavior, which serves them so well before a jury or judge, may be a terrible handicap in a mediation. Eminent mediator, Louise Lamothe, noted in a recent article that lawyers frequently come to mediation unprepared and without having adequately prepared their clients. Counsel must prepare the client with the same diligence as they would prepare for an important negotiation.

Keenberg: Gerry what else should the attorney discuss with the client prior to the mediation?

Phillips: The lawyer and client should identify the client's realistic goals and expectations and work together to formulate a settlement strategy to achieve those goals and expectations.

Keenberg: And if the client's goals or expectations are not reasonable?

Phillips: Then the attorney needs to work hard to help the client understand why those goals are unrealistic and help the client to revise them to a more reasonable level.

Keenberg: Yes, and if the attorney is unable to persuade the client and believes the client isn't being realistic, she should share that information privately with the mediator, who can be extremely helpful in guiding the client to a more reasonable position.

Phillips: Right. It is sometimes difficult for clients to accept what their own counsel advises. They want a gladiator who will fight for them, not a conciliator who advises settlement.

Keenberg: Perhaps the most difficult lesson for counsel to accept is that they must become good listeners in a mediation. Too often, participants at mediations are just waiting for their turn to speak and are not really listening to the other participants. Lawyers, in particular, tend to focus more on what they are going to say next than on what others are saying at the moment. A mediation is frequently the first opportunity the parties have had to hear each other speak about the dispute in a very long time. Attorneys typically have never heard the opposing party discuss the facts except in the context of a deposition, where that party has been counseled to withhold as much information as possible. Each party has heard his/her own attorney, but has not heard the other party's attorney talk about the case. Rarely have the parties or their attorneys had the benefit of hearing a neutral, well-informed third party give an opinion about the facts or the relevant law. At the mediation, for the first time, ideally the flow of information will be plentiful, and if everyone is really listening, so much can be achieved. But if everyone is preparing in their own minds what they want to say next and just waiting for that next turn to talk, each one may miss something very important and a great opportunity will be lost.

Phillips: I agree. During mediations that I conduct, I make it clear at the opening that I welcome the parties to speak openly to vent their feelings and express their opinions. In one mediation, I learned at the very first joint session that the parties had been good friends for many years. I used this fact to settle the dispute by going to dinner with the two parties. During this dinner, I urged them to make a deal, just as you have been doing for the past twenty years.

Keenberg: Reality-testing is a key function of the mediator in helping each party evaluate the strengths and weaknesses of the case. If a recalcitrant party believes that the mediator is both truly neutral and highly knowledgeable in the subject matter, he or she is likely to be moved by the mediator's evaluation of the case. Attorneys who find themselves with poor "client control" shouldn't hesitate to ask the mediator for help in this area. In a recent case, I told a reluctant party what I honestly thought of his case. A few months later, I met his attorney and asked why his client finally agreed to the settlement. He said, "You told the truth, which my client accepted because he had great respect for your opinion. If I had told my client exactly the same thing you explained to him, he would have fired me as a wimp." Gerry, what other advice should we offer counsel?

Phillips: We must stress how important counsel are to a successful outcome and how vital it is for them to explain the process to their clients. In most cases, without counsel's help, the dispute will not be resolved. Counsel should educate their clients that good mediation is a process that takes time: time for the mediator to explain the process; for the mediator to caucus with each side and build the parties' confidence and trust and time for the mediator to uncover the below-the line issues. Haste makes waste! Counsel

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"Houston, We Have A Problem" A Review Of, Courting Failure: How Competition For Big Cases Is Corrupting The Bankruptcy Courts, By Professor Lynn M. Lopucki

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Introduction

UCLA law professor Lynn M. LoPucki's new book, *Courting Failure: How Competition For Big Cases Is Corrupting The Bankruptcy Courts,* has elicited great interest among certain federal legislators while eliciting an even greater amount of vitriol among certain bankruptcy professionals. The conclusion of Professor LoPucki's book is relatively non-controversial—Professor LoPucki concludes that "forum shopping" of large Chapter 11 bankruptcy cases into certain jurisdictions (the Southern District of New York and the District of Delaware) should be curtailed. Professor LoPucki's conclusions are championed by, among others, the 7,500 Houston-based employees of Enron. Those employees have argued that Enron should have filed its bankruptcy case in Houston rather than in New York City. Given that the Houston bankruptcy courts are sophisticated courts and that Enron employed no more than 57 people in the entire State of New York, most can understand the employees' concerns.

The controversial part of Professor LoPucki's book is his justification for arguing against forum shopping. Instead of arguing that non-institutional creditors have better access to bankruptcy courts when bankruptcy cases are filed locally (consistent with Enron's employees' arguments), Professor LoPucki argues against forum shopping based on his conclusion that bankruptcy courts have been "corrupted" by their alleged attempts to compete with more favored fora (*i.e.,* the Southern District of New York and the District of Delaware). In Professor LoPucki's view, the bankruptcy courts in the Southern District of New York and the District of Delaware are ineffective courts that do not adequately address debtor's financial problems, while ignoring legitimate creditors' concerns. Moreover, Professor LoPucki argues that other courts are attempting to "compete" with the Southern District of New York and the District of Delaware for big Chapter 11 cases by becoming equally ineffective and equally creditor-insensitive.

Solicitation

Courting Failure includes an interesting historical analysis of the recent predominance of the Delaware bankruptcy courts. The United States Code contained a liberal forum selection clause long before Delaware bankruptcy cases became prevalent. Title 28 of the United States Code section 1408(1) allows debtors to file in their states of incorporation. Because many large corporations are incorporated in Delaware, many large corporations had the opportunity to file Chapter 11 bankruptcy cases in Delaware since section 1408(1)'s adoption in 1984. However, few large bankruptcy cases filed in Delaware until 1990. At that time, it became clear that the District of Delaware was a forum that many debtors would find favorable. Because the district had only one bankruptcy judge (Bankruptcy Judge Helen Balick), uncertainty was minimized. Because Judge Balick's procedures were faster and because her policies were attractive to prospective debtors, a large number of Chapter 11 bankruptcy cases were filed in Delaware. Favored policies included the liberal awarding of attorneys' fees, the liberal granting of management retention bonuses, and the reluctance to replace a debtor's management.

Professor LoPucki's historical analysis fails to explain whether the egg produced the chicken, or *vice versa. Courting Failure* does not, because it cannot, explain whether Judge Balick adopted her management-friendly policies to solicit large Chapter 11 bankruptcy cases into Delaware, or whether prospective Chapter 11 debtors began soliciting Delaware because of Judge Balick's management-friendly policies. That certain other districts have adopted Judge Balick's procedures may reflect that those districts are trying to compete with Delaware, or may reflect that those districts believe that Judge Balick's procedures have proven successful. Professor LoPucki provides anecdotal evidence to support his conclusion that Judge Balick adopted her policies because she wanted to solicit Chapter 11 bankruptcy cases and that other districts have adopted those procedures in an attempt to compete for cases. Obviously, however, this anecdotal evidence is not definitive.

"Failure"

Courting Failure's statistical analysis is more definitive but equally subject to interpretation. While some have argued with Professor

LoPucki's statistical data, the book makes a very strong case that large Chapter 11 bankruptcy cases in Delaware refile more often. That is, large Chapter 11 bankruptcy cases in Delaware tend to file repeat Chapter 11 cases more often than Chapter 11 bankruptcy cases in other districts. The refiling rate is Professor LoPucki's best argument that Delaware bankruptcy courts (as well as the bankruptcy courts in the Southern District of New York who recently have exhibited a similar refiling rate) are failing. Professor LoPucki attributes such failure to the courts' lax procedures approving "prepackaged" Chapter 11 plans of reorganization (where procedures are compressed, costs minimized, and opportunity for creditor involvement reduced), approving payment of preferred prepetition debts (called "critical vendors"), and approving pre-negotiated asset sales. Professor LoPucki argues that all of these procedures result in a greater probability that a Delaware debtor will confirm a plan of reorganization under which it will be financially unable to perform.

The biggest problem with Courting Failure is that it fails to identify who is harmed by the alleged "failure" that the book allegedly exposes. For the reasons described above, debtors and secured creditors often choose to have a case venued in Delaware.

Even assuming that one relies on the statistical analysis (many have agued that lies are slightly less reliable than statistics), it is unclear whether the rate of refiling is analogous to a "failure" rate. Delaware procedures are faster. As a result, prepackaged plans and pre-negotiated sales are approved faster. While creditor protections likely are reduced because of the speed in which these things are approved, Chapter 11 administrative expenses (*e.g.,* attorneys' fees) also are reduced as a result of these procedures. Because Chapter 11 bankruptcy cases typically are very expensive, the reduction of administrative expenses is a substantial benefit that likely aids in the ability to finance a reorganization. Whether the financial savings from reducing administrative expenses (thereby leaving more assets to reorganize for the benefit of creditors) justifies the faster pace in which these issues are addressed (thereby reducing creditors' abilities to participate in these decisions) is unclear, both before and after one reads *Courting Failure.*

Delaware debtors' high refiling rate may reflect a higher post-confirmation failure rate as Professor LoPucki suggests, but it just as easily might reflect a greater confidence in Delaware's expedited procedures. While non-Delaware debtors might be more likely to agree to out-of-court workouts because of their fear of refiling in a non-Delaware court, Delaware debtors might be more comfortable addressing their post-confirmation financial problems in the same place they addressed their prior financial problems (*i.e.,* the Delaware bankruptcy courts). Whether a refiling rate is reflective of a prior debtor's failure to address its financial problems, or reflective of a prior debtor's confidence in the bankruptcy court's continuing ability to address those financial problems, is unclear, both before and after one reads *Courting Failure.*

Missing the Point

The biggest problem with *Courting Failure* is that it fails to identify who is harmed by the alleged "failure" that the book allegedly exposes. For the reasons described above, debtors and secured creditors often choose to have a case venued in Delaware. Because a majority of large Chapter 11 cases are reorganizations rather than liquidations, employees often times are unaffected by a Chapter 11 filing (to the extent that there are job reductions, those reductions likely would have occurred regardless of the Chapter 11 filing). Trade creditors often times are treated better in Delaware—Professor LoPucki's criticism of liberal payments to "critical venders" helps to prove that point. Finally, there is no reason to believe that shareholders are worse off in Delaware than in other jurisdictions. Professor LoPucki is quick to label Delaware bankruptcy cases as "failures," but a failure for whom?

Professor LoPucki fails to appreciate that refilings often are reflective of a debtor's inability to satisfy its post-confirmation secured debt obligations. Accordingly, to the extent a refiling represents a "failure," it likely most often represents a failure by the debtor to pay the prepetition institutional secured creditors (or their successors) who chose Delaware in the first place. Those institutional creditors likely chose Delaware based upon their analysis that a cheaper, speedier proceeding was financially more beneficial than a slower, more thorough proceeding. In hindsight, the institutional creditor might consider the first Chapter 11 bankruptcy filing a failure, but also might perceive it as a success (depending upon its recovery during the interim). To the extent that Delaware bankruptcy cases "fail" more often, the creditors who are harmed likely can adjust their behavior by causing filings to occur in other jurisdictions (the post-confirmation debt market should be indicative of the Delaware cases' success). If those creditors are not adjusting their behaviors, then the Delaware bankruptcy cases likely are not as big "failures" as Professor LoPucki suggests.

Missing The Even Bigger Point

There are good reasons to limit Chapter 11 bankruptcy case forum shopping. However, contrary to the implicit reasoning in *Courting Failure,* saving institutional investors from choosing their

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Business Law Section Web sites Index: CLE, Practice Tips, Guides, Forms, Legislation And More...

The Agribusiness Committee Web site

For those who work in the field of agriculture and others who want insights into the field, this is the Web site for you. The Committee is unique among BLS Standing Committees in that it is industry-oriented, not law-topic oriented. As a result, the Committee's members come from a wide range of backgrounds, bringing to the Committee expertise in a very broad range of legal subjects. These include agriculture, finance, environmental, land-use, water, intellectual property, LLCs and partnerships, corporations, securities, mergers and acquisitions, insurance, employment, labor, international trade, litigation, insolvency, alternative dispute-resolution, banking, transportation, commercial transactions, and antitrust law.

The Web site includes a roster of its members and a very complete set of links to the world of private and governmental aspects of agri-law.

The Consumer Financial Services Committee

Attorneys and consumers alike should visit this site. This committee assists in the development of a sound, consistent, and well-reasoned body of law governing the consumer financial services industry and contributes to the education of both lawyers and consumers with respect to the laws governing consumer financial services. The Web site has many useful, educational and informative features including, but not limited to, Educational Programs from the Consumer Financial Services Committee, which periodically puts on educational programs both for attorneys and consumers. Recent programs include: Doing Business in a Diverse California and Identify Theft—Don't Become a Victim.

Corporate Law Departments Committee

Find out more about the many "in-house" issues this committee deals with. On this site you will find interesting articles like, "Multijurisdictional Practice of Law or Unauthorized Practice of Law: Survey of the Issue;" "Gag Orders and Handling the Media During Litigation;" and others that cover many topics of interest to all business practitioners like "Corporate Counsel Beware: The Economic Espionage Act of 1996." The site features a Legislation section that contains many useful digest summaries of bills pending before the California Legislature that may be of interest to members of the Committee. The list comprises bills selected from the State Bar Web site and includes a Bill Tracking page. This site is a must for any in-house counsel and those interested in what issues they face.

Corporations Committee

The Web site of the Corporations Committee reflects interesting recent legal developments pertinent to corporate practitioners. The mission of the Committee's Web site is to educate, inform, and alert. The site is updated regularly and includes discussions of pending California legislative proposals, proposed and new California regulations, and significant developments at the SEC, as well as important new rules and proposals from the NYSE, the NASDAQ and the Financial Accounting Standards Board. Also included on the Web site are links to other relevant sites for corporate practitioners, minutes of the Committee's meetings, and information on upcoming presentations by the Committee.

The Committee provides a forum for interested California corporate and securities law practitioners to act for the benefit of all related and general business practitioners throughout the state and as an aid to promote efficiency of practice. The Corporations Committee's Web site is located at: <www.calbar.org/buslaw/corporations>.

Cyberspace Committee Web Site

The Cyberspace Law Committee follows issues related to electronic transactions, internet-based commerce, data base security and privacy issues. On our Web site, we have posted articles and presentation materials from recent CLE programs sponsored by our committee. Of current interest, there are recent articles and presentations concerning anti-spam and identity theft legislation, Web site privacy practices and procedures, and the statutory requirements concerning notice of breaches of database security.

We also actively monitos pending California and Federal legislative activities. We have posted recent tracking reports about pending bills in the California Legislature as well as the U.S. Congress. Our site also contains links to not-for-profit and/or governmental Web sites relevant to developments in this practice area. These links cover news sites, e-commerce sites, California and Federal Agencies, as well as links to internationally-based organizations pertinent to this practice area. In the coming months, we are developing an interactive portion of the site to allow section members to exchange information and solve common problems.

Financial Institutions Committee

The Financial Institutions Committee Web site provides attorneys with a gateway to information on legal issues affecting banks and other financial institutions. The site is noted for its resource material and links providing information of changes in relevant laws and regulations, discussions of proposed legislation, and professional education on these topics.

The Financial Institutions Committee has articles and sections on: Measures Against Terrorism, Educational Opportunities/Materials for the Public, Legislative Developments, Regulatory Developments, Developments in Electronic Banking, Identity Theft—Protect Yourself Now!, Links to Useful Financial Web sites, News, and Legislation. The Corporations Committee's Web site is located at: www.calbar.org/buslaw/financial.

Franchise Law Committee

The Franchise Law Committee Web site features several publications providing an overview of California franchise law. Learn about and identify when franchise disclosure laws apply to your cli-

Business Law Section Web sites Index: CLE, Practice Tips, Guides, Forms, Legislation And More…

ents' businesses, and avoid the "hidden" franchise problem unknowingly contained in some distribution and licensing agreements.

Among the many resources provided on the committee's Web site, these featured articles are of special interest to the business law practitioner:

■ Your Client Wants to be a Franchisor or Franchisee - What Do You Do Now? Designed for the non-franchise specialist, this overview of franchise law and related business considerations will cover many of the concerns and questions your clients may raise as they contemplate entering franchising, either as a franchisee or a franchisor.

■ Franchising 101. In this three-part article, learn about "hidden" franchises, registration, and disclosure issues, and current issues arising in franchise litigation.

■ Alternative Dispute Resolution. This guide, addressing the ADR process in the franchise context, is written for both attorneys and their clients.

You can find our Web site at: <www.calbar.org/buslaw/franchise>.

Health Law Committee

This Web site is to serve as a resource for the legal community, the California State Bar, and the public by providing a forum for California lawyers and others with an interest in Health Law. The site features a HEALTH LAW COMMITTEE LEGISLATIVE WATCH UPDATE that really is updated and tracks pending California legislation of interest to health practitioners. This contains summaries and updates on the status of pending legislation. The site also has articles on selected topics including, "Medical Injury Compensation Reform Act (MICRA): History and Key Provisions;" "The Occasional Practitioner's Guide to End of Life Decisions;" and "Forming a California Professional Corporation." This site is a must for attorneys, insurance counsel dealing with health issues, and doctors who want to see the state of the law.

Insolvency Law Committee

The Insolvency Law Committee of the Business Law Section has now completed the redesign of its Web site. We now post announcements of upcoming CLE programs, minutes of past meetings of the Committee, materials from past programs when available, information on current issues and problems such as ECF, contact information, and links to useful bankruptcy and insolvency web pages. In addition, we have posted a Model Real Estate Sales Order, which has been prepared by the Committee with instructions as to its use and have provided periodic updates on pending legislation and other information useful to practitioners in this area.

Please visit our Web site and let us know what you think. Any comments or suggestions can be sent to Bob Franklin at rfranklin@murraylaw.com.

Partnerships and L.L.C.'S Committee

See the Partnerships and L.L.C.'S Committee Web site to find all the latest information affecting California companies. Update your knowledge about L.L.C.s by checking out the newly-revised Guide to Forming and Operating a Limited Liability Company in California. Review the proposed new limited partnership law, drafted by the PLLC, as well as information about meetings, articles, as well as recently enacted and pending legislation.

Of particular practical interest is the L.L.C. Guide, a major practice manual for L.L.C. formation, and governance, which also includes drafting tips for L.L.C.s in California and much more. To get to our site: <www.calbar.org/buslaw/partnerships>.

UCC Committee

The UCC Committee Web site reports on pending legislation and other commercial law issues that impact commercial and financial transactions practice in California. Highlights of the UCC Committee Web site that benefit the California commercial law practitioner include full reports or useful links to the following:

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exceptions, is comprised of all property of the debtor, wherever located. In a Chapter 7 liquidation case, the estate's representative is the Chapter 7 trustee. In a Chapter 11 reorganization case, the estate's representative is either the debtor, who remains in possession of its assets, or a Chapter 11 trustee who has been appointed in the case. *Wage earners* in Chapter 13 and *family farmers* (unless removed) in Chapter 12 also remain in possession of the estate's assets and may sell assets subject to the provisions of section 363.

The concept of estate property is broadly construed and includes all property in which the debtor has a legal or equitable interest at the moment the bankruptcy petition is filed.[3] For example, estate property includes state-issued liquor licenses,[4] the debtor's interest in property that was repossessed before the commencement of the bankruptcy case,[5] liens held by the debtor on property of a third party,[6] causes of action,[7] liability insurance coverage,[8] contractual rights,[9] and income tax refunds.[10] Estate property also includes certain property acquired after the filing of the bankruptcy petition, such as, property recovered by a trustee or debtor-in-possession[11] and inheritances that are acquired within 180 days of the commencement of the case.[12]

The concept of estate property is broadly construed and includes all property in which the debtor has a legal or equitable interest at the moment the bankruptcy petition is filed.

The existence and nature of estate property interests are determined by reference to state law. Hence, an attorney's license to practice law is not estate property (since under applicable state law a nontransferable professional license is not a *property interest*); however, stock or goodwill in a debtor's law practice is estate property and may be sold by a trustee.[13]

The trustee may also sell community property of the debtor and the debtor's spouse that would be available under applicable state law for the satisfaction of claims against the debtor.[14] However, the potential purchaser should be aware of section 363(i) of the code, which gives the non-debtor spouse a *right of first refusal.*[15]

In addition to spouses, other non-debtors may find their property interests on the 363 auction block. For example, section 363(h) permits the trustee to sell property in which the debtor held an undivided interest as a tenant in common, joint tenant, or tenant by the entirety, along with the interest of a non-debtor co-owner. Section 363(h), however, allows such a sale only if:

> (1) Partition in kind of such property among the estate and such co-owners is impracticable;
>
> (2) Sale of estate's undivided interest in such property would realize significantly less for the estate than sale of such property free of the interests of such co-owners;
>
> (3) The benefits to the estate of a sale of such property free of the interest if co-owners outweighs the determent, if any, of such co-owners; and
>
> (4) Such property is not used in the production, transmission, or distribution, for sale, of electric energy or of natural or synthetic gas for heat, light, or power.[16]

Pursuant to section 363(e), the non-debtor entity that has an interest in the property being sold is entitled to "adequate protection" of its property rights. The most typical form of adequate protection is that the interest attaches to the proceeds of the sale.

II. Sale Outside of A Chapter 11 Plan

Asset sales under section 363 outside of a Chapter 11 plan circumvent the procedural protections of the disclosure and plan confirmation process.[17] Therefore, courts have established guidelines for determining the appropriateness of a sale outside of a Chapter 11 plan. In *Committee of Equity Security Holders v. Lionel Corp.*,[18] the leading opinion on the appropriateness of sales outside of Chapter 11 plan confirmation, the Second Circuit rejected both the notion that a bankruptcy judge has *carte blanche* to approve a 363 sale and the notion that a sale outside of a plan may only take place in emergency situations. Rather, the court took the middle ground and held that a bankruptcy judge must find "good business reason" after considering all salient factors pertaining to the proceeding and then act to further the "diverse interests of the debtor, creditors and equity holders, alike." [19]

III. The Ordinary Course of Business

Businesses reorganizing under Chapter 11 may conduct their operations and sell things in the *ordinary course of business*, without prior court approval.[20] The code provides no definition of "ordinary course of business," but there are two generally accepted tests. The *Horizontal Dimension Test* queries whether the transaction is of a type that other similar businesses would engage in as ordinary business. Under this test a transaction can be ordinary and still only occur occasionally. The *Vertical Dimension Test* views the specific transaction from the vantage point of a creditor and asks whether the transaction subjects the creditor to economic risks of a nature that is different from those the creditor accepted when the decision was made to extend credit.[21]

If a transaction is not in the *ordinary course of business*, the notice and hearing requirements of section 363 apply.[22] Federal Rule

of Bankruptcy Procedure Rule 2002(a)(2), made applicable to 363 sale motions by rule 6004, requires at least 20-days notice of the sale motion, on all parties in interest; however, the court may, for good cause, shorten the time requirements and/or order another method of providing notice.[23] If a sale is "free and clear of liens," rule 6004(c) requires that the seller provide notice to all parties who have liens or interests in the property. By referencing rule 9014, rule 6004(c) also requires that if the lien holder or interested party is an insured depository institution, that party must be served by certified mail.[24]

More problematic are tort claims that arise after a sale has been consummated. Many courts have found it fundamentally unfair to bar actions by future claimants that did not have notice of the 363 sale.

An order shortening notice time requirements may be appropriate in the context of a pre-bankruptcy arrangement between the debtor, the buyer and creditors to sell assets and pay claims through a plan (referred to as a "pre-pack"). Alternatively, notice periods may be shortened in emergency situations; for example, estate assets are rapidly perishing or losing value.

IV. Free and Clear of Claims

The express language of section 363 (f) and the bankruptcy court's inherent equitable powers provide the basis for the sale of estate property and the transfer of third-party interests to the proceeds (usually cash) of the sale.[25] section 363(f) permits a Trustee to sell property free and clear of any interest in such property, if at least one of the following five conditions is met:

(1) Applicable non-bankruptcy law permits sale of such property free and clear of such interest;

(2) Such entity consents;

(3) Such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;

(4) Such interest is in bona fide dispute; or

(5) Such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interests.

Section 363(f) is written in the disjunctive, therefore, fulfillment of any one of the five conditions is sufficient to allow the sale of property free and clear of liens.[26]

By its plain language, section 363(f) protects the buyer of estate assets from lien holders asserting their liens, post-sale, against the property that has been sold. The code does not specifically address a sale of property free and clear of unsecured claims such as tort liability. There is, however, case authority that holds that unsecured claimants, who participated in the bankruptcy case, had notice of the proposed sale, and whose claims existed as of the sale date, are bound by the bankruptcy court's sale order and may not proceed against the purchaser.[27] These protections are not absolute; some courts have held that 363(f) only pertains to *in rem* claims, and does not protect a buyer from unsecured claims such as tort causes of action.[28]

More problematic are tort claims that arise after a sale has been consummated. Many courts have found it fundamentally unfair to bar actions by future claimants that did not have notice of the 363 sale. Some courts have held that that 363(f) is inapplicable to future tort claimants because at the time of the sale, they either held no "claim," or even if a *potential claim* existed, the potential claimant was not dealt with in the bankruptcy process.[29] Similarly, other courts have refused to bar claims against purchasers by parties who had no notice of the bankruptcy process based on fundamental notions of procedural due process.[30]

In order to obtain the broadest buyer protections, it is incumbent upon counsel involved in the sale transaction to provide as much notice as is practical. In addition to actual notice to all creditors and parties in interest, resources like the debtor's customer list should be used to give actual notice to potential future claimants.

V. Can I Get A Deal?

Vulture capitalists [31] know that potential bargains lie in dead and dying companies. In fact, since a Chapter 7 trustee has a statutory duty to collect and liquidate estate assets as "expeditiously" as is compatible with the best interest of the estate's constituents, time is on the side of the buyer who is immediately ready to fund and close a sale.[32] However, the duty to act expeditiously is only one of a complex set of obligations and fiduciary duties that a Chapter 7 trustee has to the estate's creditors and, to a lesser extent, the debtor.[33] For example, efforts must be made to obtain the *market value* of estate property.

In *Mama's Original Foods*,[34] the Chapter 7 trustee sought bankruptcy court approval to sell the debtor's restaurant equipment, inventory, trade name and trademark. In support of the sale motion, the trustee proffered an independent appraisal of the assets, an auction liquidation estimate for the furniture and fixtures and the debtor's bankruptcy schedules. However, the trustee provided no evidence to the bankruptcy court that he had advertised or otherwise marketed the property.

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The bankruptcy court denied the trustee's motion and held that section 702(1) requires a trustee to market the property for sale in a manner that is customary for the subject property. If there is no recognized market, then the trustee is required to advertise the property in a method that a prudent seller would use. In the case of restaurant equipment, the court stated that a prudent seller would advertise property for sale by newspaper and on the Internet.[35]

Similarly, the management of an insolvent reorganizing debtor has fiduciary duties to the estate's creditors and equity holders.[36] As fiduciaries, management must seek to maximize the value of estate assets. Once the decision to sell the assets of a reorganizing debtor is made, management must deal fairly with potential bidders and secure the maximum value of the estate's assets for the benefit of the debtor, creditors and equity holders.[37]

In light of the foregoing, a strategic purchase of estate assets does not necessarily mean acquiring assets at the lowest possible price. Often times the approach is to acquire assets because of their particular value to an existing enterprise. For example, although a *dot bomb's* business model may have been faulty, if its Web site generates enough *hits*, it may be of interest to a competitor who desires a web-presence.

This policy of maximization of estate assets will, in most cases, result in an auction or other procedure that allows interested buyers to over-bid the initial sale price.

VI. Stalking Horses and Over-Bidders

A *Stalking Horse* is the first potential buyer of a debtor's property, whose offer is used to help generate interest from other potential purchasers. Prior to court approval of the sale, the *Stalking Horse* will expend resources on due diligence and other transaction costs. In exchange for these efforts, the *Stalking Horse* should seek bankruptcy court approval of a *Break-Up Fee*, that is, a reimbursement of its costs if the sale is not consummated. A *Topping Fee* is a percentage of the amount paid by an over-bidder at the sale auction that is passed on to the *Stalking Horse* in the event that it is over-bid by another purchaser. In addition, buyers may request *No Shop* or *Window Shop* clauses preventing or limiting the seller from soliciting other bids.

In considering these buyer protections, some bankruptcy courts defer to the business judgment of the Trustee and apply the three-part test set forth in *Integrated Resources* [38]

1) Was the negotiation of the break-up fee tainted by Self-dealing and manipulation?

2) Does the fee discourage rather than encourage bidding?

3) Is the fee unreasonable relative to the proposed purchase price?

Other courts have rejected the business judgment approach and have required a showing that the proposed buyer protection "furthers the diverse interest of the debtor, creditors, and equity holders, alike."[39]

Under either approach, courts are wary of any procedure that *chills* the bidding process. Therefore, the *Stalking Horse's* counsel should persuade the bankruptcy court that the *hottest* bidding will occur if both a *Break-Up Fee* and a *Topping Fee* are approved. The *Break-Up Fee* is necessary to provide incentive to the first potential buyer to expend recourses in the early stages of the transaction. However, without a *Topping Fee*, the *Stalking Horse* has a disincentive to stay in the bidding at the time of auction because as the price moves up, the *Stalking Horse* pays a higher price, plus loses the benefit of the *Break-Up Fee.* The *Topping Fee* keeps the *Stalking Horse* in the game because if the sale is consummated by an over-bidder, the *Stalking Horse* will lose the benefit of the acquisition and the *Break-Up Fee*, but will gain a percentage of the sale price.

VII. The Meaning of Life (Or at Least Section 363)

Section 363 provides a mechanism to monetize distressed assets for the benefit of the bankruptcy estate's constituents and the acquirer. On a deeper level, section 363 reveals its drafter's fundamental understanding of the cyclical nature of financial lives and the interdependence and inter-connectedness of the currently unfortunate debtor with the contemporaneously flush buyer. ■

Endnotes

[1] 11 U.S.C. §§ 101 – 1330 (2005)[hereinafter referred to as the "Code"].

[2] 11 U.S.C. § 363 et seq. [all "section" references in this article refer to title 11].

[3] 11 U.S.C. § 541 sets forth what constitutes property of the bankruptcy estate.

[4] *In re Terwilliger's Catering Plus, Inc.* (6th Cir. 1990) 911 F.2d 1168, cert denied (1991) 501 U.S. 1212 [111 S.Ct. 2815, 115 L.Ed 2d 987].

[5] *United States v. Whiting Pool, Inc.* (1983) 462 U.S. 198 [103 S.Ct. 2309, 76 L.Ed. 2d 515].

[6] *In re Bialac* (9th Cir. 1983) 712 F.2d 426.

[7] *Sierra Swithboard Co. v. Westinghouse Elect. Co.* (9th Cir. 1986) 789 F.2d 705.

[8] *In re Minoco Group of Companies, Ltd.* (9th Cir. 1986) 799 F.2d 517.

[9] *In re Computer Communications, Inc.* (9th Cir. 1987) 824 F.2d 725.

[10] *In re Shults* (B.A.P. 9th Cir. 1983) 28 B.R. 395.

[11] *In re Seaway Exp. Corp.* (B.A.P. 9th Cir. 1989) 105 B.R. 28.

[12] *In re Fuller* (B.A.P. 9th Cir. 1992) 134 B.R. 945.

[13] *In re Wade* (B.A.P. 9th Cir. 1990) 115 B.R. 222 affd. 948 F.2d 1122 (9th Cir. 1991); Hereinafter the term "Trustee" (uppercase "T") shall refer collectively to a Chapter 7 trustee, a Chapter 11 trustee and debtors-in-possession under Chapters 11, 12 or 13 of the code.

[14] Pursuant to section 541(a)(2), estate property includes "[a]ll interests of the Debtor and the Debtor's spouse in community property as of the commencement of the case that is – (A) under the sole, equal or joint management of the debtor; or (B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim the debtor's spouse, to the extent that such interest is so liable."

[15] *In re Homan* (B.A.P. 9th Cir. 1989) 112 B.R. 356.

[16] 11 U.S.C. §§ 363(h)(1) – (4).

[17] The requirements of a Chapter 11 disclosure statement are described in section 1125 of the code; the requirements of Chapter 11 plan confirmation are set forth in Section 1129.

[18] *In re Lionel* (2nd Cir. 1983) 722 F.2d 1063 (Lionel is the toy train company founded in 1900).

[19] *Id.* at p. 1071.

[20] 11 U.S.C. § 363(c)(1).

[21] *In re Dant & Russell, Inc.* (9th Cir. 1988) 853 F.2d 700.

[22] Section 363 (b)(1) states that "The trustee, after notice and a hearing, may use or lease, other than in the ordinary course of business, property of the estate."

[23] Rule 2002(a) also requires that the notice include "the time and place of any public sale, the terms and conditions of any private sale and the time fixed for filing objections."

[24] Rule 6004(c) requires that motions to sell property free and clear of liens be made in accordance with rule 9014; rule 9014 requires service of process as set forth in rule 7004; rule 7004(h) requires certified mail service on insure depositories, unless the institution's attorney has appeared in the case, the court orders otherwise, or the institution has waived in writing its entitlement to service by certified mail.

[25] *Van Huffle v. Harkerode* (1931) 284 U.S. 225; *MacArthur Co. v. Johns-Manville Corp.* (2nd Cir. 1988) 837 F.2d 89, cert. denied 488 U.S. 868.

[26] *Citicorp Homeowner Assoc. v. Elliot (In re Elliot)* (E.D.Pa. 1988) 94 B.R. 343; *In re Bygaph, Inc.* (Bankr. S.D.N.Y. 1986) 56 B.R. 596; *Mutual Life Ins. Co. of New York v. Red Oaks Farms, Inc. (In re Red Oaks Farms, Inc.)* (Bankr. W.D.Mo. 1984) 36 B.R. 856.

[27] See e.g., *Paris Mfg. Corp. v. Ace Hardware Corp. (In re Paris Indus.)* (Bankr. D.Me. 1991) 132 B.R. 504; *American Living Sys. V. Bonapfel (In re All Am.)* (Bankr. N.D.Ga. 1986) 56 B.R. 186.

[28] *In re White Motor Credit Corp.* (Bankr. N.D. Ohio 1987) 75 B.R. 944, 948.

[29] *Zerand-Bernal Group, Inc. v. Cox* (7th Cir. 1994) 23 F.3d 159 (no bar because injury occurred after the sale, but different result if claimant had an opportunity to file a proof of claim in the bankruptcy case).

[30] *Western Auto Supply Co. v. Savage Arms, Inc. (In re Savage Indus., Inc.)* (1st Cir. 1994) 43 F.3d 714.

[31] Vultures, from biblical references, are *keen sighted birds of prey*, rather then the modern image of a weak clawed profiteer. See Job 28:7*(Easton's 1897 Bible Dictionary)*.

[32] Section 704(1) states that "The Trustee shall – (1) collect and reduce to money the property of the estate for which the trustee serves, and close the estate as expeditiously as is compatible with the best interests of the parties in interest . . ."; see also *In re Hutchinson* (4th Cir. 1993) 5 F.3d 750 (question is whether trustee acted as expeditiously as possible consistent with interests of the parties, not whether trustee acted reasonably in general).

[33] *In re Kay* (M.D.Fla. 1998) 223 B.R. 816.

[34] *In re Mama's Original Foods, Inc.* (C.D.Cal. 1999) 234 B.R. 500.

[35] *Id.* at p. 594.

[36] *Value Property Trust v. Zim Co. (In re Mortgage Realty Trust)* (Bankr. C.D.Cal. 1996) 195 B.R. 740.

[37] *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.* (Del. 1986) 506 A.2d 173 (in corporate finance parlance, the *Revlon Duty to Shop*).

[38] *In re Integrated Resources, Inc.* (Bankr. S.D.N.Y.) 135 B.R. 746, aff'd. 147 B.R. 650 (S.D.N.Y. 1992) appeal dismissed on jurisdictional grounds (2d cir. 1993) 3 F.3d 49.

[39] *In re America West Airlines, Inc.* (Bankr. D.Az. 1994) 166 B.R. 908, 912; see also *In re S.N.A. Nut Co.* (Bankr. N.D.Ill. 1995) 186 B.R. 98, 101-102 (no deference to be afforded to the debtor's business judgment, test is whether break-up fee is in the estate's best interest").

Continued from page 4 . . . Assignment Provisions

Pre-bankruptcy counseling allows practitioners to identify those contracts that are critical to their clients so that contract negotiations can anticipate all circumstances affecting the enforceability of the negotiated contract and the terms thereof, including the possibility of the subsequent bankruptcy of one or more parties to the contract. For debtors, it is paramount that the debtor's assets, specifically including intellectual property critical to the debtor's continued business operations, be identified and analyzed so that the ramifications of any prohibition on the debtor's assumption or assignment of governing contracts are fully understood. For creditors, it is key to keep in mind what allowances a client is willing to make and still retain its rights in the event that a counter-party files for bankruptcy. For both, it is a delicate line to walk given that any one of our clients is a potential debtor in bankruptcy. ■

Endnotes

[1] In order for a debtor in bankruptcy to retain an executory contract, it needs to "assume" such contract in accordance with the requirements of section 365 of the Bankruptcy Code. This is because the Bankruptcy Code treats a debtor in possession as a separate legal entity from the pre-bankruptcy debtor. Thus, in order to continue to operate the debtor's pre-bankruptcy business after emerging from bankruptcy, a debtor in possession must assume the agreements that it desires going forward.

[2] In order to assign an executory contract, the debtor must first assume the executory contract. *See* 11 U.S.C. § 365(f)(2).

[3] Countryman, *Executory Contracts in Bankruptcy*, *Part I* (1974) 57 Minn. L.Rev. 439, 450; see, e.g., *Unsecured Creditors' Comm. v. Southmark Corp. (In re Robert L. Helms Const. & Dev. Co.)* (1998) 139 F.3d 702, 705 (adopting the Countryman definition).

[4] However, this is subject to certain limitations. For example, an executory contract may not be able to be assumed and/or assigned by a debtor despite the anti-assignment provisions if it is a contract to make a loan, or extend other debt financing or financial accommodations. (See, e.g., 11 U.S.C. § 365(c).)

[5] The "hypothetical test" provides that a debtor in possession may not assume an executory contract over the objection of the counter-party to the contract if applicable law would bar assignment to a hypothetical third party, even where the debtor in possession does not intend to assign the contract to any third party. See, e.g., *Perlman v. Catapult Entm't., Inc. (In re Catapult Entm't., Inc.)* (9th Cir. 1999) 165 F.3d 747; *In re James Cable Partners* (11th Cir. 1994) 27 F.3d 534, 537; *In re West Elecs., Inc.* (3d Cir. 1988) 852 F.2d 79, 83.

[6] Significant to the analysis of *Sunterra* is the fact that no other Circuit following the hypothetical test has analyzed a contract that contained a clause allowing assignment.

[7] The enforceability of a provision in a pre-petition contract that dictates what happens in a bankruptcy is questionable, although the presence of such provision certainly supports the intention of the parties.

[8] In the context of secured financings of intellectual property, it has also been suggested that if the technology is crucial to business, the debtor may consider paying a fee to ensure that consent to assumption and/or assignment is given in the contract.

[9] See, e.g., 11 U.S.C. § 365(n) (providing additional protections to licensee of certain intellectual property when a licensor files for bankruptcy and rejects the license agreement); see also *In re Hernandez* (Bankr. D.Az. 2002) 287 B.R. 795 (allowing the debtor to use the judicially created "ride-through" doctrine to avoid assuming or rejecting an exclusive patent license during the bankruptcy proceeding).

Continued from page 1 . . . Bad Faith Filings and Solvent Tenant Bankruptcies

The PPI Enterprises Case

The recent series of favorable decisions for solvent tenants began with the *PPI Enterprises* case[3] in 2003, where tenants won a major battle permitting a solvent debtor-tenant to file for bankruptcy in good faith and to cap a landlord's lease termination damages. In *PPI Enterprises*, the commercial landlord of a Manhattan office tower leased space to the tenant for its corporate headquarters. After facing financial difficulties and abandoning its corporate headquarters, the tenant owed approximately $6 million in remaining rent to its landlord. On the eve of a damages trial following nearly four and one-half years of litigation in federal court, the tenant filed for Chapter 11 bankruptcy. One of the debtor's stated objectives was to limit the landlord's lease termination damages under section 502(b)(6) of the Bankruptcy Code.

The landlord moved to dismiss the tenant's Chapter 11 filing for bad faith. In its motion, the landlord alleged that the debtor-tenant's bankruptcy was a sham filing designed to create value for the tenant's corporate parent and its creditors at the landlord's expense, and that the bankruptcy served no legitimate purpose because the company had no ongoing business, only one remaining employee, and no assets other than stock certificates representing a 2% interest in a non-related public company worth at least $11 million. Importantly, the landlord also challenged about $55 million in insider claims as improperly characterized equity interests, which, if successful, would render the debtor solvent. Other than liability under

its lease with the landlord, the debtor had a "very small amount of non-insider claims." The bankruptcy court denied the landlord's motion, and the district court affirmed the decision.

The Third Circuit affirmed and relied exclusively on the bankruptcy court's reasoning that the "only inquiry is to determine whether the debtor seeks to abuse the bankruptcy law by employing it for a purpose for which it was not intended … and that the primary purpose of the petition was to cap [the landlord's] claim pursuant to § 502(b)(6)."[4] Based on this reasoning, the Third Circuit agreed that the debtor-tenant's intention to cap the landlord's claim in filing for bankruptcy was "not a use of the code for a purpose for which it was not intended" and that the debtor did not file its bankruptcy petition in bad faith.[5]

The Chameleon Systems Case

Subsequent to the *PPI Enterprises* case, solvent tenants scored another important win, this time in California, and continued to carry the day on the issue of bad faith filings. In February of 2004, the question of a tenant's good faith in filing for bankruptcy solely to cap a landlord's claim for damages was squarely addressed in California in the *Chameleon Systems* case.[6] The debtor-tenant in *Chameleon Systems* was in the telecommunications business in Silicon Valley, and like others in this business in late 2002, experienced serious financial trouble. By the time of its bankruptcy filing, the debtor-tenant had no income and no employees, but retained more than $4 million in cash, less than $10,000 in unsecured debt (other than to its landlord), and total obligations to other creditors of only about $15,000. As of the petition date, the debtor-tenant had cash reserves in excess of its full liability to the landlord, which was estimated to be about $4.4 million. On these facts, the landlord moved to dismiss the Chapter 11 petition as having been filed in bad faith.

The bankruptcy court for the Northern District of California, San Jose Division, denied the landlord's motion to dismiss. The court expressly concurred with the Third Circuit's decision in the *PPI Enterprises* case, and following the same reasoning, held that the filing was a legitimate use of the Bankruptcy Code even though the decision would result in a "windfall" for the debtor's shareholders.

The Liberate Technologies Case

However, following the *Chameleon Systems* case, the tide began to turn in favor of landlords. On September 9, 2004, the landlords scored an important victory in the *Liberate Technologies* case,[7] and dealt a blow to the solvent tenants' advances in bad faith filing law. The debtor-tenant in the *Liberate Technologies* case was losing a significant amount of money due to expenses that significantly exceeded its revenue. Specifically in 2004, the debtor incurred expenses of $44 million while generating revenue of only $9 million, and expected to continue to incur losses of $8 million per quarter for the foreseeable future. The debtor was also subject to several pending lawsuits for patent infringement and for securities violations. In addition to its losses and the contingent liability of its lawsuits, the debtor's liability to its landlord was approximately $45 million.

*On September 9, 2004, the landlords scored an important victory in the **Liberate Technologies** case, and dealt a blow to the solvent tenants' advances in bad faith filing law.*

However, the debtor had cash well in excess of its liabilities and acknowledged that it held $212 million of unrestricted cash, with total cash in excess of total liabilities of between $45 to $153 million depending upon the outcome of the pending litigation. Not surprisingly, the landlord promptly filed a motion in this case to dismiss the Chapter 11 petition as having been filed in bad faith.

The bankruptcy court for the Northern District of California, San Francisco Division, granted the landlord's motion to dismiss by relying on what it characterized as the "most conspicuous element of the good faith requirement" — that the debtor needs chapter 11 relief.[8] In particular, the court distinguished the *PPI Enterprises* case and held that the debtor's purpose in filing bankruptcy to cap a landlord's claim for future rent though section 502(b)(6) did not, *in and of itself*, establish good faith because the debtor was still required to prove its need for Chapter 11 relief. Based in large part on a finding that the debtor could more than pay all its creditors in full, the court dismissed the case and returned the parties to *status quo ante*.

The Integrated Telecom Case

Then, on September 20, 2004, landlords may have turned back the tide of bad faith filing decisions in favor of solvent tenants. Only 11 days after the decision in the *Liberate Technologies* case, the landlords scored their most significant victory on this issue to date in the *Integrated Telecom* case.[9] Integrated Telecom was a supplier of software and equipment to the broadband communications industry. In the summer of 2000, at the absolute height of the real estate frenzy in Silicon Valley, Integrated Telecom entered into a ten-year lease for commercial space at the then prevailing market rate. Almost immediately after occupying its new premises, the market for Integrated Telecom's products effectively vanished, which caused Integrated Telecom to suffer net losses of over $36 million in 2001. Having endured such poor market timing, unable to find a suitor for its business and unable to change its business model, Integrated Telecom prepared a plan for liquidation. Two items dominated its dissolution plan: (1) the resolution of outstanding liability to its

landlord, which was estimated to be about $26 million; and (2) the sale of its intellectual property rights.

When the landlord would not accept $8 million to settle its claim for damages, Integrated Telecom filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code in Delaware. One of Integrated Telecom's stated reasons for filing its bankruptcy petition was its desire to take advantage of the section 502(b)(6) cap on the landlord's claim. The landlord moved to dismiss the case on the basis that the debtor-tenant did not file its petition in good faith. The bankruptcy court denied the motion, a decision that was affirmed by the district court.

The Third Circuit, however, relying heavily on the fact that the company was highly solvent and had an overabundance of cash at the time of the filing—over $105 million in unrestricted cash in the face of at most $32 million in possible total liabilities—reversed and remanded to the Delaware bankruptcy court with instructions to dismiss the debtor's petition. Integrated Telecom did not have a right to pursue a Chapter 11 filing on the grounds it was losing money at a substantial rate and, as a result, had gone "out of business." According to the Third Circuit, this was not enough to show that the debtor was in "financial distress." The court found that the Bankruptcy Code does not allow for the filing of a Chapter 11 petition "by a financially healthy debtor, with no intention of reorganization or liquidating as a going concern" and that the debtor had "no reasonable expectation" that its Chapter 11 proceedings would "maximize the value of the debtor's estate for creditors." Instead, the evidence showed that the debtor filed the petition "solely to take advantage of a provision of the Bankruptcy Code" that limits claims on long-term leases.

By precluding a solvent tenant from filing bankruptcy solely to cap a landlord's damages, the Third Circuit's decision in *Integrated Telecom* and the decision of the California bankruptcy court in the *Liberate Technologies* case have advanced essential bankruptcy policies. The purpose underlying the claim cap, specifically, precluding a landlord with a claim under a long-term lease from disproportionately dominating the recovery for unsecured creditors, would not be served if a solvent tenant were allowed to cap a landlord's claim to benefit solely the tenant's equity holders. Also, permitting a debtor to benefit equity holders at the expense of landlord-creditors would be an end-run around a core principle of bankruptcy—the "absolute priority rule," which allows shareholders to retain equity interests only after creditors have been paid in full.

In addition, the *Integrated Telecom* decision has a significant effect on the ownership of commercial real property in California in two ways. First, the case is binding authority over a California landlord if a tenant files for bankruptcy in the Third Circuit, which includes Delaware, New Jersey, and Pennsylvania. Second, due to the fact that the Delaware Bankruptcy Court is a leading forum in developing new bankruptcy law, this case can be highly persuasive in bankruptcy cases filed outside of the Third Circuit.

It would not be surprising for the Ninth Circuit, in an appropriate case, to publish authority in line with *Integrated Telecom* given the strong policy arguments in favor of limiting solvent tenants from using bankruptcy law as a means to redirect funds from a landlord to the tenant's shareholders. In the meantime, property owners and managers can take some comfort in knowing that the courts are recognizing and imposing some limits on a solvent tenant's ability to use the bankruptcy process to cap a landlord's damages. ■

Endnotes

[1] *NMSBPCSLDHB, L.P. v. Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)* (3rd Cir. 2004) 384 F.3d 108, reh'g en banc denied 389 F.3d 423 (3rd Cir. 2004).

[2] The "claim cap" under Section 502(b)(6) of Title 11, United States Code (the "Bankruptcy Code") limits a landlord's damages resulting from the termination of a real property lease to, in many instances, an amount equal to rent for one year. The cap is particularly stinging for a landlord where a debtor is solvent because all allowed (and not capped) claims of creditors will be paid in full in such a situation with the remaining assets returned to equity holders.

[3] *Solow v. PPI Enterprises (U.S.), Inc. (In re PPI Enterprises (U.S.), Inc.)* (3rd Cir. 2003) 324 F.3d 197.

[4] *In re PPI Enterprises (U.S.), Inc.* (Bankr. D.Del. 1998) 228 B.R. 339, 343.

[5] *Solow*, *supra,* 324 F.3d at pp. 211-212.

[6] *In re Chameleon Systems, Inc.* (Bankr. N.D.Cal. 2004) 306 B.R. 666.

[7] *In re Liberate Technologies* (Bankr. N.D.Cal. 2004) 314 B.R. 206.

[8] *Id.* at 211.

[9] *Integrated Telecom*, *supra,* 384 F.3d at p. 108.

Continued from page 6 . . . Calculation of Holdover Rent

recovery on the claim than would the lease rate. In such a situation, both the landlord and the debtor should compile evidence supporting their asserted fair market value of the premises.

Must the Debtor Pay for Anything Beyond Its Actual Use of the Leased Premises During the Holdover Period?

An additional issue easily overlooked by debtors and their counsel is the following: Will the court compel the debtor to pay for anything beyond its actual use of the leased premises during the holdover? In other words, is the debtor only required to pay for its actual use of the leased premises, or is it required to pay for the full amount of space covered by the lease?

One of the most debtor friendly cases addressing this issue may be *In re Bilyk.* [13] In *Bilyk*, a Chapter 7 case was filed, and several months later, the lease at issue was rejected by operation of law. The trustee, however, did not remove certain personal property of the debtor from the premises. Instead, he used the premises to store the personal property until he could arrange for the sale of such personal property. The landlord sought an administrative claim for the holdover period, and a dispute arose as to the amount of holdover rent due. The court held that the contract rate did not control, the lessor was entitled to an administrative claim under section 503(b)(1)(A), and that the court would determine a "fair and reasonable value" of such claim. The court wrote:

> The post-petition use of these premises was limited to storage of certain personal property while the Trustee attempted to obtain a purchaser [of the personal property]. The lessors were not prejudiced by the Trustee's actions…. The Trustee has submitted evidence that the reasonable rental value of this type of property when storing inventory and fixtures is approximately 20% of the full rental value. [14]

The court looked to the debtor's actual use of the leased premises, and allowed the lessor's claim at 20% of the lease rate, which figure represented the cost the trustee would have incurred for storing the assets elsewhere.

Another pro-debtor case is *In re Cardinal Industries, Inc.* [15] There, a debtor heldover post-rejection for purposes of storing equipment, and remained in possession up through the hearing on the lessor's claim. The court wrote:

> [Debtor] and its subsidiaries have equipment stored on the Premises that, if consolidated into one area, would occupy approximately one-third of the leased space. And such storage has been the sole usage of the Premises since rejection of the Lease. Further, there has been no showing that such usage has adversely affected [lessor's] ability to show the Premises to prospective tenants. Therefore, for the period from August 24, 1989 until [debtor] vacates the Premises, [lessor's] allowed administrative claim for rent for the 6,000 square feet actually in use shall be calculated at approximately one-half the contract rate….[16]

Thus, the court not only reduced the amount of space on which the debtor was required to pay rent, but also reduced the rental rate the debtor had to pay on such space. The court offered no specific explanation as to why it reduced the rate, but the only relevant factor discussed by the court was the debtor's use of the facility for storage, rather than for operations. Therefore, it appears logical to assume that the court found that mere storage conferred less benefit on the estate than actual operations would have, and thus entitled the lessor to a smaller claim. Whatever the case, the debtor in *Cardinal* prevailed on both the rental rate it was required to pay, and the amount of space on which it was required to pay the reduced rental rate. A debtor prevailing on both of these issues will likely achieve a significantly smaller claim allowed to the landlord. Such a result is significant given that the landlord's claim is an administrative claim, and will thus be payable in cash on a priority basis.

While the Ninth Circuit has not ruled directly on the "space actually used" issue in the context of holdover rent, it has made clear on numerous occasions that, across the board, administrative claims arising under leases are limited to the actual use of the property by the debtor or trustee. [17]

Practically speaking, a debtor holding over beyond lease rejection should consolidate its use of the leased space as much as possible, and document such consolidation, to minimize its use of the space as well as its rental liability. A landlord whose debtor is not using the full premises should make every effort to relet the premises, even while still occupied by the debtor. The landlord should document any detrimental effect on its reletting efforts caused by the debtor's continued occupancy, as the court may consider that factor in determining the claim amount.

Conclusion

During the 60-day period after an order for relief is entered, timely payments as specified in a lease are required by section 365(d)(3). Once the lease is rejected, however, whether by motion or operation of law, the lease rate no longer controls. Instead, section 503(b)(1)(A) applies, and a debtor is only required to pay the reasonable rental value of the premises. Furthermore, because the

relevant inquiry under section 503(b)(1)(A) involves the benefit to the estate, the debtor is only required to pay for the portion of the leased premises actually used during the holdover period. ■

Endnotes

[1] Unless otherwise noted, all cites herein are to Title 11 United States Code section 101 et al.

[2] At precisely what stage of a bankruptcy case the lessor is entitled to payment on such a claim is the subject of some dispute among the circuits, and is beyond the scope of this memorandum.

[3] See *In re Metro Fulfillment, Inc.* (B.A.P. 9th Cir. 2003) 294 B.R. 306, 309; *In re Palau Corp.* (9th Cir. 1994) 18 F.3d 746, 750; *In re Dant & Russell, Inc.* (9th Cir. 1988) 853 F.2d 700, 705.

[4] *In re National Refractories & Minerals Corp.* (Bankr. N.D.Cal. 2003) 297 B.R. 614.

[5] *In re Trak Auto Corp.* (Bankr. E.D.Va. 2002) 277 B.R. 655.

[6] *National Refractories, supra,* 297 B.R. at p. 618 (emphasis added).

[7] *Chandel Enterprises, Inc.* (Bankr. C.D.Cal. 1986) 64 B.R. 607.

[8] The opinion suggests that two different judges heard motions on this case at the bankruptcy court level.

[9] *Chandel, supra,* 64 B.R. at p. 610.

[10] *In re Gillis* (Bankr. D.Hi. 1988) 92 B.R. 461.

[11] *Gillis, supra,* 92 B.R. at p. 465 (emphasis added).

[12] See *In re Brio-Med Laboratories* (Bankr. N.D.Ohio 1991) 131 B.R. 72; *In re Trak Auto, supra*, 277 B.R. at. p. 655.

[13] *In re Bilyk* (Bankr. E.D.Mo. 1989) 101 B.R. 586.

[14] *Bilyk,supra,* 101 B.R. at p. 587.

[15] *In re Cardinal Industries, Inc.* (Bankr. S.D.Ohio 1989) 109 B.R. 738.

[16] *Cardinal, supra,* 109 B.R. at p. 741 (emphasis added).

[17] See *In re Dant & Russell, Inc.* (9th Cir. 1988) 853 F.2d 700, 708 (Administrative claims under section 503(b)(1)(A) arising out of leases are limited to the "portion of the leased property that is **actually used or occupied**.") (citing *Thompson v. IFG Leasing Co. (In re Thompson)* (9th Cir. 1986) 788 F.2d 560, 564 (emphasis added)); see also *In re Cuckierman* (9th Cir. 2001) 265 F.3d 846, 850 (While pre-rejection claims arising under section 365(d)(3) "may exceed the reasonable value of the debtor's actual use of the property," claims arising under section 503(b)(1)(A) are limited "to the fair and reasonable value of the **debtor's actual use of leased property**.") (emphasis added)).

Continued from page 10 . . . California's Energy Crisis

Chapter 11 proceedings as well as several series of litigation. Two distinct series of proceedings arose out of the manipulation of energy prices in California's wholesale electricity market—the Refund Proceedings and the Market Manipulation Proceedings. The Refund Proceedings began with a complaint filed at FERC by SDG&E challenging that wholesale rates in California were unjust and unreasonable. On November 1, 2000, FERC agreed. (*San Diego Gas & Elec. Co. v. Sellers of Energy* (2000) 93 FERC ¶ 61,121, 61,349-61,350.) In addition, on July 25, 2001, FERC held that prices would be mitigated, and buyers would be entitled to reductions in the rates paid or owing—termed "refunds"—for power purchased in California's market from October 2, 2000 through June 20, 2001. (*San Diego Gas & Elec. Co. v. Sellers of Energy* (2001) 96 FERC ¶ 61,120, 61,513-61,514.) The amount of rate reductions, and the amounts owed and owing after those reductions, were left to be determined in subsequent FERC proceedings that are still not finally determined. Additionally, the Ninth Circuit recently issued an opinion that may expand FERC's refund period. (See *Cal. ex rel. Lockyer v. FERC* (2004) 383 F.3d 1006.)[3]

The Market Manipulation Proceedings are a series of proceedings initiated by FERC to determine whether individual Participants are guilty of manipulating California's wholesale energy prices.

The Market Manipulation Proceedings are a series of proceedings initiated by FERC to determine whether individual Participants are guilty of manipulating California's wholesale energy prices. In the Market Manipulation Proceedings, as distinct from the Refund Proceedings, FERC may impose any of the following remedies on individual entities found to have unlawfully manipulated the market: (1) disgorgement of profits; (2) loss of authorization to sell electricity at market-based rates; (3) audits; (4) commitments to sell all available energy in certain markets; and (5) prohibitions against certain business practices.

In addition to the Refund and Market Manipulation Proceedings, litigation over commandeering the BFM Contracts is also pending.[4] In response to Governor Davis' commandeering the BFM Contracts, several cases were filed alleging the improper taking of the BFM Contracts without just compensation in violation of: (a) Article I, section 19 of the California Constitution; (b) California Code section 8572 (the California Emergency Services Act); and (c) the Fifth and Fourteenth Amendments to the United States Constitution. These cases were ultimately coordinated into the Inverse Condemnation Cases which are currently pending in the Superior Court for the State of California in Sacramento.

Jurisdictional Battle

A common theme throughout the varIOU's energy bankruptcy proceedings has been the conflict between the Bankruptcy Code's and FERC's jurisdiction. FERC's exclusive jurisdiction is to set and ensure that wholesale electricity rates are just and reasonable. Debtors or their creditors often argue that this conflicts with rights under the Bankruptcy Code.

FERC jurisdiction ultimately prevailed in the CalPX case. CalPX's plan, confirmed by the Bankruptcy Court on November 1, 2002, became effective upon FERC's approval on April 1, 2003. The confirmed CalPX plan provides that distribution of funds in CalPX's Settlement Clearing Account and return of the collateral held by CalPX will only happen when and in the manner approved by FERC pending the outcome of the Refund Proceedings.

CalPX's post-petition governance and reorganization activities are also subject to FERC approval. In order to approve CalPX's plan, FERC required the Reorganized CalPX to have a nine-member board consisting of three independent directors, three members designated one each by the IOU's, and three members chosen by the Participants. This Board overseas the functions of the Reorganized CalPX, including CalPX's main activity of processing certain claim reruns and adjustments of market trades using FERC approved pricing.

FERC's jurisdiction similarly impacted the PG&E proceedings. PG&E's plan was confirmed on December 22, 2003. Pursuant to PG&E's plan, Participant claims are classified in class 6. PG&E also established a $1.6 billion escrow account pursuant to its plan, to which CalPX is a party, for amounts to be distributed to Class 6 claimants following final resolution of the Refund Proceedings. Thus, no funds may be distributed without FERC approval.

Bankruptcy Code versus FERC jurisdiction was also a significant issue in the Mirant proceedings where the Bankruptcy Code recently trumped FERC. In *Mirant Corp. v. Potomac Electric Power Co.* (5th Cir. 2004) 378 F.3d 511, the Fifth Circuit held that a debtor may reject an executory power purchase contract. Mirant moved to reject a power purchase agreement with Potomac Electric Power Company ("PEPCO") pursuant to section 365 of the Bankruptcy Code. The District Court held that the FPA and FERC's resulting exclusive rate-making authority preempted Mirant's right to reject the contract because the contract was for the purchase of electricity. The Fifth Circuit overturned the District Court's decision, holding that rejecting the contract did not conflict with FERC's exclusive rate-making authority. The court performed a detailed analysis of

section 365 of the Bankruptcy Code, explaining that rejection of an executory contract acts as a breach of the contract, giving the wronged party an unsecured claim for damages. As long as damages are assessed at the filed-rate approved by FERC, FERC's rate-making authority is not impacted. Although any future plan of reorganization may not provide for full payment of PEPCO's unsecured claim, the Fifth Circuit further explained that any partial payment would be an indirect consequence of the Bankruptcy Code's reorganization provisions and not a collateral attack on FERC's rate-making authority. Furthermore, because Congress had not provided an exception for wholesale electricity contracts from section 365, while it had excluded regulatory matters in other sections of the Bankruptcy Code, Congress intended to allow debtors to reject purchase power contracts. The Fifth Circuit also instructed the court on remand to apply a more rigorous standard than the business judgment standard when determining whether to allow Mirant to reject its agreement with PEPCO.

Around the time of the Fifth Circuit's decision, both Enron and Mirant filed adversary proceedings and in Mirant's case, a claims objection, seeking return of collateral held by CalPX or a determination that any application of the amounts finally determined in the Refund Proceedings constitutes an impermissible setoff violating section 553 of the Bankruptcy Code. The key issue in these proceedings is the scope of the FERC's jurisdiction to determine claims against CalPX's Settlement Clearing Account pursuant to its rate-making authority under the FPA, applicable tariffs, and the CalPX and PG&E plans. The District Courts in both cases withdrew the reference to the bankruptcy court because adjudication of the matters would require more than a *de minimis* consideration of federal law (i.e. the FPA). The interplay between the withdrawal of the reference and the Fifth Circuit's PEPCO decision motivated settlement talks in the Mirant proceedings which have been stayed pending approval of a proposed settlement. A motion to dismiss is pending in the Enron proceedings.

Conclusion

While deregulation of California's energy market lasted merely four years before the energy crisis, the Refund Proceedings, the Inverse Condemnation Cases, and battles over FERC jurisdiction remain unresolved four years later. This uncertainty over jurisdiction and the number of years CalPX and PG&E have held onto Participant funds have led many Participants, such as Williams Energy, Duke Energy, Dynegy, and Mirant, to negotiate settlements. FERC has already approved many of these settlements and many more should be expected. ■

Endnotes

[1] Unless otherwise provided, facts stated herein are taken from several Ninth Circuit decisions discussing California's energy crisis, the "Disclosure Statement Describing Official Committee of Participant Creditors' Fifth Amended Chapter 11 Plan" filed in and approved by the Bankruptcy Court in the Central District of California in the CalPX Chapter 11 proceeding (Bk. No. 01-16577-ES) (the "CalPX Disclosure Statement"), and the "Disclosure Statement for Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for Pacific Gas & Electric Company Proposed by Pacific Gas & Electric Company, PG&E Corporation, and the Official Committee of Unsecured Creditors Dated July, 31, 2003" filed with and approved by the Bankruptcy Court for the Northern District of California, Case No. 01-30923 DM ("PG&E Disclosure Statement"). See *Duke Energy Trading and Mktg., L.L.C. v. Davis* (9th Cir. 2001) 267 F.3d 1042, 1045; *Cal. ex rel. Lockyer v. FERC* (9th Cir. 2004) 383 F.3d 1006; *Public Util. Dist. No. 1 of Snohomish County v. Dynegy Power Mktg., Inc.* (9th Cir. 2004) 384 F.3d 756 ("*Snohomish* Decision").

[2] For more information about the functions and operations of CalISO, visit CalISO's website - www.caiso.com.

[3] The State of California challenged the extent of the refund period because many Participants had failed to comply with FERC's transactional reporting requirements prior to October 2, 2000. The Ninth Circuit ruled that transactional reporting was crucial for monitoring market power. Thus, while market-based tariffs are not per se invalid under the FPA, non-compliance with the reporting requirements during California's energy crisis was so egregIOU's as to eviscerate the market-based tariffs, giving FERC the power, in its discretion, to order additional refunds.

[4] Information provided is taken from the CalPX Disclosure Statement and pleadings on file with the California Superior Court in Sacramento in the Inverse Condemnation Cases, JCCP No.4203.

Continued from page 12 . . . Mediated Settlements

should permit the mediator to guide the parties on how to respond to each offer and counter offer. Counsel should prepare themselves and their clients to be patient, not to give up, and not to expect the process of exchanging settlement offers to move rapidly or to expect that a satisfactory settlement figure will be forthcoming quickly.

Keenberg: That is very good advice. I always carry a note in my briefcase that was given to me by an exhausted party at the end of a very long mediation. The note said: "Susan, thanks, nice try." Counsel for one of the parties intended to leave the note for me as he and his client slipped away while I was in one "last" caucus presenting his final offer to the other party. He didn't think they would ever settle and quite disheartened, he decided to go home. Fortunately, I came out to tell him that they accepted his offer just as he was leaving his note for me.

Phillips: Yes; parties are often surprised that the other party accepted their last offer.

Complete Adequate Discovery

Keenberg: Gerry what are your thoughts about discovery? Do you agree or disagree with the statement, "You can't mediate until discovery is completed."

Counsel should prepare themselves and their clients to be patient, not to give up, and not to expect the process of exchanging settlement offers to move rapidly or to expect that a satisfactory settlement figure will be forthcoming quickly.

Phillips: A very good question. Tom Stipanowich, publisher of the CPR Institute for Dispute Resolution "Alternatives" in one of its recent publications raised that question. He called that view a myth. He mentioned that Judy Meyer, a respected mediator, said that "extensive discovery is wasteful, and probably unnecessary . . . .You can mediate at any point. Discovery is not really a term that mediators consider or worry about, nor should the parties."

Keenberg: I certainly agree that discovery need not be completed in order to mediate successfully, but I've also found that some mediations are hampered by the failure of counsel to do sufficient discovery that they believe is necessary before they are comfortable negotiating a settlement at the mediation. For that reason, we should remind attorneys that in preparing for mediations, they should let the mediator know if there is any discovery outstanding that they believe must be completed before the mediation goes forward. This will give the mediator the opportunity either to explain why the discovery isn't necessary for a successful mediation or to work with the parties to expedite the completion of the discovery prior to the mediation.

The Advocates at Mediation

Keenberg: Gerry, in previous conversations, we have discussed whether counsel representing parties at a mediation are advocates. We finally agreed that they are, indeed, advocates but that we'd like them to think of themselves not as advocates for their clients but as advocates for the common goal of resolving the conflict.

Phillips: Along the same vain, counsel should leave their litigation weapons at the door and come with a sign of peace. Less saber-rattling and more conciliatory behavior!

The Benefits of Mediation to the Client

Keenberg: What should an attorney tell a client who is reluctant to mediate or doubtful of its benefits?

Phillips: Remind the client that the only way he or she can be absolutely certain of having a say in the outcome of the controversy is by crafting their own settlement in mediation. If the matter proceeds to trial or even arbitration, no one can predict with certainty what the outcome will be. Remind the client that the arguments advanced in the pleadings and briefs by the attorney have painted the best possible picture from the client's point of view and the client should not be persuaded by the rhetoric. A jury, a judge or an arbitrator will probably not take such a one-sided view. Leaving one's fate to the proverbial "jury of one's peers" may prove painfully unpredictable.

Furthermore, Randy Lowry, Director of The Straus Institute for Dispute Resolution at Pepperdine School of Law, has written, "[T]he litigator who treats the less formal process of (mediation) like court and includes theatrics in opening and closing statements may find he or she has missed the more subtle dynamics of the mediation process."

Keenberg: The attorney should also explain to the client the many benefits of mediation, including that it is a less expensive process that provides a quicker resolution than either arbitration or court litigation. To quote again from Lincoln, "Point out to the client that the nominal winner [in litigation] is often the real loser, in fee expenses and waste of time." For example, in some court cases and in arbitration, the prevailing party may be entitled to be reimbursed for the attorney fees paid to his or her counsel. The other party may not recover any damages and thus may be out of pocket for the fees of the other attorney. This may be a very

large sum of money. The prevailing party's costs can even exceed its recovery.

Phillips: There are many additional benefits to mediation that should be brought to the attention of the client. Many times, business disputes can be resolved in ways that allow the parties to continue doing business. If a matter goes to trial or even to arbitration, the relationship may be destroyed, making it impossible for the parties to work together in the future. A court usually can give only a monetary judgment. In mediation, there may be various business avenues included in a settlement. The parties and their counsel should help the mediator to understand the range of such possibilities. In a recent controversy involving one party on the East Coast and one here in California, after mediating for a few days, I suggested that the parties divide the assets and cease doing business together. This had not previously been discussed. When the suggestion was made to each side separately in caucus, each counsel responded with exactly the same words, "Why didn't I think of that?"

The attorneys should think of all possibilities for settlement. If you do not want to mention an avenue for settlement to the other side, suggest it privately to the mediator, who can advance it as his/her own idea. Try to ascertain what the real needs of the other party are and from that, craft a settlement proposal.

The Importance of Bringing the True Decision Maker to the Mediation

Keenberg: Do you agree, Gerry, that some attorneys don't recognize the importance of having the person with true settlement authority physically present at the mediation?

Phillips: Yes. I agree. It is vital that the real decision-makers appear in person and counsel sometimes accede to their clients' wishes and allow a substitute to attend the mediation in the place of the real decision-maker. This can be a fatal flaw that will ruin the chance of a mediation ending successfully.

Court-Mandated Mediation

Keenberg: Gerry, we both serve on the Los Angeles Superior Court ADR Panel, where the court sends cases out to be mediated. Do you think that there is a difference in the advice we should offer attorneys when they represent clients in such court-mandated mediations and when they represent clients in private mediations?

Phillips: No, I do not. My advice would be the same. I conduct both types of mediations the same way. Some in ADR, however, have advanced the argument that the attorneys appearing in a court-mandated mediation must treat the mediator, who is acting as an arm of the court, with the deference they would if he/she was the judge, i.e., with greater candor and respect.

One piece of advice I'd give to attorneys who participate in court-mandated mediations is that to the extent they are allowed, they should exercise their right to select a mediator from the panel after checking the mediator's credentials and experience rather than allowing the ADR clerk to choose a mediator at random.

Keenberg: One piece of advice I'd give to attorneys who participate in court-mandated mediations is that to the extent they are allowed, they should exercise their right to select a mediator from the panel after checking the mediator's credentials and experience rather than allowing the ADR clerk to choose a mediator at random. On the Los Angeles County Superior Court Panel, this is an option open to the attorneys. On the Second District Appellate Court Panel, on which I also serve, however, the Clerk of the Court always selects the mediator.

The Mediation Brief

Keenberg: What do you like to see in a mediation brief?

Phillips: Whether it is for a court-mandated mediation or a private mediation, a good brief should not just recite the bare facts. The claimant's brief should set forth the damages claimed and how they were calculated. All too often, the calculation of the damages claimed is not set forth. The respondent should refute the claims in detail. The briefs should also include information about any underlying conflicts between the parties that may not seem relevant to litigators but may open avenues for settlement and motivate the parties to settle. I usually ask counsel to split their briefs in two, one to share with the other party and a separate, confidential letter "for the mediator's eyes only." In the latter, the parties should educate the mediator as to what the prior settlement discussions have been, how their client would like to settle the controversy and give suggestions for settlement.

Don't Leave Until There is A Signed Agreement

Keenberg: We have not mentioned something that can become very important at the end of the day: A good mediation always ends with the settlement reduced to writing. Arrive at the mediation ready to document the terms of the settlement in the expectation that the parties will achieve settlement at the mediation. While a handwritten document that merely summarizes the "bullet points" that have been agreed to will suffice, if you want to ensure that your

favorite terms and conditions are included in the agreement, bring them along on a laptop computer, floppy disks, or other electronic medium. You and the other counsel can then incorporate them into the settlement document when the time comes.

Phillips: Yes, and if the agreement includes a provision to draft more formal documents or to further implement the settlement agreement later, it is a good idea for the parties to consider including a provision in the agreement that any disputes that arise over an interpretation of the settlement agreement or the additional documentation should be submitted to the mediator for a binding decision.

Med-Arb, A Process If Mediation Fails

Keenberg: Gerry, if you believe an impasse has been reached and all methods to break the impasse have been tried and failed, what do you do next?

Phillips: At such times, I suggest that the matter be submitted to arbitration. At that point, Counsel frequently raise the objection that bringing in another neutral just adds additional costs and ask whether I would be willing to act as the arbitrator. When that happens, I carefully explain that during the mediation, I have heard confidential information that an arbitrator would never hear. Thus, there are dangers inherent in the mediator and the arbitrator being the same person. Nevertheless, in almost every instance, counsel have decided that they want me to go forward and have signed stipulations in which they ask that I continue to handle the case. They waive any objection to my serving in the new capacity and any conflict or impropriety in my continuing as the arbitrator. They agree not to challenge the final determination or decision. I have found this process, med-arb, to be an effective way to resolve particularly difficult disputes. It should be noted, however, that some attorneys, mediators and arbitrators do not approve of this procedure. Nevertheless, this process is growing in acceptance because it works well and saves time and money. Many parties and their counsel accept this procedure because they trust the neutral and have achieved excellent results after trying it.

Keenberg: We've covered quite a bit of ground today, Gerry, yet there are still many areas for us to discuss with attorneys when we do our presentation.

Phillips: Yes, and it will be quite interesting to hear what the participants at our roundtable contribute to this conversation. See you then! ■

Continued from page 14. . . Book Review

own allegedly ineffective collection methods is not one of them. Senator John Cornyn (R-Texas) recently proposed a bill, entitled the "Fairness in Bankruptcy Litigation Act of 2005," fashioned to limit forum shopping in Chapter 11 cases. Senator Cornyn did not propose the bill based upon a conclusion that the Delaware bankruptcy courts are ineffective. Instead, Senator Cornyn proposed the bill based upon his belief that 7,500 Houston-based employees deserved a meaningful ability to participate in the Enron bankruptcy case. Enron's New York filing effectively precluded that opportunity.

While Professor LoPucki and Senator Cornyn have come to the same conclusion (in favor of local bankruptcy filings), Senator Cornyn's rational is far more persuasive. Senator Cornyn identified a constituency harmed by forum shopping (*i.e.,* employees) and proposed a solution to that problem. In contrast, Professor LoPucki fails to identify a constituency harmed by forum shopping, but instead labels a collection of observations as evidence of "failure." As a result, *Courting Failure* is an interesting description of statistical observations, but does not make a good argument for any course of action. ■

Continued from page 2. . . Message from the Chair

and the "CFSC (Consumer Financial Services Committee) E-Bulletin" have joined the "Bankruptcy eBulletin" prepared by the Insolvency Committee as we e-mail more and more targeted, timely information to members that have signed up to receive updates from one or more of our 15 Standing Committees. Add to that the Section's monthly "E-News," and you can see how we're providing our members with electronic updates on matters of interest. If you would like to be added to the distribution list for any of these electronic publications, please contract Susan Orloff at susan.orloff@calbar.ca.gov.

As always, I welcome your comments or suggestions. ■

**Suzanne is a Partner in the Corporate Finance Group of the Morrison & Foerster LLP's Palo Alto office and Chair of the Firm's Emerging Company/Venture Capital Group.*

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